



EA Review Textbook

Part 1

Individuals

Surgent EA Review:

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This book is written to provide accurate and authoritative information concerning the covered topics. It is not meant to take the place of professional advice. **The content of this book has been updated to reflect relevant legislative and governing body modifications as of April 2020.**

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Good luck on the exam!

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Dr. Curatola has chaired and served on the Tax Policy Research Oversight Committee for the American Taxation Association and more recently as a Trustee. In the IMA, he has served in various offices at the local and national levels, including National Vice President of Area C. Currently he serves on the Foundation of Academic Research. Most recently, he was awarded the R. Lee Brummet Award in Academic Excellence from the IMA.

Ellen Rackas, MBA, CPA, has more than 25 years of accounting, auditing, and tax-related industry experience, including 10 years as an accounting professor at Delaware Valley University and currently at Muhlenberg College in Pennsylvania, where she teaches accounting and tax-related courses. Her career started in Washington, DC, as a staff accountant for Raffa & Associates, a public accounting firm. After progressing through roles as a senior accountant and audit supervisor, she joined Harman International Industries, Inc., a designer, manufacturer, and marketer of audio and infotainment products. Over the course of her career, she has held roles as a finance manager, audit manager, controller, and CFO. Ellen has 14 years' independent consulting experience and has assisted more than 40 corporate clients and 100 individual clients with financial statement preparation, tax return preparation, and other accounting functions. Ellen received her Bachelor of Science degree in accounting from American University in Washington, DC, and her MBA from the University of Maryland. She holds CPA designations in both Maryland and Pennsylvania.

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1000 Individuals

1100 Preliminary Work and Taxpayer Data

1110 Preliminary Work to Prepare Tax Returns

1110.01 Use of Prior-Year's Return for Comparison

The preparation of a client's tax return for the current year normally begins with a review of the client's prior-year's income tax return. Familiarizing oneself with issues on the prior-year's tax return allows the tax return preparer to note the issues that may re-occur on the current year's return and to have a basis to compare the current year's transactions with the prior years. In many cases, a tax client's financial transactions and personal data, such as marital status, number of dependent children, etc., are consistent from year-to-year. Sources of income and types of deduction often vary little from one year to the next. Wide divergences in income, expenses, credits, and deductions from one year to the next are unusual and call for investigation on the preparer's part as to the source of such divergence.

1110.02 In the event that a taxpayer does not have a copy of a prior-year's income tax return, he or she can obtain one from the Internal Revenue Service (IRS) by completing Form 4506, *Request for Copy or Transcript of Tax Form*, and mailing it, along with the required fee, to the IRS center where the return was filed. As an alternative, a **transcript**, which is a computer printout of a prior-year's return, may be obtained from the IRS, also using Form 4506. Transcripts may be requested online, by phone or by mail. There is no charge for the transcript, which shows most line items from the original return, including accompanying forms and schedules.

1110.03 A tax return transcript shows most line items from an income tax return (Form 1040, 1040A, or 1040EZ prior to 2018 and Form 1040 and 1040-SR for 2018 and later) as it was originally filed, including any accompanying forms and schedules. In most cases, a transcript includes all the information a lender or government agency needs, but it does not show any changes the taxpayer, his or her representative, or the IRS made after it was filed. The tax return transcript is generally available for the current and past three years.

1110.04 The IRS can also provide a tax account transcript, which is also free, and shows basic data from the taxpayer's income tax return, including marital status, type of return filed, adjusted gross income, and taxable income. A transcript also includes any adjustments the taxpayer or the IRS made after the taxpayer filed his or her income tax return. Like the tax return transcript, the tax account transcript is generally available for the current and past three years.

1110.05 **Accuracy of Prior Year's Return**

A review of a client's prior-year's tax return could reveal errors or mistakes such as an intentional or accidental omission of income or overstated deductions. The discovery of these mistakes could benefit the client or result in additional tax to the taxpayer because the mistake or omission could result in reporting additional income or reducing a deduction on an amended tax return. In the case of a taxpayer who in a prior year has omitted income or overstated a deduction or credit, the tax return preparer should recommend to the client that he or she should amend his or her return so as to correct mistakes occurring on a prior-year's tax return. Circular 230, the guide for tax practitioner ethical conduct, recommends that if the client refuses to file an amended return in such circumstances, the EA (or other tax practitioner) should consider whether he or she should continue to work with and represent this client. Circular 230 does not require the EA to sever professional relations with the client in such circumstances; but he or she could determine that that is the step he or she should take.

- 1110.06** A review of a prior-year's income tax return could reveal beneficial carryovers from a prior year that had not yet been utilized, such as capital loss carryovers, charitable contribution carryovers, alternative minimum tax credit carryforwards, net operating loss carryforwards, and other tax benefits. In some cases, such as with certain energy credits, a tax benefit taken once in a prior year precludes its being taken again, either wholly or partially, in a subsequent year.
- 1110.07** Many EAs and other professional tax return preparers provide their clients with data organizers in preparation for the upcoming tax filing season. Data organizers are useful for gathering information from clients; though most of the time, the EA or other tax return preparer will find it necessary to follow-up with additional questions and requests for clarification as few clients complete 100 percent of the organizer; some make no attempt to complete it, others partially complete it or provide incorrect information.
- 1110.08** Once a taxpayer's income tax return is complete, a proper review of the completed tax return includes a comparison with the prior-year's tax return. At times, an EA may note discrepancies between the transactions reported in the two years. Since in most cases peoples' financial lives are consistent from year-to-year, major changes in a tax return from one year to the next should prompt the EA to find out why these major differences exist.
- 1110.09** Just as certain transactions in prior years impact the current-year's income tax return, the current-year's income tax return may have an impact on future tax returns. Certain transactions reported in the current year could generate losses that could be carried back to a prior year or forward to later years. In addition, certain decisions relating to expensing and depreciation made in the current year will impact future tax years also.
- 1110.10** **Taxpayer's Biographical Information**
- The taxpayer must provide the EA with his or her date of birth, age, marital status, and Social Security Number in order for the EA to accurately and fully complete the client's income tax return. Relevant biographical information must also be provided for the taxpayer's spouse and dependents. If the taxpayer wants his or her refund deposited directly into a bank account, the taxpayer

should provide the tax return preparer with his or her bank account number and routing number so the IRS will be able to make a direct deposit of the taxpayer's refund into the taxpayer's bank account. The tax preparer must verify and confirm the client's bank account each year to ensure there were no changes to the banking information. The EA must insert the taxpayer's Social Security Number as well as the Social Security Numbers for any dependents on the tax return. If the taxpayer does not have a Social Security Number, he or she may have an Individual Taxpayer Identification Number (ITIN), a number which the IRS issues to individuals requiring a United States taxpayer identification number but who are not eligible for a Social Security Number. A taxpayer that fails to include his or her Social Security number (SSN) or that of another person where required on a return, statement, or other document is subject to a \$50 penalty for each failure. The penalty can be waived if the taxpayer can show that the failure was due to reasonable cause and not willful neglect.

1110.11 Typically, a client data organizer that the EA sends to a client will ask for the taxpayer's biographical information that will be needed to prepare the individual's income tax return, e.g., date of birth, age, marital status, citizenship, dependents, etc. This information is required for purposes of preparing an individual's tax return and should be retained in the client's permanent file that a tax return preparer should keep for each client. Since tax return preparers generally use software programs to prepare tax returns, this biographical information can be retained and used to "proforma" the client's tax return for each year. This means that client information will be automatically inserted onto the succeeding year's tax forms, and the EA can change it on an exception only basis in subsequent years as the taxpayer's circumstances change and life events such as births, marriages, deaths, and divorces that impact tax return filing occur.

1110.12 Immigration Status and Citizenship

An individual's status as an alien – resident, nonresident, or dual-status - determines whether and how he or she must file a United States federal income tax return. If an individual is a resident alien for the entire year, he or she must file a tax return following the same tax rules that apply to U.S. citizens. If the individual is a nonresident alien, the tax rules and tax forms that apply are different from those that apply to U.S. citizens and resident aliens.

If an individual is a resident alien for part of the tax year and a nonresident alien for the rest of the year, he or she is a dual-status taxpayer and different tax rules will apply for each part of the year.

1110.13

An alien, a person who is not a U.S. citizen, is considered a nonresident alien unless he or she meets either the green card test or the substantial presence test for the calendar year. Even if the individual does not meet either of these tests, he or she may elect to be treated as a U.S. resident for tax reporting purposes. This sometimes occurs when aliens who are married to United States citizens choose to file a United States tax return with their United States citizen spouse. The effect of such an election would be that all of the alien's income, wherever in the world it is earned or generated, is taxed by the United States. A resident of the United States or citizen of the United States is taxed on all of his or her world-wide income, regardless of where such income is earned.

- a.** Green card test - Under the green card test, an individual is a resident of the United States for tax purposes if he or she is a lawful permanent resident of the United States at any time during calendar year. An individual is a lawful permanent resident of the United States at any time if he or she has been given permission, under U.S. immigration laws, to reside permanently in the United States. An individual has this status if the U.S. Citizenship and Immigration Services (U.S.CIS) issues the individual an alien registration card, also known as a "green card." The individual continues to have resident status under this test unless the green card status is taken away or it is administratively or judicially determined that the individual abandoned his or her green card status.
- b.** Substantial presence test - An individual will be considered a United States resident for tax purposes if he or she meets the substantial presence test for the year. To meet this test, the individual must be physically present in the United States on at least 31 days during the calendar year, and 183 days during the current year and the two preceding years, counting:

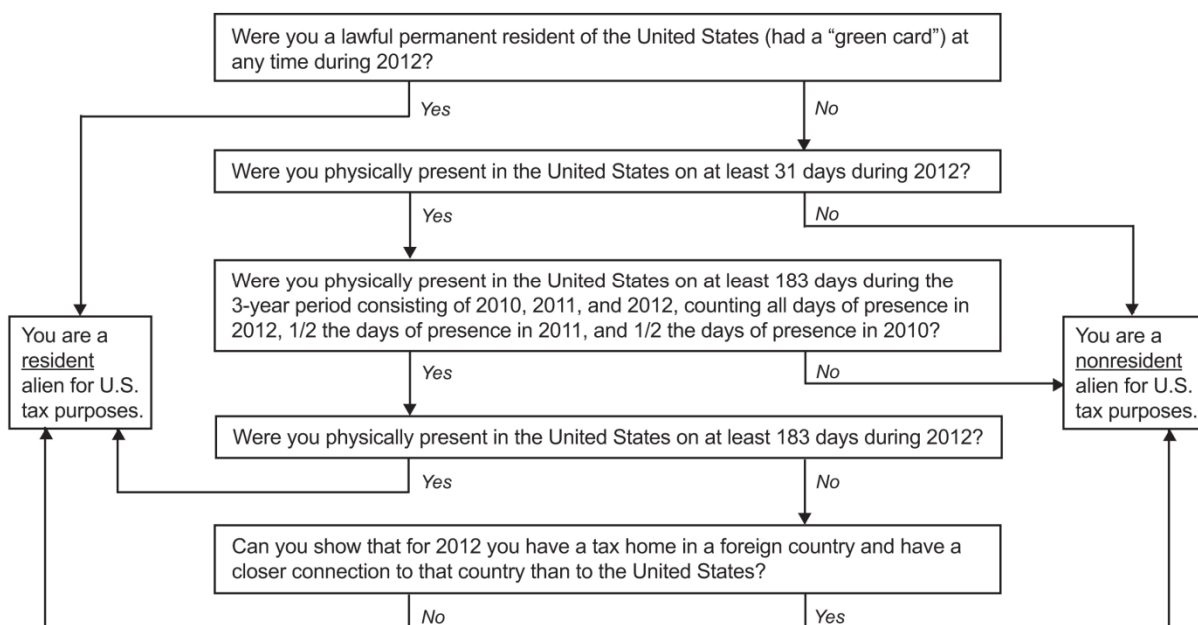
1. All the days the individual was present in the current year, and
2. One-third of the days the individual was present in the year preceding the current year, and
3. One-sixth of the days the individual was present in the second year preceding the current year.

Example: Sam was physically present in the United States on 120 days in each of the years 2018, 2020, and 2020. To determine if Sam meets the substantial presence test for 2020, count the full 120 days of presence in 2020, 40 days in 2020 ($1/3$ of 120), and 20 days in 2018 ($1/6$ of 120). Because the total for the three-year period is 180 days, Sam is not considered a resident of the United States under the substantial presence test for 2020.

See the flowchart below taken from IRS Publication 519. The flowchart uses the year 2012, but the flowchart can be used to determine residency for any year.

Nonresident Alien or Resident Alien?

Start here to determine your status for 2012



c. Closer connection to a foreign country - Even if an individual meets the substantial presence test, he or she can be treated as a nonresident alien if he or she:

1. Is present in the United States for less than 183 days during the year,
2. Maintains a tax home in a foreign country during the year, and
3. Has a closer connection during the year to a foreign country in which he or she has a tax home than to the United States.

d. Establishing a closer connection

A taxpayer will be considered to have a closer connection to a foreign country than the United States if the taxpayer or the IRS establishes that the taxpayer has maintained more significant contacts with the foreign country than with the United States. In making this determination, the following nonexclusive facts and circumstances should be considered taken into account:

1. The country of residence the taxpayer designates on forms and documents.
2. The types of official forms and documents he or she files.
3. The location of:
 - (i) Taxpayer's permanent home;
 - (ii) His or her family;
 - (iii) His or her personal belongings, such as cars, furniture, clothing, and jewelry;
 - (iv) His or her current social, political, cultural, or religious affiliations;
 - (v) His or her business activities (other than those that constitute the taxpayer's tax home);
 - (vi) The jurisdiction in which the taxpayer holds a driver's license;

- (vii) The jurisdiction in which the taxpayer votes; and
- (viii) Charitable organizations to which the taxpayer contributes.

1110.14 Filing Deadlines

Taxpayers on the calendar year generally have until April 15 of the succeeding tax year to file their income tax returns and pay any taxes due. Taxpayers have extra time when April 15 falls on a weekend or a holiday in the District of Columbia. Filing deadlines that fall on District of Columbia holidays are extended to the next day that is not a Saturday, Sunday, or holiday. Under the so called "mailbox rule," a tax return is considered filed timely if it arrives at the IRS with a proper address and sufficient postage and is postmarked on or before the due date. Thus, a 2020 income return, unless extended, may be mailed on April 15, 2021 (a Wednesday), and is considered timely filed even if it arrives at the IRS after April 15, 2021. On April 9, 2020, the IRS released Notice 2020-23 to expand the filing and payment extensions for all types of entities and individuals with the returns/payments that would have been due between April 1 and April 15 to July 15. The extension was automatic. Many individual tax returns are electronically filed. The second quarter estimate for 2021 due June 15 was also extended to July 15. No interest or late filing penalties would be assessed for the payment deferring. Although many states adopted the Federal position, there were a number of states and localities that passed different versions of this extension.

A tax return which is electronically filed is considered timely filed if the authorized electronic return transmitter postmarks the electronic transmission of the income tax return by the due date of the tax return. In many cases, the authorized electronic return transmitter is the tax preparation firm that prepared the return.

1111 Taxpayer Filing Status

1111.01 For income tax filing purposes, there are five tax filing statuses:

- a. Single;
- b. Married Filing Jointly (MFJ);
- c. Married Filing Separately (MFS);
- d. Head of Household (H of H); and
- e. Qualifying Widow(er) with Dependent Child.

1111.02 A taxpayer's filing status depends on whether he or she is considered unmarried or married at the end of the tax year. For federal tax purposes for the tax year 2020, a person is considered married if he or she is legally married to a person of the same sex or the opposite sex, as long as the marriage in question was legal in the state in which it was performed.

1111.03 A person is considered unmarried for the whole year if, on the last day of the tax year, the individual is unmarried or legally separated from his or her spouse under a divorce or separate maintenance decree. State law governs whether an individual is married or legally separated under a divorce or separate maintenance decree. If a person is divorced under a final decree by the last day of the year, for tax purposes he or she is considered unmarried for the whole year.

1111.04 If individuals obtain a divorce in one year for the sole purpose of filing tax returns as unmarried individuals, and at the time of divorce the individuals intended to, and did, remarry each other in the next tax year, the individuals must file tax returns as married individuals.

Married Persons

1111.05 If a taxpayer is considered married for the whole year, he or she and his or her spouse can file a joint return, or each spouse can file his or her own separate income tax return. The choice of whether to file as married filing jointly or married filing separately is entirely up to the taxpayers themselves. A taxpayer is considered married for the whole year if on the last day of the tax year the taxpayer and his or her spouse meet any one of the following tests:

- a. They are married and living together as husband and wife.
- b. They are living together in a common law marriage that is recognized in the state where they now live or in the state where the common law marriage began.
- c. They are married and living apart, but not legally separated under a decree of divorce or separate maintenance.
- d. They are separated under a temporary decree of divorce. For purposes of filing a joint return, they are not considered divorced.

1111.06 If a taxpayer's spouse died during the year, the surviving spouse is considered married for the whole year for filing-status purposes. If the surviving spouse did not remarry before the end of the tax year in which his or her spouse died, he or she can file a joint income tax return for himself or herself and his or her deceased spouse. For the next two years, the taxpayer may be entitled to file as a Qualifying Widow(er) with Dependent Child. If the surviving spouse remarried before the end of the tax year, he or she can file a joint return with his or her new spouse. The deceased spouse's filing status for the year of his or her death will be married filing separately for that same year.

Taxpayers "Considered Unmarried"

1111.07 If a taxpayer lives apart from his or her spouse and meets certain tests, he or she may be considered unmarried. If the taxpayer is considered unmarried, he or she can file as head of household even though he or she is not divorced or legally separated. If the taxpayer qualifies to file as head of household instead of as married filing separately, the taxpayer's standard deduction will be higher, his or her tax liability may be lower, and he or she may be able to claim the earned income credit.

1111.08 To qualify for head of household status, a taxpayer must be either unmarried or considered unmarried on the last day of the year. A taxpayer is considered unmarried on the last day of the tax year if he or she meets all the following tests:

1. The taxpayer files a separate return.
2. The taxpayer pays more than half the cost of keeping up his or her home for the tax year.
3. The taxpayer's spouse did not live in the taxpayer's home during the last six months of the tax year. A taxpayer's spouse is considered to live in the taxpayer's home even if he or she is temporarily absent due to special circumstances.
4. The taxpayer's home was the main home of his or her child, stepchild, or foster child for more than half the year.
5. The taxpayer must be able to claim an exemption for the child. However, the taxpayer meets this test if he or she cannot claim the exemption only because the noncustodial parent can claim the child.

Single

1111.09 A taxpayer's filing status is single if, on the last day of the year, he or she is unmarried or legally separated from his or her spouse under a divorce or separate maintenance decree, and he or she does not qualify for another filing status. For example, a taxpayer's filing status may be single for the year 2020 if he or she was widowed before January 1, 2020 and did not remarry before the end of 2020.

Married Filing Jointly

1111.10 A taxpayer can file as married filing jointly as his or her filing status if he or she is married and both the taxpayer and his or her spouse agree to file a joint return. On a joint return, the taxpayers report their combined income and deduct their combined allowable expenses. Both parties can file a joint income tax return even if one of them has no income or deductions. If both spouses file a joint income tax return, their tax liability may be lower than their combined tax for the other filing statuses. Also, their standard deduction (if they do not itemize deductions) may be

higher, and they may qualify for tax benefits that do not apply to other filing statuses. On the downside, each party is jointly and severally liable for the entire tax liability, regardless of how much income a party generated.

- 1111.11** If both spouses have income, they may want to figure their tax both on a joint return and on separate returns using the filing status of married filing separately since they can choose the method that gives them the lower combined tax. Most tax preparation software programs do this comparison automatically.
- a. Divorced persons** – If a taxpayer is divorced under a final decree by the last day of the year, he or she is considered unmarried for the whole year and the taxpayer cannot choose married filing jointly as his or her filing status.
 - b. Spouse died during the year** – If a taxpayer's spouse died during the year, the taxpayer is considered married for the whole year and the surviving spouse can choose to file as married filing jointly as his or her tax filing status.

Filing a joint return

- 1111.12** When married taxpayers file a joint return, both the taxpayer and his or her spouse must include all of their income, exemptions, and deductions on their joint return. Both taxpayers must use the same accounting period, but they may use different accounting methods. Both taxpayers may be held responsible, jointly and individually, for the tax and any interest or penalty due on their joint return. Because both spouses are jointly and severally liable for the tax liability, one spouse may be held liable for all the tax due on a joint return even if all the income was earned by the other spouse. A divorced taxpayer may be held jointly and individually responsible for any tax, interest, and penalties due on a joint return filed before his or her divorce even if the divorce decree states that a taxpayer's former spouse will be responsible for any amounts due on previously-filed joint returns.

Relief from Joint and Several Liabilities

1111.13 In some cases, one spouse may be relieved of joint liability for tax, interest, and penalties on a joint return for items of the other spouse that were incorrectly reported on the joint return. There are three types of relief available from joint and several liability: (i) innocent spouse relief; (ii) separation of liability; and (iii) equitable relief.

- (i) **Innocent spouse relief** -- To receive "innocent spouse relief" the taxpayer must:
- File a joint return that had an "understatement" (not merely an underpayment) of tax due to "erroneous items" of one of the spouses.
 - Establish that at the time he or she signed the joint return he or she did not know, and had no reason to know, that there was an understatement of tax.
 - Prove that, considering the facts and circumstances, it would be unfair to hold the taxpayer liable for the understatement of tax.
 - Previously it was required that a taxpayer must request relief no later than two years after IRS collection activity began. The two-year time limit no longer applies for innocent spouse requests for equitable relief. Rather, the IRS will consider a request for equitable relief if the collection statute of limitations for the tax years involved has not expired, or if the taxpayer is seeking a refund, if the refund statute of limitations has not expired. Many taxpayers that were previously denied equitable relief because of the two-year limit may now qualify for relief.

If it is established that the taxpayer signed a joint return under duress, then a joint return has not been filed.

An understatement of tax is generally the difference between the total tax liability that should have been shown on the return and the amount that was actually shown on the return. An underpayment of tax is an amount of tax the taxpayer properly reported on the return but has not paid. For example, a joint 2020

tax return shows that the taxpayer and his spouse owe \$5,000. They paid \$2,000 with the return. They have an underpayment of \$3,000.

A taxpayer may qualify for partial relief if, at the time he or she filed her return, he or she knew or had reason to know, that there was an understatement of tax due to his or her spouse's erroneous items, but he or she did not know how large the understatement was. He or she will be relieved of the understatement to the extent he or she did not know about it and had no reason to know about it.

Erroneous items are either of the following:

- Any gross income item received by the spouse that was not reported as income; or
- Any improper deduction, credit, or property basis claimed on the return.

The following are examples of erroneous items:

- The expense for which the deduction is taken was never paid or incurred. For example, the non-requesting spouse, a cash-basis taxpayer, deducted \$10,000 of advertising expenses on Schedule C (Form 1040), but never paid for any advertising.
- The expense does not qualify as a deductible expense. For example, the spouse claimed a business fee deduction of \$10,000 that was for the payment of state fines. Fines are not deductible.
- No factual argument can be made to support the deductibility of the expense. For example, the non-requesting spouse claimed \$4,000 for security costs related to a home office, which were actually veterinary and food costs for the family's two dogs.

A spouse has knowledge or reason to know of an understatement if he or she actually knew of the understatement, or if a reasonable person in similar circumstances would have known of the understatement. Facts and circumstances considered in determining whether a requesting spouse had reason to know of an understatement include, but are not limited to:

- The nature of the erroneous item and the amount of the erroneous item relative to other items;
- The couple's financial situation;
- The requesting spouse's educational background and business experience;
- The extent of the requesting spouse's participation in the activity that resulted in the erroneous item;
- Whether the requesting spouse failed to inquire, at or before the time the return was signed, about items on the return or omitted from the return that a reasonable person would question; and
- Whether the erroneous item represented a departure from a recurring pattern reflected in prior year's returns.

- (ii) **Separation of liability** – Under this type of relief, there is an allocation of the understatement of tax (plus interest and penalties) on the joint return between the taxpayer and the spouse (or former spouse). The understatement of tax allocated to the taxpayer is generally the amount he or she is responsible for. Taxpayers may request this type of relief on Form 8857 in addition to innocent spouse relief.

To request relief by separation of liability, a taxpayer must have filed a joint return and must meet one of the following requirements at the time he or she files Form 8857:

- The taxpayer must no longer be married to, or be legally separated from, the spouse with whom the joint return was filed for which relief is requested (Under this rule, the taxpayer is no longer married if he or she is widowed); or
- Taxpayer must not be a member of the same household as the spouse with whom the joint return was filed at any time during the 12-month period ending on the date he or she files Form 8857 to request separation of liability.

Even if the taxpayer meets the requirements above, a request for separation of liability will not be granted in the following situations:

- The IRS proves that the taxpayer and spouse transferred assets to third parties as part of a fraudulent scheme;
- The IRS proves that at the time the taxpayer signed the joint return, he or she had actual knowledge of any items giving rise to the deficiency that were allocable to the spouse; or
- The spouse (or former spouse) transferred property to the taxpayer to avoid tax or the payment of tax.

If it is established that the taxpayer signed the joint return under duress, then it is not a joint return, and the taxpayer is not liable for amounts from that return. However, the taxpayer may be required to file a separate return for that tax year.

If the spouse transfers property to the taxpayer for the purpose of avoiding tax or payment of tax, the tax liability allocated to the taxpayer will be increased by the value of the property transferred. A transfer will be presumed to have as its main purpose the avoidance of tax or payment of tax if the transfer is made after the date that is one year before the date on which the IRS sent its first letter of proposed deficiency allowing the taxpayer an opportunity for a meeting in the IRS Appeals Office. This presumption will not apply if the transfer was made under a divorce decree, separate maintenance agreement, or a written instrument incident to such an agreement. The presumption will also not apply if the taxpayer establishes that the transfer did not have as its main purpose the avoidance of tax or payment of tax.

- (iii) **Equitable relief** -- If the taxpayer does not qualify for innocent spouse relief or relief by separation of liability, the taxpayer may still be relieved of responsibility for tax, interest, and penalties through the IRS provisions for equitable relief.

The taxpayer may qualify for equitable relief if all of the following conditions are met:

- The taxpayer is not eligible for innocent spouse relief or relief by separation of liability;
- The taxpayer and the spouse did not transfer assets to one another as a part of a fraudulent scheme;
- The spouse did not transfer assets to the taxpayer for the main purpose of avoiding tax or the payment of tax;
- The taxpayer did not file the return with the intent to commit fraud; and
- The taxpayer establishes that, considering all the facts and circumstances, it would be unfair to hold the taxpayer liable for the understatement or underpayment of tax.

Unlike innocent spouse relief or separation of liability, the taxpayer can get equitable relief from both an understatement of tax or an underpayment of tax.

As noted, the two-year time limit no longer applies for innocent spouse requests for equitable relief. Rather, the IRS will consider a request for equitable relief if the collection statute of limitations for the tax years involved has not expired, or if the taxpayer is seeking a refund, if the refund statute of limitations has not expired. Many taxpayers that were previously denied because of the two-year limit may now qualify for relief.

1111.14 Injured Spouse

An “injured spouse” is a taxpayer who has filed a joint return with his or her spouse and all or part of his or her share of an overpayment was applied against his or her spouse’s past-due federal tax liability, child or spousal support, federal nontax debt,

or state income tax. A taxpayer may file a claim as an injured spouse to request a refund of the amount of offset. For example, if a spouse is in arrears on his or her child support, it is possible that any refund generated by the filing of a joint tax return may be withheld by the IRS and applied toward the arrearage.

A spouse who has income and withholdings or estimated tax payments and who files a joint return with an individual who owes past-due child support must file a request for a refund of his or her allocation of the joint return refund (Form 8379, *Injured Spouse Claim and Allocation*).

The requirements in order to do this include:

- (i) The taxpayer seeking relief is not required to pay the past due amounts; rather, the spouse in default is responsible for the debt;
- (ii) The taxpayer reported income such as wages, taxable interest, etc., on the joint return;
- (iii) The taxpayer made and reported payments such as federal income tax withheld from taxpayer's wages or estimated tax payments or the taxpayer claimed the Earned Income Tax Credit or other refundable credit; and
- (iv) Form 8379 is filed.

Signing a Joint Return

1111.15 For a tax return to be considered a joint tax return, both husband and wife generally must sign the return. If a spouse died before signing the return, the executor or administrator of the deceased spouse's estate must sign the return for the spouse. If neither the survivor nor anyone else has yet been appointed as executor or administrator, the surviving spouse can sign the return for his or her deceased spouse and should enter "filing as surviving spouse" in the area where the surviving spouse signs the return. If one spouse is away from home, the other spouse should prepare the return, sign it, and send it to the other spouse to sign so that it can be filed on time.

- 1111.16** If a spouse cannot sign the tax return because of injury or disease and tells the other spouse to sign the tax return on his or her behalf, the other spouse can sign the disabled spouse's name in the proper space on the return followed by the words "by (taxpayer's name), husband (or wife)." The signing individual should also sign in the space provided for his or her own signature. The signing spouse should attach a signed, dated statement that should include the form number of the return that he or she is filing, the tax year, the reason the disabled spouse cannot sign, and a statement that the disabled spouse has agreed that the other spouse should sign for him or her. If one spouse is the guardian of his or her spouse who is mentally incompetent, the one spouse can sign the return for his or her spouse as guardian. If a spouse cannot sign the joint return for any other reason other than those just discussed, the other spouse can sign for him or her only if he or she is given a valid power of attorney.

Signing Electronic Tax Returns

- 1111.17** As with an income tax return submitted to the IRS on paper, the taxpayer and paid preparer (if applicable) must sign an electronic income tax return. Taxpayers must sign individual income tax returns electronically. There are currently two methods for signing individual income tax returns electronically.
- 1111.18** Taxpayers must sign and date the Declaration of Taxpayer to authorize the origination of the electronic submission of the return to the IRS prior to the transmission of the return to IRS. The Declaration of Taxpayer includes the taxpayer's declaration under penalties of perjury that the return is true, correct, and complete, as well as the taxpayers' Consent to Disclosure. The Consent to Disclosure authorizes the IRS to disclose information to the taxpayers' Providers. Taxpayers authorize Intermediate Service Providers, Transmitters, and Electronic Return Originators (EROs) to receive from the IRS an acknowledgement of receipt or reason for rejection of the electronic return, an indication of any refund offset, the reason for any delay in processing the return, or refund and the date of the refund.

- 1111.19** Taxpayers must sign a new declaration if the electronic return data on individual income tax returns is changed after taxpayers signed the Declaration of Taxpayer and the amounts differ by more than either \$50 to "Total income" or "AGI," or \$14 to "Total tax," "Federal income tax withheld," "Refund," or "Amount you owe."
- 1111.20** As noted above, there are two methods of signing individual income tax returns with an electronic signature available for use by taxpayers. Both methods allow taxpayers to use a Personal Identification Number (PIN) to sign the return and the Declaration of Taxpayer.
- 1111.21** One of these methods is Self-Select PIN. The 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 taxpayers. EROs should encourage taxpayers who do not have their original prior AGI or PIN to call IRS Tax Help at (800) 829-1040.
- 1111.22** This method may be completely paperless if the taxpayers enter their own PINs directly into the electronic return record using keystrokes after reviewing the completed return. Taxpayers may also authorize EROs to enter PINs on their behalf, in which case the taxpayers must review and sign a completed signature authorization form after reviewing the return.
- 1111.23** The other method is Practitioner PIN. The Practitioner PIN method does not require the taxpayer to provide their prior year AGI amount or prior year PIN. When using the Practitioner PIN method, taxpayers must always appropriately sign a completed signature authorization form. Taxpayers, who use the Practitioner PIN method and enter their own PINs in the electronic return record using keystrokes after reviewing the completed return, must still appropriately sign the signature authorization form.
- 1111.24** Regardless of the method of electronic signature used, taxpayers may enter their own PINs; EROs may select and enter the taxpayers' PINs; or the software may generate the taxpayers' PINs in the electronic return. After reviewing the return, the taxpayers must agree by signing an IRS e-file signature authorization containing the PIN.

The following taxpayers are ineligible to sign individual income tax returns with an electronic signature using the Self-Select PIN:

- Primary taxpayers under age sixteen who have never filed; and
- Secondary taxpayers under the age sixteen who did not file the prior tax year.

EROs should advise taxpayers to keep a copy of their completed tax return to assist with authentication in the subsequent year.

1111.25 When taxpayers are unable to enter their PIN directly in the electronic return, taxpayers authorize the ERO to enter their PINs in the electronic return record by signing the appropriate completed IRS e-file signature authorization form. IRS e-file Signature Authorization Form 8879, *IRS e-file Signature Authorization*, authorizes an ERO to enter the taxpayers' PINs on Individual Income Tax Returns and IRS e-file Authorization for Application of Extension of Time to File. Form 8878, *IRS e-file Authorization for Form 4868 and Form 2350*, authorizes an ERO to enter the taxpayers' PINs on Forms 4868 and 2350.

1111.26 The ERO may enter the taxpayers' PINs in the electronic return record before the taxpayers sign Form 8879 or 8878, but the taxpayers must sign and date the appropriate form before the ERO originates the electronic submission of the return. After completing either Form 8879 or Form 8878, the ERO must give it to the taxpayer for review. This can be done in person or by using the U.S. mail, a private delivery service, fax, e-mail, or an Internet website. The taxpayer must sign and date the Form 8879 or Form 8878 after reviewing the return and ensuring the tax return information on the form matches the information on the return. The taxpayer may return the completed Form 8879 or Form 8878 to the ERO by hand delivery, U.S. mail, private delivery service, fax, e-mail, or an Internet website.

1111.27 EROs may use an electronic signature pad to have taxpayers sign Forms 8879 and 8878. Taxpayers must be present in the ERO's office where the electronic signature pad is located to sign using the signature pad. The ERO must retain the forms with the taxpayers' signatures and provide a copy to the taxpayer upon request.

- 1111.28** Only taxpayers who provide a completed tax return to an ERO for electronic filing may complete the IRS e-file Signature Authorization without reviewing the return originated by the ERO. The ERO must enter the line items from the paper return on the applicable Form 8879 or Form 8878 prior to the taxpayers signing and dating the form. The ERO may use these pre-signed authorizations as authority to input the taxpayer's PIN only if the information on the electronic version of the tax return agrees with the entries from the paper return.

Married Filing Separately

- 1111.29** Married individuals can choose married filing separately as their filing status. This filing status may benefit a spouse if he or she wants to be legally responsible only for his or her own tax or if it results in less tax than filing a joint return. If the spouses do not agree to file a joint return, they must file married filing separately unless one or both of the spouses qualifies for head of household status.
- 1111.30** A taxpayer may be able to choose head of household filing status if he or she lives apart from his or her spouse, meets certain tests, and is considered unmarried. This can apply to a spouse who is not divorced or legally separated. If a taxpayer qualifies to file as head of household, instead of as married filing separately, his or her tax may be lower, the individual may be able to claim the earned income credit and certain other credits, and his or her standard deduction will be higher. The head of household filing status allows a taxpayer to choose the standard deduction even if his or her spouse chooses to itemize deductions.
- 1111.31** Generally, married taxpayers will pay more combined tax on separate returns than they would on a joint return, but there are certainly exceptions to this generalization. However, unless a taxpayer is required to file separately, he or she should figure his or her tax both ways (on a joint return and on separate returns). This way the taxpayer can make sure he or she is using the filing status that results in the lower combined tax. When figuring the combined tax of husband and wife, it is important to consider state taxes as well as federal taxes.

- 1111.32** If a married individual files a separate return, he or she generally reports only his or her own income, exemptions, credits, and deductions on his or her own individual return. A taxpayer can claim an exemption for his or her spouse if the spouse had no gross income and was not the dependent of another person. However, if a taxpayer's spouse had any gross income or was the dependent of someone else, the spouse cannot claim an exemption for him or her on his or her separate income tax return.
- a.** A taxpayer can change his or her filing status by filing an amended return using Form 1040X. If a taxpayer and/or his or her spouse file separate returns, they can change to filing a joint return any time within three years from the due date of the separate return or returns. This does not include any extensions. A separate return includes a return filed by the taxpayer or his or her spouse claiming married filing separately, single, or head of household filing status.
 - b.** Once a married couple files a joint return, they cannot choose to file separate returns for that year after the due date of the return. However, a personal representative for a decedent can change from a joint return elected by the surviving spouse to a separate return for the decedent. The personal representative has one year from the due date (including extensions) of the return to make the change.

Head of Household

- 1111.33** A taxpayer may file as head of household if he or she meets all the following requirements:
- a.** He or she is unmarried or "considered unmarried" on the last day of the year;
 - b.** He or she paid more than half the cost of keeping up a home for the year; and
 - c.** A "qualifying person" lived with the taxpayer in the home for more than half the year (except for temporary absences, such as school). However, if the "qualifying person" is the taxpayer's dependent parent, the parent does not have to live with the taxpayer.

1111.34

If a taxpayer qualifies to file as head of household, his or her tax usually will be lower than if he or she had filed as single or married filing separately. The taxpayer will also receive a higher standard deduction than if he or she filed as single or married filing separately.

a. Considered unmarried – To qualify for head of household status, the taxpayer must be either unmarried or considered unmarried on the last day of the year. An individual is considered unmarried on the last day of the tax year if he or she meets all the following tests:

- (i) He or she files a separate return;
- (ii) He or she paid more than half the cost of keeping up his or her home for the tax year;
- (iii) The taxpayer's spouse did not live in his or her home during the last six months of the tax year;
- (iv) The taxpayer's home was the main home of his or her child, stepchild, or foster child for more than half the year; and
- (v) The taxpayer must be able to claim an exemption for the child.

To qualify for head of household status, the taxpayer must pay more than half of the cost of keeping up a home for the year. A taxpayer can determine whether he or she paid more than half of the cost of keeping up a home by using the following worksheet.

	Amount Taxpayer Paid	Total Cost
Property taxes	\$	\$
Mortgage interest expense		
Rent		
Utility charges		
Repairs/maintenance		
Property insurance		
Food consumed on the premises		
Other household expenses		
Total	\$	\$
Minus total amount taxpayer paid		()
Amount others paid	\$	\$
If the total amount the taxpayer paid is more than the amount others paid, he or she meets the requirement of paying more than half the cost of keeping up the home.		

Included in the cost of upkeep expenses are such expenditures as rent, mortgage interest, real estate taxes, insurance on the home, repairs, utilities, and food eaten in the home. The cost of upkeep expenses such as clothing, education, medical treatment, vacations, life insurance, or transportation are not included nor is the rental value of a home or the value of the taxpayer's services or those of a member of his or her household.

- b. Qualifying person for head of household purposes** – The following table can be used to determine whether a person is a qualifying person allowing the taxpayer to file as head of household.

IF the Person Is The Taxpayer's:	AND:	THEN That Person Is:
Qualifying child (such as a son, daughter, or grandchild who lived with taxpayer more than half the year and meets certain other tests) ²	He or she is single	A qualifying person, whether or not taxpayer can claim an exemption for the person.
	He or she is married, and taxpayer can claim an exemption for him or her	A qualifying person.
	He or she is married, and taxpayer cannot claim an exemption for him or her	Not a qualifying person. ³
Qualifying relative who is your father or mother	Taxpayer can claim an exemption for him or her ⁵	A qualifying person.
	Taxpayer cannot claim an exemption for him or her	Not a qualifying person.
Qualifying relative other than taxpayer's father or mother (such as a grandparent, brother, or sister who meets certain tests)	He or she lived with taxpayer more than half the year, and he or she is related to taxpayer in one of the ways listed under <i>Relatives who do not have to live with taxpayer, later, and taxpayer can claim an exemption for him or her</i> ⁴	A qualifying person.
	He or she did not live with taxpayer more than half the year	Not a qualifying person.
	He or she is not related to taxpayer in one of the ways listed under <i>Relatives who do not have to live with taxpayer, later, and</i> is taxpayer's qualifying relative only because he or she lived with you all year as a member of taxpayer's household	Not a qualifying person.
	Taxpayer cannot claim an exemption for him or her	Not a qualifying person.

1. A person cannot qualify more than one taxpayer to use the head of household filing status for the year.
2. The term “qualifying child” is defined under *exemptions for dependents*, later. **Note:** If taxpayer is a noncustodial parent, the term “qualifying child” for head of household filing status does not include a child who is taxpayer’s qualifying child for exemption purposes only because of the rules described under *children of divorced or separated parents or parents who live apart* under *qualifying child*, later. If taxpayer is the custodial parent and those rules apply, the child generally is taxpayer’s qualifying child for head of household filing status even though the child is not a qualifying child for whom taxpayer can claim an exemption.
3. This person is a qualifying person if the only reason taxpayer cannot claim the exemption is that taxpayer can be claimed as a dependent on someone else’s return.
4. If taxpayer can claim an exemption for a person only because of a multiple support agreement, that person is not a qualifying person.

Example 1: Child – Taxpayer’s unmarried son lived with taxpayer all year and was 18 years old at the end of the year. He did not provide more than half of his own support and does not meet the tests to be a qualifying child of anyone else. As a result, he is taxpayer’s qualifying child and, because he is single, is a qualifying person for the taxpayer to claim head of household filing status.

Example 2: Child who is not qualifying person – The facts are the same as in **Example 1**, except the taxpayer’s son was 25 years old at the end of the year and his gross income was \$5,000. Because he does not meet the age test, the taxpayer’s son is not his qualifying child. Because he does not meet the gross income test, he is not the taxpayer’s qualifying relative and as a result, he is not the taxpayer’s qualifying person for head of household purposes.

Example 3: Girlfriend – Taxpayer’s girlfriend lived with him all year. Even though she may be the taxpayer’s qualifying relative if the gross income and support tests are met, she is not the taxpayer’s qualifying person for head of household purposes because she is not related to the taxpayer in one of the ways listed above in the table.

Example 4: Girlfriend’s child – The facts are the same as in **Example 3**, except the taxpayer’s girlfriend’s 10-year-old son also lived with them all year. The 10-year-old son is not the taxpayer’s qualifying child and, because he is the girlfriend’s qualifying child, he is not the taxpayer’s qualifying relative.

As a result, he is not the taxpayer's qualifying person for head of household purposes.

Home of qualifying person – Generally, the qualifying person must live with the taxpayer for more than half of the year. However, if the taxpayer's qualifying person is his or her father or mother, the taxpayer may be eligible to file as head of household even if his or her father or mother does not live with the taxpayer. However, the taxpayer must be able to claim an exemption for his or her father or mother. Also, the taxpayer must pay more than half the cost of keeping up a home that was the main home for the entire year for the taxpayer's father or mother. A taxpayer keeps up a main home for his or her father or mother if he or she pays more than half the cost of keeping the taxpayer's parent in a rest home or home for the elderly.

A taxpayer may be eligible to file as head of household if the individual who qualifies the taxpayer for this filing status is born or dies during the year. The taxpayer must have provided more than half of the cost of keeping up a home that was the individual's main home for more than half of the year, or, if less, the period during which the individual lived.

Example: The taxpayer is unmarried. Taxpayer's mother, for whom she can claim an exemption, lived in an apartment by herself until she died on September 2 of the current year. The cost of the upkeep of her apartment for the year until her death was \$6,000, of which the taxpayer paid \$4,000 and her brother paid \$2,000. The brother made no other payments towards the mother's support. The mother had no income. Because the taxpayer paid more than half of the cost of keeping up her mother's apartment from January 1 until her death, and the taxpayer can claim an exemption for her, the taxpayer can file as a head of household for the current year.

- d. **Temporary absences** – The taxpayer and his or her qualifying person are considered to live together even if one or both of these individuals are temporarily absent from home due to special circumstances such as illness, education, business, vacation, or military service. It must be reasonable to assume that the absent person will return to the home after the temporary absence. The taxpayer must continue to keep up the home during the absence.

Qualifying Widow(er) with Dependent Child

- 1111.35** If the taxpayer's spouse died in the current year, he or she can use married filing jointly as his or her filing status for the current year if the taxpayer otherwise qualifies to use that status. The year of death is the last year for which the taxpayer can file jointly with his or her deceased spouse.
- 1111.36** The taxpayer may be eligible to use qualifying widow(er) with dependent child as his or her filing status for two years following the year the taxpayer's spouse died. For example, if the taxpayer's spouse died in 20X1 and he or she has not remarried, the taxpayer may be able to use this filing status for 20X2 and 20X3. This filing status entitles the taxpayer to use joint return tax rates and the highest standard deduction amount (if the taxpayer does not itemize deductions). This status does not entitle the taxpayer to file a joint return.

- a. A taxpayer is eligible to file his or her 2020 income tax return as a qualifying widow(er) with dependent child if the taxpayer meets all the following tests:
- (i) The taxpayer was entitled to file a joint return with his or her spouse for the year his or her spouse died. It does not matter whether the taxpayer actually filed a joint return;
 - (ii) The taxpayer's spouse died in 2018 or 2019 and the taxpayer did not remarry before the end of 2020;
 - (iii) The taxpayer has a child or stepchild for whom he or she can claim an exemption;
 - (iv) The child lived in the taxpayer's home all year, except for temporary absences; and
 - (v) The taxpayer paid more than half the cost of keeping up a home for the child.

Example: John Reed's wife died in 2018. John has not remarried. He has continued during 2019 and 2020 to keep up a home for himself and his child, who lives with him and for whom he can claim an exemption. For 2018, he was entitled to file a joint return for himself and his deceased wife. For 2019 and 2020, he can file as a qualifying widower with a dependent child. After 2020, he can file as head of household if he qualifies.

- b. A taxpayer may be eligible to file as a qualifying widow(er) with dependent child if the child who qualifies the taxpayer for this filing status is born or dies during the year. The taxpayer must have provided more than half of the cost of keeping up a home that was the child's main home during the entire part of the year he or she was alive.

Sources of All Income

1111.37 Part of an EA's task is to determine all of the taxpayer's sources of income, and to differentiate the taxpayer's taxable income from the nontaxable income. As a general rule, all increments to wealth are taxable, regardless whether the transaction generating the income is reported to the IRS. Many income generating events require a payor to send an information return -- Form 1099, Form K-1, Form W-2 -- to the recipient and to the IRS. The IRS's "matching program" matches up income reported on a taxpayer's tax return with the information returns it receives from the payers. When there is a mismatch, the IRS will notify the taxpayer and inquire about the mismatch and/or make an adjustment to the taxpayer's tax liability itself. Regardless of whether an income generating event results in the issuance of an information return such as a Form W-2, 1099, or Schedule K-1, the recipient taxpayer is required to include the fair market value of property he or she receives in income for purposes of tax return reporting.

1111.38 As noted, one important step in preparing income tax returns is to examine the information returns that the taxpayer reported receiving in the prior tax year. For example, if a client reported income from various Forms W-2s, 1099s, and Schedules K-1s in 2019, the chances are he or she will have income from most of those sources of income again in 2020. If he or she does not report such items, the absence of such income should encourage the EA to investigate why income from a certain source reported in the prior year does not appear on the current-year's return. The following is a schedule of some common income reporting forms:

- a.** W-2 forms for taxpayer and his or her spouse;
- b.** 1099-C forms for cancellation of debt;
- c.** 1099-G forms for unemployment income, state, or local tax refunds;
- d.** 1099-NEC forms for taxpayer and his or her spouse (for any independent contractor work);
- e.** 1099-R, Form 8606 for payments/distributions from IRAs or retirement plans;
- f.** 1099-S forms for income from sale of a property;

- g. 1099-INT, -DIV, -B, or K-1s for investment or interest income;
- h. SSA-1099 for Social Security benefits received; and
- i. 1095-A, *Health Insurance Marketplace Statement*.

Sources of Applicable Adjustments to Gross Income

1111.39 Deductions are categorized as either “adjustments to income” (above the line deductions) that are used to reduce gross income to produce adjusted gross income (AGI), or itemized deductions, which reduce AGI to produce taxable income. A taxpayer may take adjustments to income regardless of whether he or she itemizes his or her deductions. The following discussion addresses a number of important above the line deductions.

Self-Employed Health Insurance

1111.40 A taxpayer with self-employment income can take a deduction for health and long-term care insurance expenses incurred for the taxpayer, his or her spouse, and his or her dependents on Line 16 of the 2020 Schedule 1. Eligible individuals include self-employed people reporting income on Schedule F (for farmers) or Schedule C (self-employed persons), general partners in a partnership, actively participating members in an LLC treated as a partnership who have self-employed income, and employees of an S-corporation who own 2 percent or more of the S corporation’s stock.

1111.41 Before claiming a deduction for self-employed health insurance, the taxpayer must calculate his or her allowable health insurance deduction by taking his or her self-employment income and subtracting the 50 percent deduction for self-employment taxes and any retirement contributions the taxpayer made to a SEP-IRA, SIMPLE-IRA, or Keogh plan. The remainder is the taxpayer’s allowable deduction for health insurance expenses. If the taxpayer is reporting a loss from his or her self-employed activity, then he or she is not eligible to deduct his or her health insurance costs since this particular deduction is limited by the taxpayer’s self-employment income. The taxpayer can, however, still claim the health insurance expenses as an itemized medical deduction on his or her Schedule A. This Schedule A deduction is limited in 2020 by a 7.5 percent AGI limitation.

- 1111.42** A self-employed individual cannot deduct any health insurance costs for any months he or she was eligible to participate in an employer subsidized health insurance plan through his or her spouse's employer.

Example: John, a self-employed individual operating his own business, paid for 12 months of health insurance coverage for himself and his family. In December of the year in question, he became eligible to participate in his spouse's group health insurance. He can deduct only 11 months' worth of insurance premiums.

The taxpayer deducts this expenditure on Line 16 of the year 2020 Schedule 1, not on the Schedule C or the Schedule F. This deduction will not reduce the taxpayer's self-employment tax. If the taxpayer were to employ his or her spouse and provide health insurance to him or her that included family coverage, the Tax Court has indicated that this deduction could be taken on the Schedule C. It appears the IRS does not agree with this position.

Student Loan Interest Deduction and Form 1098-E

- 1111.43** A taxpayer may be able to deduct interest he or she paid on a qualified student loan. Generally, the amount deductible is the lesser of \$2,500 or the amount of interest actually paid. The deduction is claimed as an adjustment to income, so the taxpayer does not need to itemize his or her deductions on Schedule A Form 1040. A taxpayer may claim the deduction if all of the following circumstances apply:

- a.** Taxpayer paid interest on a qualified student loan in the tax year;
- b.** Taxpayer is legally obligated to pay interest on a qualified student loan;
- c.** Taxpayer's filing status is not married filing separately;
- d.** Taxpayer's modified adjusted gross income is less than a specified amount which is set annually that precludes taking the deduction; and
- e.** Taxpayer and his or her spouse, if filing jointly, cannot be claimed as dependents on someone else's return.

1111.44 A qualified student loan is a loan the taxpayer took out solely to pay qualified higher education expenses for the taxpayer, his or her spouse, or a person who was the taxpayer's dependent when he or she took out the loan. The educational expenses must be paid or incurred within a reasonable period of time before or after the taxpayer took out the loan, and the expenses were for education provided during an academic period for an eligible student. Loans from a related person or a qualified employer plan are not qualified student loans.

1111.45 An eligible student is a student who was enrolled at least half-time in a program leading to a degree, certificate, or other recognized educational credential. A student was enrolled at least half-time if the student was taking at least half the normal full-time workload for his or her course of study. The standard for what is half of the normal full-time workload is determined by each eligible educational institution.

For purposes of the student loan interest deduction, these expenses are the total costs of attending an eligible educational institution, including graduate school. They include amounts paid for the following items:

- a.** Tuition and fees;
- b.** Room and board;
- c.** Books, supplies, and equipment, and
- d.** Other necessary expenses (such as transportation).

1111.46 The cost of room and board qualifies only to the extent that it is not more than the greater of:

- a.** The allowance for room and board, as determined by the eligible educational institution, that was included in the cost of attendance (for federal financial aid purposes) for a particular academic period and living arrangement of the student; or
- b.** The actual amount charged if the student is residing in housing owned or operated by the eligible educational institution.

