MARITAL STATUS AND THE ADOPTION CREDIT, MOVING EXPENSES, AND GAIN ON SALE OF MAIN HOME

STUDY GUIDE
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COURSE OVERVIEW

COURSE DESCRIPTION

In Marital Status, the goal is to identify which acts constitute consideration of marriage, as well as the benefits and consequences of obtaining married status. For the most part, the ability to file married-joint creates the most beneficial situation for taxpayers. In certain circumstances, like adoption of a spouse's child, marital status can create adverse effects. In addition, this course identifies how to treat income from the sale of a main home, and how to handle moving expenses following the passage of the Tax Cuts and Jobs Act of 2017 (TCJA).

LEARNING OBJECTIVES

- Marital Status
- Adoption Credit (e.g., Form 8839 Qualified Adoption Expenses)
- Child Tax Credit (e.g., Schedule 8812 Additional Child Tax Credit)
- Moving expenses (e.g., Form 3903 Moving Expenses)
- Sale of a principal residence (e.g., IRC 121 exclusions, Form 1099-S Proceeds From Real Estate Transactions)
- Understand tax payments (e.g., withholding, estimated payments)
- Understand due dates, including extensions
- Penalties to be assessed by the IRS against a preparer for negligent or intentional disregard of rules and regulations, and for a willful understatement of liability (e.g., IRC 6694(a), IRC 6694(b))
- Safeguarding taxpayer information (e.g., Publication 4600 Safeguarding Taxpayer Information, Quick Reference Guide for Business, IRC 7216)

MARITAL STATUS

COMMON LAW VS. LEGAL MARRIAGE

"Congratulations!" you offer to Janet and Skip on their recent engagement.

"Thanks," responds Janet with a gleam in her eye. "We've finally decided to formalize our marriage."

"It's about time!" you offer jovially with a wink. Janet and Skip have been together as long as you can remember, and no one thought they would ever get married. You are, however, somewhat perplexed by Janet's choice of terms. "What do you mean 'formalize'?"

"Our lawyer says we may actually be married already," says Skip.

"How's that?" you ask, your interest now peaked.

Skip explains: "Well, up until a few years ago we lived in a state that recognizes common law marriage. While we lived there we normally referred to each other as husband and wife - that's even how we filled out our lease application. The lawyer says we may have established a common law marriage."
You remember from your last CPE course that the IRS treats common law marriages just like their more common statutory variety. If Skip and Janet are really married, they will have to file a joint return or a married-separate return. You immediately make a note to contact their lawyer to determine the legal status of their relationship after your meeting.

"Come in and sit down," you say to your long-time clients, waving the pair into your office. "So what else has been going on with the two of you?"

"Where do we begin?" says Skip as the two exchange a furtive smile. "In addition to getting engaged, we have decided to move to the other side of the state!"

"Well. That's exciting," you offer.

"And that's not all," chimes in Janet.

After a pregnant pause during which their two sets of eyes lock in what appears to be mutual excitement and joy, they simultaneously turn to you and in unison announce: "We're getting a baby!"

**ADOPTION CREDIT**

**FULL ADOPTION AND STEP ADOPTION**

"Getting?" you ask, somewhat puzzled.

"We're adopting," says Skip.

"That's terrific," you say. "You know, there is a credit you may be eligible for if you paid any out-of-pocket expenses related to the adoption."

"It's always about taxes with you," Janet says, playfully smiling and rolling her eyes.

"That's what we're here for!" shouts Skip, removing his cap and playfully swatting Janet. "Tell us about this credit, Robbie"
"Well, generally speaking, you can claim a credit for qualified adoption expenses, including reasonable and necessary adoption fees, court costs, attorney fees, and other expenses that are directly related to the legal adoption of an eligible child."

"What is an 'eligible child'?' Janet inquires.

"Any child under age 18 or a child who is physically or mentally incapable of self-care counts as an eligible child. The credit is a little more generous if you are adopting a special needs child."

"However," you continue, "a biological parent can't take the credit for surrogacy expenses."

"So if we used a surrogate mother, we couldn't take the credit?" asks Janet.

"Sort of," you reply. "The expenses of the sperm donor would not count toward the credit. That only makes sense of course because the sperm donor doesn't have any adoption expenses -- the child is already biologically his. The adoption expenses of the other parent, however, might be eligible for the credit in some cases."

"Why only 'in some cases'?" Janet inquires.

"Well, there is an additional complication. Generally, you are not allowed a credit for the expenses of adopting the child of your spouse."

"Wait a second," Janet interrupts with a look of concern on her face. "Skip has a biological child, Skippy, whose biological mother is deceased. I adopted Skippy last year. Are you saying that I am not eligible for the adoption credit for my expenses?"

"Well, I'm not sure," you explain. "Assuming you are not married to Skip, there should be no problem. However, if your lawyer is right and you have been married under the common law, the IRS could take the position that the prohibition on the credit for step-parent adoption applies."

"But how will the IRS ever know that we were married?" asks Skip.

"You either were or you weren't," you reply. "If you were married, we will have to file your tax return accordingly. Furthermore, I would have to advise you to amend any prior returns that were filed incorrectly."

"Well, if it means Janet can get the adoption credit, let's just say we weren't married - the IRS will never find out about it," says Skip.
"But if the law says you were married . . ."

Before you can finish your sentence Skip jumps in. "We don't care," Skip says defiantly. "You go ahead and take the adoption credit on Janet's return for the adoption of Skippy. We'll deal with whatever consequences there are. We'll fight this all the way to the Supreme Court if we have to!"

"It's not that simple," you plead to your clients. "I would be subject to a preparer's penalty of as much as $1,000 or 50% of the fee you pay to me, whichever is greater, if I prepare a return that results in an understatement of tax liability due to an unreasonable position."

"But this is a reasonable position!" shouts Skip, standing up and pounding his fist on your desk. Skip's not insubstantial girth casts a shadow over your desk but all you can see is the rage emanating from his bulging ocular orbitals. Just then Janet begins to cry. "This is all my fault!" she sobs.
The distress of his betrothed sidetracks Skip from what you assume to be an impending assault, as he turns to comfort Janet. "Now, now, baby, it's alright. Everything is alright."

Relieved that Skip is no longer a threat to your life and limb, you clear your throat and try a more academic approach. "Let's just take a minute to review the situation," you say.

**SUBSTANTIAL AUTHORITY VERSUS REASONABLE BASIS**

"In cases involving issues other than tax shelters and reportable transactions, there are two possible criteria for taking a tax position without being subject to penalties. First, if the position is supported by substantial authority, we're OK."

"What does 'substantial authority' mean?" scowls Skip as he gently rocks the still sobbing Janet.

"It's an objective standard and is met only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting the contrary treatment. In other words, we have to gather the authority that supports the position we want to take, and compare it to the authority that goes against us."

"Tax authority comes from a variety of sources, and not all of it has the same significance," you continue.

"Sources of tax authority, in order of their importance, include: the Internal Revenue Code itself; regulations; revenue rulings and revenue procedures; court cases; documented congressional intent; General Explanations of tax legislation prepared by the Joint Committee on Taxation, otherwise known as the "Blue Book"; private letter rulings; technical advice memoranda; actions on decisions and general counsel memoranda; and IRS information or press releases and notices, announcements and other administrative pronouncements published in the Internal Revenue Bulletin."

"Based on the amount and sources of authority for each position," you continue, "we have to decide if the authority supporting us is more significant than the authority against us."

"If it is determined that Janet is considered Skippy's step-parent under state law and I can't find any authority that would permit the adoption credit under those circumstances, we can't take the position under the substantial authority criteria."
"You said," sniff "that there were two," sniff, "criteria," Janet says between efforts to compose herself, dabbing her eyes and then proceeding to blow her nose with a honk that rattles the windows in your office.

"Yes," you reply, "we can take a position for which we have a 'reasonable basis,' as long as there is adequate disclosure of the relevant facts, which is commonly accomplished by attaching a properly completed Form 8275 Disclosure Statement or its equivalent to the return."

"Great," say Skip, his anger evolving into optimism. "Then let's say we have a reasonable basis."

"Unfortunately, it's not that easy," you tell him. "While it's true that 'reasonable basis' positions do not have to meet the more rigorous 'substantial authority' criteria, it is still a relatively high standard of tax reporting, and it is not satisfied by a position that is merely arguable. Our position still has to be based on one or more of the authorities I just described."

"Look," says Skip. "What are the chances either of us will be audited...one in a million? Isn't there a reasonable basis in that this will probably never be challenged?"

"Well, no," you tell him, shaking your head. "Whether or not you will get audited does not impact the assessment of whether we have a reasonable basis for the position. In fact, if we were dealing with written advice under Circular 230, I would be specifically prohibited from taking into account the possibility that your return will not be audited, that an issue will not be raised on audit, or that an issue will be resolved through settlement if raised."

**PENALTIES FOR WILLFUL UNDERSTATEMENT OF TAX LIABILITY**

"That puts me in a precarious position," you explain. "If I prepare your return knowing that we have no substantial authority or reasonable basis, the IRS could also impose a penalty on me for aiding and abetting an understatement of tax liability. Furthermore, such an action would be considered 'disreputable conduct' under Circular 230 and I could lose my ability to practice before the IRS."

