ANNUAL FEDERAL TAX REFRESHER COURSE

STUDY GUIDE

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LESSON 1

Domain 1 – New Tax Law/Recent Updates

ANNUAL INFLATION ADJUSTMENTS (REV. PROC. 2020-45)

2021 INCOME TAX RATES FOR INDIVIDUALS AND ESTATES AND TRUSTS

The passage of the Tax Cuts and Jobs Act (TCJA) of 2017 brought about a temporary change to the tax rate structure. The new provision applies to taxable years beginning after December 31, 2017. Changes from this provision will sunset and revert to the prior structure for taxable years beginning after December 31, 2025.

The TCJA reduced tax rates for many taxpayers, leaving the top tax rate at 37-percent. For tax year 2021, the highest 37-percent rate applies if income exceeds $628,300 (for joint returns and surviving spouses). The threshold is $523,600 for single taxpayers and heads of households, and $314,150 for married taxpayers filing separately.

2021 FEDERAL INCOME TAX RATES FOR INDIVIDUALS AND ESTATES AND TRUSTS

Single / Unmarried Individuals (other than Surviving Spouses and Heads of Households)	
If taxable income is:	**Then income tax equals:**
Not over $9,950	10% of the taxable income
Over $9,950 but not over $40,525	$995 plus 12% of the excess over $9,950
Over $40,525 but not over $86,375	$4,664 plus 22% of the excess over $40,525
Over $86,375 but not over $164,925	$14,751 plus 24% of the excess over $86,375
Over $164,925 but not over $209,425	$33,603 plus 32% of the excess over $164,925
Over $209,425 but not over $523,600	$47,843 plus 35% of the excess over $209,425
Over $523,600	$157,804.25 plus 37% of the excess over $523,600

Heads of Households	
If taxable income is:	**Then income tax equals:**
Not over $14,200	10% of the taxable income
Over $14,200 but not over $54,200	$1,420 plus 12% of the excess over $14,200
Over $54,200 but not over $86,350	$6,220 plus 22% of the excess over $54,200
Over $86,350 but not over $164,900	$13,293 plus 24% of the excess over $86,350
Over $164,900 but not over $209,400	$32,145 plus 32% of the excess over $164,900
Over $209,400 but not over $523,600	$46,385 plus 35% of the excess over $209,400
Over $523,600	$156,355 plus 37% of the excess over $523,600

Married Individuals Filing Joint Returns and Surviving Spouses	
If taxable income is:	**Then income tax equals:**
Not over $19,900	10% of the taxable income
Over $19,900 but not over $81,050	$1,990 plus 12% of the excess over $19,900
Over $81,050 but not over $172,750	$9,328 plus 22% of the excess over $81,050
Over $172,750 but not over $329,850	$29,502 plus 24% of the excess over $172,750
Over $329,850 but not over $418,850	$67,206 plus 32% of the excess over $329,850
Over $418,850 but not over $628,300	$95,686 plus 35% of the excess over $418,850
Over $628,300	$168,993.50 plus 37% of the excess over $628,300

Married Individuals Filing Separate Returns	
If taxable income is:	**Then income tax equals:**
Not over $9,950	10% of the taxable income
Over $9,950 but not over $40,525	$995 plus 12% of the excess over $9,950
Over $40,525 but not over $86,375	$4,664 plus 22% of the excess over $40,525
Over $86,375 but not over $164,925	$14,751 plus 24% of the excess over $86,375
Over $164,925 but not over $209,425	$33,603 plus 32% of the excess over $164,925
Over $209,425 but not over $314,150	$47,843 plus 35% of the excess over $209,425
Over $314,150	$84,496.75 plus 37% of the excess over $314,150

Estates and Trusts	
If taxable income is:	**Then income tax equals:**
Not over $2,650	10% of the taxable income
Over $2,650 but not over $9,550	$265 plus 24% of the excess over $2,650
Over $9,550 but not over $13,050	$1,921 plus 35% of the excess over $9,550
Over $13,050	$3,146 plus 37% of the excess over $13,050

OTHER REV. PROC. 2020-45 ANNUAL INFLATION ADJUSTMENTS FOR 2021

The Internal Revenue Service has updated the tax year 2021 annual inflation adjustments. The tax year 2021 adjustments are generally used on 2021 tax returns filed in 2022.

The tax items affected by annual inflation adjustments for the tax year 2021 of greatest interest to most taxpayers include the following:

- **Standard Deduction**:
  - For taxable years beginning in 2021, the standard deduction amounts are as follows:
    - Married Individuals Filing Joint Returns and Surviving Spouses $25,100

        - Heads of Households $18,800
        - Unmarried Individuals (other than Surviving Spouses and Heads of Households) $12,550
        - Married Individuals Filing Separate $12,550
    - Aged or blind – For 2021, the additional standard deduction for the aged or the blind is $1,350. Increase this amount to $1,700 if the individual is also unmarried and not a surviving spouse.
    - Dependent – For 2021, the standard deduction amount for an individual who may be claimed as a dependent by another taxpayer cannot exceed the greater of (1) $1,100, or (2) the sum of $350 and the individual's earned income.
- **Gross Income Limitation for a Qualifying Relative** – For 2021, the exemption amount is $4,300.
- **Adoption Credit** – For 2021:
    1. A $14,440 credit is available for adopting a child with special needs.
    2. The credit is available for other adoptions but is limited to the lesser of qualified adoption expenses or $14,440.
    3. A phase-out applies to taxpayers with modified adjusted gross income above $216,660. The credit is completely phased out at $256,660 or more.
- **Exemption Amounts for Alternative Minimum Tax**:
    - For 2021, the exemption amounts are:
        - $114,600 – Joint Returns or Surviving Spouses
        - $73,600 – Unmarried Individuals (other than Surviving Spouses)
        - $57,300 – Married Individuals Filing Separate Returns
        - $25,700 – Estates and Trusts
    - For 2021, the excess taxable income above which the 28-percent tax rate applies is:
        - $99,950 – Married Individuals Filing Separate Returns
        - $199,900 – Joint Returns, Surviving Spouses, Unmarried Individuals, and Estates and Trusts
    - For 2021, the amounts used to determine the phaseout of the exemption amounts are:
        - $1,047,200 – Joint Returns or Surviving Spouses
        - $523,600 – Unmarried Individuals (other than Surviving Spouses)
        - $523,600 – Married Individuals Filing Separate Returns
        - $85,650 – Estates and Trusts
    - Child subject to the "Kiddie Tax" – For 2021, the AMT exemption cannot exceed the child's earned income for the taxable year, plus $7,950.
- **Certain Expenses of Elementary and Secondary School Teachers** – For 2021, an eligible educator is allowed a deduction of up to $250 for expenses of books, supplies, computer equipment (including related software and services), other equipment, and supplementary materials used by the eligible educator in the classroom.
- **Medical Savings Accounts** – For 2021, to qualify as a "high deductible health plan" the annual deductible must not be less than $2,400 ($4,800 for family coverage) and not more than $3,600 ($7,150 family coverage). The limit on annual out-of-pocket expenses (other than for premiums) for covered benefits cannot exceed $4,800 ($8,750 for family coverage).
- **Interest on Education Loans** – For 2021, certain taxpayers with qualified education loans are eligible for a $2,500 maximum deduction for interest paid. This amount is subject to phase-out for taxpayers with modified adjusted gross income in excess of $70,000 ($140,000 for joint returns). No deduction is available when modified adjusted gross income is $85,000 or more ($170,000 or more for joint returns).
- **Income from US Savings Bonds for Taxpayers Who Pay Qualified Higher Education Expenses** – For 2021, certain taxpayers are able to exclude income from United States savings bonds if they pay qualified higher education expenses. The exclusion begins to phase out for modified adjusted gross income above $124,800 for joint returns

and $83,200 for all other returns. The exclusion is no longer available if the taxpayer has modified adjusted gross income of $98,200 or more ($154,800 or more for joint returns).

- **Foreign Earned Income Exclusion** – For 2021, the foreign earned income exclusion amount is $108,700.
- **Unified Credit Against Estate Tax** – For an estate of any decedent dying in calendar year 2021, the basic exclusion amount is $11,700,000 for determining the amount of the credit against the estate tax.
- **Annual Exclusion for Gifts** – For the calendar year 2021:
  - The first $15,000 of gifts to any person (other than gifts of future interests in property) are not included in the total amount of taxable gifts made during that year.
  - The annual gift exclusion increases to $159,000 (other than gifts of future interests in property) of gifts to a noncitizen spouse.

Revenue Procedure 2020-45 provides greater detail on these and other tax items affected by annual inflation adjustments for the tax year 2021.

OTHER 2021 ANNUAL INFLATION ADJUSTMENTS AND CHANGES

- **Health Savings Accounts (HSAs)** – Revenue Procedure 2020-32 provides the 2021 inflation-adjusted amounts for Health Savings Accounts (HSAs) as determined under the Internal Revenue Code.
  - Annual contribution limitation – For the calendar year 2021, the annual limitation on deductions for an individual with:
    - Self-only coverage under a high deductible health plan is $3,600.
    - Family coverage under a high deductible health plan is $7,200.
  - High deductible health plan – For the calendar year 2021 a “high deductible health plan” is defined as a health plan with an annual deductible that is not less than $1,400 for self-only coverage or $2,800 for family coverage, and the annual out-of-pocket expenses (deductibles, co-payments, and other amounts, but not premiums) do not exceed $7,000 for self-only coverage or $14,000 for family coverage.
- **Personal exemption** remains at $0 for 2021.

2021 COLA INCREASES FOR DOLLAR LIMITATIONS ON BENEFITS AND CONTRIBUTIONS

CHANGES FOR 2021

The contribution limit remains at $19,500 for employees who participate in 401(k), 403(b), most 457 plans, and the federal government’s Thrift Savings Plan. The catch-up contribution also remains at $6,500 for employees aged 50 and over who participate in these plans.

The limit on annual contributions to an IRA remains unchanged at $6,000. The additional catch-up contribution limit for individuals aged 50 and over is not subject to an annual cost-of-living adjustment and remains $1,000.

Deductible contributions to a **traditional IRA** may be reduced or eliminated if during the year either the taxpayer or their spouse was **covered by a retirement plan** at work. A phase-out applies based on filing status and income. Here are the phase-out ranges for 2021:

- For single taxpayers covered by a workplace retirement plan, the phase-out range is $66,000 to $76,000.
- For joint filers (where the spouse making the IRA contribution is covered by a workplace retirement plan) the phase-out range is $105,000 to $125,000. If a contributing spouse is not covered by a workplace retirement plan (but their spouse is), the deduction is phased out if the couple’s income is between $198,000 and $208,000.
- For a married individual filing a separate return who is covered by a workplace retirement plan, the phase-out range is not subject to an annual cost-of-living adjustment and remains $0 to $10,000.

TIP: If neither the taxpayer nor their spouse is covered by a retirement plan at work, the phase-outs of the deduction do not apply.

For 2021, the income phase-out range for taxpayers making **contributions** to a **Roth IRA** is $125,000 to $140,000 for singles and heads of household, $198,000 to $208,000 for joint filers, and $0 to $10,000 for married filing separately.

DOLLAR LIMITATIONS FOR 2020 AND 2021

	2020	2021
IRAs		
IRA Contribution Limit	$6,000	$6,000
IRA Catch-Up Contributions	1,000	1,000
SEP		
SEP Minimum Compensation	600	650
SEP Maximum Contribution	57,000	58,000
SEP Maximum Compensation	285,000	290,000
SIMPLE Plans		
SIMPLE Maximum Contributions	13,500	13,500
Catch-up Contributions	3,000	3,000
401(k), 403(b), Profit-Sharing Plans, etc.		
Annual Compensation	285,000	290,000
Elective Deferrals	19,500	19,500
Catch-up Contributions	6,500	6,500
Defined Contribution Limits	57,000	58,000
ESOP Maximum Balance Subject to 5-year Distribution Period	1,150,000	1,165,000
ESOP Limit for Determining Length of 5-year Distribution Plan	230,000	230,000
Other		
HCE Threshold	130,000	130,000
Defined Benefit Limits	230,000	230,000
Key Employee	185,000	185,000
457 Elective Deferrals	19,500	19,500
Control Employee (board member or officer)	115,000	115,000
Control Employee (compensation-based)	230,000	235,000
Taxable Wage Base	137,700	142,800

2021 SAVER'S CREDIT

A taxpayer may claim the nonrefundable saver's credit (formerly retirement savings contributions credit) for qualified contributions or deferrals made to certain retirement plans. The credit amount begins at 50% of the taxpayer's contributions to the plan, contributions up to $2,000 ($4,000 MFJ), and is reduced depending on the taxpayer's adjusted gross income (AGI) and filing status. The maximum credit is $1,000 ($2,000 MFJ).

Credit Rate	Married Filing Jointly	Head of Household	All Other Filers*
50% of your contribution	AGI not more than $39,500	AGI not more than $29,625	AGI not more than $19,750
20% of your contribution	$39,501 – $43,000	$29,626 – $32,250	$19,751 – $21,500
10% of your contribution	$43,001 – $66,000	$32,251 – $49,500	$21,501 – $33,000
0% of your contribution	more than $66,000	more than $49,500	more than $33,000
*Single, married filing separately, or qualifying widow(er).			

NEW STANDARD MILEAGE RATES (NOTICE 2021-02)

DEDUCTION FOR VEHICLE USE

A taxpayer can deduct car expenses for vehicles used exclusively in a trade or business. If using a car for both business and personal purposes, the taxpayer must divide expenses based on actual mileage. Generally, commuting expenses between the taxpayer's home and a business location, within the area of the taxpayer's tax home, are not deductible.

A taxpayer can deduct the business part of the actual vehicle expenses, which include depreciation (or lease payments), gas and oil, tires, repairs, tune-ups, insurance, and registration fees. Or, instead of figuring the business part of these actual expenses, may be able to use the standard mileage rate for business use to figure the deduction.

To qualify to use actual expenses, the taxpayer must use the actual expense method for the first year placing the vehicle in service for business use. A taxpayer may not use the business standard mileage rate for a vehicle after using any depreciation method other than straight-line, or after claiming a Section 179 deduction for that vehicle. The taxpayer can not claim the business standard mileage rate for more than four vehicles used simultaneously. A taxpayer may use the business standard mileage rate for vehicles used for hire, such as taxicabs.

TIP: A taxpayer can choose to use the standard mileage rate method or the actual expenses method. For business use, a taxpayer using the standard mileage rate method, in later years can choose to use the standard mileage rate or switch to actual expenses. However, once a taxpayer uses actual expenses for the vehicle, the taxpayer can not switch to the standard mileage rate. The taxpayer must continue using actual expenses as long as they use that vehicle for business.

Beginning on January 1, 2021, the standard mileage rates are as follows:

- **56 cents** per mile driven for **business** use
- **16 cents** per mile driven for **medical** or **moving** purposes (moving purpose applies only to a member of the Armed Forces on active duty who moves pursuant to a military order and incident to a permanent change of station)
- **14 cents** per mile driven in service of **charitable** organizations

The taxpayer can also deduct the **business** part of the interest on the car loan, state and local personal property tax on the car, parking fees, and tolls, under either method used for business.

TIP: Taxpayers can calculate the actual vehicle expenses or use the standard mileage rate. Note: The calculation of actual vehicle expenses for business use differs from charitable, medical, or moving use.

UPDATE ON CARES ACT PROVISIONS

Several provisions were enacted during the pandemic in 2020 to help individuals and families affected by COVID-19. It is important to understand the implications of these rules in 2021. You should specifically be aware of:

- The resumption of ***required minimum distribution (RMD)*** rules starting in tax year 2021. The CARES Act paused RMDs only for tax year 2020. The requirement to take minimum distributions for IRAs and retirement plans resumes in 2021.
- The required 3-yr repayment of COVID-19 related distributions from retirement accounts.
- The ability for certain taxpayers to claim a ***Recovery Rebate Credit (RRC)*** for stimulus check they qualify for but did not receive.
- The adjustment to income for charitable contributions of cash (up to $300) made by taxpayers who claim the standard deduction. Taxpayers who file jointly may claim $300 for each spouse, increasing the adjustment to $600.

2021 RMD PROVISIONS

Taxpayers generally must begin taking distributions from eligible retirement plans upon reaching age 72. The IRS waived the mandatory distribution requirement for taxpayers subject to the RMD rules in 2020. The waiver applied to defined contribution plans and IRAs, as well as 403(b) and 457 plans. Required distributions from inherited IRAs were also not required in 2020. Required minimum distributions must resume in 2021.

3-YEAR REPAYMENT OF COVID-19 RELATED DISTRIBUTIONS

The CARES Act waived the 10% early withdrawal penalty for up to $100,000 of ***coronavirus-related distributions*** from ***eligible retirement plans*** on or after January 1, 2020, and before December 31, 2020.