- 1111.47** An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the U.S. Department of Education. It includes virtually all accredited public, nonprofit, and proprietary postsecondary institutions.
- 1111.48** To help the taxpayer figure his or her student loan interest deduction, he or she should receive Form 1098-E. Generally, an institution (such as a bank or governmental agency) that received interest payments of \$600 or more during the tax year on one or more qualified student loans must send Form 1098-E (or acceptable substitute) to each borrower by January 31 of the succeeding tax year.
- 1111.49** For 2020, the amount of student loan interest deduction is phased out if a taxpayer's MAGI is between \$70,000 and \$85,000 (\$140,000 and \$170,000 for MFJ). A taxpayer cannot take a student loan interest deduction if his or her MAGI was \$85,000 or more (\$170,000 or more if MFJ). See the chart below illustrating the impact of MAGI on the deduction for 2020:

IF taxpayer's filing status is:	AND MAGI is:	THEN the student loan interest deduction is:
Single, head of household, or qualifying widow(er)	Not more than \$70,000	Not affected by the phase-out
	More than \$70,000, but less than \$85,000	Reduced because of the phase-out
	\$85,000 or more	Eliminated by the phase-out
Married filing joint return	Not more than \$140,000	Not affected by the phase-out
	More than \$140,000, but less than \$170,000	Reduced because of the phase-out
	\$170,000 or more	Eliminated by the phase-out

Tuition and Fees Deduction

1111.50 Publication 970, on page 2, states that the tuition and fees deduction has been extended to cover qualified education expenses paid in 2018, 2019, and 2020. However, starting with 2021, the tuition and fees deduction has been eliminated. Instead, an enlarged Lifetime Learning Credit will allow the benefit to more taxpayers. For years 2018 through 2020, Publication 970 states that a taxpayer may be able to deduct qualified education expenses paid during the year for the taxpayer, taxpayer's spouse, or a dependent, unless the taxpayer is married and files as married separate or if another person can claim an exemption for the taxpayer as a dependent. The qualified expenses must be for higher education. The maximum deduction as an adjustment to income for qualified education expenses is \$4,000 and it includes tuition and fees but not living expenses (i.e., room and board). In addition, the deduction for qualified education expenses is an adjustment to income or, put another way, it is an above-the-line deduction. **Note:** It may be more beneficial to the taxpayer to claim the American Opportunity Credit or the Lifetime Learning Credit instead of the tuition and fees deduction, especially since a taxpayer can choose the education benefit that will result in the lowest tax liability.

Educator Expenses

1111.51 An “**eligible educator**” can deduct as an above the line deduction up to \$250 of qualified expenses paid in the current year. If the taxpayer and his or her spouse file jointly and both are eligible educators, the maximum deduction is \$500. However, neither spouse can deduct more than \$250 of his or her qualified expenses on Schedule 1, line 23.

- (i) An eligible educator is a kindergarten through grade 12 teacher, instructor, counselor, principal, or aide who worked in a school for at least 900 hours during a school year.
- (ii) Qualified expenses include ordinary and necessary expenses paid in connection with books, supplies, equipment (including computer equipment, software, and services), and other materials used in the classroom. An ordinary expense is one that is common and accepted in the taxpayer’s educational field. A necessary expense is one that

is helpful and appropriate for the taxpayer's profession as an educator. An expense does not have to be required to be considered necessary. Qualified expenses do not include expenses for home schooling or for nonathletic supplies for courses in health or physical education.

Health Savings Account

1111.55 A health savings account (HSA) is a tax-exempt trust or custodial account a taxpayer can set up with a qualified HSA trustee to pay or reimburse certain medical expenses the taxpayer incurs. No permission or authorization from the IRS is necessary to establish an HSA.

1111.56 The tax advantages of an HSA are as follows:

- A taxpayer can claim a tax deduction for contributions he or she or someone other than his or her employer makes to his or her HSA even if he or she does not itemize his or her deductions.
- Contributions to an HSA made by an employer (including contributions made through a Cafeteria plan) may be excluded from gross income.
- The contributions remain in the taxpayer's account from year to year until he or she uses them.
- The interest or other earnings on the assets in the account are tax free.
- Distributions may be tax free if the taxpayer pays for qualified medical expenses.
- An HSA is "portable", so it stays with the taxpayer if he or she changes employers or leaves the work force.

Qualifying for an HSA

1111.57 To be an eligible individual and qualify for an HSA, a taxpayer must meet the following requirements.

- The taxpayer must be covered under a high deductible health plan (HDHP) on the first day of the month.
- The taxpayer has no other health coverage, except what is permitted.
- Taxpayer is not enrolled in Medicare.
- Taxpayer cannot be claimed as a dependent on someone else's current year tax return.

1111.58 A High Deductible Health Plan (HDHP) has:

- A higher annual deductible than typical health plans; and
- A maximum limit on the sum of the annual deductible and out-of-pocket medical expenses that you must pay for covered expenses. Out-of-pocket expenses include copayments and other amounts, but do not include premiums.

1111.59 An HDHP may provide preventive care benefits without a deductible or with a deductible below the minimum annual deductible. Preventive care includes, but is not limited to, the following:

1. Periodic health evaluations, including tests and diagnostic procedures ordered in connection with routine examinations, such as annual physicals.
2. Routine prenatal and well-childcare.
3. Child and adult immunizations.
4. Tobacco cessation programs.
5. Obesity weight-loss programs.
6. Screening services. This includes screening services for the following:
 - a. Cancer.
 - b. Heart and vascular diseases.
 - c. Infectious diseases.

- d. Mental health conditions.
- e. Substance abuse.
- f. Metabolic, nutritional, and endocrine conditions.
- g. Musculoskeletal disorders.
- h. Obstetric and gynecological conditions.
- i. Pediatric conditions.
- j. Vision and hearing disorders.

Other Health Coverage

1111.60 The taxpayer (and his or her spouse, if he or she has family coverage) generally cannot have any other health coverage that is not an HDHP. However, the taxpayer can still be an eligible individual even if his or her spouse has non-HDHP coverage provided he or she is not covered by that plan. A taxpayer can have additional insurance that provides benefits only for the following items:

- Liabilities incurred under workers' compensation laws, tort liabilities, or liabilities related to ownership or use of property.
- A specific disease or illness.
- A fixed amount per day (or other period) of hospitalization.

1111.61 A taxpayer can also have coverage (whether provided through insurance or otherwise) for the following items:

- Accidents.
- Disability.
- Dental care.
- Vision care.
- Long-term care.

1111.62 For an employee's HSA, the employee, the employee's employer, or both may contribute to the employee's HSA in the same year. For an HSA established by a self-employed (or unemployed) individual, the individual can contribute. Family members or any other person may also make contributions to an HSA on behalf of an eligible individual. Contributions to an HSA must be made in cash; contributions of stock or property to an HSA are not allowed.

1111.63 The amount a taxpayer or any other person can contribute to the taxpayer's HSA depends on the type of high deductible health plan (HDHP) coverage the taxpayer has, his or her age, the date the individual becomes an eligible individual, and the date he or she ceases to be an eligible individual. For 2020, if the taxpayer has only HDHP coverage, he or she can contribute up to \$3,550. If the taxpayer has family HDHP coverage, he or she can contribute up to \$7,100. Contributions to an HSA are tax-deductible and earnings, such as interest and dividends, in the HSA are tax-exempt at the federal level. Withdrawals from an HSA are tax-free as long as the funds are used for qualified medical expenses. No HSA contributions or tax deductions are permitted if the taxpayer is enrolled in Medicare Part A or Part B. Catch-up contributions of \$1,000 are allowed for those age 55 and over.

Alimony

1111.64 The Tax Cuts and Jobs Act of 2017 changes the treatment of alimony and separate maintenance payments negotiated after December 31, 2018.

For agreements on or before December 31, 2018, a taxpayer can deduct alimony paid, whether or not he or she itemizes deductions on his or her return. The taxpayer should enter the amount of alimony paid on line 18a of Schedule 1 of Form 1040 and the payee's spouse's Social Security Number on Line 18b. If the taxpayer paid alimony to more than one person, the taxpayer should enter the Social Security number of one of the recipients on Line 18b and show the Social Security Number and amount paid to each other recipient on an attached statement. The taxpayer should enter his or her total payments on Line 18a. Alimony received should be reported on line 11 of Schedule 1 of Form 1040.

For agreements after December 31, 2018, or agreements changed after December 31, 2018 to state that alimony is not included in income, a taxpayer cannot deduct alimony paid (and taxpayers are not required to report alimony received as income).

1112 Sources of Applicable Deductions**Standard Deduction versus Itemized Deductions**

1112.01 The standard deduction amount depends on the taxpayer's filing status, whether the taxpayer is 65 or older or blind, whether an exemption can be claimed for the taxpayer by another taxpayer and whether the taxpayer has a net qualified disaster loss from a federally declared disaster. Generally, the standard deduction amounts are adjusted each year for inflation.

Higher Standard Deduction for Blindness

1112.02 If a taxpayer is blind on the last day of the year and he or she does not itemize deductions, he or she is entitled to a higher standard deduction. If the taxpayer is not totally blind, he or she must get a certified statement from an ophthalmologist or optometrist that:

- a. Taxpayer cannot see better than 20/200 in the better eye with glasses or contact lenses; or

- b.** Taxpayer's field of vision is 20 degrees or less.

1112.03

If the taxpayer's eye condition is not likely to improve beyond these limits, the statement should include this fact and the statement must be kept in the taxpayer's records. If the taxpayer's vision can be corrected beyond these limits only by contact lenses that the taxpayer can wear only briefly because of pain, infection, or ulcers, the taxpayer can take the higher standard deduction for blindness if he or she otherwise qualifies.

Standard Deduction for Dependents**1112.04**

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

- a.** \$1,100 in 2020; or
- b.** The individual's earned income for the year plus \$350 for 2020, but not more than the regular standard deduction amount, \$12,400 (single) for 2020.

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

1112.05 The standard deduction amounts for 2020 are listed on the following chart.

Filing Status	2020
Married filing jointly	\$24,800
Single and married individuals filing separately	\$12,400
Head of household	\$18,650
Additional standard deduction for blind people and senior citizens for married individuals	\$1,300
Additional standard deduction for blind people and senior citizens for singles and head of households	\$1,650
Dependent	Greater of (1) \$1,100, or (2) the sum of \$350 and the individual's earned income but not more than the regular standard deduction amount

1112.06 The amount of the standard deduction for a decedent's final tax return is the same as it would have been had the decedent continued to live. However, if the decedent was not 65 or older at the time of death, the higher standard deduction for age cannot be claimed on the decedent's final tax return.

Who Should Itemize?

1112.07 A taxpayer is better off economically if he or she itemizes his or her deductions when his or her total deductions are more than the standard deduction amount. Also, a taxpayer should itemize if he or she does not qualify for the standard deduction. It is important to note that many taxpayers who regularly itemized deductions prior to 2018 may have a greater benefit from the new, higher standard deduction. The taxpayer should first figure his or her itemized deductions and compare that amount to his or her standard deduction to make sure he or she is using the method that gives him or her the greater benefit. A taxpayer may benefit from itemizing his or her deductions if he or she:

- a. Does not qualify for the standard deduction, or the amount he or she can claim is limited;
- b. Had large uninsured medical and dental expenses during the year;
- c. Paid interest and taxes on their home;
- d. Made large contributions to qualified charities; or
- g. Have total itemized deductions that are more than the standard deduction to which the taxpayer is otherwise entitled.

It is important to note that the deduction for state and local taxes and property taxes or sales taxes are limited to \$10,000 per year.

Since tax returns are generally prepared electronically, the software is generally programmed to use the option that produces the greater benefit for the taxpayer.

Electing to Itemize for State Tax or Other Purposes

1112.08 Even if a taxpayer's itemized deductions are less than the amount of his or her standard deduction, the taxpayer can elect to itemize deductions on his or her federal return rather than take the standard deduction. A taxpayer may want to do this, for example, if the tax benefit of being able to itemize his or her deductions on his or her state tax return is greater than the tax benefit the taxpayer would lose on his or her federal return by not taking the standard deduction. If married filing separately and one of the

spouses itemizes, the other spouse must itemize as well. To make this election, the taxpayer must check the box on Line 18 of Schedule A.

- 1112.09** If the taxpayer did not itemize his or her deductions and later finds that he or she should have itemized -- or if he or she itemized deductions and later concluded that he or she should not have -- the taxpayer can amend his or her tax return by filing Form 1040X and itemize deductions or take the standard deduction.

Married Person Who Filed Separate Returns

- 1112.10** A taxpayer who filed married filing separately can change his or her method of taking deductions only if the taxpayer and his or her spouse both make the same change. Both spouses must file a consent to assessment for any additional tax either spouse may owe as a result of the change. The taxpayer and his or her spouse can use the method that gives them the lower total tax, even though one of the taxpayers may pay more tax than he or she would have paid by using the other method. Both spouses must use the same method of claiming deductions. If one itemizes deductions, the other spouse must also itemize his or her deductions because he or she will not qualify for the standard deduction.

Qualification for Dependency

- 1112.11** The TCJA suspended personal exemptions for years 2018 through 2025 for taxpayers and their dependents; however there are still many tax credits which are applicable to dependents. The term dependent means a qualifying child or a qualifying relative.
- a.** A taxpayer cannot claim any dependents if the taxpayer (or taxpayer's spouse, if filing jointly) can be claimed as a dependent by another taxpayer.
 - b.** A taxpayer cannot claim a married person who files a joint return as a dependent unless that joint return is filed only to claim a refund of withheld income tax or estimate tax paid.
 - c.** A taxpayer cannot claim a person as a dependent unless that person is a U.S. citizen, U.S. resident alien, U.S. national, or a resident of Canada or Mexico.
 - d.** A taxpayer cannot claim a person as a dependent unless that person is their qualifying child or qualifying relative.

Qualifying Child Tests

1112.12 There are five tests to determine if a child qualifies as a dependent for tax purposes. These tests are:

- a.** 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.
- b.** The child must be:
 - i. Under age 19 at the end of the year and younger than the taxpayer (or taxpayer's spouse, if filing jointly),
 - ii. Under age 24 at the end of the year, a student, and younger than the taxpayer (or taxpayer's spouse, if filing jointly), or
 - iii. Any age if permanently disabled.
- c.** The child must have lived with the taxpayer for more than half of the year. There are exceptions for temporary absences, children who were born or died during the year, children of divorced or separated parents (or parents who live apart), and kidnapped children.
- d.** The child must not have provided for more than half of his or her own support for the year.
- e.** The child must not be filing a joint return for the year (unless that return is filed only to get a refund of income tax withheld or estimated tax paid).

If the child meets the rules to be a qualifying child of more than one person, only one person can treat the child as a qualifying child.

Qualifying Relative Test

- 1112.13** There are four tests to determine if a relative qualified as a dependent for tax purposes. These tests are:
- a.** The person cannot be the taxpayer's qualifying child or the qualifying child of any other taxpayer.
 - b.** The person either:
 - 1) Must be related to the taxpayer in one of the following ways:
 - i. The taxpayer's child, stepchild, foster child, legally adopted child, or a descendant of any of them.
 - ii. The taxpayer's brother, sister, half-brother, half-sister, stepbrother, or stepsister.
 - iii. The taxpayer's father, mother, grandparent, or other direct ancestor, but not foster parent.
 - iv. The taxpayer's stepfather or stepmother.
 - v. A son or daughter of the taxpayer's brother or sister (including half-brother and half-sister).
 - vi. A brother or sister of the taxpayer's father or mother.
 - vii. The taxpayer's son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law.
 - 2) Must live with the taxpayer all year as a member of their household.
 - c.** The person's gross income for the year must be less than \$4,300 for 2020.
 - d.** The taxpayer must provide more than half of the person's total support for the year.

Any of these relationships that were established by marriage are not ended by death or divorce.

1113 Sources of Applicable Credits

1113.01 Child tax credit: The Child Tax Credit under the TCJA (Tax Cuts and Jobs Act of 2017) tax reform is worth up to \$2,000 per qualifying child. The age cutoff remains at 17.

(The child must be under 17 at the end of the year for taxpayers to claim the credit. Please note that the recent enactment of American Rescue Plan expanded the qualifying age to be 17 as opposed to under 17.)

- a. Child dependent: For 2020, the refundable portion of the credit is limited to \$1,400. The beginning credit phaseout for the child tax credit in 2020 is \$200,000 (\$400,000 for joint filers). The child must have a valid Social Security number (SSN) to qualify for the \$2,000 child tax credit.
- b. Other dependents: This new credit, created under the TCJA, allows for a credit worth \$500 for each qualifying dependent who does not qualify for the child tax credit discussed in (a) above; the credit is nonrefundable. For 2020, the phaseout begins for taxpayers with AGI of \$200,000 (\$400,000 for joint filers). This phaseout applies in combination with the new child tax credit. Unlike the child tax credit, the dependent does not require a valid SSN for the taxpayer to claim the credit for other dependents; an ITIN (Individual Taxpayer Identification Number) or ATIN (Adoption Taxpayer Identification Number) will suffice.

1113.02 Saver's Credit for contributions to qualified retirement plans

A nonrefundable tax credit is available for contributions, or deferrals, to retirement savings plans. The credit is claimed by completing and attaching IRS Form 8880, Credit for Qualified Retirement Savings Contributions, to the taxpayer's return.

- a.** The credit applies to traditional and Roth IRAs and other qualified retirement plans such as 401(k) plans, 403(b) annuities, 457 plans, SIMPLE plans, and SEP plans.
- b.** For tax year 2020, an eligible lower-income taxpayer can claim a nonrefundable tax credit for the applicable percentage (50%, 20%, or 10%, depending on filing status and AGI) of up to \$2,000 of their qualified retirement savings contributions. In other words, the absolute most the credit could be is \$1,000. The credit is in addition to any deduction or exclusion relating to the retirement plan contribution. Joint filers with AGI in excess of \$65,000 receive no credit. For heads of households, the amount is \$48,750, and for all others it is \$32,500.
- c.** The contribution eligible for the credit must be reduced by any distributions received from qualified retirement plans.
 - 1.** Such distributions include those paid out during (a) the current year, (b) the two preceding tax years, and (c) the period before the due date (including extensions) of the current return.
 - 2.** Distributions received by a spouse are considered as distributions to the taxpayer if a joint return is filed.
- d.** Qualifying taxpayers must be at least 18 years old.
- e.** Dependents and full-time students are not eligible for the credit.

1113.03 Adoption credit: A nonrefundable tax credit is available for qualified adoption expenses paid or incurred in the adoption of a qualified child. Expenses paid before the adoption are claimed as a credit in the year the adoption is finalized. The credit is claimed by completing and filing IRS Form 8839, Qualified Adoption Expenses, with the taxpayer's return.

- a. **Qualified expenses** include reasonable and necessary adoption fees, court costs, attorney fees, and other directly related expenses. For 2020, expenses up to \$14,300 may be claimed as a credit. Adoption expenses for a child with special needs are considered to be \$14,300, even if the expenses are less.
- b. **Qualifying children** are those under age 18 or those who are physically or mentally handicapped.
- c. The credit allowable is phased out ratably as AGI rises from \$214,520 to \$255,520.
- d. Unused credits carry forward five years.
- e. Married taxpayers must file jointly, and the child's Social Security number must be reported.

1113.04 Education Credits

Two tax credits available for students pursuing postsecondary college or vocational education are the American Opportunity Tax Credit and the Lifetime Learning Credit. These credits are available for qualified educational expenditures of the taxpayer, spouse, and dependents. If both the Lifetime Learning Credit and the American Opportunity Tax Credit can be claimed for the same student in the same year, only one can be used, not both. Both credits must be supported by an IRS Form 1098-T from the college or other postsecondary institution showing the amount of qualified expenses that were paid during the tax year. American Opportunity Tax Credit (AOTC) makes the Hope Credit available to a broader range of taxpayers, including many with higher incomes and those who owe no tax. It also adds required course materials to the list of qualifying expenses and allows the credit to be claimed for four postsecondary education years instead of two.

- 1) The credit is equal to 100% of the first \$2,000 and 25% of the next \$2,000, not to exceed \$4,000. Therefore, the maximum Hope Scholarship Credit allowance is \$2,500.
- 2) Students must be enrolled no less than half-time during at least one semester during the year.
- 3) The taxpayer claiming the full credit (not necessarily the student) must have modified adjusted gross income (MAGI) of \$80,000 or less for a single taxpayer or \$160,000 or less if filing jointly. A partial credit may be available up to MAGI of \$90,000 and \$180,000, respectively.
- 4) A taxpayer can claim the credit for each qualifying student for whom qualifying expenses are paid.

b. Lifetime Learning Credit: This nonrefundable credit is equal to 20% of up to \$10,000 of tuition expenses paid each year by the taxpayer. Expenses for which the American Opportunity Tax Credit is claimed do not qualify for this credit. In contrast to the American Opportunity Tax Credit, this credit:

- 1) does not vary with the number of students in the household,
- 2) is available for an unlimited number of years,
- 3) applies to undergraduate, graduate, and professional degree expenses, (4) applies to any course at an eligible institution that helps individuals acquire or improve their job skills, and
- 4) does not require half-time enrollment for one semester. (Thus, CPE credit courses and professional seminars provided by eligible educational institutions may qualify for the credit.)

For tax year 2020, a taxpayer's modified adjusted gross income in excess of \$59,000 (\$118,000 for a joint return) is used to determine the reduction in the amount of the Lifetime Learning Credit otherwise allowable.

- c. Other limitations:
- 1) Married taxpayers must file jointly to receive these credits.
 - 2) In a given tax year, only one of the following benefits may be claimed with respect to each student: (a) the American Opportunity Tax Credit or (b) the Lifetime Learning Credit. However, the American Opportunity Tax or Lifetime Learning credit can be claimed in the same year as distributions from a Coverdell Education IRA, provided that the proceeds from the distribution are not used to pay for the education costs used in claiming the American Opportunity or Lifetime Learning credit.
 - 3) The credits are not available if the cost of the course may be deducted by the taxpayer as a business expense.

1113.05 Foreign Tax Credit: A taxpayer may apply income taxes paid to a foreign country or U.S. possession as a credit against United States income tax liability or may use such taxes as an itemized deduction. This credit is claimed on IRS Form 1116 for an individual and on IRS Form 1118 for a corporation.

- a. This treatment is available for taxes paid to a foreign country on income that is taxable in the United States when no foreign income exclusion is taken.
- b. The election to use the credit or the deduction is made annually.
- c. The taxpayer cannot split foreign taxes between a credit and a deduction.
- d. The overall limit for the credit on taxes paid to all foreign countries is restricted to that portion of the U.S. income tax which relates to the taxable income from all foreign countries.

Total foreign taxable income ----- Total worldwide taxable income	= U.S. income tax
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- e. Excess credits may be carried back 1 year and forward 10 years.

1113.06

Child and dependent care credit: Taxpayers are permitted a nonrefundable tax credit for expenses incurred in caring for dependents so that the taxpayer(s) may be gainfully employed.

- a.** The credit is available on a three-tiered basis as follows:
 - i. Taxpayers with an adjusted gross income of \$15,000 or less will be entitled to a credit of 35% of dependent care expenses.
 - ii. The credit will be reduced by one percentage point for each \$2,000 of adjusted gross income, or fraction thereof, above \$15,000.
 - iii. For taxpayers with an adjusted gross income over \$43,000, the credit will be 20%.
- b.** The maximum amount of dependent care expenses that may be considered for the credit is \$3,000 if there is one qualifying child or dependent and \$6,000 if there are two or more qualifying dependents.
- c.** Expenditures for dependent care cannot exceed the earned income of the low-income parent. Special provisions apply where one of the spouses is a full-time student or is incapacitated, and the other spouse works. In this situation, the nonworking spouse is considered to have earned at least \$250 per month, where one dependent requires care and \$500 per month, where more than one dependent requires care.
- d.** The dependent must be:
 - i. a child under age 13 or
 - ii. an incapacitated dependent or spouse.
- e.** Married taxpayers must file a joint return unless they live apart for the last six months of the year.
 - i. For divorced or separated parents, the credit is available to the parent having custody of the child for the longer period.
 - ii. A custodial parent may claim the credit even though the child may not qualify as a dependent. However, two taxpayers filing separate returns cannot claim separate credits for the same child.

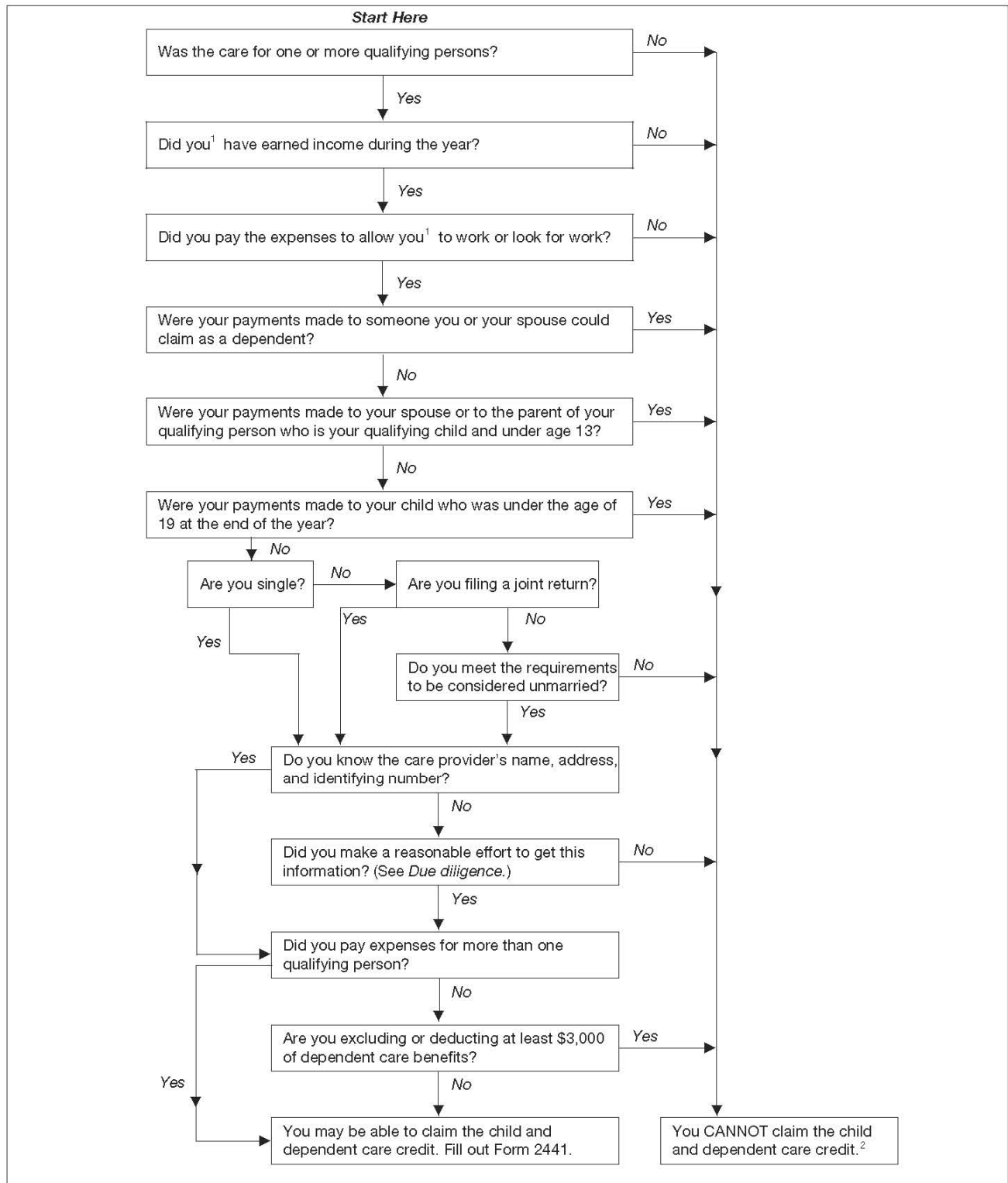
- f.** Expenditures that qualify for the credit include amounts paid for both in-the-home care and out-of-the-home care.

 - i. In-the-home care may include expenditures for household services if they were partly for the well-being and protection of a qualifying individual.
 - ii. Expenditures for out-of-the-home care are eligible for the credit only if incurred for:

 - 1. a dependent under age 13 or
 - 2. any other qualifying person who regularly spends at least eight hours each day in the taxpayer's household.
- g.** Expenditures do not qualify for the credit if they were made to:

 - i. a relative who is a dependent of the taxpayer or
 - ii. the taxpayer's child who is under age 19.
- h.** The following flowchart is helpful in determining if an individual is eligible to take the child and dependent care credit.

Figure A. Can You Claim the Credit?



¹ This also applies to your spouse, unless your spouse was disabled or a full-time student.

1113.07 Credit for Other Dependents

The TCJA provided for a \$500 nonrefundable credit for qualifying dependents other than qualifying children or for a qualifying child who has an ITIN or ATIN instead of an SSN.

1113.08 Earned income credit

A special refundable tax credit may be available for low-income workers who have a principal residence in the United States. It represents a form of negative income tax – workers may receive money from government even though they do not have a tax liability. This credit is claimed by filing Schedule EIC of IRS Form 1040 with the taxpayer's return

- a.** The earned income credit (EIC) is equal to a percentage of a limited amount of earned income. Taxpayers with qualifying children receive greater benefits—a greater amount of income is eligible for a higher credit percentage.
- b.** When the taxpayer's adjusted gross income (or earned income, if greater) exceeds a threshold amount, the EIC is phased out.
 - 1) "Earned income" includes only taxable compensation; it does not include nontaxable employee compensation.
 - 2) Threshold and phaseout amounts for 2020 are given in the following table. The tax year 2020 earned income and adjusted gross income (AGI) must each be less than:

Qualifying Children Claimed				
If filing...	Zero	One	Two	Three or More
Single, head of household, or widowed	\$15,820	\$41,756	\$47,440	\$50,954
Married filing jointly	\$21,710	\$47,646	\$53,330	\$56,844

- 3) No credit is allowed to those with “disqualified income” (i.e., investment income or unearned income) in excess of \$3,650 for 2020.
 - 4) No credit is allowed for those failing to provide correct Social Security numbers for themselves, spouse, and qualifying child.
 - 5) The maximum amount of credit for 2020 is \$6,660 with three or more qualifying children, \$5,920 with two qualifying children, \$3,584 for one qualifying child, and \$538 with no qualifying children.
- c. IRC Section 32 (d) provides that a married taxpayer who does not file a joint return is not entitled to an EIC. In Action on Decision (AOD) 2018-05, the IRS gave notice it would follow a Tax Court decision that the taxpayer’s filing status was married filing separately and that the taxpayer had qualifying children, and therefore the taxpayer was entitled to the EIC. However, there is no mention of IRC Section 32(d) in the court’s opinion; therefore, it appears that the Tax Court overlooked the prohibition disallowing the EIC to married taxpayers filing separately. Accordingly, the IRS stated that it will not follow the court’s opinion in allowing an EIC to a married taxpayer filing separately.
- d. Qualifying children: To be eligible for the earned income credit, parents must have children that can meet the following tests:
- 1) Relationship: The child must be a “qualifying child.” The child may, however, provide over half of his or her own support.
 - 2) Residency: The child must live in the taxpayer’s residence over half of the year; foster children for the entire tax year.
 - 3) Age: the child must be:
 - i. Under age 19,
 - ii. A full-time student under age 24, or
 - iii. Permanently and totally disabled.

- e. Individuals without qualifying children may be eligible for this credit if:
 - 1) They (or their spouse) are at least 25 years old, but not more than 64 years old, at the end of the year and
 - 2) They cannot be claimed as a dependent by another taxpayer.

1113.09 Credit for withholding and estimated tax payments: A refundable tax credit is available to the taxpayer for withheld taxes and estimated tax payments.

1114 Tax Payments

1114.01 Employers withhold income tax from the pay of most employees. For purposes of employer tax withholding, employee pay includes regular pay, bonuses, commissions, and vacation allowances and reimbursements and other expense allowances paid under a nonaccountable plan. If a taxpayer's income is low enough that he or she will not have to pay income tax for the year, the taxpayer may be exempt from employer withholding. The amount of income tax an employer withholds from a taxpayer's regular pay depends on two factors:

- a. The amount the taxpayer earns in each payroll period; and
- b. The information the taxpayer gives the employer on Form W-4.

1114.02 Form W-4 includes four types of information that the employee provides that an employer uses to figure a taxpayer's withholding:

- a. Personal information and anticipated filing status.
- b. If you worked multiple jobs and/or your spouse works.
- c. Information about number of dependents that will be claimed.
- d. Information about other adjustments regarding income, deductions or additional withholding.

- 1114.03** The W-4 is filled out by the employee and submitted to the employer so that the employer will withhold taxes based on the filing status. For instance, a person who is married can opt to have taxes withheld at rates corresponding to single filers. Withholding allowances are no longer used. When starting a new job, an employee must fill out Form W-4 and give it to the employer. If a taxpayer is receiving pension or annuity income and begins a new job, he or she will need to file Form W-4 with his or her new employer and can choose to split withholding allowances between the pension and the job in any manner.
- 1114.04** During the year changes may occur with respect to a taxpayer's marital status, exemptions, adjustments, deductions, or credits the taxpayer expects to claim on his or her tax return. When this happens, the employee may give his or her employer a new Form W-4 to change his or her withholding status or number of allowances. If the taxpayer's marital status changed from married to single, he or she must give his or her employer a new Form W-4 within 10 days of the change. An employee can submit a new Form W-4 whenever he or she wishes to adjust withholding.
- 1114.05** **Completing Form W-4 and worksheets**
Form W-4 has worksheets to help a taxpayer figure how much withholding he/she needs. These worksheets are for the taxpayer's own records and should not be given to the employer. For those working multiple jobs, option (a) most accurately calculates the additional tax you need to have withheld, while option (b) does so with a little less accuracy.
- 1114.06** If you (and your spouse) have a total of only two jobs, you may instead check the box in option (c). The box must also be checked on the Form W-4 for the other job. If the box is checked, the standard deduction and tax brackets will be cut in half for each job to calculate withholding. This option is roughly accurate for jobs with similar pay; otherwise, more tax than necessary may be withheld, and this extra amount will be larger the greater the difference in pay is between the two jobs.

1114.07 The IRS estimates that in most situations, the tax withheld from a taxpayer's pay will be close to the tax liability he or she figures on his or her return if the taxpayer follows these two rules:

1. Accurately complete all the Form W-4 worksheets that apply; and
2. Give the employer a new Form W-4 when changes occur.

1114.08 Because the IRS's worksheets and withholding methods do not account for all possible situations, the taxpayer may not get the right amount of tax withheld. The IRS estimates this under withholding is most likely to happen in the following situations:

- a. Taxpayer is married and both spouses work.
- b. Taxpayer has more than one job at a time.
- c. Taxpayer has nonwage income, such as interest, dividends, alimony, unemployment compensation, or self-employment income.
- d. Taxpayer will owe additional amounts with his/her return, such as self-employment tax.
- e. Taxpayer's withholding is based on obsolete, inaccurate Form W-4 information for a substantial part of the year.
- f. Taxpayer's earnings are more than the amount shown under check taxpayer's withholding in the instructions at the top of Page 1 of Form W-4.
- g. Taxpayer works only part of the year.
- h. Taxpayer changes the number of his or her withholding allowances during the year.

1114.09 When an employee starts a new job, the employer gives the new employee a Form W-4 to complete. Beginning with the taxpayer's first payday, the employer will use the information the taxpayer gave on the form to figure the employee's withholding. If the employee later fills out a new Form W-4, the employer can put it into effect immediately; though the deadline for putting it into effect is the start of the first payroll period ending 30 or more days after the employee turns it in. If the employee does not give

his or her employer a completed Form W-4, the employer must withhold at the highest rate, as if the taxpayer were single and claimed no withholding allowances.

1114.10 If a taxpayer finds he or she is having too much tax withheld, the taxpayer should give his or her employer a new Form W-4. The employer cannot repay any of the tax previously withheld so the taxpayer should claim the full amount withheld when he or she files his or her tax return. If the employer has withheld more than the correct amount of tax for the Form W-4 the taxpayer had in effect, the taxpayer does not have to fill out a new Form W-4 to have his or her withholding lowered to the correct amount. The employer can repay the amount that was withheld incorrectly. If the taxpayer is not repaid, the taxpayer's Form W-2 will reflect the full amount actually withheld, which the taxpayer would claim when he or she filed his or her tax return.

1114.11 Exemption from withholding

If a taxpayer claims exemption from withholding, the employer will not withhold federal income tax from wages. The exemption applies only to income tax, not to Social Security or Medicare tax.

A taxpayer can claim exemption from withholding for 2020 only if both of the following situations apply:

1. For 2019, the taxpayer the taxpayer had no tax liability; and
2. For 2020, the taxpayer expects to have no tax liability.

1114.12 Estimated tax for 2020

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

both, the taxpayer may have to pay a penalty. If the taxpayer does not pay enough by the due date of each payment period, he or she may be charged a penalty even if he or she is due a refund when he or she files his or her tax return.

1114.13 If a taxpayer receives salaries or wages, he or she can avoid having to pay estimated tax by asking his or her employer to take more tax out of his or her earnings. To do this, the taxpayer should give a new Form W-4 to his or her employer. The taxpayer does not have to pay estimated tax for 2021 if he or she meets all three of the following conditions:

- a. He or she had no tax liability for 2020;
- b. He or she was a U.S. citizen or resident alien for the whole year; and
- c. His or her 2020 tax year covered a 12-month period.

1114.14 A taxpayer had no tax liability for 2020 if his or her total tax was zero or he or she did not have to file an income tax return. If he or she owed additional tax for 2020, he or she may have to pay estimated tax for 2021.

In most cases, a taxpayer must pay estimated tax for 2021 if both of the following apply:

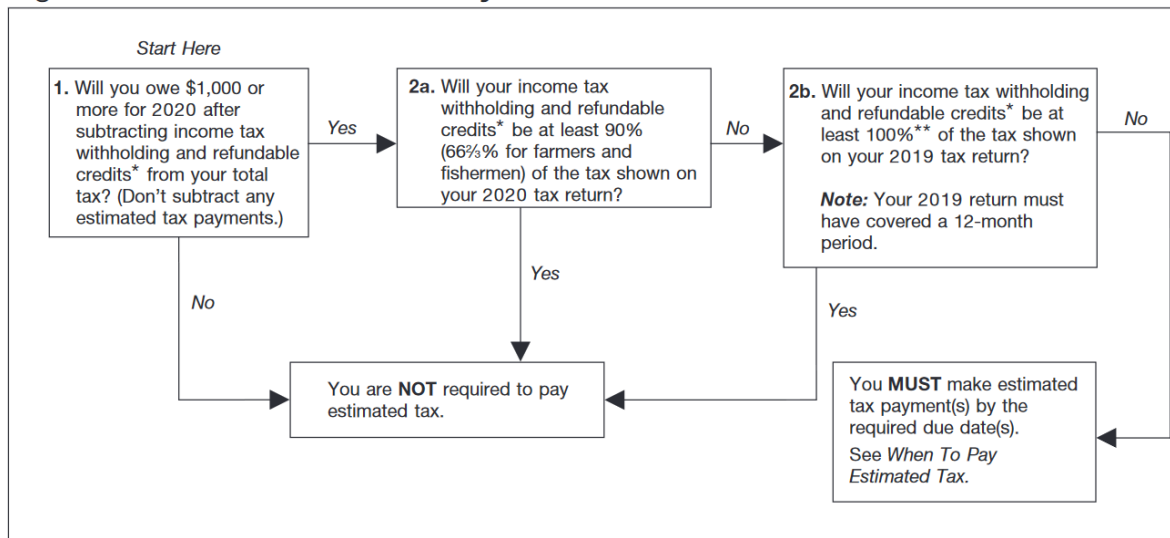
- a. Taxpayer expects to owe at least \$1,000 in tax for 2021, after subtracting withholding and refundable credits.
- b. Taxpayer expects his or her withholding plus his or her refundable credits to be less than the smaller of:
 - (i) 90 percent of the tax to be shown on the 2021 tax return, or
 - (ii) 100 percent of the tax shown on the 2020 tax return. If the 2020 AGI is over \$150,000, taxpayer is covered if he or she pays in at least 110 percent of last year's tax liability.

Note:

For purposes of the EA examination, the above formula for estimated payments should be memorized. It invariably shows up on the EA examination.

- 1114.15** Use the following flowchart to determine if an individual must make estimated payments:

Figure 2-A. **Do You Have To Pay Estimated Tax?**



* Use the refundable credits shown on the 2020 Estimated Tax Worksheet, line 11b.

** 110% if less than two-thirds of your gross income for 2019 and 2020 is from farming or fishing and your 2019 adjusted gross income was more than \$150,000 (\$75,000 if your filing status for 2020 is married filing a separate return).

- 1114.16** To figure a taxpayer's estimated tax, the preparer must figure the taxpayer's expected adjusted gross income (AGI), taxable income, taxes, deductions, and credits for the year. When figuring 2021 estimated tax, it may be helpful to use the taxpayer's income, deductions, and credits for 2020 as a starting point. Use the 2020 federal tax return as a guide. The preparer can use Form 1040-ES to figure estimated tax. Tax preparer must make adjustments both for changes in taxpayer's own situation and for recent changes in the tax law. Form 1040-ES includes a worksheet to help figure client's estimated tax.

- 1114.17** For estimated tax purposes, the tax year is divided into four payment periods. Each period has a specific payment due date. If a taxpayer does not pay enough tax by the due date of each payment period, he or she may be charged a penalty even if he or she is due a refund when he or she files his or her income tax return. The payment periods and due dates for estimated tax payments are shown below:

<u>For the Period:</u>	<u>Due Date:</u>
January 1-March 31	April 15
April 1-May 31	June 15
June 1-August 31	September 15
September 1-December 31	January 15, next year

If a taxpayer files his or her 2020 Form 1040 by January 31, 2021 and pays the rest of the tax he or she owes, the taxpayer does not need to make the payment due on January 15, 2021.

- 1114.18** A taxpayer does not have to make estimated tax payments until he or she has income on which he or she will owe income tax. If the taxpayer has income subject to estimated tax during the first payment period, he or she must make his or her first payment by the due date for the first payment period. A taxpayer can pay all his or her estimated tax at that time, or he or she can pay it in installments. If a taxpayer chooses to pay in installments, he or she should make the first payment by the due date for the first payment period and make remaining installment payments by the due dates for the later periods.

- 1114.19** If a taxpayer does not have income subject to estimated tax until a later payment period, he or she must make his or her first payment by the due date for that period. The taxpayer can pay his or her entire estimated tax by the due date for that period or he or she can pay it in installments by the due date for that period and the due dates for the remaining periods. The following chart shows when to make installment payments.

If taxpayer has income on which he or she must pay estimated tax:	Make a payment by:	Make later installments by:
Before April 1	April 15	June 15 September 15 January 15 next year
April 1-May 31	June 15	September 15 January 15 next year
June 1-August 31	September 15	January 15 next year
After August 31	January 15 next year	None

A taxpayer should pay enough estimated tax by the due date of each payment period to avoid a penalty for that period. A taxpayer can figure his or her required payment for each period by using either the regular installment method or the annualized income installment method.

- 1114.20** Under the regular installment method, if the estimated tax payment for any period is less than one-fourth of taxpayer's estimated tax, he or she may be charged a penalty for underpayment of estimated tax for that period when he or she files his or her tax return. Under the annualized income installment method, an individual's estimated tax payments vary with his or her income, but the amount required must be paid each period. After the taxpayer makes an estimated tax payment, changes in his or her income, adjustments, deductions, credits, or exemptions may make it necessary for him or her to refigure his or her estimated tax. The taxpayer should pay the unpaid balance of his or her amended estimated tax by the next payment due date after the change or in installments by that date and the due dates for the remaining payment periods.

A taxpayer does not have to pay estimated tax if his or her withholding in each payment period is at least as much as:

- a. One-fourth of his or her required annual payment; or
- b. His or her required annualized income installment for that period.

A taxpayer does not have to pay estimated tax if he or she will pay enough through withholding to keep the amount he or she owes with his or her tax return under \$1,000.

1114.21 How to pay estimated tax

There are five ways to pay estimated tax.

- a. Credit an overpayment on taxpayer's 2020 return to the 2021 estimated tax.
- b. Send in a payment (check or money order) with a payment voucher from Form 1040-ES.
- c. Pay electronically using the Electronic Federal Tax Payment System (EFTPS).
- d. Pay by electronic funds withdrawal if taxpayer is filing Form 1040 electronically.
- e. Pay by credit or debit card using a pay-by-phone system or the Internet.

1114.22 Credit an overpayment

If a taxpayer can show an overpayment of tax after completing Form 1040 for 2020, he or she can apply part or all of it to his or her estimated tax for 2021. On Form 1040, line 36, enter the amount the taxpayer wants credited to his or her estimated tax rather than refunded. The taxpayer will then take the amount the taxpayer has credited into account when figuring his or her estimated tax payments. A taxpayer cannot have any of the amount he or she credited to his or her estimated tax refunded to him or her until he or she files his or her tax return for the following year. The taxpayer also cannot use that overpayment in any other way.

1114.23 Pay by check or money order using the estimated tax payment voucher

Each payment of estimated tax by check or money order must be accompanied by a payment voucher from Form 1040-ES. If the taxpayer made estimated tax payments last year and did not use a paid preparer to file his or her return, he or she should receive a copy of the Form 1040-ES in the mail. It will contain payment vouchers preprinted with taxpayer's name, address, and Social Security Number. Using the preprinted vouchers will speed processing, reduce the chance of error, and help save processing costs. Use the window envelopes that came with the Form 1040-ES package. If a taxpayer uses his or her own envelopes, make sure he or she mails the payment vouchers to the address shown in the Form 1040-ES instructions for the place where he or she lives. Do not use the address shown in the Form 1040 instructions.

1114.24 Pay electronically

If a taxpayer wants to make estimated payments by using the Electronic Federal Tax Payment System (EFTPS), by electronic funds withdrawal, or by credit or debit card, go to www.irs.gov/e-pay for directions.

1114.25 Credit for withholding and estimated tax for 2020

When a taxpayer files his or her 2020 income tax return, take credit for all the income tax and excess Social Security or railroad retirement tax withheld from his or her salary, wages, pensions, etc. Also take credit for the estimated tax he or she paid for 2020. These credits are subtracted from the taxpayer's total tax. Because these credits are refundable, he or she should file a return and claim these credits, even if he or she does not owe tax.

1114.26 Underpayment penalty for 2020

If a taxpayer did not pay enough tax, either through withholding or by making timely estimated tax payments, he or she may have an underpayment of estimated tax and he or she may have to pay a penalty.

Generally, a taxpayer will not have to pay a penalty for 2020 if any of the following apply:

- a. The total of taxpayer's withholding and estimated tax payments was at least as much as his or her 2019 tax (or 110 percent of the 2019 tax if taxpayer's AGI was more than \$150,000, \$75,000 if his or her 2019 filing status was married filing separately) and the taxpayer paid all required estimated tax payments on time;
- b. The tax balance due on the 2020 return is no more than 10 percent of taxpayer's total 2020 tax, and taxpayer paid all required estimated tax payments on time;
- c. Taxpayer's total 2020 tax minus withholding and refundable credits is less than \$1,000;
- d. Taxpayer did not have a tax liability for 2019 and his or her 2019 tax year was 12 months; and
- e. Taxpayer did not have any withholding taxes and his or her current year tax less any household employment taxes is less than \$1,000.

1114.27 Installment payments of taxes owed

Those who owe taxes that they are unable to pay can set up an installment plan to make payments over time to pay their liability. An installment plan with the IRS costs the taxpayer more money because the IRS charges interest and penalties on the taxes that are not paid in full before the due date. The IRS encourages taxpayers who cannot pay their tax liability to explore less costly options. In order to enter into an installment agreement with the IRS, the taxpayer must file all required tax returns and determine the largest monthly payment the taxpayer can make (\$25 minimum). The IRS will apply future refunds to the taxpayer's tax debt until it is paid in full. The taxpayer uses Form 9465 to apply for an installment agreement.

1115 Previous IRS correspondence with taxpayer

In addition to reviewing prior year tax returns before preparing a tax return for a taxpayer, an Enrolled Agent should also review previous correspondence between the IRS and the taxpayer. This correspondence may include changes to a prior year tax return, additional tax or penalties owed, etc. It is important to review this information to determine whether the taxpayer owes tax from a previous year and whether the correspondence affects how the current year's tax return should be filed.

1116 Special filing requirements

1116.01 Enrolled agents should always note when special transactions, such as gifts, foreign income, and certain disasters necessitate the preparation of special IRS forms or returns in addition to the normal Form 1040 and its associated schedules. Certain gifts that a taxpayer makes would require filing Form 709 and sometimes paying a transfer tax on the amount of the gifted property. The receipt of foreign income might require special United States as well as foreign tax reporting.

1116.02 Casualty losses

Casualty losses are generally deductible in the year the casualty occurred. However, if a taxpayer has a casualty loss from a federally declared disaster that occurred in an area warranting public or individual assistance (or both), the taxpayer can choose to treat the loss as having occurred in the year immediately preceding the tax year in which the disaster happened, and the taxpayer can deduct the loss on his/her return or amended return for that preceding tax year.

- 1116.03** A casualty loss in a federally declared disaster area can result from the damage, destruction, or loss of property from any sudden, unexpected, or unusual event such as a flood, hurricane, tornado, fire, earthquake, or even volcanic eruption. A casualty does not include normal wear and tear or progressive deterioration. If the property is personal-use property or is not completely destroyed, the amount of the casualty loss is the lesser of:
- The adjusted basis of the property; or
 - The decrease in fair market value of the property as a result of the casualty.
- 1116.04** The loss must be reduced by any salvage value and by any insurance or other reimbursement received or expected to be received. The adjusted basis of the property is usually its cost, increased or decreased by certain events such as improvements or depreciation. A taxpayer may determine the decrease in fair market value by appraisal, or if certain conditions are met, by the cost of repairing the property.
- 1116.05** Individuals are required to claim their casualty losses as an itemized deduction on Form 1040, Schedule A. For property held for personal use, once any salvage value and any insurance or other reimbursement is subtracted, the taxpayer must subtract \$100 from each casualty or theft event that occurred during the year. Then, add up all those amounts and subtract 10 percent of the taxpayer's adjusted gross income from that total to calculate his or her allowable casualty and theft losses for the year.
- 1116.06** Special requirements for Form 1040-NR: Form 1040-NR is the standard IRS form for nonresident aliens: that is, those who are not United States residents and do not primarily live in the country but do have taxable U.S. income. Everyone who is not a U.S. citizen is considered either a resident alien or nonresident alien for tax purposes. A resident alien for 2020 is anyone who either holds a green card or spent at least 31 days in the U.S. during the year and 183 days during the 3-year period of 2020, 2019, and 2018. All other noncitizens are classified as nonresident aliens, as are those who qualify as resident aliens, but can establish they are more closely connected to another country in which they have a "tax home."

1116.07 Nonresident aliens must file 1040-NR if they meet any of four conditions: having engaged in a trade or business during the tax year; having other U.S. income such as dividends of interest; representing a deceased person who would have been eligible for the Form 1040-NR; or representing an estate or trust eligible for 1040-NR.

1117 Foreign Account and Asset Reporting (e.g., FBAR, Form 8938)

1117.01 Beginning on September 30, 2013, a taxpayer that has a financial interest in or signature authority over a foreign financial account, including a bank account, brokerage account, mutual fund, trust, or other type of foreign financial account, exceeding certain thresholds is required by the Bank Secrecy Act to report the account yearly to the Internal Revenue Service by filing electronically a Financial Crimes Enforcement Network (FinCEN) Form 114, *Report of Foreign Bank and Financial Accounts* (FBAR). This form is filed electronically with the Financial Crimes Enforcement Network (FinCEN).

The FBAR must be received by the Department of the Treasury **on or before April 15** of the year immediately following the calendar year being reported. FinCEN will grant filers failing to meet the FBAR annual due date of April 15 an automatic extension to October 15 each year. Accordingly, specific requests for this extension are not required.

The following individuals are required to file an FBAR:

- a United States person that has a financial interest in or signature authority over at least one financial account located outside of the United States; and
- the aggregate value of the foreign financial accounts exceeds \$10,000 (not equal to \$10,000) at any time during the calendar year.

1117.02 The FinCEN Form 114a, *Record of Authorization to Electronically File FBARs*, is not submitted with the filing, but instead is maintained with the FBAR records by the filer and the account owner and made available to FinCEN or the IRS on request.