"You guys have been my clients for a long time, and I want to do everything I can to achieve the best tax results for you, but I can't risk my livelihood. If you insist on taking a position for which I can't conclude we have either substantial support or a reasonable basis, I'm afraid I won't be able to prepare your return."

Janet finishes dabbing her eyes and your two clients take a reflective moment to look at each other. They simultaneously let out a large sigh.

"Should we shop around for someone who'll do this for us?" Janet asks Skip.

"Don't be ridiculous!" bellows Skip.

"We don't want to get you into trouble," Skip says. "Let's just do things right. If Janet can't take the credit for her adoption of Skippy, so be it. At least we'll get the credit for the adoption of the baby. That's true, isn't it? What if the adoption doesn't go through?"

"For U.S. adoptions, you can get the credit for expenses even if the adoption falls through. If you are adopting a foreign child, however, no credit is allowed if the adoption is unsuccessful," you tell them. "The adoption credit can be very beneficial. It is allowed against both the income tax and alternative minimum tax."

"How much of a credit will we get?" asks Skip.

"Well, there are a couple of things we need to consider," you tell him. "We'll figure the credit on Form 8839. The total aggregate amount that may be taken as a credit for all tax years for the adoption of a child changes from year to year. For example, the maximum credit was $14,300 for 2020 and is $14,440 for 2021. If you're adopting a special needs child, you get the full amount of the adoption credit, even if your out-of-pocket expenses are less than the tax credit amount."

"Also," you continue, "the credit is subject to a phase-out based on your modified adjusted gross income."

"Modified adjusted gross income?" Janet asks quizzically.
"That's just your regular adjusted gross income plus any foreign earned income exclusion you take," you explain.

"We had plenty of adoption-related expenses last year, but the adoption won't be final until this year. Are we still eligible for the credit?"

"Oh, I see. Well, you may still get the credit, but not yet. Expenses paid prior to the year the adoption becomes final, generate the adoption credit for the year following the year of payment. In other words, because the adoption was not final in 2020, the expenses you incurred in 2020 will be used to figure the credit on your 2021 tax return. For expenses paid in and after the year the adoption becomes final, however, the credit is allowed in the year of payment. Assuming the adoption becomes final in 2021, you will be able to use both the 2020 and 2021 expenses to figure the credit on your 2021 return.

**EMPLOYER QUALIFIED ADOPTION ASSISTANCE**

"What about the expenses my employer reimbursed?" Skip asks.

"In addition to the credit for out-of-pocket expenses, you can also exclude from your income any amounts paid for qualified adoption expenses under your employer's qualified adoption assistance program. In fact, you can claim both the exclusion and the credit for expenses of adopting an eligible child, as long as you don't claim both a credit and exclusion for the same expenses."

"OK," says Skip. "One last question, if it turns out we are not married and can't file a joint federal tax return, which one of us gets the credit?"

"Since you are both adopting the baby," you explain to them, "you are both eligible for the credit based on the amounts you each paid toward the expenses, so make sure you carefully document who pays what. If you need additional funds to cover adoption expenses, the recent passage of the SECURE Act allows you to take up to $5,000 out of a retirement account without paying the early distribution penalty."

"If you are not, in fact, married, there are also lots of tax preparation issues to consider in the future," you offer. "For example, until you get married, one or both of you will be able to file as 'head-of-household,' which should reduce your tax liability as compared to the 'single' filing status. It is essential to have the division of expenses related to the maintenance of the household and support of the children clearly documented to support this election, so make sure you keep good records this year."

You conclude by explaining to them some of the planning opportunities to consider. "Depending on the circumstances, we may have some flexibility as to how we divide up the dependents and who gets head of household status. Typically we would try to arrange it so that whoever has the higher income is eligible for the head of household status, but given phase-outs for things like the child credit and dependent care credit, it may be advantageous to put the baby on the return of the lower-earning partner. This is one area where we actually have some tax advantage over married couples because, as long as they stay together, neither married taxpayer can file as head of household."

**MOVING EXPENSES**

"Alright," says Skip, "let's move on to the next big event we had this year, our move to the other side of the state. Can the moving expenses be deducted?"

You sigh, "Unfortunately not anymore. Prior to 2018, moving expenses were an above-the-line deduction, an adjustment to gross income. But, starting in 2018, the Tax Cuts and Jobs Act of 2017 repealed the deduction for moving expenses for all taxpayers except for active-duty members of the Armed Forces that move pursuant to a military order and incident to a permanent change of station."
You continue, "Moving expenses were generally deductible if you moved because of a change in your principal place of work and you met the distance and time tests. The law allowed you to take the deduction in the year the expenses were incurred. But since your expenses were incurred in 2021 and you were not an active duty member of the Armed Forces, you do not qualify for the moving expense deduction in 2021."

"What? I can't deduct my moving expenses because I'm not an active duty member of the Armed Forces?" asked Skip. "Correct," you say.

Skip asked, "So if I had moved back in 2017 versus this year, it would have been deductible then?"
"Yes," you say "If your moving expenses were closely related, both in time and in place, to the start of work at a new job location."

Skip says, "Well my moving expenses were related to the start of work at a new job location, but I guess that does not matter anymore."

Janet says, "At least an active duty member of the Armed Forces still qualifies for the moving expense deduction."

**REIMBURSED MOVING EXPENSES**

"You've explained why the expenses we paid out of pocket when we moved for my new job are no longer deductible, but what about reimbursements from my new employer? How are those treated?" Skip asks.

Before you can answer, he begins the dramatic recreation of the plight of their cross-town move, the color in his face turning slightly crimson as he speaks. "First, the cost of physically moving our household goods and personal items. I'm not sure if you've priced moving trucks lately, but you'd think we were hiring a sponsored race team."

"And don't get him started on the storage fee," Janet chided.

Skip picked up where Janet left off, "as if we were the only people who have sold one house and bought another, it was impossible to coordinate closing dates. We had to pay to store our own belongings for almost a full month!"

Skip proceeded to layout every penny spent, from the various trips to look for a new home, to the fees for disconnecting utilities. For the next ten minutes, you go into more detail for Skip about costs that would have been covered under the old moving expense rules.

Janet interjects her happiness about saving money by staying with her mom, instead of at a hotel; but this topic appears to spark fire in Skip's eyes. Before an argument over the in-laws can erupt, you take the opportunity to point the conversation back to Skip's original question, "how are employer reimbursements of moving expenses treated?"

You begin with the good news, "the employer is allowed to reimburse you for costs incurred to move. Hopefully, you negotiated a fair amount."

"The way you say 'good news' leads me to believe there is bad news," says Skip, the first hint of exhaustion at the process starting to creep into his voice.

"It's not bad, it's reasonable. Amounts reimbursed are included in wages. You'll pay income tax on what the company paid you, even though you can substantiate expenses." You're hoping at this point that any other topics that arise resolve clearly in their favor.

**GAIN ON SALE OF MAIN HOME AND CAPITAL GAINS**

**GAIN ON SALE OF MAIN HOME**

You mentioned you sold your house, correct?" you ask.

"Yes we did," says Skip. "Both of our names were on the old house, but we bought the new one in my name only because of Janet's credit issues. Will that be a problem?"
"Not at all," you say. "When did you buy the house?"

"Well, we actually bought it ten years ago, but we did not move into it until a little more than two years before we sold it," explains Skip. "We rented it out until then because we were living in Janet's mother's basement. She was elderly and Janet wanted to be nearby to help her out."

"Alright," you say. "First let's figure out the gain on the sale. As I recall you purchased the house for $125,000, is that right?"

"Yep, you have a good memory," Janet confirms.

"The closing document you brought me on Form HUD-1 indicates that the sale price was $200,000 and that you paid $12,000 in commissions and $3,000 in other closing costs. That means your net sale proceeds were $185,000."

"But our mortgage was actually $195,000 because Skip here can't stay away from the slot machines," Janet announces.

"Me?" Skip exclaims in surprise, "What about all of your cosmetic surgery? We used that money to pay for your tummy tuck and your eyelid lift."

"Those were necessary expenses," Janet retorts. "You were just flushing money down the toilet, just flushing it!" she says with a wave of her hand.

"Why you ungrateful louse, I oughtta . . ."

"Please! Stop!" you shout before Skip loses his cool. "Now calm down, the both of you. The amount of your mortgage is irrelevant. The gain is strictly determined by comparing your basis to the sales proceeds - it does not matter how much debt you had on the property."

DEPRECIATION AND ADJUSTMENTS TO BASIS

After you've gotten things under control again, you review their prior year returns to see how much depreciation was taken. "It looks like you took $35,000 in depreciation altogether. Did you make any improvements to the property?"
"Yes," says Janet. "I planted daffodils in the front and petunias in the back. I also had the shutters painted turquoise to match Skip’s eyes."

"Anything other than cosmetic?" you ask, realizing too late that the last word may have inadvertently stirred up the tempest. Although Skip shoots a disgusted look at Janet, no additional hostilities ensue.

"Yes," says Skip. We spent $5,000 to add a bathroom to the first floor last year."

"OK, so when I add that amount to the amount you paid for the house, your total costs were $130,000. From that we subtract the $35,000 in depreciation deductions, giving you an adjusted basis of $95,000. Since your net proceeds from the sale were $185,000, you have a $90,000 gain."

"But we don’t have to pay tax on the gain from the sale of our home," declares Skip authoritatively.

"Well, not normally, but there are a couple of exceptions that will apply in your case," you tell him.