Unless the taxpayer elects otherwise, any amount required to be included in gross income for the year of distribution is **spread over the 3-taxable-year period** beginning with such taxable year.

> The taxpayer can treat contributions (up to the amount of the coronavirus-related distribution) made **within 3 years** to eligible retirement plans (including an IRA) the same as if the taxpayer made a direct trustee-to-trustee transfer (rollover) within 60 days of the distribution.

In other words, the taxpayer can ***recontribute*** the money taken as a coronavirus-related distribution back into the plan for a period of 3 years beginning the day after the contribution without penalty or tax consequences. Repaid amounts are not subject to any contribution or rollover limits.

TIP: Taxpayers can claim a refund for any income taxes paid on amounts previously included in income that were subsequently repaid timely.

Only coronavirus-related distributions that are eligible for tax-free rollover treatment under Section 402(c), 403(a)(4), 403(b)(8), 408(d)(3), or 457(e)(16) may be recontributed.

For example, any coronavirus-related distribution from a workplace retirement plan or IRA paid to a qualified individual as a beneficiary of an employee or IRA owner—other than the surviving spouse of the employee or IRA owner—is not eligible to be repaid.

Hardship distributions are not typically an eligible rollover distribution. However, if the hardship distribution meets requirements to be a coronavirus-related distribution, it can be recontributed to an eligible retirement plan.

Taxpayers who take coronavirus-related distributions from qualified plans (including IRAs) use ***Form 8915-E, Qualified 2020 Disaster Retirement Plan Distributions and Repayments,*** to report all distributions for the year, identify coronavirus-related and other qualified disaster distributions, to report repayments made for the year, to calculate the taxable amount of the distributions, and to identify qualified distributions for the purchase or construction of a main home.

Form 8915-E is filed with the tax return, or sent in separately for individuals not otherwise required to file a return. The timing of the distribution determines whether a return needs to be amended to include the form.

RECOVERY REBATE CREDIT

A third round of economic impact payments of ***$1,400 per eligible taxpayer or dependent*** was authorized for distribution beginning in March 2021. Unlike the first two payments, the third payment is not restricted to children under 17. Eligible individuals will get a payment based on all qualifying dependents claimed on their return, including older relatives like college students, adults with disabilities, parents, and grandparents.

Eligibility requirements for the third stimulus payment include:

- Must be US citizen or US resident alien (and their spouse if filing a joint return), and
- Must not be a dependent of another taxpayer
- Adjusted gross income (AGI) not more than:
  1. $150,000 if married and filing a joint return or if filing as a qualifying widow or widower
  2. $112,500 if filing as head of household or
  3. $75,000 for eligible individuals using any other filing status
- Payments are reduced when AGI is above the limits and completely phased out for taxpayers with AGI above:
  1. $160,000 if married and filing a joint return or if filing as a qualifying widow or widower
  2. $120,000 if filing as head of household
  3. $80,000 for eligible individuals using any other filing status

These advance payments are not taxable income as they are a credit against tax. All taxpayers must have a valid Social Security Number (or ATIN for an adopted child) to qualify.

> ***Recovery Rebate Credit (RRC)*** - A taxpayer who qualifies for a stimulus payment but did not receive the full amount may claim a **refundable credit** when filing a 2021 federal income tax return.

CERTAIN CHARITABLE CONTRIBUTIONS DEDUCTIBLE BY NON-ITEMIZERS

Another temporary provision involves a special $300 adjustment for cash contributions to qualified tax-exempt organizations. While this provision benefits the individual as well, it is designed to help charities that are struggling as a result of coronavirus.

Typically only taxpayers who itemize deductions benefit from charitable contributions on their tax return. This special provision is available for taxpayers taking the standard deduction and was introduced for the 2020 tax return (filed in 2021). It allows for an ***above-the-line deduction*** (adjustment) of ***$300*** for cash contributions to qualifying organizations. As part of the passage of the Consolidated Appropriations Act, 2021, this provision was extended for tax year 2021, with minor adjustments. For tax year 2021, married taxpayers filing a joint return are eligible to deduct up to $600 of cash contributions.

Cash contributions include contributions made with a check, credit or debit card (excludes donations of securities, household items, or other property). A taxpayer should verify the organization qualifies using the Tax Exempt

Organization Search tool on the IRS website. Additionally, taxpayers must observe the same recordkeeping requirements for charitable donations detailed in Publication 526.

Along with the introduction of this adjustment for non-itemizers, the IRS increased the penalty assessed under Section 6662 for overstatements of qualified charitable contributions. Section 6662 establishes the accuracy-related penalty for understatements on a tax return. The penalty is generally 20% of the understated amount. For overstatements of the charitable contribution adjustments resulting in underpayments, the penalty increased to 50%.

CURRENT STATUS OF TAX EXTENDERS

Some tax benefits are not permanently written into the code. These benefits expire unless Congress extends the rules into future years by updating the law. We have come to know these "expiring" benefits as extenders.

Unfortunately, Congress doesn't always act in time and benefits expire. This creates a fair amount of uncertainty with these benefits and makes it difficult for taxpayers to plan. Sometimes the changes apply retroactively to prior years requiring taxpayers to file amended returns in order to claim the benefits.

On December 21, 2020, Congress passed the ***Consolidated Appropriations Act, 2021*** which extends or changes certain provisions that expired at the end of 2020.

- **Exclusion of cancellation of debt income from the discharge of qualified principal residence indebtedness** – A taxpayer is able to exclude from gross income a discharge of qualified principal residence indebtedness. This exclusion now applies to discharges made after 2006 and before 2026.
  - Previously this exclusion was extended in one-year increments; however, this exclusion is now extended to include discharges made before January 1, 2026.
  - The Act also reduced the exclusion amount to $750,000 ($375,000 married filing separate) for discharges of indebtedness after December 31, 2020. For discharges prior to 2021, the exclusion amount was $2 million ($1 million if married filing separately). Thus, the maximum amount a taxpayer may treat as qualified principal residence indebtedness is $750,000 ($375,000 if married filing separately) for debt discharged 2021 through 2025.
- **Itemized deduction for qualified mortgage insurance premiums** – The amount paid during the year for qualified mortgage insurance is treated as home mortgage interest (and claimed as an itemized deduction) when the insurance is purchased in connection with the acquisition indebtedness of the taxpayer's qualified residence. This deduction decreases by 10% for each $1,000 ($500 MFS) of AGI above $100,000 ($50,000 MFS). This deduction is extended through December 31, 2021.
- **Nonbusiness energy property credit** – A taxpayer may be able to claim a credit equal to the sum of 10% of the amount paid or incurred for qualified energy efficiency improvements and any residential energy property costs. A total combined credit limit of $500 for all tax years after 2005. If the total of any nonbusiness energy property credits you have taken in previous years (after 2005) is more than $500, you generally can't take the credit. This credit is extended through December 31, 2021.
- **Medical expense deduction AGI limit** – A taxpayer itemizing deductions on Schedule A is able to deduct the amount of medical and dental expenses paid during the tax year that exceed an AGI limit. The temporary 7.5% AGI limit was set to expire and the limit was to increase to the Section 213 10% AGI limit. The ***Consolidated Appropriations Act, 2021*** amended Section 213 and changed the medical expense deduction floor percentage to **7.5%** for taxable years beginning after December 31, 2020. Since the code section was amended, the AGI limit is no longer subject to an extension.
- **Tuition and fees deduction** – The ***Consolidated Appropriations Act, 2021*** provides a provision for the transition from the deduction for qualified tuition and related expenses to an increased income limitation on the lifetime learning credit. The deduction for qualified tuition and fees is **repealed** effective for taxable years beginning after December 31, 2020. Therefore, beginning in 2021, the tuition and fees deduction is no longer available.

- The phaseout limits for the lifetime learning credit increased effective for taxable years beginning after December 31, 2020. Beginning in 2021, the phaseout limits for the Lifetime Learning credit will be the same as the phaseout limits for the American Opportunity credit. Also, like the American Opportunity credit, beginning in 2021 the Lifetime Learning credit phaseout limits will no longer adjust for inflation. Beginning in 2021, the phaseout limits for the lifetime learning credit are:
    1. ***Full credit*** if modified adjusted gross income (MAGI) is $80,000 or less ($160,000 or less for married filing joint).
    2. ***Reduced credit*** if MAGI is over $80,000 but less than $90,000 (over $160,000 but less than $180,000 for married filing joint).
    3. ***No credit*** if MAGI is $90,000 or more ($180,000 or more for married filing joint).

AMERICAN RESCUE PLAN ACT OF 2021 (ARPA)

In March 2021, Congress passed another bill that brought about several changes to important tax benefits. The ***American Rescue Plan Act of 2021*** (ARPA) introduces significant changes in tax year 2021. Of most importance are the changes to the:

- Child Tax Credit
- Earned Income Credit
- Child and Dependent Care Credit
- Employer-Provided Dependent Care Assistance

A short summary of the changes to each credit is listed below:

CHILD TAX CREDIT (CTC)

Child Tax Credit improvements for 2021 include:

1. The credit is fully refundable for qualifying taxpayers
2. Qualifying child age is increased to younger than 18 (previously 17)
3. The credit amount increases to $3,000 (ages 6-17) and $3,600 (5 and under)
4. Income phaseout ranges are reduced
5. Option for annual advance payment of child tax credit

EARNED INCOME CREDIT (EIC)

The changes to the EIC are primarily aimed at strengthening the credit for individuals with no qualifying children and, for the tax year 2021, include:

1. Reduction in the applicable minimum age to 19 (24 and 18 in certain circumstances)
2. Removal of maximum age limit to claim credit (previously capped at age 65)
3. Increased the EIC maximum credit amount for taxpayers with no qualifying children
4. Increased earned income phaseout amounts for those without qualifying children
5. Certain MFS taxpayers may be able to claim credit
6. Increase in disqualified investment income test to $10,000 (up from $3,650)
7. Option to use 2019 AGI/Earned Income to determine 2021 credit if 2019 earned income results in higher credit

CHILD AND DEPENDENT CARE CREDIT

Changes to the Child and Dependent Care Credit make the credit available to more taxpayers as well as increasing the amount of qualifying care expenses subject to the credit.

1. This credit is now refundable
2. Increase in dollar amount for qualifying expenses to $8,000 for one qualifying child and $16,000 for two or more (up from $3,000/$6,000).
3. Increase in applicable percentage to 50% (up from 35%)
4. Addition of 0% credit for taxpayers with income above the AGI phaseout threshold
5. Increase in the income threshold for the maximum applicable percentage to $125,000 (up from $15,000)

6. Established income phaseout range

EMPLOYER-PROVIDED DEPENDENT CARE ASSISTANCE

The act increases the exclusion amount of employer-provided dependent care assistance to $10,500 (half of such amount for MFS). This amount is for the tax year 2021 and is up from $5,000 ($2,500 for MFS) in prior years.

LESSON 2

Domain 2 - General Review

TAXABILITY OF EARNINGS

Gross income includes all income from all sources, whether received in the form of money, goods, property, or services (IRC §67). All transfers of economic benefits are considered income unless specifically exempted under the Internal Revenue Code ("Code").

The tax code excludes certain economic benefits from a taxpayer's income:

- Certain death benefits (§101)
- Gifts and inheritances (§102)
- Interest on state and local bonds (§103)
- Compensation for injuries or sickness (§104)
- Amounts received under accident and health plans (§105)
- Contributions by an employer to accident and health plans (§106)
- Rental value of parsonages for ministers (§107)
- Income from discharge of indebtedness (§108)
- Improvements by the lessee on lessor's property (§109)
- Qualified lessee construction allowances for short-term leases (§110)
- Recovery of tax benefit items (§111)
- Certain combat zone compensation of members of the armed forces (§112)
- Qualified scholarships (§117)
- Meals or lodging furnished for the convenience of the employer (§119)
- Amounts received under qualified group legal services plans (§120)
- Gain from sale of a principal residence (§121)
- Certain reduced uniformed services retirement pay (§122)
- Amounts received under insurance contracts for certain living expenses (§123)
- Cafeteria plans (§125)
- Certain environmentally-related cost-sharing payments (§126)
- Educational assistance programs (§127)
- Dependent care assistance programs (§129)
- Certain personal injury liability assignments (§130)
- Certain foster care payments (§131)
- Specified fringe benefits (§132)
- Certain military benefits (§134)
- Income from United States savings bonds used to pay higher-education tuition and fees (§135)
- Energy conservation subsidies provided by public utilities (§136)
- Adoption assistance programs (§137)
- Medicare Advantage MSA (§138)
- Disaster relief payments (§139)
- Federal subsidies for prescription drug plans (§139A)
- Benefits provided to volunteer firefighters and emergency medical responders (§139B)
- COBRA premium assistance (§139C)
- Indian health care benefits (§139D)

> **EXAMPLE:** Joan works for XYZ, which pays her a salary, provides her with health insurance, and allows her to live in an apartment owned by the company without having to pay any rent. The fair rental value of the apartment (i.e., what the company could have received in rent from a paying tenant) is an economic benefit that has been transferred to Joan and is thus taxable income to her. On the other hand, while the health insurance benefits are also an economic benefit transferred to her, Code section 106 specifically excludes employer-provided health care coverage from income. Thus the amount XYZ pays for Joan's health insurance is not taxable to her.

In some instances, an economic benefit may be only partially excluded from income. For example, a taxpayer has to include part of his or her social security benefits if they were married, but file a separate return, and lived with their spouse at any time during 2021 or if half of the social security benefits plus other gross income and any tax-exempt interest equals more than $25,000 ($32,000 if married filing jointly).

> **EXAMPLE:** Sam and John both receive social security benefits. Sam is married, but lives with his spouse for only 3 days in 2021 and files a separate return. He has $15,000 of taxable income, social security benefits of $12,000, and tax-exempt interest of $2,000). John is single and earns $35,000 from working as a greeter at a local chain store. Both Sam and John will have to include part of their social security benefits in income. This is true for Sam because he lived with his spouse a portion of 2021 (even though it was only 3 days) and files a separate return. John will have to include a portion of his social security benefits because his income exceeds $25,000 ($35,000 in wages). If Sam filed a joint return with his spouse, he could exclude all of his social security benefits. Likewise, if the total of John's income equaled less than $25,000, he would be able to exclude all of his social security benefits.

There is a special rule for individuals who are married and whose permanent home is in one of the nine ***community property states***—Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. In these states, any income that qualifies under state law as "community income" is divided equally between the spouses for tax purposes. Note that same-sex couples in a registered domestic partnership in California, Nevada, and Washington are treated as married for this purpose (but not for filing status purposes, as noted below). This is because those states extend community property rules to registered domestic partners but registered domestic partners are not "married" under state law. Therefore, these taxpayers are not married for federal tax purposes. The inclusion of income for federal tax purposes depends on state property law, not state matrimonial law.

> **EXAMPLE:** Jennifer lives in Nevada and does not work, but her registered domestic partner earns $100,000 of income that is considered community income under state property law. Although Jennifer is not considered married for federal tax purposes and will have to file her federal income tax return as single, she will have to include $50,000 of the community income on that return due to state property law principles.

SCHEDULE B: INTEREST, DIVIDENDS, FOREIGN ACCOUNTS AND TRUSTS

INTEREST (SCHEDULE B, PART I)

A taxpayer must generally report taxable interest from Form 1099-INT (and from Schedule K-1 for partnerships, S corporations, estates, and trusts). Taxable interest includes income from various sources such as the following:

- Bank, savings and loan, or credit union accounts
- Certificates of deposit
- U.S. Treasury bills, notes, and bonds (exempt from all state and local income taxes)
- Loans made to others
- Gifts more than $10 for opening financial accounts ($20 if the account is more than $5,000)

- Interest received on tax refunds
- U.S. Savings Bond interest
  - Series H and HH – report semi-annual interest payments in the year received.
  - Series I, E, and EE – interest is credited at maturity. Taxpayers who use the cash method of accounting may elect to defer reporting interest until maturity; those using the accrual method must report interest on U.S. savings bonds each year as it accrues. Interest may be tax-free if used for qualified education expenses.

TIP: Interest from Series I or EE bonds may be tax-free if used to pay for qualified education expenses the same year. This exclusion is known as the Education Savings Bond Program and is not available when married filing separately. A taxpayer uses Form 8815 to figure the exclusion and attaches the form to Form 1040.

DIVIDENDS (SCHEDULE B, PART II)

ORDINARY DIVIDENDS

Ordinary (taxable) dividends are the most common type of distribution from a corporation. The corporation pays ordinary dividends out of its earnings and profits, and the shareholders must report such payments as ordinary income.

QUALIFIED DIVIDENDS

Qualified dividends are subject to the same 0%, 15%, or 20% maximum tax rates that apply to ***net capital gain***.