1118 Kiddie Tax

1118.01 Unearned income of minor children for 2020 and beyond is reported on the parents' tax return and taxed at parents' marginal rate (called the "kiddie tax"). For 2018 and 2019, a child can choose between TCJA rules and pre-TCJA rules for computing the kiddie tax. This provision applies if:

- a. one of three age requirements is met:
 - 1) the child is under age 19 at year-end,
 - 2) the child is age 19 at year-end and did not have earned income that was more than half of the child's support, or
 - 3) the child is over age 18 and under age 24 at year-end, and a full-time student, and did not have earned income that was more than half of the child's support;
- b. the child has at least one living parent;
- c. the child has net unearned income of more than \$2,200 (for tax year 2020); and
- d. the child does not file a joint return for the year.

1119 ACA Net Premium Tax Credit or Repayment

1119.01 Taxpayers who are not eligible for a health insurance plan through their employer can purchase health insurance through a federal or state marketplace. The premium tax credit is in place to assist taxpayers who could not otherwise afford insurance. Taxpayers may qualify for the premium tax credit if their gross income is 100%-400% of the current poverty level.

1119.02 Individuals may qualify for the advanced premium tax credit based on projected income when enrolling in a health insurance plan through the federal or state marketplace. This advanced premium tax credit is paid directly to the health insurance provider in monthly installments during the year, lowering the taxpayer's required health insurance premium payments.

1119.03 Individuals who received the advanced premium tax credit or who may qualify for the premium tax credit must file Form 8962, *Premium Tax Credit (PTC)* to figure the premium tax credit and reconcile any advanced premium tax credit received during the year. Taxpayers who have a positive net premium tax credit (premium tax credit minus amount received during the year) can

include the net premium tax credit as a refundable credit. Taxpayers who received a greater advanced premium tax credit than allowed must repay the excess.

1200 Income and Assets

1211 Income

- 1211.01** Wages, salaries, and tips received by an employee for performing services for an employer must be included in the employee's gross income. Amounts withheld for taxes, including but not limited to income tax, Social Security, and Medicare taxes are considered "received" and must be included in gross income in the year they are withheld. Generally, an employer's contribution to a qualified pension plan for the taxpayer is not included in his or her gross income at the time it is contributed. However, amounts withheld under certain salary reduction agreements with the taxpayer's employer may have to be included in gross income in the year they are withheld.
- 1211.02** An employer should provide a Form W-2 showing the taxpayer's total income and withholding. The taxpayer must include all wages and withholdings from all Forms W-2 he or she receives, and if filing jointly, all of the taxpayer's spouse's Forms W-2. The taxpayer should attach a copy of each W-2 to the front of his or her tax return as indicated in the instructions.
- 1211.03** A taxpayer must include every increment to wealth in his or her gross income for federal tax purposes unless there is a specific statutory exclusion from gross income for a specific item. For example, a gift that a taxpayer receives is an increment to a taxpayer's wealth, but the Internal Revenue Code specifically provides that gifts are not taxable.
- 1211.04** All increments to wealth, unless they are statutorily excluded from tax, must be included in the taxpayer's income regardless whether he or she receives a W-2, K-1, or 1099 indicating that such income will be reported to the IRS. Although income is normally received in dollars, gross income includes the fair market value of property received or the amount of debt a taxpayer is relieved of.

1211.05 Most individuals use the cash basis method of accounting. Under the cash basis method of accounting, a taxpayer includes items on income in the years in which they are received. The term “received” includes actual receipt and constructive receipt. Constructive receipt occurs when a taxpayer is legally entitled to receive income. This concept applies to various types of income such as interest, compensation, and dividends.

1211.06 A taxpayer has constructive receipt on the first date he or she has a right to claim income. Thus, a taxpayer does not have to physically possess the income; it is considered received if it is credited to the taxpayer’s account or made available to the taxpayer. There is no constructive receipt if there are substantial limitations or restrictions on the taxpayer’s control of its receipt.

Example: Taxpayer received a paycheck on December 31, 20X1, but did not cash the check until sometime in January 20X2. The taxpayer must include the paycheck as income on her 20X1 tax return as the money was available to her in 20X1.

1211.07 Earned income includes all the taxable income and wages a taxpayer gets from working. There are two ways to get earned income: the taxpayer works for someone who pays him or her; or he or she works in a business he or she owns or runs. Taxable earned income includes:

- a.** Wages, salaries, tips, and other taxable employee pay;
- b.** Union strike benefits;
- c.** Long-term disability benefits received prior to minimum retirement age;
- d.** Net earnings from self-employment if:
 - (i) The taxpayer owns or operates a business, or
 - (ii) The taxpayer is a minister or member of a religious order.
- e.** Gross income received as a statutory employee.

- 1211.08** Examples of income that is **not** earned income include the following:
- a. Pay received for work while an inmate in a penal institution;
 - b. Interest and dividends;
 - c. Retirement income;
 - d. Social Security;
 - e. Unemployment benefits;
 - f. Alimony; and
 - g. Child support.
- 1211.09** If a taxpayer works as an employee in the United States, he or she must pay Social Security and Medicare taxes in most cases. The taxpayer's payments of these taxes contribute to his or her coverage under the U.S. Social Security system. An employer deducts these taxes from each wage payment. In general, U.S. Social Security and Medicare taxes apply to payments of wages for services performed as an employee in the United States, regardless of the citizenship or residence of either the employee or the employer.
- 1211.10** The United States has entered into totalization agreements with certain foreign countries to coordinate the taxation of United States citizens employed for part or all of their working careers in certain foreign countries and the taxation of foreign citizens from certain countries working in the United States. These agreements are commonly referred to as "totalization agreements." Under these agreements, dual coverage and dual contributions (taxes) for the same work are eliminated. The agreements generally make sure that Social Security taxes (including self-employment tax) are paid only to one country. These agreements must be taken into account when determining whether any alien is subject to the U.S. Social Security/Medicare tax, or whether any U.S. citizen or resident alien is subject to the Social Security taxes of a foreign country.

1211.11 The United States has an “extraterritorial” income tax, in that an American citizen or a resident of the United States must report all income regardless where it is earned. Thus, a United States citizen living and working in Canada must report and pay tax on all his or her income to the United States.

1211.12 Generally, a taxpayer is in constructive receipt of income when interest is posted to his or her savings or checking account regardless of whether the taxpayer withdraws or spends the interest. A taxpayer who owns a certificate of deposit (CD) or some other deferred interest account will be paid interest one or more times per year, or in one lump sum at maturity. The taxpayer must report the interest as income when he or she actually receives it or when he or she can withdraw money from the CD **without paying** a substantial penalty.

If a taxpayer withdraws funds from a deferred interest account before it matures and he or she pays an early withdrawal penalty, the taxpayer must report the total amount of interest paid during the year **without subtracting** the penalty.

1211.13 Interest Income

Generally, all interest received is taxable. Interest on state and municipal obligations is, however, excluded from gross income. Interest on U.S. Savings Bonds may be reported in the year accrued or postponed until the year of surrender by a cash-basis taxpayer.

Original issue discount (OID)

Original issue discount (OID), a form of interest, is the excess of an obligation’s stated redemption price at maturity over its issue price (acquisition price for a stripped bond or coupon). A discount of less than 1/4 of 1 percent of the stated redemption price at maturity, multiplied by the number of full years from the date of issue to maturity, is considered to be zero. Original issue discount can apply to securities, such as bonds, debentures, notes, or certificates and is the difference between the maturity, or face value, of the security and the original cost to purchase the security. The original issue discount is important because the IRS uses special rules for determining them. Taxpayers receive the amount of their original issue discount on Form 1099-OID.

The issuer will prepare a Form 1099-OID for each person who is a holder of record of the obligation if the OID includible in the holder's gross income is \$10 or more and the debt instrument term is at least one year.

A taxpayer may be able to exclude from income all or part of the interest they receive on the redemption of qualified U.S. savings bonds during the year if the taxpayer pays qualified higher educational expenses during the same year. This exclusion is known as the Education Savings Bond Program.

1211.14**Dividends of cash or property:**

- a.** Dividends are distributions of cash or property from corporation to their shareholders. Generally, dividends are taxable when received. Federal law requires a corporation to inform the shareholder as to taxable and nontaxable amounts.
- b.** Dividends paid on deposits with the following: mutual savings banks, cooperative banks, credit unions, U.S. building and loan associations, and other similar institutions are not considered dividends. These are interest and should be reported as such.
- c.** There are two types of dividends.
 - 1) Ordinary dividends are paid out of the earnings and profits of a corporation. They are the most common type of dividends and taxed at the taxpayer's ordinary tax rate, along with most other income.
 - 2) Qualified dividends are subject to a lower tax rate than ordinary dividends. The qualified dividend tax rates are 0% for amounts that would be taxed at 10% or 15%, 15% for amounts that would be taxed at 15%-37%, and 20% for amounts that would be taxed at higher rate than 37%. Use the worksheet included with Schedule D instructions to figure the qualified dividends tax rate. To be a qualified dividend, the dividend must have been paid by a U.S. corporation or qualified foreign corporation, the taxpayer must meet the holding period (generally greater than 60 days during the 121-day period beginning 60 days before the first date

following the declaration of a dividend on which the buyer cannot receive the next dividend payment, or the ex-dividend date), and the dividend cannot be one of the following:

- i. Capital gain distributions
- ii. "Dividends" that are actually interest (discussed in (b) above)
- iii. Dividends on employer securities paid by a corporation and held by an employee stock ownership plan (ESOP)
- iv. Dividends on stock for which the taxpayer is required to purchase substantially similar or related property
- v. Payments in lieu of dividends (if the taxpayer knows or has reason to know that the payments are not qualified dividends)
- vi. Dividends reported as qualified dividends from a foreign corporation to the extent the taxpayer knows or has reason to know that these are not qualified dividends

3) Capital gain distributions are paid by regulated investment companies (RICs) and real estate investment trusts (REITs). These are always reported as long-term capital gains and must be reported even if undistributed.

- d. Individuals with modified adjusted gross income over certain threshold amounts must pay the Net Investment Income Tax (NIIT) if they have net investment income. This is a 3.8% tax on the lesser of net investment income or the modified adjusted gross income (MAGI). The threshold amount for 2020 is \$250,000 for joint returns, \$125,000 for married filing separate returns, and \$200,000 for other filing statuses. The Net Investment Income Tax is a contribution to Medicare and is calculated/reported on Form 8960, *Net Investment Income Tax – Individuals, Estates, and Trusts*.

- e. If the taxpayer has a choice of stock or cash:
 - 1) Any cash received is income.
 - 2) Any stock received is income to the extent of the fair market value of the stock on the date received.
 - i. The basis of the new stock is also the fair market value of the stock.
 - ii. The holding period for the new stock begins on the date the dividend is received.
- f. Stock dividends that do not result in a disproportionate distribution are not considered income. Likewise, stock splits do not produce income for the shareholders.
 - 1) The basis of original shares must be allocated between the new and the original shares.
 - 2) The holding period of the acquired stock is the same as that of the old stock.
- g. Any distribution of stock or stock rights made to preferred shareholders is taxable as a dividend.
 - 1) The fair market value of the property received constitutes income and establishes the basis of that property.
 - 2) The holding period for this property begins at the date of receipt.
- h. Property received as a dividend is income.
 - 1) The fair market value of the property on the date of distribution constitutes income.
 - 2) The basis of the property is also equal to the fair market value.
 - 3) The holding period of the property acquired begins on the date the property is received.
- i. Amounts received in a partial or complete liquidation are treated as follows:
 - 1) A return of capital until the taxpayer's investment is recovered.
 - 2) A capital gain on amounts received after the taxpayer's investment is recovered.

1211.15 Rents and royalties:

- a.** Royalties are included in gross income when received.
- b.** Rental income is any payment received for the use or occupation of property. A taxpayer must include in gross income all amounts that are received as rent.
 - 1) Rent is taxable when received if the taxpayer uses the cash basis; or when accrued, if the taxpayer uses the accrual basis. Any amount received from a tenant to cancel a lease is treated as rent and included in income.
 - 2) If a tenant pays any of the taxpayer's expenses, the payments are rental income and included in income.
 - 3) Prepaid rental income (i.e., advance rent) is recognized in the year received whether the taxpayer is on the accrual or cash basis.
- c.** Security deposits are not included in rental income if the amount is to be returned to the tenant at the end of the lease. If the taxpayer keeps part or all of the security deposit during any year because the tenant does not live up to the terms of the lease, the amount retained becomes income for that year.
- d.** If an amount called a security deposit is to be used as a final payment of rent, it is advance rent, and as such, it is included as rental income in the year that it is received.
- e.** Rental of personal residence:
 - 1) When a personal residence is rented out for less than 15 days, no rental income is recognized and expenses are not required to be prorated between personal use and rental use.
 - 2) When a personal residence is rented out for more than 14 days, the rental income is recognized and the expenses must be allocated between personal use and rental use. A portion of mortgage interest and real estate taxes must be allocated to reduce the rental income. Taxpayers cannot deduct a loss from renting a personal residence.

1211.16 Gambling winnings and losses:

- a. All gambling winnings are included in gross income.
- b. Losses are deductible as an itemized deduction, but only to the extent of winnings. Under the Tax Cuts and Jobs Act of 2017 (TCJA), the law is clarified: for example, an individual's expenses traveling to and from a casino are only deductible to the extent of gambling winnings. That is, there is no separate deduction for expenses incurred in winning the gambling income.

1211.17 Tax treatment for forgiveness of debt

In general, if a taxpayer is liable for a debt that is canceled, forgiven, or discharged, he or she will receive a Form 1099-C, *Cancellation of Debt*, and must include the amount of the canceled debt in gross income unless he or she qualifies for an exception under §108. For example, §108 provides that if the debtor is insolvent or in bankruptcy, he or she need not include the cancelled debt in income. If the taxpayer receives a Form 1099-C, but the creditor continues to attempt to collect the debt, then the creditor has not cancelled the debt and the taxpayer does not have taxable cancellation of debt income at that time. One exception to this rule is debt forgiveness associated with PPP loans. The Tax Relief Act of 2020 clarified that PPP loan forgiveness will not generate income from cancellation of debt. Additionally, the taxpayer will not have to decrease any tax attributes as a result of nonrecognition of income.

1211.18 A debt includes any indebtedness whether the taxpayer is personally liable or liable only to the extent that he or she owns the property securing the debt. Cancellation of all or part of a debt that is secured by property may occur because of a foreclosure, a repossession, a voluntary return of the property to the lender, abandonment of the property, or a loan modification. The taxpayer must report any taxable amount of a cancelled debt for which he or she is personally liable, as ordinary income from the cancellation of debt. The taxpayer must report as taxable amount of a discharged or forgiven debt whether or not he or she receives a Form 1099-C (exception PPP loan forgiveness, see above).

1211.19 If a taxpayer's debt is secured by property and that property is taken by the lender in full or partial satisfaction of the debt, the taxpayer will be treated as having sold that property and may have a reportable gain or loss. The gain or loss on such a deemed sale of property is a separate issue from whether any canceled debt also associated with that same property is includable in gross income.

1211.20 Canceled debts that meet the requirements for any of the following exceptions or exclusions are not taxable:

- a. Amounts specifically excluded from income by law such as gifts or bequests;
- b. Cancellation of certain qualified student loans;
- c. Canceled debt that if paid by a cash basis taxpayer is otherwise deductible; and
- d. A qualified purchase price reduction given by a seller.

1211.21 Canceled debts that qualify for **exclusion** from gross income are as follows:

- a. Cancellation of qualified principal residence indebtedness;
- b. Debt canceled in a Title 11 bankruptcy case;
- c. Debt canceled during insolvency;
- d. Cancellation of qualified farm indebtedness; and
- e. Cancellation of qualified real property business indebtedness.
- f. Cancellation of debt associated with PPP loans

- 1211.22** The exclusion for “qualified principal residence indebtedness” provides canceled debt tax relief for many American homeowners involved in the mortgage foreclosure crisis that affected much of the country. The exclusion allows taxpayers to exclude up to \$2,000,000 (\$1,000,000 if married filing separately) of “qualified principal residence indebtedness.” This provision expired at the end of 2017, but now is extended to January 1, 2021 and applies retroactively to 2018 and 2019. After January 1, 2021, the Consolidations and Appropriations act extended this provision, but lowered the exclusion limit to \$750,000 for married filing jointly taxpayers or \$375,000 for those filing married filing separately.
- 1211.23** Generally, if a taxpayer excludes canceled debt from income under one of the exclusions listed above, he or she must also reduce his or her tax attributes (certain credits, losses, and basis of assets) by the amount excluded. The taxpayer must file Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*, to report the exclusion and the corresponding reduction of certain tax attributes.
- 1211.24** Tax treatment of a U.S. citizen/resident with foreign earned income: If a taxpayer meets certain requirements, he or she may qualify for the foreign earned income, foreign housing exclusions, and the foreign housing deduction. A U.S. citizen or a resident alien of the United States who lives abroad is taxed on his or her worldwide income. However, the taxpayer may qualify to exclude from income up to \$107,600 in 2020. In addition, a taxpayer can exclude or deduct certain foreign housing amounts.

1211.25 To claim the foreign earned income exclusion, the foreign housing exclusion, or the foreign housing deduction, a taxpayer must meet all three of the following requirements.

- a. The taxpayer's tax home must be in a foreign country;
- b. The taxpayer must have foreign earned income; and
- c. The taxpayer must be one of the following:
 - (i) A U.S. citizen who is a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire tax year,
 - (ii) A U.S. resident alien who is a citizen or national of a country with which the United States has an income tax treaty in effect and who is a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire tax year, or
 - (iii) A U.S. citizen or a U.S. resident alien who is physically present in a foreign country or countries for at least 330 full days during any period of 12 consecutive months.

1211.26 Tax home in a foreign country

To qualify for the foreign earned income exclusion, the foreign housing exclusion, or the foreign housing deduction, the taxpayer's tax home must be in a foreign country throughout his or her period of bona fide residence or physical presence abroad.

1211.27 Tax home

If a taxpayer does not have a regular or main place of business because of the nature of his or her work, the taxpayer's tax home may be the place where he or she regularly lives. If the taxpayer has neither a regular or main place of business nor a place where he or she regularly lives, the taxpayer is considered an itinerant and his or her tax home is wherever he or she works.

1211.28 Temporary or indefinite assignment

The location of a taxpayer's tax home often depends on whether his or her assignment is temporary or indefinite. If he or she is temporarily absent from his or her tax home in the United States on business, he or she may be able to deduct his or her away-from-home expenses (for travel, meals, and lodging), but he or she would not qualify for the foreign earned income exclusion. If his or her new work assignment is for an indefinite period, his or her new place of employment becomes his or her tax home and he or she would not be able to deduct any of the related expenses that he or she has in the general area of this new work assignment. If his or her new tax home is in a foreign country and he or she meets the other requirements, his or her earnings may qualify for the foreign earned income exclusion. If he or she expects his or her employment away from home in a single location to last, and it does last, for one year or less, it is temporary unless facts and circumstances indicate otherwise. If he or she expects it to last for more than one year, it is indefinite. If the taxpayer expects it to last for one year or less, but at some later date he or she expects it to last longer than one year, it is temporary (in the absence of facts and circumstances indicating otherwise) until his or her expectation changes. Once his or her expectation changes, it is indefinite.

1211.29 Foreign country

To meet the bona fide residence test or the physical presence test, a taxpayer must live in or be present in a foreign country. A foreign country includes any territory under the sovereignty of a government other than that of the United States.

1211.30 Bona fide residence test

A taxpayer meets the bona fide residence test if he or she is a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire tax year. The taxpayer can use the bona fide residence test to qualify for the exclusions and the deduction only if he or she is either:

- a. A U.S. citizen; or
- b. A U.S. resident alien who is a citizen or national of a country with which the United States has an income tax treaty in effect.

1211.31 A taxpayer does not automatically acquire bona fide resident status merely by living in a foreign country or countries for one year. If a taxpayer goes to a foreign country to work on a particular job for a specified period of time, he or she ordinarily will not be regarded as a bona fide resident of that country even though he or she works there for one tax year or longer. The length of his or her stay and the nature of his or her job are only two of the factors to be considered in determining whether he or she meets the bona fide residence test.

1211.32 To meet the bona fide residence test, a taxpayer must have established a bona fide residence in a foreign country. A taxpayer's bona fide residence is not necessarily the same as his or her domicile. A taxpayer's domicile is their permanent home, the place to which he or she always returns or intends to return.

Example: A taxpayer could have his or her domicile in Cleveland, Ohio, and a bona fide residence in Edinburgh, Scotland, if he or she intends to return eventually to Cleveland. The fact that a taxpayer goes to Scotland does not automatically make Scotland his or her bona fide residence. If he or she goes there as a tourist, or on a short business trip, and returns to the United States, he or she has not established bona fide residence in Scotland. But if he or she goes to Scotland to work for an indefinite or extended period and he or she sets up permanent quarters there for himself or herself and his or her family, he or she probably has established a bona fide residence in a foreign country, even though he or she intends to return eventually to the United States.

1211.33 The taxpayer is clearly not a resident of Scotland in the first instance. However, in the second, he or she is a resident because his or her stay in Scotland appears to be permanent. If his or her residency is not as clearly defined as either of these illustrations, it may be more difficult to decide whether he or she has established a bona fide residence.

1211.34 Physical presence test

A taxpayer meets the physical presence test if he or she is physically present in a foreign country or countries 330 full days during a period of 12 consecutive months. The 330 days do not have to be consecutive. Any U.S. citizen or resident alien can use the physical presence test to qualify for the exclusions and the deduction.

The physical presence test is based only on how long a taxpayer stays in a foreign country or countries. This test does not depend on the kind of residence he or she establishes, his or her intentions about returning, or the nature and purpose of his or her stay abroad.

Generally, to meet the physical presence test, a taxpayer must be physically present in a foreign country or countries for at least **330 full days** during a 12-month period. The taxpayer can count days he or she spent abroad for any reason.

1211.35 Foreign earned income

To claim the foreign earned income exclusion, the foreign housing exclusion, or the foreign housing deduction, a taxpayer must have foreign earned income. Foreign earned income generally is income a taxpayer receives for services he or she performs during a period in which he or she meets both of the following requirements:

- a.** His or her tax home is in a foreign country; and
- b.** He or she meets either the bona fide residence test or the physical presence test.

1211.36 Earned income

This is pay for personal services performed, such as wages, salaries, or professional fees. The list that follows classifies many types of income into three categories. The column headed *Variable Income* lists income that may fall into either the earned income category, the unearned income category, or partly into both.

Earned Income	Unearned Income	Variable Income
Salaries and wages	Dividends interest	Business profits
Commissions	Capital gains	Royalties
Bonuses	Gambling winnings	Rents
Professional fees	Alimony	Scholarships and fellowships
Tips	Social Security benefits	
	Pensions	
	Annuities	

1212 Other Income**1212.01 Scholarships and fellowships**

- a. A degree candidate may exclude scholarships and fellowships to the extent the amount received is used for tuition, course fees, books, and supplies. Amounts used for room and board are taxable.
- b. Amounts received are taxable if specific services, such as teaching, are required to receive the scholarship or fellowship.
- c. Any amount paid to a nondegree candidate is taxable.

1212.02 Bartering income

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

- b. Generally, a taxpayer reports this income on Form 1040, Schedule C, *Profit or Loss from Business*. If a taxpayer failed to report this income, he or she should correct his or her return by filing a Form 1040X.
- c. A barter exchange or barter club is any organization with members or clients or persons who contract with each other (or with the barter exchange) to jointly trade or barter property or services. The term does not include arrangements that provide solely for the informal exchange of similar services on a noncommercial basis.
- d. The Internet has provided a medium for new growth in the bartering exchange industry. This growth prompts the following reminder: barter exchanges are required to file Form 1099-B for all transactions unless they meet certain exceptions. Persons who do not contract a barter exchange, but who trade services, are not required to file Form 1099-B. However, they may be required to file Form 1099-MISC. If a taxpayer is in a business or trade, he or she may be able to deduct certain costs incurred to perform the work that was bartered. If a taxpayer exchanged property or services through a barter exchange, he or she should receive a Form 1099-B, *Proceeds from Broker and Barter Exchange Transactions*. The IRS also will receive the same information.

1212.03**Hobby income**

- a. The TCJA of 2017 eliminates the itemized deduction for hobby expenses. Some expenses, however, are deductible regardless of hobby income. These would include all expenses to which the taxpayer is normally entitled as a personal deduction, such as interest, taxes, and casualty losses.
- b. A hobby may be treated as a business if it meets the following profitability tests:
 - 1) A profit is generated in three out of five consecutive years.
 - 2) A profit is generated in two out of seven consecutive years for breeding, training, showing, or racing horses.

- c. If facts and circumstances can prove an intent to make a profit, the activity may still be considered a business after failing the above test. However, the burden of proof is on the taxpayer.

1212.04 Alimony and separate maintenance payments

Note: The TCJA of 2017 changes the treatment of alimony and separate maintenance payments negotiated after December 31, 2018. (see f below)

- a. Excluding the portion that is designated for child support, qualified payments are included in the gross income of the recipient and deductible from gross income by the payor if the payments are made after:
 - 1) Decree or divorce or separate maintenance,
 - 2) Written separation agreement, or
 - 3) Decree for support (this applies to periods pending finality of divorce or legal separation).
- b. Qualified payments are required to meet the following guidelines:
 - 1) Payments must be in cash.
 - 2) Payments must terminate at the death of the recipient.
 - 3) Payments cannot be made to a payee who lives in the same household as the payor.
 - 4) Payments cannot be specified as something other than alimony.
- c. Special rules apply if alimony payments in the second- or third-year decrease by more than \$15,000 from the payments made in the previous year.
 - 1) If the change in payments exceeds statutory limits, recapture of excessive alimony payments will result.
 - 2) All of the recapture will take place in the third year.
 - i. The payor must include the excess amounts in gross income.
 - ii. The payee is allowed to deduct the excess payments from gross income to arrive at adjusted gross income.

- d. Any amount that can be identified as child support cannot be treated as alimony.
 - 1) Child support payments are neither deductible by the payor nor income to the recipient
 - 2) If both child support and alimony are provided for in the agreement, any amounts paid are first considered to be child support until that obligation is met.
- e. The transfer of property between divorcing spouses in exchange for release from marital obligations is nontaxable. The basis of the transferred property to the transferee will be the same as it was to the transferor.
- f. For any divorce or separation agreement executed after December 31, 2018, or executed before that date but modified after it (if the modification expressly provides that the new amendment applies), alimony and separate maintenance payments are not deductible by the payor spouse nor includible in income of the payee spouse.

1212.05**Military combat pay**

- a. U.S. Armed Forces members, including enlisted persons or warrant officers, may exclude military pay received for military services for the entire month of any month while serving in a combat zone. Commissioned officers are capped at the highest enlisted pay, plus any hostile fire or imminent danger pay received.
- b. Military pay received by enlisted personnel who are hospitalized as a result of injuries sustained while serving in a combat zone is excluded from gross income for the period of hospitalization.
- c. Reenlistment bonuses received are excluded from gross income if the member reenlists early while in a combat zone even if the bonus is not received until several months later while stationed outside the combat zone.

- d. Deadlines, including filing and paying income tax due, are automatically extended for service persons in a combat zone.

1212.06**Canceled debt:**

- a. Generally, a canceled debt is income to the debtor when the cancellation is not intended to be a gift.
- b. The presence or absence of consideration is a vital factor in determining whether or not a gift was intended.
- c. When a seller cancels a buyer's purchase indebtedness, the buyer can generally avoid income recognition by electing to reduce the basis of the property by the amount of the debt discharged.
- d. Discharge of indebtedness due to debtor insolvency or federal bankruptcy law is generally not included in gross income but is used instead to reduce the basis of assets or other items carrying favorable tax attributes, such as loss or credit carryovers.
- e. A shareholder's cancellation of a corporation's indebtedness is treated as a contribution of capital.
- f. Some states make loans to students under an agreement that the loan will be canceled if the student works in a certain profession, in a location within the state after graduation.
 - 1) The canceled debt is excluded from gross income.
 - 2) This exclusion also applies to loans from tax-exempt charitable organizations. However, the debt cancellation cannot relate to services performed for the lender organization.
 - 3) The TCJA of 2017 excludes any income resulting from the discharge of student debt due to death or disability for discharges of student loans after 2017 and before 2026.

1213 Constructive receipt of income

1213.01 An accounting method is a set of rules used to determine when and how income and expenses are reported. A taxpayer's accounting method includes not only the overall method of accounting he or she uses, but also the accounting treatment he or she uses for any material item.

1213.02 A taxpayer chooses an accounting method for his or her business when he or she files his or her first income tax return that includes a Schedule C for the business. After that, if a taxpayer wants to change his or her accounting method, he or she must generally get IRS approval.

Generally, a taxpayer can use any of the following accounting methods:

- a. Cash method;
- b. An accrual method;
- c. Special methods of accounting for certain items of income and expenses; or
- d. Combination method using elements of two or more of the above.

A taxpayer must use the same accounting method to figure his or her taxable income and to keep his or her books and must use an accounting method that clearly shows his or her income.

1213.03 A taxpayer can account for business and personal items under different accounting methods. For example, a taxpayer can figure business income under an accrual method, even if he or she uses the cash method to figure personal items. If a taxpayer has two or more separate and distinct businesses, he or she can use a different accounting method for each if the method clearly reflects the income of each business. They are separate and distinct only if he or she maintains complete and separate books and records for each business.

1213.04 Cash method

Most individuals and many sole proprietors with no inventory use the cash method because they find it easier to keep cash method records. However, if an inventory is necessary to account for income, the taxpayer must generally use an accrual method of accounting for sales and purchases.

Under the cash method, the taxpayer should include in gross income all items of income he or she actually or constructively received during his or her tax year. If a taxpayer receives property or services, he or she must include their fair market value in income.

Example: On December 30, 20X1, Mrs. Sycamore sent taxpayer a check for interior decorating services the taxpayer provided to her. The taxpayer received the check on January 2, 20X2. The taxpayer must include the amount of the check in income for 20X2.

A taxpayer has constructive receipt of income when an amount is credited to his or her account or made available to him or her without restriction. The taxpayer does not need to have possession of it. If the taxpayer authorizes someone to be his or her agent and receives income for the taxpayer, he or she is treated as having received it when his or her agent received it.

Example: Interest is credited to a taxpayer's bank account in December 20X1. The taxpayer does not withdraw it or enter it into his or her passbook until 20X2. The taxpayer must include it in his or her gross income for 20X1.

1213.05 Delaying receipt of income: A taxpayer cannot hold checks or postpone taking possession of similar property from one tax year to another to avoid paying tax on the income. The taxpayer must report the income in the year the property is received or made available to him or her without restriction.

Example: Frances Jones, a service contractor, was entitled to receive a \$10,000 payment on a contract in December 20X1. She was told in December that her payment was available. At her request, she was not paid until January 20X2. She must include this payment in her 20X1 income because it was constructively received in 20X1.

1213.06 Checks: Receipt of a valid check by the end of the tax year is constructive receipt of income in that year, even if the taxpayer cannot cash or deposit the check until the following year.

Example: Dr. Redd received a check for \$500 on December 31, 20X1. She could not deposit the check in her business account until January 3, 20X2. She must include this fee in her income for 20X1.

1214 Passive income

1214.01 In order to understand the rules dealing with rental income and expenses, it is necessary to understand how the passive activity loss rules work. The passive activity loss rules (§469 of the Internal Revenue Code) limits the taxpayer's ability to deduct losses from businesses in which he or she does not materially participate and from rental activities. The passive activity loss rules are applied at the individual level and extend to virtually every business or rental activity whether reported on Schedule C, Schedule F, or Schedule E of the Form 1040, as well as to flow-through income and losses from partnerships, S corporations, and trusts. The passive loss limitations also apply to personal service corporations and to closely held C corporations, but with limited applications.

1214.02 In general, losses generated by passive activities can only be used to offset income generated by passive activities. A passive activity is an activity for the tax year if the activity is a trade or business activity in which the taxpayer does not materially participate for such taxable year or is a rental activity, without regard to whether or to what extent the taxpayer participates in the activity.

1214.03 Section 469 generally divides a taxpayer's income and losses into three types, which relate to the three types of activities provided for under §469:

1. Passive;
2. Active; and
3. Portfolio.

1214.04 Section 469 provides that passive losses may only be used to offset passive income and expenses related to passive activities can be deducted only to the extent of income from all of the taxpayer's passive activities. Passive losses that cannot be used to offset other income are suspended and carried forward to offset

passive income in a subsequent year. Suspended passive losses may also offset portfolio or active income when the taxpayer disposes of his or her entire interest in the activity that generated the suspended passive losses.

1214.05 When the taxpayer makes a full and complete disposition of a passive activity with suspended losses, the losses are used to offset income in the following order:

1. Gain on the disposition of the passive activity.
2. Net income from any of the taxpayer's passive activities.
3. All other income -- active and portfolio income.

1214.06 **Activities that are generally passive:** Income and losses from the following activities are generally passive:

1. Rental real estate (except rentals in which a real estate professional materially participates) and equipment leasing.
2. Sole proprietorship or a farm in which the taxpayer does not materially participate.
3. Limited partnership interest, with some exceptions.
4. Partnership, S corporation, and limited liability company business in which the taxpayer does not materially participate.

1214.07 **Activities that are generally non-passive:** Income and losses from the following are generally non-passive:

1. Salaries, wages, and Form 1099-MISC commissions.
2. Guaranteed payments from partnerships.
3. Portfolio income (interest, dividends, royalties, gains on stocks and bonds).
4. Sale of undeveloped land or other investment property.
5. Royalties.

6. Sole proprietorship or farm in which the taxpayer materially participates.
7. Partnership, S corporation, or LLC business in which the taxpayer materially participates.

1214.08 **Portfolio income:** Passive activity gross income does not include portfolio income, which includes all gross income other than income derived in the ordinary course of a trade or business that is attributable to the following:

- Interest.
- Dividends.
- The disposition of property that produces interest.
- Gross income derived in the ordinary course of a trade or business.
- The disposition of property held for investment.
- Royalties.

1214.09 **Definition of passive activity loss:** Generally, a taxpayer's passive activity loss for the tax year is the excess of his or her passive activity deductions over his or her passive activity gross income. Closely held corporations can offset net active income with passive activity losses but cannot use passive losses to offset their portfolio income. Portfolio income is interest, dividends, annuities, and royalties not derived in the ordinary course of a trade or business. For a closely held corporation, the passive activity loss is the excess of passive activity deductions over the sum of passive activity gross income and net active income.

A trade or business activity is not a passive activity if the taxpayer materially participated in the activity.

1214.10

Material participation tests: A taxpayer materially participated in a trade or business activity for a tax year if he or she satisfies any one of the following tests:

1. He or she participated in the activity for more than 500 hours.
2. His or her participation was substantially all the participation in the activity of all individuals for the tax year, including the participation of individuals who did not own any interest in the activity.
3. He or she participated in the activity for more than 100 hours during the tax year, and he or she participated at least as much as any other individual (including individuals who did not own any interest in the activity) for the year.
4. The activity is a significant participation activity, and the taxpayer participated in all significant participation activities for more than 500 hours. A significant participation activity is any trade or business activity in which the taxpayer participated for more than 100 hours during the year and in which he or she did not materially participate under any of the material participation tests, other than this test.
5. The taxpayer materially participated in the activity for any five (whether or not consecutive) of the ten immediately preceding tax years.
6. The activity is a personal service activity in which the taxpayer materially participated for any three (whether or not consecutive) preceding tax years. An activity is a personal service activity if it involves the performance of personal services in the fields of health (including veterinary services), law, engineering, architecture, accounting, actuarial science, performing arts, consulting, or any other trade or business in which capital is not a material income-producing factor.
7. Based on all the facts and circumstances, the taxpayer participated in the activity on a regular, continuous, and substantial basis during the year.

1214.11 Documenting material participation: An individual may establish his or her participation in an activity by any reasonable means. Reasonable means may include, for example, the identification of services performed over a period of time and the number of hours spent performing such services based on appointment books, calendars, or narrative summaries. An individual is not required to maintain contemporaneous daily time reports, logs, or similar documents, provided he or she can otherwise substantiate the level of his or her participation in an activity.

1215 **Pass through entities**

1215.01 Certain domestic corporations may elect not to be taxed. Instead, the corporation makes an “S election” and income is passed through to the stockholders, who are taxed on their share of the corporation’s earnings. Stockholders are taxed on their share of the earnings even though the earnings are not distributed.

1215.02 Shareholders must include on their personal tax returns their share of the S corporation’s income or loss and special items from the corporate tax year that has ended with or within the shareholder’s tax year. Thus, income is reported and recognized on a basis similar to but not the same as that of partnerships.

- a. When ownership has changed during the year, each owner must recognize their share of income on a per-share per-day of ownership allocation.
- b. Loss pass-throughs in excess of the taxpayer’s basis in the corporation may be carried forward indefinitely and deducted when the taxpayer’s basis is increased sufficiently, either by the corporation’s income or a contribution of capital, to absorb the loss.

1215.03

Distributions of cash and property are basically given the same treatment. Shareholders must recognize as a distribution the amount of cash and the fair market value of any property distributed.

- a. The taxability of a distribution is determined by its source.
- b. Distributions from an S corporation come from the following sources in the order listed:
 - 1) Distributions are first considered to come from an “accumulated adjustments account” (AAA).
 - i. The AAA represents income earned after 1982 adjusted by any additions and subtractions that shareholders were required to make to the basis of their stock for this period. However, no adjustment is made for the following:
 - 1. Tax-exempt income
 - 2. Corporate expenses not deductible in computing taxable income and not chargeable to a capital account
 - ii. Distributions from the AAA are nontaxable.
 - 2) Distributions are then considered as dividends to the extent of any accumulated earnings and profits (E&P) from a time when the corporation’s S election was not in effect (provided the entity was a C corporation prior to electing S status. If the entity elects S status immediately after formation, the entity would not have any Accumulated E&P).
 - 3) When E&P is exhausted, distributions are a return of capital to the extent of the shareholder’s stock basis, and then capital gain.
- c. If an S corporation distributes appreciated property to a shareholder, the transfer is treated as if the property had been sold to the shareholder at fair market value.
 - 1) A gain is recognized at the corporate level.
 - 2) The gain is subsequently passed through to the shareholders, each of whom reports the percentage of the gain equal to her or his percentage ownership of the corporation’s shares.

1215.04

Before 2018, partnerships were not taxable entities. They were reporting entities. Partnerships functioned as a conduit for income tax purposes and passed all items of income, deduction, gain, loss, and credits through to the partners.

- a. Ordinary income and losses along with special gain and loss items channel through the partnership to the partners, who report these items on their tax returns. In addition to individuals, partners can be corporations, trusts, other partnerships, and estates.
- b. The partnership must report each partner's distributive share of the ordinary gain or loss as well as any specially treated items that the partner might use on an individual return.
- c. Self-employment taxes apply to all ordinary income passing to the owners.
- d. Beginning with tax year 2018, new rules for auditing partnerships and assessing tax deficiencies will apply. The new rules are commonly referred to as the "partnership audit regime" and they provide, among other items:
 - 1) a requirement that a partnership appoint a "partnership representative" who will act for the partnership in all matters involving the IRS.
 - 2) that a tax deficiency arising from an audit of a partnership is a liability of the partnership, not the partners.
 - 3) elections to deal with issues created by the new rules, such as assessing and collecting a partner's share of a tax deficiency.
 - 4) a procedure for a small partnership to elect out and remain covered by the TEFRA (Tax Equity and Fiscal Responsibility Act of 1982) rules.

1216 Itemized deduction recoveries**1216.01 State and/or Local tax refund**

If the taxpayer received a state or local income tax refund in 2020, the taxpayer generally must include it in income if the tax was previously deducted. The state or local agency should send a Form 1099-G by January 31, 2021 to the taxpayer. The IRS will also receive a copy of the Form 1099-G. The maximum refund that you may have to include in income is limited to the excess of the tax the taxpayer deducted for the year.

1216.02 Mortgage interest refund

If the taxpayer received a refund or credit of mortgage interest paid in an earlier year, the amount should be included in Form 1098 received from the mortgage servicer. The amount refunded is not subtracted from the interest paid; it is instead reported as income.

1216.03 Interest on recovery

Interest on any amounts the taxpayer recovers must be reported as interest income in the year received.

1216.04 Deductions not itemized

If the taxpayer did not itemize their deductions for the year which the recovery was received, the amounts are not included in income.

1217 1099 Reporting**1217.01 1099 Reporting requirements:****a. 1099-MISC**

This is the most common form used. The following are the items reported on this form:

- 1) At least \$10 in royalties or broker payments in lieu of dividends or tax-exempt interest;
- 2) At least \$600 in:
 - i. Rents;
 - ii. Prizes and awards;
 - iii. Other income payments;
 - iv. generally, the cash paid from a notional principal contract to an individual, partnership, or estate.
 - v. Any fishing boat proceeds
 - vi. Medical and health care payments;
 - vii. Crop insurance proceeds;
 - viii. Payments to an attorney (box 10)
 - ix. Section 409(A) – box 12
 - x. Non-qualified deferred compensation (box 14).

b. 1099-NEC

This form is used for each person in the course of your business beginning with tax year 2020 to whom you have paid the following of at least \$600 during the year:

- 1) Services performed by someone who is not the taxpayer's employee (including parts and materials)
- 2) Cash payments for fish (or other aquatic life) the taxpayer purchases from anyone engaged in the trade of business of catching fish; or
- 3) Payments to an attorney (box 1)

c. 1099-C

This form is used to report cancellation of debt in excess of \$600

d. 1099-DIV

This form is used to report payment of dividends.

e. SSA-1099

This form is used by the Federal government to report the taxpayer's Social Security benefits.

f. 1099-G

This form is used by state and local governments to report payments to taxpayers. The most common types of payments reported on this form are unemployment compensation and tax refunds.

1217.02 1099 Reporting Issues**a. Form 1099 Not Received**

The taxpayer is required to maintain accurate records. The taxpayer is required to report any income received in excess of the limits listed previously even if a Form 1099 is not received. The taxpayer should contact the paying organization and inform them of non-receipt.

b. Errors

The taxpayer should contact the payer presenting the 1099 of any errors as soon as practicable so they may provide the taxpayer with a corrected 1099. Also, a corrected 1099 is sent to the IRS.

1220 Retirement Income**1221 IRA Overview****1221.01 Deductible and nondeductible contributions to an IRA**

A traditional individual retirement account (IRA) is an IRA that allows individuals to direct pretax income, up to specific annual limits, toward investments that can grow tax-deferred (no capital gains or dividend income is taxed until withdrawn). Individual taxpayers are allowed to contribute 100 percent of compensation up to a specified maximum dollar amount to their traditional IRA. Contributions to the traditional IRA may be tax deductible depending on the taxpayer's income, tax-filing status, and other factors. IRAs cannot be owned jointly; however, any amount remaining in an IRA upon the owner's death can be paid to his or her beneficiary or beneficiaries.

- 1221.02** Contributions to a traditional IRA can be made for a given year at any time during the year or by the due date for filing the taxpayer's income tax return for that year, not including extensions. For example, contributions to an IRA for 2020 must be made by April 15, 2021. For 2020 and later, there is no age limit on making regular contributions to traditional or Roth IRAs.
- 1221.03** Contributions to a traditional IRA may be deductible, partially deductible, or nondeductible. A non-deductible traditional IRA is a traditional IRA that consists of non-deductible contributions. If a taxpayer is covered by an employer's retirement plan and his or her Modified Adjusted Gross Income (MAGI) exceeds the applicable income limit, he or she cannot deduct contributions to a traditional IRA.
- 1221.04** If an amount is contributed to a taxpayer's traditional IRA between January 1 and April 15, the taxpayer should tell the IRA sponsor which year (the current year or the previous year) the contribution is for. If the taxpayer does not tell the sponsor which year the contribution is for, the sponsor can assume, and report to the IRS, that the contribution is for the current year (the year the sponsor received it).
- 1221.05** A taxpayer can file his or her tax return claiming a traditional IRA contribution before the contribution is actually made. A taxpayer is not required to contribute to his or her traditional IRA annually; any contributions an IRA owner does make are discretionary with the IRA account owner.
- 1221.06** **Comparison of traditional IRA and Roth IRA**
- With a traditional IRA, contributions may be tax-deductible and can grow tax-deferred. With a Roth IRA, contributions are non-deductible, but have the potential to grow tax-free. A taxpayer may contribute 100 percent of earned income to a traditional IRA, a Roth IRA, or both types of IRAs up to the annual contribution limit. The annual contribution limits for 2020 for both traditional and Roth IRAs is \$6,000 or \$7,000 if the taxpayer is 50 years of age or older.

1221.07 Amount of the IRA contribution

Generally, a taxpayer can deduct the lesser of:

- a.** The contributions to the taxpayer's traditional IRA for the year; or
- b.** The general limit (or the spousal IRA limit, if applicable) -- \$6,000 for those under 50 years of age in 2020; \$7,000 for those 50 years of age or older in 2020.

1221.08 If contributions to a taxpayer's IRA for a year were more than the allowed limit, the taxpayer can apply the excess contribution in one year to a later year if the contributions for that later year are less than the maximum allowed for that year. However, a penalty or additional tax may apply. As soon as a taxpayer opens his or her traditional IRA, contributions can be made to it through his or her chosen sponsor (trustee or other administrator). Contributions must be in the form of money (cash, check, or money order). Other types of property cannot be contributed to an IRA.

1221.09 Spousal IRA

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

- a.** \$6,000 (\$7,000 if the spouse with the lower compensation is age 50 or older); or
- b.** The total compensation includible in the gross income of both spouses for the year reduced by the following three amounts:
 - (i) The IRA deduction for the year of the spouse with the greater compensation,
 - (ii) Any designated nondeductible contribution for the year made on behalf of the spouse with the greater compensation, and
 - (iii) Any contributions for the year to a Roth IRA on behalf of the spouse with the greater compensation.

1221.10 If a taxpayer was divorced or legally separated (and did not remarry) before the end of the year, he or she cannot deduct any contributions to his or her spouse's IRA. After a divorce or legal separation, a taxpayer can deduct only the contributions to his or her own IRA. The taxpayer's deductions are subject to the rules for single individuals.

1221.11 IRA contributions by an individual covered by an employer retirement plan

The rules determining if an individual is covered by an employer plan differ depending on whether the plan is a defined contribution plan or a defined benefit plan. Generally, a taxpayer is covered by a defined contribution plan for a tax year if amounts are contributed or allocated to the taxpayer's account for the plan year that ends with or within that tax year.

1221.12 A defined contribution plan is a plan that provides for a separate account for each person covered by the plan. In a defined contribution plan, the amount to be contributed to each participant's account is spelled out in the plan. The level of benefits actually provided to a participant depends on the total amount contributed to that participant's account and any earnings and losses on those contributions. Types of defined contribution plans include profit-sharing plans, stock bonus plans, and money purchase pension plans.

Example: Company A has a money purchase pension plan. Its plan year is from July 1 to June 30. The plan provides that contributions must be allocated as of June 30. Bob, an employee, leaves Company A on December 31, 20X3. The contribution for the plan year ending on June 30, 20X4, is made February 15, 20X4. Because an amount is contributed to Bob's account for the plan year, Bob is covered by the plan for his 20X3 tax year.

1221.13 Amount taxable

Generally, if a taxpayer has made only deductible IRA contributions, he or she must include the full amount of all IRA distributions in his or her gross income. The distribution will be taxed as ordinary income. If such distributions are “premature,” generally those made before the account owner attains age 59½, they are subject to a 10-percent tax penalty as well unless an exception applies. An IRA account owner may withdraw funds from an IRA temporarily without becoming subject to the regular income tax, the premature withdrawal penalty, or the excess contribution excise tax, provided he or she returns the withdrawn funds to the IRA within 60 days. Thus, a taxpayer may make a transfer from a traditional IRA to another traditional IRA or can make a distribution to himself or herself on an interest-free basis for a maximum of 60 days and then make a return rollover contribution to an IRA. Such rollovers/interest free loans may occur only once during a 12- month period beginning with the date of the withdrawal. A taxpayer may also roll over an IRA to a qualified plan as long as the qualified plan contains a provision permitting such a rollover.

1221.14 If a taxpayer has made both deductible and non-deductible IRA contributions, he or she must treat a portion of each distribution as a non-taxable return of the non-deductible contributions and partially as a return of deductible or rollover contributions and earnings. When the taxpayer computes the taxable and non-taxable portions of the distribution, all IRA distributions made during the taxable year are treated as one distribution, and all of a taxpayer's IRA accounts are treated as a single account. Thus, IRAs, annuity contracts, Simplified Employee Pension (SEP) IRAs, and rollover IRAs are aggregated for purposes of determining the character of an IRA distribution. This rule provides uniform treatment for distributions from all IRA accounts so that the actual source of an IRA distribution in terms of identifying the distribution as coming from a specific IRA account is irrelevant.

1221.15 Defined benefit plan

If a taxpayer is eligible to participate in the employer's defined benefit plan for the plan year that ends within the tax year, the taxpayer is covered by the plan. This rule applies even if the taxpayer:

- a. Declined to participate in the plan;
- b. Did not make a required contribution; or
- c. Did not perform the minimum service required to accrue a benefit for the year.

1221.16 A defined benefit plan is any plan that is not a defined contribution plan. In a defined benefit plan, the level of benefits to be provided to each participant is spelled out in the plan. The plan administrator figures the amount needed to provide those benefits and those amounts are contributed to the plan.

1221.17 The amount of any reduction in the limit on a taxpayer's IRA deduction depends on whether the taxpayer or his or her spouse was covered by an employer retirement plan. If a taxpayer is covered by an employer retirement plan and the taxpayer did not receive any Social Security retirement benefits, his or her IRA deduction may be reduced or eliminated depending on his or her filing status and MAGI, as shown in the tables below, effective for 2020.

1221.18 If the taxpayer is covered by a retirement plan at work, use this table to determine if the taxpayer's modified AGI affects the amount of his or her deduction.

If Your Filing Status Is...	And Your Modified AGI Is...	Then You Can Take...
Single or head of household	\$65,000 or less	a full deduction up to the amount of your <u>contribution limit</u> .
	more than \$65,000 but less than \$75,000	a partial deduction.
	\$75,000 or more	no deduction.
Married filing jointly or qualifying widow(er)	\$104,000 or less	a full deduction up to the amount of your <u>contribution limit</u> .
	more than \$104,000 but less than \$124,000	a partial deduction.
	\$124,000 or more	no deduction.
Married filing separately	less than \$10,000	a partial deduction.
	\$10,000 or more	no deduction.
If you file separately and did not live with your spouse at any time during the year, your IRA deduction is determined under the "Single" filing status.		

1221.19 If the taxpayer is not covered by a retirement plan at work, use this table to determine if his or her modified AGI affects the amount of his or her deduction for 2020.

If Your Filing Status Is...	And Your Modified AGI Is...	Then You Can Take...
Single, head of household, or qualifying widow(er)	any amount	a full deduction up to the amount of your <u>contribution limit</u> .
Married filing jointly or separately with a spouse who is not covered by a plan at work	any amount	a full deduction up to the amount of your <u>contribution limit</u> .
Married filing jointly with a spouse who is covered by a plan at work	\$196,000 or less	a full deduction up to the amount of your <u>contribution limit</u> .
	more than \$196,000 but less than \$206,000	a partial deduction.
	\$203,000 or more	no deduction.
Married filing separately with a spouse who is covered by a plan at work	less than \$10,000	a partial deduction.
	\$10,000 or more	no deduction.
If you file separately and did not live with your spouse at any time during the year, your IRA deduction is determined under the "Single" filing status.		

1221.20 Nondeductible contributions to an IRA

Although a taxpayer's deduction for IRA contributions may be reduced or eliminated, contributions can be made to a taxpayer's IRA of up to the general limit or, if it applies, the spousal IRA limit. The difference between a taxpayer's total permitted contributions and his or her IRA deduction, if any, is his or her nondeductible contribution.