"A couple of exceptions," Janet says to Skip in a jocular tone, "that’s like us—we’re a couple of exceptions." Both laugh heartily, their recent tete-a-tete apparently a distant memory.

"Generally, under Code Section 121," you explain, "you can exclude up to $250,000 of gain, assuming you owned and lived in the house for at least two out of the five years immediately preceding the sale. Since both of you have owned the house for ten years and you both lived there for the past two years, the general rule would allow each of you to exclude up to $250,000 of gain."

"I’m confused about a couple of things," says Janet.

"More than a couple of things," murmurs Skip under his breath, to which Janet responds with a sharp elbow to the ribs residing deep with Skip’s torso.

"Which one of us excludes the gain?" continues Janet.
"Since you are joint owners and assuming you are unmarried, the gain is allocated equally to each of you, and you each get a separate $250,000 exclusion amount," you explain.

"That's my second question," Janet continues. "You said we both had to own the house and live in it for at least two out of the past five years. My sister and her husband sold their home last year. They had each lived in the house for several years, but it was titled in her husband's name only—my sister did not own the house. How could they both get the exclusion?"

"That's one of the special rules," you explain. "Taxpayers who are married for federal tax purposes and who file jointly for the year of sale can exclude up to $500,000 of gain if they both used the house as their principal residence for at least two of the last five years, as long as either one of them owned the home for at least two of the last five years."

EXCLUSION AND RECAPTURE

"Unfortunately, a couple of other special rules apply to you guys," you explain. "First, the exclusion also does not apply to any gain attributable to post-May 6, 1997 depreciation. The $35,000 in depreciation expenses you took is attributable to periods after May 6, 1997, so $35,000 of the gain cannot be excluded from your income."

"Geez," Skip observes. "The $35,000 is taxed at the capital gains rate, right?"

"Well, no, I'm afraid it's not. Remember, the purpose of the recapture is to offset the benefit you got from the depreciation deductions. Those depreciation deductions reduced your ordinary income. However, there is a special 25% rate for the depreciation recapture, so it may not be taxed as much as your ordinary income if you're in a higher marginal bracket. We call this 'unrecaptured Section 1250 gain.'"

"That's just great," says Skip with a disgusted look on his face. "Do you have any more good news for us?"

"Yeah, there is another special rule that applies in your situation."

Skip removes his cap and begins wiping sweat from his brow. "I've about had it with these special rules," he says, "but go ahead."
For home sales that occur after 2008, the exclusion rule doesn't apply to the extent there were periods of post-2008 'non-qualifying use.' Non-qualifying use is basically any use of the house other than as your principal residence, such as use as a vacation home or rental property.

"You mean we don't get to exclude the gain because we used the house as a rental property for most of the time we owned it?" asks Skip, becoming agitated once again.

"No, you will still get to exclude part of the gain," you explain, in as calm a tone as you are able to muster. "The limit on the exclusion only applies to the extent of post-2008 non-qualifying use. You rented the property for 8 years (96 months), and all of that rental period occurred after 2008. The exclusion is reduced by the ratio of the post-2008 non-qualifying use to your total ownership period. You guys owned that house for a total of 10 years (120 months). Since 96 months represents the post-2008 non-qualifying use, 96/120ths of the gain, or 80%, cannot be excluded. You had $90,000 in gain, and $35,000 of that is subject to depreciation recapture, so the remaining gain is $55,000, and 80% of the remaining gain, or $44,000, must be recognized as a taxable capital gain. Because you owned the house for more than one year, this amount is taxed at preferential long-term capital gains rates."

"Most of the gain is subject to tax!" Skip exclaims, again wiping his brow. "How do they expect us to pay all that tax and why do they make it so complicated?"

"The idea is to inhibit taxpayers from temporarily converting vacation and rental homes to principal residences just to exclude the gain," you explain. "Since you only have to live in a house for two years to get the exclusion, Congress felt that some taxpayers were doing this to avoid large amounts of gain on properties that were really vacation or rental homes. There are exceptions for absences related to duty in the military or foreign service, as well as for temporary absences due to change of employment, health conditions, or any other unforeseen circumstances."

"What if you have to move, but it takes you a couple of years to sell your house?" asks Janet.

"Non-qualifying use after you have converted the house to your principal residence doesn't matter," you tell them. "Congress was only concerned about use before the conversion of the property into a principal residence - once you've made it your principal residence the rule limiting the exclusion doesn't apply."

"So let's recap," you suggest. "After reducing the sales price of your house for commissions and other selling expenses, we subtracted your adjusted basis to arrive at a gain of $90,000. Of that gain, $35,000 will be taxed at 25% and $44,000 will be taxed as a long-term capital gain. That leaves $11,000 of gain that will be excluded under Code Section 121. Because you both owned and lived in the house for the requisite two out of five years prior to the sale, each of these amounts will be divided equally between you."

EXTENSIONS

TIME TO FILE - TIME TO PAY

"Alright, alright, I'm about worn out with this tax stuff," says Skip. "I know the filing deadline is coming up soon. Can't we get an extension?"

You explain to them that an automatic six-month extension is available to October 15. "But that is only an extension for filing, not for payment. Any payment that is due must be paid by April 15 whether or not we file an extension."

"I heard that you don't have to file if you're due a refund, is that right?" asks Janet.

"Not really," you respond. "It is true that the penalties for late filing are based on the amount of tax due, so if you're due a refund there won't be any penalty. But nothing in the law allows you to ignore the filing requirements if you have overpaid your tax liability. Also, you only have three years from the filing deadline, or two years after you make a payment, whichever is later, to claim a refund."

"Why would you ever overpay your tax liability?"
"If you work for an employer, you pay a portion of your tax liability with each paycheck, through withholding. Self-employed taxpayers and people who have taxable income other than from employment have to make quarterly estimated payments. Because you don't know in advance exactly what your tax liability will be, these are always 'guesstimates.' If your total withholding or estimated payments exceed the liability figured on your tax return, you have overpaid and you get a refund."

"A few years ago, when I was self-employed, my refund was reduced by a late payment penalty. How could I have both overpaid and paid late?" asks Skip.

"That's possible due to the timing of your income and your payments," you explain. For example, if you earned all your self-employment income in the first quarter, but did not make an estimated tax payment until the third quarter, there would be a late payment penalty even if the amount you paid exceeded your tax liability."

"Golly, there is a lot of stuff to know about taxes," observes Janet. "We sure are glad we have you. If Skip had to handle this we'd probably both be going to jail."
CASE STUDIES

FILING STATUS

MERRILL V. COMMISSIONER, TC MEMO 2009-166 (JULY 13, 2009)

FACTS:

Charles Merrill is a well-known gay rights activist, artist, and millionaire member of the family that founded Merrill Lynch. He was married for 23 years to an heiress of the Johnson & Johnson Company and, upon her death, took up with Kevin Boyle, with whom he lived for 18 years. The couple lived in North Carolina and participated in a commitment ceremony there. North Carolina, however, did not recognize same-sex marriages. Several years later (after the tax years that were at issue in this case), Charles and Kevin were legally married after moving to California. At this time the Defense of Marriage Act ("DOMA") had not yet been addressed by the Supreme Court, and under that Act (as described below) the federal government did not recognize same-sex marriages. Charles refused to file a tax return as an act of civil disobedience advocating same-sex marriage equality, whereupon the IRS prepared substitutes for returns on the basis of the "single" filing status and issued deficiency notices for the thus calculated. Challenging the alleged deficiencies in Tax Court, Charles argued that he must be accorded "married filing joint" status, rather than "single" status, because of his long-term domestic partnership with Kevin. To no one's surprise (including, it is suspected, Charles's), the court rejected the argument and affirmed the IRS's proposed deficiency.

LAW:

Every married individual is entitled to file a joint return with his or her spouse. IRC sections 1(a)(10; 6013. The determination of whether an individual is married is made as of the last day of the taxable year. IRC section 7703(a)(1).
Both spouses must sign the return in order to achieve married filing joint status. IRC sections 1(a)(1) and 6013(a); Treas. Reg. section 1.6013-1(a)(2). The signing requirement applies regardless of whether the return is delinquent or filed timely. See Columbus v. Commissioner, T.C. Memo. 1998-60. Absent a valid power of attorney, a married person cannot sign a joint return on behalf of his or her spouse unless necessary due to the non-signing spouse’s being physically unable to sign because of disease or injury. In that case, the other spouse may, with the oral consent of the incapacitated spouse, sign the incapacitated spouse’s name on the return, followed by the words “By ... Husband (or Wife)” and then by the signature of the signing spouse in his or her own name. Furthermore, there must be attached to the return a dated statement signed by the spouse who is signing that indicates: (1) the return being filed; (2) the tax year; (3) the reason for the inability of the spouse who is incapacitated to sign the return; and (4) that the spouse who is incapacitated consented to the signing. Rev. Rul. 70-216, 1970-1 CB 265.

Generally, whether a taxpayer is married for federal income tax purposes is determined by reference to the laws of the state of the taxpayer's domicile. See Sullivan v. Commissioner, 256 F.2d 664 (4th Cir. 1958), affg. 29 T.C. 71 (1957); Dunn v. Commissioner, 70 T.C. 361, 366 (1978). However, DOMA provided that, in applying any federal law or regulation, the term “marriage” means only a legal union between one man and one woman as husband and wife, and that the word “spouse” refers only to a person of the opposite sex who is a husband or wife. The IRS maintained, therefore, that same-sex couples could not file joint returns pursuant to DOMA, even if their domicile state recognizes the marriage as valid. PLR 9717018.