DIVIDENDS USED TO BUY MORE STOCK

Some corporations have dividend reinvestment plans that allow for the purchase of more stock in the corporation instead of receiving the dividends in cash. Taxpayers who are members of this type of plan must report the dividends as income. If the plan allows the purchase of more stock at a price less than its fair market value, the taxpayer must report the fair market value of the additional stock as dividend income on the dividend payment date.

MONEY MARKET FUNDS

A taxpayer reports amounts received from money market funds as dividend income. Money market funds are a type of mutual fund, not to be confused with bank money market accounts that pay interest.

CAPITAL GAIN DISTRIBUTIONS

Capital gain distributions reflect income paid or credited to the taxpayer's account by mutual funds (or other regulated investment companies) and real estate investment trusts (REITs). A taxpayer must report capital gain distributions as long-term capital gains regardless of how long the taxpayer has owned the shares of the mutual fund or REIT.

FOREIGN ACCOUNTS AND TRUSTS (SCHEDULE B, PART III)

Taxpayers must complete **Schedule B Part III Foreign Accounts and Trusts** if (a) had over $1,500 of taxable interest or ordinary dividends; (b) had a foreign account; or (c) received a distribution from, or were a grantor of, or a transferor to, a foreign trust. Also, if required to file FinCEN Form 114, enter the name of the foreign country where the financial account is located on Part III.

The ***Foreign Account Tax Compliance Act (FATCA)*** is a tax law addressing tax non-compliance by U.S. taxpayers with foreign accounts by focusing on reporting by U.S. taxpayers and foreign financial institutions.

In general, federal law requires U.S. citizens and resident aliens to report any **worldwide income**, including income from foreign trusts and foreign bank and securities accounts. In most cases, affected taxpayers need to complete and attach Schedule B to their tax returns. **Part III of Schedule B asks about the existence of foreign accounts**, such as bank and securities accounts, and generally requires U.S. citizens to report the country in which each account is located.

RETIREMENT INCOME REPORTING AND TAXABILITY

SOCIAL SECURITY BENEFITS

A taxpayer whose modified AGI plus one-half of the social security benefits received (including Tier 1 Railroad Retirement benefits) for a tax year exceeds either of two threshold amounts is taxed on a portion of social security benefits received that year. “Modified AGI” for this purpose means AGI increased by the amount of tax-exempt interest received or accrued by a taxpayer during the tax year and determined without regard to: the social security benefits; the deduction for qualified education loan interest; the exclusions for foreign earned income and housing costs; savings bond proceeds for education expenses; employer-provided adoption assistance; and income from sources within U.S. possessions and Puerto Rico.

A “base amount” is used in determining the taxability of social security benefits under the first threshold. This base amount is $32,000 for individuals filing married-joint returns; zero for individuals filing married-separate returns; and $25,000 for all other individuals. If modified AGI plus one-half of the social security benefits received exceeds the applicable base amount, the taxpayer must include in gross income the lesser of: (1) 50% of the social security benefits received that year or (2) 50% of the excess of modified AGI plus one-half of the social security benefits received over the base amount.

> **EXAMPLE:** Gertrude and Gary receive social security benefits of $10,000. They file a married-joint return which includes modified AGI consisting of pension income of $22,000. The sum of their modified AGI plus one-half of the social security benefits received is $27,000 ($22,000 + $5,000). Since this is less than their base amount of $32,000, no part of the social security benefits is taxable.

An “adjusted base amount” is used in determining the taxability of social security benefits under the second threshold. The adjusted base amount is $44,000 for married individuals filing jointly; zero for a married individual filing separately; and $34,000 for all other individuals.

If modified AGI plus one-half of the social security benefits received exceeds the applicable adjusted base amount, the taxpayer must include in gross income the lesser of: (1) 85% of the social security benefits received that year; or (2) the sum of: (a) the amount included under the first threshold rule or, if less, one-half of the difference between taxpayer's adjusted base amount and base amount, plus (b) 85% of the excess of modified AGI plus one-half of the social security benefits received over the “adjusted base amount.”

PENSIONS, ANNUITIES, 401(K), AND IRA DISTRIBUTIONS

TAXABILITY AND PENALTIES FOR EARLY WITHDRAWAL

Taxpayers can take distributions from their IRAs (including SEP-IRAs and SIMPLE-IRAs) at any time. There is no need to show a hardship to take a distribution. However, the distribution is includible in taxable income and may be subject to a 10% additional tax if the taxpayer is under age 59.5. The additional tax is 25% if the taxpayer takes a distribution from their SIMPLE-IRA in the first 2 years they participate in the SIMPLE IRA plan. There is no hardship exception to these additional taxes.

Required minimum distributions (“RMDs”) must be taken from a traditional IRA each year beginning with the year the taxpayer turns 72. The RMD for each year is calculated by dividing the IRA account balance as of December 31 of the prior year by the applicable distribution period or life expectancy. The RMD requirements do not apply to Roth IRAs. The recent passage of the Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act) increased the age threshold for the beginning RMD date. Previously, the RMD age threshold was 70.5. For taxpayers who did not reach age 70.5 before January 1, 2020, the increased RMD age threshold applies.

> A taxpayer may **defer the first-year distribution to April 1** of the year following the year in which the taxpayer reaches age 72 (or 70.5). This is referred to as the ***required beginning date***. The taxpayer must withdraw the RMD for any year after the year attaining age 72 by December 31 of that later year.

TIP: For 401(k), profit-sharing, 403(b), or other defined contribution plans the required beginning date may be delayed until April 1 following the year the participant retires from the employer sponsoring the plan.

In general, distributions from a traditional IRA or qualified plan are taxable in the year the taxpayer receives them. Distributions are made from a designated Roth account, however, are not included in gross income. A qualified distribution is generally a distribution that is: (1) made after a period of participation of 5 or more tax years and (2) made on or after the date the taxpayer reaches age 59.5, made to a beneficiary of the taxpayer's estate on or after the taxpayer's death, or made on account of the disability of the taxpayer.

Taxpayers typically have not made any contributions to a traditional pension or defined benefit plans and therefore distributions from these plans are almost always fully taxable. A distribution will be only partially taxable, however, if the taxpayer has an unrecovered basis in the traditional IRA or defined contribution plan when the distribution is made. If only deductible contributions were made to the taxpayer's traditional IRA or defined contribution plan, then he or she has no basis to recover and any distributions are fully taxable when received. If, on the other hand, nondeductible (***i.e***., after-tax) contributions were made or rolled over to a traditional IRA or defined contribution plan, there is a cost basis or investment in the contract equal to the amount of those contributions. Those nondeductible contributions are not taxed when they are distributed to the taxpayer but rather are a nontaxable return of the taxpayer's investment.

Retirement plan and annuity payments (including military retirement pay) should be reported to the taxpayer on Form 1099-R.

Benefits distributed from an IRA or qualified retirement plan are generally taxable to the participant or beneficiary who is entitled to the distribution. For example, a taxpayer, not his ex-wife, was deemed to be the taxable recipient of pension benefits even though his divorce decree contained a provision that required him to pay his ex-wife a monthly amount from his pension plan "if, as, and when" he received a payment from the plan (***see Platt v. Commissioner, TC Memo 2008-17***). However, a participant's spouse or former spouse is taxable on any distribution that is made to the spouse (or former spouse) as an "alternate payee" under a qualified domestic relations order ("QDRO").

IRA ROLLOVER PER YEAR LIMIT

Generally, a distribution from an IRA or a qualified plan is includible in gross income. There are important exceptions to this rule regarding "rollovers." An IRA rollover is defined as a distribution from the IRA to the taxpayer that is subsequently re-deposited by the taxpayer into the same IRA account or into another IRA. Rollovers are distinguished from trustee-to-trustee transfers, where the funds are paid directly by one IRA trustee to another IRA trustee and conversions of traditional IRAs into Roth IRAs.

With respect to rollovers, a taxpayer does not have to include in gross income any amount distributed from an IRA if that taxpayer deposits the amount into another eligible plan (including an IRA) within 60 days (***see IRC § 408(d)(3)***). This provides for a great deal of planning flexibility for taxpayers, allowing, for example, a taxpayer to use amounts in their IRA account for a short-term financial need. As long as the withdrawn amount is re-deposited into a qualified account within 60 days, there is no income inclusion.

Note, however, that a rollover generally requires that 20% of the amount distributed be withheld for taxes. This is the case unless the payout: (1) is part of (or in excess of) a required minimum distribution; (2) a distribution that constitutes one of a series of substantially equal periodic payments; or (3) a hardship distribution from a 401(k) or 403(b) plan. A hardship distribution is one made on account of an immediate and heavy financial need that is necessary to satisfy that need. The financial need must be for medical care, housing, or educational expenses. A series of substantially equal periodic payments must be made at least annually for a specified period of at least ten years or for the life (or life expectancy) of the recipient or joint lives or expectancies of the recipient and the designated beneficiary.

The tax statute law limits the taxpayer to one IRA-to-IRA rollover in any 12-month period. (***see IRC § 408(d)(3)(B)***). In the past, the IRS has interpreted this limitation as applying on an IRA-by-IRA basis, meaning that a rollover from one IRA to another would not affect a rollover involving ***other*** IRAs of the same individual. In other words, a taxpayer could engage in as many rollovers as he or she wished, as long as they were from different IRA accounts.

This has all been changed, however, by a 2014 Tax Court decision involving tax attorney Alvan Bobrow (***see Bobrow v. Commissioner, T.C. Memo 2014-21***). Alvan maintained two separate IRA accounts and during one year he took distributions from each of them. Arguably, he re-deposited the distributions within 60 days. There was a dispute as to the effective dates of the re-deposits. The Tax Court held that the statute's limitation, contrary to the IRS's previous position, refers to any ***amount*** characterized as a nontaxable rollover contribution by virtue of that amount being repaid into a qualified plan within 60 days. In other words, the separate identity of multiple IRAs is irrelevant – one rollover per year is all that is allowed regardless of the number of accounts.

Shortly after the Tax Court decision in ***Bobrow***, the IRS announced that it would apply the court's interpretation going forward. As a consequence, a taxpayer can make only a single rollover from one IRA to another (or the same) IRA in any 12-month period, regardless of the number of IRAs the taxpayer owns. For the purpose of applying the limit, all of the taxpayer's IRA accounts are treated as one IRA, so that the limit is applied by aggregating all of the IRAs, including SEP and SIMPLE IRAs as well as traditional and Roth IRAs.

Since the limitation only applied to rollovers, other transactions escape the application of the limit. For example, trustee-to-trustee transfers between IRAs are not limited. Likewise, conversions from traditional IRAs to Roth IRAs are not limited.

As a result of ***Bobrow***, if the taxpayer receives a distribution from an IRA of previously untaxed amounts, he or she must include the amounts in gross income if they made an IRA-to-IRA rollover at any time during the preceding 12 months and will be subject to the 10% early withdrawal tax on the amounts included in gross income if the taxpayer has not reached the age of 59.5. If the limitation is violated and the taxpayer deposits the distributed amounts into another (or the same) IRA, such amounts may be treated as excess contributions and taxed at 6% per year as long as they remain in the IRA.

ROTH RECHARACTERIZATION RULES

Contributions to traditional IRAs and to Roth IRAs must be segregated into separate IRAs, meaning arrangements with separate trusts, accounts, or contracts, and separate IRA documents. Except in the case of conversion or recharacterization, amounts cannot be transferred or rolled over between the two types of IRAs.

Taxpayers generally may convert an amount in a traditional IRA to a Roth IRA. The amount converted is **includible in the taxpayer's income** as if a withdrawal had been made. Subject to various exceptions, distributions from an IRA before age 59.5 that are includible in income are subject to a 10% early distribution tax under section 72(t). An exception applies to amounts includible in income as a result of the conversion from a traditional IRA into a Roth IRA. However, the early distribution tax applies if the taxpayer withdraws the amount within five years of the conversion. The conversion is accomplished by a trustee-to-trustee transfer of the amount from the traditional IRA to the Roth IRA, or by a distribution from the traditional IRA and contribution to the Roth IRA within 60 days.

Rollovers to IRAs of distributions from tax-favored employer-sponsored retirement plans (that is, qualified retirement plans, tax-deferred annuity plans, and governmental eligible deferred compensation plans) are also permitted. For tax-free rollovers, distributions from pretax accounts under an employer-sponsored plan generally must are contributed to a traditional IRA, and distributions from a designated Roth account under an employer-sponsored plan must be contributed only to a Roth IRA. However, a distribution from an employer-sponsored plan that is not from a designated Roth account is also permitted to be rolled over into a Roth IRA, subject to the rules that apply to conversions from a traditional IRA into a Roth IRA. Thus, a rollover from a tax-favored employer-sponsored plan to a Roth IRA is includible in gross income (except to the extent it represents a return of after-tax contributions).

RECHARACTERIZATION OF IRA CONTRIBUTIONS

If an individual makes a contribution to an IRA (traditional or Roth) for a taxable year, the individual is permitted to recharacterize the contribution as a contribution to the other type of IRA (traditional or Roth) by making a trustee-to-trustee transfer to the other type of IRA before the due date for the individual's income tax return for that year. In the case of a recharacterization, the contribution will be treated as having been made to the transferee IRA (and not the original, transferor IRA) as of the date of the original contribution.

The amount transferred in a recharacterization must be accompanied by any net income allocable to the contribution. In general, even if a recharacterization is accomplished by transferring a specific asset, net income is calculated as a pro-rata portion of the income on the entire account rather than income allocable to the specific asset transferred.

> Under the TCJA, the rule that permits a contribution to one type of IRA to be recharacterized as a contribution to the other type of IRA does not apply to a **conversion contribution to a Roth IRA**. Thus, recharacterization cannot be used to unwind a Roth conversion. However, recharacterization is still permitted with respect to other contributions. For example, an individual may make a contribution for a year to a Roth IRA and, before the due date for the individual's income tax return for that year, recharacterize it as a contribution to a traditional IRA. Effective for taxable years beginning after December 31, 2017.

ANALYSIS

A conversion of a traditional IRA to a Roth IRA, and a rollover from any other eligible retirement plan to a Roth IRA, made after December 31, 2017, cannot be recharacterized as having been made to a traditional IRA.

When converting to a Roth IRA, the contributions that were previously deductible are included in the taxpayer's income. If the value of the assets in the Roth IRA decline after the conversion, under prior rules the taxpayer was able to reverse the conversion (and effectively not include the converted balance in income) by recharacterizing that IRA as a traditional IRA. The individual could then later convert that traditional IRA to a Roth IRA (referred to as a reconversion), including only the lower value in income. The new provision closes this loophole.

INDIVIDUAL RETIREMENT ACCOUNTS (IRAS)

TYPES OF IRAS

An ***Individual Retirement Account*** (IRA) is a trust or custodial account set up in the United States for the exclusive benefit of a taxpayer or their beneficiaries. The two commonly discussed individual retirement accounts are traditional IRAs and Roth IRAs.

In a **traditional IRA**, contributions may be tax-deductible, and amounts in the IRA, including earnings and gains, are not taxed until distributed. Traditional IRAs require distributions to begin at a certain age.

In a **Roth IRA**, contributions are not tax-deductible, and qualified distributions, including earnings and gains, are typically not taxed, even when distributed. Roth IRAs are not subject to required distributions at any age.

CONTRIBUTIONS

A taxpayer can make contributions to traditional IRAs and Roth IRAs at any time during the year or by the due date for filing the return for that year, not including extensions. For most taxpayers, this is April 15. There is no age limit on making ***regular contributions*** to traditional IRAs or Roth IRAs. (Previously, traditional IRAs had a contribution age limit.) ***Catch-up contributions*** for traditional and Roth IRAs are for taxpayers age 50 or older.

Taxpayers can set up and contribute to ***traditional IRAs*** or ***Roth IRAs*** only if the taxpayer or spouse received ***taxable compensation*** during the year.

For 2021, the **total contributions** a taxpayer can make to all their ***traditional IRAs*** and ***Roth IRAs*** cannot exceed the smaller of the following:

- **$6,000 ($7,000 if age 50 or older**, due to a $1,000 catch-up contribution)
- 100% of taxable compensation for the year

The total contributions a taxpayer can make each year to all their traditional IRAs and Roth IRAs can not exceed the general IRA contribution limit.

Roth IRA contributions might be further limited if the taxpayer's income exceeds a certain level. ***Traditional IRA contributions*** are not limited based on the taxpayer's income level.

If a taxpayer files a joint return, the taxpayer may be able to contribute to a ***traditional IRA*** or ***Roth IRA*** even if the taxpayer did not have taxable compensation as long as the taxpayer's spouse did. Each spouse can make a contribution up to the current limit; however, the total of the combined contributions (taxpayer's and spouse's) can not be more than the taxable compensation reported on their joint return.

Individuals can have a traditional IRA even if covered by another retirement plan. Contributions may not be deductible if the taxpayer (or spouse) is covered by an employer retirement plan. If both a taxpayer and a spouse have compensation each can set up an IRA; however, they cannot participate in the same IRA. If filing a joint return, only one spouse needs to have compensation.