- a. Form 8606** -- To designate contributions to an IRA as nondeductible, a taxpayer must file Form 8606, *Nondeductible IRAs*. A taxpayer must file Form 8606 to report nondeductible contributions even if he or she does not have to file a tax return for the year. A taxpayer uses Form 8606 if he or she makes nondeductible contributions to a traditional IRA or takes distributions from a traditional or Roth IRA, or from SEP and SIMPLE retirement accounts. Completing Form 8606 provides the taxpayer with the total taxable amount of IRA distributions that must be reported as income for the tax year on Form 1040.
- b.** The instructions that accompany Form 8606 provide a worksheet a taxpayer can use to determine the maximum amount she is entitled to contribute to a Roth IRA in one calendar year. Furthermore, a taxpayer's total basis in a traditional IRA is reported to the IRS on Form 8606, and this amount can be used in subsequent tax years to calculate nontaxable amounts of distributions. With traditional IRAs, the basis is all nondeductible contributions plus nontaxable amounts included in rollovers to the IRA, minus the sum of all nontaxable distributions.
- c.** If a taxpayer does not report nondeductible contributions on Form 8606, all of the contributions to a traditional IRA will be treated like deductible contributions when withdrawn. Thus, all distributions from an IRA will be taxed unless the taxpayer can show, with satisfactory evidence, that nondeductible contributions were made. A taxpayer must pay a \$50 penalty if he or she does not file a required Form 8606, unless he or she can prove that the failure was due to reasonable cause.

- d. As long as contributions are within the contribution limits, none of the earnings or gains on contributions (deductible or nondeductible) will be taxed until they are distributed.
- e. A taxpayer will have a cost basis in his or her traditional IRA if he or she made any nondeductible contributions. The taxpayer's cost basis is the sum of the nondeductible contributions to his or her IRA minus any withdrawals or distributions of nondeductible contributions. Commonly, distributions from a traditional IRAs will include both taxable and nontaxable amounts.

1221.21 Inherited IRA

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

1221.22 If a taxpayer inherits a traditional IRA from his or her spouse, he or she has the following three choices:

- a. Treat it as his or her own IRA by designating himself or herself as the account owner;
- b. Treat it as his or her own by rolling it over into his or her IRA, or to the extent it is taxable, into a:
 - (i) Qualified employer plan;
 - (ii) Qualified employee annuity plan [§403(a) plan];
 - (iii) Tax-sheltered annuity plan [§403(b) plan]; or
 - (iv) Deferred compensation plan of a state or local government (§457 plan).
- c. Treat himself or herself as the beneficiary rather than treating the IRA as his or her own.

- 1221.23** A spousal beneficiary will be considered to have chosen to treat the IRA as his or her own if:
- a.** He or she makes contributions (including rollover contributions) to the inherited IRA; or
 - b.** The taxpayer does not take the required minimum distribution for a year as a beneficiary of the IRA.
- 1221.24** The taxpayer will only be considered to have chosen to treat the IRA as his or her own if the taxpayer is the sole beneficiary of the IRA, and he or she has an unlimited right to withdraw amounts from it. However, if a taxpayer receives a distribution from his or her deceased spouse's IRA, he or she can roll that distribution over into his or her own IRA within the 60-day time limit, as long as the distribution is not a required distribution, even if he or she was not the sole beneficiary of his or her deceased spouse's IRA.
- 1221.25** **Nonspousal beneficiaries**
- If a taxpayer inherits a traditional IRA from anyone other than his or her deceased spouse, he or she cannot treat the inherited IRA as his or her own. In such a case, the taxpayer cannot make any contributions to the IRA. It also means he or she cannot roll over any amounts into or out of the inherited IRA. However, a taxpayer can make a trustee-to-trustee transfer as long as the IRA into which amounts are being moved is set up and maintained in the name of the deceased IRA owner for the benefit of the taxpayer as beneficiary.
- 1221.26** Like the original owner, a taxpayer generally will not owe tax on the assets in the IRA until he or she receives distributions from it. The taxpayer must begin receiving distributions from the IRA under the rules for distributions that apply to beneficiaries. If the taxpayer inherits a traditional IRA from a person who had a basis in the IRA because of nondeductible contributions, that basis remains with the IRA.
- 1221.27** Unless the taxpayer is the decedent's spouse and chooses to treat the IRA as his or her own, the taxpayer cannot combine this basis with any basis the taxpayer has in his or her own traditional IRA(s) or any basis in traditional IRA(s) he or she inherited from other decedents. If a taxpayer takes distributions from both an inherited IRA and his or her IRA, and each has basis, he or she must

complete separate Forms 8606 to determine the taxable and nontaxable portions of those distributions.

1221.28 Trustee-to-trustee transfer

A transfer of funds in a taxpayer's traditional IRA from one trustee directly to another, either at the taxpayer's request or at the trustee's request, is not a rollover. Because there is no distribution to the taxpayer, the transfer is tax free. Because it is not a rollover, it is not affected by the one-year waiting period required between rollovers.

1221.29 Rollovers

Generally, a rollover is a tax-free distribution to the taxpayer of cash or other assets from one retirement plan that a taxpayer contributes to another retirement plan. The contribution to the second retirement plan is called a "rollover contribution." An amount rolled over tax free from one retirement plan to another is generally includible in income when it is distributed from the second plan.

1221.30 A taxpayer can roll over amounts from the following plans into a traditional IRA:

- a. A traditional IRA;
- b. An employer's qualified retirement plan for its employees;
- c. A deferred compensation plan of a state or local government (§457 plan); or
- d. A tax-sheltered annuity plan (§403 plan).

1221.31 The following chart indicates the rollovers that are permitted between various types of qualified plans and IRAs.

Roll To									
Roll From		Roth IRA	Traditional IRA	SIMPLE IRA	SEP IRA	457(b) Plan	Qualified Plan ¹ (pre-tax)	403(b) Plan (pre-tax)	Designated Roth Account [401(k), 403(b), or 457(b)] ²
	Roth IRA	Yes	No	No	No	No	No	No	No
	Traditional IRA	Yes ³	Yes	No	Yes	Yes ⁴	Yes	Yes	No
	SIMPLE IRA	Yes ³ , after 2 years	Yes, after 2 years	Yes	Yes, after 2 years	Yes ⁴ , after 2 years	Yes, after 2 years	Yes, after 2 years	No
	SEP IRA	Yes ³	Yes	No	Yes	Yes ⁴	Yes	Yes	No
	457(b) Plan	Yes ³	Yes	No	Yes	Yes	Yes	Yes	Yes ^{3, 5} after 12/31/10
	Qualified Plan ¹ (pre-tax)	Yes ³	Yes	No	Yes	Yes ⁴	Yes	Yes	Yes ^{3, 5} after 9/27/10
	403(b) Plan (pre-tax)	Yes ³	Yes	No	Yes	Yes ⁴	Yes	Yes	Yes ^{3, 5} after 9/27/10
	Designated Roth Account [401(k), 403(b) or 457(b)] ²	Yes	No	No	No	No	No	No	Yes, if a direct trustee-to-trustee transfer
1. Qualified plans include, for example, profit-sharing, 401(k), money purchase, and defined benefit plans. 2. Governmental 457(b) plans, after December 31, 2010. 3. Must include in income. 4. Must have separate accounts. 5. Must be an in-plan rollover.									

1221.32**Rollovers completed after the 60-day period**

In the absence of a waiver, amounts not rolled over within the 60-day period do not qualify for tax-free rollover treatment. A taxpayer must treat them as a taxable distribution from either the taxpayer's IRA or the taxpayer's employer's plan. These amounts are taxable in the year distributed, even if the 60-day period expires in the next year. A taxpayer may also have to pay a 10 percent additional tax on early distributions, as discussed later. Unless there is a waiver or an extension of the 60-day rollover period, any contribution a taxpayer makes to his or her IRA more than 60 days after the distribution is a regular contribution, not a rollover contribution.

Example: A taxpayer received a distribution in late December 2020 from a traditional IRA that she did not roll over into another traditional IRA within the 60-day limit. She did not qualify for a waiver. This distribution is taxable in 2020 even though the 60-day limit did not expire until 2021.

1221.33 Converting from any traditional IRA into a Roth IRA

A taxpayer can withdraw all or part of the assets from a traditional IRA and reinvest them (within 60 days) in a Roth IRA. The amount that he or she withdraws and timely contributes to the Roth IRA is called a conversion contribution. If properly (and timely) rolled over, the 10 percent additional tax on early distributions will not apply. The taxpayer must roll over into the Roth IRA the same property he or she received from the traditional IRA. The taxpayer can roll over part of the withdrawal into a Roth IRA and keep the rest of it. The amount he or she keeps will generally be taxable (except for the part that is a return of nondeductible contributions) and may be subject to the 10 percent additional tax on early distributions.

1221.34 A taxpayer cannot convert amounts that must be distributed from his or her traditional IRA for a particular year (including the calendar year in which the taxpayer reaches age 70½) under the required distribution rules.

1221.35 The taxpayer must include in his or her gross income distributions from a traditional IRA that he or she would have had to include in income if he or she had not converted them into a Roth IRA. These amounts are normally included in income on the taxpayer's tax return for the year that he or she converted them from a traditional IRA to a Roth IRA.

1221.36 Recharacterizations

A taxpayer may be able to treat a contribution made to one type of IRA as having been made to a different type of IRA. This is called recharacterizing the contribution.

1221.37 To recharacterize a contribution, a taxpayer must have the contribution transferred from the first IRA (the one to which it was made) to the second IRA in a trustee-to-trustee transfer. If the transfer is made by the due date (including extensions) for the taxpayer's tax return for the year during which the contribution was made, the taxpayer can elect to treat the contribution as having been originally made to the second IRA instead of to the first IRA. If a taxpayer recharacterizes his or her contribution, he or she must do all three of the following:

- a. Include in the transfer any net income allocable to the contribution. If there was a loss, the net income the taxpayer must transfer may be a negative amount;
- b. Report the recharacterization on his or her tax return for the year during which the contribution was made; and
- c. Treat the contribution as having been made to the second IRA on the date that it was actually made to the first IRA.

1221.38 Reconversions

A taxpayer cannot convert and reconvert an amount during the same tax year or, if later, during the 30-day period following a recharacterization. If a taxpayer reconverts during either of these periods, it will be a failed conversion.

1221.39 If a taxpayer converts an amount from a traditional IRA to a Roth IRA and then transfers that amount back to a traditional IRA in a recharacterization in the same year, the taxpayer may not reconvert that amount from the traditional IRA to a Roth IRA before:

- a. The beginning of the year following the year in which the amount was converted to a Roth IRA or; if later,
- b. The end of the 30-day period beginning on the day on which the taxpayer transfers the amount from the Roth IRA back to a traditional IRA in a recharacterization.

Example: On June 1, 2020, Christine properly and timely converted her traditional IRA to a Roth IRA. In December 2020, Christine decided to recharacterize the conversion and move the funds to a traditional IRA. In January 2021, to make the necessary adjustment to remove the conversion, Christine opened a traditional IRA with the same trustee. Also, in January 2021, she instructed the trustee of the Roth IRA to make a trustee-to-trustee transfer of the conversion contribution made to the Roth IRA (including net income allocable to it since the conversion) to the new traditional IRA. She also notified the trustee that she was electing to recharacterize the contribution to the Roth IRA and treat it as if it had been contributed to the new traditional IRA. Because of the recharacterization, Christine has no taxable income from the conversion to report for 2020, and the resulting rollover to a traditional IRA is not treated as a rollover for purposes of the one-rollover-per-year rule.

1222 Required minimum distributions (RMDs)

1222.01 A taxpayer cannot keep funds in a traditional IRA indefinitely. Eventually they must be distributed. If there are no distributions, or if the distributions are not large enough, the taxpayer may have to pay a 50 percent excise tax on the amount not distributed as required. The requirements for distributing IRA funds differ, depending on whether the taxpayer is the IRA owner or the beneficiary of a decedent's IRA.

1222.02 The amount that must be distributed each year is referred to as the required minimum distribution. Amounts that must be distributed (required minimum distributions) during a particular year are not eligible for rollover treatment. Please note that CARES Act of 2020 temporarily suspended required minimum distributions for 2020. People who had already complied with the RMDs for 2020 before the passing of the Act, had the option to return their distributions back to their eligible retirement accounts.

1222.03 IRA owners

If the taxpayer is the owner of a traditional IRA, he or she must generally start receiving distributions from his or her IRA by April 1 of the year following the year in which he or she reaches age 72. April 1 of the year following the year in which he or she reaches age 72 is referred to as the required beginning date (exception for 2020 when people turning 72 did not have to take RMDs)

1222.04 A taxpayer must receive at least a minimum amount for each year starting with the year he or she reaches age 72. If the taxpayer does not (or did not) receive that minimum amount in his or her 72 year, then he or she must receive distributions for his or her 72 year by April 1 of the next year. If an IRA owner dies after reaching age 72, but before April 1 of the next year, no minimum distribution is required because death occurred before the required beginning date.

1222.05 Even if a taxpayer begins receiving distributions before he or she reaches age 72, he or she must begin calculating and receiving required minimum distributions by his or her required beginning date. If, in any year, a taxpayer receives more than the required minimum distribution for that year, he or she will not receive credit for the additional amount when determining the minimum required distributions for future years. This does not mean that the taxpayer does not reduce his or her IRA account balance. It means that if a taxpayer receives more than his or her required minimum distribution in one year, he or she cannot treat the excess (the amount that is more than the required minimum distribution) as part of his or her required minimum distribution for any later year. However, any amount distributed in the taxpayer's 72 year will be credited toward the amount that must be distributed by April 1 of the following year.

1222.06 Distributions after the required beginning date

The required minimum distribution for any year after the year a taxpayer turns 72 must be made by December 31 of that later year.

Example: A taxpayer reached age 72 on August 20, 2021. The taxpayer must receive the first required minimum distribution from his IR, SEP IRA, or SIMPLE IRA by April 1, 2022. For all the subsequent years after the first required minimum distribution, the taxpayer must comply with his RMD requirement by December 31 of that year. For instance, an RMD for 2022 would have to be taken by December 31, 2022.² If the taxpayer had reached age 70½ in 2020 or later, the taxpayer must take his first RMD by April 1 of the year after the taxpayer reached age 72. Also, keep in mind that for 2020, required minimum distributions were suspended.

1222.07 Tax on early distributions from traditional and Roth IRAs

To discourage the use of IRAs for purposes other than retirement, the law imposes a 10-percent additional tax on early distributions from traditional and Roth IRAs unless an exception applies. Generally, early distributions are those received from an IRA before reaching age 59½. The 10-percent additional tax applies to the part of the distribution that the taxpayer must include in gross income. It is in addition to any regular income tax on that amount. See *10-percent early distribution penalty* following.

1222.08 Tax on early distributions from retirement plans other than IRAs

To discourage the use of retirement funds for purposes other than normal retirement, the law imposes a 10-percent additional tax on certain early distributions of these funds. Early distributions are those a taxpayer receives from a qualified retirement plan or deferred annuity contract before reaching age 59½. One exception was made for coronavirus-related distributions up to \$100,000 taken in 2020. Taxpayers would not have to pay the 10% penalty if the distribution qualified as coronavirus-related. Moreover, the distributions can be included in income ratably over a three-year period, starting with the year the taxpayer received the distribution. Alternatively, the taxpayer had the option to include the entire distribution in the income in the year of distribution.

1222.09 The term “qualified retirement plan” means:

- a.** A qualified employee plan under §401(a), such as a §401(k) plan;
- b.** A qualified employee annuity plan under §403(a);
- c.** A tax-sheltered annuity plan under §403(b) for employees of public schools or tax-exempt organizations; or
- d.** An IRA.

1222.10 While an eligible state or local government §457 deferred compensation plan is not a qualified retirement plan, any distribution attributable to amounts the plan received in a direct transfer or rollover from one of the qualified retirement plans listed above would be subject to the 10-percent additional tax. Distributions that are not taxable, such as distributions that a taxpayer rolls over to another qualified retirement plan or a distribution of a taxpayer’s designated Roth IRA contributions are not subject to this 10-percent additional tax.

1222.11 There are certain exceptions to this additional tax. The following six exceptions apply to distributions from any qualified retirement plan.

- a.** Distributions made to a beneficiary or estate on or after the owner’s death.
- b.** Distributions made because the taxpayer is totally and permanently disabled.
- c.** Distributions made as part of a series of substantially equal periodic payments over the taxpayer’s life expectancy or the life expectancies of the taxpayer and his or her designated beneficiary. If these distributions are from a qualified plan other than an IRA, the taxpayer must separate from service with this employer before the payments begin for this exception to apply.
- d.** Distributions that are equal to or less than the taxpayer’s deductible medical expenses under §213, that is, the amount of the taxpayer’s medical expenses that is more than 7.5 percent of his or her adjusted gross income. The taxpayer does not have to itemize to meet this exception.

- e. Distributions made due to an IRS levy of the plan under §6331.
- f. Distributions to qualified reservists. Generally, these are distributions made to individuals called to active duty with the United States military.

1222.12

The following additional exceptions apply only to distributions from a qualified retirement plan other than an IRA:

- a. Distributions made to a taxpayer after he or she separated from service with his or her employer if the separation occurred in or after the year the taxpayer reached age 55, or distributions made from a qualified governmental defined benefit plan if taxpayer was a qualified public safety employee (state or local government) who separated from service on or after he or she reached age 55;
- b. Distributions made to an alternate payee under a qualified domestic relations order; and
- c. Distributions of dividends from employee stock ownership plans.

1222.13**Recognizing losses on IRA investments**

A loss on your traditional IRA (or Roth IRA) investment is a miscellaneous itemized deduction and can no longer be deducted.

1222.14 10-percent early distribution penalty

A taxpayer can access his or her money inside a traditional IRA at any time, but a withdrawal is subject to ordinary income tax and a 10 percent early withdrawal penalty if he or she takes a distribution before reaching age 59½. Exceptions to the 10 percent early withdrawal penalties are:

- a. Death or disability;
- b. College expenses;
- c. First-time home purchase (up to \$10,000);
- d. Payment of health insurance premiums after 12 consecutive weeks of unemployment;
- e. Payment of medical expenses that exceed 7.5 percent of AGI;
- f. Systematic distributions [72(t)];
- g. IRS levy; and
- h. Qualified reservist distribution.

If a taxpayer takes a distribution after age 59½, he or she pays ordinary income tax on the withdrawal but does not pay a penalty. Required minimum distributions (RMDs) begin at age 72.

1222.15 The owner of a Roth IRA account can access contribution dollars at any time without taxes or penalties. However, if the taxpayer has owned a Roth IRA, including converted accounts, for less than five years and withdraws earnings from the IRA before reaching age 59½, he or she may be subject to income tax and a 10 percent early withdrawal penalty on those earnings.

1222.16 Required minimum distributions from qualified plans

RMDs generally are minimum amounts that a retirement plan account owner must withdraw annually starting with the year that he or she reaches 72 years of age or, if later, the year in which he or she retires. However, if the retirement plan account is an IRA or the account owner is a 5-percent owner of the business sponsoring the retirement plan, the RMDs must begin once the account holder is age 72, regardless of whether he or she is retired.

- 1222.17** Retirement plan participants and IRA owners are responsible for taking the correct amount of RMDs on time every year from their accounts, and they face stiff penalties for failure to take RMDs. When a retirement plan account owner or IRA owner dies before RMDs have begun, different RMD rules apply to the beneficiary of the account or IRA. Generally, the entire amount of the owner's benefit must be distributed to the beneficiary who is an individual either: (1) within five years of the owner's death; or (2) over the life of the beneficiary starting no later than one year following the owner's death.
- 1222.18** The RMD rules apply to all employer sponsored retirement plans, including profit-sharing plans, 401(k) plans, 403(b) plans, and 457(b) plans. The RMD rules also apply to traditional IRAs and IRA-based plans such as SEPs, SARSEPs, and SIMPLE IRAs. The RMD rules also apply to Roth 401(k) accounts. However, the RMD rules do not apply to Roth IRAs while the owner is alive.
- 1222.19** An account owner must take the first RMD for the year in which he or she turns 72. However, the first RMD payment can be delayed until April 1st of the year following the year in which he or she turns 72. For all subsequent years, including the year in which the first RMD was paid by April 1st, the account owner must take the RMD by December 31st of the year (exception for 2020, CARES Act allowed taxpayers to suspend their RMDs)
- 1222.20** Generally, an RMD is calculated for each account by dividing the prior December 31st balance of that IRA or retirement plan account by a life expectancy factor that the IRS publishes in three tables that may be found in IRS Publication 590:
- a. The Joint and Last Survivor Table** is used by an account owner whose sole beneficiary of the account is his or her spouse and is more than 10 years younger than the account owner;
 - b. The Uniform Lifetime Table** is used by account owners whose spouse is not the sole beneficiary or whose spouse is not more than 10 years younger; and
 - c. The Single Life Expectancy Table** is used by a beneficiary of an account.

- 1222.21** An IRA owner must calculate the RMD separately for each IRA that he or she owns, but can withdraw the total amount from one or more of the IRAs. Similarly, a 403(b) contract owner must calculate the RMD separately for each 403(b) contract that he or she owns, but can take the total amount from one or more of the 403(b) contracts. However, RMDs required from other types of retirement plans, such as 401(k) and 457(b) plans must be taken separately from each of those plan accounts.
- 1222.22** If an account owner fails to withdraw an RMD, fails to withdraw the full amount of the RMD, or fails to withdraw the RMD by the applicable deadline, the amount not withdrawn is taxed at 50 percent. In such a case, the account owner should file Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*, with his or her federal tax return for the year in which the full amount of the RMD was not taken. The penalty may be waived if the account owner establishes that the shortfall in distributions was due to reasonable error and that reasonable steps are being taken to remedy the shortfall.
- 1222.23** The account owner is taxed at his or her income tax rate on the amount of the withdrawn RMD. However, to the extent the RMD is a return of **basis** or is a **qualified distribution from a Roth IRA**, it is tax free.
- 1222.24** This comparison chart highlights the basic RMD rules as applied to IRAs and defined contribution plans [e.g., 401(k), profit-sharing, and 403(b) plans].

Required Minimum Distributions for Account Owners		
	IRAs including SEP, SIMPLE, and SARSEP IRAs	Defined Contribution Plans
When do I take my first RMD (the required beginning date)?	The taxpayer must take your first RMD by April 1 of the year following the year in which you turn 72 (70 ½ if you reach 70 ½ before January 1, 2020) regardless of whether they are still employed.	April 1 of the year following the later of the year the taxpayer turns 72 (70 ½ if you reach 70 ½ before January 1, 2020) or the year you retire (if allowed by your plan). If the taxpayer is a 5% owner, they must start RMDs by April 1 of the year following the year you turn 72 (70 ½ if you reach 70 ½ before January 1, 2020).
When do I reach age 70½?	If the taxpayer reached 70 ½ before December 31, 2019, for instance, for someone whose birthday was on or before June 30, they would have had to take a contribution by April 1, 2020. CARES Act specifically exempted individuals who had an RMD for 2020. It also exempted individuals who turned 70 ½ in 2019 and delayed taking their RMD until April of 2020. Individuals who turned 70 ½ in 2020 no longer had to comply with the required minimum distribution requirement as the applicable age was increased to 72. As such, the new rule is that for individuals who will turn 72 in 2021, they will have the option to delay taking their first RMD until April 2022 and December 31 for each year thereafter.	Same as IRA rule.
What is the deadline for taking subsequent RMDs after the first RMD?	After the first RMD, you must take subsequent RMDs by December 31 of each year beginning with the calendar year containing your required beginning date. Example: You turn 72 on July 15, 2020. You are not required to take an RMD thanks to CARES Act exemption. If you turned 72 in 2021 ,your first RMD, for 2021 could be delayed by April 1, 2022. You must take your second RMD, for 2022 by December 31, 2022, and your third RMD, for 2023, by December 31, 2023.	Same as IRA rule.

Required Minimum Distributions for Account Owners		
	IRAs including SEP, SIMPLE, and SARSEP IRAs	Defined Contribution Plans
How do I calculate my RMD?	Your RMD is generally determined by dividing the adjusted market value of your IRAs as of December 31 of the preceding year by the distribution period that corresponds with your age in the Uniform Lifetime Table [Table III in IRS Publication 590, <i>Individual Retirement Arrangements (IRAs)</i>]. If your spouse is your sole beneficiary and is more than 10 years younger than you, you will use the Joint Life and Last Survivor Expectancy Table (Table II in IRS Publication 590).	Same as IRA rule. Your plan sponsor/administrator should calculate the RMD for you.
How should I take my RMDs if I have multiple accounts?	If you have more than one IRA, you must calculate the RMD for each IRA separately each year. However, you may aggregate your RMD amounts for all of your IRAs and withdraw the total from one IRA or a portion from each of your IRAs. You do not have to take a separate RMD from each IRA.	If you have more than one defined contribution plan, you must calculate and satisfy your RMDs separately for each plan and withdraw that amount from that plan. Exception: If you have more than one 403(b) tax-sheltered annuity account, you can total the RMDs and then take them from any one (or more) of the tax-sheltered annuities.
May I withdraw more than the RMD?	Yes, an IRA owner can always withdraw more than the RMD. You cannot apply excess withdrawals toward future years' RMDs.	Same as IRA rule.

Required Minimum Distributions for Account Owners		
	IRAs including SEP, SIMPLE, and SARSEP IRAs	Defined Contribution Plans
May I take more than one withdrawal in a year to meet my RMD?	You may withdraw your annual RMD in any number of distributions throughout the year, as long as you withdraw the total annual minimum amount by December 31 (or April 1 if it is for your first RMD).	Same as IRA rule.
What happens if I do not take the RMD?	If the distributions to you in any year are less than the RMD for that year, you are subject to an additional tax equal to 50 percent of the undistributed RMD.	Same as IRA rule.

*Note: All Required Minimum Distributions were suspended for 2020 whether they were for taxpayers turning 70 ½ in 2020 or for older taxpayers as a result of the CARES Act.

Note:

There are no RMD requirements for a Roth IRA while the owner is alive. However, designated Roth accounts are subject to the RMD rules. The distributions to the beneficiaries of the Roth IRA will not be taxable.

1223 Prohibited transactions and tax effects relating to IRAs

- 1223.01** An IRA cannot purchase **collectibles** and **life insurance**. Collectibles are not allowed in an IRA account, meaning collectible coins are prohibited transactions, according to the IRS. The result of buying collectible coins with IRA assets is a distribution of the amount used to buy the coins. The distribution will be added to gross income and penalized 10 percent if the taxpayer is under age 59½. The IRS does allow investors to purchase certain coins minted by the U.S. Treasury, such as the one-ounce gold eagle, along with certain bullion coins. However, in general, coins are considered prohibited collectibles. Other examples of prohibited collectibles include artwork, rugs, gems, stamps, metals, antiques, and alcoholic beverages.

1223.02 Minted coins exception

The precious metals that are allowable with IRA investments are U.S. minted coins. The coins must contain a minimum amount of gold, silver, platinum, or palladium to qualify. Gold coins must maintain either one-tenth, one-quarter, one-half, or full one-ounce gold mixture. One-ounce minted silver coins are acceptable, as are designated bullion.

1223.03 In addition, an IRA owner cannot engage in prohibited transactions with his or her IRA. In general, a prohibited transaction is a transaction between a plan and a disqualified person. Generally, “disqualified persons” are defined to be the account holder, other fiduciaries, certain family members (lineal descendants and spouses of lineal descendants), and businesses under the account holder’s (or disqualified person’s) control.

1223.04 Prohibited transactions are:

- a. A sale or exchange, or leasing of property between a plan and a related party;
- b. Lending of money between a plan and a related party;
- c. Furnishing goods, services or facilities between a plan and a related party;
- d. Transfer to, or use by, a related party of the income or assets of a plan;
- e. Act by a related party whereby he deals with the income or assets of a plan in his own interest or for his own account; and
- f. Receipt of any benefit for his or her own personal account by any related party in connection with a transaction involving the income or assets of the plan.

1223.05 A **disqualified person** is the IRA owner, his or her children, grandchildren, spouse, or parents. It is also any business owned 50 percent or more by any of the above. According to the IRS, siblings, aunts, uncles, cousins, and step relations are **not** included in the definition of disqualified persons.

If a taxpayer engages in a prohibited transaction the IRS will consider the IRA fully distributed.

1223.06 Examples of prohibited transactions

- a.** Taxpayer's IRA buys a house and taxpayer, or another disqualified person, lives in the house. It does not matter if rent is paid or not.
- b.** Taxpayer's IRA buys a house and rents it to an outside party at a discount. The outside party agrees to provide some benefit to the taxpayer (such as adding an addition to the house) in exchange for that discounted rent.
- c.** Taxpayer's IRA buys a house and sells it to an outside party at a discount. The outside party agrees to provide some benefit to the taxpayer or another disqualified person in exchange for that discounted sales price.
- d.** Taxpayer's IRA buys a house and runs out of cash to pay the mortgage. Taxpayer, or another disqualified person, puts up the money to cover the shortfall.
- e.** Taxpayer wants to buy a house and half of the down payment comes from the taxpayer's savings account. Taxpayer directs his or her IRA to invest the rest of the purchase price.
- f.** Taxpayer takes out a loan and uses his or her IRA assets as collateral to secure the personal loan.
- g.** Taxpayer loans money to the IRA so that the IRA has enough cash to buy a house. Loan is between two disqualified entities, taxpayer, and his or her IRA.

1224 Loans from IRC §401(k) plans and other qualified plans

1224.01 A loan that a qualified plan owner takes from his or her qualified plan is not considered a taxable distribution from a qualified plan if the following requirements are met:

- a.** The amount of the loan does not exceed the amount limitation, generally the amount cannot be greater than \$50,000 or 50 percent of the participant's vested balance, whichever is less;
- b.** The term of the loan does not exceed five years, unless the loan is used to purchase a principal residence;

- c. Substantially level repayments, made not less frequently than quarterly, are required over the term of the loan; and
- d. The loan is evidenced by a legally enforceable agreement that shows compliance with the three requirements listed above.

If any of these four requirements is not met, the loan is subject to federal income tax.

1224.02 Failure to make required payments results in a deemed distribution to the participant. The amount of the deemed distribution equals the entire outstanding balance of the loan at the time of such failure to repay. The entire outstanding balance includes all the unpaid interest and the principal on the loan. However, the plan loan continues to exist, it remains a plan asset, and interest continues to accrue until the entire loan is repaid with principal and interest. The plan administrator may allow a cure period for loan payments. The cure period may not continue beyond the last day of the calendar quarter following the calendar quarter in which the required payment was due.

1224.03 Qualified charitable distributions

Generally, a qualified charitable distribution is an otherwise taxable distribution from an IRA (other than an ongoing SEP or SIMPLE IRA) owned by an individual who is age 70½ or over that is paid directly from the IRA to a qualified charity.

1224.04 The taxpayer's qualified charitable distributions can satisfy all or part the amount of the required minimum distribution from their IRA. For example, if the 2020 required minimum distribution was \$10,000, and the taxpayer made a \$5,000 qualified charitable distribution for 2020, they would have had to withdraw another \$5,000 to satisfy their 2020 required minimum distribution.

1224.05 To report a qualified charitable distribution on Form 1040 tax return, the taxpayer generally reports the full amount of the charitable distribution on the line for IRA distributions. On the line for the taxable amount, enter zero if the full amount was a qualified charitable distribution. Enter "QCD" next to this line. See the Form 1040 instructions for additional information.

You must also file Form 8606, Nondeductible IRAs, if:

- the taxpayer made the qualified charitable distribution from a traditional IRA in which they had basis and received a distribution from the IRA during the same year, other than the qualified charitable distribution; or
- the qualified charitable distribution was made from a Roth IRA.

1230 Property, real and personal

1231 Acquisition and Disposition of Assets

Overview

1231.01 Two major types of property

All property falls into one of two categories: real property or personal property.

- a. Real property (realty):** Land and anything permanently attached to the land or very closely and exclusively associated with the use of the land; immovables

Examples: Land, buildings, and growing trees

- b. Personal property (personalty):** Property that is not real; movables

Examples: Car, table, or book

1231.02 Conversion from real to personal property

Conversion from real to personal property is called *severance*.

Examples of severance:

- a.** A growing tree is cut into firewood. While growing in the ground, the tree is real property. When cut into firewood, it becomes personal property.
- b.** Sand is dug from the ground and put on a truck. While in the ground, the sand is real property. When dug from the ground and put on the truck, it is personal property.

1231.03 Conversion from personal to real property

Conversion from personal to real property is called *attachment*.

Examples of attachment:

- a. A brick is mortared into the wall of a building. While loose, the brick is personal property; when mortared into the wall, it becomes a part of the real property.
- b. A central air conditioning unit is installed in a house during construction. The unit is personal property until it is installed, then it becomes real property.

1231.04 For federal tax purposes, all property is either classified as ordinary income property or as a capital asset.

Tax Treatment of Gains and Losses

1231.05 When a taxpayer has determined that the taxpayer has a gain or a loss to be recognized, the next step is to establish whether it is to be treated as a capital gain or loss or as an ordinary income or loss item.

1231.06 A capital gain or loss is that gain or loss arising from the sale or exchange of a capital asset.

1231.07 **Capital assets** are defined as all property, *except* for the following:

- a. Property held for resale (inventory)
- b. Depreciable property or real property used in a trade or business
- c. Accounts or notes receivable acquired in normal business operations
- d. A copyright or a literary, artistic, or musical composition in the hands of the creator or anyone who assumes the creator's basis (property received through gift)
- e. U.S. government publications received from the government other than by purchase at the price that it is offered for sale to the public
- f. Certain commodities derivative instruments held by a commodities derivatives dealer

- g.** Any hedging transaction that is clearly identified as such before the close of the day on which it is acquired, originated, or entered into
- h.** Supplies of a type regularly used or consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer

1231.08 Real property subdivided for sale:

- a. Individuals and S corporations subdividing real estate for sale may qualify for capital gain treatment if the following conditions apply:
 - (1) Subdivider must *not* be a real estate dealer.
 - (2) No substantial improvements may be made to the lots sold.
 - (3) Lots sold must be held at least five years (unless inherited).
- b. All gain is capital gain until the year the sixth lot is sold. Contiguous lots sold to one buyer are treated as one lot.
 - (1) When the sixth lot is sold, 5% of the revenue from all lots sold that year is ordinary income.
 - (2) This ordinary income is offset by any selling expenses to determine the net amount taxed as ordinary income. Any gain not taxed as ordinary income is capital gain.

Section 1231 Assets

1231.09 Section 1231 of the Internal Revenue Code provides long-term capital gain treatment for certain transactions involving noncapital assets (generally land, buildings, and equipment used in business). If there is a loss, the loss is treated as an ordinary versus a capital loss.

- 1231.10** Section 1231 transactions include the following:
- a. Sale or exchange of real or depreciable business property
 - b. Involuntary conversion of:
 - (1) real or depreciable business property
 - (2) any capital asset that is held for more than one year and is held in connection with a trade or business or a transaction entered into for profit
 - c. Certain farming transactions involving crops and livestock
 - d. Certain transactions involving timber, iron ore, and coal

1231.11 To qualify as Section 1231 property, the property items listed must be held long enough to meet the long-term capital gain and loss holding period requirement, greater than one year.

1231.12 Section 1231 benefits:

- a. Gains and losses from Section 1231 transactions must be grouped and compared.
 - (1) If Section 1231 gains exceed Section 1231 losses, the net gain will be treated as ordinary income to the extent of net Section 1231 losses claimed by the taxpayer in the previous five years. Any remaining gain will receive long-term capital gain treatment.
 - (2) If Section 1231 losses exceed Section 1231 gains, the net loss will receive *ordinary loss* treatment.

Example: The taxpayer has a net Section 1231 gain of \$21,000 for the current year. This is the taxpayer's first net Section 1231 gain in over six years. Looking back, the taxpayer was able to deduct \$9,000 of net Section 1231 losses during the last five years. The gain is taxed as follows—\$9,000 is taxed as ordinary income and the remaining gain of \$12,000 is taxed as long-term capital gain.

- b.** A special rule applies to casualty and theft losses on property used in the business and capital assets in the business held longer than one year.
 - (1) Gains and losses from these involuntary conversions must be separately grouped and compared.
 - (2) If casualty gains exceed casualty losses, these gains and losses are then grouped with Section 1231 items to compute the net Section 1231 gain or loss.
 - (3) If casualty losses exceed casualty gains, the resulting net loss is treated as an ordinary loss. In this situation, these casualty gains and losses are not grouped with the Section 1231 items.

Depreciation

1231.13 A deduction is allowed for wear, tear, exhaustion, and normal obsolescence of property held for the production of income or for property used in a trade or business

- a.** This cost recovery process can take the form of depreciation, cost recovery, amortization, or depletion
- b.** While depletion relates to natural resources, no depreciation, cost recovery, or amortization is available for the following:
 - (1) Personal property not used in a trade or business
 - (2) Inventory
 - (3) Land

1231.14 For assets acquired after 1986, depreciation is computed using the modified accelerated cost recovery system (MACRS). Under this system, the full cost of the property (including salvage value) is written off over a prescribed recovery period:

- a.** Revenue Procedure 87-56 sets out a class life, recovery period, and alternative depreciation system life for classes of tangible property used in a trade or business or held for the production of income.

- (1) MACRS uses the recovery period.
- (2) Class life and alternative depreciation system lives have special purposes not generally affecting calculation of regular taxable income.
- b.** MACRS depreciation cannot be used for intangible property and property not depreciated in terms of years (units-of-production method)

c. Real estate:

- (1) Under MACRS, real estate acquired after 1986 is depreciated using the straight-line method over the following periods:

Residential real estate	27.5 years
Nonresidential real estate placed in service before May 13, 1993	31.5 years
Nonresidential real estate placed in service after May 12, 1993	39.0 years

- (2) Real property acquisitions are subject to the *mid-month convention*. One-half month's cost recovery is allowed in both the month of acquisition and the month of disposition.
- (3) The Tax Cuts and Jobs Act of 2017 (TCJA) provides that a real property trade or business electing out of the limitation on the deduction for business interest is required to use ADS (alternative depreciation system) to depreciate any of its nonresidential real property, residential rental property, and qualified improvement property.

d. Personal property

- (1) There are six recovery periods for personal property—3, 5, 7, 10, 15, and 20 years.
 - (a) Under MACRS, the 200% declining-balance method is used for the 3-, 5-, 7-, and 10-year properties. The 150% declining-balance method applies to the 15- and 20-year properties. Both methods switch to straight-line depreciation when that method produces a larger deduction.
 - (b) The 5- and 7-year properties are most common.
 - i. The 5-year class includes automobiles, general-purpose light trucks, computers, and office machinery (typewriters, calculators, copiers, etc.).
 - ii. The 7-year class includes heavy, special-purpose trucks and office furniture and fixtures (desks, filing cabinets, etc.).
- (2) Generally, a half-year's recovery deduction is taken in the first year of use regardless of the month the property was placed in service (half-year convention).
- (3) Basically, the recovery deduction is determined by applying a prescribed statutory percentage to the unadjusted basis of the property. The government provides tables listing the applicable percentages.

(4) A mid-quarter convention will apply to property acquired after 1986 if more than 40% of the value of all property acquired during a tax year is placed in service during the last quarter of the year.

(a) If the mid-quarter convention applies, property acquisitions must be grouped by the quarter they were acquired.

(b) A cost recovery deduction for each of these groups is computed as follows:

Acquisitions	Depreciation Allowable
1st quarter	10.5 months
2nd quarter	7.5 months
3rd quarter	4.5 months
4th quarter	1.5 months

These adjustments are built into the MACRS tax tables for the mid-quarter convention.

(5) Disposal of personal property generally results in a cost recovery deduction in the year of disposal.

(a) In most cases, a half-year of cost recovery is allowed in the year of disposition or retirement.

(b) If the mid-quarter convention applies, the cost recovery will range from 1.5 months to 10.5 months of depreciation depending on which quarter the disposal of the property takes place.

(6) The taxpayer may elect to use the straight-line method of depreciation for personal property. This election is available on a class-by-class basis for each tax year.

- (7) Under Section 179 of the Internal Revenue Code, the taxpayer, other than an estate, a trust, or certain noncorporate lessors, may elect to deduct as an expense, rather than to depreciate, up to a specified amount of the cost of new or used tangible personal property or certain real property placed in service during the tax year in the taxpayer's trade or business.
- (a) The basis of the asset(s) must be reduced by the amount expensed. The amount "expensed" cannot exceed the taxpayer's aggregate taxable income from trade or business activities. Amounts in excess of trade or business income that would otherwise be deductible are carried forward indefinitely.
 - (b) Under the Tax Cuts and Jobs Act of 2017 (TCJA), a taxpayer may expense \$1,040,000. The phaseout threshold is now \$2,590,000. There is also an index for inflation.
 - (c) The TCJA further clarifies that the cost of roofing; heating, ventilation, and air conditioning property; fire protection and alarm systems; and security systems can be deducted under IRC Section 179 as "qualified real property."
- (8) "Bonus depreciation" refers to a special depreciation allowance for the first year that certain classes of property are placed in service.
- (9) Under the Tax Cuts and Jobs Act of 2017, bonus depreciation increases from 50% to 100% for property acquired and placed in service (both new and used, so long as the use is new to the taxpayer) after September 27, 2018, and before 2023. After 2023, there is a gradual decrease in the percentage: 80% for 2023, 60% for 2024, 40% for 2025, and 20% for 2026. CARES Act modified the provisions of TCJA to include qualified improvement property in the asset class eligible for bonus depreciation.

- e. Alternative depreciation system:
 - (1) After 1986, an alternative depreciation system (ADS) must be used in certain computations.
 - (a) To compute that portion of depreciation treated as a tax preference item for purposes of the alternative minimum tax for property purchased before 1999
 - (b) To calculate depreciation for property:
 - i. Used predominantly outside the United States
 - ii. Leased or used by a tax-exempt entity
 - iii. Financed with the proceeds from tax-exempt bonds
 - iv. Imported from countries engaged in discriminatory practices
 - v. Listed property used 50% or less in a qualified business use
 - vi. Certain farming equipment
 - (c) To compute depreciation for earnings and profits purposes
 - (2) Generally, depreciation under this method is calculated using the straight-line method without regard to salvage value.
 - (3) Depreciation of personal property for the alternative minimum tax is calculated by using 150% declining-balance depreciation, switching to the straight-line method when appropriate to maximize deductions.
 - (4) Depreciation of real estate for the alternative minimum tax uses the mid-month convention.
 - (5) The recovery period for the ADS is generally the ADR midpoint life of the asset.
 - (6) Taxpayers may elect to use ADS in lieu of MACRS.

f. The government publishes tables that automatically provide for each of the special conventions that a taxpayer may use in the year of acquisition for both real estate and personal property.

g. Listed property:

(1) Special rules apply to property suitable for both business and personal use (e.g., automobiles, computers).

(a) If business usage of such property is not more than 50%, the property does not qualify for regular (accelerated) MACRS, bonus, or the Section 179 first-year expense. It must be depreciated under ADS using the straight-line method.

(b) If business usage exceeds 50%, the property is available for regular MACRS and Section 179 depreciation. If future business usage drops below 50%, a permanent switch to the straight-line method is required. In addition, previous cost recoveries in excess of straight-line depreciation must be recaptured as additional income.

(2) An additional limitation is placed on luxury automobiles. A dollar limit for depreciation is mandated for each year the car is in use. For tax years beginning after 2017, these limits will be adjusted for inflation using the automobile component of the consumer price index (CPI).

(a) The depreciation limit under Sec. 280F(d)(7) assuming bonus depreciation is:

Year 1	\$18,100
Year 2	16,100
Year 3	9,700
Year 4 and after	5,760

- (b) These limits must be reduced proportionately if business usage is less than 100%.
- (c) Trucks, SUVs, and vans weighing over 6,000 pounds are not subject to the luxury automobile limits. Likewise, ambulances, hearses, taxis, and limousines are not subject to these limits.

Recovering the Cost of Leasehold Improvements and Intangible Assets

- 1231.15** Improvements made by the lessee that are made in lieu of rent are deductible as rent by the lessee and included as income by the lessor.
- 1231.16** Improvements made by the lessee that are *not* made in lieu of rent must be capitalized by the lessee and written off using the modified accelerated cost recovery system (MACRS).
- 1231.17** Taxpayers generally amortize the cost of intangibles acquired after August 10, 1993, over a 15-year period on a straight-line basis, beginning with the month acquired.
- a. Section 197 intangibles are a qualifying asset acquired and held in connection with the conduct of a trade or business. This includes goodwill, going-concern value, trademarks, and franchises.
 - b. Copyrights, patents, and covenants not to compete are included when acquired with the purchase of a business.
 - c. Intangibles not required to be written off over 15 years are amortized over their useful lives. Such assets include copyrights and patents acquired separately, not acquired with the purchase of a business.
 - d. Interests in land, financial interests, computer software, mortgage servicing, and leases of tangible personal property are excluded from the definition of Section 197 intangibles.
 - e. A loss cannot be recognized on the disposition of Section 197 intangibles if the taxpayer retains other Section 197 intangibles acquired in the same transaction.

- f. Research and experimental expenditures may be (1) expensed in the year paid or incurred, (2) capitalized and amortized over a period of time not less than 60 months, or (3) capitalized and amortized ratably over 10 years and thereby avoiding alternative minimum tax considerations.

Depletion

1231.18 **Depletion** is the process whereby owners of an economic interest in natural resources may recover the cost of their investment (e.g., oil, timber, gas, minerals).

1231.19 Two methods are available for computing depletion. Annually, the taxpayer must choose the method that gives the *greatest* depletion deduction for that year.

a. Cost depletion method:

- (1) Divide the estimated number of units in a resource deposit into the cost or other adjusted basis of the property to obtain the cost depletion per unit.
- (2) Multiply this quotient by the number of extracted units that were sold for that year to obtain the cost depletion deduction.
- (3) Cost depletion is no longer applicable when the adjusted basis of the resource is reduced to \$0.

b. Percentage depletion method:

- (1) Percentage depletion is the *lesser* of the following two figures:
 - (a) A flat percentage of gross receipts from the property; the percentage is specified by the government and varies according to the type of resource or
 - (b) 50% of taxable income from the property before taking a depletion deduction.
- (2) Percentage depletion is not restricted to the cost basis of the resource. Consequently, taxpayers can recover through depletion deductions far more than they have invested in the resource. The excess taken becomes a tax preference for alternative minimum tax.

(3) Some of the more common percentage depletion rates are:

- (a) 15% for copper, gold, silver, iron, and oil and gas;
- (b) 10% for coal and lignite; and
- (c) 5% for gravel, peat, sand, and pumice.

- c. The cost basis of the resource must be reduced each year by the amount claimed as depletion, whether determined by the cost or the percentage method. The basis will not be reduced below \$0, however.

1231.20 Timber is not available for percentage depletion; the cost method must be used.

1231.21 Percentage depletion is generally not available for oil and gas wells. Exceptions include certain domestic gas wells and small independent producers and royalty owners. Special rules apply to these interests.

Depreciation and Recovery Allowance Recapture

1231.22 Whereas IRC Section 1231 provides long-term capital gain treatment for certain noncapital assets, IRC Sections 1245 and 1250 deny this special treatment, where the gain represents a recovery of some or all of the depreciation allowances previously deducted. IRC Sections 1245 and 1250 take precedence over IRC Section 1231.

1231.23 **Section 1245 recapture:**

- a. IRC Section 1245 requires that any gain on IRC Section 1245 property will be treated as ordinary income to the extent of *all* depreciation taken
- b. Any gain on IRC Section 1245 property which is not recaptured as ordinary income becomes IRC Section 1231 gain.
- c. IRC Section 1245 property refers primarily to equipment used in a trade or business. It also includes most buildings acquired during the ACRS (accelerated cost recovery system) recovery period (1981–1986).

- d. Depreciation recapture rules do not apply when property is disposed of by gift or by transfer at death.
- e. Gift property retains its ordinary income potential in the hands of the donee.
- f. The charitable contribution deduction for Section 1245 property must be reduced by the amount that would have been recognized as ordinary income if the item had been sold at its fair market value.
- g. In tax-free exchanges and involuntary conversions of Section 1245 property, depreciation recapture is considered only to the extent that a gain is recognized on the exchange or conversion.
- h. Any depreciation recapture resulting from an installment sale is to be recognized in the year of sale even if no proceeds are received.

1231.24**Section 1250 property rules:**

- a. IRC Section 1250 applies to real property—buildings and their structural components
- b. IRC Section 1250 requires that excess depreciation (actual depreciation in excess of straight-line depreciation) be recaptured as ordinary income. However, this provision no longer applies since straight-line depreciation has been required on buildings acquired after 1986. Thus, there is no excess depreciation, and all of the depreciation is “unrecaptured.”
- c. The unrecaptured gain on the sale of a building becomes IRC Section 1231 gain. If Section 1231 gains exceed Section 1231 losses for the current and past five years, the remaining gain receives long-term capital gain treatment. However, unrecaptured Section 1250 gain may be taxed at a special rate of 25%.

- (1) Unrecaptured Section 1250 gain is equal to the lesser of the gain or the total depreciation taken on the property.
- (2) Any gain not treated as unrecaptured Section 1250 gain is taxed at the long-term capital gain rate applicable to the transaction based on the taxpayer's tax bracket.

Example: A commercial building acquired at a cost of \$2,028,000 was sold in 2020 for \$3 million after deducting straight-line depreciation of \$650,000 over the years. Assuming that no other Section 1231 events affect this transaction, the taxation of the \$1,622,000 gain is as follows.

Because straight-line depreciation was used, no depreciation is recaptured as ordinary income. Consequently, there is unrecaptured Section 1250 gain of \$650,000. This portion of the gain is taxed at 25%. The remaining gain of \$972,000 is taxed at 20%, assuming the taxpayer is an individual with taxable income in excess of \$434,550.

Amount realized		\$3,000,000
Less: Adjusted basis		
Cost	\$2,028,000	
Less: Straight-line depreciation	(650,000)	<u>(1,378,000)</u>
Realized gain		\$1,622,000
Recognized gain:		
As ordinary income		\$ 0
As unrecaptured Section 1250 gain taxed at 25% rate		650,000
As Section 1231 long-term capital gain taxed at 20% rate		<u>972,000</u>
Total recognized gain		\$1,622,000

d. Additional rule for corporations (IRC Section 291):

- (1) A corporation's ordinary income from the sale of IRC Section 1250 real property will be increased by 20% of the lesser of (1) depreciation taken or (2) the recognized gain.

Example: Over the years, \$30,000 of straight-line depreciation was taken on a building costing \$10,000. If this property is sold for \$110,000, a gain of \$40,000 results (\$110,000 – (\$100,000 – \$30,000)). The corporation must recognize \$6,000 ($\$30,000 \times 20\%$) of this gain as ordinary income under IRC Section 291.

Amount realized		\$110,000
Less: Adjusted basis		
Cost	\$100,000	
Less: Straight-line depreciation	(30,000)	<u>(70,000)</u>
Realized gain		\$ 40,000
Recognized gain:		
As ordinary income, Section 291:		
Lesser of: $\$30,000 \times 0.20 = \$6,000$		
or $\$40,000 \times 0.20 = \$8,000$		\$ 6,000
As Section 1231 long-term capital gain		<u>34,000</u>
Total recognized gain		\$ 40,000

(2) This provision does not affect Subchapter S corporations.

Taxable and Nontaxable Dispositions

1232.01 Once the amount of gain or loss has been calculated, the amount of the gain or loss to be recognized for tax purposes must be computed.

- a. Generally, gains on property transactions are recognized, but the recognized gain never exceeds the realized gain.
- b. Losses on the sale, exchange, or condemnation of *personal use* assets are *not* recognized.
- c. Losses on the sale of income-producing property to certain related parties are *not* recognized. However, the disallowed loss may be used by the related purchasing party to offset any gain on a later disposition of this property.

- d. Gains are generally recognized in the year of the sale.
 - (1) Taxpayers using the installment method of reporting sales recognize and report their gain as the payments are received.
 - (2) The gain reported each year is determined by multiplying the gross profit percentage on the sale by the payments received that year.
 - (3) The installment method cannot be used to report losses.
- e. In certain transactions, some or all of the gain or loss may be postponed.
 - (1) Postponement is possible in these transactions *only if replacement property is acquired*.
 - (2) Postponement is accomplished by modifying the basis of the new property according to the following guidelines:
 - (a) Postponed gains: *Decrease* the basis (fair market value (FMV)) of the new asset by the amount of the unrecognized gain.
 - (b) Postponed losses: *Increase* the basis (FMV) of the new asset by the amount of the unrecognized loss.