Constitutional challenges to the federal tax treatment of same-sex couples were legion. While most courts had rejected these efforts, see, e.g., Mueller v. Commissioner, 39 Fed. Appx.437 (7th Cir. 2002), the federal district court in Massachusetts held portions of DOMA to be unconstitutional. Gill v. Office of Personnel Management, 699 F. Supp. 2d 374, (D.C. Mass. 2010). Noting financial benefit associated with joint filing status, the court determined that denial of same on basis of DOMA’s federally mandated nonrecognition of same-sex marriage was unconstitutional. Likewise, the federal court in New York held that the definition of marriage in DOMA was unconstitutional, and that decision was upheld by the federal Circuit Court of Appeals. Windsor v. United States, 699 F.3d 169 (2d Cir. 2012). Both Gill and Windsor were appealed to the Supreme Court.

On June 26, 2013, the Supreme Court issued its decision in Windsor. That case involved a same-sex partner who was denied spousal status with respect to the estate tax, even though the decedent and the taxpayer had been validly married under local law. In deciding in favor of the taxpayer, the Supreme Court held that the provision of DOMA defining marriage as only existing between a man and a woman for federal purposes was unconstitutional as a deprivation of the liberty of the person protected by the Fifth Amendment of the Constitution. As such, the federal government cannot ignore any marital status validly created under state law. Thus, same-sex partners who are validly married under state law must now be treated as spouses for federal law purposes, including federal income tax filing. Pursuant to the Supreme Court’s decision, the IRS has announced that it will recognize the validity of a same-sex marriage that was valid in the state where it was entered into, regardless of the married couple's place of domicile. Rev. Rul. 2013-17. Under the ruling, same-sex couples will be treated as married for all federal tax purposes, including income and gift and estate taxes. The ruling applies to all federal tax provisions where marriage is a factor, including filing status, claiming personal and dependency exemptions, taking the standard deduction, employee benefits, contributing to an IRA and claiming the earned income tax credit or child tax credit. The IRS notes, however, that the term "marriage" does not include registered domestic partnerships, civil unions, or other similar formal relationships recognized under state law that are not denominated as a "marriage" under that state's law.

ANALYSIS:

Note that Charles Merrill’s case did not stand or fall on constitutional issues, but rather on simple procedural grounds. The fact of the matter is that Charles and Kevin did not file a return at all. A substitute for return was prepared using single filing status, and in this case, the only way any taxpayer can claim married filing joint status is by subsequently filing a return. See Millsap v. Commissioner, 91 T.C. 926, 937 (1988). This they did not do, and accordingly there was no legal basis for Charles’s claimed eligibility for married filing joint status. Thus, the Windsor ruling does not affect the
outcome in Merrill. However, individuals who were in same-sex marriages may now (but are not required to) file amended returns choosing to be treated as married for federal tax purposes for one or more prior tax years still open under the statute of limitations. Additionally, employees who purchased same-sex spouse health insurance coverage from their employers on an after-tax basis may treat the amounts paid for that coverage as pre-tax and excludable from income.

MOVING EXPENSES

ZILBERBERG v. COMMISSIONER, TC MEMO 2011-5 (JANUARY 5, 2011)

FACTS:

Mark Haller did not file tax returns for three years in a row, from 2004 through 2006. During part of that time he lived in Okaloosa County, Florida. In July of 2005 he was hired by the Monroe County School District in Key West as an alternative education and GED teacher.

When the IRS caught up with him, they filed substitute for returns for each of the missing years and asserted a tax liability. Mark contested that liability in Tax Court, claiming that he was entitled to, among other things, a moving expense deduction for his move from Okaloosa County to the Keys. Although he had no documentation, Mark stated that he paid $5,000 to have "everything he had" packed up and shipped to his new home, a distance of some 805 miles.

LAW:

Moving expenses were ordinarily considered nondeductible personal expenses before the enactment of Code Section 217. See Hughes v. Commissioner, 65 T.C. 566, 570 (1975); Jorman v. Commissioner, T.C. Memo. 1996-297. However, the Code now allows taxpayers, subject to certain conditions, to deduct "moving expenses paid or incurred during the taxable year in connection with the commencement of work by the taxpayer as an employee or as a self-employed individual at a new principal place of work." Moving expenses are defined as the reasonable expenses of: (1) moving household goods and personal effects from the former residence to the new residence, and (2) of traveling (including lodging) from the former residence to the new place of residence. IRC section 217(b)(1).

There are two conditions that a taxpayer must satisfy in order to claim a moving expenses deduction. First, the taxpayer's new principal place of work must be at least 50 miles farther from his former residence than was his former principal place of work. Second, the taxpayer must meet either the 39-week or the 78-week time test. As relevant to this case, Mark would have to demonstrate that, during the 12-month period immediately following his arrival in the general location of his new principal place of work, he was a full-time employee, in such general location, for at least 39 weeks. Alternatively, a taxpayer can demonstrate entitlement to the moving expense deduction if he or she works on a full time basis or is self-employed for at least 78 weeks during the 24-month period immediately following the move. IRC §217(c).

The IRS did not challenge the fact that Mark moved from Okaloosa County to Key West, and conceded that the move qualified for the moving expense deduction under Code Section 217. Mark could not, however, substantiate the amount of his expenses and, as with respect to any deduction, however, the burden of proof is on the taxpayer. Such expenses are normally documented with receipts, credit card statements, or even contemporaneous summaries of the expenses incurred. Mark had nothing other than his own testimony.

Deductions are considered to be a matter of legislative grace, and taxpayers always bear the burden of proving entitlement to a claimed deduction. INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992). Such proof is not sufficient if it is general in nature. Rather, the taxpayer is required to identify each deduction and show that they have met all applicable requirements regarding the keeping of books or records related to the deduction and to otherwise substantiate the claim. IRC §6001; New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934); Roberts v. Commissioner, 62 T.C. 834, 836 (1974); Treas. Reg. §1.60011(a).
If a taxpayer's records are lost or destroyed through circumstances beyond his or her control, substantiation of the claimed deduction may still be achieved by use of other credible evidence. Lockett v. Commissioner, 306 Fed. Appx. 464, 466-467 (11th Cir. 2009), aff'g. T.C. Memo. 2008-5. However, the Tax Court is not required to accept a taxpayer's unverified, undocumented testimony. Hradesky v. Commissioner, 65 T.C. 87, 90 (1975), aff'd. per curiam 540 F.2d 821 (5th Cir. 1976).

Finally, the Tax Court sometimes uses what is commonly referred to as the "Cohan Rule" to resolve issues of proof regarding claimed deductions. Under the Cohan Rule, when a taxpayer is able to establish that a deductible expense was, in fact, incurred but is unable to substantiate the precise amount, the court may approximate the amount that is deductible so long as the taxpayer presents sufficient evidence to establish a rational basis for making the estimate. Cohan v. Commissioner, 39 F.2d 540, 543-544 (2d Cir. 1930); Vanicek v. Commissioner, 85 T.C. 731, 742-743 (1985); Villarreal v. Commissioner, T.C. Memo. 1998-420.

ANALYSIS:

Not only was Mark unable to establish his moving expenses though appropriate documentation, he could not even provide the court with specific information such as the exact days he moved, whether he drove himself to Key West, or the name of the moving company. Nonetheless, it was clear that he had, in fact, moved, that the move was related to his employment, and that both the distance and the time tests were met for the deductibility of expenses under Code Section 217.

While the Cohan Rule provides the court with a great deal of discretion, it is discretion that the court does not use lightly. As Judge Wherry observed in this case, the Cohan Rule only allows the court to estimate the amount of deductible expense after "bearing heavily. . . upon the taxpayer whose inexactitude is of his own making."

While there was no doubt that Mark moved the 805 miles to Key West and that it must have cost him something, the court declined to allow the $5,000 claimed. Nonetheless, invoking the Cohan Rule on the basis of Mark's own testimony and an exhibit listing his items of personal property, the court allowed a moving expense deduction of $3,000.

GAIN ON THE SALE OF MAIN HOME

GATES V. COMMISSIONER, 135 T.C. 1 (2010)

FACTS - CASE 3

On December 14, 1984, David Gates paid $150,000 for an 880-square-foot two-story building with a studio on the second level and living quarters on the first level. Approximately 5 years later he married Christine. David and Christine resided in the house for at least 2 years from August 1996 to August 1998.

In 1996 they decided to enlarge and remodel the house and hired an architect. The architect advised them that more stringent building and permit restrictions had been enacted since the original house was built. Subsequently, they demolished the house and constructed a new three-bedroom dwelling on the site. The new house complied with the building and permit requirements existing in 1999.

David and Christine, however, never resided in the newly constructed dwelling. On April 7, 2000, they sold the house for $1,100,000, resulting in a $591,406 gain. The couple asserted that gain of $500,000 was excludable from their income under Code section 121. The IRS disagreed.