A taxpayer can contribute to a traditional IRA or Roth IRA even if they participate in another retirement plan through their employer or business. The IRA contribution limit is not limited if an employer retirement plan covers either the taxpayer or spouse at any time during the year. Employer retirement plans do not affect the amount a taxpayer can contribute to a traditional IRA or Roth IRA.

Excess Contributions

Contributions above the allowed limits are ***excess contributions***. For purposes of determining excess contributions, any contribution that is withdrawn on or before the due date (including extensions) for filing the tax return for the year is **treated as an amount not contributed**. This treatment only applies if any earnings on the contributions are also withdrawn. The earnings are considered earned and received in the year the excess contribution was made. The taxpayer will include the interest or other income that was earned on the excess contribution in gross income on the return for the year in which the excess contribution was made. The withdrawal of interest or other income may be subject to an additional 10% tax on early distributions.

A **6% excise tax** applies if the taxpayer does not withdraw excess contributions (and interest or other income resulting from the contribution) by the due date of the return (including extensions).

DEDUCTIONS

Traditional IRA contributions may be tax-deductible. The deduction may be limited if the taxpayer or taxpayer's spouse is covered by a retirement plan at work and the taxpayer's modified adjusted gross income (MAGI) exceeds certain levels.

Generally, the **deduction** is the lesser of the following:

- The actual contributions to a traditional IRA for the year
- The general limit on contributions (or the spousal IRA contribution limit, if it applies)

The deduction may be limited if an employer's retirement plan covers either spouse at any time during the year for which contributions are made. **The deduction limitation does not affect the amount that the taxpayer can contribute.**

The deduction amount is decreased (phased out) when income rises above a certain amount, and it is eliminated altogether when it reaches a higher amount. These amounts vary depending on filing status.

Effect of MAGI on Deduction if Taxpayer Is Covered by a Retirement Plan at Work – 2021		
IF your filing status is	**AND** your modified AGI is	**THEN** you can take
single or head of household	$66,000 or less	a full deduction
	between $66,000 – $76,000	a partial deduction
	$76,000 or more	no deduction
married filing jointly or qualifying widow(er)	$105,000 or less	a full deduction
	between $105,000 – $125,000	a partial deduction
	$125,000 or more	no deduction
married filing separately	less than $10,000	a partial deduction
	$10,000 or more	no deduction

Effect of MAGI on Deduction if Taxpayer Is NOT Covered by Retirement Plan at Work – 2021		
IF your filing status is	**AND** your modified AGI is	**THEN** you can take
single, head of household, or qualifying widow(er)	any amount	a full deduction
married filing jointly or **separately** and spouse is not covered by a plan at work	any amount	a full deduction
married filing jointly and spouse is covered by a plan at work	$198,000 or less	a full deduction
	between $198,000 – $208,000	a partial deduction
	$208,000 or more	no deduction
married filing separately with a spouse who is covered by a plan at work	less than $10,000	a partial deduction
	$10,000 or more	no deduction

TIP: If you file separately and did not live with your spouse **at any time** during the year, your IRA deduction is determined under the "Single" filing status.

> **EXAMPLE:** Tony is 29 years old and single. In 2021, he was covered by a retirement plan at work. His salary is $67,000. His modified AGI is $80,000. Tony makes a $6,000 IRA contribution for 2021. Because he was covered by a retirement plan and his modified AGI is above $76,000, he can't deduct his $6,000 IRA contribution. He must designate this contribution as a nondeductible contribution by reporting it on Form 8606.
>
> If Tony was not covered by a retirement plan at work, he would not be limited by his modified AGI and could take a full deduction for his IRA contribution.

TIP: Contributions to Roth IRAs are not deductible; however, qualified distributions (including earnings and gain) are generally tax-free.

DISTRIBUTIONS

TRADITIONAL IRA

Amounts in a traditional IRA, including earnings and gains, are **not taxed until distributed.** A taxpayer must include distributions from a traditional IRA, other than the taxpayer's cost (basis), in gross income. A traditional IRA consisting only of deductible contributions and earnings does not have a basis.

Although the deduction for traditional IRA contributions may be reduced or eliminated, contributions can be made up to the general limit or, if it applies, the spousal IRA limit. The difference between the total permitted contributions and the IRA deduction is a ***nondeductible contribution***. A nondeductible contribution increases the basis of the IRA and is not taxable when withdrawn. The IRS treats ***distributions of basis*** as a tax-free return of principal (not income).

For ***individual retirement arrangements (IRA)*** basis equals the amount of after-tax (non-deductible) contributions remaining within the plan. A taxpayer who made nondeductible contributions has a cost basis equal to the sum of the nondeductible contributions minus any withdrawals or distributions of nondeductible contributions. Contributions that the taxpayer excludes from gross income do not increase basis.

If the IRA has a basis resulting from nondeductible contributions, distributions consist partly of nondeductible contributions (basis) and partly of deductible contributions, earnings, and gains (if any). Until the entire basis has been distributed, each distribution is partly nontaxable and partly taxable. To determine the nontaxable percentage of the distribution, divide the basis at the beginning of the year (plus contributions for the tax year) by the total value of all IRAs at the end of the year (plus distributions in the tax year).

Generally, a taxpayer must make annual withdrawals from a qualified retirement plan (including a traditional IRA) upon reaching age 72 (or age 70.5 if turned 70.5 prior to January 1, 2020). RMDs must begin no later than April 1st of the year following the year the taxpayer turns 72. If distributions are less than the ***required minimum distribution (RMD)*** for the year, taxpayers may have to pay a **50% excise tax on the amount not distributed as required**.

ROTH IRA

Qualified distributions from a ***Roth IRA*** may be **tax-free**. A qualified distribution meets both of the following requirements:

- Made after the **five-year** period beginning with the first year a contribution was made, and
- Meets one of the following criteria:
  1. Made on or after the date the taxpayer reaches **age 59.5**
  2. Meets one of the exceptions to distributions from an IRA listed below under Additional Tax (10% Penalty)

If a taxpayer receives a distribution that is not a ***qualified distribution***, they may have to pay the 10% additional tax on early distributions. The 5-year period used for determining whether the 10% early distribution tax applies to a distribution from a conversion or rollover contribution is separately determined for each conversion and rollover and is not necessarily the same as the 5-year period used for determining whether a distribution is a qualified distribution. Begin counting the five-year period on January 1 of the contribution year (regardless of when during the year the contribution is made).

> **EXAMPLE:** For example, if a calendar-year taxpayer makes a conversion contribution on February 25, 2022, and makes a regular contribution for 2021 on the same date, the 5-year period for the conversion begins January 1, 2022, while the 5-year period for the regular contribution begins on January 1, 2021.

Most retirement plan withdrawals are subject to income tax, including ***qualified distributions***. Withdrawals other than qualified distributions may be subject to a 10% additional tax on the distribution. This additional tax applies to the part of the distribution the individual must include in income and is in addition to any regular income tax on that amount.

For a ***Roth*** retirement plan, amounts can remain in the account until the taxpayer dies (**no RMD**). Mandatory distributions are not required when attaining age 72 (or 70.5) for a Roth account.

ADDITIONAL TAX (10% PENALTY)

The amount a taxpayer withdraws from a retirement plan before **reaching age 59.5** is called "early" or "premature" distributions. To discourage the use of retirement funds for purposes other than normal retirement, the law imposes an additional 10% tax on certain early distributions from certain retirement plans. The additional tax is equal to 10% of the portion of the distribution that is includible in income. Distributions that aren't taxable, such as distributions that are rolled over to another qualified retirement plan, aren't subject to this additional 10% tax.

Taxpayers must pay the additional 10% early withdrawal tax, often called a penalty, unless an exception applies.

The following exceptions apply to early distributions from IRAs:

- Distributions made to a beneficiary or estate on or after the owner's death
- Distributions made because the taxpayer is totally and permanently disabled
- Distributions made as part of a series of substantially equal periodic payments over taxpayer's life expectancy or the life expectancies of the taxpayer and their designated beneficiary
- Distributions to the extent taxpayer has deductible medical expenses that exceed **7.5%** of adjusted gross income regardless of whether they itemize deductions for the year

  TIP: A taxpayer does not have to itemize deductions to take advantage of this exception to the additional tax. However, a taxpayer can only take into account unreimbursed medical expenses includable in figuring a deduction for medical expenses on Schedule A. The exception amount is the amount paid for unreimbursed medical expenses the tax year minus 7.5% of AGI.
- Distributions made due to an IRS levy of the plan
- Distributions that are qualified military reservist distributions (generally, these are distributions made to individuals called to active duty for at least 180 days after September 11, 2001)
- Distributions that are excepted from the additional income tax by federal legislation relating to certain emergencies and disasters. Made as a qualified disaster distribution related to certain federally declared disasters (limited to $100,000 for qualified hurricane distributions and a separate $100,000 for qualified wildfire distributions)

  TIP: Participants taking a qualified disaster distribution can include it in income in equal amounts over three years, beginning with the year that includes the distribution date. Participants may also repay qualified disaster distributions within three years of receiving a distribution by making one or more contributions to an eligible retirement plan. Any repayment is treated as a trustee-to-trustee transfer.

- Distributions up to **$5,000** if the distribution is a qualified birth or adoption distribution:
  1. 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)
  2. Must include the name, age, and TIN of such child or eligible adoptee on the taxpayer's return
  3. 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
  4. 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
- Qualified first-time homebuyer distributions, if the distribution is to buy, build, or rebuild a first home:
  1. Up to **$10,000** for qualified acquisition costs if used within 120 days of the distribution
  2. $10,000 for **each spouse** if both are first-time homebuyers (a first-time homebuyer cannot own a main home during the two-year period ending on the date of acquisition of the home)
  3. Must be used for qualified acquisition costs for the main home of a taxpayer, spouse, child, grandchild, parent, or other ancestors
- Distributions are not in excess of the taxpayer's qualified higher education expenses (the education must be for the taxpayer, taxpayer's spouse, or the children or grandchildren of the taxpayer or taxpayer's spouse)
- Distributions are not in excess of certain health insurance premiums paid while unemployed
- Returned IRA contributions (and associated earnings) if withdrawn by extended due date of the return (Note: the exception to the additional tax does not apply to the earnings on these returned contributions)

TIP: Distributions that are rollovers or transfers to another IRA or qualified retirement plan aren't subject to this additional 10% tax. This is true as long as the taxpayer follows the one IRA-to-IRA rollover per year rule.

INHERITED IRAS

Most beneficiaries of a traditional IRA from decedents who die after December 31, 2019, must withdraw the entire IRA account balance by the end of the 10th year after the IRA owner's death. The 10-year withdrawal rule offers flexibility regarding the timing and amount of distributions, as it does not require annual withdrawals, funds can be withdrawn in any amount, at any time over the course of the 10-years, as long as all funds are withdrawn within 10 years after the year of the account owners death. The new 10-year rule applies regardless of whether the participant dies before, on, or after, the required beginning date, which is now age 72.

There is an exception to the 10-year withdrawal rule for certain eligible designated beneficiaries. Eligible designated beneficiaries include:

- a surviving spouse
- a child of the account owner who has not reached the age of majority
  1. does not include minor grandchild of the account owner
  2. the age of majority is a matter of state law (most states deem an individual to have reached the age of majority upon turning 18)
  3. a child may be treated as having not reached the age of majority if the child has not completed a "specified course of education" and is under the age of 26
  4. once the child reaches the age of majority, the child is no longer an eligible designated beneficiary and the 10-year withdrawal rule applies
- a disabled or chronically ill person
- a person not more than ten years younger than the IRA account owner

These eligible designated beneficiaries are subject to the pre Secure Act withdrawals rules for non-spouse designated beneficiaries.

UNEMPLOYMENT COMPENSATION REPORTING AND TAXABILITY

The tax treatment of unemployment benefits you receive depends on the type of program paying the benefits.

Unemployment compensation includes any amount received under an unemployment compensation law of the United States or of a state. It includes the following benefits:

- Paid by a state or the District of Columbia from the Federal Unemployment Trust Fund.
- State unemployment insurance benefits.
- Railroad unemployment compensation benefits.
- Disability payments from a government program paid as a substitute for unemployment compensation. (Does not include Workers' Compensation for injuries or illness)
- Trade readjustment allowances under the Trade Act of 1974.
- Unemployment assistance under the Disaster Relief and Emergency Assistance Act of 1974.
- Unemployment assistance under the Airline Deregulation Act of 1978 Program.

Generally, a taxpayer receiving unemployment compensation during the year must ***include*** it in gross income. Taxpayers receiving unemployment compensation benefits have the option to have federal income tax withheld.

For those who opt out of withholding of federal income tax, quarterly estimated tax payments may be required to avoid an underpayment penalty.

Unemployment compensation payments are reported to the taxpayer on ***Form 1099-G, Certain Government Payments***. The amount of compensation and any taxes withheld are included on the individual's tax return on ***Schedule 1***. Total unemployment compensation for the return is reported on Line 7 of Schedule 1. Withholding from unemployment shows up on Form 1040 at line 25b, ***Federal income tax withheld, Other Forms***.

ALIMONY

The taxation of alimony payments will depend on when the divorce or separation instrument was **executed** or **modified**.

AGREEMENTS EXECUTED AFTER 2018

Under the Tax Cuts and Jobs Act, the payment of alimony and separate maintenance under a divorce or separate maintenance agreement (or modifications to prior agreements that account for the new TCJA provision) **executed after December 31, 2018**, is no longer deductible by the payor spouse and is no longer includible in income by the payee spouse.

The intent of the provision is to follow the rule of the United States Supreme Court's holding in ***Gould v. Gould 245 U.S. 151 (1917)***, in which the Court held that such payments are not income to the recipient. Income used for alimony payments is taxed at the rates applicable to the payor spouse rather than the recipient spouse.

Under the provision, any divorce or separation instrument executed after December 31, 2018, including the modification of a prior instrument that expressly provides that the amendments made by this section apply to such modification, alimony and separate maintenance payments are not deductible by the payor spouse. The provision also repeals Code provisions that specify that alimony and separate maintenance payments are included in income. Payments of alimony under this provision are handled in the same manner as child support, not deductible and not includible in income.

AGREEMENTS EXECUTED IN 2018 OR EARLIER

Under prior rules, alimony is deductible by the payor and includible in the recipient's income for a divorce or separation instrument **executed on or before December 31, 2018**, even when payments are made after 2018.

> If a prior year agreement is **modified after December 31, 2018**, the tax treatment will follow the old rules unless the modification **expressly states** the repeal of the deduction for alimony payments applies to the modification, or if the agreement is changed to expressly provide that alimony received is not included in income.

SCHEDULE C: PROFIT OR LOSS FROM BUSINESS (SOLE PROPRIETORSHIP)

DETERMINATION OF INCOME AND EXPENSES

GROSS RECEIPTS

Income from self-employment is reported on Schedule C of Form 1040. In general, self-employment income includes any non-wage income received from a continuous, regular activity engaged in with a profit motive, including income from rents and bartering. Taxpayers report both the gross income earned from self-employment and deductions allowable against self-employment income on Schedule C.

The taxpayer must report all income received from the taxpayer's business unless it is excluded by law, regardless of whether or not the taxpayer received a Form 1099-MISC, 1099-NEC, or other information reports of the income. Business income may be in cash, but can also be in other forms, such as property or services.

For example, bartering is an exchange of property or services. The taxpayer must include, at the time received, the fair market value of property or services the taxpayer receives in exchange for something else. If the taxpayer exchanges services with another person and they both have agreed ahead of time on the value of the services, that value will be accepted as the fair market value unless the value can be shown to be otherwise.

Suppose the taxpayer is a self-employed lawyer. Assume the taxpayer performs legal services for a client, a small corporation. In payment for his services, the taxpayer receives shares of stock in the corporation. Under these circumstances, the taxpayer must include the fair market value of the shares in gross income. Likewise, suppose the taxpayer is an artist and creates a work of art to compensate her landlord for the rent-free use of the taxpayer's apartment. The taxpayer must include the fair rental value of the apartment in gross receipts. Note that the taxpayer's landlord must include the fair market value of the work of art in his or her rental income.

While rental income is commonly included on Schedule E, Schedule C is used when the taxpayer provides "substantial services" in conjunction with the property or when the rental is part of the taxpayer's trade or business as a real estate dealer. Substantial services include regular cleaning, changing linens, and maid service. Substantial services do not include the furnishing of heat and light, cleaning of public areas, trash collection, etc. Thus, if the taxpayer is a real estate dealer who receives income from renting real property or an owner of a hotel, motel, etc., who provides services (maid services, etc.) for guests, he or she should report the rental income and expenses on Schedule C. The taxpayer is a real estate dealer if the taxpayer is engaged in the business of selling real estate to customers with the purpose of making a profit from those sales

Advance payments received under a lease that does not put any restriction on the use or enjoyment of the funds are included in gross income in the year the taxpayer receives them. This is true no matter what accounting method or period the taxpayer uses. Likewise, a bonus the taxpayer receives from a lessee for granting a lease or payments the taxpayer receives from the lessee for canceling a lease should be included in the taxpayer's gross receipts in the year received.