1232.02 Property transactions in which the gain or loss may be postponed by adjusting the basis of the replacement property include the following:

- a. Tax-free exchange
- b. Involuntary conversions (condemnation, casualty, theft)
- c. Wash sale

1232.03 Tax-free exchange:

- a.** To postpone a gain or loss, property held for productive use in a trade or business, or for investment, must be exchanged for property of like kind to be held for business or investment purposes. Under the Tax Cuts and Jobs Act of 2017, the tax-free exchange provision applies only to real estate and no longer applies to personal property.
- b.** Treatment of gains and losses:
 - (1) If a gain is realized on the exchange of properties, the gain is recognized to the extent of the lesser of the gain realized or the fair market value (FMV) of the boot (cash or other assets) received. Any unrecognized gain is postponed.
 - (2) A loss incurred in a tax-free exchange is generally not recognized. The unrecognized loss is postponed.
 - (3) If boot is given in the exchange, gain or loss on the boot is recognized to the extent that the boot has appreciated or depreciated in value.
- c.** The following property items are not tax-free exchange items:
 - (1) Property held primarily for sale
 - (2) Securities
- d.** The following items do *not* qualify as like-kind items:
 - (1) Real property for personal property
 - (2) Livestock of different sexes
 - (3) Interests in a partnership
 - (4) After December 31, 2017, any property other than real property

- e. Tax-free exchanges *do* include the following special items:
 - (1) Exchanges of the same type of stock in the same corporation
 - (2) Transfer of property to a controlled corporation (80% owned)
 - (a) No gain or loss is recognized if property is exchanged solely for stock or securities.
 - (b) If cash or other property is received in addition to the securities, gain is recognized to the extent of the lesser of the gain realized or the cash or FMV of the other property received.
 - (3) Certain types of corporate reorganizations, including the following:
 - (a) A statutory merger or consolidation (Type A)
 - (b) An exchange of stock for voting stock (Type B)
 - (c) An exchange of assets for voting stock (Type C)
 - (d) A divisive reorganization—spin-offs, split-offs, split-ups (Type D)
- f. The basis of property acquired in a tax-free exchange is equal to the adjusted basis of the property surrendered, *or*:
 - (1) the amount derived when the unrecognized gain is subtracted from the FMV of the new asset or
 - (2) the amount derived when the unrecognized loss is added to the FMV of the new asset.

1232.04 Involuntary conversions (condemnation, casualty, theft):

- a. Gains:
 - (1) Taxpayer may elect to recognize the gain.
 - (2) Taxpayer may elect postponement. (IRC Section 1033)
 - (3) Taxpayer must recognize gains to the extent that there are proceeds left over after replacement of the asset.

b. Losses:

- (1) If income-producing property, the loss is recognized.
- (2) If non-income-producing property, the loss is recognized only to the extent that the casualty or theft (but not a condemnation) exceeds \$100 for each event.
 - (a) The deduction for casualty and theft losses on nonbusiness property is further limited to the excess of the loss over 10% of the adjusted gross income (AGI).
 - (b) For tax years beginning after December 31, 2017, and before January 1, 2026, the personal casualty and theft loss deduction is limited to a loss incurred in a disaster declared by the president under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act.
 - (c) However, when a taxpayer has personal casualty gains, losses may be offset against the gains.
 - (d) Taxpayers experiencing several allowable losses during the year may deduct the amount by which the combined losses (reduced by \$100 per event) exceed 10% of AGI.
- (3) In calculating the loss:
 - (a) The loss is limited to the difference in the fair market value immediately before and immediately after the event *or* the adjusted basis of the property, whichever is smaller.
 - (b) If business or income-producing property is completely destroyed, the adjusted basis may be deducted if it is greater than the fair market value immediately preceding the casualty.
 - (c) Insurance and/or other compensation received acts to reduce the loss.

- c. Taxpayers must also net gains and losses when there are both recognized gains and recognized losses from the involuntary conversion of trade or business property held for more than one year.
 - (1) If the gains exceed the losses, *all* casualty and theft gains and losses are combined with the other Section 1231 transactions.
 - (2) If the losses exceed the gains, the net loss is deductible as an ordinary loss.
- d. The basis of any replacement property is equal to the cost of the property reduced by any unrecognized gain.
- e. Replacement must take place within a period that begins on the date of destruction or condemnation, or the date when the property was first threatened with condemnation, whichever is earlier.
 - (1) The period ends two years after the close of the tax year in which some part of the gain is realized.
 - (2) On the condemnation (as opposed to casualty and theft) of business and investment real property, the replacement period ends three years after the close of the tax year in which some part of the gain is realized.
 - (3) The replacement period for the involuntary conversion of a personal residence in a declared federal disaster area is extended to four years beyond the year of gain.

1232.05**Sale or exchange of a principal residence:**

- a. Individuals may exclude \$250,000 (\$500,000 on a joint return) of gain on the sale or exchange of a principal residence. Gains in excess of the excludible amount will be taxed. These excess gains may not be postponed by adjusting the basis of a replacement residence.
 - (1) The residence must have been owned and occupied by the taxpayer for an aggregate of at least two of the five years before the sale or exchange.
 - (2) The exclusion may be used only once every two years.
 - (3) The \$500,000 exclusion is available to married taxpayers filing jointly if (a) *either* spouse satisfies the ownership test, (b) *both* spouses meet the occupancy test, and (c) neither spouse has used the exclusion within the last two years.
 - (a) When the spouse has used the exclusion within the past two years, an eligible taxpayer may still exclude \$250,000 on either a joint return or a separate return.
 - (b) When a husband and wife each sell a principal residence, they are each eligible to exclude \$250,000 on the sale of their residences. They may claim their exclusions on either a joint return or separate returns.
 - (c) A surviving spouse can exclude up to \$500,000 from the sale of a principal residence if the sale is within two years of the date of death and the other requirements were met on the date of death.
 - (4) If the ownership and occupancy tests are not met, a prorated exclusion is available if the sale or exchange is the result of (a) change of place of employment, (b) health, or (c) unforeseen circumstances.

(5) An individual is treated as using property as his or her principal residence during any period of ownership while the individual's spouse or former spouse is granted use of the property under a divorce decree or separation instrument.

- b. Losses are not recognized; neither are they postponed.
- c. The basis of any new residence is its cost. There is no basis adjustment for unrecognized gains and losses.

1232.06 Wash sale:

- a. A wash sale takes place when securities are sold at a loss and replaced with substantially identical securities within 30 days *before or after* the sale.
- b. Such losses are not recognized—they are postponed. The disallowed loss increases the basis of the stock or securities acquired.
- c. This law does not apply to dealers.

1232.07 Section 1202:

Depending on the acquisition date of qualified small business stock (QSBS), IRC Section 1202 permits noncorporate investors to exclude a percentage of gain they realize on the disposition of QSBS issued after August 10, 1993, under certain conditions.

1232.08 Qualified small business stock (QSBS):

For a small business stock to qualify under IRC Section 1202:**Error! Bookmark not defined.**

- a. The business must be a United States C corporation with \$50 million or less in capital. Exceeding the \$50 million limit does not disqualify otherwise qualifying stock, but the corporation can never again issue qualified stock.
- b. The stock must have been directly acquired as an original issuance from the C corporation (or via gift or inheritance from the original acquirer).
- c. The stock must be held for more than five years from the date of acquisition.

- d. Eighty percent (80%) of the value of the corporate assets must be used in the active conduct of business.
- e. The company must provide services in an eligible sector—those in personal services, law, banking, finance, leasing, hospitality, health, farming, or mining are not eligible for this exclusion.

1232.09 QSBS capital gain exclusions:

Acquisition Date	Capital Gain Exclusion Percentage
2/18/2009–9/27/2010	75%
After 9/27/2010 (see PATH Act)	100%

1232.10 The PATH Act:

In December 2015, the Protecting Americans from Tax Hikes Act of 2015 (PATH Act) was signed into law

- a. The PATH Act made the small business stock gains exclusion permanent; 100% of the gain on the sale or exchange of QSBS (qualified small business stock) acquired after September 27, 2010 and held for more than five years is excluded from taxable income, with certain limitations.
- b. The PATH Act also permanently extended the rule that eliminates the 100% excluded QSBS gain as a preference item for alternative minimum tax (AMT) purposes.
- c. In addition, QSBS gain excluded from income is not subject to the 3.8% “Obamacare” tax on “net investment income” from capital gains (and other investment income) on high-income taxpayers.

1232.11 Per-issuer limitation on gain exclusion:

- a. Eligible gain from any one corporate issuer in any given tax year cannot exceed the greater of:
 - (1) \$10 million reduced by the aggregate amount of eligible gain taken into account by the taxpayer in prior years from the same issuer or
 - (2) 10 times the adjusted basis of all qualified stock of the issuer that the taxpayer disposed of during the tax year.
- c. The \$10-million limitation is applied on a shareholder-by-shareholder basis and any property contributed to the issuing corporation is its fair market value as of the contribution date.
- d. Married taxpayers filing separately have \$5 million of eligible gain for each spouse.

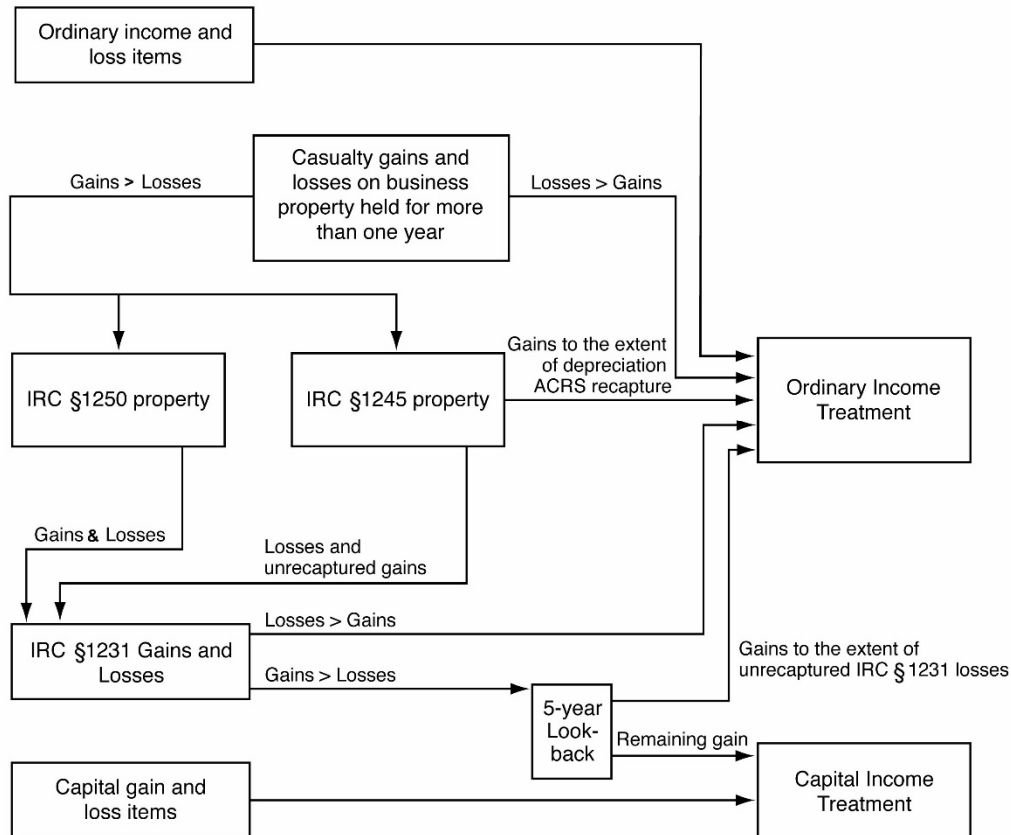
1232.12 Section 1244 stock:

IRC Section 1244 allows losses from the sale of shares of small, domestic corporations to be deducted as ordinary losses instead of as capital losses up to a maximum of \$50,000 for individual tax returns or \$100,000 for joint returns.

- a. The corporation's aggregate capital must not have exceeded \$1 million when the stock was issued.
- b. The corporation must not derive more than 50% of its income from passive investments.
- c. The shareholder must have paid for the stock and not received it as compensation.
- d. Only individual shareholders who purchase the stock directly from the company qualify for the special tax treatment.
- e. Losses in excess of the maximum can then be deducted as a capital loss on Schedule D (IRS Form 1040).

Amount and Character of Gains and Losses, and Netting Process

1233.01 The following summarizes the tax treatment of gains and losses.



1233.02 The gain or loss on the disposal of property is computed by comparing the value of the assets received with the investment in the property given up.

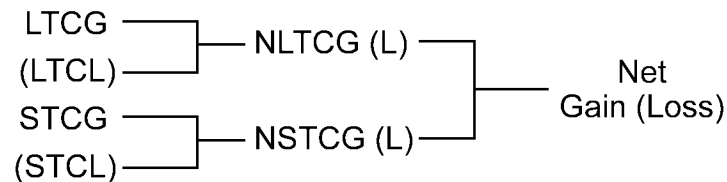
$$\begin{aligned} & \text{Amount realized} \\ - & \text{Adjusted basis} \\ = & \text{Gain or loss} \end{aligned}$$

1233.03 The amount realized on the disposition of property is equal to the net proceeds received for that property.

$$\begin{aligned} & \text{Gross selling price} \\ - & \text{Selling expenses} \\ = & \text{Amount realized} \end{aligned}$$

- a.** The gross selling price includes everything received for the property given up, including the following:
- (1) Cash
 - (2) Fair market value of property and services received
 - (3) Amount of mortgage, assumed by buyer, on property given up
- b.** Selling expenses include advertising, legal fees, commissions, and any other costs required to effect the transfer of property.

1233.04 All items receiving capital gain or loss treatment should be classified as short term or long term and summarized as follows:



The result is either a net gain or a net loss.

1233.05**Net gains for individuals, estates, and trusts:**

- a.** Any of the net gain arising from short-term sales and exchanges receives ordinary income treatment. A short-term capital gain is from a capital asset that is held 1 year or less. A long-term capital gain is from a capital asset this is held for longer than 1 year.
- b.** Capital gain is subject to one of three rates depending on the nature of the asset responsible for the gain. Maximum rates are 25% on recaptured depreciation on real property, 28% on gains from the sale of collectibles and IRC Section 1202 stock, and—finally—20% on all other “regular” gains.
- c.** Maximum capital gain tax rates are 0% for individuals with income up to \$40,000 (\$53,600 for head of household, \$80,000 for married filing jointly), 15% for individuals with income up to \$441,450 (\$469,050 for head of household, \$496,600 for married filing jointly), and 20% for individuals earning over \$441,450 (\$469,050 for head of household, \$496,600 for married filing jointly). These same breakpoints apply to qualified dividends. Breakpoints will change with inflation. Do not forget the following exceptions:
 - (1) Unrecaptured IRC Section 1250 gain (gain up to the original cost of real property) will be taxed at a maximum rate of 25%. Any excess of sales price over original cost of real property used in a trade or business is regular gain taxed at 0%, 15%, or 20%.
 - (2) Taxable gains arising from the sale of collectibles (e.g., art, coins, and antiques) and Section 1202 stock will be taxed at a maximum rate of 28%.

1233.06 Net capital losses for individuals, estates, and trusts:

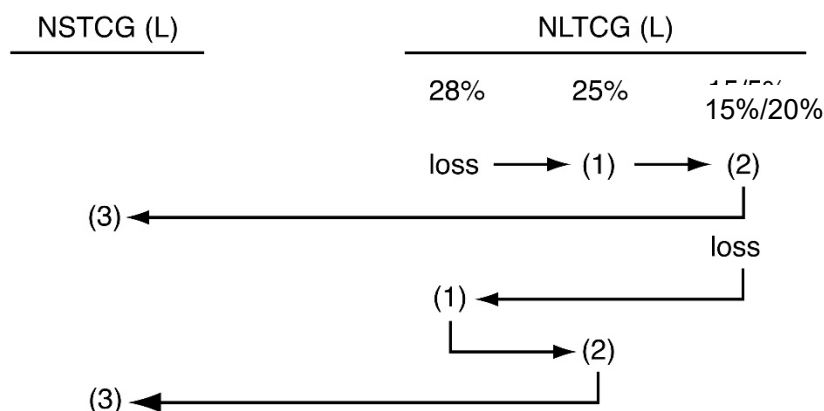
- a. If the taxpayer has a net capital loss, up to \$3,000 may be deducted in the current year as a deduction from adjusted gross income (reported on Schedule D of IRS Form 1040).
- b. Short-term losses are used before long-term losses.
- c. Both short-term (STCL) and long-term (LTCL) losses are deductible dollar-for-dollar.
- d. Any remaining capital loss will be carried forward indefinitely.
- e. The carryover will be treated as STCL or LTCL depending on its origin.

1233.07 Special netting procedures:

- a. Long-term capital gain and loss items are netted in the following manner. Separately list 28% gains (losses), 25% gains, 15%/20% gains (losses), then:
 - (1) offset any 28% losses against 25% gains, then against 15%/20% gains. If a loss still exists, offset it against any available net short-term gain. Any remaining loss is eligible for the \$3,000 deduction. A loss in excess of \$3,000 carries forward indefinitely.
 - (2) offset any 15%/20% losses against 28% gains, then 25% gains. Offset any remaining loss against available net short-term gain. If a loss remains, it is eligible for the \$3,000 deduction. A loss in excess of \$3,000 carries forward indefinitely.

While losses can result from the sale of 28% and 15%/20% items, the 25% situation involves only gains (by definition).

Summary of the netting process for long-term capital gains and losses:



When the netting process produces a net long-term capital gain, the gain is used to absorb any net short-term capital loss. Any remaining 28%, 25%, or 15%/20% gains will be taxed at those rates (see short-term netting process in part *b.*, following).

Example: A taxpayer with \$250,000 of taxable income (35% tax bracket in 2020) has no short-term gains and losses, but does have the following long-term capital gains and losses:

- (a) 28% gain from the sale of stamp collection: \$4,000
- (b) 25% gain from unrecaptured depreciation on sale of a commercial building: \$105,000
- (c) 15%/20% loss from sale of stock held as investment: \$65,000

In this situation, the taxpayer first offsets the \$65,000 loss against the \$4,000 gain. The remaining loss of \$61,000 then offsets the 25% gain of \$105,000. The remaining NLTCG (net long-term capital gains) of \$44,000 is taxed at 25%.

b. Short-term capital gains and losses are netted to produce a net short-term gain or loss.

- (1) If the result is a gain, the gain is used to absorb any net long-term capital loss. Any remaining short-term capital gain is taxed as ordinary income.
- (2) If the netting process results in a net short-term capital loss, the loss will offset available net long-term capital gain in the following order: 28% gains, 25% gains, and 15%/20% gains. If a loss remains, up to \$3,000 may be deducted as a deduction for adjusted gross income (AGI). Any additional loss is carried forward indefinitely.

Example: If the taxpayer in the preceding example also had a net short-term capital loss of \$15,000, the loss would offset the NLTCG of \$44,000. The remaining \$29,000 gain would be taxed at 25%.

- (3) Capital losses of individuals carry forward as either long term or short term depending on their origin. However, short-term losses are used first in calculating the \$3,000 deduction.

1233.08 Net capital gains for corporations:

- a. Corporate capital gains are taxed at the same tax rate as ordinary income.
- b. Before 1987, corporate capital gains received favorable tax treatment through an alternative tax.

1233.09 Net capital losses for corporations:

- a. Corporations are not allowed to deduct capital losses in excess of capital gains from ordinary income.
- b. Capital losses of a corporation can only be used to offset capital gains.
- c. All net capital losses carry back three years and forward five years as capital losses.

- d. Ordering of losses:
- (1) If carrying losses from more than one year, use the earlier losses first.
 - (2) Loss carryback/carryforward rules operate as follows:
 - (a) First, carry back to the third prior year.
 - (b) Next, carry back what is left to the second prior year.
 - (c) Next, carry back to the year immediately preceding the loss.
 - (d) Then, whatever loss remains is carried forward for the five years following the year of loss.
 - (e) Finally, any loss remaining after five years is lost.

Basis and Holding Periods of Assets

1234.01 In determining the taxpayer's investment (adjusted basis) in an asset, several cost factors must be considered

Original basis
+ Capital additions
– Capital recoveries
= Adjusted basis

- a. The basis of property *must be adjusted* by the cost of any improvements made since its acquisition. Real property taxes and mortgage interest on unimproved and unproductive real property may be capitalized at the election of the taxpayer.
- b. The basis of property *must be reduced* for depreciation and depletion along with other recoveries such as casualty losses.

1234.02

Establishing the basis of property acquisitions depends primarily on the method by which the property was acquired.

- a. **Standard purchase**—Basis is cost.
 - b. **Group purchase**—The cost is allocated to the individual assets in proportion to their fair market values.
 - c. **Bargain purchase**—Basis is the cost plus the bargain (fair market value at the date of the bargain purchase).
 - d. **Inherited property**—Basis is usually the fair market value at date of death.
- (1) Fair market value (FMV) six months after death is an alternative for an estate tax return if this produces a lower value for the gross estate and a lower estate tax liability. The FMV at six months after death can only be used for basis if an estate tax return is filed using that FMV.
 - (2) If the alternative value is chosen and property is disposed of before the six-month period has expired, that property shall be valued at the fair market value at the date of disposition, the sale price.

e. Gift property acquired since January 1, 1921:**(1) Basis to compute gain—donor's basis**

- (a) On gifts made before 1977, any gift taxes paid by the donor could be added to the donor's basis as long as the addition of the taxes did not cause the basis of the property in the donee's hands to exceed the fair market value of the property at the date of the gift.
- (b) On gifts made after 1976, the basis of the property is increased by the gift tax attributable to the net appreciation in the value of the gift property, but the donee's basis cannot be increased beyond the fair market value of the property at the date of the gift.

(2) Basis to compute loss—lower of:

- (a) donor's basis plus the gift tax adjustment or
 - (b) fair market value at date of gift
- In certain situations, neither a gain nor a loss can be computed on the sale of property received by gift. In such a situation, the selling price is less than the basis for gain and more than the basis for loss.

(3) Basis for calculating depreciation—Use the gain basis.**(4) Basis of gifts made prior to 1921—fair market value at date of gift**

- f. Personal property converted to income production:**
 - (1) **Basis for gain**—adjusted basis of the asset at conversion minus allowable depreciation after conversion
 - (2) **Basis for loss**—lower of:
 - (a) the adjusted basis of the asset at conversion minus allowable depreciation or
 - (b) fair market value at conversion minus allowable depreciation thereafter
 - (3) **Basis for calculating depreciation**—lower of:
 - (a) the adjusted basis of the asset at conversion or
 - (b) fair market value at conversion
- g. Property received as compensation for services:**

Basis is the fair market value of the property when received.

h. Property transferred to a controlled corporation:

- (1) The basis of stock received for property transferred to a controlled corporation is equal to the basis of the property exchanged plus any recognized gain on the exchange minus any cash and/or other property received
- (2) The basis of property acquired by the corporation is the same as it was in the possession of the transferor plus any gain recognized by the transferor on the exchange.
- (3) To qualify as a controlled corporation, persons transferring property to a corporation for its stock or securities must own 80% of the voting stock plus 80% of all other stock of the corporation immediately after the exchange.

i. Taxable exchange—Basis is the fair market value of the property received.**1234.03**

Capital gains and losses, once determined, must be classified as either short term or long term depending on the holding period of the asset given up

- a.** Holding period requirements:
 - (1) One year or less—short term
 - (2) More than 12 months—long term
- b.** The holding period for long-term capital gains and losses is measured as follows:
 - (1) As a minimum, property must be held to that day of the 12th month following the month of acquisition that is numerically *one day* later than the date acquired.
 - (2) If property is purchased on the last day of the month, it must be held to at least the first day of the 13th month.
- c.** The holding period normally begins on the day that the basis originated.

- d. In transactions in which some portion of the basis of an asset carries forward, the holding period begins at the time the carryover basis originated.

Example: If the donor's basis is used to establish the basis of gift property, the holding period for the donee begins at the time the donor's basis originated.

If the fair market value is used as the basis of gift property (a loss situation), the holding period begins at the date of the gift.

- e. The Internal Revenue Code provides that inherited property disposed of within one year shall be considered to have been held for more than one year.
- f. If any security, which is a capital asset, becomes worthless during the taxable year, the loss resulting therefrom shall be treated as a sale or exchange of a capital asset on the last day of the taxable year.

1235 Basis of stock after stock splits and/or stock dividends

1235.01 Corporations may increase the number of shares outstanding (and at the same time reduce the value of each share) by issuing stock dividends or stock splits. These events are usually non-taxable but change the number of shares you own and the basis of those shares. A stock dividend is generally declared in terms of a percentage. For example, in a 5 percent stock dividend, a taxpayer will receive one additional share for every 20 shares he or she already owns. A stock split is usually declared as a fraction. In a 2-for-1 split, the taxpayer receives one additional share for every share he or she owns (so that the taxpayer ends up owning two shares for every one he or she owned before the split). Stock splits can occur at odd fractions. For example, if a stock splits 3-for-2, the owner receives one additional share for every two he or she owned before the split (and end up owning three for every two he or she had before). A 3-for-2 stock split is the same as a 50 percent stock dividend.

1235.02 When a taxpayer receives additional shares as a result of a non-taxable stock dividend or split, the total basis in the stock remains the same. The basis is divided among the shares already owned and the new shares in proportion to the value of the shares. In the usual case, where the new shares are exactly the same as the old ones, the value is the same, and basis is allocated equally to each share.

Example 1: Taxpayer owns 400 shares of XYZ with a basis of \$33 per share (total basis of \$13,200). XYZ declares a 10 percent stock dividend. He receives 40 additional shares and now owns a total of 440 shares. Taxpayer's total basis is unchanged, so his basis per share is now \$13,200 divided by 440, or \$30.

Example 2: Taxpayer owns 150 shares of ABC with a basis of \$24 per share, and another 100 shares of ABC with a basis of \$28 per share. The stock splits 2-for-1. After the split, she owns 300 shares with a basis of \$12 per share, and 200 shares with a basis of \$14 per share. (This is true even if the taxpayer receives a single certificate representing her 250 new shares.)

1235.03 Holding period

A taxpayer is treated as if he or she held the new shares as long as he or she held the old shares.

Example: A taxpayer bought 400 XYZ on June 10, 20X4 and received 40 new shares in a non-taxable stock dividend on November 10, 20X9. Any gain or loss on a sale of the 40 new shares will be treated as a long-term capital gain even if the taxpayer sold them immediately after he or she acquired them.

1235.04 Publicly traded partnerships (PTP)

A publicly traded partnership (PTP) is a business organization owned by two or more co-owners whose shares are regularly traded on an established securities market. A publicly traded partnership is a type of limited partnership that is managed by two or more general partners who can be individuals, corporations or other partnerships, and that is capitalized by limited partners who provide capital but have no management role in the partnership. That capital is typically in the form of cash.

1236 Sale of personal residence

1236.01 Section 121(a) provides that a taxpayer may exclude gain realized on the sale or exchange of property if the property was owned and used as the taxpayer's principal residence for at least two years during the five-year period ending on the date of the sale or exchange. The amount of the exclusion is limited to \$250,000 (\$500,000 for certain joint returns). Any gain attributable to depreciation adjustments for periods after May 6, 1997, is not eligible for the exclusion. This limitation applies only to depreciation allocable to the portion of the property to which the §121 exclusion applies.

1236.02 To exclude gain on the disposition of a home from income under §121, a taxpayer must own and occupy the property as a principal residence for two of the five years immediately before the sale. However, the ownership and occupancy need not be concurrent. The law permits a maximum gain exclusion of \$250,000 (\$500,000 for certain married taxpayers). A taxpayer is considered to have owned and used a home as a principal residence during the time his or her deceased spouse used the home as a principal residence. This rule applies as long as on the day the home is sold the taxpayer's spouse is deceased and the taxpayer has not remarried. Divorced spouses can also benefit from the ownership and use periods of former spouses to satisfy the exclusion requirements.

1236.03 If a taxpayer excludes the entire gain on the sale from income, the transaction is not reported on his or her tax return. If any part of the gain is taxable, he or she reports the sale on Schedule D of Form 1040. Alternatively, a taxpayer can elect to include the gain from a sale by reporting it on his or her tax return. For example, someone who realizes gains on the sale of two principal residences within two years can exclude the gain on only one. Most would want to recognize the smaller gain and exclude the larger. Since the exclusion applies automatically to the first disposition, a taxpayer would need to elect to be taxed on this one if it is the smaller of the two.

1236.04 Principal residence requirement

The rules define the term residence fairly broadly -- it includes a houseboat, house trailer, or stock held by a tenant-stockholder in a cooperative housing corporation. Personal property that is not a fixture under local law will not qualify as a residence.

Consequently, EAs should consult local law, particularly on the status of mobile dwellings. If a taxpayer owns more than one home, practitioners will find the determination as to which home is the taxpayer's principal residence depends on all of the facts and circumstances. The home a taxpayer uses for the majority of the time during the year will be considered his or her principal residence for that year.

Example: For the period 2016 to 2020, Albert owns a home in Michigan and a home in Florida. During each of these years, Albert lives in the Michigan home for seven months and in the Florida home for five months. If Albert decides to sell one of the homes in 2020, only the Michigan home will qualify for the gain exclusion. Because he lives in Michigan for the majority of each year, that home is Albert's principal residence for 2016 to 2020.

1236.05 Ownership and use requirements

The ownership and use requirements are based on the total number of days or months the taxpayer owns and uses the property as a principal residence during the five-year period ending on the date of disposition. The gain on the sale of a home is excluded from income only if, during that five-year period, the taxpayer owns and uses the property as a principal residence for periods totaling two years or more. Either 24 full months or 730 days will satisfy the two-year ownership and use requirements. The ownership and use periods do not need to be concurrent.

Example 1: On January 1, 2016, Barbara bought a home and began to live in it. On January 1, 2018 (24 months after purchasing the home), Barbara moved out of town and began to lease the home. On December 28, 2020, she sells the property. Because Barbara owned and used the home as a principal residence for 24 months during the five-year period ending on the date of sale, she is eligible for the gain exclusion. If, however, Barbara sells her house on February 1, 2020, the five-year period would have begun on February 1, 2016. In this case Barbara would not be eligible for the gain exclusion because she would have lived in the home for only 23 months during the five-year period before the date of sale.

Example 2: Carmella rented a home from January 1, 2016 to January 1, 2018. She purchased the home on January 1, 2018 and lived in it until February 1, 2018. On March 1, 2020, Carmella sold the home. During the five-year period ending on the date of sale (March 1, 2015 to March 1, 2020), Carmella owned the home for at least two years (January 1, 2018 to March 1, 2020) and lived in it for at least two years (January 1, 2016 to February 1, 2018). Therefore, Carmella is eligible for the gain exclusion even though she did not live in the residence during the same two years she owned it.

1236.06 If a taxpayer owns two homes during the five-year period, both may qualify for the exclusion if the taxpayer uses each of them as a principal residence for at least two years during the five-year period. However, usually the gain on only one of the two otherwise qualified homes can be excluded during any two-year period.

Example: For the period January 1, 2016 to December 31, 2020, David owns a home in Kansas and also in Texas. David lived in the Kansas home during 2016, 2017, and 2020 and in the Texas home during 2018 and 2019. David's principal residence for 2016, 2017, and 2020 was the Kansas property. His principal residence for 2018 and 2019 was the Texas home. If David decides to sell one of the homes during 2020, both qualify for the gain exclusion because he owned and used each one as a principal residence for at least two years during the five-year period before the sale date.

To satisfy the use requirement, the taxpayer must physically occupy the home. However, short temporary absences, such as vacations, are counted as periods of use even if the home is rented during that time.

1236.07 Deceased spouse

For the ownership and use requirements, a taxpayer is considered to have owned and used a home as a principal residence during the time his or her deceased spouse owned and used the home (before death) as a principal residence, as long as on the day the home is sold the taxpayer's spouse is deceased and the taxpayer has not remarried.

1236.08 Former spouse

In cases of divorce, taxpayers can benefit from both the ownership and use periods of former spouses to satisfy the requirements. If a taxpayer receives a home as part of a divorce property settlement, the taxpayer's ownership period will include the time the spouse or former spouse owned the home. In addition, a taxpayer is treated as having used the home as a principal residence during the time the taxpayer owned the residence and the taxpayer's spouse or former spouse was permitted to use it --under a decree of divorce or separation -- as a principal residence.

Example: On January 1, 2018, Harry bought a home and began to live in it with his spouse, Jennifer. On January 1, 2020, Harry and Jennifer were divorced. Under the divorce decree, Jennifer is allowed to live in the home until February 1, 2020. Harry sells the home on March 1, 2020. Harry and Jennifer could both meet the two-year ownership and use requirements. Although Harry lived in the home for only 12 months, if he continues to own it, he is also considered to have lived in the home for the 13 months Jennifer lived there. If Jennifer owns the residence after January 1, 2020, her ownership period includes Harry's ownership from January 1, 2018 to January 1, 2020.

1236.09 Disallowance for use as a nonresidence

If a taxpayer also uses a home for purposes other than as a principal residence, the gain exclusion does not apply to the extent of depreciation taken on the home after May 6, 1997.

Example: On January 1, 2016, Kelly bought a home and rented it to tenants for two years. During the rental period, Kelly takes depreciation deductions of \$14,000. On January 1, 2018, Kelly moves into the home and begins to use it as a principal residence. On February 1, 2020, after owning and using the home as a principal residence for more than two years, she sells the home at a \$40,000 gain. Only \$26,000 (\$40,000 realized gain minus \$14,000 depreciation) of the gain is eligible for the exclusion. Kelly must recognize the remaining \$14,000. The gain is an unrecaptured \$1250 gain taxable at up to 25 percent.

If a taxpayer uses a home partially for business purposes, only the part of the gain attributable to the residential portion of the home is excluded from income. Also, the gain exclusion does not apply to the extent depreciation allowable after May 6, 1997, with respect to the home, exceeds the gain on the home allocable to the business-use portion. Therefore, pre-May 7, 1997, depreciation does not reduce the amount of gain excludable under §121 on the residential portion in any circumstances. However, post-May 6, 1997, depreciation allowable on nonresidential use can trigger gain recognition on the residential-use part of the house.

1236.10 Overall dollar limitation

The maximum gain exclusion for an individual taxpayer is \$250,000. This amount is not adjusted for inflation. Taxpayers who jointly own a principal residence, but file separate returns, may each exclude up to \$250,000 of the gain attributable to their interest in the home. A husband and wife who file a joint return may exclude up to \$500,000 of the gain if:

- a.** Either spouse meets the two-year ownership requirement.
- b.** Both spouses meet the two-year use requirement.
- c.** Neither spouse excluded gain from a prior sale or exchange of a principal residence within the last two years.

If the taxpayers do not meet any one of these requirements, the maximum exclusion amount a married couple can claim on a joint return is the sum of each spouse's exclusion amount, determined as though: (1) the spouses were not married; and (2) each spouse owned the home during the period that either spouse owned the home. Although one spouse's ownership is attributed to the other for purposes of determining a separately calculated exclusion, both spouses must actually use the house as a principal residence to qualify for their own \$250,000 exclusion.

Example: Nancy and Oscar marry in 2019 and move into an apartment. The couple each separately owned and used a home for at least two years before marrying. Nancy and Oscar sell their separate homes in 2020. Nancy realizes a gain of \$225,000 on the sale of her home and Oscar realizes a gain of \$275,000 on his sale. Although Nancy and Oscar do not meet the requirements to exclude up to \$500,000 of gain on their joint return, each spouse may exclude up to \$250,000. Therefore, Nancy and Oscar will exclude \$225,000 from the sale of Nancy's home and \$250,000 from the sale of Oscar's home. Because Oscar cannot use any of Nancy's unused exclusion, the couple must include \$25,000 of the gain on his home in income. The result would be the same if Nancy and Oscar each had sold their homes before marrying.

If a married couple meets the ownership and use requirements to qualify for the \$500,000 gain exclusion and one spouse dies, the \$500,000 exclusion will continue to apply if the surviving spouse sells the house in a year in which he or she can file a joint return with the deceased spouse. Further, if the surviving spouse has not

remarried, both the deceased spouse's ownership and use as a principal residence are attributed to the survivor.

Example: Peter and Quill, a married couple, have owned and used their home as a principal residence since 2016. Peter dies on June 1, 2020. On November 1, 2020, Quill sells the home at a \$280,000 gain. The entire \$280,000 is eligible for the gain exclusion if she files a joint return for 2020. If, however, Quill sells the home on January 10, 2021, only \$250,000 of the gain is eligible for the exclusion because Peter and Quill cannot file a joint return in 2021.

1236.11 Once-every-two-years limitation

A taxpayer cannot use the gain exclusion if, during the two-year period ending on the date of the sale or exchange, he or she sold another home and excluded the gain on that home. However, as discussed below, a reduced exclusion may be allowed.

Example: Robert buys a home that he uses as a principal residence in 2017 and 2018. In 2019, he bought a condo that he uses as a principal residence in 2019 and 2020. He then sold the original home in 2020 and excludes that gain from income. If Robert sells the condo in 2021, he cannot exclude the gain on that sale -- even though he satisfies the two-year ownership and use requirements -- because he excluded the gain on the sale of the home within the prior two years.

1236.12 Reduced exclusion

Taxpayers who sell their principal residence, but do not meet the ownership and use requirements, or who sell their home within two years of selling another home, may be eligible for a reduced exclusion. The reduced exclusion is available if a change in place of employment, health, or unforeseen circumstances necessitated the sale. Neither the Internal Revenue Code nor the proposed regulations define the change in place of employment, health problems, or unforeseen circumstances that would allow taxpayers to qualify for the reduced exclusion.

The reduced exclusion would be calculated by multiplying the maximum dollar limitation (\$250,000 or \$500,000 for qualifying married taxpayers) by a fraction. The numerator of the fraction is the shortest of: (1) the time the taxpayer **owned** the home during the five-year period ending on the date of the home's sale; (2) the time the taxpayer **used** the home during the five-year period ending on the date of sale; or (3) the time between the date of the prior sale for which gain was excluded and the date of the current sale. The numerator and denominator are expressed in either days or months. If the measure is days, the denominator is 730 days (365 days x 2 years). If the measure is months, the denominator is 24 months.

Example 1: On January 1, 2019, Sally, an unmarried taxpayer, buys a home and uses it as a principal residence. On July 1, 2020, 18 months later, Sally sells the home because her employer transfers her to an office in another state. Sally may exclude up to \$187,500 ($250,000 \times 18/24$) of the gain on the sale of her home.

Example 2: On January 1, 2017, Tom buys and begins to live in a home. On January 1, 2019, Tom marries Ursula and she moves into Tom's home. On January 1, 2020 (12 months after Ursula began residing in the home), they sell the home because their employers transfer them to another state. Because only Tom has satisfied the two-year use requirement, the couple cannot use the \$500,000 exclusion. Rather, their exclusion is determined by calculating the limitation amount for each spouse as if they had not been married. Therefore, Tom can exclude up to \$250,000 of gain because he meets both the ownership and use requirements. Although Ursula does not meet these use requirements, she can claim the reduced exclusion because the sale is due to a job change. Ursula can exclude up to \$125,000 ($250,000 \times 12/24$) of the gain. Therefore, Tom and Ursula can claim a combined exclusion of \$375,000.

A taxpayer must recognize any gain on a portion of a residential property they do not use for residential purposes. Any post-May 6, 1997, depreciation allowable on the property triggers recognition of otherwise excludable gain. A taxpayer can claim only one §121 **exclusion** every two years. However, a taxpayer who disposes of more than one residence within two years or who otherwise fails to satisfy the requirements, for example, due to a job change or health problem, may qualify for a reduced exclusion amount.

A taxpayer who uses a portion of a property for residential purposes and a portion of the property for business purposes is treated as using the entire property as the taxpayer's principal residence for purposes of satisfying the two-year use requirement if the residential and business portions of the property are within the same dwelling unit. If; however, the business portion of the property is separate from the dwelling unit used for residential purposes, the gain allocable to the business portion of the property is not excludable unless the taxpayer has also met the two-year use requirement for the business portion of the property.

Installment Sales

1237.01 Installment sales (in general)

- a.** Generally, a taxpayer is required to recognize the gain or loss from the sale or exchange of property at the time of the sale or exchange.
- b.** Under the installment sales method, a taxpayer elects to report capital gain from an installment sale over the period during which payments are received. The installment sale rule does not apply to the reporting of losses or ordinary income.
- c.** The installment method generally applies to sales in which the taxpayer has a gain if at least one payment will be received after the tax year in which the sale occurs.
- d.** The installment sale reporting method may not be used:
 - (1) to report gains on property held for sale in the ordinary course of business (inventory),
 - (2) for gain that must be recaptured as ordinary income under IRC Section 1245 or 1250, or
 - (3) for any gain on stocks or securities that are traded on an established securities market.

- e. However, the installment method can be used to report gain on the sale of:
 - (1) time-share units,
 - (2) residential real estate lots if the seller has made no improvements to the lots, and
 - (3) property used or produced in farming.
- f. If the installment method applies to a sale, the taxpayer generally must use that method unless they elect out. Electing out is done by simply reporting the entire gain from a transaction in the year of origin.

1237.02 Computation of gain

- a. The gain recognized under the installment method is computed using the following formula:

$$\frac{\text{Total gain}}{\text{Contract price}} \times \text{Payments received during the tax year} = \text{Gain recognized}$$

- b. **Total gain** is the selling price of the property reduced by the adjusted basis of the property and any selling expenses.
- c. The **contract price** is the selling price of the property reduced by any of the seller's liabilities that are assumed by the buyer as part of the sale.

1237.03 Installment sales: Other issues

- a. Generally, if a taxpayer disposes of the installment obligation, the remainder of the gain under the installment sale is accelerated and must be recognized in the year of the disposition of the obligation.
- b. A taxpayer can make an election not to use the installment reporting method. This election is made by reporting all of the recognized gain from the installment sale in the tax year of the sale.
- c. A taxpayer must receive IRS permission to revoke an election not to use the installment sales reporting method.

1237.04 Stock Options:

- a. An employee receiving a qualified incentive stock option will not recognize income when it is granted.
- b. A sale of the stock will produce long-term capital gain if the sale occurs more than one year after exercise and two years after grant.
- c. However, when computing the alternative minimum tax, generally must include the excess of the fair market value of the incentive stock options exercised during the year over the option price.
- d. A nonqualified stock option plan requires employee recognition of the bargain element on the exercise date. The bargain element is the difference between the stock price and the fair market value on the exercise date.

1237.05 Stock Rights:

- a. Generally, the distribution of stock rights does not constitute income. Exceptions include the following:
 - 1) The option to receive cash or other property in lieu of money
 - 2) A distribution of stock rights made on preferred stock

b. Nontaxable stock rights:

- 1) No income is recognized when rights are received.
- 2) The basis of the rights received is generally \$0.
 - i. The taxpayer may elect to allocate a portion of the basis of the underlying stock to the rights according to the relative fair market values of each at the time of distribution.
 - ii. If the fair market value of the rights at the date of distribution is 15% or more of the fair market value of the stock on which they are issued, the basis of the stock must be allocated between the stock and the rights according to the relative fair market values of each.
- 3) The holding period for stock acquired through the exercise of the rights begins at the date of exercise.

c. Taxable stock rights:

- 1) Gross income is realized to the extent of the fair market value of the rights at the time of distribution.
- 2) The basis of the rights received is equal to the fair market value of the rights.
- 3) The holding period for stock acquired through exercise of the rights begins at the date of exercise.

d. The basis of the stock acquired through the exercise of the rights is equal to the subscription price plus the basis of the rights.

1238.01 Non-business bad debts

If someone owes a taxpayer money that he or she cannot collect, he or she may have a bad debt. To deduct a bad debt, the taxpayer must have previously included the amount in his or her income or loaned out his or her cash. If the taxpayer is a cash basis taxpayer, he or she may not take a bad debt deduction for money he or she expected to receive, but did not (for example, for money owed to him or her for services performed, or rent) because that amount was never included in his or her income. For a bad debt, the taxpayer must show that there was an intention at the time of the transaction to make a loan and not a gift. If a taxpayer lent money to a relative or friend with the understanding that it may not be repaid, it is considered a gift and not a loan.

There are two kinds of bad debts -- business and nonbusiness.

1238.02 A debt becomes worthless when the surrounding facts and circumstances indicate there is no reasonable expectation of payment. To show that a debt is worthless, a taxpayer must establish that he or she has taken reasonable steps to collect the debt. It is not necessary to go to court if a taxpayer can show that a judgment from the court would be uncollectible. A taxpayer may take the deduction only in the year the debt becomes worthless. A taxpayer does not have to wait until a debt is due to determine whether it is worthless.

1238.03 A nonbusiness bad debt is reported as a short-term capital loss on Form 8949 and Schedule D. It is subject to the capital loss limitations. A nonbusiness bad debt deduction requires a separate detailed statement attached to the taxpayer's tax return. This includes losses or gains attributable to condemnation.

1240 Adjustments to Income**1241 Self-employment tax**

1241.01 Self-employment tax is a tax consisting of Social Security and Medicare taxes primarily for individuals who work for themselves. It is similar to the Social Security and Medicare taxes withheld from the pay of most wage earners. The taxpayer calculates self-employment tax using Schedule SE (Form 1040). Social Security and Medicare taxes of most wage earners are calculated by their employers. Also, the taxpayer can deduct the employer-

equivalent portion of their self-employment tax in calculating their adjusted gross income.

1241.02 Self-employment tax rate: The self-employment tax rate is 15.3%. The rate consists of two parts: 12.4% for Social Security and 2.9% for Medicare. For 2020, the first \$137,700 of the taxpayer's combined wages and tips, and net earnings is subject to any combination of the Social Security part of the self-employment tax. All combined wages, tips, and net earnings are subject to any combination of the 2.9% Medicare part of the self-employment tax. An additional Medicare tax of 0.9% applies to wages, compensation, and self-employment income above \$250,000 for those filing married jointly, \$125,000 for those filing married separate, and \$200,000 for all remaining filing statuses.

1241.03 Self-employment tax deduction: The taxpayer may deduct the employer-equivalent portion of the self-employment tax in calculating adjusted gross income. This deduction only affects the taxpayer's income tax. It does not affect either net earnings from self-employment or self-employment tax.

1241.04 Who must pay self-employment tax? Taxpayers must pay self-employment tax and file Schedule SE (Form 1040) if either of the following apply:

- a.** Net earnings from self-employment (excluding church employee income) were \$400 or more
- b.** Church employee income of \$108.28 or more.

Generally, net earnings from self-employment are subject to self-employment tax. If the taxpayer is a sole proprietor or independent contractor, a Schedule C or C-EZ is used to calculate net earnings from self-employment. The self-employment tax rules apply no matter the age of the taxpayer and even if they are already receiving Social Security or Medicare.

1242 Retirement contribution limits and deductibility**1242.01 Roth IRAs**

- a.** For 2020, taxpayers who qualify may make nondeductible contributions of up to \$6,000 each year to a Roth IRA. A qualifying taxpayer over age 50 may add \$1,000 to that amount for total contribution of \$7,000. That \$1,000 is referred to as a “catch-up amount.”
- b.** Contributions from taxpayer age 72 or older are allowable.
- c.** Distributions before death are not required.
- d.** Contributions limits:
 - i. The 2020 contribution limit of \$6,000 (\$7,000) is phased out proportionately between the following AGI levels:
 - 1. Singles and head of households: \$124,000–\$139,000
 - 2. Joint filers: \$196,000–\$206,000
 - 3. For 2020, for married individuals filing a separate return, the phaseout is not subject to annual cost-of-living adjustment and remains \$0 to \$10,000.
 - ii. For 2020, the limit for total contributions to Roth IRAs and traditional IRAs combined is \$6,000 (\$7,000) (before phaseout), not counting rollover contributions.

1242.02 Traditional IRAs

- a. For 2020, taxpayers who qualify may make deductible contributions of up to \$6,000 each year to a traditional IRA. A qualifying taxpayer over age 50 may add \$1,000 to that amount for total contribution of \$7,000. That \$1,000 is referred to as a “catch-up amount.”
 - i. A portion of the taxpayer’s IRA contribution may be deductible even if they are covered by a retirement plan through their employer.
 - 1. For those filing as single or head of household with modified AGI of:
 - a. Up to \$65,000, fully deductible
 - b. Over \$65,000 but less than \$75,000, partially deductible.
 - c. \$75,000 or more, not deductible.
 - 2. For those filing as married jointly with modified AGI of:
 - a. Up to \$104,000, fully deductible
 - b. Over \$104,000 but less than \$124,000, partially deductible
 - c. \$124,000 or more, not deductible
 - 3. For those filing married separately with modified AGI of:
 - a. Less than \$10,000, partially deductible
 - b. \$10,000 or more, not deductible
 - ii. Deduction amounts for taxpayers **not covered** by a retirement plan at work.
 - 1. For those filing as single or head of household earning any amount, it is fully deductible.
 - 2. For those filing as married jointly or separately with a spouse who is not covered by a plan at work, it is fully deductible.
 - 3. For those filing married jointly with a spouse who is covered by a plan at work with modified AGI of:
 - a. \$196,000 or less, fully deductible

- b. Over \$196,000 but less than \$206,000, partially deductible
 - c. \$206,000 or more, not deductible
 - 4. For those filing married separately with a spouse who is covered by a plan at work with modified AGI of:
 - a. Less than \$10,000, partially deductible
 - b. \$10,000 or more, not deductible
- b. Contributions from taxpayer age 70-1/2 or older are allowed beginning 2020. For earlier years, they were not allowed.
- c. The taxpayer must start taking distributions by April 1 following the year in which you turn age 70-1/2 and by December 31 of later years. For 2020, required minimum distributions were suspended by the CARES Act.

1242.03**SIMPLE retirement plan for small businesses:**

- a. The Savings Incentive Match Plan for Employees (SIMPLE) simplifies complexities of retirement plans. It can be established by employers, including self-employed individuals. The SIMPLE plan allows eligible employees to contribute part of their pretax compensation to the plan.
 - 1. The amount an employee contributes from his or her salary to a SIMPLE IRA cannot exceed \$13,500 for 2020. An additional \$3,000 contribution is permitted for employees age 50 or over.
 - 2. If an employee participates in any other employer plan during the year and has elective salary deductions under those plans, the total amount of the salary reduction contributions that an employee can make to all the plans he or she participates in is limited to \$19,500 in 2020.
 - 3. If permitted by the SIMPLE IRA plan, participants who are age 50 or over at the end of the calendar year can also make catch-up contributions. The

catch-up contribution limit for SIMPLE IRA plans is \$3,000 in 2020.

- b.** SIMPLE plans can be adopted by employers having 100 or fewer employees.
 - 1. The employee must not be part of another employer-sponsored retirement plan.
 - 2. All contributions are fully vested immediately.
 - 3. Employee contributions are deductible for AGI, and taxation on accumulations is deferred until distributed.
- c.** CAUTION: Distributions before age 59-1/2 are subject to an additional tax of 10% (25% if taken during the two-year period beginning on the date the individual first participated in any SIMPLE IRA plan of the employer). Exceptions include distributions for the following:
 - 1. Death
 - 2. Disability
 - 3. Deductible medical expenses
 - 4. Health insurance of an unemployed individual
 - 5. Qualified higher education expenses:
 - a. Included tuition, fees, books, supplies, equipment, and room and board for postsecondary education (includes graduate-level courses),
 - b. Applies to taxpayer, spouse, children, and grandchildren, and
 - c. Expenses are reduced by scholarships and similar excludible funding.
 - 6. First time homebuyer expenses (\$10,000) limit
 - 7. Qualified birth or adoption (\$5,000 limit per individual or \$10,000 limit for married couples filing a joint return)

8. For coronavirus-related distributions made after January 1, 2020 (\$100,000 limit). A coronavirus-related distribution must meet one of the following criteria:
 - a. Made to an individual who is diagnosed with COVID-19
 - b. Made to an individual whose spouse or dependent is diagnosed with COVID-19
 - c. Made to an individual who experiences adverse consequences as a result of being quarantined, furloughed, laid-off, having work hours reduced, being unable to work due to lack of child care due to COVID-19, closing or reducing hours of business owned or operated by the individual due to COVID-19, or other factors as determined by the Treasury Secretary.

1242.04 401(k)

- a. A 401(k) plan is a qualified employer-sponsored retirement plan that eligible employees may make tax-deferred contributions from their salary or wages to a post-tax and/or pre-tax basis. Employers offering a 401(k) plan may matching or non-elective contributions to the plan on behalf of eligible employees and may also add a profit-sharing feature to the plan. Earnings in a 401(k) plan accrue on a tax deferred basis.
 1. The amount an employee contributes from his or her salary to a SIMPLE IRA cannot exceed \$19,500 for 2020. An additional \$6,500 contribution is permitted for employees age 50 or over.
 2. There are two types of 401(k) plans: traditional and Roth.
 - i. A traditional 401(k) uses pre-tax dollars and earnings are tax deferred.
 - ii. A Roth IRA uses post-tax dollars and earnings are tax-exempt.