LAW - CASE 3

Gross income means all income from whatever source derived, unless excluded by law. Generally, gain realized on the sale of property is included in a taxpayer's income. Code section 121(a), however, allows a taxpayer to exclude from income gain on the sale or exchange of property if the taxpayer has owned and used such property as his or her
principal residence for at least 2 of the 5 years immediately preceding the sale. Section 121(a) specifically provides as follows:

Exclusion.—Gross income shall not include gain from the sale or exchange of property if, during the 5-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer’s principal residence for periods aggregating 2 years or more.

The maximum exclusion is $500,000 for a married couple who file a joint return for the year of the sale or exchange. A married couple may claim the $500,000 exclusion on the sale or exchange of property they owned and used as their principal residence if either spouse meets the ownership requirement, both spouses meet the use requirement, and neither spouse claimed an exclusion under Code section 121(a) during the 2-year period before the sale or exchange.

ANALYSIS - CASE 3

The issue presented arises from the fact that Code section 121(a) does not define two critical terms—“property” and “principal residence.” Code section 121(a) simply provides that gross income does not include gain from the sale or exchange of property if “such property” has been owned and used by the taxpayer “as the taxpayer's principal residence” for the required statutory period.

The IRS contended that David and Christine did not sell property they had owned and used as their principal residence for the required statutory period because they never occupied the new house as their principal residence before they sold it. The IRS interpreted the term “property” to mean, or at least include, a dwelling that was owned and occupied by the taxpayer as his or her “principal residence” for at least 2 of the 5 years immediately preceding the sale. Therefore they argued that because David and Christine never resided in the new house before its sale in 2000, the new house was never their principal residence.

David and Christine, on the other hand, focused their argument on two facts—that they used the original house as their principal residence for the required term by Code section 121(a) and they sold the land on which the original house had been situated. They contended that the term “property” includes not only the dwelling but also the land on which the dwelling is situated. Thus, in their opinion, the requirements of Code section 121(a) are satisfied if a taxpayer lived in any dwelling on the property for the required 2-year period even if that dwelling is not the dwelling that is sold. Because they used the original house and the land on which it was situated as their principal residence for the required term, the property qualified as their principal residence and $500,000 of the gain generated by the sale of the property should be excluded under section 121.

Because Code section 121 does not define the terms “property” and “principal residence”, the Tax Court had to apply accepted principles of statutory construction to ascertain Congress' intent. It is a well-established rule of construction that if a statute does not define a term, the term is given its ordinary meaning. It is also well established that a court may look to sources such as dictionaries for assistance in determining the ordinary meaning of a term. A court will look to the legislative history to ascertain Congress' intent if the statute is ambiguous.

The American Heritage Dictionary of the English Language defines “property” as “Something owned; a possession”, “A piece of real estate”, and “The right of ownership; title.” Merriam-Webster's Collegiate Dictionary defines “property” as “a quality or trait belonging and esp. peculiar to an individual or thing” and “something owned or possessed; specif: a piece of real estate”. Black's Law Dictionary defines “property” as “The right to possess, use, and enjoy a determinate thing (either a tract of land or a chattel)” and “Any external thing over which the rights of possession, use, and enjoyment are exercised”. The American Heritage Dictionary of the English Language 1395 (4th ed. 2000) defines “principal” in its first definition as “First, highest, or foremost in importance, rank, worth, or degree; chief.” Similar definitions appear in other dictionaries.

The American Heritage Dictionary of the English Language defines “residence” as “The place in which one lives; a dwelling” and “The act or a period of residing in a place.” Merriam-Webster's Collegiate Dictionary defines “residence” as “1 a: the act or fact of dwelling in a place for some time b: the act or fact of living or regularly staying at or in some
place for the discharge of a duty or the enjoyment of a benefit” and “3 a: building used as a home: DWELLING [synonym].”

When the dictionary definitions of “principal” and “residence” are combined, the court concluded that “principal residence” may have two possible meanings. It can either mean the chief or primary place where a person lives or the chief or primary dwelling in which a person resides. Likewise, the term “property” as used in Code section 121(a) can refer more broadly to a parcel of real estate, or it can refer to the dwelling (and related curtilage) used as a taxpayer’s principal residence.

Because there is more than one possible meaning for both the term “property” and the term “principal residence”, the court could not conclude that the meaning of Code section 121(a) is clear and unambiguous. That section is not explicit as to whether Congress intended it to apply to a sale of property when the property sold does not include the dwelling that the taxpayer used as a principal residence for the period that Code section 121(a) requires. Because it is ambiguous, the court had to examine the legislative history to ascertain Congress’ intent regarding the proper tax treatment of principal residence sales.

Until 1951 any gain realized on the sale of a principal residence was taxed as capital gain. In 1951 Congress recognized that many taxpayers faced hardship as a result of tax on gain realized on the sale of their principal residences—especially where a taxpayer was compelled to sell his or her principal residence and move to a new one because of a change in circumstances such as an increase in family size or relocation for employment—and granted relief by enacting Code section 112(n)(1). That section originally provided that no gain on the sale of a principal residence was recognized if a taxpayer purchased a new residence for a price at least equal to the selling price of the old residence within the period specified therein. Unlike the current Code section 121(a), which excludes gain from the sale of property used as a principal residence, the original provision provided for a deferral of gain from the sale of a principal residence.

In 1964 Congress enacted a new provision to provide older taxpayers tax relief on the sale of their principal residences. Former section 121 was subsequently amended and, as amended, permitted an individual, on a one-time basis, to elect to exclude from gross income up to $125,000 of gain from the sale or exchange of a principal residence if the taxpayer (1) had attained age 55 before the sale and (2) had owned the property and used it as a principal residence for 3 or more of the 5 years immediately preceding the sale.

In the Taxpayer Relief Act of 1997, Congress again amended former section 121 and repealed former section 1034. That section now provides that a taxpayer generally may exclude up to $250,000 of gain realized on the sale or exchange of a principal residence occurring after May 6, 1997, each time the taxpayer sells or exchanges a principal residence and meets the eligibility requirements under Code section 121.

The legislative history of Code section 121 supports a conclusion that Congress intended the terms “property” and “principal residence” to mean a house or other dwelling unit in which the taxpayer actually resided. In explaining the 1997 amendment to section 121, the House Committee on the Budget used the terms “home” and “house” and their derivations interchangeably with the term “principal residence.”

The legislative history demonstrates that Congress intended the term “principal residence” to mean the primary dwelling or house that a taxpayer occupied as his principal residence. Nothing in the legislative history indicates that Congress intended Code section 121 to exclude gain on the sale of property that does not include a house or other structure used by the taxpayer as his principal place of abode. Although a principal residence may include land surrounding the dwelling, the legislative history supports a conclusion that Congress intended the section 121 exclusion to apply only if the dwelling the taxpayer sells was actually used as his principal residence for the period required by section 121(a).

The conclusion that the court reached from an examination of the legislative history surrounding the enactment of Code section 121 is bolstered by and is consistent with regulations promulgated under the predecessor provisions of section 121. The regulations under former section 121, provided that the term “principal residence” has the same
meaning as in section 1034 and the regulations thereunder. Those regulations provided that whether property was used by the taxpayer as his principal residence depended on all the facts and circumstances in each case, including the good faith of the taxpayer. The section 1034 regulations further provided that property used by the taxpayer as his principal residence may include a houseboat, a house trailer, or stock held by a tenant-stockholder in a cooperative housing corporation, if the dwelling which the taxpayer is entitled to occupy as such stockholder is used by him as his principal residence. The focal point of these regulations was the dwelling unit a taxpayer uses as his principal residence. Thus, the section 1034 regulations reinforce the conclusion that to obtain the benefits of former section 1034, a taxpayer who sells a dwelling must have actually used it as his or her principal residence.

Although the court recognized that David and Christine would have satisfied the requirements under Code section 121 had they sold or exchanged the original house instead of tearing it down, it felt it had to apply the statute as written by Congress. Rules of statutory construction require that the court narrowly construe exclusions from income. Under Code section 121(a) and its legislative history, the court could not conclude on the facts of this case that David and Christine sold their principal residence. Accordingly, it held that they could not exclude from income under Code section 121(a) the gain realized on the sale of the property.

**APPENDIX A**

**ADOPTION CREDIT AND CHILD TAX CREDIT**

**ADOPTION CREDIT**

A credit is available for qualified expenses paid to adopt an eligible child (under age 18 or with special needs). This credit was not refundable for the tax year 2009 and was set to expire at the end of 2010. Changes made the credit refundable and available for tax years through 2012. Lastly, changes made the adoption credit no longer refundable again but made it available for tax years after 2012. For 2021, the maximum adoption credit is $14,440 per child (minus any qualified adoption expenses claimed for the same child in a prior year). The full credit may be allowed for the adoption of a child with special needs even if there are no qualified expenses. For 2021, the adoption credit begins to phase out for taxpayers with modified adjusted gross income in excess of $216,660 and is completely phased out for taxpayers with modified adjusted gross income of $256,660 or more.