If the taxpayer's lessee makes payments to someone else under an agreement to pay the taxpayer's debts or obligations, include the payments in the taxpayer's gross receipts when the lessee makes the payments. A common example of this kind of income is a lessee's payment of the taxpayer's property taxes on the leased real property.

Payments the taxpayer receives in settlement of a lessee's obligation to restore the leased property to its original condition are income in the amount that the payments exceed the adjusted basis of the leasehold improvements destroyed, damaged, removed, or disconnected by the lessee.

Interest and dividends may also be considered business income. For example, interest received on notes receivable that the taxpayer has accepted in the ordinary course of business is business income. Interest received on loans is business income if the taxpayer is in the business of lending money.

Generally, dividends are business income to dealers in securities. For most sole proprietors and statutory employees, however, dividends are nonbusiness income. If the taxpayer holds stock as a personal investment separately from the taxpayer's business activity, the dividends from the stock are nonbusiness income. If the taxpayer receives dividends from business insurance premiums the taxpayer deducted in an earlier year, the taxpayer must report all or part of the dividend as business income on the taxpayer's return.

Generally, if the taxpayer's debt is canceled or forgiven, other than as a gift or bequest to the taxpayer, the taxpayer must include the canceled amount in the taxpayer's gross income for tax purposes. Report the canceled amount as other income on Schedule C if the taxpayer incurred the debt in the taxpayer's business.

Report promissory notes and other evidence of debt issued to the taxpayer in a sale or exchange of property that is stock in trade or held primarily for sale to customers on Schedule C. In general, the taxpayer reports them at their stated principal amount (minus any unstated interest) when the taxpayer receives them.

If the taxpayer recovers a bad debt or any other item deducted in a previous year, include the recovery in income on Schedule C. However, if all or part of the deduction in earlier years did not reduce the taxpayer's tax, the taxpayer can exclude the part that did not reduce the taxpayer's tax. If the taxpayer excluded part of the recovery from income, the taxpayer must include with the taxpayer's return a computation showing how the taxpayer figured the exclusion.

> **EXAMPLE:** Assume that Joe Smith, a sole proprietor, had gross income of $8,000, a bad debt deduction of $300, and other allowable deductions of $7,700. With his standard or itemized deductions, he would not pay income tax even if he did not deduct the bad debt. Therefore, he will not report as income any part of the $300 he may recover in any future year.

This rule, however, does not apply to depreciation. In the following situations, the taxpayer has to recapture the depreciation deduction and include it in gross income.

- **Listed property** – If the taxpayer's business use of listed property falls to 50% or less in a tax year after the tax year the taxpayer placed the property in service, the taxpayer may have to recapture part of the depreciation deduction. The taxpayer does this by including in income on Schedule C part of the depreciation the taxpayer deducted in previous years. Use Part IV of Form 4797, Sales of Business Property, to figure the amount to include on Schedule C.
- **Section 179 property** – If the taxpayer takes a section 179 deduction for an asset and before the end of the asset's recovery period the percentage of business use drops to 50% or less, the taxpayer must recapture part of the section 179 deduction. The taxpayer does this by including in income on Schedule C part of the deduction the taxpayer took. Use Part IV of Form 4797 to figure the amount to include on Schedule C.
- **Sale or exchange of depreciable property** – If the taxpayer sells or exchanges depreciable property at a gain, the taxpayer may have to treat all or part of the gain due to depreciation as ordinary income. The taxpayer figures the income due to depreciation recapture in Part III of Form 4797.

Consignments of merchandise to others to sell for the taxpayer is not counted in sales. The title of merchandise remains with the taxpayer, the consignor, even after the consignee possesses the merchandise. Therefore, if the taxpayer ships goods on consignment, the taxpayer has no profit or loss until the consignee sells the merchandise. Merchandise the taxpayer has shipped out on consignment is included in the taxpayer's inventory until it is sold.

If the taxpayer enters into a lease after August 5, 1997, the taxpayer can exclude from income the construction allowance the taxpayer receives (in cash or as a rent reduction) from the taxpayer's landlord if the taxpayer receives it under both the following conditions:

1. Under a short-term lease of retail space.
2. For the purpose of constructing or improving qualified long-term real property for use in the taxpayer's business at that retail space.

The taxpayer can exclude the construction allowance to the extent it does not exceed the amount the taxpayer spent for construction or improvements. A "short-term lease" is a lease (or other agreement for occupancy or use) of retail space for 15 years or less. Take into account options to renew when figuring whether the lease is for 15 years or less. But do not take into account any option to renew at the fair market value determined at the time of renewal.

If a tenant erects buildings or makes improvements to the taxpayer's property, the increase in the value of the property due to the improvements is not income to the taxpayer. However, if the facts indicate that the improvements are a payment of rent to the taxpayer, then the increase in value would be income.

Money borrowed through a bona fide loan is not income, nor are state and local sales taxes imposed on the buyer, which the taxpayer is required to collect and pay over to state or local governments.

If the taxpayer is a licensed real estate agent or a direct seller, the taxpayer's earnings are reported on Schedule C if both the following apply:

1. Substantially all the taxpayer's pay for services as a real estate agent or direct seller directly relates to the taxpayer's sales or other output rather than to the number of hours the taxpayer works; and
2. The taxpayer performs the services under a written contract that says the taxpayer will not be treated as an employee for federal tax purposes.

If the taxpayer is a dealer in options or commodities, the taxpayer's gains and losses from dealing or trading in section 1256 contracts (regulated futures contracts, foreign currency contracts, nonequity options, dealer equity options, and dealer securities futures contracts) or property related to those contracts (such as stock used to hedge options) are reported on Schedule C. The taxpayer is a trader in securities if the taxpayer is engaged in the business of buying and selling securities for the taxpayer's own account. As a trader in securities, the taxpayer's gain or loss from the disposition of securities is not reported on Schedule C.

DEDUCTIBLE BUSINESS EXPENSES

To be deductible, a business expense must be both ordinary and necessary. An ordinary expense is one that is common and accepted in your trade or business. A necessary expense is one that is helpful and appropriate for your trade or business. An expense does not have to be indispensable to be considered necessary. By definition, business expenses do not include the cost of goods sold, amounts paid for capital items, and costs that are personal in nature.

Cost of goods sold is deducted from gross receipts to figure gross profit for the year. Costs of goods sold may include the cost of products or raw materials used to manufacture goods, freight, storage, direct labor costs (including contributions to pensions or annuity plans) for workers who produce the products, and overhead related to the production process (i.e., utilities related to the manufacturing plant). Any costs included in the cost of goods sold cannot be deducted again as business expenses. Inventory must be valued at the beginning and end of each tax year to determine the cost of goods sold.

There are, in general, three types of costs that must be capitalized: (1) business start-up costs; (2) business assets; and (3) improvements. A taxpayer may elect a limited deduction of up to $5,000 for start-up expenses paid or incurred to acquire or to create a new active trade or business. This amount does not include expenses incurred in connection with the expansion of an existing trade or business. The taxpayer is deemed to have made the election unless he or she opts out. The remainder of business start-up expenses, if any, are capitalized and allowed as a deduction ratably over a 180-month period beginning with the month in which the active trade or business begins.

Costs to improve, restore, or adapt a unit of property to a new or different use must be capitalized. Materials and supplies used to improve a unit of property are generally deductible in the year they are used or consumed in the taxpayer's business operations. Materials and supplies acquired for use in business operations are generally expensed rather than capitalized. The regulations define the term "materials and supplies" as any component acquired to maintain, repair, or improve a unit of property that is not itself part of the unit of property, and any unit of property, including fuel, lubricants, and water, with an economic useful life of twelve months or less (***see Reg. section 1.162-3(c)(1)(ii) and (iii)***).

Finally, a taxpayer cannot deduct personal, living, or family expenses on Schedule C. However, expenses that are partly for business and partly for personal purposes may be deductible in part. Specifically, the portion of the expense that is directly related to the business may be deducted.

> **EXAMPLE:** Harry takes out a loan in the amount of $10,000, using $7,000 for his business and $3,000 for a family vacation. Harry may include on Schedule C a business deduction equal to the interest on $7,000 of the indebtedness. Interest on the remaining $3,000 of the loan is a personal expense and not deductible against self-employment income.

Automobile Expenses

A taxpayer can deduct car expenses if they use their car for business purposes. These deductions may include the actual expenses of operating and maintaining a car used for business purposes or a specified amount per business mile driven. Thus, a taxpayer may use the actual cost method or the standard mileage rate. Under the actual cost method, taxpayers may deduct the actual costs of operating a motor vehicle, including depreciation, licenses, gas, oil, tolls, lease payments, insurance, garage rent, parking fees, registration fees, repairs, tires, and car washes.

> The standard mileage rate for deductible transportation expenses paid or incurred during 2021 for business is **56 cents** per mile (down slightly from 57.5 cents in 2020). The business standard mileage rate cannot be used to claim an itemized deduction for unreimbursed employee travel expenses as the TCJA temporarily suspends all miscellaneous deductions subject to the 2% limit (suspended for tax years 2018 through 2025).

Taxpayers can use this standard mileage rate in computing the deductible costs of operating for business purposes automobiles (including vans, pickups, or panel trucks) they own or lease. However, the standard mileage rate cannot be used to compute the deductible costs of an automobile for which the taxpayer:

1. Claimed depreciation using a method other than straight-line for the automobile's estimated useful life;
2. Used the Modified Accelerated Cost Recovery System ("MACRS") or Accelerated Cost Recovery System ("ACRS") under Code section 168;
3. Claimed a Code section 179 deduction; or
4. Claimed the additional depreciation allowance ("bonus depreciation").

Furthermore, a taxpayer can only use the standard mileage rate in computing the deductible costs of operating up to four automobiles that are used simultaneously for business purposes; if the taxpayer uses five or more automobiles for business, the standard mileage rate method is not available.

Note that automobiles are "listed property," which means that expenses related to them are not deductible unless they are strictly substantiated. As such, it is not only the cost of operating the automobile that must be substantiated, but the amount and date of each use, total use during the relevant tax period, and the business purpose of each use.

Use of the standard mileage rate does not relieve the taxpayer of the requirement to substantiate the amount of each business use (that is, the mileage), or the time and business purpose of each use.

It is imperative therefore that the taxpayer keep accurate documentation of the specific business use. The best documentation is a mileage log showing the beginning and ending mileage for each business trip and a description of the business purpose of the trip. If the taxpayer uses his or her car for both business and personal purposes, the expenses must be divided based on actual mileage.

TIP: A taxpayer may also deduct **16 cents** per mile driven for medical purposes and **14 cents** per mile driven in the service of charitable organizations during 2021.

Travel Expenses

In general, daily transportation expenses incurred in traveling between a taxpayer's residence and his or her work location are nondeductible commuting expenses. However, there are three sets of circumstances in which those expenses are deductible:

1. A taxpayer may deduct daily transportation expenses incurred in going between his or her residence and a temporary work location outside the metropolitan area where the taxpayer lives and normally works;
2. If a taxpayer has one or more regular work locations away from his or her residence, the taxpayer may deduct daily transportation expenses incurred in going between the residence and a temporary work location in the same trade or business, regardless of the distance; and
3. If a taxpayer's residence is his or her principal place of business, the taxpayer may deduct daily transportation expenses incurred in going between the residence and another work location in the same trade or business, regardless of whether the other work location is regular or temporary and regardless of the distance.

In ***Curphey v. Commissioner***, 73 T.C. 766 (1980) the Tax Court held that daily transportation expenses incurred in going between an office in a taxpayer's residence and other work locations were deductible where the home office was the taxpayer's principal place of business. The court stated that "[w]e see no reason why the rule that local transportation expenses incurred in travel between one business location and another are deductible should not be equally applicable ***where the taxpayer's principal place of business with respect to the activities involved is his residence***." (***see 73 T.C. at 777-78***). As has been noted by the IRS itself, implicit in the court's analysis in ***Curphey*** is that the deductibility of daily transportation expenses is determined on a business by business basis.

In determining whether daily transportation expenses incurred in going to and from a place of business located at the taxpayer's residence are more properly treated as personal commuting expenses or as ordinary and necessary business expenses, great weight must be given to the inherently personal character of a taxpayer's residence and trips to and from that residence. If an office in the taxpayer's residence satisfies the principal place of business requirements of Code section 280A(c)(1)(A), then the business activity there is deemed to be so central to the taxpayer's business as to overcome the inherently personal nature of the residence and the daily transportation expenses incurred in going between the residence and other work locations in the same trade or business. If an office in the taxpayer's residence does not satisfy the principal place of business requirements of section 280A(c)(1)(A), then the business activity there (if any) is not sufficient to overcome the inherently personal nature of the residence and the daily transportation expenses incurred in going between the residence and other regular work locations.

Other Business Deductions Related to Self-Employment

Other types of business expenses include payments made to others, whether employees or independent contractors, for services related to the business, rent expenses, state and local taxes and licenses attributable to the business, and insurance. The following is a list of some of the more common expenses for which a self-employed person may take a business deduction. This is not designed to be a comprehensive list, and the actual deductibility of any expense listed below depends on its being ordinary and necessary to the business activity and adequately documented:

- Books, trade journals, newspapers, and publications for the taxpayer's trade or profession
- Dues to a professional organization related to the taxpayer's profession
- Regulatory fees
- Dues to chambers of commerce and similar organizations if the membership helps the taxpayer generate business
- Equipment and supplies, including computer, telephone, and copying equipment
- Internet fees
- Advertising in phone directories and elsewhere
- Legal and accounting fees
- Cost of meals related to the conduct of business purchased from a restaurant (2021, 2022)
- Separate business telephone (home phone line is not deductible)
- Traveling costs incurred while away from home on business
- Transportation from one job to another if the taxpayer works at two or more locations in one day
- Specialized clothing designed for your job, as long as it's not suitable for everyday wear
- Safety equipment, such as hard hats, safety glasses, safety boots, and gloves
- Business gifts (but only up to $25 per recipient)
- Postage
- Office supplies
- Interest on business loans
- Repairs and maintenance

BUSINESS VERSUS HOBBY

Code section 183 treats activities that are not pursued for-profit as "hobbies", and distinguishes deductions related to those activities from deductions for business expenses. Code section 183 only allows loss deductions for hobbies up to the amount of any income from the hobby.

The Code directs the IRS and the courts to presume that an activity is engaged in for profit if the gross income from the activity exceeds the deductions for the activity (i.e., there is profit) for **three or more of the immediately preceding five years.** This is merely a presumption, not a conclusive determination. That means that when the presumption applies, the burden shifts to the IRS to demonstrate by a preponderance of evidence that the activity is not being conducted for the purpose of making a profit. The presumption of the taxpayer's intent to make a profit can be defeated by the IRS if it offers credible evidence that the taxpayer's activity is only a hobby. Perhaps even more important, the presumption works in one direction only. There is no presumption that the activity is not engaged in for profit if the taxpayer does not show a profit for three years out of five consecutive years. Instead, the general rule applies and the taxpayer retains the burden of showing that a profit motive exists.

The regulations contain nine factors to help discern whether an activity is intended to be profitable. None of these factors is more important than any other factor, and the final decision about a taxpayer's intent is not automatically made by a majority of the factors being met. Rather, the totality of the facts and circumstances must be considered in light of these factors. These factors include:

1. Manner in which the taxpayer carries on the activity
2. Expertise of the taxpayer or advisors
3. Time and effort expended by the taxpayer in carrying on the activity
4. Expectation that assets used in the activity may appreciate in value
5. Taxpayer's success in carrying on other similar or dissimilar activities
6. Taxpayer's history of income or losses with respect to the activity
7. Profits actually earned and possibility of ultimate profit
8. Taxpayer's financial status
9. Elements of personal pleasure or recreation

BUSINESS USE OF HOME

A deduction is allowable for business use of the taxpayer's home under three circumstances. First, a taxpayer may deduct costs allocable to a portion of his or her home or a separate structure not attached to the home if the portion or separate structure is used "exclusively" and on a regular basis in connection with the taxpayer's business. "Exclusively" for this purpose means that the taxpayer must use the portion of the home or separate structure ***solely*** for the purpose of carrying on his or her trade or business. If that portion or separate structure is used for both business and personal purposes, no deductions related to the structure are allowed against self-employment income. Furthermore, expenses attributable to the exclusive but incidental or occasional trade or business use are not allowed because the use must be on a "regular" basis for business purposes.