- b.** 401(k) plans can be adopted for any size company, including self-employed.

 - 1. Participation is optional for all employees.
 - 2. Employee salary deferral are immediately 100 percent vested – that is, the money the employee has put aside through salary deferrals cannot be forfeited. When an employee leaves employment, they are entitled to those deferrals, plus an investment gains (or minus losses) on their deferrals. In a traditional 401(k) plan, the employer designs their plan to that contributions become vested over time, according to a defined vesting schedule
 - 3. Nondiscrimination testing: 401(k) plan tax benefits require that plan provide substantive benefits for rank-and-file employees, not only for business owners and managers. These requirements are referred to as nondiscrimination rules and cover the level of plan benefits for rank-and-file employees compared to owners/managers. Traditional 401(k) plans are subject to annual testing to assure that the amount of contributions made on behalf of rank-and-file employees is proportional to contributions made on behalf of owners and managers. Safe harbor 401(k) plans and SIMPLE 401(k) plans are not subject to annual nondiscrimination testing.
- c.** Contributions can continue up until retirement.
- d.** The taxpayer must start taking distributions by April 1 following the year in which you turn age 72 and by December 31 of later years or when the taxpayer retires, whichever comes first. This requirement was suspended for 2020 by the CARES Act.
- e.** Contributions limits: For 2020 the contribution limit is \$19,500 (\$26,000 for taxpayers age 50 or older).

1243 Health savings accounts**1243.01 Health savings accounts**

- a.** Within limits, employer contributions to an employee's health savings account (HSA) are excluded from the employee's income.
- b.** Both employer and employee contributions are combined to determine the maximum allowable contribution.
- c.** Contributions to an HSA are limited:
 - 1.** For 2020, the contribution limit for families is limited to \$7,100 and \$3,550 for singles for the year. For 2020, taxpayers age 55 and older may contribute an additional \$1,000 per year. This makes the contributions limit for these families \$8,100 and \$4,550 for singles.
 - 2.** Employer contributions to an employee's HSA are excluded from income. However, both employer and employee contributions are combined to determine the maximum allowable contribution.

1243.02 Health care flexible spending accounts (FSAs):

- a.** A taxpayer's employer's plan can allow a \$550 carryover balance to the following year for money not used for allowed purposes, or
- b.** Allow a grace period through March 15 of the following year.
- c.** For 2020, the dollar limit on amounts an employee may contribute through salary reduction contributions is \$2,750 per year.
- d.** Due to the Tax Relief Act signed in December 2020, plans may permit unused funds in medical or dependent care FSA plans to completely rollover from 2020 into 2021, and 2021 into 2022. If this option is chosen, **the standard \$550 rollover max will not apply for these plan years**. Plans may permit a 12-month grace period for unused benefits for plan years ending in 2020 or 2021.

1244 Other adjustments to income

1244.01 Student loan interest: Qualified student loan interest up to \$2,500, made permanent by the American Taxpayer Relief Act of 2012. For taxable years beginning in 2020, the \$2,500 maximum deduction begins to phase out for joint filers with modified adjusted gross income (MAGI) in excess of \$140,000 and for single filers with gross income in excess of \$70,000. It is completely phased out for MAGI of \$170,000 for joint filers and \$85,000 for single filers.

1244.02 **Alimony:** NOTE: The TCJA of 2017 changes the treatment of alimony and separate maintenance payments negotiated after December 31, 2018. See f below.

- a.** Excluding the portion that is designated for child support, qualified payments are included in the gross income of the recipient and deductible from gross income by the payor if the payments are made after:
 - 1. Decree of divorce or separate maintenance,
 - 2. Written separation agreement, or
 - 3. Decree for support (this applies to periods pending finality of divorce or legal separation).
- b.** Qualified payments are required to meet the following guidelines:
 - 1. Payments must be in cash.
 - 2. Payments must terminate at the death of the recipient.
 - 3. Payments cannot be made to a payee who lives in the same household as the payor.
 - 4. Payments cannot be specified as something other than alimony.

- c.** Special rules apply if alimony payments in the second- or third-year decrease by more than \$15,000 from the payments made in the previous year.

 - 1. If the change in payments exceeds statutory limits, recapture of excessive alimony payments will result.
 - 2. All of the recapture will take place in the third year.
 - i. The payor must include the excess amounts in gross income.
 - ii. The payee is allowed to deduct the excess payments from gross income to arrive at adjusted gross income.
- d.** Any amount that can be identified as child support cannot be treated as alimony.

 - 1. Child support payments are neither deductible by the payor nor income to the recipient.
 - 2. If both child support and alimony are provided for in the agreement, any amounts paid are first considered to be child support until that obligation is met.
- e.** The transfer of property between divorcing spouses in exchange for release from marital obligations is nontaxable. The basis of the transferred property to the transferee will be the same as it was to the transferor.
- f.** For any divorce or separation agreement executed after December 31, 2018 (not 2017), or executed before that date but modified after it (if the modification expressly provides that the new amendment applies), alimony and separate maintenance payments are not deductible by the payor spouse nor includible in income of the payee spouse.

1244.03 Moving expenses: The TCJA suspended the deduction for moving expenses for taxable years 2018 through 2025. However, during that suspension period, the provision retains the deduction for moving expenses (and reimbursements or allowances for these expenses) for members of the Armed Forces (or their spouse or dependents) on active duty that move pursuant to a military order and incident to a permanent change of station. The suspension of the deduction for moving expenses does not apply to taxable years beginning after December 31, 2025.

1245 Self-Employed Health Insurance

1245.01 Self-employed taxpayers may deduct 100% of the medical and long-term care insurance premiums paid for themselves and their families. This deduction cannot exceed the net earnings from the business. IRC Section 213(d)(10)(A) provides for limitations on the amount of eligible long-term care insurance premium deduction allowed per person based on age at the end of the year.

1245.02 No deduction is available to those self-employed taxpayers who are eligible to participate in an employer's subsidized health insurance program. The employer may be the employer of the taxpayer or the spouse.

1300 Deductions and Credits

1310 Itemized deductions

1311 Medical and dental expenses

1311.01 The deduction for medical expenses is the amount of unreimbursed qualifying medical expenses paid during the year regardless of when the services were provided. Medical expenses are considered paid when the credit card charge is made regardless of when the credit card is paid. For calendar year 2020, medical and dental expenses in excess of 7.5% of AGI are deductible. The taxpayer calculates the amount they are allowed to deduct on Form 1040, Schedule A.

1311.02 Medical care expenses include payments for the diagnosis, cure, mitigation, treatment, or prevention of disease, or payments for treatments affecting any structure or function of the body. Medical care expenses include the insurance premiums paid for policies that cover medical care or for a qualified long-term care

insurance policy covering qualified long-term care services. If the taxpayer is an employee, medical expenses do not include that portion of his or her premiums paid by the employer under its sponsored group accident or health policy or qualified long-term care insurance policy. Further, medical expenses do not include the premiums that the taxpayer paid under his or her employer-sponsored policy under a premium conversion policy; for example, a federal employee, participating in the premium conversion program of the Federal Employee Health Benefits (FEHB) program, may not include the premiums paid for the policy as a medical expense.

1311.03 If a taxpayer is self-employed and has a net profit for the year, he or she may be able to deduct (as an adjustment to income) the premiums he or she paid on a health insurance policy covering medical care including a qualified long-term care insurance policy covering medical care including a qualified long-term care insurance policy for the taxpayer himself or herself and his or her spouse and dependents. A taxpayer cannot take this deduction for any month in which he or she was eligible to participate in any subsidized health plan maintained by his or her employer, former employer, a spouse's employer, or his or her former spouse's employer. If the taxpayer does not claim 100 percent of his or her self-employed health insurance deduction, he or she can include the remaining premiums with his or her other medical expenses as an itemized deduction on Form 1040, Schedule A. A taxpayer may not deduct insurance premiums paid by an employer-sponsored health insurance plan (cafeteria plan) unless the premiums are included in Box 1 of the taxpayer's Form W-2.

1311.04 Deductible medical expenses may include, but are not limited to:

- a.** Payments of fees to doctors, dentists, surgeons, chiropractors, psychiatrists, psychologists, and nontraditional medical practitioners;
- b.** Payments for in-patient hospital care or nursing home services, including the cost of meals and lodging charged by the hospital or nursing home;

- c. Payments for acupuncture treatments or inpatient treatment at a center for alcohol or drug addiction, for participation in a smoking-cessation program and for drugs to alleviate nicotine withdrawal that require a prescription;
- d. Payments to participate in a weight-loss program for a specific disease or diseases, including obesity, diagnosed by a physician, but not ordinarily, payments for diet food items or the payment of health club dues;
- e. Payments for insulin and payments for drugs that require a prescription;
- f. Payments for admission and transportation to a medical conference relating to a chronic disease that the taxpayer, his or her spouse, or his or her dependents have (if the costs are primarily for and essential to medical care necessitated medical care). However, a taxpayer may not deduct the costs for meals and lodging while attending the medical conference;
- g. Payments for false teeth, reading or prescription eyeglasses or contact lenses, hearing aids, crutches, wheelchairs, and guide dogs for the blind or deaf; and
- h. Payments for transportation primarily for and essential to medical care that qualify as medical expenses, such as, payments of the actual fare for a taxi, bus, train, or ambulance or for medical transportation by personal car, the amount of his or her actual out-of-pocket expenses such as for gas and oil, or the amount of the standard mileage rate for medical expenses, plus the cost of tolls and parking fees.

1311.05 A taxpayer may not deduct funeral or burial expenses, over-the-counter medicines, toothpaste, toiletries, cosmetics, a trip or program for the general improvement of his or her health, or most cosmetic surgery. A taxpayer may not deduct amounts paid for nicotine gum and nicotine patches, which do not require a prescription.

1311.06 A taxpayer can only include the medical expenses he or she paid during the year. A taxpayer's total deductible medical expenses for the year must be reduced by any reimbursement of deductible medical expenses. It makes no difference if a taxpayer receives the reimbursement or if it is paid directly to the doctor, hospital, or other medical provider.

1311.07 Capital expenditures qualifying as medical expenses: The IRS will not **disallow** amounts paid that otherwise qualify as medical expenses simply because they are capital in nature. However, if a taxpayer claims a medical capital expenditure, he or she must meet the following criteria:

- a. The expenditure must have as its primary purpose the medical care of the taxpayer, his spouse or his dependents;
- b. It must be related only to the sick person, not to the permanent improvement of property; or
- c. If the expenditure is for the **betterment** of property, only the portion that exceeds the increase in the property's value may be claimed.

Moreover, the cost of operating and maintaining the capital asset is deductible.

1311.08 If the initial capital expenditure qualified as a medical expense, the full cost of its operation and maintenance qualifies, regardless of how much of the original cost qualified. Put simply, if the capital expenditure itself qualified as a medical expense (yet was not deductible because, for example, its cost was less than the increase in value of the underlying property), the asset's operating and maintenance costs are still deductible.

1311.09 A physician's advice is not required to substantiate the medical necessity of any expenditure. However, in many cases dealing with disputed capital medical expenditures, the reason for denial was failure to show medical purpose. Therefore, a taxpayer must produce solid documentation to substantiate the deduction, including a physician's "statement of need" for the expenditure.

1312 Various taxes**1312.01** There are five types of deductible non-business taxes:

- a.** State, local, and foreign income taxes;
- b.** State and local real estate taxes;
- c.** State and local personal property taxes;
- d.** State and local sales taxes; and
- e.** Qualified motor vehicle taxes.

To be deductible, the tax must be imposed on the taxpayer and must have been paid during the taxpayer's tax year. However, tables are available to determine the taxpayer's state and local general sales tax amount. Taxes may be claimed only as an itemized deduction on Form 1040, Schedule A. For tax years beginning after December 31, 2017, this amount will be capped at \$10,000.

1312.02 State and local income taxes withheld from a taxpayer's wages during the year appear on his or her Form W-2. The following amounts are also deductible:

- a.** Any estimated taxes the taxpayer paid to state or local governments during the year, and
- b.** Any prior year's state or local income tax the taxpayer paid during the year.

1312.03 Generally, a taxpayer can take either a deduction or a tax credit for foreign income taxes imposed by a foreign country or a United States possession. As an employee, the taxpayer can deduct mandatory contributions to state benefit funds that provide protection against loss of wages.**1312.04** Deductible real estate taxes are generally any state or local taxes on real property. They must be charged uniformly against all property in the jurisdiction and must be based on the assessed value. Many states and counties also impose local benefit taxes for improvements to property, such as assessments for streets, sidewalks, and sewer lines. These taxes cannot be deducted. However, a taxpayer can increase the cost basis of his or her property by the amount of the assessment. Local benefits taxes

are deductible if they are for maintenance or repair, or interest charges related to those benefits.

1312.05 If a portion of the taxpayer's monthly mortgage payment goes into an escrow account, and periodically the lender pays his or her real estate taxes out of the account to the local government, do not deduct the amount paid into the escrow account. Only deduct the amount actually paid out of the escrow account during the year to the taxing authority.

1312.06 Deductible personal property taxes are those based only on the value of personal property such as a boat or car. The tax must be charged to the taxpayer on a yearly basis, even if it is collected more than once a year or less than once a year.

1312.07 Taxes and fees a taxpayer cannot deduct on Schedule A include federal income taxes, Social Security taxes, stamp taxes, or transfer taxes on the sale of property, homeowner's association fees, estate and inheritance taxes and service charges for water, sewer, or trash collection. A taxpayer may be subject to a limit on some of his or her itemized deductions including non-business taxes.

1312.08 Taxpayers have the option of claiming state and local sales taxes as an itemized deduction instead of claiming state and local income taxes (the taxpayer cannot claim both). If a taxpayer saved his or her receipts throughout the year, he or she can add up the total amount of sales taxes he or she actually paid and claim that amount. If a taxpayer did not save all his or her receipts, he or she can choose to claim a standard amount for state and local sales taxes.

1313 Interest expense

1313.01 Interest is an amount a taxpayer pays for the use of borrowed money. To deduct interest paid on a debt the taxpayer must be legally liable for the debt. There must be a true debtor-creditor relationship. Additionally, the taxpayer must itemize his or her deductions, unless the interest is on rental or business property or on a student loan.

- 1313.02** If a taxpayer prepays interest, he or she must allocate the interest over the tax years to which it applies. The taxpayer may deduct in each year only the interest that applies to that year. However, there is an exception that applies to points paid on a principal residence.
- 1313.03** Types of interest a taxpayer can deduct as itemized deductions on Form 1040, Schedule A include investment interest (limited to net investment income) and qualified residence interest. A taxpayer cannot deduct personal interest. Personal interest includes interest paid on a loan to purchase a car for personal use. Personal interest also includes credit card and installment interest incurred for personal expenses. Items a taxpayer cannot deduct as interest include points (if taxpayer is a seller), service charges, credit investigation fees, and interest relating to tax-exempt income, such as interest to purchase or carry tax-exempt securities.
- 1313.04** Home mortgage interest: Qualified residence interest is interest paid on a loan secured by the taxpayer's main home or a second home. A taxpayer's main home is where the taxpayer lives most of the time. It can be a house, cooperative apartment, condominium, mobile home, house trailer, or houseboat that has sleeping, cooking, and toilet facilities. Taxpayers can only deduct qualified mortgage interest on funds that were used to buy, build, or substantially improve a home. For example, if a taxpayer takes out a second mortgage in order to purchase a vehicle, that amount cannot be deducted.
- 1313.05** A second home can include any other residence the taxpayer owns and treats as a second home. The taxpayer does not have to use the home during the year. However, if the taxpayer rents it to others, he or she must also use it as a home during the year for more than the greater of 14 days or 10 percent of the number of days rented, for the interest to qualify as qualified residence interest.

1313.06

Qualified residence interest and points are generally reported to the taxpayer on Form 1098, *Mortgage Interest Statement*, by the financial institution to which the taxpayer made the payments. The following mortgages yield qualified residence interest and the taxpayer can deduct all of the interest on these mortgages:

- a.** A mortgage the taxpayer took out on or before October 13, 1987 (grandfathered debt).
- b.** A mortgage taken out after October 13, 1987, to buy, build, or improve the taxpayer's home (called home acquisition debt) up to a total of \$1 million for this debt plus any grandfathered debt. The limit is \$500,000 if taxpayer is married filing separately.
- c.** Home equity debt other than home acquisition debt taken out after October 13, 1987, up to a total of \$100,000. The limit is \$50,000 if taxpayer is married filing separately. Home equity debt other than home acquisition debt is further limited to the taxpayer's home's fair market value reduced by the grandfathered debt and home acquisition debt.
- d.** The total amount of mortgage debt cannot exceed \$1,000,000 (\$500,000 for married filing separately) on mortgages taken out on or before December 15, 2017. Remaining interest on any remaining debt will be grandfathered in. Mortgage insurance premiums are treated as qualified residence interest. In certain instances, home equity interest is also deductible.
- e.** The total amount of mortgage debt cannot exceed \$750,000 (\$375,000 for married filing separately) on mortgages taken out after December 15, 2017.
- f.** You cannot combine the limits if you have multiple mortgages taken out in different years. You must reduce the limit on loans taken out after December 15, 2017 by the amount of qualifying debt subject to the \$1,000,000 limit.

1313.07 **Home mortgage points:** The term “points” is used to describe certain charges paid to obtain a home mortgage. Points are prepaid interest and may be deductible as home mortgage interest, if the taxpayer itemizes deductions on Form 1040, Schedule A. If the taxpayer can deduct all of the interest on his or her mortgage, he or she may be able to deduct all of the points paid on the mortgage. If the taxpayer’s acquisition debt exceeds the applicable limit or the taxpayer’s home equity, he or she cannot deduct all the interest on his or her mortgage and he or she cannot deduct all of his or her points.

1313.08 A taxpayer can deduct the points in full in the year they are paid if all the following requirements are met:

- a.** The loan is secured by the taxpayer’s main home (a taxpayer’s main home is the one he or she lives in most of the time);
- b.** Paying points is an established business practice in taxpayer’s area;
- c.** The points paid were not more than the amount generally charged in that area;
- d.** The taxpayer uses the cash method of accounting. This means he or she reports income in the year he or she receives it and deduct expenses in the year he or she pays them;
- e.** The points were not paid for items that usually are separately stated on the settlement sheet such as appraisal fees, inspection fees, title fees, attorney fees, or property taxes;
- f.** The funds the taxpayer provided at or before closing, plus any points the seller paid, were at least as much as the points charged. The taxpayer cannot have borrowed the funds from his or her lender or mortgage broker in order to pay the points;
- g.** The taxpayer uses the loan to buy or build his or her main home;

- h.** The points were computed as a percentage of the principal amount of the mortgage; and
- i.** The amount is clearly shown as points on the taxpayer's settlement statement.

1313.09

A taxpayer can also fully deduct (in the year paid) points paid on a loan to improve his or her main home if the above tests a. through f. are met. Points that do not meet these requirements may be deductible over the life of the loan. Points paid for refinancing generally can only be deducted over the life of the new mortgage. However, if a taxpayer uses part of the refinanced mortgage proceeds to improve his or her main home, and he or she meets the first six requirements stated above, the taxpayer can fully deduct the part of the points related to the improvement in the year he or she paid them with his or her own funds. A taxpayer can deduct the rest of the points over the life of the loan. Points charged for specific services, such as preparation costs for a mortgage note, appraisal fees, or notary fees are not interest and cannot be deducted. Points paid by the seller of a home cannot be deducted as interest on the seller's return, but they are a selling expense which will reduce the amount of gain realized. Points paid by the seller may be deducted by the buyer, provided the buyer subtracts the amount from the basis or cost of the residence. Points paid on loans secured by a second home can be deducted only over the life of the loan.

1313.10

Investment interest expense: Investment interest is the interest expense in any amount that is paid on loan proceeds used to purchase investments or securities. Investment interest expenses include margin interest used to leverage securities in a brokerage account on a loan used to buy property held for investment. An investment interest expense is deductible within certain limitations.

- a.** Investment interest deduction is limited to the amount of investment income received, such as dividends and interest.
- b.** Investment interest is reported on Schedule A or Schedule E of Form 1040.

1314 Charitable contributions

1314.01 Charitable contributions are deductible only if a taxpayer itemizes his or her deductions on Form 1040, Schedule A. CARES Act allowed taxpayers to deduct up to \$300 of qualified charitable contribution as an above-the-line deduction even for taxpayers who will not itemize their deductions in 2020. To be deductible, charitable contributions must be made to qualified organizations. Payments to individuals are never deductible. If a taxpayer's contribution entitles the taxpayer to merchandise, goods, or services, including admission to a charity ball, banquet, theatrical performance, or sporting event, the taxpayer can deduct only the amount that exceeds the fair market value of the benefit received.

1314.02 For a contribution of cash, check, or other monetary gift (regardless of amount), the taxpayer must maintain as a record of the contribution a bank record or a written communication from the qualified organization containing the name of the organization, the date of the contribution, and the amount of the contribution. In addition to deducting cash contributions, a taxpayer generally can deduct the fair market value of any other property donated to qualified organizations. The TCJA of 2017 repealed this requirement.

1314.03 For a contribution of cash, check, or other monetary gift (regardless of amount), the taxpayer must maintain as a record of the contribution a bank record or a written communication from the qualified organization containing the name of the organization, the date of the contribution, and the amount of the contribution. In addition to deducting cash contributions, a taxpayer generally can deduct the fair market value of any other property donated to qualified organizations. For any contribution of \$250 or more (including contributions of cash or property), the taxpayer must obtain and keep in his or her records a contemporaneous written acknowledgment from the qualified organization indicating the amount of the cash and a description of any property contributed. The acknowledgment must say whether the organization provided any goods or services in exchange for the gift and, if so, must provide a description and a good faith estimate of the value of those goods or services. One document from the qualified organization may satisfy both the

written communication requirement for monetary gifts and the contemporaneous written acknowledgment requirement for all contributions of \$250 or more.

- 1314.04** The taxpayer must fill out Form 8283, and attach it to his or her return, if the taxpayer's deduction for a noncash contribution is more than \$500. If the taxpayer claims a deduction for a contribution of noncash property worth \$5,000 or less, he or she must fill out Form 8283, Section A. If the taxpayer claims a deduction for a contribution of noncash property worth more than \$5,000, the taxpayer will need a qualified appraisal of the noncash property and must fill out Form 8283, Section B. If the taxpayer claims a deduction for a contribution of noncash property worth more than \$500,000, he or she also will need to attach the qualified appraisal to his or her return.
- 1314.05** The TCJA of 2017 increased the percentage limit for contributions of cash to public charities from 50% to 60% effective for tax years beginning after December 31, 2017. For cash contributions, the CARES Act increased the AGI threshold to 100% for cash contributions.
- 1314.06** The TJCA of 2017 provides that no charitable deduction is allowed for any payment to an institution of higher education in exchange for which the payor receives the right to purchase tickets or seating at an athletic event.
- 1314.07** In the case of volunteer work, a person is not able to deduct the value of his or her time but can deduct any out-of-pocket costs. For example, a volunteer can deduct the cost and upkeep of uniforms that are not suitable for everyday use and that the taxpayer must wear while performing donated services for a charitable organization. A volunteer also can deduct 14 cents per mile for travel to and from the charitable activity.

1315 Casualty and theft losses

The TCJA temporarily modified the deduction for personal casualty and theft losses so that a taxpayer may claim a personal casualty loss only if such loss was attributable to a disaster declared by the President under Section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act. The provision was effective to losses incurred in taxable years beginning after December 31, 2017 but does not apply with respect to losses incurred after December 31, 2025.

In such situations, the taxpayer is able to deduct the loss on the taxpayer's return or amended return for the tax year immediately preceding the tax year in which the disaster happened. If the person files an amended return, the loss is treated as having occurred in the preceding year.

1316 Travel & Entertainment Deductions

1316.01 For tax years 2018 through 2025, the treatment of certain meals and entertainment expenses changed. In general, entertainment, amusement, or recreation expenses are no longer deductible. The cost of business meals generally remains deductible, subject to the 50% limitation. The Tax Relief Act of December 2020 allowed a 100% deductibility for qualified business meals for 2021. For years prior to 2021, a taxpayer can deduct a higher percentage of their meal expenses while traveling away from their tax home if the meals take place during or incident to any period subject to the Department of Transportation's "hours of service" limits. The percentage, in this situation, is 80%.

1316.02 Generally, a taxpayer cannot deduct any expense for the use of an entertainment facility. This includes expenses for depreciation and operating costs such as rent, utilities, maintenance, and protection.

An entertainment facility is any property that the taxpayer owns, rents, or uses for entertainment. Examples include a yacht, hunting lodge, fishing camp, swimming pool, tennis court, bowling alley, car, airplane, apartment, hotel suite, or home in a vacation resort.

1316.03

There are some expenses a taxpayer can deduct for business transportation when not traveling away from home. These expenses include the cost of transportation by air, rail, bus, taxi, etc., and the cost of driving and maintaining the taxpayer's car.

Transportation expenses include the ordinary and necessary costs of all of the following.

- Getting from one workplace to another in the course of your business or profession when you are traveling within the area of your tax home (Tax home is defined under the heading of "Travel Expenses" in chapter 20 of Publication 17.)
- Visiting clients or customers
- Going to a business meeting away from your regular workplace
- Getting from your home to a temporary workplace when you have one or more regular places of work (These temporary workplaces can be either within the area of the taxpayer's tax home or outside that area.)

The standard mileage rate for 2020 is 57.5 cents per mile and for 2019 is 58 cents per mile.

If the taxpayer was an employee with unreimbursed business expenses, he or she cannot deduct the expenses because TJCA suspended the 2% miscellaneous deductions for 2018 through 2026.

1316.04

A taxpayer can no longer claim any miscellaneous itemized deductions that are subject to the 2% of adjusted gross income limitation, including unreimbursed employee expenses. However, a taxpayer may be able to deduct certain unreimbursed employee business expenses if they fall into one of the following categories of employment:

- Armed Forces reservists
- Qualified performing artists
- Fee-basis state or local government officials
- Employees with impairment-related work expenses

1316.05 Expense Allowance

If a taxpayer's allowance is more than the federal rate, the employer must include the allowance amount up to the federal rate under Code L in box 12 and the excess allowance in box 1 of the employee's W-2:

- If the employee's actual expenses are less than or equal to the federal rate, he or she does not need to complete Form 2106 because the allowance should not be included in box 1 of Form W-2.
- If the employee's actual expenses are greater than the federal rate **and** they are eligible to file Form 2106, he or she needs to complete Form 2106 to deduct the excess expenses. However, the employee must report on Form 2106 their reimbursements up to the federal rate (as shown under code L in box 12 of your Form W-2) and all their expenses. The employee should be able to prove these amounts to the IRS.
- If the employee's actual expenses are greater than the federal rate and they are NOT eligible to file Form 2106, he or she cannot deduct the unreimbursed employee expenses.

Example: Joe lives and works in Austin. In May, his employer sent him to San Diego for 4 days and paid the hotel directly for Joe's hotel bill. The employer reimbursed Joe \$75 a day for his meals and incidental expenses. The federal rate for San Diego is \$71 a day.

Joe can prove that his actual non-entertainment-related meal expenses totaled \$380. His employer's accountable plan won't pay more than \$75 a day for travel to San Diego, so Joe doesn't give his employer the records that prove that he actually spent \$380. However, he does account for the time, place, and business purpose of the trip. This is Joe's only business trip this year.

Joe was reimbursed \$300 ($\$75 \times 4$ days), which is \$16 more than the federal rate of \$284 ($\$71 \times 4$ days). His employer includes the \$16 as income on Joe's Form W-2 in box 1. His employer also enters \$284 under code L in box 12 of Joe's Form W-2.

Assuming Joe is eligible, he can file Form 2106 to figure his deductible expenses. He enters the total of his actual expenses for the year (\$380) on Form 2106. He also enters the reimbursements that weren't included in his income (\$284). His total deductible expense, before the 50% limit, is \$96. After he figures the 50% limit on his unreimbursed meals, he will include the balance, \$48, on Schedule 1 (Form 1040 or 1040-SR), line 11.

1317 Allowed itemized deductions for Form 1040-NR

You can claim the same itemized deductions as U.S. citizens using Schedule A of Form 1040.

If you do not itemize your deductions, you can claim the standard deduction for your particular filing status.

1320 Credits**1320.01 Child and dependent care credit**

Taxpayers are permitted a nonrefundable tax credit for expenses incurred in caring for dependents so that the taxpayer(s) may be gainfully employed.

- a.** The credit is available on a three-tiered basis as follows:
 - (1) Taxpayers with an adjusted gross income of \$15,000 or less will be entitled to a credit of 35% of dependent care expenses.
 - (2) The credit will be reduced by one percentage point for each \$2,000 of adjusted gross income, or fraction thereof, above \$15,000.
 - (3) For taxpayers with an adjusted gross income over \$43,000, the credit will be 20%.
- b.** The maximum amount of dependent care expenses that may be considered for the credit is \$3,000 if there is one qualifying child or dependent and \$6,000 if there are two or more qualifying dependents.
- c.** Expenditures for dependent care cannot exceed the earned income of the low-income parent.

Special provisions apply where one of the spouses is a full-time student or is incapacitated, and the other spouse works. In this situation, the nonworking spouse is considered to have earned at least \$250 per month, where one dependent requires care and \$500 per month, where more than one dependent requires care.

- d.** The dependent must be:
 - (1) a child under age 13 or
 - (2) an incapacitated dependent or spouse.
- e.** Married taxpayers must file a joint return unless they live apart for the last six months of the year.
 - (1) For divorced or separated parents, the credit is available to the parent having custody of the child for the longer period.
 - (2) A custodial parent may claim the credit even though the child may not qualify as a dependent. However, two taxpayers filing separate returns cannot claim separate credits for the same child.
- f.** Expenditures that qualify for the credit include amounts paid for both in-the-home care and out-of-the-home care.
 - (1) In-the-home care may include expenditures for household services if they were partly for the well-being and protection of a qualifying individual.
 - (2) Expenditures for out-of-the-home care are eligible for the credit only if incurred for:
 - (a) a dependent under age 13 or
 - (b) any other qualifying person who regularly spends at least eight hours each day in the taxpayer's household.
- g.** Expenditures do not qualify for the credit if they were made to:
 - (1) a relative who is a dependent of the taxpayer or
 - (2) the taxpayer's child who is under age 19.

1320.02 Child tax credit and credit for other dependents

The Child Tax Credit under the TCJA (Tax Cuts and Jobs Act of 2017) tax reform is worth up to \$2,000 per qualifying child. The age cutoff remains at 17. (The child must be under 17 at the end of the year for taxpayers to claim the credit.)

- a. **Child dependent:** For 2020, the refundable portion of the credit is limited to \$1,400. The beginning credit phaseout for the child tax credit in 2020 is \$200,000 (\$400,000 for joint filers). The child must have a valid Social Security number (SSN) to qualify for the \$2,000 child tax credit.
- b. **Other dependents:** This new credit, created under the TCJA, allows for a credit worth \$500 for each qualifying dependent who does not qualify for the child credit discussed in (a) above; the credit is nonrefundable. For 2020, the phaseout begins for taxpayers with AGI of \$200,000 (\$400,000 for joint filers). This phaseout applies in combination with the new child tax credit. Unlike the child tax credit, the dependent does not require a valid SSN for the taxpayer to claim the credit for other dependents; an ITIN (Individual Taxpayer Identification Number) or ATIN (Adoption Taxpayer Identification Number) will suffice.

1320.03 Education credits

Two tax credits available for students pursuing postsecondary college or vocational education are the American Opportunity Tax Credit and the Lifetime Learning Credit. These credits are available for qualified educational expenditures of the taxpayer, spouse, and dependents. If both the Lifetime Learning Credit and the American Opportunity Tax Credit can be claimed for the same student in the same year, only one can be used, not both. **Both credits must be supported by an IRS Form 1098-T from the college or other postsecondary institution showing the amount of qualified expenses that were paid during the tax year.**

- a. **American Opportunity Tax Credit (AOTC):** The AOTC makes the Hope Credit available to a broader range of taxpayers, including many with higher incomes and those who owe no tax. It also adds required course materials to the list of qualifying expenses and allows the credit to be claimed for four postsecondary education years instead of two.

- (1) The credit is equal to 100% of the first \$2,000 and 25% of the next \$2,000, not to exceed \$4,000. Therefore, the maximum Hope Scholarship Credit allowance is \$2,500.
- (2) Students must be enrolled no less than half-time during at least one semester during the year.
- (3) The taxpayer claiming the full credit (not necessarily the student) must have modified adjusted gross income (MAGI) of \$80,000 or less for a single taxpayer or \$160,000 or less if filing jointly. A partial credit may be available up to MAGI of \$90,000 and \$180,000, respectively.
- (4) A taxpayer can claim the credit for each qualifying student for whom qualifying expenses are paid.

- b. **Lifetime Learning Credit:** This nonrefundable credit is equal to 20% of up to \$10,000 of tuition expenses paid each year by the taxpayer. Expenses for which the American Opportunity Tax Credit is claimed do not qualify for this credit. In contrast to the American Opportunity Tax Credit, this credit:

- (1) does not vary with the number of students in the household,
- (2) is available for an unlimited number of years,
- (3) applies to undergraduate, graduate, and professional degree expenses,
- (4) applies to any course at an eligible institution that helps individuals acquire or improve their job skills, and

- (5) does not require half-time enrollment for one semester. (Thus, CPE credit courses and professional seminars provided by eligible educational institutions may qualify for the credit.)

For tax year 2020, a taxpayer's modified adjusted gross income in excess of \$59,000 (\$118,000 for a joint return) is used to determine the reduction in the amount of the Lifetime Learning Credit otherwise allowable.

c. Other limitations:

- (1) Married taxpayers must file jointly to receive these credits.
- (2) In a given tax year, only one of the following benefits may be claimed with respect to each student: (a) the American Opportunity Tax Credit or (b) the Lifetime Learning Credit. However, the American Opportunity Tax or Lifetime Learning credit can be claimed in the same year as distributions from a Coverdell Education IRA, provided that the proceeds from the distribution are not used to pay for the education costs used in claiming the American Opportunity or Lifetime Learning credit.
- (3) The credits are not available if the cost of the course may be deducted by the taxpayer as a business expense.

1320.04 Foreign tax credit

A taxpayer may apply income taxes paid to a foreign country or U.S. possession as a credit against United States income tax liability, or he or she may use such taxes as an itemized deduction. This credit is claimed on IRS Form 1116 for an individual and on IRS Form 1118 for a corporation.

- a. This treatment is available for taxes paid to a foreign country on income that is taxable in the United States when no foreign income exclusion is taken.
- b. The election to use the credit or the deduction is made annually.
- c. The taxpayer cannot split foreign taxes between a credit and a deduction.
- d. The overall limit for the credit on taxes paid to *all* foreign countries is restricted to that portion of the U.S. income tax which relates to the taxable income from all foreign countries.
- e. Excess credits may be carried back 1 year and forward 10 years.

1320.05 Earned income tax credit (e.g., paid preparer's earned income credit checklist, eligibility and disallowance)

A special refundable tax credit may be available for low-income workers who have a principal residence in the United States. It represents a form of *negative income tax*—workers may receive money from the government even though they do not have a tax liability. This credit is claimed by filing Schedule EIC of IRS Form 1040 with the taxpayer's return.

- a. The earned income credit (EIC) is equal to a percentage of a limited amount of earned income. Taxpayers with qualifying children receive greater benefits—a greater amount of income is eligible for a higher credit percentage.

- b.** When the taxpayer's adjusted gross income (or earned income, if greater) exceeds a threshold amount, the EIC is phased out.
- (1) "Earned income" includes only taxable compensation; it does not include nontaxable employee compensation.
 - (2) Threshold and phaseout amounts for 2020 are given in the following table. The tax year 2020 earned income and adjusted gross income (AGI) must each be less than:

Children or Relatives Claimed	Maximum AGI (filing as Single, Head of Household or Widowed)	Maximum AGI (filing as Married Filing Jointly)
Zero	\$15,820	\$21,710
One	\$41,756	\$47,646
Two	\$47,440	\$53,330
Three	\$50,594	\$56,844

Investment income limit: \$3,650 or less

- (3) No credit is allowed to those with "disqualified income" (i.e., investment income or unearned income) in excess of \$3,650 for 2020.
- (4) No credit is allowed for those failing to provide correct Social Security numbers for themselves, spouse, and qualifying child.
- (5) The maximum amount of credit for 2020 is \$6,660 with three or more qualifying children, \$5,920 with two qualifying children, \$3,584 with one qualifying child, and \$538 with no qualifying children.

- c. IRC Section 32(d) provides that a married taxpayer who does not file a joint return is not entitled to an EIC. In Action on Decision (AOD) 2017-05, the IRS gave notice it would not follow a Tax Court decision that the taxpayer's filing status was married filing separately and that the taxpayer had qualifying children, and therefore the taxpayer was entitled to the EIC. However, there is no mention of IRC Section 32(d) in the court's opinion; therefore, it appears that the Tax Court overlooked the prohibition disallowing the EIC to married taxpayers filing separately. Accordingly, the IRS stated that it will not follow the court's opinion in allowing an EIC to a married taxpayer filing separately.
- d. **Qualifying children:** To be eligible for the earned income credit, parents must have children that can meet the following tests:
 - (1) **Relationship:** The child must be a "qualifying child." The child may, however, provide over half of his or her own support.
 - (2) **Residency:** The child must live in the taxpayer's residence over half of the year; foster children for the entire tax year.
 - (3) **Age:** The child must be:
 - (a) under age 19,
 - (b) a full-time student under age 24, or
 - (c) permanently and totally disabled.
- e. Individuals without qualifying children may be eligible for this credit if:
 - (1) they (or their spouse) are at least 25 years old, but not more than 64 years old, at the end of the year and
 - (2) they cannot be claimed as a dependent by another taxpayer.

1320.06 Retirement contribution credit

A nonrefundable tax credit is available for contributions, or deferrals, to retirement savings plans. The credit is claimed by completing and attaching IRS Form 8880, *Credit for Qualified Retirement Savings Contributions*, to the taxpayer's return.

- a.** The credit applies to traditional and Roth IRAs and other qualified retirement plans such as 401(k) plans, 403(b) annuities, 457 plans, SIMPLE plans, and SEP plans.
- b.** For tax year 2020, an eligible lower-income taxpayer can claim a nonrefundable tax credit for the applicable percentage (50%, 20%, or 10%, depending on filing status and AGI) of up to \$2,000 of their qualified retirement savings contributions. In other words, the absolute most the credit could be is \$1,000.
- c.** The credit is in addition to any deduction or exclusion relating to the retirement plan contribution.
- d.** Joint filers with AGI in excess of \$65,000 receive no credit. For heads of households, the amount is \$48,750, and for all others it is \$32,500.
- e.** The contribution eligible for the credit must be reduced by any distributions received from qualified retirement plans.
 - (1) Such distributions include those paid out during (a) the current year, (b) the two preceding tax years, and (c) the period before the due date (including extensions) of the current return.
 - (2) Distributions received by a spouse are considered as distributions to the taxpayer if a joint return is filed.
- f.** Qualifying taxpayers must be at least 18 years old.
- g.** Dependents and full-time students are not eligible for the credit.

1320.07 Adoption credits (e.g., carryovers, limitations, special needs)

For taxable years beginning in 2020, the credit allowed for an adoption of a child with special needs is \$14,080. For taxable years beginning in 2020, the maximum credit allowed for other adoptions is the amount of qualified adoption expenses up to \$14,300. The available adoption credit begins to phase out for taxpayers with modified adjusted gross income in excess of \$214,520 and is completely phased out for taxpayers with modified adjusted gross income of \$254,520 or more.

1320.08 Other credits (refundable and nonrefundable) (e.g., health coverage tax credit, general business credits)

FICA tax credit on tips: Proprietors of food and beverage establishments may claim a tax credit for a portion of the employer's share of FICA taxes. The credit is limited to those FICA taxes attributable to reported tips in excess of those treated as wages under the federal minimum wage laws. No deduction is permitted for any of the FICA expense claimed as a credit. The credit is claimed by filing IRS Form 8846, *Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips*, with the business tax return.

Investment credit (ITC): This general business credit is based on the amount invested in qualified business properties during the tax year. While there are five separate credits currently included in the calculation of the ITC, only the rehabilitation credit will be discussed. The investment credit is claimed by filing IRS Form 3468, *Investment Credit*, with the taxpayer's return.

- a. **A rehabilitation credit** will be allowed to taxpayers for expenditures incurred to rehabilitate old commercial and industrial buildings and certified historic structures. No credit is allowed for personal-use property.
- b. The credit is 20% of the expenditures incurred to rehabilitate buildings that were placed in service after 1936.
- c. The taxpayer is required to depreciate rehabilitated property using the straight-line method.
- d. The basis of rehabilitated buildings must be reduced by 100% of the rehabilitation credit taken.

- e. The rehabilitation credit is subject to recapture provisions if the building is disposed of prematurely or ceases to be qualified property.
- f. The Tax Cuts and Jobs Act (TCJA), signed December 22, 2017, affects the rehabilitation tax credit for amounts that taxpayers pay or incur for qualified expenditures after December 31, 2017. The credit is a percentage of expenditures for the rehabilitation of qualifying buildings in the year the property is placed in service. The legislation:
 - (1) requires taxpayers take the 20% credit ratably over five years instead of in the year they placed the building into service.
 - (2) eliminates the 10% rehabilitation credit for the pre-1936 buildings.
- g. A transition rule provides relief to owners of either a certified historic structure or a pre-1936 building by allowing owners to use the prior law if the project meets these conditions:
 - (1) The taxpayer owns or leases the building on January 1, 2018, and at all times thereafter.
 - (2) The 24- or 60-month period selected for the substantial rehabilitation test begins by June 20, 2018.

1320.09 **Work opportunity credit** (a general business credit): Employers hiring employees from 1 of 10 selected high unemployment groups are allowed a special credit. After completing and filing IRS Form 8850, *Pre-Screening Notice and Certification Request for the Work Opportunity Credit*, the work opportunity credit is claimed by completing and attaching IRS Form 5884, *Work Opportunity Credit*, to the tax return.

- a. The credit is equal to 40% of the first \$6,000 of first-year wages paid or accrued to each qualified employee who is hired during the year. That first-year wage amount can be as much as \$24,000 for certain qualified veterans.
 - (1) To qualify for the 40% rate, an employee must complete 400 or more hours of service.
 - (2) Employees completing less than 400 hours of service, but at least 120 hours, qualify for a rate of only 25%.
- b. The work opportunity tax credit is elective. If taken, the employer's deduction for wages must be reduced by the amount of the credit.

1320.10

Research activities credit (a general business credit): To encourage technical research and development (R&D), a tax credit is available for qualified R&D expenditures. The credit is based on two research components. The research credit is claimed by completing and attaching IRS Form 6765, *Credit for Increasing Research Activities*, to the tax return.

- a. **Amount of credit.** The research credit is the sum of (1) 20% of the excess of qualified research expenses for the current year over a base period amount, (2) 20% of the basic research payments made to a qualified research organization, and (3) 20% of the amounts paid to an energy research consortium.
- b. **Base amount.** The base amount is determined by a special formula, but it may not be less than 50% of the qualified research expenses for the current year.

- c. The research activities credit may be claimed if the taxpayer expenses research expenditures or capitalizes them. However, the deduction for research expenditures must be reduced by the credit taken.
- d. This credit expired at the end of 2014; it was then permanently extended, effective January 1, 2015, under the PATH Act. Eligible small businesses may use the credit to offset both regular tax and AMT liabilities, as well as payroll taxes.

1320.11 **Low-income housing credit** (a general business credit): A tax credit may be claimed by owners of low-income rental housing units constructed, rehabilitated, or acquired after 1986. The credit is claimed by completing and attaching IRS Form 8586, *Low-Income Housing Credit*, to the tax return.

- a. A credit may be taken in each of 10 years starting with the year the project is placed in service, or the next year if the taxpayer so elects.
- b. The annual credit is equal to:

$$\begin{array}{l} \text{Qualified basis of low-income rental units} \\ \times \text{ Applicable percentage rate } \\ = \text{ Low-income housing credit } \end{array}$$

- (1) The qualified basis is that portion of the building's qualified cost that is attributable to low-income rental units.
- (2) The applicable percentages are issued by the IRS for the month the building is placed in service.
- c. An owner is required to recapture part of the credits taken if the owner disposes of the interest in the project or violates some aspect of the original entitlement any time within a 15-year period.

1320.12 **Disabled access credit** (a general business credit): Qualified taxpayers have available a nonrefundable tax credit that is based on the expenditures incurred to make their business accessible to disabled individuals. IRS Form 8826, *Disabled Access Credit*, is completed and attached to the taxpayer's return to claim the credit.

- a. The credit is equal to 50% of the eligible access expenditures for the year that fall between \$250 and \$10,250. Thus, the maximum credit available is \$5,000
($50\% \times (\$10,250 - \$250)$).
- b. The credit is available to those small businesses that in the preceding tax year had either:
 - (1) gross receipts of \$1 million or less or
 - (2) 30, or fewer, full-time employees.
- c. The credit is not available for expenditures paid or incurred on buildings placed in service after November 5, 1990
- d. The adjusted basis is reduced by the full amount of the credit taken.

1320.13 **Employer-provided childcare credit** (a general business credit): To encourage smaller businesses to provide childcare for their employees, a credit is available for childcare expenses paid by the employer. IRS Form 8882, *Credit for Employer-Provided Childcare Facilities and Services*, is completed and attached to the business tax return to claim the credit.

- a. A 25% credit is available for expenditures to acquire or prepare property for use as a childcare facility. The 25% credit also applies to:
 - (1) the operating costs of a childcare facility or
 - (2) the amount paid to a contracted childcare facility to provide childcare services to the taxpayer's employees.
- b. A 10% credit is also available for expenses paid by the employer under a contract to provide childcare resource and referral services to the employees.
- c. The total credit cannot exceed \$150,000 per year.

- d. Any credit based on the acquisition or improvement of property must be used to reduce the basis of that property. Likewise, any deductible expenses must be reduced by the related tax credit.

If a credit is claimed for a property acquisition or improvement, terminating the use of that property as a childcare facility within 10 years will trigger a recapture of some or all of the credit claimed.

1320.14 Credit for the elderly and the permanently and totally disabled:

Individuals age 65 or over and individuals under 65 who are permanently and totally disabled have a special tax credit available. This credit is claimed on Schedule R of IRS Form 1040.

- a. Individuals are permanently and totally disabled when they are expected to be unable to work for a period of 12 continuous months.
- b. This credit is equal to 15% of a base figure after certain adjustments.
 - (1) The base figure available to the taxpayer depends on the following factors:
 - (a) **Singles:**
 - i. Age 65—\$5,000
 - ii. Disabled—lesser of \$5,000 or disability income
 - (b) **Married persons filing jointly:**
 - i. Both 65—\$7,500
 - ii. One 65—\$5,000
 - iii. One 65, one disabled—lesser of \$7,500 or \$5,000 plus disability income
 - iv. One disabled—lesser of \$5,000 or disability income
 - v. Both disabled—lesser of \$7,500 or sum of spouses' disability income

(c) **Married persons filing separately:**

- i. Age 65—\$3,750
- ii. Disabled—lesser of \$3,750 or disability income

(2) Adjustments (deductions) to the base figure are required for the following:

- (a) Social Security payments
- (b) Railroad Retirement pensions
- (c) One-half of adjusted gross income in excess of:
 - i. \$7,500 (single)
 - ii. \$10,000 (married, filing jointly)
 - iii. \$5,000 (married, filing separately)

- c. A married taxpayer filing separately may use the credit only if the couple has lived apart the entire tax year.

The credit phases out for the elderly or the disabled at income levels of \$17,500 or more (or taxpayer received \$5,000 or more of nontaxable Social Security or other nontaxable pensions, annuities, or disability income) for single people, \$20,000 for married filing jointly and only one spouse is eligible for the credit (or taxpayer received \$5,000 or more of nontaxable Social Security or other nontaxable pensions, annuities, or disability income), \$25,000 for married filing jointly and both spouses are eligible for the credit (or taxpayers received \$7,500 or more of nontaxable Social Security or other nontaxable pensions, annuities, or disability income), and \$12,500 for married filing separately taxpayers (or taxpayer received \$3,750 or more of nontaxable Social Security or other nontaxable pensions, annuities, or disability income).

1320.15**Coronavirus related employee and employer credit.**

An eligible employer uses Form 8994 to figure the employer credit for paid family and medical leave. The credit ranges from 12.5% to 25% of certain wages paid to a qualifying employee while the employee is on family and medical leave. An employee who was not able to work because of coronavirus quarantine or self-quarantine is entitled to paid sick leave for up to 10 days (80 hours) at the employee's regular rate of pay, or if higher, the Federal minimum wage or any applicable state or local minimum wage, up to \$511 per day, but no more than \$5,110 in total.

An employee who is unable to work due to caring for someone with coronavirus, or caring for a child because the child's school or place of care is closed, or the paid child care provider is unavailable due to the coronavirus, is entitled to paid sick leave for up to two weeks (up to 80 hours) at two-thirds the employee's regular rate of pay or, if higher, the Federal minimum wage or any applicable State or local minimum wage, up to \$200 per day, but no more than \$2,000 in total.

An employee who is unable to work because of a need to care for a child whose school or place of care is closed or whose child care provider is unavailable due to the coronavirus, is also entitled to paid family and medical leave equal to two-thirds of the employee's regular pay, up to \$200 per day and \$10,000 in total. Up to ten weeks of qualifying leave can be counted towards the family leave credit.

Eligible employers are entitled to receive a credit in the full amount of the required sick leave and family leave, plus related health plan expenses and the employer's share of Medicare tax on the leave, for the period of April 1, 2020, through December 31, 2020. The refundable credit is applied against certain employment taxes on wages paid to all employees. Eligible employers can reduce federal employment tax deposits in anticipation of the credit. They can also request an advance of the paid sick and family leave credits for any amounts not covered by the reduction in deposits. The advanced payments will be issued by paper check to employers.

Employee Retention Credit

Eligible employers can claim the employee retention credit, a refundable tax credit equal to 50 percent of up to \$10,000 in qualified wages (including health plan expenses), paid after March 12, 2020 and before January 1, 2021. Eligible employers are those

businesses with operations that have been partially or fully suspended due to governmental orders due to COVID-19, or businesses that have a significant decline in gross receipts compared to 2019.

The refundable credit is capped at \$5,000 per employee and applies against certain employment taxes on wages paid to all employees. Eligible employers can reduce federal employment tax deposits in anticipation of the credit. They can also request an advance of the employee retention credit for any amounts not covered by the reduction in deposits. The advanced payments will be issued by paper check to employers.

Also, under CARES Act, employers had the option to defer the employment tax deposits and payments through December 31, 2020 for the employer related share of the Social Security tax. As a result, of the presidential memorandum signed August 8, 2020, employees were also given the option to defer their share of Social Security taxes from September 1 through December 31, 2020. This applied to employees paid less than \$4,000 every two weeks. Any taxes thus deferred would be paid ratably between January 1, 2021 and December 31, 2021.

1400 Taxation and Advice

1410 Taxation

1410.01 Alternative minimum tax and credit for prior year

A special alternative minimum tax (AMT) is payable to the extent that it exceeds the taxpayer's regular tax before credits.

- a.** For 2020, the exemption amounts are \$113,400 for joint returns or qualifying widow(er)s with dependent child, \$72,900 for unmarried individuals, \$56,700 for married individuals filing separate returns, and \$25,000 for estates and trusts.
- b.** For 2020, the above exemption amounts are reduced (not below zero) to an amount equal to 25% of the amount by which the AMTI (alternative minimum taxable income) of the taxpayer exceeds the phaseout amounts, increased for joint and qualifying widow(er)s with dependent child to

\$1,036,800 and to all others (other than trusts and estates) to \$518,400.