- Qualified adoption expenses are reasonable and necessary expenses directly related to, and whose principal purpose is for, the legal adoption of an eligible child. These expenses include the following:
  1. Adoption fees
  2. Court costs
  3. Attorney fees
  4. Travel expenses (including meals and lodging) while away from home
  5. Re-adoption expenses to adopt a foreign child
- Nonqualified expenses are expenses that meet the following criteria:
  1. Expenses that violate state or federal law
  2. Expenses for carrying out any surrogate parenting arrangement
  3. Expenses for the adoption of spouse's child
  4. Expenses for which the taxpayer received funds under any federal, state, or local program
  5. Expenses allowed as a credit or deduction under any other federal income tax rule
  6. Expenses paid or reimbursed by an employer or any other person or organization
  7. Expenses paid before 1997
WHEN TO CLAIM THE ADOPTION CREDIT

If the eligible child is a U.S. citizen or resident, a taxpayer may claim the adoption credit even if the adoption never became final. A taxpayer may claim expenses paid prior to finalization in the year following the year of payment. Expenses paid in the year the adoption becomes final are included in that year. A taxpayer may claim expenses paid after the adoption becomes final in the year of payment. If the eligible child is not a U.S. citizen or resident, a taxpayer cannot take the adoption credit or exclusion unless the adoption becomes final.

Corresponding to the adoption credit is a gross income exclusion for employer-provided adoption assistance. Parallel to the adoption credit, for 2021 the amount that can be excluded from an employee’s gross income for the adoption of a child with special needs is $14,440 per child adopted. The maximum amount that can be excluded from an employee's gross income for the amounts paid or expenses incurred by an employer for qualified adoption expenses furnished pursuant to an adoption assistance program for other adoptions (adoption of a child without special needs) by the employee is $14,440 per child adopted for 2021. For 2021, these amounts begin to phase out for taxpayers with modified adjusted gross income in excess of $216,660 and are completely phased out for taxpayers with modified adjusted gross income of $256,660 or more.

The aggregate amount paid or expenses incurred that may be taken into account for purposes of the gross income exclusion or the credit for all tax years with respect to the adoption of a child by the taxpayer is (per child adopted):

- For 2021, the amount for the adoption of a child with special needs is $14,440 ($14,440 allowed for the adoption of a child with special needs even if no qualified expenses).
- For 2021, the maximum amount for other adoptions is the amounts paid or expenses incurred up to $14,440 (the lesser of amounts paid/expenses incurred or $14,440 for the adoption of a child without special needs).

Tax benefits for adoption include both a tax credit for qualified adoption expenses paid to adopt an eligible child and an exclusion from income for employer-provided adoption assistance. The credit is nonrefundable, which means it's limited to the tax liability for the year. However, any credit in excess of tax liability may be carried forward for up to five years. To prevent a double benefit, no adoption credit is allowed for expenses for which an income tax deduction (income excluded from gross income) is allowed, or for expenses to the extent funds for the expenses are received under a federal, state, or local program.

In addition to the adoption credit, the passage of the Setting Every Community Up for Retirement Enhancement Act (SECURE Act) allows for a penalty-free distribution from a retirement plan to aid with the cost of adoption (or birth). Section 72(t) is amended to allow for up to $5,000 in penalty-free withdrawals from any qualified plan or IRA (traditional, Roth, SEP, SIMPLE) for individuals in case of birth of a child or adoption of a child:

- Up to $5,000 for the birth or adoption of a child (each parent can receive up to $5,000 for the same child and can receive up to $5,000 for each child if multiple births and/or adoptions)
- The taxpayer must include the name, age, and TIN of such child or eligible adoptee on the taxpayer's return.
- An eligible adoptee is any individual (other than a child of the taxpayer’s spouse) who has not attained age 18 or is physically or mentally incapable of self-support.
- A qualified distribution is made during the 1-year period beginning on the date on which a child of the individual is born or on which the legal adoption by the individual of an eligible adoptee is finalized.

CHILD TAX CREDIT

CHILD TAX CREDIT FOR QUALIFYING CHILD

The Tax Cuts and Jobs Act of 2017 temporarily increased the child tax credit to $2,000 per qualifying child. This temporary increase is effective for taxable years 2018 through taxable years 2025.
Under the tax act, the maximum amount refundable may not exceed $1,400 per qualifying child. Additionally, the provision provides that, to receive the child tax credit (both the refundable and nonrefundable portion), a taxpayer must include a Social Security number for each qualifying child for whom the credit is claimed on the tax return. For these purposes, a Social Security number must be issued before the due date for filing the return for the taxable year.

The provision generally retains the present-law definition of dependent. The provision also retains the present-law age limit for a qualifying child. A qualifying child for purposes of the child tax credit is a child who meets the following criteria of seven tests (relationship, age, support, residency, dependent, joint return, and citizenship):

1. Is the taxpayer's son, daughter, stepchild, eligible foster child, adopted child, brother, sister, stepbrother, stepsister, half brother, half sister, or a descendant of any of them (a grandchild, niece, or nephew)
2. Was younger than age 17 at the end of the tax year and younger than the taxpayer (or spouse if filing jointly)
3. Did not provide more than half of his own support for the year
4. Lived with the taxpayer for more than half of the year
5. Is claimed as a dependent on the taxpayer's return
6. Does not file a joint return for the year (or files it only to claim a refund of withheld income tax or estimated tax paid)
7. Is a U.S. citizen, a U.S. national, or a resident of the United States

Treat a person who was born or died as having lived with the taxpayer for the entire tax year if the taxpayer’s home was the person's home the entire time he was alive. Temporary absences for special circumstances, such as school, vacation, business, medical care, military service, or detention in a juvenile facility, count as time the child lived with the taxpayer.

Thus, a qualifying child is an individual who has not attained age 17 during the taxable year. A child who is not a citizen, national, or resident of the United States cannot be a qualifying child.

The provision modifies the adjusted gross income phaseout thresholds. The credit begins to phase out for taxpayers with adjusted gross income in excess of $400,000 (in the case of married taxpayers filing a joint return) and $200,000 (for all other taxpayers). These phaseout thresholds are not indexed for inflation.

Child Tax Credit for 2021 Only

The American Rescue Plan Act of 2021 introduces Child Tax Credit (CTC) improvements for 2021 only. The child tax credit increases to $3,000 per qualifying child ($3,600 for a qualifying child who has not attained age 6 as of the close of the calendar year) and is fully refundable for qualifying taxpayers. Currently, the CTC improvements apply only to the 2021 tax year.

Child Tax Credit improvements for 2021 include:

1. The credit is fully refundable for qualifying taxpayers (previously partially refundable)
2. Qualifying child age increases to younger than age 18 (previously younger than age 17)
3. The credit amount increases per qualifying child to $3,000 for children ages 6 to 17 and $3,600 for children under age 6 (up from $2,000 per qualifying child under age 17)
4. MAGI phaseout thresholds are reduced to $150,000 for joint return or surviving spouse, $112,500 for head of household, and $75,000 for all others (previously $400,000 for married filing jointly and $200,000 for all others)
5. Advance payment of credit – periodic payments to taxpayers during the calendar year (July 1 through December 31 for 2021). The annual advance amount is estimated as being equal to 50% of the amount which would be treated as allowed. Taxpayers can elect not to receive advance payments. Note: The
amount of credit allowed to any taxpayer for any taxable year shall be reduced (but not below zero) by the aggregate amount of advanced payments made to such taxpayer during such taxable year.

ADDITIONAL NONREFUNDABLE CREDIT FOR QUALIFYING DEPENDENTS OTHER THAN QUALIFYING CHILD

The Tax Cuts and Jobs Act of 2017 also temporarily enhanced the child tax credit by allowing an additional $500 nonrefundable credit for qualifying dependents other than qualifying children. The provision generally retains the present-law definition of dependent. Examples of a qualified dependent include dependents over age 17, such as children in college or a dependent parent. This temporary increase is also effective for taxable years 2018 through taxable years 2025.

The Social Security number requirement, for the child tax credit, does not apply to a non-child dependent for whom the $500 nonrefundable credit is claimed.

The provision modifies the adjusted gross income phaseout thresholds. The credit begins to phase out for taxpayers with adjusted gross income in excess of $400,000 (in the case of married taxpayers filing a joint return) and $200,000 (for all other taxpayers). These phaseout thresholds are not indexed for inflation.

APPENDIX B

PREPARATOR PENALTIES

Return preparers are responsible for taking a reasonable position on a tax return. To be reasonable, there must be substantial authority for the position, or in the case of a disclosed position, a reasonable basis for the treatment of such item on the return. The return cannot contain frivolous positions, which have no basis for validity in existing law or which have been deemed frivolous by the U.S. Tax Court or other federal courts. The IRS may assess penalties within three years after the taxpayer files the return. No proceeding in court without assessment for the collection of such tax shall begin after the expiration of such period. There is no statute of limitations for fraudulent returns.

The substantial authority standard is an objective standard involving an analysis of the law and application of the law to relevant facts. It is less stringent than the more likely than not standard (the standard that is met when there is a greater than 50% likelihood of the position being upheld) but more stringent than the reasonable basis standard. There is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment. All authorities relevant to the tax treatment of an item, including the authorities contrary to the treatment, are taken into account in determining whether substantial authority exists. The weight of authorities is determined in light of the pertinent facts and circumstances.

Reasonable basis is a relatively high standard of tax reporting that is significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable. If a return position is reasonably based on one or more of the authorities set forth in §1.6662-4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard.

A tax shelter, for purposes of the substantial understatement portion of the accuracy-related penalty, is a partnership or other entity, plan, or arrangement, with a significant purpose to avoid or evade federal income tax. Tax shelters have a higher standard and must have a confidence level of at least more likely than not (greater than 50% likelihood) that one or more significant tax issues would be resolved in the taxpayer’s favor.