> **EXAMPLE:** Frances uses a spare room in her apartment to conduct her self-employment trade or business. Once a month she also uses the room to review her personal finances and pay personal bills. Carl has a separate room in his home that he uses for approximately four hours during the course of the year to prepare an annual budget for his self-employment activities and uses the room for nothing else. Neither Frances nor Carl is entitled to any Schedule C business deduction related to the business use of these spare rooms: Frances because her use is not exclusive and Carl because his use is not regular.

The second circumstance in which a deduction is allowable for business use of the taxpayer's home is to the extent there is space in the residence that the taxpayer uses on a regular basis to store inventory or product samples in connection with his or her business of selling products at retail or wholesale. However, to take a deduction on this basis, the residence must be the sole fixed location of the trade or business.

Third, a deduction is allowable for business use of the taxpayer's home if the residence is used regularly to provide day-care services for compensation to children, handicapped individuals, or persons aged 65 years or older. If there is only part-time use of a portion of the residence for this purpose, allocation must be made first on the basis of the proportion of total space used to furnish services and then on the basis of the amount of time that space is used for those services compared to the total time the space is available for all uses. The deduction is allowed only if the day-care services are not primarily educational and comply with any applicable state licensing certification, or approval requirements.

REGULAR METHOD

A taxpayer can deduct expenses related to a portion of his or her home if some portion of the home is used exclusively and regularly as the taxpayer's principal place of business or a place where the taxpayer meets or deals with patients, clients, or customers in the normal course of his or her trade or business. Also, a deduction is available if a portion of the home is used on a regular basis for certain storage use. Special rules apply for daycare use of the home.

In order for the taxpayer to take a business use of the home deduction, the taxpayer must be engaged in an activity for the purpose of generating a profit. This determination is made under the so-called "hobby loss rules" of Code section 183. A taxpayer who is not engaged in an activity for profit cannot take a deduction for the business use of the home.

If not electing to use the simplified method (described below), the deduction for business use of the taxpayer's home will be based on the taxpayer's actual expenses. To calculate the deductible amount, the percentage of the taxpayer's home used for business must be determined and certain limits applied. If the taxpayer uses his or her home in a trade or business and files Schedule C, Form 8829 is used to figure the deduction.

If the home was used for business for only part of the year, the deduction is prorated. For example, if the business use began on July 1 and continued for the rest of the calendar year, only half of the otherwise allowable expenses could be deducted.

In determining the actual expenses, the taxpayer must divide the expenses of operating the home between personal and business use. To find the business percentage, compare the size of the part of the home that the taxpayer uses for business to the taxpayer's whole house. Use the resulting percentage to figure the business part of the expenses for operating the taxpayer's entire home. The taxpayer can use any reasonable method to determine the business percentage. For example, one method is to divide the area (length multiplied by the width) used for business by the total area of the taxpayer's home. Alternatively, if the rooms in the taxpayer's home are all about the same size, the taxpayer can divide the number of rooms used for business by the total number of rooms in the taxpayer's home.

The part of a home operating expense the taxpayer can use to figure the deduction depends on whether the expense is direct, indirect, or unrelated and the percentage of the home used for business.

Direct expenses are those that apply only to the business part of the home and are deductible in full. Examples would include painting or repair to the business portion of the home. Indirect expenses, such as insurance, utilities, and general repairs, are deductible based on the percentage of the home used for business. Unrelated expenses are those incurred only with respect to the parts of the home not used for business and are not deductible.

The taxpayer determines the deductible portion of indirect expenses by multiplying the expenses by the percentage of the taxpayer's home used for business. These expenses include real estate taxes, qualified mortgage insurance premiums, deductible mortgage interest, casualty losses, depreciation, insurance, rent, repairs, security systems, and utilities.

The cost of repairs that relate to the taxpayer's business, including labor (other than the taxpayer's own labor), is a deductible expense. For example, a furnace repair benefits the entire home. If the taxpayer uses 10% of the taxpayer's home for business, the taxpayer can deduct 10% of the cost of the furnace repair. Note that permanent improvements to the home are not deductible, but rather get added to the basis of the home and may be recovered through depreciation.

Expenses for utilities and services, such as electricity, gas, trash removal, and cleaning services, are primarily personal expenses. However, if the taxpayer uses part of the taxpayer's home for business, the taxpayer can deduct the business part of these expenses. Generally, the business percentage for utilities is the same as the percentage of the taxpayer's home used for business.

The basic local telephone service charge, including taxes, for the first telephone landline into the taxpayer's home, is a nondeductible personal expense. However, charges for business long-distance phone calls on that line, as well as the cost of a second line into the taxpayer's home used exclusively for business, are deductible business expenses. Do not include these expenses as a cost of using the taxpayer's home for business. Deduct these charges separately on the appropriate form or schedule. For example, if the taxpayer files Schedule C (Form 1040), deduct these expenses as Utilities (instead of Expenses for business use of the taxpayer's home).

The taxpayer must carefully distinguish between repairs and improvements. The taxpayer also must keep accurate records of these expenses. These records will help the taxpayer decide whether an expense is a deductible or a capital (added to the basis) expense. However, if the taxpayer makes repairs as part of an extensive remodeling or restoration of the home, the entire job is an improvement.

If the taxpayer's gross income from the business use of the taxpayer's home equals or exceeds total business expenses (including depreciation), the taxpayer can deduct all the business expenses related to the use of the taxpayer's home. However, if the taxpayer's gross income from the business use of the home is less than the taxpayer's total business expenses, the deduction for certain expenses for the business use of the taxpayer's home is limited.

The taxpayer's deduction of otherwise nondeductible expenses, such as insurance, utilities, and depreciation of the taxpayer's home (with depreciation of the home taken last), that are allocable to the business, is limited to the gross income from the business use of the taxpayer's home minus the sum of the following:

1. The business part of expenses the taxpayer could deduct even if the taxpayer did not use the taxpayer's home for business (such as mortgage interest, real estate taxes, and casualty and theft losses that are allowable as itemized deductions on Schedule A).
2. The business expenses that relate to the business activity in the home (for example, business phone, supplies, and depreciation on equipment), but not to the use of the home itself.

If the taxpayer's deductions are greater than the current year's limit, the taxpayer can carry over the excess to the next year in which the taxpayer uses actual expenses. They are subject to the deduction limit for that year, whether or not the taxpayer lives in the same home during that year.

If part of the gross income from the taxpayer's trade or business is from the business use of part of the taxpayer's home and part is from a place other than the taxpayer's home, the taxpayer must determine the part of the taxpayer's gross income from the business use of the taxpayer's home before the taxpayer figures the deduction limit. In making this determination, consider the time the taxpayer spends at each location, the business investment in each location, and any other relevant facts and circumstances.

SIMPLIFIED METHOD

The simplified method is an alternative to the calculation, allocation, and substantiation of actual expenses. In most cases, the taxpayer will figure the deduction by multiplying five dollars ($5) by the area of the taxpayer's home used for a qualified business use. The area the taxpayer uses to figure the taxpayer's deduction is limited to 300 square feet.

If the taxpayer elects to use the simplified method, the taxpayer cannot deduct any actual expenses for the business except for business expenses that are not related to the use of the home. The taxpayer also cannot deduct any depreciation for the portion of the home that is used for a qualified business use. The depreciation deduction allowable for that portion of the home is deemed to be zero for a year the taxpayer uses the simplified method. If the taxpayer figures the deduction for business use of the home using actual expenses in a subsequent year, the taxpayer will have to use the appropriate optional depreciation table for MACRS to figure the depreciation.

When using the simplified method, treat as personal expenses those business expenses related to the use of the home that are deductible without regard to whether there is a qualified business use of the home. These expenses include mortgage interest, real estate taxes, and casualty losses, subject to any limitations. If the taxpayer also rents part of the taxpayer's home, the taxpayer must still allocate these expenses between rental use and personal use (for this purpose, personal use includes business use reported using the simplified method).

If the taxpayer used actual expenses to figure the taxpayer's deduction for business use of the home in a prior year and the taxpayer's deduction was limited, the taxpayer cannot deduct the disallowed amount carried over from the prior year during a year the taxpayer figure the taxpayer's deduction using the simplified method. Instead, the taxpayer will continue to carry over the disallowed amount to the next year that the taxpayer uses actual expenses to figure the taxpayer's deduction.

The taxpayer chooses whether or not to use the simplified method each tax year. Make the election for a home by using the simplified method to figure the deduction for the qualified business use of that home on a timely filed, original federal income tax return. An election for a tax year, once made, is irrevocable. A change from using the simplified method in one year to actual expenses in a succeeding tax year, or vice-versa, is not a change in method of accounting.

To figure the amount the taxpayer can deduct for qualified business use of the taxpayer's home using the simplified method, follow these 3 steps:

1. Multiply the allowable area by $5.
2. Subtract the expenses from the business that are not related to the use of the home from the gross income related to the business use of the home. If these expenses are greater than the gross income from the business use of the home, then the taxpayer cannot take a deduction for this business use of the home.
3. Take the smaller of the amounts from (1) and (2). This is the amount the taxpayer can deduct for this qualified business use of the taxpayer's home using the simplified method.

If the taxpayer conducts more than one business qualifying for the deduction, the taxpayer is limited to a maximum of 300 square feet for all of the businesses. Allocate the actual square footage used (up to the maximum of 300 square feet) among the taxpayer's qualified business uses in a reasonable manner. However, do not allocate more square feet to a qualified business use than the taxpayer actually uses for that business.

The simplified method does not apply to rental use. A rental use that qualifies for the deduction must be figured using actual expenses. If the rental use and a qualified business use share the same area, the taxpayer will have to allocate the actual area used between the two uses. The taxpayer cannot use the same area to figure a deduction for the qualified business use as he uses to figure the deduction for the rental use.

If the taxpayer's qualified business use was for a portion of the year (for example, a seasonal business, a business that begins during the year, or the taxpayer moved during the year) or the taxpayer changed the square footage of the taxpayer's qualified business use, the taxpayer's deduction is limited to the average monthly allowable square footage. The taxpayer calculates the average monthly allowable square footage by adding the amount of allowable square feet the taxpayer used in each month and dividing the sum by 12. When determining the average monthly allowable square footage, the taxpayer cannot take more than 300 square feet into account for any one month. Additionally, if the taxpayer's qualified business use was less than 15 days in a month, the taxpayer must use -0- for that month.

If the taxpayer moved during the year, the taxpayer's average allowable square footage will generally be less than 300.

The taxpayer's deduction for business use of the home is limited to an amount equal to the gross income derived from the qualified business use of the home reduced by the business deductions that are unrelated to the use of the taxpayer's home. If the business deductions that are unrelated to the use of the taxpayer's home are greater than the gross income derived from the qualified business use of the taxpayer's home, then the taxpayer cannot take a deduction for this qualified business use of the taxpayer's home.

RECORDKEEPING REQUIREMENTS

Except in a few cases, the law does not require any specific kind of records. The taxpayer can choose any recordkeeping system suited to the business that clearly shows the taxpayer's income and expenses.

The type of business the taxpayer is in affects the type of records he or she needs to keep for federal tax purposes. The taxpayer should set up a recordkeeping system using an accounting method that clearly shows the taxpayer's income for the tax year. If the taxpayer has more than one business, the taxpayer should keep a complete and separate set of records for each business. A corporation should keep minutes of the board of directors' meetings.

The taxpayer's recordkeeping system should include a summary of the taxpayer's business transactions. This summary is ordinarily made in the taxpayer's books (for example, accounting journals and ledgers). The taxpayer's books must show the taxpayer's gross income, as well as the taxpayer's deductions and credits. For most small businesses, the business checkbook (discussed later) is the main source for entries in the business books.

All requirements that apply to hard copy books and records also apply to electronic storage systems that maintain tax books and records. When the taxpayer replaces hard copy books and records, the taxpayer must maintain the electronic storage systems for as long as they are material to the administration of tax law. An electronic storage system is any system for preparing or keeping the taxpayer's records either by electronic imaging or by transfer to an electronic storage media. The electronic storage system must index, store, preserve, retrieve, and reproduce the electronically stored books and records in a legible format. All electronic storage systems must provide a complete and accurate record of the taxpayer's data that is accessible to the IRS. Electronic storage systems are also subject to the same controls and retention guidelines as those imposed on the taxpayer's original hard copy books and records.

The original hard copy books and records may be destroyed provided that the electronic storage system has been tested to establish that the hard copy books and records are being reproduced in compliance with IRS requirements for an electronic storage system and procedures are established to ensure continued compliance with all applicable rules and regulations. The taxpayer still has the responsibility of retaining any other books and records that are required to be retained.

In addition to books and records comprising the taxpayer's accounting system, documents supporting those accounting entries must also be maintained. Purchases, sales, payroll, and other transactions generate supporting documents. Supporting documents include sales slips, paid bills, invoices, receipts, deposit slips, and canceled checks. It is important to keep these documents because they support the entries in the taxpayer's books and on the taxpayer's tax return.

Examples of documents supporting the taxpayer's gross receipts include: cash register tapes, bank deposit slips, receipt books, invoices, credit card charge slips, and Forms 1099-MISC. Documents supporting the cost of inventory may include canceled checks, cash register tape receipts, credit card sales slips, and invoices. Other expenses may be supported by canceled checks, cash register tapes, account statements, credit card sales slips, and invoices.

Since the taxpayer needs to determine annual depreciation and the gain or loss when an asset is sold, supporting documentation must be maintained for assets as well. That supporting documentation should show: when and how the taxpayer acquired the asset, the purchase price, the cost of any improvements, the amount of any Section 179 deduction taken, deductions taken for depreciation, how the taxpayer used and disposed of the asset, the selling price, and expenses of sale.

ENTERTAINMENT EXPENSES NOT DEDUCTIBLE BUT CERTAIN MEALS ALLOWED AT 100% IN 2021 AND 2022

The TCJA **repealed the deduction for entertainment**, amusement, or recreation that is directly related to (or, in certain cases, associated with) the active conduct of the taxpayer's trade or business (and the related rule applying a 50 percent limit to such deductions).

EXCEPTION: A business may continue to deduct expenses for recreational, social, or similar activities (including facilities therefor) primarily for the benefit of **employees** (other than employees who are highly compensated employees).

The TCJA allowed taxpayers to continue deducting **50 percent of the cost of business meals** if the taxpayer (or an employee of the taxpayer) is present and the food or beverages are not considered **lavish or extravagant**. The meals may be provided to a person with whom the taxpayer could reasonably expect to engage or deal in the active conduct of the taxpayer's trade or business.

The ***Consolidated Appropriations Act, 2021*** enacted a **temporary exception** to the 50% limitation on the business meal deduction. For tax years 2021 and 2022, meals that meet eligibility requirements to be deductible business meals are fully deductible (**100%**) when food and beverage are:

- purchased from a restaurant - defined as a location that sells food or beverages to retail customers for immediate consumption, regardless of whether actually consumed on-premises; and
- purchased between January 1, 2021 - December 31, 2022.

Restaurants do not include businesses that primarily sell pre-packaged food/beverage not for immediate consumption (i.e., grocery stores, convenience stores, drug stores, liquor/beer/wine stores, newsstands, vending machines, or kiosks). Eligible meal expenses from non-restaurants remain subject to the 50% deduction limit

In tax years 2021 and 2022, taxpayers may generally deduct **100 percent** of the **food and beverage expenses *purchased from restaurants*** associated with **operating their trade or business** (e.g., meals consumed by employees on work travel).

The temporary 100% provision does not apply to expenses of the employer associated with providing food and beverages to employees through an eating facility that meets requirements for de minimis fringes and for the convenience of the employer.

SECTION 179 EXPENSE LIMITS

A taxpayer claims a Section 179 deduction to recover the cost of qualifying property used in a trade or business in the current year, rather than over a longer recovery period. The Section 179 deduction applies to tangible personal property such as machinery and equipment purchased from an **unrelated party** for use in a trade or business, and if the taxpayer elects, qualified real property.

Section 179 applies to both **new and used equipment**. If a taxpayer buys qualifying property with cash and a trade-in, its cost for purposes of the section 179 deduction includes only the cash paid. This deduction is not allowed for property held for the production of income, such as rental property. Instead of depreciating property over time, a taxpayer may elect to claim as an expense up to **$1,050,000** in 2021. This dollar limitation is reduced (but not below zero) by the cost of §179 property placed in service during the 2021 taxable year that exceeds $2,620,000. If the cost of Section 179 property placed in service during 2021 is $3,670,000 or more, the taxpayer cannot take a Section 179 deduction.

For a sport utility vehicle (SUV), a taxpayer may elect to claim as an expense up to **$26,200** in 2021.