- c. Basically, the alternative minimum tax is computed as follows:

	Regular taxable income
+ or –	Adjustments
+	<u>Tax preferences</u>
=	AMTI
–	<u>Exemption amount</u>
=	AMT base
×	<u>26% under threshold (28% over threshold)</u>
=	Tentative tax before foreign credit
–	<u>Foreign tax credit</u>
=	Tentative minimum tax
–	<u>Regular tax (less foreign tax credit)</u>
=	Alternative minimum tax

- (1) Adjustments (plus or minus) include such items as the following:
- (a) Itemized deductions
 - (b) Standard deduction
 - (c) Excess ACRS deductions (accelerated depreciation)
 - (d) Circulation expenditures (magazines and newspapers)
 - (e) Research and experimental expenditures
 - (f) Mining exploration and development costs
 - (g) Passive activity losses
 - (h) Certain installment sales
 - (i) Long-term construction contracts
 - (j) Incentive stock options
 - (k) Alternative tax net operating loss

- (2) Tax preferences may arise in the following areas:
 - (a) Percentage depletion
 - (b) Intangible drilling costs
 - (c) Seven percent (7%) of excluded gain on qualified small business stock
 - (d) Accelerated depreciation
 - (e) Certain tax-exempt interest
- d. An AMT tax credit may be available when regular taxable income is greater than AMTI (alternative minimum taxable income). The regular tax liability, in this situation, may be offset by a credit representing minimum tax liabilities from prior years attributable to timing differences. The AMT credit carries forward indefinitely.

1410.02 Penalties and exceptions on premature distributions from qualified retirement plans and IRAs

An early withdrawal from an Individual Retirement Account (IRA) or a qualified retirement plan prior to age 59½ is subject to being included in gross income plus a 10 percent additional penalty. There are exceptions to the 10 percent penalty such as using the funds for an immediate and heavy need such as to pay medical insurance premiums after a job loss. In 2020, coronavirus related distributions of up to \$100,000 were not subject to the early withdrawal penalty.

1410.03 Household employees

- a. Gross amounts of domestic wages paid in cash (in excess of \$2,200 for 2020), and payroll taxes thereon, must be reported to the taxing authorities.
- b. Usually for businesses, Social Security and Medicare withholdings are reported on IRS Form 941/944. Form 1040, Schedule H, may be used to report federal employment taxes on cash wages paid to household employees. Federal employment taxes that may be paid with Schedule H include Social Security, Medicare, withheld federal income, and federal unemployment (FUTA) taxes.
- c. Wages paid for domestic services are subject to federal unemployment tax if they exceed \$1,000 per quarter for 2020, aggregating wages paid to all employees. The employer's required payment for federal unemployment (FUTA) tax cannot be withheld from the employee's wages; it must be paid from the employer's own funds.
- d. The employee's share of the Social Security and Medicare tax can be withheld from the domestic service employee's wages.
- e. Withholding federal income taxes for household employees is required only if requested by the employee and agreed to by the employer. Such withholding would be reported on Schedule H. and filed with Form 1040.

1410.04 Underpayment penalties and interest

Just like any other taxes required to be paid, the IRS will impose a penalty for underpayment of tax as well as interest. Due to Coronavirus, household employers have the option to defer employment tax deposits and payments through December 31, 2020 for the employer's share of Social Security.

1410.05 Conditions for filing a claim for refund (e.g., amended returns)

If an employer makes an error in withholding taxes or overpays taxes, an amended 941X should be filed to correct the error.

1410.06 Self-employment tax

Self-Employment tax must be paid as an addition to the tax if net earnings from self-employment are \$400 or more. A completed Schedule SE (IRS Form 1040) is included with the self-employed person's income tax return.

Although the net self-employment earnings base changes annually, the tax rate remains constant at 15.3%. This is 12.4% for Old Age, Survivor, and Disability Insurance (OASDI) and 2.9% for the Hospital Insurance Plan (HIP). The maximum amount of income subject to this tax varies according to the type of insurance.

1410.07 Excess Social Security withholding

Should an employee work for two or more employers and the combination of those wages exceed the total social security maximum to be withheld for the calendar year, the employee is entitled to a credit on their personal return for the excess social security taxes withheld.

1410.08 Tax provisions for members of the clergy

A licensed, commissioned, or ordained minister who performs ministerial services as an employee may be able to exclude from gross income the fair rental value of a home provided as part of compensation (a parsonage) or a housing allowance provided as compensation if it is used to rent or otherwise provide a home. A minister who is furnished a parsonage may exclude from gross income the fair rental value of the parsonage, including utilities. However, the amount excluded can't be more than reasonable compensation for the minister's services.

1410.09 Income in respect of decedent (e.g., allocations)

For the year of a taxpayer's death, you generally should file a final tax return. Determine the income you should include, generally, as of the date of death, and file a short year tax return for the year of death. Income after the date of death should be included on the estate or beneficiary's tax return, as appropriate.

- a.** If the deceased taxpayer was married, and the surviving spouse qualifies to file a joint return, include income for the deceased taxpayer up to the date of death. Include income for the surviving spouse for the entire year. A short year tax return is not required.
- b.** If the deceased taxpayer used the cash method of reporting income, include only income items that were actually or constructively received up to the date of death.
- c.** Issuers of certain forms (Form 1099-INT and Form 1099-DIV) should issue separate forms for interest paid to the decedent and interest paid to the estate or other recipient. If not, you can request a corrected form. Otherwise, you should include all interest/dividends on the return, and then show any interest received as a nominee separately, subtracting it from the subtotal and writing "Nominee Distribution" on the adjustment line.
- d.** For most deductions, including itemized deductions, include only those paid on or before the date of death.
- e.** The full amount of some deductions and credits, such as the standard deduction, earned income credit, child tax credit, and credit for the elderly or the disabled, can be taken on the final tax return.
- f.** See IRS Publication 559, *Survivors, Executors, and Administrators*, for additional information on specific income or deduction items to be included on the final tax return.

1410.10 Healthcare individual responsibility payment and exceptions

The individual shared responsibility provision of the Affordable Care Act is no longer applicable for 2020. The premium tax credit is still applicable.

1410.11 Net investment income tax

The net investment income tax is a 3.8 percent surtax on a portion of a taxpayer's modified adjusted gross income over certain thresholds. The net investment income tax thresholds for 2018 are \$200,000 for single or head of household taxpayers, \$250,000 for married filing jointly taxpayers, or \$125,000 for married filing separately taxpayers.

1410.12 Additional Medicare tax

Employers are required to withhold additional Medicare taxes, above the 1.45% Medicare tax rate, at a rate of 0.9% on all Medicare wages in excess of \$200,000 paid to an employee.

1410.13 Uncollected Social Security and Medicare tax

If an employee was treated as an independent contractor and Social Security and Medicare taxes were not collected on their wages, Form 8919 should be filed.

1410.14 Other taxes (e.g., first time homebuyer credit repayment, IRC Section 965 transition tax)**First Time Homebuyer Credit**

The first-time homebuyer credit was a credit offered in 2008-2011 to certain qualified homebuyers. In certain years, the credit was a loan that must be repaid. In other years, the credit must be repaid if the home was sold within a certain time period. The homebuyer credit is repaid as an additional tax on a taxpayer's federal tax return. The repayment calculates to annual repayments of \$500 per year on a maximum \$7,500 tax credit.

Transition Tax

Section 965 requires United States shareholders (as defined under section 951(b)) to pay a transition tax on the untaxed foreign earnings of certain specified foreign corporations as if those earnings had been repatriated to the United States.

1410.15 ABL Accounts

In general, a person can take distributions from their ABLE account to pay for any qualified disability expenses such as expenses for maintaining or improving their health, independence, or quality of life. Qualified disability expenses include those for education; housing; transportation; employment training and support; assistive technology; personal support services; health, prevention and wellness; financial management; administrative services; legal fees; expenses for oversight and monitoring; and funeral and burial.

If distributions from a person's ABLE account during a year are not more than their qualified disability expenses for that year, no amount is taxable for that year. If the total amount distributed during a year is more than their qualified disability expenses for that year, the earnings portion of the distribution is included in their income for that year. The includible portion is calculated as follows:

- $(\text{Qualified portion of distribution} \div \text{Total distribution}) \times \text{Earnings portion of distribution} = \text{Nontaxable earnings amount}$

In addition, the tax on any distribution included in a person's taxable income is increased by 10%. This tax is figured on Form 5329, Part II, and is filed even if the taxpayer is not otherwise required to file a federal income tax return.

1420 Advising the Individual taxpayer

1420.01 When advising an individual taxpayer on how to report and calculate the tax return, consider all circumstances. When there are multiple avenues that can be taken, advise the taxpayer of the most beneficial or option with the least burden of proof. Always advise taxpayers to keep appropriate records and documentation and to follow the appropriate tax laws.

1420.02 Reporting obligations for individuals

In addition to reporting income and deductions on the income tax return (Form 1040), individuals may be responsible for other reporting requirements. These include reporting a foreign person's U.S. source income on Form 1042-s, Form 1099 reporting (for example, a Form 1099-MISC for amounts you paid a nonemployee as compensation), wages paid to employees, partnership withholding on effectively connected income, and withholding of tax on dispositions of United States real property interests. Some of these reporting requirements also have withholding requirements. Ask questions to see if the taxpayer is required to report any obligations.

1420.03 Property sales (e.g., homes, stock, businesses)

Taxpayers who sell any type of property during the year may have a gain or loss to report. This includes both personal and business property. Each sale is classified as ordinary or capital, depending on whether the asset is considered capital or noncapital. Capital assets include most assets you own for personal purposes, pleasure, or investment. This includes stocks, bonds, your personal residence, household furnishings, collections (coin, stamp, etc.) Any other asset, generally, is a noncapital asset, including property used in your business, stocks you hold mainly for sale to customers, inventories, patents and other similar intellectual property, and other items. IRS Publication 544 has lists containing examples of capital and noncapital assets. Report the sale of most capital assets on Schedule D.

- a.** You cannot claim a loss on most personal-use assets (such as household furnishings or a car you drive only for personal use), though you must report the gain on the sale of a personal-use asset.
- b.** The sale of a partnership interest is generally treated as the sale of a capital asset. If the taxpayer has gain or loss from unrealized receivables or inventory items, treat that portion of the sales as an ordinary gain or loss.
- c.** Corporation interests are stocks. When a taxpayer sells interest in a corporation, treat the sale as any other stock sale.

If the taxpayer sells a business, treat it as the sale of each individual asset rather than the sale of one asset. Use the residual method to allocate the basis and sale price of each business asset. This method determines the buyer's basis in the asset, the gain or loss from the transfer, and how much of the consideration is for goodwill and other intangible property. Using this method, allocate the consideration among the assets in a set order, starting with cash and general deposit accounts. You cannot allocate more to an asset than its fair market value on the purchase date.

1420.04 Education planning (e.g., lifetime learning credit, IRC Section 529 plans)

Many taxpayers prefer to plan for their children's (or their own) education in advance. Besides scholarships and grants, the tax code provides several methods for tuition relief.

- a. **Lifetime learning credit and American Opportunity Tax Credit:** Taxpayers can use education credits to reduce the tax by a portion of the amount spent on education. This method can only be used for tuition already paid and is limited based on the taxpayers modified AGI.
- b. **Coverdell Education Savings Account (ESA):** Taxpayers with modified AGI under certain limits (\$110,000, \$220,000 for married filing jointly) can establish a Coverdell ESA to put aside funds a designated beneficiary can use for qualified education expenses. This is a trust or custodial account. This includes both higher education expenses and elementary and secondary education expenses. Taxpayers can make nondeductible contributions of up to \$2,000 for each designated beneficiary. The beneficiary can withdraw distributions tax-free to pay qualified education expenses. Distributions that are not used to pay qualified education expenses are taxed.
- c. **Qualified Tuition Programs (QTPs, or 529 plans):** Qualified Tuition Programs work in a similar way to Coverdell ESAs, but are established and maintained by the state or an eligible educational institution. Taxpayers cannot deduct contributions to a QTP. As with a Coverdell ESA, the

qualified education expenses can be to a qualified postsecondary educational institution or an elementary or secondary school. Taxpayers can contribute up to the amount necessary to provide for the qualified education expenses of the designated beneficiary and there is not an income restriction for the contributor. Distributions are not taxable if withdrawn for qualified education expenses.

- d. **IRA Distributions:** If the taxpayer has an IRA, he or she can withdraw funds from the IRA without incurring the 10% additional tax/penalty on the distribution, if the funds are used for qualified education expenses paid for the taxpayer, spouse, child, foster child, adopted child, or grandchild. You should still report the early distribution and use the appropriate exclusion to exclude the 10% penalty. This does not affect whether the distribution itself is taxable as income.

1420.05 Estate planning (e.g., gift versus inheritance, trusts, family partnerships, charitable giving, LTC, life insurance)

When advising taxpayers in estate planning, consider the tax consequences for both the taxpayer and any beneficiaries. Estates must generally pay estate taxes when the estate is valued at \$11.58 million or more for 2020. However, this is set to revert to \$5 million after 2025.

- a. For married couples, make use of the portability election, which allows a surviving spouse to add any unused federal estate tax exclusion from the first spouse to their own exclusion. This must be elected, however, so advise taxpayers to do so to avoid losing the option.
- b. Taxpayers who may be subject to the estate tax may want to make annual gifts up to the federal gift tax exclusion amount, currently \$15,000 per person to whom the gift is made (\$30,000 if a married couple give the gift together).
- c. Consider gifting appreciable property rather than waiting for inheritance. For gifted property, the new owner's basis depends on the donor's adjusted basis, fair market value

just before the time of the gift, and whether the new owner sells at a gain or loss. For inherited property, the basis is generally the fair market value on the date of death (with exceptions). Appreciable property may have a lower basis for the recipient if gifted rather than inherited.

- d. Taxpayers can take advantage of the current higher limits on charitable contributions (60% of AGI) by making charitable contributions in one year rather than spread over several years. The AGI limit was raised to 100% for cash contributions made to qualified charitable organizations in 2020.
- e. Make plans to pay for long-term care if needed in the future. In addition to personal funds and health insurance programs, long-term care insurance may be a consideration. This allows the taxpayer to purchase insurance that covers services needed for long-term care (such as daily living assistance).
- f. Life insurance death benefits are not taxed federally, but must be included for estate tax purposes if the policy includes certain incidents of ownership. The taxpayer can plan for this by naming a surviving spouse as beneficiary or setting up an irrevocable life insurance trust.

1420.06 Retirement planning (e.g., annuities, IRAs, employer plans, early retirement rules, required minimum distribution, beneficiary ownership, charitable distributions from an IRA)

Many retirement savings plans exist. The taxpayer should choose the retirement savings plan (or set of plans) that benefits their situation the most. Some, such as traditional IRAs and employer plans (401(k)), are not taxed when contributions are made, but the taxpayer must pay tax when distributions are made. Others, such as Roth IRAs do not have deductible contributions, but distributions are at least partly nontaxable.

- a. Keep in mind that many plans have a required minimum distribution at age 70½. The taxpayer should account for that in retirement planning.

- b.** Review the beneficiary ownership situation, including taxability of distributions to the beneficiary, with the taxpayer.
- c.** Taxpayers who are age 70 ½ may request that the trustee of an IRA (other than SEP or SIMPLE) make a charitable contribution from an IRA on their behalf. The charitable distribution is not taxable, allowing the taxpayer to reduce taxability of the distributions.

1420.07 Marriage and divorce (e.g., divorce settlement, common-law, community property)

Marriage and divorce can have a tax impact in the year of the divorce or for future years.

- a.** When taxpayers get married or divorced during a tax year, the tax rates may be different than anticipated. File new Forms W-4 with employers as soon as possible, and refigure estimated tax payments based on new tax situations.
- b.** For divorce settlements reached on or after January 1, 2020, alimony is neither included in income of the recipient or deductible for the payer. For divorce settlements before that date, it is included in income/deductible, unless the agreement is modified to specifically state otherwise.
- c.** Divorce settlements can affect whether dependents can be claimed on the tax return (for child tax credit, etc.). Plan appropriately for the tax consequence.
- d.** Transfers during a divorce may be taxable, including pensions, annuities, and other retirement plans and stocks or brokerage funds. Also, if one spouse buys property from the other during the divorce, the income on the sale may be taxable.

1420.08 Items that will affect future/past returns (e.g., carryovers, net operating loss, Schedule D, Form 8801, negative QBI carryover)

Due to limitations of losses on current year returns, many losses may need to be carried to other tax returns.

- a. Unused capital losses can be carried forward to future years until they are used. Short-term and long-term capital loss carryovers must be carried over and used separately, but are subject to the same limit each year.
- b. NOLs arising in years 2018, 2019 or 2020 can be carried back 5 years or forward. If the NOL is carried back to a year where the TCJA 80% of taxable income limitation applied (prior to 2021), this limitation is temporarily suspended by the provisions of CARES Act. If the NOL is carried forward to year beginning after December 31, 2020, the 80% limitation applies. Farmers may enjoy the same benefit. However, those farmers who had previously elected the 2 year-carryback that was available to them prior to the enactment of CARES Act, can preserve their 2 year-carryback.
- c. A taxpayer with an unused credit for prior year minimum tax can carry that credit forward to the next tax year. Use Form 8801, *Credit for Prior Year Minimum Tax – Individuals, Estates, and Trusts*, to figure or apply the carryforward.
- d. An unused Qualified Business Income deduction can be carried forward. Use the worksheet in Forms 8995 and 8995-A or IRS Publication 535 to figure any net loss carryforward or apply the net loss carryforward from prior years.

1420.09 Injured spouse

An injured spouse is a taxpayer whose tax refund is appropriated for the past-due debts of a spouse or former spouse.

1420.10 Innocent spouse

An innocent spouse can be relieved of responsibility for paying tax, interest, and penalties if the taxpayer's spouse or former spouse improperly or fraudulently reported items or omitted items on a jointly filed tax return.

1420.11 Estimated tax and penalty avoidance

Taxpayers are expected to make estimated tax payments for the current tax year if both of the following apply:

- the taxpayer expects to owe at least \$1,000 in tax for the current tax year after subtracting your withholding and refundable credits.
- the taxpayer expects that their tax withholding and refundable credits to be less than the smaller of:
 - 90% of the tax on the current year's tax return, or
 - 100% of the tax on the prior year's tax return.

Failure to do so, may result in both underpayment and late payment penalties for the taxpayer. The penalty for substantial understatement of income is the larger of 10% of the correct tax or \$5,000.

1420.12 Adjustments, deductions, and credits for tax planning (e.g., timing of income and expenses)

Taxpayers should plan in advance for certain adjustments, deductions, and credits to maximize the tax benefit.

- a. Contributions to certain retirement plans can be deducted, reducing the taxable income on the return. In addition, taxpayers with lower income may be able to take a credit for retirement contributions.
- b. Expenses for qualified education expenses, childcare, adoption, and certain other expenses for your child can be used for credits. Taxpayers should ensure that they keep appropriate records and pay these expenses only as required by tax law in order to have a tax benefit from the expense.

Review financial and life-changing plans with the taxpayer in order to accurately plan the tax consequences or benefit of these decisions. Also, ensure that the taxpayer makes adjustments to withholding or estimated tax payments appropriately to avoid a penalty or unusually large balance due.

Form 1040-ES is filed with each estimated payment. If a taxpayer changes his or her name because of marriage, divorce, etc. and

they made estimated tax payments using their former name, the taxpayer should attach a statement to the front of the form. On the form, the following information should be given: all of the estimated tax payments the taxpayer (and the taxpayer's spouse, if filing jointly) made for the current tax year and the name(s) and SSN(s) under which the taxpayer made the payments. 'In addition, the taxpayer should be advised to report the change, if they have not already, to their local Social Security Administration office before filing the tax return to prevent delays in processing the tax return.

1420.12 Character of transaction (e.g., use of capital gain rates versus ordinary income rates)

Ordinary income tax is paid on earnings from interest, dividends, employment, royalties, or self-employment. Capital gains tax is paid on income that is derived from the sale or exchange of an asset, such as a stock or property. Typically, capital tax rates on long term capital gains are taxed at a more favorable (lower) tax rate.

1420.13 Advantages and disadvantages of MFJ/MFS/HOH filing statuses in various scenarios

Married taxpayers have the option to select married filing jointly or married filing separately on their federal income tax returns. The IRS strongly encourages most couples to file joint tax returns by extending several tax breaks to those who file together. In the vast majority of cases, it's best for married couples to file jointly, but there may be a few instances when it's better to submit separate returns.

Married taxpayers who file together can usually qualify for multiple tax credits such as the earned income tax credit, the American Opportunity and Lifetime Learning Education tax credits, the credit for adoption expenses and child and dependent care tax credits.

Married taxpayers who select to file separately receive few tax considerations. In most instances, separate tax returns result in higher taxes. The standard deduction for separate filers is far lower than that offered to joint filers.

In rare instances, filing separately may result in tax savings. An example of this type of instance would include if one of the

spouses has a large amount of out-of-pocket medical expenses to claim and jointly the taxpayers would not be able to deduct the costs.

The best approach is to prepare the married taxpayers return both as filing jointly and as filing separately to determine which method results in the greater tax savings.

1420.14 Health Insurance

Under the health care law, certain health coverage is called minimum essential coverage (MEC). A taxpayer generally cannot take the premium tax credit (PTC) for an individual in their tax family for any month that the individual is eligible for minimum essential coverage, except for coverage in the individual market. Minimum essential coverage includes the following:

- Individual market coverage (including qualified health plans)
- Most coverage through government-sponsored programs (including Medicaid coverage, Medicare parts A or C, the Children's Health Insurance Program (CHIP), certain benefits for veterans and their families, TRICARE, and health coverage for Peace Corps volunteers)
- Most types of employer-sponsored coverage
- Grandfathered health plans
- Other health coverage designated by the Department of Health and Human Services as minimum essential coverage

Minimum essential coverage does not include coverage consisting solely of excepted benefits. Excepted benefits include vision and dental coverage not part of a comprehensive health insurance plan, workers' compensation coverage, and coverage limited to a specified disease or illness.

1420.15 Social Security Income

To find out whether any of a taxpayer's Social Security benefits may be taxable, compare the base amount for their filing status with the total of:

- one-half of their benefits plus
- all their other income, including tax-exempt interest.

When making this comparison, do not reduce the taxpayer's other income by any exclusions for:

- interest from qualified U.S. savings bonds,
- employer-provided adoption benefits,
- foreign earned income or foreign housing, or
- income earned by bona fide residents of American Samoa or Puerto Rico.

The base amount for the various filing statuses is:

- \$25,000 if the taxpayer is single, head of household, or a qualifying widow(er);
- \$25,000 if the taxpayer is married filing separately and lived apart from their spouse for the entire year;
- \$32,000 if the taxpayer is married filing jointly; or
- \$0 if the taxpayer is married filing separately and lived with their spouse at any time during the year.

1500 Specialized Returns for individuals

1510 Estate Tax

1510.01 The estate tax and the gift tax are both excise taxes on the transfers of property. The estate tax is imposed on the amount of a decedent's net wealth (fair market value of total assets less debts and expenses) that passes to his or her heirs at death. The gift tax is imposed on the value of property transferred during an individual's life. Only a relatively small percentage of taxpayers are affected by the gift or estate tax since they apply only when the transfer of wealth is substantial. Transfer taxes (gift and estate taxes) are triggered in 2020 only when transfers exceed \$11,580,000. Despite their limited application, for those to whom the taxes do apply, the cost can be significant.

Generally, an estate tax return, Form 706, is not required for a death in 2015 unless the taxable estate of the deceased is more than the exemption amount, which is \$11,580,000 in 2020. The estate tax return is due nine months after the date of death, though it is possible to extend the return for another six months automatically.

In 1976, the gift tax and estate tax were combined into what is conceptually a unified transfer tax. In years 2012 and after, the gift and estate taxes are unified. As an individual makes taxable gifts during life, the gift tax is computed on a cumulative basis. To

calculate the tax on current year gifts, the donor must add all taxable gifts made in prior years (since 1976) to the current gifts, calculate the gross tax on the sum of the lifetime transfers, and then subtract gift taxes assessed on the prior years' gifts. The remainder is the current year gift tax. When the individual dies, the estate tax is computed in a similar manner by adding all prior taxable gifts to the taxable estate, applying the appropriate rate and subtracting any prior gift taxes assessed. It is helpful to think of the transfer at death as the final gift.

As a practical matter, the estate and gift tax does not apply to most taxpayers. To eliminate the administrative problems that would result if the gift tax were imposed on all gifts (e.g., birthday presents), the gift tax is imposed only on those transfers that exceed a certain threshold known as the "annual exclusion." In 2020, this amount is \$15,000. Technically, individuals are entitled to an exclusion of the annual exclusion amount per donee, per year. The exclusion enables an individual to make an unlimited number of gifts as long as they do not exceed \$15,000 per donee in 2020. For married couples, these rules permit a husband and wife to give \$30,000 in 2020 to a particular donee (e.g., a child) tax free by electing to make joint gifts. In addition to the annual exclusion, gifts to a spouse, charity, or transfers for educational or medical purposes normally are not taxable. In addition to the annual exclusion and the unlimited gifting opportunity for medical and education related gifts, in 2020, a taxpayer may gift up to \$11,580,000 in gifts before such gifts become taxable. This exclusion applies to gifts made during life, and also applies to testamentary gifts to the extent the \$11,580,000 exclusion was not used during life.

Once either inter vivos or testamentary transfers exceed the exclusion amount, the transfer is taxed at up to 40 percent (progressive rate depending on taxable amount of gifts) in 2020.

A decedent's estate tax liability is based on his or her net wealth and whether he or she leaves it to a surviving spouse or to a qualified charity. The procedure for computing the federal estate tax liability is discussed below. The first step in computing the estate tax is to identify the decedent's gross estate. A decedent's gross estate includes the value of all property owned at date of death, wherever located. This includes the proceeds of an

insurance policy on the life of the decedent if the decedent's estate is the beneficiary, or if the decedent had any ownership rights in the policy at time of death. Property is generally included in the gross estate at its fair market value as of the date of death or the fair market value at the alternative valuation date six months from the date of death. The alternative valuation date may be used only if it results in a reduction of the applicable estate tax.

The taxable estate is the gross estate reduced by deductions allowed for funeral and administrative expenses, debts of the decedent, certain taxes and losses, state death taxes and charitable gifts made from the decedent's estate. It is important to note that there is no limit imposed on the charitable deduction. If an individual is willing to leave his or her entire estate to a charity or to a spouse, there will be no taxable estate. An unlimited marital deduction is allowed for the value of property passing to a surviving spouse. Thus, if a married taxpayer leaves all of his or her property to the surviving spouse, no federal estate tax will be imposed on the estate. On the death of the surviving spouse, the couple's wealth may be subject to taxation.

1510.02 Gross estate

The gross estate of the decedent consists of the fair market value at date of death of everything a decedent owned or had an interest in at time of death. The includible property may consist of cash and securities, real estate, insurance, trusts, annuities, business interests, and other assets. The gross estate will likely include non-probate as well as probate property.

Generally, the gross estate does not include property owned solely by the decedent's spouse or other individuals. Lifetime gifts that are complete (no powers or other control over the gifts are retained) are not included in the gross estate (but taxable gifts are used in the computation of the estate tax). Life estates given to the decedent by others in which the decedent has no further control or power at the date of death are not included.

The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts. The fair market value of a

particular item of property includible in the decedent's gross estate is not to be determined by a forced sale price. Nor is the fair market value of an item of property to be determined by the sale price of the item in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate.

An heir takes a tax basis in gifted property generally equal to the donor's basis if the property is sold at a gain. If the property is depreciated at the time it is gifted and the property is subsequently sold at a loss, the donee's basis will be the property's fair market value at the time of the gift. An individual's basis in inherited property is the property's fair market value at the decedent's date of death. If the alternative valuation date is used to value the property, then the property's basis is the fair market value of the property six months from the date of death.

The gross estate includes all property in which the decedent had an interest (including real property outside the United States). It also includes:

- a.** Certain transfers made during the decedent's life without an adequate and full consideration in money or money's worth;
- b.** Annuities;
- c.** The includible portion of joint estates with right of survivorship;
- d.** The includible portion of tenancies by the entirety;
- e.** Certain life insurance proceeds (even though payable to beneficiaries other than the estate, see the instructions for Schedule D);
- f.** Property over which the decedent possessed a general power of appointment;
- g.** Dower or curtesy (or statutory estate) of the surviving spouse; and
- h.** Community property to the extent of the decedent's interest as defined by applicable law.

1. Alternative valuation date

An executor may elect the alternative valuation date regarding the time at which property included in a decedent's gross estate will be valued: the date of death (the usual valuation date), or a date that is six months after the date of death (the alternate valuation date).

Once made, the selection of the valuation date generally applies to all property in the estate for purposes of computing the estate tax liability. If the executor elects the alternate valuation date, an exception exists for property that is sold or otherwise disposed of within the six-month period between the date of death and the alternate valuation date: such property is valued as of the date it was sold or disposed of. The alternate valuation date rule is designed to be a relief provision in cases where the value of a decedent's estate declines in the six-month period following his or her death.

If an executor uses the alternate valuation date for assets, this lower valuation amount also sets the basis that heirs will have in the assets they receive from the estate. If they have a lower basis, they can expect to face a higher capital gains tax liability when they later sell these properties. In order to use the alternative valuation date, three requirements must be met:

- a.** The total value of the gross estate must decrease by using the alternative valuation date;
- b.** The amount of the estate tax must decrease by using the alternative valuation date; and
- c.** The person who files the deceased person's estate tax return must make the proper election on the return.

The executor can only elect to use the alternative valuation method if it will lower both:

- a.** The value of the gross estate; and

- b.** The sum of the estate tax and GST tax after taking the application of all allowable credits against these taxes.

Estates that owe no federal estate tax or no generation skipping tax may not use the alternative valuation method. This election must be made within one year after the due date of the federal estate tax return (including extensions). There is no exception to this one-year rule. The election is irrevocable.

2. Generation Skipping Transfer Tax (GST Tax)

A donor is liable for the GST when he or she makes an inter vivos direct skip, which is a transfer made during the donor's lifetime that is subject to the gift tax, of an interest in property, and made to a skip person.

A donee, who is a natural person, is a *skip person* if that donee is assigned to a generation that is two or more generations below the generation assignment of the donor. The exemption for the GST tax in 2020 is \$11,580,000.

1510.03 Taxable estate (calculations and payments)

One of the primary deductions for married decedents is the marital deduction. All property that is included in the gross estate and passes to the surviving spouse is eligible for the marital deduction. The property must pass "outright." In some cases, certain life estates also qualify for the marital deduction.

If the decedent leaves property to a qualifying charity, it is deductible from the gross estate. Additional deductions include: mortgages and debt, administration expenses of the estate, and losses during estate administration. The following tax formula sets forth how the estate tax liability is determined:

$$\begin{array}{rcl} & \text{Gross estate} & \\ - & \text{Administrative and funeral expenses} & \\ - & \text{Debts} & \\ - & \text{Losses} & \\ - & \text{Taxes} & \\ - & \text{Charitable bequests} & \\ - & \text{Marital deduction*} & \\ = & \text{Taxable estate} & \\ + & \text{Post-1976 taxable gifts} & \\ = & \text{Total taxable transfers} & \end{array}$$

$$\begin{array}{rcl} & \text{Tax on total transfers} & \\ - & \text{Gift taxes paid on post-1976 gifts} & \\ - & \text{Applicable credit amount} & \\ - & \text{State death tax credits} & \\ - & \text{Other credits} & \\ = & \text{Estate tax liability} & \end{array}$$

* Every married individual may give an unlimited amount of assets either by gift or bequest to his or her spouse without the imposition of any federal gift or estate taxes. In effect, the unlimited marital deduction allows married couples to delay the payment of estate taxes at the passing of the first spouse because at the death of the surviving spouse, all assets in the estate over applicable exclusion amount (\$11,580,000 in 2020) will be included in the survivor's taxable estate. It is important to note that the unlimited marital deduction is only available to surviving spouses who are United States citizens.

1510.04 Unified Credit

In 2012 and thereafter, taxpayers can take advantage of the portability rule, which provides that any credit that remains unused as of the death of a spouse who dies after 2010 is portable; that is, the unused amount is generally available for use by the surviving spouse as an addition to the surviving spouse's exemption. In 2020, portability effectively allows a married couple to exempt up to \$23,160,000 from the estate tax.

If a surviving spouse is predeceased by more than one spouse, the amount of unused credit that is available for use by such surviving spouse is limited to unused exclusion of the last such deceased spouse. The first spouse to die must file an estate tax return (IRS Form 706) even though he or she may not owe any estate tax since the amount of unused credit must be determined. The unused exclusion amount is available to a surviving spouse only if the executor of the estate of the deceased spouse files an estate tax return on which such amount is computed and makes an election on such return that such amount may be used. The election is irrevocable. The election cannot be made unless that estate tax return is filed on a timely basis as extended. Thus, even if a decedent normally is not required to file an estate tax return, filing an estate tax return is now necessary simply to preserve the unused estate tax exclusion amount of the first spouse to die.

1510.05 Life insurance

Life insurance death benefit proceeds are usually federal-income-tax-free. However, the proceeds from any policy on a decedent's life are included in his or her estate for federal estate tax purposes if the decedent had any incidents of ownership in the policy. Incidents of ownership include:

- a. The right to change the beneficiary.
- b. The right to surrender or cancel the policy.
- c. The right to assign the policy.
- d. The right to revoke an assignment of the policy.
- e. The right to pledge the policy for a loan.
- f. The right to obtain a loan from the insurer against the surrender value of the policy.

In addition, proceeds from a life insurance policy are included in the insured's gross estate if the insured had any incident of ownership in the policy and the insured transferred the policy within three years of his or her death. On the other hand, as long as certain conditions are met, namely, the insured does not possess any of the incidents of ownership when he or she dies, the proceeds of the life insurance policy are not paid to the insured's estate, and the insured does not transfer any incidents of ownership in the policy within three years of his or her death, the proceeds will not be included in the insured's gross estate for estate tax purposes.

The life insurance ownership rule is more likely to adversely affect unmarried people because death benefit proceeds from a policy on the life of a married person can be left to the surviving spouse without any immediate federal estate tax hit, thanks to the unlimited marital deduction privilege (assuming the surviving spouse is a U.S. citizen). However, all the insurance money going to a surviving spouse could cause his or her estate to eventually exceed the federal estate tax exemption.

The estate-tax-saving solution is to set up an irrevocable life insurance trust to own the policies on the taxpayer's life. Since the trust, rather than the taxpayer, owns the policies, the death benefit proceeds are not counted as part of the taxpayer's estate (unless the estate is named as the policy beneficiary which would defeat the purpose). The taxpayer is still able to direct who gets the insurance money because the taxpayer may name the beneficiaries of the irrevocable life insurance trust (typically the taxpayer's children and/or grandchildren).

One complicating factor is that when a taxpayer moves existing insurance policies into the trust, he or she must live for at least three years or the death benefit proceeds will be included in the decedent's estate, just as if he or she still owned the policies at the time of death. Also, when existing whole life policies are transferred into the trust, their cash values are treated as gifts to the trust beneficiaries.

A taxpayer with a large estate that will owe some federal estate tax can set up an irrevocable life insurance trust to buy coverage on his or her life. The death benefit proceeds can then be used to cover all or part of the estate tax bill after the insured dies. This result is achieved by authorizing the trustee of the life insurance trust to purchase assets from decedent's estate or make loans to the estate. The extra liquidity is then used to cover the estate tax bill. When the irrevocable life insurance trust is eventually liquidated by distributing its assets to the trust beneficiaries (usually insured's children and/or grandchildren), the beneficiaries will wind up with the assets purchased from taxpayer's estate or with liabilities owed to them. The end result is that the federal estate tax bill gets paid with dollars that are not themselves subject to the federal estate tax.

1510.06 Filing requirements

The executor of a decedent's estate uses Form 706 to figure the estate tax. This tax is levied on the entire taxable estate and not just on the share received by a particular beneficiary.

For decedents dying in 2020 or later, Form 706 must be filed by the executor for the estate of every U.S. citizen or resident:

- a.** Whose gross estate, plus adjusted taxable gifts and specific exemption, is more than \$11,580,000 (in 2020); or
- b.** Whose executor wants to make the election to permit the decedent's surviving spouse to use the decedent's unused exclusion amount, regardless of the size of the decedent's gross estate.

If it is determined that filing a return for the estate is not required, the estate should nonetheless file a return if the executor wishes to elect to allow the decedent's surviving spouse to use the decedent's unused exclusion amount for estate and gift tax purposes.

A taxpayer must file Form 706 to report estate and/or GST tax within nine months after the date of the decedent's death. If the taxpayer is unable to file Form 706 by the due date, the estate may receive an extension of time to file. Use Form 4768, *Application for Extension of Time To File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes*, to apply for an automatic six-month extension of time to file.

1510.07 Jointly-held property**1. Joint tenants with rights of survivorship**

If the property was held by both spouses as joint tenants with rights of survivorship (i.e., they each owned half of the property and each half automatically passes to the other), then each spouse is considered to own 50 percent of the property's value. Thus, 50 percent of the value will be considered part of the estate and potentially subject to estate tax. Because of the rights of survivorship, that half will automatically pass into possession of the surviving spouse, typically without any probate process. Furthermore, because spouses are entitled to a tax deduction on the value of estates passed to them from a marriage partner, the surviving spouse likely will not end up owing estate tax on the value of this jointly held property.

This arrangement may only delay the tax rather than allow the heirs to forego it entirely. Because the property need not go through probate when one spouse dies, estate tax requirements are not considered at that time. But when the final surviving spouse passes away, the property -- valued in its entirety -- will have to go through probate and will be considered taxable to the estate.

2. Tenancy by the entirety

Tenancy by the entirety means that the two spouses do not have an independent interest in the property and are considered to be one legal unit that owns the whole property. This means that there is nothing to pass upon the death of one spouse, as each owned the entire estate during life. The right of survivorship means one person succeeds to exclusive ownership; therefore, no estate tax applies. It is important to note; however, that this arrangement is currently available only to husbands and wives by marriage and cannot be used by any other individuals to avoid estate tax requirements when property is transferred.

3. When two or more non-married people own property together with rights of survivorship

When the joint tenants with rights of survivorship are not married, the full value of the property in question will be included in the estate and taxed accordingly upon the passing of one of the owners. This does not apply if the surviving individual can prove they paid for the acquisition of their part of the property. In other words, if two business partners jointly own an office building, and one passes away, the surviving business partner must show proof of the payments he or she personally made for his or her share of the building. If he or she proves that he or she paid for 70 percent of the building, then the remaining 30 percent will be regarded as owned by the deceased and only that 30 percent will be subject to the estate tax.

1510.08 Marital deduction and other marital issues

If a taxpayer's spouse is a U.S. citizen, the taxpayer can leave any amount to him or her with no federal estate tax, and if the taxpayer is a U.S. citizen, the taxpayer's spouse can do the same. This is the so-called unlimited marital deduction privilege. For married couples, the \$11,580,000 federal estate tax exemption and the unlimited marital deduction privilege provide significant federal estate tax shelter for those who died in 2020.

For 2020, a taxpayer can direct the executor of his or her estate to leave any unused federal estate tax exemption to his or her surviving spouse. For example, if a taxpayer dies in 2020, he or she can bequeath all his or her property to his or her spouse, including his or her unused \$11,580,000 exemption. The surviving spouse would then have a \$23,160,000 exemption if he or she died in 2020 (his or her own \$11,580,000 exemption plus the deceased spouse's unused \$11,580,000 exemption). Portability was made permanent for 2013 and after. Portability requires that an estate tax return (Form 706) be filed and portability be elected on that return even if there is no federal estate tax liability.

1510.09 IRAs and retirement plans

Upon the death of an owner of an IRA or a qualified plan, any remaining balance is included in the calculation of the gross estate. After death, income payments made from retirement accounts to the designated beneficiaries will be taxed when they are received as ordinary income. Although qualified plans and IRAs are generally a very good way to accumulate dollars for retirement, they are not necessarily good vehicles for passing money to future generations. At death, these assets trigger tax and are known as “income in respect of a decedent” (IRD) assets. For income tax purposes, IRD assets, unlike other assets, do not receive a step-up in basis at the death of the owner. The bottom line is that such assets are theoretically subject to both estate tax and income tax.

When a participant dies with a qualified plan or IRA asset, it is included in his or her estate subject to estate tax. Then, in the year(s) it is distributed to the named beneficiary, it must be included in the recipient’s income for tax purposes and is taxed again. Even though the recipient beneficiary is allowed a deduction for the estate tax attributed to the amount received, this “double tax” can substantially reduce the value passing to the heirs. The IRD deduction is a Schedule A deduction not subject to the 2 percent AGI limitation.

The IRD deduction is taken in proportion to how much of the IRD income is included by the distributee. A taxpayer does not run out of time to claim the IRD deduction and can claim the deduction until the account is totally distributed. There is no dollar limit on the amount of IRD deduction that can be claimed, but the taxpayer can only take the deduction against IRD income that he or she reports. If a taxpayer missed taking the IRD deduction, he or she may go back three years (the statute of limitations) and amend his or her federal income tax returns to claim the IRD deductions that he or she missed. If there are still funds in the IRA or employer-sponsored plan the taxpayer inherited, he or she can keep taking the IRD deduction against future distributions as long as those funds last.

1520 Gift Tax**1520.01 Introduction**

The purpose of the federal gift tax is to prevent a taxpayer's avoidance of the estate tax. To arrive at taxable gifts for the year, the taxpayer's total gifts may be reduced by the annual exclusion and by the deductions allowed for property transferred to a spouse or charity. The annual exclusion is \$15,000 in 2020. The annual exclusion is allowed each year even if the donor has made gifts in the prior years to the same donee.

As a practical matter, the \$11,580,000 transfer tax exemption (\$23,160,000 for married couples), protects most individuals from the estate and gift tax. However, for high wealth individuals, gifts can produce substantial savings. For example, a gift of income producing property (e.g., dividend paying stock or rental real estate) to children who may be in lower tax brackets not only reduces the income tax that might be paid but also removes all of the accumulated income from the donor's estate. In addition, a gift of property that is appreciating or will increase in value (e.g., land, stock, art, life insurance), removes all of the appreciation from the estate by transferring ownership of the property.

Under current federal estate tax laws, taxable gifts made after 1976 are added to the taxable estate to arrive at total taxable transfers. A tentative estate tax is then computed on the base amount. All gift taxes paid on post-1976 gifts, as well as certain tax credits, are subtracted from this tentative tax in arriving at the federal estate tax due, if any. Most estate tax credits have a single underlying purpose -- to reduce or eliminate the effect of multiple taxation of a single estate. Estate taxes paid to the various states or foreign countries on property owned by the decedent and located within their boundaries are examples of estate tax credits. However, the major credit available to reduce the federal estate tax has been the unified credit. The unified credit protects all but the wealthiest of taxpayers from the estate and gift tax. The credit is unified in the sense that it can be used to offset gift taxes during the taxpayer's life. However, any credit used for gift tax purposes is not available at death.

A citizen or resident of the United States must file a gift tax return (whether or not any tax is ultimately due) in the following situations. If taxpayer gave gifts to someone in 2020 totaling more than \$15,000 (other than to a spouse), Form 709 must be filed. Certain gifts, called future interests, are not subject to the \$15,000 annual exclusion (for 2020) and the taxpayer must file Form 709 even if the gift was under \$15,000. A husband and wife may not file a joint gift tax return. Each individual is responsible for his or her own Form 709. A taxpayer must file a gift tax return to split gifts with spouse (regardless of their amount).

- a. If a gift is of community property, it is considered made one-half by each spouse. For example, a gift of \$100,000 of community property is considered a gift of \$50,000 made by each spouse, and each spouse must file a gift tax return.
- b. Likewise, each spouse must file a gift tax return if they have made a gift of property held by them as joint tenants or tenants by the entirety.
- c. Only individuals are required to file gift tax returns. If a trust, estate, partnership, or corporation makes a gift, the individual beneficiaries, partners, or stockholders are considered donors and may be liable for the gift and GST taxes.
- d. The donor is responsible for paying the gift tax. However, if the donor does not pay the tax, the person receiving the gift may have to pay the tax.
- e. If a donor dies before filing a return, the donor's executor must file the return.

If a taxpayer meets all of the following requirements, he or she is **not** required to file Form 709:

- a. Taxpayer made no gifts during the year to his or her spouse;
- b. Taxpayer did not give more than \$15,000 to any one donee in 2020; and
- c. All the gifts made were of present interests.

The gift tax is a tax on the transfer of property by one individual to another while receiving nothing, or less than full value, in return. The tax applies whether the donor intends the transfer to be a gift or not.

The gift tax applies to the transfer by gift of any property. A taxpayer makes a gift if he or she gives property (including money) or the use of or income from property, without expecting to receive something of at least equal value in return. If a taxpayer sells something at less than its full value or if a taxpayer makes an interest-free or reduced-interest loan, he or she may be making a gift.

The donor is generally responsible for paying the gift tax. Under special arrangements, the donee *may* agree to pay the tax instead. Any transfer to an individual, either directly or indirectly, where full consideration (measured in money or money's worth) is not received in return is a gift.

The general rule is that any gift is a taxable gift. However, there are many exceptions to this rule. Generally, the following gifts are not taxable gifts:

- a.** Gifts that are not more than the annual exclusion for the calendar year -- \$15,000 for 2020;
- b.** Tuition or medical expenses a taxpayer pays for someone (the educational and medical exclusions);
- c.** Gifts to a taxpayer's spouse; and
- d.** Gifts to a political organization for its use.

In addition to this, gifts to qualifying charities are deductible from the value of the gift(s) made. Making a gift or leaving an estate to a taxpayer's heirs does not ordinarily affect a taxpayer's federal income tax. The taxpayer cannot deduct the value of gifts he or she makes (other than gifts that are deductible charitable contributions).

1520.02 Gift-splitting

Another unique feature of the federal gift tax involves the gift-splitting election available to a married donor. If a donor makes the election on his or her current gift tax return, one half of all gifts made during the year will be considered to have been made by the donor's spouse. The election is valid only if both spouses consent to gift-splitting. If each spouse agrees, each can then take the annual exclusion for his or her part of the gift. For 2020, the gift splitting election allows married couples to give up to \$30,000 to a person without making a taxable gift.

If spouses split a gift, each must file a gift tax return (Form 709) to show that the spouses have agreed to split gifts. The taxpayers must file a Form 709 even if half of the split gift is less than the annual exclusion. The consent is effective for the entire calendar year; therefore, all gifts made by both spouses to third parties during the calendar year (while they were married) must be split. If the consent is effective, the liability for the entire gift tax of each spouse is joint and several.

1520.03 Annual per donee exclusion

The annual exclusion is the maximum amount that an individual is allowed to give another person without incurring federal gift tax. The annual exclusion for 2020 is \$15,000 per year per recipient. There is no limit on the number of these gifts an individual can make to different people in a year. To qualify as a gift, the transfer must be of a "present interest," meaning that the recipient can make use of the gift immediately, and the donor must not have any control over the asset after it is given.

Gifts of future interests cannot be excluded under the annual exclusion. A gift of a future interest is a gift that is limited so that its use, possession, or enjoyment will begin at some point in the future. If the taxpayer is married, both spouses can separately give gifts valued up to \$15,000 to the same person without making a taxable gift in 2020.

As part of an overall strategy to minimize or eliminate estate taxes, many taxpayers take advantage of the annual exclusion from gift tax, the ability in 2020 to gift a present interest in property of up to \$15,000, or \$30,000 if gift splitting is elected, to as many individuals as the donor wishes. In addition to the annual

exclusion, an individual may utilize the \$11,580,000 gift tax exemption amount for 2020 for gifts made during the individual's lifetime. Gifts serve to remove the appreciation on the gifted property after the gift, as well as any income earned after the gift is made, from the estate of the donor. Some tax practitioners recommend that their clients utilize the \$11,580,000 lifetime exemption (for 2020) as quickly as possible when the donor will be gifting rapidly appreciating property so as to avoid gift or estate taxation on the future appreciation.

Gifts to nonspouse individuals in excess of an individual's annual exclusion gifts and his or her lifetime exemption are generally taxable. Although the tax rate schedules for gift tax and estate tax appear to be the same in terms of applicable rates, the amounts against which these rates are applied are different. Gift taxes are computed only on the amount the recipient actually receives, whereas estate taxes are computed on the total of the assets in the estate prior to any distribution. As a result of this difference in computation, the highest gift tax rate is effectively lower than the lowest estate tax rate.

1520.04 Unified credit

The *unified credit* applies to both the gift tax and the estate tax, and it equals the tax on the applicable exclusion amount. The donor must subtract the unified credit from any gift or estate tax that he or she owes. Any unified credit a taxpayer uses against gift tax in one year reduces the amount of credit that he or she can use against gift or estate taxes in a later year.

Beginning in 2011, the amount of unified credit available to a person equals the tax on the basic exclusion amount plus the tax on any deceased spousal unused exclusion (DSUE) amount. The DSUE is only available if an election was made on the deceased spouse's Form 706.

The unified credit amount of \$11,580,000 is in effect for 2020, and allows an individual to make gifts or bequests to any person up to \$11,580,000 free of estate and gift taxes. If the estate exceeded \$11,580,000 in 2020, the excess would be subject to estate and gift taxed at a 40 percent rate. When a person dies, his or her total taxable lifetime gifts (gifts in excess of the annual gift exclusion) are added to his or her gross estate to compute the

estate tax, if any. The same gift tax rates apply to estate taxes; however, a tax credit is given based on prior gift taxes paid. This is why estate and gift taxes are referred to as a unified tax regime. Basically, any unified credit not used to eliminate gift tax can be used to eliminate or reduce estate tax. However, to determine the unified credit available for use against the estate tax, the taxpayer must complete the Estate Tax return, Form 706.

Although it may seem counterintuitive to make taxable gifts in excess of the \$11,580,000 exemption amount for 2020, it may make economic sense to do so if the estate tax exemption would not otherwise exceed the value of the taxable estate at the time of the donor's death. In addition, gifting income-generating assets allows the income and appreciation related to those assets to inure to the transferees rather than to the transferor. Although there are clearly certain offsetting factors, such as loss of a "stepped up" basis at death and loss of the use of the money used to pay gift taxes, in many cases these offsetting factors do not outweigh the benefits of making taxable gifts during the owner's lifetime.

1. Gifts for education and medical expenses

Gifts used for tuition or medical expenses are not limited by the \$15,000 (in 2020) maximum annual exclusion limitation. An unlimited gift tax exclusion is allowed for amounts paid on behalf of a donee directly to an educational organization, provided such amounts constitute tuition payments. Amounts paid for books and dormitory fees on behalf of the donee are not eligible for the exclusion. Amounts paid directly to health care providers for medical services on behalf of a donee also qualify for the unlimited gift tax exclusion.

Many donors have historically used minority interest and marketability discounts to leverage the value of both their annual exclusion gifts as well as their lifetime exemption gifts when interests are transferred where discounting would be appropriate. Gifts of limited partnership interests, for example, in family limited partnerships, are often subject to substantial discounts. The magnitude of discounts taken has varied depending upon the kind of

property gifted and whether or not minority interest discounts apply.

2. Gifting and §529 Plans

A qualified tuition program (§529 plan) is a program set up to allow an individual to either prepay, or contribute to an account established for paying, a student's qualified education expenses at an eligible educational institution. A §529 plan can be established and maintained by states (or agencies or instrumentalities of a state) and eligible educational institutions. The amount invested grows tax-deferred, and distributions to pay for the beneficiary's college costs come out federally tax-free. In a §529 plan, the donor remains in control of the account even though the funding of the account is a completed gift. With a few exceptions, the named beneficiary has no rights to the funds. The donor decides when withdrawals are taken and for what purpose. Most §529 plans even allow the donor to reclaim the funds any time he or she desires; however, the earnings portion of the "non-qualified" withdrawal will be subject to income tax and an additional 10 percent penalty tax. There are no tax consequences if the designated beneficiary of an account is changed to a member of the beneficiary's family.

3. Five-year front-loaded annual exclusion gifts

With respect to the gift and estate tax treatment of an investment in a §529 plan, the contribution is treated as a gift to the named beneficiary for gift tax and generation-skipping transfer tax purposes; however, the contribution qualifies for the \$15,000 (in 2020) annual gift tax exclusion. An individual who makes a contribution of between \$15,000 and \$75,000 in 2020 for a beneficiary can elect to treat the contribution as made over a five calendar-year period. This allows the donor to utilize as much as \$75,000 in annual exclusions to shelter a contribution (\$150,000 if the spousal election is utilized in 2020). The advantage of "front loading" §529 plan contributions is that the growth of the funds invested in the account is removed from the donor's estate faster

than if the donor made \$15,000 annual exclusion contributions each year.