Taxpayers and tax return preparers who wish to avoid certain penalties can use Form 8275, Form 8275-R, or the current year Rev. Proc. to disclose items or positions—except those taken contrary to a regulation—that are not otherwise adequately disclosed on a tax return. The form is filed in order to avoid the portions of the accuracy-related penalty due to disregard of rules or to a substantial understatement of income tax for non-tax shelter items if the
return position has a reasonable basis. It also is used for disclosures relating to preparer penalties for understatements due to unreasonable positions or disregard of rules.

The portion of the accuracy-related penalty attributable to the following types of misconduct cannot be avoided by disclosure on Form 8275:

• Negligence
• Disregard of regulations
• Any substantial understatement of income tax on a tax shelter item
• Any substantial valuation misstatement under chapter one of the Internal Revenue Code
• Any substantial overstatement of pension liabilities
• Any substantial estate or gift tax valuation understatements

APPENDIX C

PREPARATOR PENALTIES

UNDERSTATEMENT OF LIABILITY §6694

Preparer penalties are applicable in the following circumstances:

• Unreasonable positions - A penalty of $1,000 or 50% of preparer’s fee, whichever is greater.
  1. A position lacking substantial authority is unreasonable if the preparer knew (or should have known) of the position, and
     A. For undisclosed positions - The position does not have substantial authority.
     B. For disclosed positions - The position does not have a reasonable basis.
     C. For tax shelters - There was not a reasonable belief that the position would more likely than not be sustained on its merits.
  2. If a return preparer understates tax liability on a return, the IRS will not impose a penalty if the preparer shows that there is reasonable cause and the tax return preparer acted in good faith.
• Willful or reckless conduct - A penalty of $5,000 or 75% of preparer’s fee, whichever is greater.
  1. Willful or reckless conduct is conduct by the tax return preparer that is a willful attempt in any manner to understated the liability for tax on the return or claim, or a reckless or intentional disregard of rules or regulations.
  2. The amount of any penalty payable for willful misconduct is reduced by any penalty for an unreasonable position.

APPENDIX D

MOVING EXPENSES

NOTE: Job-related moving expenses were an above-the-line deduction prior to the Tax Cuts and Jobs Act of 2017. Starting in 2018, the tax act repeals the deduction for moving expenses for all taxpayers except for active-duty members of the Armed Forces (including spouse and dependents) that move pursuant to a military order and incident to a permanent change of station.

Members of the Armed Forces on active duty who, due to a military order, move because of a permanent change of their duty station are still eligible for the moving expense deduction.

Use Form 3903 to figure your moving expense deduction if you are a member of the Armed Forces on active duty and, due to a military order, you move because of a permanent change of station.
A permanent change of station includes:

- A move from your home to your first post of active duty,
- A move from one permanent post of duty to another permanent post of duty, and
- A move from your last post of duty to your home or to a nearer point in the United States. The move must occur within 1 year of ending your active duty or within the period allowed under the Joint Travel Regulations.

If you qualify to deduct expenses for more than one move, use a separate Form 3903 for each move.

**Spouse and dependents** — If you are the spouse or dependent of a member of the Armed Forces who deserts, is imprisoned, or dies, a permanent change of station for you includes a move to:

- The member's place of enlistment or induction;
- Your, or the member's, home of record; or
- A nearer point in the United States.

If the military moves you to or from separate locations, the moves are treated as a single move to your new main job location.

**Note:** The deductible and nondeductible expenses below apply for members of the Armed Forces (and their spouses and dependents) who qualify for the moving deduction.

### DEDUCTIBLE MOVING EXPENSES

If you move because of a permanent change of station, you can deduct the reasonable unreimbursed expenses of moving you and members of your household. A member of your household is anyone who has both your former home and your new home as his or her main home. It doesn't include a tenant or employee unless you can claim that person as a dependent on your tax return.

Taxpayers may deduct expenses (if not reimbursed or furnished in-kind) for:

- Moving household goods and personal effects, including:
  - Packing, crating, and transporting household goods and personal effects.
  - Storing and insuring household goods and personal effects within any period of 30 consecutive days after the day these goods and effects are moved from the former home and before they are delivered to the new home (includes in-transit or foreign-move storage).
- Traveling from old home to new home, including:
  - Transportation (including car expenses and airfare) and lodging for the taxpayer and household members. This includes expenses for the day of arrival. There is no deduction for meals.
  - For car expenses, a taxpayer may deduct actual out-of-pocket expenses such as the amount paid for gas and oil for the car, if keep an accurate record of each expense. There is no deduction for certain automobile expenses such as general repairs, general maintenance, insurance, or depreciation for the car. An alternative to deducting actual expenses is to use the moving standard mileage rate of 16 cents per mile for 2021. Taxpayers can also deduct parking fees and tolls regardless of the method used.

Don't deduct any expenses for moving services that were provided by the government. Also, don't deduct any expenses that were reimbursed by an allowance not include in income.
NONDEDUCTIBLE MOVING EXPENSES

A taxpayer cannot deduct the following items as moving expenses:

- Expenses for moving furniture or other goods bought on the way from old home to new home
- House-hunting expenses
- Meals
- Costs of unnecessary side trips or lavish and extravagant lodging
- Any part of the purchase price of a new home
- Car tags
- Driver's license
- Expenses of buying or selling a home (including closing costs, mortgage fees, and points)
- Expenses of entering into or breaking a lease
- Home improvements to help sell a home
- Loss on the sale of a home
- Losses from disposing of memberships in clubs
- Mortgage penalties
- Real estate taxes
- Refitting of carpet and draperies
- Return trips to a former residence
- Security deposits (including any given up due to the move)
- Storage charges except those incurred in transit and for foreign moves

RULES FOR TAXPAYERS PRIOR TO THE TAX CUTS AND JOBS ACT OF 2017 REPEAL

Important: To qualify as an adjustment to gross income, moving expenses must closely relate—both in time and in place—to the start of work at a new job location.

The taxpayer must meet the specific requirements of the Distance Test and the Time Test:

- Closely related in time - Expenses incurred within one year from the date first reporting to work at a new location relate closely in time to the start of work. It is not necessary for a person to arrange to work before moving, as long as he actually goes to work in that location.
- Closely related in place - The distance from the new home to the new job location is not more than the distance from the former home to the new job location. If the move does not meet this requirement, an individual may still deduct moving expenses if he meets one of the following:
  - Is required to live in the new home as a condition of employment
  - Spends less time or money commuting from the new home to the new job location
- Distance Test - The new main job location must be at least 50 miles farther from the taxpayer's former home than the old main job location. For example, if the old job was 3 miles away from the former home, the new job location must be at least 53 miles away.
- Time Test - The requirements for the time test will vary depending on employment. If married filing jointly, only one spouse must satisfy this test.
• For employees - Work full time in the same general area for at least 39 weeks during the first 12 months after arriving in the area of the new job location.
  • Taxpayer does not need to work for the same employer for all 39 weeks.
  • Do not have to work 39 weeks in a row.
• For self-employed persons - Work full time for at least 39 weeks during the first 12 months and for a total of at least 78 weeks during the first 24 months.

A taxpayer who expects to meet the requirements may deduct moving expenses even if the taxpayer does not satisfy the time test by the due date of the return. If a taxpayer fails to meet the time test requirements, he must report the moving expense deduction as other income on Form 1040 for the year he cannot meet the test, or amend the prior return, figuring tax without the moving expense deduction.

REMINDER: Starting in 2018, the tax act repeals the deduction for moving expenses for all taxpayers except for active-duty members of the Armed Forces that move pursuant to a military order and incident to a permanent change of station.

APPENDIX E

GAIN ON SALE OF MAIN HOME

A taxpayer who meets certain qualifications may exclude gains on the sale of a principal residence. This is a Section 121 exclusion. Usually, the home in which the taxpayer lives most of the time is the main home. In addition to a house, a main home may also be a condominium, cooperative apartment, houseboat, or mobile home. If a taxpayer uses only part of the property as a main home, these rules apply only to the gain or loss on the sale of that part.

Important: The taxpayer must own and live in the property as his main home for at least two years during the five-year period ending on the date of sale.

OWNERSHIP AND USE TESTS

During the five-year period ending on the date of the sale, the taxpayer must meet the following ownership and use tests in order to claim the exclusion:

• Ownership test - Owned the home for at least two years.
• Use test - Lived in the home as a main home for at least two years. Occupancy does not have to be consecutive so long as periods of residence total 24 months (730 days). Occupancy does not have to begin on or end on the dates of purchase or sale of the property.
• Taxpayers with occupancy of less than two years may claim a reduced exclusion if the move is due to unexpected changes in employment, health, or other unforeseen circumstances.
• Certain members of the military, intelligence community, or Peace Corps volunteers may suspend the five-year test by up to 10 additional years if on qualified official extended duty.

MAXIMUM EXCLUSION

Taxpayers may exclude up to $250,000 of the gain if all of the following are true:

• The taxpayer meets the ownership test.
• The taxpayer meets the use test.
• The taxpayer did not exclude the gain from the sale of another home during the two-year period ending on the date of the sale.
Taxpayers may exclude up to $500,000 of the gain if all of the following are true:

- The taxpayer is married and files a joint return for the year of sale.
- Either the taxpayer or spouse meets the ownership test.
- Both the taxpayer and spouse meet the use test.
- During the two-year period ending on the date of the sale, neither taxpayer nor spouse excluded gain from the sale of another home.