BONUS DEPRECIATION (100% SPECIAL DEPRECIATION ALLOWANCE) SECTION 168(K)

A business taxpayer may take an additional **100% *special depreciation allowance***, often referred to as "bonus depreciation" on certain qualified property. The Section 168(k) special depreciation allowance applies only for the first year the property is in service. The allowance is an additional deduction taken after any Section 179 expense

> deduction and before the taxpayer figures regular depreciation under MACRS. Qualified property includes tangible property depreciated in **20 years or less under MACRS**. Under the TCJA, the 100% special depreciation allowance now applies to both **new and used property**.

The provision extends and modifies the additional first-year depreciation deduction through 2026 (through 2027 for longer production period property and certain aircraft). The 50-percent allowance is increased to 100-percent for property acquired and placed in service after September 27, 2017, and before January 1, 2023 (January 1, 2024, for longer production period property and certain aircraft), as well as for specified plants planted or grafted after September 27, 2017, and before January 1, 2023. The 100-percent allowance is phased down by 20-percent per calendar year for property placed in service, and specified plants planted or grafted, in taxable years beginning after 2022 (after 2023 for longer production period property and certain aircraft).

Thus, for the 100% special depreciation allowance, the qualified property must be acquired and placed in service after September 27, 2017, and before January 1, 2023 (January 1, 2024, for longer production period property and certain aircraft).

> A taxpayer **may elect out** of the Section 168(k) additional first-year depreciation deduction with respect to any class of property that is qualified property placed in service during the taxable year.

SPECIAL RULE FOR PASSENGER AUTOMOBILES

The provision maintains the section 280F increase amount of $8,000 for passenger automobiles acquired and placed in service after December 31, 2017. Thus, for passenger automobiles acquired and placed in service after September 27, 2017, the section 280F increase amount remains at $8,000.

PRESENT-LAW PHASE-DOWN OF BONUS DEPRECIATION

In addition, the present-law phase-down of bonus depreciation is maintained for property acquired before September 28, 2017, and placed in service after September 27, 2017, as well as the present-law phase-down of the section 280F increase amount in the limitation on the depreciation deductions allowed with respect to certain passenger automobiles acquired before September 28, 2017, and placed in service after September 27, 2017.

BONUS DEPRECIATION RATES

Under the provision, the bonus depreciation rates are as follows:

The first table is for property **acquired before** September 28, 2017, and **placed in service after** September 27, 2017. The second table is for property **acquired and placed in service after** September 27, 2017.

Portion of Basis of Qualified Property Acquired **BEFORE** Sept. 28, 2017		
	Bonus Depreciation Percentage	
Placed in Service Year	Qualified Property in General/Specified Plants	Longer Production Period Property and Certain Aircraft
Sept. 28, 2017 – Dec. 31, 2017	50%	50%
2018	40%	50%
2019	30%	40%
2020	None	30%
2021 and thereafter	None	None

Portion of Basis of Qualified Property Acquired AFTER Sept. 27, 2017		
	Bonus Depreciation Percentage	
Placed in Service Year	Qualified Property in General/Specified Plants	Longer Production Period Property and Certain Aircraft
Sept. 28, 2017 – Dec. 31, 2022	100%	100%
2023	80%	100%
2024	60%	80%
2025	40%	60%
2026	20%	40%
2027	None	20%
2028 and thereafter	None	None

LUXURY AUTO DEPRECIATION LIMITS

Section 280F(a) limits the annual cost recovery deduction with respect to certain **passenger automobiles** (cars, trucks, vans, and SUVs **weighing 6,000 pounds or less**). This limitation is commonly referred to as the ***luxury automobile depreciation limitation*** or the ***Section 280F limitation***.

The TCJA increases the depreciation limitations under section 280F that apply to listed property, and for passenger automobiles placed in service after December 31, 2017, and for which the additional first-year depreciation deduction under section 168(k) is not claimed (elected out).

Depreciation limitations for passenger automobiles **acquired after** September 27, 2017, and placed in service during calendar year 2020, for which the §168(k) additional first-year depreciation **(bonus depreciation) deduction applies**:

- 1st Tax Year $18,100 ($10,100 plus $8,000 bonus depreciation)
- 2nd Tax Year $16,100
- 3rd Tax Year $9,700
- Each Succeeding Year $5,760

> **NOTE:** Section 280F limitations are subject to annual inflationary increases for passenger automobiles placed in service after 2018. At the time of publication, the IRS has not released the 2021 amounts.

LISTED PROPERTY

In the case of certain listed property, special rules apply. The listed property rules are designed to keep people from claiming tax deductions for the personal use of the property while claiming it is used in a trade or business.

Listed property is any of the following:

- Passenger automobiles (cars, trucks, vans, and SUVs) **weighing 6,000 pounds or less**
- Any other property used for transportation, unless it is an excepted vehicle
- Property generally used for entertainment, recreation, or amusement (including photographic, phonographic, communication, and video-recording equipment)

> The TCJA **removed computer or peripheral equipment** from the definition of listed property. Such property is therefore not subject to the heightened substantiation requirements that apply to listed property. The provision is effective for property placed in service after December 31, 2017, in taxable years ending after such date.

First, if for the taxable year in which the property is placed in service, the use of the property for trade or business purposes does not exceed 50 percent of the total use of the property, then the depreciation deduction with respect to such property is determined under the alternative depreciation system. The alternative depreciation system generally requires the use of the straight-line method and a recovery period equal to the class life of the property. Second, if an individual owns or leases listed property that is used by the individual in connection with the performance of services as an employee, no depreciation deduction, expensing allowance, or deduction for lease payments is available with respect to such use unless the use of the property is for the convenience of the employer and required as a condition of employment. Both limitations apply for purposes of section 179 expensing.

For listed property, no deduction is allowed unless the taxpayer adequately substantiates the expense and business usage of the property. A taxpayer must substantiate the elements of each expenditure or use of listed property, including:

- the amount (e.g., cost) of each separate expenditure and the amount of business or investment use, based on the appropriate measure (e.g., mileage for automobiles), and the total use of the property for the taxable period,
- the date of the expenditure or use, and
- the business purposes for the expenditure or use.

The level of substantiation for business or investment use of listed property varies depending on the facts and circumstances. In general, the substantiation must contain sufficient information as to each element of every business or investment use.

A taxpayer can claim the Section 179 deduction and a special depreciation allowance (bonus depreciation) for listed property and depreciate listed property using GDS and a declining balance method if the property meets the business-use requirement. To meet this requirement, listed property must be **used predominantly for qualified business use** (**more than 50%** of its total use). If this requirement is not met, the following rules apply:

- Property not used predominantly for qualified business use during the year it is placed in service does not qualify for the ***Section 179 deduction***.
- Property not used predominantly for qualified business use during the year it is placed in service does not qualify for a ***special depreciation allowance***.

- Any depreciation deduction under MACRS for property not used predominantly for qualified business use during any year must be figured using the ***straight-line method over the ADS recovery period***. This rule applies each year of the recovery period.
- ***Excess depreciation*** on property previously used predominantly for qualified business use must be ***recaptured*** (included in income) in the first year in which it is no longer used predominantly for qualified business use.

SCHEDULE D AND FORM 8949: OVERVIEW OF CAPITAL GAINS AND LOSSES

CAPITAL ASSETS

Generally, a sale or trade of a ***capital asset*** results in a ***capital gain or loss***. A sale or trade of a non-capital asset results in an ***ordinary gain or loss***. In some situations, part of the gain or loss may be a capital gain or loss and part may be an ordinary gain or loss. Rather than defining capital assets, the Internal Revenue Code provides a list of properties that are not capital assets. Any property a taxpayer holds is a capital asset, except the following non-capital assets:

- Inventory or property **held mainly for sale to customers** or property that will physically become a part of the merchandise that is for sale to customers
- Accounts or notes receivable acquired in the ordinary course of a trade or business for services rendered or from the sale of property held mainly for sale to customers
- Depreciable property **used in the taxpayer's trade or business**
- Real property (real estate) **used in the taxpayer's trade or business**
- Copyright, literary, musical, artistic composition, letter or memorandum, or similar property that meets one of the following criteria:
  1. Created by a taxpayer's personal efforts
  2. Prepared or produced for a taxpayer (as in a letter, memorandum, or similar property)
  3. Acquired under circumstances (for example, by gift), entitling the taxpayer to the basis of the person who created the property or for whom it was prepared or produced
- U.S. government publications that a taxpayer received from the government free or for less than the normal sales price, or that was acquired under circumstances entitling the taxpayer to the basis of someone who received the publications free or for less than the normal sales price
- Certain commodities derivative financial instruments held by commodities derivatives dealers
- Hedging transactions, but only if the transaction is clearly identified as a hedging transaction before the close of the day on which it was acquired, originated, or entered into
- Supplies of a type regularly used in the ordinary course of a taxpayer's trade or business

For the most part, everything owned and used for personal purposes, pleasure, or investment is a capital asset. Some examples include the following:

- Stocks or bonds held in a personal account
- House owned and used by the taxpayer and the taxpayer's family
- Household furnishings
- A car used for pleasure or commuting
- Coin or stamp collections
- Gems and jewelry

GENERAL REPORTING REQUIREMENTS

Form 8949 is for detailed reporting of short and long-term capital gain or loss transactions. A taxpayer uses ***Form 8949*** to list all capital gain and loss transactions and carries the subtotals from this form to Schedule D (Form 1040), where gain or loss will be calculated in aggregate. Short-term gains are listed together in Part I, while long-term gains are listed in Part II. Form 8949 is also used to report the sale or exchange of capital assets not reported on other forms or schedules (e.g., Form 4797); gains from involuntary conversions (other than from casualty or theft) of capital assets not held for business or profit; and nonbusiness bad debts.

Separate Forms 8949 are used to report three different classes of transactions: (1) transactions reported on Form 1099-B showing basis was reported to the IRS; (2) transactions reported on Form 1099-B showing basis wasn't reported to the IRS; and (3) transactions not reported to you on Form 1099-B. Each individual security sale during the year must be separately reported on Form 8949. When there are statements from more than one broker or more than one account with the same broker, the taxpayer should report the totals from each broker or account on a separate line of Form 8949.

Schedule D is still used to report:

1. The overall gain or loss from transactions reported on Form 8949;
2. Gains from Form 2439 or 6252 or Part I of Form 4797;
3. Gains or losses from Form 4684, 6781, or 8824;
4. Gains or losses from a partnership, S corporation, estate, or trust;
5. Capital gain distributions not reported directly on Form 1040; and
6. Capital loss carryovers from prior years.

WASH SALES

Wash sales are defined as a transfer of stock or securities at a loss when, within the 30 days before or after the sale, the taxpayer acquires substantially identical stock or securities or a contract or option to buy substantially identical stock or securities. Losses from sales or trades of stock in a wash sale may not be deducted. Instead, disallowed wash sale losses are added to the cost basis of the acquired stock or securities. The holding period of the new stock begins on the same day as the holding period of the stock sold.

> **EXAMPLE:** Jollette buys 500 shares of ABC Corp. for $10,000. On December 15, 20X1, she sells all of these shares for $7,000. On January 10, 20X2, she buys another 500 shares of ABC Corp. for $8,000. Because she acquired substantially identical stock within 30 days of the sale, the loss on the sale is disallowed under the wash sale rules and is instead added to her basis, resulting in a basis of $11,000 in the stock acquired on January 10 ($8,000 cost + $3,000 disallowed loss). Note also that only the sale (and not the later acquisition) will be reflected on Jollette's 20X1 year-end brokerage statement. For this reason, preparers should be careful to check subsequent statements when there is a sale for a loss near year-end.

Note that wash sales include transactions in traditional and Roth IRAs as well. This means that when an individual sells stocks or securities at a loss and causes his or her IRA or Roth IRA to purchase substantially identical stocks or securities within 30 days before or after the sale, the loss is disallowed under the wash sale rules. Under these circumstances, the individual's basis in the IRA or Roth IRA is **not** increased.

CAPITAL GAIN RATES

If a taxpayer has a taxable gain or a deductible loss from a transaction, it may be either a capital gain or loss or an ordinary gain or loss, depending on the circumstances. Capital gains receive more favorable tax treatment than ordinary gains, to which ordinary income tax rates apply. The tax rates that apply to a ***net capital gain*** are generally lower than the tax rates that apply to other income. These lower rates are the ***maximum capital gain rates***.

In general, the holding period for investment property begins the day after the day the property is acquired (***trade date***) or receipt of title and includes the date of disposition, transfer, or sale. Gain or loss is ***short-term*** on property held one year or less; otherwise, the holding period is ***long-term***.

Long-term capital gains (other than gains on collectibles, small business stock, or unrecaptured section 1250 gains) receive special tax treatment and are taxed at a **maximum rate of 20%**.

Short-term capital gains are taxed at the same rates as **ordinary income**.

Report overall capital gains and losses on Schedule D (Schedule D is not necessary if only gains are from distributions).

2021 MAXIMUM RATES ON CAPITAL GAINS AND QUALIFIED DIVIDENDS

For taxable years beginning in 2021, the maximum zero rate amount is $80,800 for a joint return or surviving spouse, $40,400 for married filing separate, $54,100 for head of household, $40,400 for any other individual, and $2,700 for an estate or trust. The maximum 15-percent rate amount is $501,600 for a joint return or surviving spouse, $250,800 for married filing separate, $473,750 for head of household, $445,850 for any other individual, and $13,250 for an estate or trust.

2021 Capital Gain Breakpoints		
Filing Status	**15-percent Breakpoint**	**20-percent Breakpoint**
Married Individuals Filing Joint Returns and Surviving Spouses	$80,800	$501,600
Married Individuals Filing Separate	$40,400	$250,800
Heads of Households	$54,100	$473,750
Unmarried Individuals (other than Surviving Spouses and Heads of Households)	$40,400	$445,850
Estates and Trusts	$2,700	$13,250

Thus, for 2021, the 15-percent breakpoint is $80,800 for joint returns and surviving spouses, $40,400 for married filing separate returns (1⁄2 the amount for joint returns), $54,100 for heads of households, $40,400 for other unmarried individuals, and $2,700 for estates and trusts. The 20-percent breakpoint is $501,600 for joint returns and surviving spouses, $250,800 for married filing separate returns (1⁄2 the amount for joint returns), $473,750 for heads of households, $445,850 for other unmarried individuals, and $13,250 for estates and trusts.

In the case of an individual (including an estate or trust) with an adjusted net capital gain, to the extent the gain would not result in ***taxable income*** exceeding the 15-percent breakpoint, such **capital 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, such **capital gain is taxed at 15-percent**. The remaining adjusted net **capital gain is taxed at 20-percent**.

Unrecaptured section 1250 gain generally is taxed at a maximum rate of 25-percent, and 28-percent rate gain is taxed at a maximum rate of 28-percent.

> Long-term capital gains (other than gains on collectibles, small business stock, or unrecaptured §1250 gains) receive special tax treatment and a maximum rate of 20%. Ordinary income tax rates apply to short-term capital gains.

STANDARD DEDUCTION

STANDARD DEDUCTION

The standard deduction reduces the amount of income subject to tax. Taxpayers generally benefit from the standard deduction if it is more than the allowable ***itemized deductions***.

The following taxpayers are not eligible for the standard deduction:

- Married filing a separate return (MFS) and the other spouse itemizes deductions.
- The tax return is for a **short tax year** because of a change in the annual accounting period.
- ***Nonresident*** or ***dual-status alien*** during the year. A dual-status alien is both a nonresident and resident alien during the year.

EXCEPTION: A nonresident alien who is married to a U.S. citizen or resident alien at the end of the year can choose tax treatment as a U.S. resident and as such may claim the standard deduction. Students and business apprentices from India may be eligible to claim the standard deduction under Article 21 of the U.S.A.-India Income Tax Treaty.

STANDARD DEDUCTION AMOUNT

A taxpayer's filing status determines the amount of the standard deduction:

Filing Status	2021
S or MFS	$12,550
HH	$18,800
MFJ or QW	$25,100

The standard deduction is higher for taxpayers who are **65 or older** at the end of the year **and/or blind** (vision not better than 20/200). This extra deduction applies to both the taxpayer and to a spouse if married. Increase the standard deduction by the following for **each occurrence** of the conditions above.

Filing Status	2021
MFJ, MFS or QW	$1,350
S or HH	$1,700

EXAMPLE: For 2021, a blind taxpayer and spouse who are not blind and both age 66, may add $4,050 ($1,350 MFJ × 3 occurrences) to the MFJ basic standard deduction of $25,100 for a total deduction of $29,150. A taxpayer who qualifies as both blind and elderly is entitled to two additional standard deductions, for a total additional amount of $2,700 (MFJ, MFS, or QW) or $3,400 (S or HH) for 2021.

INCREASED STANDARD DEDUCTION FOR NET QUALIFIED DISASTER LOSS IF NOT ITEMIZING

If a taxpayer has a net qualified disaster loss and is not itemizing their deductions, they can claim an increased standard deduction for the net qualified disaster loss using Schedule A (see details under Casualty and Theft Loss Deduction).