The unified credit equals the tax on the applicable exclusion amount applies to both the gift tax and the estate tax. In calculating the gift or estate tax, the taxpayer will subtract the unified credit from any gift or estate tax owed. Any unified credit used against gift tax in one year reduces the amount of credit that the taxpayer can use against gift or estate taxes in a later year.

1520.05 Effect on estate tax (e.g., Generation skipping transfer tax)

The federal generation skipping tax (GST) applies when a donor conveys in excess of a stated dollar limitation (GST limitation) to a generation beyond the next living generation, for example, skipping over living children in favor of grandchildren, etc. (known as a “generation skip”). The dollar limitation for the GST limitation has historically been the same dollar amount as the unified credit against estate taxes (i.e., \$11,580,000 in 2020). In effect, this means that fully utilizing the GST limitation transfers by means of a generation skip (e.g., to grandchildren, etc.) passes without the estate(s) of the skipped generation (e.g., children) ever being exposed to imposition of any estate or gift tax on such a transfer. As to amounts above the GST limitation, the GST essentially recaptures these prospective savings immediately.

Gifts of the annual exclusion amount to children, grandchildren, and other beneficiaries are often recommended as an excellent way to reduce taxable estate at no transfer tax cost. Outright gifts to grandchildren of the annual exclusion amount will also be exempt from the GST. Gifts in trust for grandchildren that qualify for the gift tax annual exclusion can also qualify for exclusion from the GST if the trust is properly structured. Payments of tuition, if paid directly to the educational institution, and payments of medical expenses, if paid directly to the provider of the services, are also transfers that are not considered taxable gifts and are not subject to GST. The exemption from the GST for 2020 is \$11,580,000, the same as for gifts and estates. Hence transfers of this amount or less are not subject to the GST.

The GST tax may apply to gifts during a taxpayer’s life or transfers occurring at the taxpayer’s death, called bequests, made to skip

persons. A skip person is a person who belongs to a generation that is two or more generations below the generation of the donor. For instance, a grandchild will generally be a skip person to a taxpayer or to his or her spouse.

The GST tax is figured on the amount of the gift or bequest transferred to a skip person after subtracting any GST exemption allocated to the gift or bequest at the maximum gift and estate tax rates. Each individual has a GST exemption equal to the basic exclusion amount, as indexed for inflation, for the year involved.

GSTs have three forms: direct skip, taxable distribution, and taxable termination.

A **direct skip** is a transfer made during the taxpayer's life or occurring at his or her death that is:

- a. Subject to the gift or estate tax;
- b. Of an interest in property; and
- c. Made to a skip person.

A **taxable distribution** is any distribution from a trust to a skip person which is not a direct skip or a taxable termination.

A **taxable termination** is the end of a trust's interest in property where the property interest will be transferred to a skip person.

1520.06 Filing requirements

Generally, an individual taxpayer must file a gift tax return (Form 709) if any of the following apply:

- a. Taxpayer gave gifts to at least one person (other than his or her spouse) that are more than the annual exclusion for the year -- \$15,000 for 2020. A husband and wife may not file a joint gift tax return. Each individual is responsible for his or her own Form 709;
- b. Taxpayer gave someone (other than his or her spouse) a gift of a future interest that he or she cannot actually possess, enjoy, or receive income from until sometime in the future; or
- c. Taxpayer gave his or her spouse an interest in property that will be ended by some future event.

A taxpayer does not have to file a gift tax return to report gifts to (or for the use of) political organizations and gifts made by paying someone's tuition or medical expenses.

A taxpayer does not need to report the following deductible gifts made to charities:

- a.** The taxpayer's entire interest in property, if no other interest has been transferred for less than adequate consideration or for other than a charitable use; or
- b.** A qualified conservation contribution that is a perpetual restriction on the use of real property.

1. Gifts to charities

If the only gifts a taxpayer made during the year are deductible as gifts to charities, he or she needs to file a return as long as the taxpayer transferred his or her entire interest in the property to qualifying charities. If the taxpayer transferred only a partial interest, or transferred part of his or her interest to someone other than a charity, he or she must still file a return and report all of his or her gifts to charities. If a taxpayer is required to file a return to report noncharitable gifts and he or she made gifts to charities, he or she must include all of his or her gifts to charities on the return.

2. Filing Form 709

Generally, a donor must file Form 709 no earlier than January 1, but not later than April 15, of the year after the gift was made. If the donor died during 2020, the executor must file the donor's 2020 Form 709 not later than the earlier of:

- The due date (with extensions) for filing the donor's estate tax return; or
- April 15, 2020, or the extended due date granted for filing the donor's gift tax return.

3. Who must file Form 709

Generally, a citizen or resident of the United States must file a gift tax return (whether or not any tax is ultimately due) in the following situations:

- If the taxpayer gave gifts to someone in 2020 totaling more than \$15,000 (other than to a spouse), he or she probably must file Form 709.
- Certain gifts, called future interests, are not subject to the \$15,000 annual exclusion and the donor must file Form 709 even if the gift was under \$15,000.
- A husband and wife may not file a joint gift tax return. Each individual is responsible for his or her own Form 709.
- A taxpayer must file a gift tax return to split gifts with his or her spouse (regardless of their amount).
- If a gift is of community property, it is considered made one-half by each spouse. For example, a gift of \$100,000 of community property is considered a gift of \$50,000 made by each spouse, and each spouse must file a gift tax return. Likewise, each spouse must file a gift tax return if they have made a gift of property held by them as joint tenants or tenants by the entirety.

1530 International Information Reporting

1530.01 FinCEN Form 114

In a global economy with diversified investment portfolios that oftentimes include an international component, more and more American people are impacted by the provisions of the law known as the Bank Secrecy Act. More than any other country, the United States has a significant number of permanent resident immigrants who maintain economic ties with their countries of birth, economic ties that are associated with bank accounts in that respective country.

FinCen Form 114 is a **disclosure form** (informational purposes only, no tax due associated with the Form itself) that must be filed by a **United States person** (defined below) that has:

- a. Financial interest in or signature or other authority over at least one financial account located outside the United States is
- b. The **aggregate** value of those foreign financial accounts exceeded \$10,000 at any time during the calendar year reported.

One common question filers have refers to whether they have a filing obligation when the foreign bank accounts maintained abroad each have a balance below \$10,000. The answer is “yes” to the extent the aggregate of the balances held in each account amounts to \$10,000. The highest balance does not need to be measured at the same time. Each highest balance has to be considered throughout the year independent of when the other accounts have reached their own highest balance for purposes of determining whether the filing threshold has been reached. The \$10,000 amount does not double for a married filing jointly couple.

One very important aspect to remember is that even though the filing threshold of \$10,000 has not been reached by a certain taxpayer (John Smith is the owner of a single foreign account in France holding 8,000 euros), the question in Part III, Schedule B (Form 1040) should still be marked **YES**. In this case, the correct way of reporting this would be as per below:

Part III		Yes	No
You must complete this part if you (a) had over \$1,500 of taxable interest or ordinary dividends; (b) had a foreign account; or (c) received a distribution from, or were a grantor of, or a transferor to, a foreign trust.			
Foreign Accounts and Trusts	7a	At any time during 2020, did you have a financial interest in or signature authority over a financial account (such as a bank account, securities account, or brokerage account) located in a foreign country? See instructions	
		☒	☐
		If "Yes," are you required to file FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR), to report that financial interest or signature authority? See FinCEN Form 114 and its instructions for filing requirements and exceptions to those requirements	
		☐	☒
Caution: If required, failure to file FinCEN Form 114 may result in substantial penalties. See instructions.	b	If you are required to file FinCEN Form 114, enter the name of the foreign country where the financial account is located ►	
	8	During 2020, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If "Yes," you may have to file Form 3520. See instructions	
		☐	☐

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 17146N Schedule B (Form 1040) 2020

What is a United States person?

United States Person means United States citizens (including minor children), residents, entities (including corporations, partnerships, limited liability companies created or organized in the United States, trusts or estates formed under the laws of the United States). The tax treatment for purposes of Title 26 does not have any bearing over the obligation to file. For instance, disregarded entity or a grantor trust still has an obligation to file if it meets the filing requirements.

United States resident is defined as an alien residing the United States by applying the residency tests in 26 U.S.C. section 7701(b). As such, a foreign national who meets the presence tests as described in Section 7701(b) may have a filing requirement if the other tests are met. He or she does is not required to hold a Green Card to be considered a resident.

What is Signature Authority?

"Signature Authority is the authority of an individual (alone or in conjunction with another individual) to control the disposition of the assets held in a foreign financial account by direct communication to the bank."

What is a Foreign Financial Account?

A foreign financial account is a financial account located outside of the United States. An account maintained with a foreign bank within the United States does not constitute a foreign financial account: holding a money market account at UBS or Credit Suisse within the United States will not give rise to a filing requirement. However, holding an account with Citibank in the UK will give rise to a filing requirement if the reporting threshold is reached.

What is a financial interest?

A US person has a financial interest in a foreign financial account if:

- The US person is the owner of record or holder of legal title in the following:
 - A corporation in which the US person owns directly or indirectly more than 50% of the total value of the shares of stock OR more than 50% of the voting power of all shares of stock.
 - A partnership in which is the US person owns directly or indirectly an interest in more than 50% of the partnership's profits or more than 50% in the partnership's capital.
 - A trust of which the US person is either the grantor or has an ownership interest in the trust, or a trust in which the US person has a greater than 50% present beneficial interest in the assets or income of the trust for the calendar year.
 - Any other entity in which the US person owns directly or indirectly more than 50% of the voting power, value of equity or interest in profits.
- All bank accounts that hold cash or securities are considered a financial account. A financial account also includes a commodity, futures, or options account, an insurance policy with a cash value (such as a whole life insurance policy), an annuity policy with a cash value, and shares in a mutual fund or similar pooled fund (i.e., a fund that is available to the general public with a regular net asset value determination and regular redemptions).

Example: John Smith is a 55% owner in Foreign Co Ltd. – a corporation under the laws of United Kingdom. Foreign Co maintains two money market accounts at the local bank – HSBC London. Each account maintains a balance of the equivalent of \$14,000. John would have to disclose his interest in the two accounts held by Foreign Co in which he is deemed to have a foreign financial interest.

For purposes of defining interest in a joint account, joint account refers to an account that is held by any two or more people and does not necessarily imply ownership held by two spouses.

Exceptions from filing:

- A. The spouse of an individual who files an FBAR (foreign bank account reporting) is not required to file a separate FBAR if:
 - All the financial accounts that the non-filing spouse is required to report are jointly owned with the filing spouse and
 - The filing spouse reports the jointly owned accounts on a timely filed FBAR electronically signed and
 - The filers have completed and signed Form 114A "Record of Authorization to electronically File FBARs."
- B. Consolidated FBAR. If a US person is included in a consolidated FBAR filed by a greater than 50% owner, such entity is not required to file a separate FBAR.
- C. Correspondent/Nostro Account – maintained by banks and used solely for bank-to-bank settlements.
- D. Governmental entities – a foreign financial account held by any governmental entity of the United States.
- E. IRA or Tax Qualified Retirement Plans owners and beneficiaries – an owner or beneficiary of an IRA or retirement plan defined in Sections 401(a), 403(a) or 403(b) is not required to report a foreign financial account held by those respective plans.
- F. Trust beneficiaries – if the trust, trustee, or agent of the trust is a US person that files an FBAR disclosing the trust's foreign financial accounts.

Practice Note: Interest in foreign pension plans does not constitute interest in a foreign financial account for Form 114 purposes, but it does constitute an interest in a foreign asset that may need be disclosed on Forms 8938 or 3520 discussed later.

When and Where to File

The FBAR is an annual report and must be filed on or before APRIL 15th of the year following the calendar year being reported. For example, the 2020 FBAR would be due by April 15 of 2021 and must be filed electronically either by tax preparers, using their e-file software or directly by the taxpayer using the FinCEN's BSA E-filing System <http://bsaefiling.fincen.treas.gov/>.

Filers who do not file by April 15th are granted an **automatic extension to October 15**.

Records that contain information such as: the name in which each account is maintained, number or other designation of the account, name and address of the foreign financial institution, maximum value of each account during the reporting period must be retained for a period of 5 years from April 15th of the year following the calendar year

reported or the date filed (if later). An officer or an employee who files an FBAR to report signature authority over an employer's foreign financial account is not required to personally retain records regarding these accounts.

To determine the maximum amount held in each account monthly statements for that account can be used in the local currency. For conversion to US dollars, taxpayers are encouraged to use the rates published by the Treasury Financial Management Service (www.fms.treas.gov) or any other verifiable exchange rate as long as the source is provided.

For a U.S. person with a **financial interest** in 25 or more foreign financial accounts should check the YES box in Part I, item 14a, and indicate the number of accounts. The US persona should not complete Part II or Part III of the report but maintain records of the information.

A U.S. person who has **signature authority** in 25 or more foreign financial accounts should check the YES box in Part I, Item 14b and indicate the number of accounts in the space provided.

The two categories: financial interest and signature authority are not aggregated for purposes of meeting the 25 or more filing disclosure. For instance, if Emily holds 13 foreign financial interests and has signature authority in 14 other accounts, she still needs to list the accounts separately since each category is under 25 accounts.

Penalties

Failure to file an FBAR when required may result in civil penalties, criminal penalties, or both. A filer who became aware of an FBAR filing requirement should use the online system to submit any delinquent FBAR as soon as possible. The system allows for late filing as well as submitting an explanation for the late filing. If the foreign financial account is properly reported on a late-filed FBAR, and the IRS determines that the FBAR violation was due to reasonable cause, no penalty is imposed.

Those required to file an FBAR who fail to properly file a complete and correct FBAR may be subject to civil monetary penalties.

Violation	Civil Penalty	Criminal Penalty
Negligent Violation	Up to \$1,078	N/A
Non-Willful Violation	Up to \$12,459 for each negligent violation	N/A
Pattern of Negligent Activity	In addition to penalty under § 5321(a)(6)(A) with respect to any such violation, not more than \$83,864.	N/A
Willful - Failure to File FBAR or retain records of Account	Up to the greater of \$124,588, or 50 percent of the amount in the account at the time of the violation.	Up to \$250,000 or 5 years or both
Willful – Failure to File FBAR or retain records of account while violating other laws	Up to the greater of \$100,000, or 50 percent of the amount in the account at the time of the violation.	Up to \$500,000 or 10 years or both
Knowingly and Willfully Filing False FBAR	Up to the greater of \$100,000, or 50 percent of the amount in the account at the time of the violation.	\$10,000 or 5 years or both
Civil and Criminal Penalties may be imposed together under IRS Code Section 5321(d)		

Note regarding civil penalty assessment prior to August 1, 2016: For those violations occurring on or before November 2, 2015, the IRS may assess a civil penalty not to exceed \$10,000 per violation for non-willful violations that are not due to reasonable cause. For willful violations, the penalty may be the greater of \$100,000 or 50 percent of the balance in the account at the time of the violation, for each violation.

In a recent court case, *U.S. v. Kaufman*, a district court had found that the \$10,000 non-willful FBAR penalty applies per FBAR form, not per the number of bank accounts required to be reported on the form. Two district courts have reached to the same conclusion in similar cases. One district court has found the opposite.

1530.02 Form 8938

Form 8938 is used for reporting specified **foreign financial assets** which are valued in aggregate at or more than:

- \$50,000 on the last day of the tax year or more than \$75,000 at any time during the tax year for **unmarried taxpayers living in the United States.**
- \$100,000 on the last day of the tax year or more than \$150,000 at any time during the tax year for **married taxpayers filing a joint income tax returns living in the United States.** A married individual filing a separate return living in the United States will have the same filing thresholds as a single individual living in the United States
- \$200,000 on the last day of the tax year or more than \$300,000 at any time during the year for a **single individual living outside** of the United States
- \$400,000 on the last of the tax year or more than \$600,000 at any time during the year for **married taxpayers filing a joint income tax return living outside** of the United States
- \$50,000 on the last day of the tax year or more than \$75,000 at any time during the tax year for a specified entity (defined below).

The presence abroad test is satisfied if the US citizen has been a bona fide resident of a foreign country for an interrupted period that includes an entire tax year or a US citizen or resident who is present in a foreign country for at least 330 full days during any period of 12 consecutive months that ends in the tax year being reported.

Example: Jean McDavid accepted a new position with Nestle Switzerland on June 1, 2020. Jean has been living in Switzerland since. Although Jean does not meet the 330-day test for physical presence abroad during the calendar year 01/01/2020-12/31/2020, she will meet the test for the year starting 06/01/2020-05/31/2021. If Jean files an extension to file, she can claim she meets the 330-day test for presence abroad.

Form 8938 must be filed and submitted by a **specified individual or specified entity.**

A Specified individual is:

- A US citizen
- A resident alien of the United States for any part of the tax year (as defined in Publication 519)
- A nonresident alien who makes an election to be treated as a resident alien for purposes of filing a joint return

A Specified entity is:

- A closely held domestic corporation that has at least 50% of its gross income from passive income
- A closely held domestic corporation if at least 50% of its assets produce passive income
- A closely held domestic partnership with at least 50% of its gross income from passive income
- A closely held domestic partnership if at least 50% of its assets produce passive income
- A domestic trust described in section 7701(a)(30)(E) that has one or more specified persons (a specified individual or a specified domestic entity) as a current beneficiary.

Generally, for purposes of measuring the highest value, **fair market value** is used. If fair market value is impractical to be determined, then the **highest value of the interest** can be used. For instance, if an interest in a foreign partnership is valued at \$120,000 and an additional of \$10,000 contribution is made, the highest value of the interest in the partnership that must be reported is \$130,000. For interests in a foreign estate, pension plan or deferred compensation plan the value would be determined as of the last day of the year adding back any distributions made throughout the year. Where the fair market value cannot be ascertained or the specified financial asset is less than zero, use zero for the value of the asset.

Foreign financial assets that must be reported on 8938:

- Financial accounts maintained by a foreign financial institution
- Stock or securities **issued by a foreign entity and not owned through an investment account** (direct or indirect ownership)
- An outright interest in a foreign entity
- Any financial instrument or contract that has an issuer/counterparty a person that is NOT as U.S. a person.

Examples:

- Stock issued by a foreign corporation.
- A capital or profits interest in a foreign partnership.
- A note, bond, debenture, or other form of indebtedness issued by a foreign person.
- An interest in a foreign trust or foreign estate.
- An interest rate swap, currency swap, basis swap, interest rate cap, interest rate floor, commodity swap, equity swap, equity index swap, credit default swap, or similar agreement with a foreign counterparty.
- An option or other derivative instrument with respect to any of these examples or with respect to any currency or commodity that is entered into with a foreign counterparty or issuer.

An interest in the Social Security program, social insurance or other similar program of a foreign government is **NOT** a specified foreign financial asset.

Interests in property transferred in connection with the performance of services (i.e., foreign stock option plans). Taxpayers are considered to have an interest in property transferred in connection with the performance of services on the first date that the property is **substantially vested** or if a valid section 83(b) election is in place with respect to the property, on the date of transfer of the property.

Interests held through disregarded entities or grantor trusts are reportable if they meet the filing threshold.

Interest in foreign estates and foreign trusts is not a specified foreign financial asset unless a value can be ascertained for the interest. If a distribution is received from said foreign estate or trust, the taxpayer is considered to know of the interest.

Interests in foreign pension plans and deferred compensation plans are reported in Part IV of Form 8938. Assets held by those plans need not be reported separately.

The reporting period is generally the calendar year for individuals. Some exceptions apply for dual status residents and other cases (i.e., taxpayer's death).

Assets not required to be reported include:

- Financial accounts maintained by a U.S. payer, even if the U.S. payer is the US branch of a foreign bank. Example: pension account held at a Barclays branch in New York.
- Financial accounts maintained by dealers or traders in securities if all the holdings in the account are subject to the mark-to-market accounting rules **or** an election under section 475(e) or 475(f) is made for all the holdings in the account.
- Foreign Social Security, social insurance, or similar program of a foreign government. **Practice Note:** if the foreign government has a Totalization Agreement with the United States, the amounts paid from those respective Social Security(ies) programs may not be taxable to the US person.

Duplicative reporting:

If assets are reported timely on any of the following forms:

- Form 3520 "Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts"
- Form 5471 "Information Return of US Persons with Respect to Certain Foreign Corporations"
- Form 8621 "Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund"
- Form 8865 "Return of U.S. Persons with Respect to Certain Foreign Partnership"

The information about the assets needs to be duplicated on Form 8938. Instead, indicate in Part IV of 8938 the type of return where the information is presented.

Form 8938 Department of the Treasury Internal Revenue Service	Statement of Specified Foreign Financial Assets ▶ Go to www.irs.gov/Form8938 for instructions and the latest information. ▶ Attach to your tax return. For calendar year 2020 or tax year beginning _____, 2020, and ending _____, 20____	OMB No. 1545-2195 2020 Attachment Sequence No. 938		
If you have attached continuation statements, check here ☐ Number of continuation statements _____				
1 Name(s) shown on return _____		2 Taxpayer identification number (TIN) _____		
3 Type of filer a ☐ Specified individual b ☐ Partnership c ☐ Corporation d ☐ Trust				
4 If you checked box 3a, skip this line 4. If you checked box 3b or 3c, enter the name and TIN of the specified individual who closely holds the partnership or corporation. If you checked box 3d, enter the name and TIN of the specified person who is a current beneficiary of the trust. (See instructions for definitions and what to do if you have more than one specified individual or specified person to list.) a Name _____ b TIN _____				
Part I Foreign Deposit and Custodial Accounts Summary				
1 Number of deposit accounts (reported in Part V) ▶				
2 Maximum value of all deposit accounts \$				
3 Number of custodial accounts (reported in Part V) ▶				
4 Maximum value of all custodial accounts \$				
5 Were any foreign deposit or custodial accounts closed during the tax year?		☐ Yes ☐ No		
Part II Other Foreign Assets Summary				
1 Number of foreign assets (reported in Part VI) ▶				
2 Maximum value of all assets (reported in Part VI) \$				
3 Were any foreign assets acquired or sold during the tax year?		☐ Yes ☐ No		
Part III Summary of Tax Items Attributable to Specified Foreign Financial Assets (see instructions)				
(a) Asset category	(b) Tax item	(c) Amount reported on form or schedule	Where reported	
			(d) Form and line	(e) Schedule and line
1 Foreign deposit and custodial accounts	a Interest	\$		
	b Dividends	\$		
	c Royalties	\$		
	d Other income	\$		
	e Gains (losses)	\$		
	f Deductions	\$		
	g Credits	\$		
2 Other foreign assets	a Interest	\$		
	b Dividends	\$		
	c Royalties	\$		
	d Other income	\$		
	e Gains (losses)	\$		
	f Deductions	\$		
	g Credits	\$		
Part IV Excepted Specified Foreign Financial Assets (see instructions)				
If you reported specified foreign financial assets on one or more of the following forms, enter the number of such forms filed. You do not need to include these assets on Form 8938 for the tax year.				
1. Number of Forms 3520 _____		2. Number of Forms 3520-A _____		3. Number of Forms 5471 _____
4. Number of Forms 8621 _____		5. Number of Forms 8865 _____		

Penalties:

If you are required to file Form 8938 but do not file a complete and correct Form 8938 by the due date, you may be subject to a penalty of \$10,000.

If a taxpayer fails to file Form 8938 within 90 days after the IRS mailed a notice of a failure to file, there may be an additional penalty of \$10,000 for each 30-day period for which you continue to fail to file. The additional failure to file penalty caps at \$50,000.

For a married couple filing a joint return, the liability for failure to file penalty applies jointly and severally.

Accuracy related penalty refers to an underpayment of tax as a result of a transaction involving an undisclosed specified foreign financial asset, a penalty of up to 40% of the underpayment may be assessed.

In case of **fraud**, a penalty of 75% of the underpayment may be imposed.

Statute of limitations remains open for 3 years.

Reasonable Cause Exception

No penalty will be imposed if you fail to file Form 8938 or to disclose one or more specified foreign financial assets on Form 8938 and the failure is due to reasonable cause and not to willful neglect. You must affirmatively show the facts that support a reasonable cause claim.

1530.03

114A vs. 8938 Reporting

Although the reporting requirements may seem at times duplicative, especially in terms of those taxpayers who report only foreign bank accounts as foreign financial assets, the two forms are very different.

114A or FBAR is a separate filing submitted on the Financial Crimes Enforcement Network's (FinCEN) dedicated website: bsaefiling.fincen.treas.gov, whereas Form 8938 is submitted with the 1040 return.

They both have April 15th deadlines, but 8938 is not automatically extended if the taxpayer has not filed a Form 4868 or 7004.

FBAR has a much lower reporting threshold of \$10,000 than Form 8938, and focuses mainly on bank accounts and investment accounts, whereas 8938 casts a much wider net, encompassing most of the foreign financial assets with a determinable value. Direct outright interests in foreign real estate properties do not constitute foreign financial assets, but an interest in a foreign real estate partnership is reportable on Form 8938. To the extent a foreign rental activity is associated with a foreign bank accounts whose balance exceeds \$10,000, then the bank account and not the interest in the real estate property is reportable on 114A.

Form 8938 relies more heavily on fair market values for reporting the foreign assets whereas 114A relies on periodic statements and converting to U.S. dollars using the end of the calendar year exchange rate.

A side-by-side comprehensive comparison is offered by the IRS: <https://www.irs.gov/businesses/comparison-of-form-8938-and-fbar-requirements>.

1530.04 Form 3520 “Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts

Form 3520 is an informational form that discloses “reportable events” between the U.S. owners/beneficiaries/executors and their respective foreign trusts. It is also used to report gifts/bequests **received by U.S. persons from foreign persons** (nonresident aliens or foreign estates) of \$100,000 or more. In case of receipt of **gift from a foreign corporation or foreign partnership**, the reporting threshold for a US person is \$16,649 or more.

Examples of reportable events include receipt of **distributions** from a foreign trust; receipt of a **loan** of cash or marketable securities from a foreign trust, when the receiving party is the trust’s beneficiary or the owner, **uncompensated use** of a foreign trust property.

Practice note: in many cases, depending on the type of funding (for instance, if employer funded or employee funded) and other requirements, interests in **foreign pensions** can be classified as an interest in a **foreign grantor trust**. As such, distributions, contributions or even earnings in such trusts would be subject to disclosure on **Form 3520 or Form 3520-A**. **Rev. Proc. 2020-17** updated this requirement by exempting foreign trust information reporting on Form 3520 and 3520-A for certain US individuals’ transactions with, and ownership of, certain tax-favored trusts that are established and exclusively or almost exclusively to provide pension or retirement benefits, or to provide medical disability or educational benefits. For example, a US taxpayer who temporarily lived in the UK and financed a pension plan under the UK pension scheme with mostly his funds would be considered the owner of a foreign grantor trust from US tax perspective. However, **Rev. Proc. 2020-17** exempts the US taxpayer from filing Form 3520 in this case. The interest in the foreign pension plan is still reportable on Form 8938.

Penalties

Under Section 6677, a penalty for untimely, incomplete or incorrect return may be assessed in the amount equal to the greater of \$10,000 or:

- 35% of the gross value of any property transferred to a foreign trust for failure by a US transferor to report the creation or transfer to a foreign trust in Part I.
- 35% of the gross value of distributions received from a foreign trust for failure to report the distributions received from a foreign trust in Part III.
- 5% of the gross value of the foreign trust's assets treated as owned by a US person under the grantor trust rules (section 671 through 679), if the foreign trust either fails to file a timely Form 3520-A and provide the required annual statements to its U.S. owners/beneficiaries or does not provide all of the information required by section 6048(b) or includes incorrect information.

Under Section 6039(F) in case of a failure to timely report foreign gifts, the IRS may determine the income tax consequences of the receipt of such gift, and a penalty equal to 5% of the amount of such foreign gifts apply for each month for which the failure to report continues (not to exceed a total of 25%). No penalty will be imposed if the taxpayer can demonstrate that the failure to comply was due to reasonable cause and not willful neglect.

Under Section 6662(j), if a U.S. owner of a foreign trust is subject to a penalty imposed under section 6662 for an underpayment of tax required to be shown on a return, then such penalty may be increased under section 6662(j) for any portion of an underpayment which is attributable to any transaction involving any asset with respect to which information was required to be provided on Form 3520-A.

Form 3520 is due on the 15th day of the 4th month following the of the tax year. For individuals, the due date is April 15th. For U.S. citizens residing abroad, Form 3520 is due on the 15th day of the 6th month (June 15th) following the end of the tax year. In the case of a Form 3520 filed with respect to a U.S. decedent, the due date to file a Form 3520 is the 15th day of the 4th month following the end of the decedent's last tax year for income tax purposes.

1530.05 Form 5471 “Information Return of Persons with Respect to Certain Foreign Corporations

Form 5471 is a very complex informational form that generally covers the events that occur between at least 10% owners/shareholders, directors and/or officers and foreign corporations. All US persons that must complete Form 5471 are grouped and described in the five *Categories of Filers*. If filers fit more than one category, they need not duplicate the information but complete all items that apply. A separate 5471 is required for each applicable foreign corporation.

Definitions:

A **US Shareholder (Category 1 Filer)** is a US person who owns directly or indirectly **10% or more** of the total combined voting power or, in a case of a tax year of a foreign corporation beginning after December 31, 2017, 10% or more of combined voting power of a **specified foreign corporation**.

A **US Person (Categories 2 and 3 Filers)** is a citizen or resident of the United States; or a domestic partnership, a domestic corporation, or an estate or trust that is not a foreign estate or trust as defined in section 7701(a)(31).

A **US Person (Category 4 Filers)** is a *citizen or a resident of the United States or a non-resident alien who elected to be treated as a resident of the United States, or an individual who became a resident during the year and are married to a citizen or resident of the United States, or a domestic partnership, a domestic corporation, an estate or trust that is not a foreign estate or trust.*

A **US Shareholder (Category 5)** owns at least **10%** or more of the total combined voting power of all classes of voting stock of **controlled foreign corporation** or owns **any** stock of a controlled foreign corporation that is also a captive insurance company.

A **controlled foreign corporation** is a foreign corporation in which **US shareholders own more than 50%** of the voting power of all classes of its voting stock or the total value of the stock at any point in time during the tax year of the foreign corporation.

A **Specified Foreign Corporation (SFC)** is:

- a controlled foreign corporation or
- any foreign corporation that has a US domestic corporation as a shareholder.

Category 1 filers are US shareholders who own 10% or more of a SFC (refer to definitions above).

Category 2 filers are US citizens or residents who are officers or directors of a foreign corporation in which a US person has either acquired stock that meets the 10% ownership requirement or an additional 10% of the outstanding stock of the foreign corporation.

Category 3 filers are filers who either purchase sufficient stock in a foreign corporation to meet the 10% stock ownership requirement, a person who **acquires stock which meets the 10% ownership** requirement or a person who disposes of a sufficient stock in the foreign corporation to reduce his/her interest to **less than 10%** stock ownership.

Category 4 filers are US persons who had control (defined as either more than 50% of the voting power or of the value of shares of all classes of stock) of a foreign corporation during the annual accounting period of the foreign corporation.

Category 5 filers are US shareholders who own stock in a foreign corporation that is a CFC at any time during any tax year of the foreign corporation and who owned that stock on the last day in that year on which it was a CFC.

The following table summarizes the Schedules that are required to be completed in reference to each category of filers as described above:

Table of Required Information

Required Information*	Category of Filer						
	1 ₁	2	3	4	5 ₁	Unrelated section 958(a) U.S. Shareholder	Related Constructive U.S. Shareholder
The identifying information on page 1 of Form 5471 above Schedule A, see Specific Instructions	✓	✓	✓	✓	✓	✓	✓
Schedule A			✓	✓			
Schedule B, Part I			✓	✓			
Schedule B, Part II	✓		✓	✓	✓		✓
Schedules C and F			✓	✓			
Separate Schedule E	✓			✓	✓	✓ ₂	✓ ₃
Schedule E-1 (included with separate Schedule E)	✓			✓	✓	✓ ₂	
Schedule G			✓	✓	✓		✓
Separate Schedule H				✓	✓		
Schedule I				✓	✓	✓	
Separate Schedule I-1				✓	✓	✓	✓
Separate Schedule J	✓			✓	✓		
Separate Schedule M				✓			
Separate Schedule O, Part I		✓					
Separate Schedule O, Part II			✓				
Separate Schedule P	✓			✓	✓	✓	
*See also Additional Filing Requirements on this page.							
1. Certain Category 1 and Category 5 filers may meet the requirements to file under the last two columns of this chart. See Certain Category 1 and Category 5 Filers .							
2. Schedules E and E-1 are required for an unrelated section 958(a) U.S. Shareholder only if the filer claims deemed paid foreign income taxes of the foreign-controlled corporation under section 960 for the filer's taxable year. See Rev. Proc. 2019-40 for more details.							
3. Related constructive U.S. shareholders only need to complete Schedule E (they can leave Schedule E-1 blank). See Rev. Proc. 2019-40 for more details.							

Filers who own interests that meet the ownership requirement in foreign corporations that are “**dormant**” (inactive) are eligible to elect under a summary filing procedure, as described in Rev. Proc. 92-70.

Practice Note: The Tax Cuts and Jobs Act introduced a new tax – Global Intangible Low-Taxed Income meant to close a well-known loophole that allowed multinational companies to develop intangible assets using R&D resources in the United States but register the final product under the laws of a foreign jurisdiction with a lower income tax rate. Pre-TCJA, the profits of the foreign affiliate would not be taxed by the United States until the profits got paid as a dividend to the US parent. Global intangible low-taxed income (**GILTI**) tax is a tax on **foreign earnings that exceed a 10% return on a company’s invested foreign assets**. It is applicable only to those foreign jurisdictions whose tax is 13.125% or lower. For levels above this rate, there is no additional GILTI tax (GILTI tax will be discussed more in detail later in the chapter).

Schedule I-1 of Form 5471 is used to report information determined at the CFC level with respect to amounts used in the determination of income inclusions by US shareholders under section 951A. Information reported on this schedule will be used of the US shareholders to file Form 8992 “U.S. Shareholder Calculation of Global Intangible Low-Taxed Income (GILTI) and may assist in completion of Form 1118 “Foreign Tax Credits – Corporations” or Form 1116 “Foreign tax credit” for individuals, estates and trusts.

Form 5471 is filed with the income tax return by the due date (including extensions).

1530.06 Form 8865 “Return of U.S. Persons with Respect to Certain Foreign Partnerships”

Form 8865 is the reporting equivalent of Form 5471 but for partnerships. Similar to 5471, it has various categories of filers, described below. Generally, 8865 is used to report events between US persons and US partners and foreign partnerships. Information presented on Form 8865 will satisfy reporting requirements under IRS Code Sections 6038, 6038B and 6046A.

If a taxpayer qualifies under multiple categories, they must submit all the schedules required under both categories.

A separate Form 8865 must be filled out and filed for each applicable foreign partnership.

A **foreign partnership** is a partnership that was not created or organized in the United States or under the law of the United States or of any state or the District of Columbia.

A section 721(c) partnership is a domestic or foreign partnership if there is a contribution of 721(c) property and after the contribution, a. a related foreign person with respect to the U.S. transferor is a direct or indirect partner and b. the US transferor and related persons own 80% or more of the interests in the partnership's capital, profits, deductions or losses.

U.S. Transferor is a U.S. Person (a citizen or resident of the United States, a domestic partnership, a domestic corporation, and any estate or trust that isn't foreign) other than a domestic partnership. For purposes of Form 8865, interest usually refers to capital, profits, deductions or losses.

Category 1 Filer is a US Person who controlled (owned more than a 50% interest) the foreign partnership at any time during the partnership's tax year. It also includes a U.S. transferor who must report certain information with respect to a section 721(c) partnership for the tax year of contribution.

Category 2 Filer is a U.S. person who at any time during the tax year of the foreign partnership owned a **10% or greater interest in the partnership** while the partnership was controlled by US persons each owning at least 10% interest. Example: if 5 US person are partners in Foreign Partnership and each owns 10%, the partnership would meet the definition above. If the respective 5 US partners' interest were: 5%, 15%, 10%, 12% and 8%, the definition would not be met. If the foreign partnership has at least one Category 1 filer, then no person will be considered a Category 2 filer.

Category 3 Filer is a US person who contributed property during that person's tax year to a foreign partnership in exchange for an interest in the partnership if that person owned directly or constructively at least 10% interest in the foreign partnership or the value of the property contributed exceeds \$100,000. If a domestic partnership contributed property to a foreign partnership, the domestic partnership's partners are considered to have transferred a proportionate share of the property to the foreign partnership themselves. If the domestic partnership files Form 8865 with its own tax return, the individual partners of the domestic partnership do not have a filing requirement with respect to that transfer.

Category 4 filer is a US person that had a reportable event under IRS Code Section 6046A. Categories of reportable events are:

- Acquisitions – if the person who did not previously own a 10% interest, but whose additional investment brings him/her over the 10% interest threshold. Or a person whose interest increased by at least 10% when compared to the person's interest when the person last had a reportable event (from 12% to 22%).
- Dispositions – if the person goes from a higher than 10% ownership interest in a foreign partnership to less than 10% ownership as a result of the disposition or their interest decreases by at least 10% when compared to the period of the last reportable event (from 21% to 11%).

Exceptions to Filing:

If during the tax year of the partnership more than one US person qualifies as a Category 1 filer, only one of these Category 1 partners is required to file Form 8865. If one US partner has a controlling interest in the losses and deductions and another one has the controlling interest in capital or profits, only the latter may file Form 8865. The Category 1 filer not filing the form must attach a statement entitled "Controlled Foreign Partnership Reporting" to that person's income tax return.

If a filer is deemed to be a Category 1 or 2 filers based on constructive ownership (as opposed to direct ownership) then US person is not required to file Form 8865 if the form is filed the US person through which the indirect partner constructively owns an interest in the foreign partnership or the US person through which the indirect partner constructively owns an interest is also a constructive owner, or Form 8865 is filed by another Category 1 filer under the multiple Category 1 filers exception.

If a foreign partnership files Form 1065 for its tax year, Category 1 and 2 filers may use a copy of the completed Form 1065 schedules in place of the equivalent schedules of Form 8865.

Penalties

For failure to timely submit all information required under Categories 1 and 2 filers, \$10,00 penalty is imposed for each tax year of each foreign partnership. If the information is not submitted within 90 days after the IRS has mailed a notice of failure to the US person, an additional \$10,000 penalty per foreign partnership is charged for each 30-day period, not to exceed \$50,000.

Any person who fails to provide all of the information required within the time prescribed will be subject to a reduction of 10% of the foreign taxes available for credit. If the failure continues 90 days or more after the date the IRS mails notice of failure, an additional 5% reduction is made for each 3-month period or fraction thereof.

Criminal penalties under sections 7203, 7206 and 7207 may apply for failure to file or for filing false or fraudulent information.

For Category 3 filers, the failure to properly report a contribution to a foreign partnership is subject to a penalty of 10% of the fair market value of the property at the time of contribution, limited to \$100,000 unless the failure is due to intentional disregard. In addition, the transferor must recognize gain on the contributed property as if he contributed property that sold for fair market value.

For Category 4 filers, any person who fails to report information requested by section 6046A is subject to a \$10,000 penalty in addition to the section 7203 criminal penalty.

Penalties may be imposed under Section 6662(j) for underpayment attributable to undisclosed foreign financial assets understatements – an understatement of taxed caused by a transaction associated with an undisclosed financial asset.

Form 8865 is filed with the income tax return for tax year beginning in 2020.

1530.07 Global Intangible Low Taxed Income

Tax Cuts and Jobs Act of 2017 introduced sweeping changes in the overall fiscal system of the United States. One of these sweeping changes impacted multinational entities by introducing a territorial tax system and by providing an 100% dividend-received deduction for certain qualified dividends. To limit abuse, the TCJA also adopted a new tax – global intangible low taxed income – as an anti-base erosion provision meant to discourage companies from using intellectual property to shift profits to outbound jurisdictions with lower tax rates. Its focus lies on active income as opposed to passive income and operates mainly as type of minimum tax on “portable income”.

The provisions of GILTI tax are comprised in IRS Code Section 951A and apply to C and S corporations, partnerships, and individuals.

The GILTI rules impact controlled foreign corporations. IRS defines a controlled foreign corporation (CFC) as any foreign corporation in which more than 50% of the total combined voting power of all classes of stock entitled to vote is owned directly, indirectly or constructively by U.S. shareholders on **any** day during the taxable year of such foreign corporation or more than 50% of the total value of stock is owned directly, indirectly or constructively by U.S. shareholders on any day during the taxable year of the corporation.

Under the GILTI provisions any U.S. shareholder who owns a 10% interest in CFC must include in current income his/her pro-rata share of GILTI income of the CFC.

GILTI income is defined as the excess of the “net CFC tested income” over the U.S. shareholder’s “net deemed tangible income return” less interest expense. The formula is presented below:

GILTI inclusion = Net CFC tested income – Deemed Tangible Return – Interest Expense

Net CFC tested income is the CFC’s gross income less certain exclusions, such as U.S. effectively connected income, subpart F income, income that would be Subpart F, but is excluded due to high tax exceptions and others. Deductions associated with the income that is being excluded are added back.

Net Deemed Tangible income return is a 10% return on the U.S. shareholder’s pro rata share of the adjusted tax basis of tangible depreciable property of CFCs that earn the tested income, reduced by allocable interest expense to the extent the interest expense reduced the tested income.

Net Deemed Tangible Income Return = 10% QBAI – Specified interest

QBAI is qualified business asset investment which is tangible depreciable property used in a trade or business that produced the tested income.

The assets considered depreciated using the ADS depreciation regime and life and do not include assets amortizable under section 197 (intangibles such as goodwill, patents, trademarks).

C corporations and individuals electing to be taxed as a corporation (election discussed later) may deduct 50% of the GILTI inclusion, subject to limitations reducing the effective GILTI income tax rate from 21% to 10.5%. In addition, U.S. corporate shareholders may also claim an indirect foreign tax credit for 80% of the foreign tax paid by the foreign corporation on the income included in GILTI.

Example: ABC, a U.S. corporation determines its share GILTI inclusion to be \$1,000,000 from Foreign Corp A (a CFC). Foreign Corp A paid 20% local taxes on the \$1,000,000 or \$200,000. As a result, ABC is entitled to claim 80% of the foreign taxes paid by the CFC or $80\% \times \$200,000 = \$160,000$.

ABC can claim a Section 250 Deduction and exclude 50% of its GILTI income inclusion, making the GILTI income inclusion to be \$500,000 (the original $\$1,000,000 \times 50\%$).

U.S. Tax on the GILTI income inclusion is 105,000 calculated as $\$500,000 \times 21\%$.

But ABC also has a foreign tax credit available as calculated above of \$160,000 that effectively reduces the U.S. tax liability to zero ($\$105,000$ less $\$160,000$, excess is lost not carried over).

In the example above, the indirect foreign tax credit was high enough to “wipe out” any US tax liability. If we substitute the foreign tax rate of 20% with a 10% foreign tax rate, the U.S. tax liability goes from zero to \$25,000. In this simple example, GILTI functions to level the playfield for competitors in various tax jurisdictions.

In practice, due to the mechanics of calculating foreign income tax credits (credit cannot exceed the US tax liability multiplied by the share of foreign profits/worldwide profits), U.S. corporations end up with a GILTI inclusion tax liability even when their CFC income comes and is being taxed in high tax countries like Mexico (rate is 30%).

For an individual who **does not elect** to be taxed as a corporation, GILTI income inclusion comes with a higher price tag since individuals would not benefit from the indirect foreign tax credit.

Assume John Smith – a U.S. individual is the sole owner of a CFC. The CFC operates in a jurisdiction where the tax rate is 20%. the CFC pays \$200,000 in foreign taxes. John Smith has a GILTI inclusion of \$1,000,000. His U.S. tax considering 2020 ordinary income tax brackets would be \$334,427. None of the foreign tax credit of \$200,000 would offset the \$334,427.

In year 2, CFC has \$800,000 of cash: $\$1,000,000$ less taxes paid of \$200,000. Foreign Corp A decides to distribute all of the cash to its sole shareholder – John Smith. Under the previously taxed income, John would have no additional ordinary income tax, but the foreign jurisdiction would impose a withholding tax at source for distributions made to nonresidents of 15%, for example.

Based on the example above, the GILTI income inclusion would have a significant tax impact on an individual U.S. shareholder.

Under section 962, an individual shareholder can elect to calculate tax as if imposed under Section 11 for a domestic corporation. As such, an individual can also claim the 50% deduction and the indirect foreign tax credit.

GILTI Income inclusion is calculated on Form 8992 "U.S. shareholder Calculation of Global Intangible Low Taxed Income".

Form 8993 "Section 250 Deduction for Foreign Derived Intangible Income (FDII) and Global Intangible Low-Taxed Income (GILTI)" is used for calculating the GILTI deduction.

An individual electing to be taxed as a corporation must attach both Forms 8992 and 8993 to his individual tax return. Both forms need to be filed by the due date, including extensions for that return.

In addition to the two forms, as mentioned early in the 5471 section, Schedule I-1 of Form 5471 also includes information on GILTI.

1530.08

Foreign Derived Intangible Income Deduction

As a counterpart to GILTI, the foreign derived intangible income deduction was introduced by TCJA as an incentive for the US companies to generate more revenue from foreign markets and enjoy a lower tax rate applied to that foreign derived income. Foreign derived intangible income is the portion of a **domestic corporation's** intangible income that is derived from foreign income. Foreign derived means property sold to any person who is not a U.S. person or services provided by the U.S. entity to any person not located with the United States.

Eligible income does not include Subpart F income, GILTI income, CFC dividends, foreign branch income, or financial services income.

The deemed intangible income is the excess of total net income over a routine 10% rate of return on the adjusted tax basis of its total fixed assets. Another way of looking at it is that if income is not realized based on its tangible assets, then it is income connected to intangible assets.

The formula for FDII is:

$$\blacksquare \text{ FDII} = \text{Deemed Intangible income} * \frac{\text{Foreign-derived deduction eligible inc.}}{\text{Deduction eligible income}}$$

Example: XYZ Corp has \$100M in sales and \$6M in taxable income. \$60M if XYZ' sales are to customers outside the United States. XYZ has \$5M of tax basis in its depreciable assets.

Step 1: Calculate deemed intangible income:

Deemed Intangible Income = Deduction Eligible Income – 10% QBAI =
 $\$6,000,000 - 10\% \times \$5,000,000 = \$5,500,000$

Step 2: Calculate foreign portion of deemed intangible income:

$\$60,000,000 / \$100,000,000 = 60\%$

Step 3: Calculate FDII:

$FDII = \$5,500,000 \times 60\% = \$3,300,000$

Total taxable income is \$6,000,000 with \$3,300,000 taxed at 13.125% and \$2,700,000 taxed at 21%.

1530.09

IRC Section 965 Transition Tax

Section 965 as added by the TCJA applied to US person who directly, indirectly or constructively owned 10% or more of the voting power or value any specified foreign corporation (SFC) on the last day of the last tax year beginning before January 1, 2018. A SFC included any controlled foreign corporation (defined in earlier) or any other foreign corporation that had at least one U.S. shareholder that is a corporation.

As such, U.S. shareholders were required to include in income their proportionate share of the unrepatriated foreign earnings of those SFCs as a taxable subpart F inclusion under section 951. These unrepatriated foreign earnings would have accrued abroad during periods after 1986 during those years in which the foreign corporation was an SFC.

This tax was imposed as a one-time tax on taxpayers whose tax year ended in 2017 or 2018. Corporate taxpayers were allowed to claim reduced indirect foreign tax credits against their transition tax liability. Individuals and trusts did not enjoy the same benefit.

Subsequent distributions of the same earnings would not be subject to federal income tax.

Taxpayers were allowed to elect to pay their transition tax liability over eight years, with no interest charge imposed. Taxpayers owning foreign corporate stock through an S corporation were permitted to elect to defer their transition tax inclusions indefinitely. There are events that can trigger the acceleration of the liability.

For those taxpayers who made a section 965(h) election on a prior year tax return and elected to pay the net tax liability over 8 years, the IRS published the table for the installment plan:

Successive tax year payments should be made separately from income tax payments. Generally, the IRS will issue an installment notice and payment voucher for each successive installment approximately six to eight weeks before their respective due dates. The notice will provide the total amount of the unpaid 965(h) net tax liability and the net 965(h) liability currently due.

1530.10 Delinquent International Information Returns

U.S. taxpayers with undisclosed financial assets have the following options for addressing previous failures to comply with U.S. tax and information return obligations with respect to non-U.S. investments:

- IRS Criminal Investigation Voluntary Disclosure Practice
- Streamlined Filing Compliance Procedures
- Delinquent FBAR Submission Procedures
- Delinquent International Information Return Submission Procedures

IRS Criminal Investigation Voluntary Disclosure Practice

The Voluntary Disclosure Practice is an option for taxpayers who have committed tax or tax-related crimes and have criminal exposure due to willful violation of the law and who seek protection from potential criminal prosecution.

The IRS Criminal Investigation will consider if a taxpayer's timely, accurate and complete voluntary disclosure is sufficient in the IRS not recommending prosecution. Aside from a truthful, timely, and complete disclosure, the Criminal Investigation will also require the taxpayers to cooperate in determining the correct tax liability and making good faith arrangements to pay in full the tax, the interest, and any applicable penalties.

A disclosure is considered to be timely received only if the IRS has not already commenced a civil examination or criminal investigation, did not receive information from a third party alerting as to the taxpayer's noncompliance or acquired the information directly related to specific noncompliance from a criminal enforcement action (search warrant, grand jury, subpoena, etc.).

Participation in the program is a two-part process that starts with filing Part I of Form 14457, "Voluntary Disclosure Practice Preclearance Request and Application". This step determines the taxpayer's eligibility but does not guarantee acceptance into the practice. Once the preclearance has been confirmed, Part II of Form 14457 should be submitted within 45 days or make a written request for additional time. Criminal Investigation will review the submission of Part II and determine if the taxpayer is allowed to participate in the Voluntary Disclosure Practice.

Streamlined Filing Compliance Procedures

Originally introduced in 2012, the modified streamlined filing compliance procedures are designed for individual taxpayers (and their estates) only.

The eligibility of taxpayers has been extended to those residing in the United States. U.S. residents can follow the requirements of the Streamlined Domestic Offshore Procedures whereas non-U.S. residents can use "Streamlined Foreign Offshore Procedures".

Under these procedures, taxpayers certify that their failure to report foreign financial assets and pay all the tax due in respect of those assets did not result from willful conduct on their part. Non-willful conduct is conduct that is due to negligence, inadvertence, or mistake or conduct that is the result of a good faith misunderstanding of the requirement of the law.

A taxpayer who is already under examination or investigation, related or unrelated to delinquent reporting of foreign financial assets become ineligible for the program.

Taxpayers who have previously filed delinquent or amended tax return in an attempt to address U.S. Tax and information reporting obligation – "quiet disclosures" are still eligible to participate in the streamlined procedures program but the penalties already paid will not be abated.

Tax returns submitted under this program will be processed like regular returns submitted to the IRS, thus no receipt or acknowledgment will be sent by the IRS and no closing agreement will be signed.

Delinquent FBAR submission procedure

Taxpayers who do not need to use either the IRS Criminal Investigation Voluntary Disclosure Practice or the Streamlined Filing Compliance Procedures to file delinquent or amended tax return to report and pay additional tax, but who:

- Have not filed a Report of Foreign Bank and Financial Accounts
- Are not under a civil examination or criminal investigation by the IRS
- Have not already been contacted by the IRS about delinquent FBARs

The above should file the delinquent FBAR as per form 114A instruction. The delinquent FBAR should be submitted online and on the cover page of the electronic form, a reason for the late filing should be stated. The IRS will not impose a penalty for failure to file delinquent FBARs if the taxpayer properly and timely reported all the income associated with the foreign bank accounts associated with the delinquent FBARs, provided that the taxpayer had not been already contacted by the IRS in this regard.

Delinquent International Information Return Submission Procedures

Taxpayers who have identified the need to file delinquent international information returns who are NOT under a civil examination or a criminal investigation by the IRS and have not already been contacted by the IRS about the delinquent information returns should file the returns in question through normal filing procedures.

Penalties may be assessed in accordance with existing procedures:

- All non-3520 or non-3520-A international information returns should be attached to an amended return and filed according to the instructions.
- All Forms 3520 and 3520-A should be filed according to the applicable instructions for those forms.

A reasonable cause statement can be attached to each delinquent information return filed for which reasonable cause is claimed.