**PERIODS OF NONQUALIFIED USE**

Generally, the gain from the sale or exchange of a main home will not qualify for the exclusion to the extent that the taxpayer allocates gains to periods of nonqualified use. Nonqualified use is any period after December 31, 2008, during which the taxpayer does not use the property as his main home. Allocate the gain resulting from the sale of the property between qualified and nonqualified use periods based on the amount of time the taxpayer held property for qualified and nonqualified use. Gain from the sale or exchange of a main home allocable to periods of qualified use will continue to qualify for the exclusion for the sale of a main home. Gain from the sale or exchange of property allocable to nonqualified use will not qualify for the exclusion.

A period of nonqualified use does not include:

- Any portion of the five-year period ending on the date of the sale or exchange that is after the last date the taxpayer (or spouse) used the property as a main home.
- Any period (not to exceed an aggregate period of 10 years) during which taxpayer or spouse is serving on qualified official extended duty:
  - As a member of the uniformed services,
  - As a member of the Foreign Service of the United States, or
  - As an employee of the intelligence community; and
- Any other period of temporary absence (not to exceed an aggregate period of two years) due to change of employment, health conditions, or such other unforeseen circumstances as may be specified by the IRS.

To figure the portion of the gain that is allocated to the period of nonqualified use, multiply the gain by the following fraction:

\[
\frac{\text{total nonqualified use during period of ownership after 2008}}{\text{total period of ownership}}
\]

**BUSINESS USE OR RENTAL OF HOME**

A taxpayer may be able to exclude gain from the sale of a home that he has used for business or to produce rental income. However, a taxpayer must meet the ownership and use tests. If a taxpayer is entitled to take depreciation deductions because his main home was used for business purposes or as rental property (even if he did not actually claim them), he may not exclude the part of the gain equal to any depreciation allowed or allowable as a deduction for periods after May 6, 1997. If the taxpayer can show, by adequate records or other evidence, that the depreciation allowed was less than the amount allowable, the amount a taxpayer may not exclude is the amount allowed.
APPLENIX F

ADJUSTED BASIS

Before figuring gain or loss on a sale, exchange, or other disposition of property or figuring allowable depreciation, depletion, or amortization, a taxpayer must usually make certain adjustments (increases and decreases) to the cost of the property. The result is the adjusted basis.

• Increase the basis of any property by all items properly added to a capital account. These include (but are not limited to) the following items:
  1. Capital improvements - The costs of improvements having a useful life of more than one year, which increase the value of the property, lengthen its life, or adapt it to a different use. Improvements include the following:
     A. Putting a recreation room in an unfinished basement
     B. Adding another bathroom or bedroom
     C. Building a fence
     D. Installing new plumbing or wiring
     E. Installing a new roof
     F. Paving the driveway
  2. Assessments for local improvements - Add property assessments for improvements that increase the value of the property assessed to the basis. Do not deduct these assessments as taxes. Examples of assessments are as follows:
     A. Roads
     B. Sidewalks
     C. Water connections
     D. Extending utility service lines to the property

• Decrease the basis of any property by all items that represent a return of capital for the period during which the taxpayer held the property. Examples of items that decrease basis include (but are not limited to) the items discussed below:
  1. Non-taxable corporate distributions - Also known as non-dividend distributions. This amount reflects a return of capital and reduces basis.
  2. Casualty and theft losses - Decrease the basis of property by any insurance proceeds or other reimbursement and by any deductible loss not covered by insurance. Increase the basis in the property by the amount spent on repairs that restore the property to its pre-casualty condition.
  3. Depreciation and Section 179 deduction - The basis of a taxpayer’s qualifying business property will be decreased by any Section 179 deductions taken and the depreciation deducted, or could have deducted (including any special depreciation allowance), on the taxpayer’s returns under the method of depreciation selected.
  4. Easements - Generally, the IRS considers compensation for granting easement proceeds from the sale of an interest in real property. Reduce the basis of the property by the amount received.
  5. Certain Credits - Basis may be reduced by the amount of credits received for one of the following:
     A. Alternative motor vehicle credit
     B. Alternative fuel vehicle refueling property credit
     C. Residential energy efficient property credit
APPENDIX G

BUSINESS PROPERTY

SECTION 1250 RECAPTURE

All real property that is subject to an allowance for depreciation and has never been Section 1245 property is subject to Section 1250 recapture rules. It includes a leasehold of land or Section 1250 property subject to an allowance for depreciation. A fee simple interest in land is not included because it is not depreciable. A tax rate of 25% applies to depreciation up to the amount of straight-line depreciation. This portion is unrecaptured Section 1250 gain. Any amount of additional depreciation is taxed at ordinary income rates and is recaptured as Section 1250 gain. Additional depreciation is the actual depreciation that is more than the depreciation figured using the straight-line method. If a taxpayer holds Section 1250 property for one year or less, all the depreciation is additional depreciation.

Example: Christine has taxable income exceeding the 20-percent capital gain breakpoint for 2021. She purchased a rental property several years ago for $100,000. She sells the property for $150,000. The depreciation taken under ACRS was $41,840, but if she had used the straight-line method, the depreciation would have been $37,970. Christine used a method of accelerated depreciation (ACRS) and has a Section 1250 gain. Section 1250 gain is $3,870, the difference between ACRS and the straight-line depreciation. Sec 1250 Gain is taxed at ordinary income rates. Unrecaptured Section 1250 gain is $37,970, the amount of straight-line depreciation taxed as a capital gain at a 25% rate. The remaining $50,000 gain is taxable as a long-term capital gain at a maximum rate of 20% in 2021.

Starting in 2018, rates on net capital gains are based on breakpoints versus the taxpayer’s marginal bracket. Thus, in the case of an individual with an adjusted net capital gain, to the extent the gain would not result in taxable income exceeding the 15-percent breakpoint, such gain is not taxed. Any adjusted net capital gain which would result in taxable income exceeding the 15-percent breakpoint but not exceeding the 20-percent breakpoint is taxed at 15%. The remaining adjusted net capital gain is taxed at 20%.

For 2021, the maximum zero rate amount is $80,800 for married filing joint or surviving spouse, $40,400 for married filing separate, $54,100 for head of household, and $40,400 for any other individual. The maximum 15-percent rate amount is $501,600 for married filing joint or surviving spouse, $250,800 for married filing separate, $473,750 for head of household, and $445,850 for any other individual.

Under the Tax Cuts and Jobs Act of 2017, starting in 2018 and still effective in 2021, rates on net capital gains are based on breakpoints and are as follows:

<table>
<thead>
<tr>
<th>IF the net capital gain is from...</th>
<th>THEN the maximum capital gain rate is...</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gain on collectibles or qualified small business stock</td>
<td>28%</td>
</tr>
<tr>
<td>Un-recaptured Section 1250 gain</td>
<td>25%</td>
</tr>
<tr>
<td>Other gain (other than gains on collectibles, small business stock, or un-recaptured §1250):</td>
<td></td>
</tr>
<tr>
<td>Taxable income exceeding the 20-percent breakpoint</td>
<td>20%</td>
</tr>
<tr>
<td>Taxable income exceeding 15-percent breakpoint but not exceeding 20-percent breakpoint</td>
<td>15%</td>
</tr>
<tr>
<td>Taxable income not exceeding the 15-percent breakpoint</td>
<td>0%</td>
</tr>
</tbody>
</table>
Capital Gain Breakpoints for 2021

<table>
<thead>
<tr>
<th>Filing Status</th>
<th>15-percent Breakpoint</th>
<th>20-percent Breakpoint</th>
</tr>
</thead>
<tbody>
<tr>
<td>Married Individuals Filing Joint and Surviving Spouses</td>
<td>$80,800</td>
<td>$501,600</td>
</tr>
<tr>
<td>Married Individuals Filing Separate</td>
<td>$40,400</td>
<td>$250,800</td>
</tr>
<tr>
<td>Heads of Households</td>
<td>$54,100</td>
<td>$473,750</td>
</tr>
<tr>
<td>Unmarried Individuals (other than Surviving Spouses, Heads of Households)</td>
<td>$40,400</td>
<td>$445,850</td>
</tr>
</tbody>
</table>

**APPENDIX H**

**SAFEGUARDING TAXPAYER INFORMATION**

Tax return preparers must obtain consent to use tax return information before tax return information is used and before returns are provided to the taxpayer for signature. Internal Revenue Code §7216 is a criminal provision enacted by the U.S. Congress in 1971 that prohibits preparers of tax returns from knowingly or recklessly disclosing or using tax return information. A convicted preparer may be fined not more than $1,000 or imprisoned not more than one year or both, for each violation.

Internal Revenue Code §6713 imposes a civil penalty of $250 on any person who is engaged in the business of preparing, or providing services in connection with the preparation of returns of tax, or any person who for compensation prepares a return for another person, and who:

• Discloses any information furnished to him for, or in connection with, the preparation of any such return, or
• Uses any such information for any purpose other than to prepare, or assist in preparing, any such return. Imposition of the penalty under Internal Revenue Code §6713 does not require that the disclosure be knowing or reckless as it does under Internal Revenue Code §7216.

Generally, unless otherwise specified, written consent is effective for a period of one year from the date the taxpayer signs the consent. Disclosing tax return information to another tax preparer within the United States that is assisting in the preparation of the return generally does not require the consent of the taxpayer.