INCREASED STANDARD DEDUCTION FOR QUALIFIED CASH CHARITABLE CONTRIBUTIONS IF NOT ITEMIZING

> If a taxpayer is taking the standard deduction, there is a special deduction for ***qualified cash charitable contributions*** that is an adjustment to income. **For 2021, the increased standard deduction for qualified cash charitable contributions is up to $600 for married filing jointly and up to $300 for all other filers.**

Under the ***CARES Act***, individual taxpayers can claim an "above-the-line" deduction of up to **$300 per return** for ***qualified cash donations*** made to charity during 2020. The special $300 deduction is designed especially for people who take the standard deduction, rather than itemizing their deductions. Contributions of non-cash property do not qualify for this relief.

The ***Consolidated Appropriations Act, 2021*** increased the special deduction up to **$600 for married filing jointly** but only for 2021. For 2020, the charitable deduction was up to $300 per "tax unit"—meaning those married filing jointly can only get up to a $300 deduction. For 2021, married filing jointly can each take up to a $300 deduction, for a total deduction of up to $600.

Cash contributions include those paid by cash, check, electronic funds transfer, credit card, debit card, or payroll deduction. They don't include securities, household items, or other property.

Normally, charitable contributions can only be deducted if taxpayers itemize their deductions. If the taxpayer is taking the standard deduction, the special deduction for cash charitable contributions is an adjustment to income and is reported on ***Form 1040 or 1040-SR on line 10b, adjustments to income, charitable contributions if you take the standard deduction***. If the taxpayer is not taking the standard deduction, the taxpayer may claim cash and non-cash charitable contributions as an itemized deduction on Schedule A, subject to the normal limits.

Increased Penalty for Overstated Deduction

The ***Consolidated Appropriations Act, 2021*** also increased the penalty for the overstatement of this special deduction. Any portion of an underpayment that is attributable to an overstatement of the special deduction shall be **50%** instead of 20%.

STANDARD DEDUCTION FOR DEPENDENTS

The standard deduction for a dependent cannot exceed the regular standard deduction, based on filing status. The basic standard deduction for an individual who is a dependent on another person's tax return is generally limited to the greater of:

- $1,100 in 2021 or
- The individual's earned income for the year, plus $350

> **EXAMPLE 1:** Michael is 16 years old and single. His parents can claim him as a dependent on their 2021 tax return. He has interest income of $780 and wages of $150. He has no itemized deductions.
>
> Michael's standard deduction is $1,100 because it is greater than $500 ($150 earned income (wages) + $350).

> **EXAMPLE 2:** Joe, a 22-year-old college student, can be claimed as a dependent on his parents' 2021 tax return. Joe is married and files a separate return. His wife doesn't itemize deductions on her separate return. Joe has $1,500 in interest income and wages of $3,800. He has no itemized deductions.
>
> Joe's standard deduction is $4,150 ($3,800 earned income (wages) + $350) because it is greater than $1,100.

SCHEDULE A, ITEMIZED DEDUCTIONS

ITEMIZED DEDUCTIONS

A taxpayer with deductions that surpass the standard deduction amount, or one who does not qualify for the standard deduction, may wish to itemize on ***Schedule A*** if it provides a greater benefit.

Common itemized deductions include:

- Medical and dental expenses that exceed **7.5% of AGI**
- Certain taxes
- Interest expense
- Non-business casualty and theft losses attributable to a federally declared disaster
- Charitable contributions
- Certain miscellaneous expenses (other itemized deductions not subject to the 2% limit)

Phase-out of Itemized Deductions

> **TCJA:** Congress repealed the overall limitation on itemized deductions for tax years 2018 through 2025.

MEDICAL AND DENTAL EXPENSES

Medical expenses are the costs of diagnosis, cure, mitigation, treatment, or prevention of disease, and the costs for treatments affecting any part or function of the body. They include the costs of equipment, supplies, and diagnostic devices needed for these purposes. Medical expenses also include dental care and the cost of insurance.

Deductible medical/dental expenses also include:

- Certain Medical insurance premiums
- Meals and lodging (related to medical care)
- Nursing home expenses
- Transportation or car expenses
- Capital expenses (equipment and medically related home improvements)

Do not include expenses for procedures that are purely cosmetic or those that are merely beneficial to general health, such as vitamins or a vacation.

> The ***Consolidated Appropriations Act, 2021*** amended Section 213 and changed the medical expense deduction floor percentage to 7.5 percent for taxable years beginning after December 31, 2020.

Only the amount of medical and dental expenses that **exceed 7.5% of AGI are deductible**. Include only the expenses **paid this tax year**, even if services were provided in a prior year. Payment made in advance for medical treatment is not deductible until the medical treatment is actually rendered.

A taxpayer can generally deduct medical expenses paid for himself, and someone who was a spouse or dependent or would have been a dependent when the services were provided or when the taxpayer paid for them.

Medical expenses include expenses paid for a dependent or for an individual that **would have been a dependent** except that, for 2021:

- He or she had gross income of **$4,300** or more,
- He or she filed a joint return, or

- Taxpayer, or the taxpayer's spouse if filing jointly, could be claimed as a dependent on someone else's return.

TIP: The IRS no longer requires a taxpayer to claim a dependent on the tax return to deduct medical expenses provided the individual would qualify as a dependent if it were not for one of these exceptions.

TAXES

> For taxable years 2018 through 2025, the itemized deduction for taxes is limited. The TCJA allows a taxpayer to claim an itemized deduction on Schedule A of **up to $10,000** ($5,000 married filing a separate return) for the **aggregate** of property taxes and state and local income (or sales) taxes paid or accrued in the taxable year.

Deductible Taxes

A taxpayer receives a deduction for taxes he is legally liable to pay:

- State and local income taxes, if applicable, or general sales taxes, but not both.
- Foreign income taxes paid. Generally, one may take either a deduction or a credit for income taxes imposed by a foreign country or a U.S. possession.
- Real estate taxes on real property levied for the general public welfare. Deduct only the taxes that are based on the ***assessed value*** of the real property and charged uniformly against all property under the jurisdiction of the taxing authority.
  1. If property was bought or sold during the year, divide the current real estate taxes between buyer and seller according to the number of days owned, pro-rata. The seller pays the taxes up to, but not including, the date of sale.
  2. If mortgage payments include taxes placed in escrow, no tax is deductible until paid by the mortgage servicing company.
- Personal property taxes that meet the following criteria:
  1. Based only on the value of personal property.
  2. Charged on a yearly basis, even if they are collected more or less than once a year.

> **TCJA:** For taxable years 2018 through 2025, the tax act modifies the deduction for taxes not paid or accrued in a **trade or business**. An individual's state, local, and foreign property taxes and state and local sales taxes are allowed as a deduction only when paid or accrued in carrying on a trade or business or relating to expenses for the production of income. Thus, deductions for property taxes and sales taxes are only deductible in computing income on an individual's Schedule C, Schedule E, or Schedule F.
>
> Also, an individual is not allowed a deduction for state and local income taxes. An exception allows a taxpayer to claim an itemized deduction on Schedule A of up to **$10,000** ($5,000 married filing a separate return) for the aggregate of property taxes and state and local income (or sales) taxes paid or accrued in the taxable year. Foreign real property taxes are nondeductible.

Nondeductible Taxes

- Real estate items individuals generally cannot deduct include the following:
  1. Special assessments for local benefits that increase the property value, such as sidewalks or sewer
  2. Itemized fixed charge assessments for services. Service charges used to maintain or improve services (such as trash collection or police and fire protection) are deductible as real estate taxes if the following conditions exist:
     A. Fees or charges are imposed at a like rate against all property in the taxing jurisdiction
     B. The funds collected are not earmarked; and are part of general revenue funds

    C. Funds used to maintain or improve services are not limited to or determined by the amount of these fees or charges collected
3. Transfer taxes (or stamp taxes)
4. Rent increases due to higher real estate taxes
5. Homeowners' association charges

- Foreign real property taxes
- Employment taxes, including Social Security and Medicare
- Estate, inheritance, legacy, or succession taxes
- Federal income taxes
- Fines and penalties
- Gift taxes
- License fees, and per capita taxes

INTEREST EXPENSE

Home Mortgage Interest

A taxpayer may deduct interest paid on ***home acquisition debt*** to buy, build, or improve a ***qualified home*** (main home or second home).

For taxable years beginning **after 2017** and beginning before 2026, a taxpayer may treat no more than **$750,000** ($375,000 married filing separately) as acquisition indebtedness. In the case of acquisition indebtedness incurred on or before December 15, 2017, this limitation is $1,000,000 ($500,000 married filing separately). For taxable years beginning after 2025, a taxpayer may treat up to $1,000,000 ($500,000 married filing separately) of indebtedness as acquisition indebtedness, regardless of when the indebtedness was incurred.

TIP: Special rules apply in the case of indebtedness from **refinancing** existing acquisition indebtedness. Specifically, the $1,000,000 ($500,000 married filing separately) limitation continues to apply to refinanced prior qualified residence indebtedness to the extent the amount of the new indebtedness resulting from the refinancing does not exceed the amount of the prior indebtedness refinanced. Thus, the maximum dollar amount that may be treated as principal residence acquisition indebtedness will not decrease by reason of a refinancing.

> Interest on ***home equity debt*** (mortgage taken other than to buy, build, or improve a home) is **no longer deductible**.

Mortgage interest on home acquisition debt to buy, build, or improve a qualified home is deductible if all the following conditions exist:

- File Form 1040 or 1040-SR and itemize deductions on Schedule A
- The taxpayer is legally liable for the loan
- There is a true debtor-creditor relationship between the taxpayer and the lender
- The taxpayer has an ownership interest in the qualified home that secures the mortgage

Points

The term "points" describes certain charges paid or treated as paid, by a borrower to obtain a home mortgage. In general, taxpayers amortize points (deduct ratably over the life of the mortgage). A taxpayer may fully ***deduct*** points in the year paid if the following conditions exist:

- The taxpayer must use the loan proceeds to buy, build or improve a **main home** (points on a second home or to refinance an existing loan are ***amortized*** over the life of the loan)
- Paying points is an established business practice in the area where the loan was made
- The points paid were not more than the points generally charged in that area
- The taxpayer uses the cash method of accounting
- The points are not in place of amounts that ordinarily are stated separately on the settlement statement, such as appraisal fees, inspection fees, title fees, attorney fees, and property taxes
- The points are not financed into the mortgage amount
- The points were computed as a percentage of the principal amount of the mortgage
- The amount clearly appears on the settlement statement as points charged for the mortgage

> **EXAMPLE:** Lamont purchased a new home to use as his primary residence. He pays $5,000 in points to improve the rate on his 15-year loan. On Schedule A, he deducts the points as interest in the year paid. If this were an investment property, he would amortize the points over a period of 15 years.

> Points on ***home equity debt*** are **no longer deductible**.

Mortgage Insurance Premiums

Treat the amount paid during the year for ***qualified mortgage insurance*** as home mortgage interest. The insurance must be purchased in connection with the acquisition indebtedness of the taxpayer's qualified residence. This deduction decreases by 10% for each $1,000 ($500 MFS) of AGI above $100,000 ($50,000 MFS). No deduction is allowed when AGI exceeds $109,000 ($54,500 MFS).

TIP: Congress allowed this deduction (and several others) to expire after 2017. The ***Taxpayer Certainty and Disaster Tax Relief Act of 2019*** extended this benefit to tax years 2018 (retroactively), 2019, and 2020. The ***Consolidated Appropriations Act, 2021*** further extended this deduction through 2021.

Investment Interest

Interest on loans to buy property held for investment is ***investment interest***.

> The deduction for investment interest is limited to the taxpayer's ***net investment income***. If the taxpayer does not use the deduction, he may carry it forward into the next year. Interest incurred to produce tax-exempt income is <u>not</u> deductible.

An individual, estate, or trust must use ***Form 4952*** to claim a deduction for investment interest expenses. Form 4952 is not necessary if a taxpayer meets <u>both</u> the following conditions:

- Income from interest and ordinary dividends (minus any qualified dividends) exceeds the amount of investment interest expenses
- The taxpayer does not have any other deductible investment expenses or carryover of disallowed prior-year investment interest expense

CHARITABLE CONTRIBUTIONS

A charitable contribution deduction may be available for contributions to a ***qualified organization.*** Qualified organizations include:

- Churches, an association of churches, temples, synagogues, mosques, and other religious organizations
- Most nonprofit charitable organizations such as the Red Cross and the United Way
- Most nonprofit educational organizations (Boy and Girl Scouts of America, colleges, and museums)
- Nonprofit hospitals and medical research organizations
- Utility company emergency energy programs, if the utility company is an agent for a charitable organization that assists individuals with emergency energy needs
- Nonprofit volunteer fire companies
- Public parks and recreation facilities
- Civil defense organizations

Nondeductible Contributions

- Contributions of the value of taxpayer-provided time or services.
- Contributions of less than the entire interest in the property.
  1. Right to use property – A contribution of the right to use property is a contribution of less than the taxpayer's entire interest in that property (a contribution of a partial interest) and isn't deductible.

     > **Example:** You own a 10-story building and donate rent-free use of the top floor to a charitable organization. Because you still own the building, you have contributed a partial interest in the property and can't take a deduction for the contribution.

- Contributions to **specific individuals**, including the following:
  1. Contributions to fraternal societies for paying medical or burial expenses of deceased members
  2. Contributions to individuals who are needy or worthy
  3. Payments to a member of the clergy that the member may spend as he wishes
  4. Expenses paid for another person who provided services to a qualified organization
  5. Payments to a hospital for a specific patient’s care or for services for a specific patient
- Contributions to nonqualified organizations:
  1. Groups that are run for a profit
  2. Certain state bar associations
  3. Chambers of commerce and other business leagues or organizations
  4. Civic leagues and associations
  5. Country clubs and other social clubs
  6. Foreign organizations except certain Canadian, Israeli, or Mexican charitable organizations
  7. Homeowners’ associations
  8. Labor unions
  9. Political organizations and candidates

Contributions of Property

The deductible amount for **capital gain property** is generally the fair market value of the property at the time of the contribution.

The deduction for **ordinary income property** is limited to the gift's fair market value minus the amount that would be ordinary income or a short-term capital gain if the taxpayer sold the property for its fair market value. Generally, this rule limits the deduction to the taxpayer's basis in the property. Ordinary income property includes short-term gain property, inventory, works of art created by the taxpayer, property subject to depreciation recapture, etc.

> **EXAMPLE:** You donate stock you held for 5 months to your church. The fair market value of the stock on the day you donate it is $1,000, but you paid only $800 (your basis). Because the $200 of appreciation would be a short-term capital gain if you sold the stock, your deduction is limited to $800 (fair market value minus the appreciation).

EXCEPTION: Do not reduce the charitable contribution if reporting the ordinary or capital gain income in the same year as the contribution.

The deduction for contributed property that has decreased in value (i.e., fair market value is less than cost basis) is limited to the value of the property. A taxpayer can't claim a deduction for the original cost. Common examples of property that decrease in value include clothing, furniture, appliances, and cars.

Donated clothing or household items must be in good used condition or better in order to qualify for a deduction. A good measure of value might be the price that buyers of these used items actually pay in consignment or thrift shops. However, a taxpayer may take a deduction for items in poor condition if the deduction is more than $500 and the taxpayer includes a qualified appraisal with the return.

> A taxpayer claiming a deduction for non-cash gifts of more than **$500** must file ***Form 8283***. The IRS requires an **appraisal** for any single item or group of related items with a value exceeding **$5,000**.

A taxpayer looking to deduct more than $500 resulting from a donation of a qualified vehicle must attach a copy of the contemporaneous written acknowledgment. In general, a contemporaneous acknowledgment must be issued within 30 days of the contribution or later sale. The organization receiving the property may use Form 1098-C copy B as the acknowledgment. The deduction is limited to the smaller of the vehicle's FMV on the date of the contribution or the gross proceeds received from a later sale of the vehicle. An acceptable measure of the FMV of a donated vehicle is an amount not in excess of the price listed in a used vehicle pricing guide for a private party sale of a similar vehicle.

Limits on Charitable Deductions

> The ***CARES Act*** temporarily suspended limits on certain **cash contributions** made in 2020. Individuals may deduct qualified contributions of cash up to **100% of adjusted gross income**. Contributions of non-cash property do not qualify for this relief. This relief also applies to qualified cash contributions made in 2021, as the relief was extended by the ***Consolidated Appropriations Act, 2021***.
>
> ***Cash contributions*** include those paid by cash, check, electronic funds transfer, credit card, debit card, or payroll deduction. They don't include securities, household items, or other property.

The limit that applies to a contribution depends on the type of property donated and the category of the qualified organization that receives the property. The charitable contribution deduction generally is limited to a percentage of adjusted gross income.

> For 2021, the charitable contribution deduction is generally **limited to 100% of adjusted gross income** for **cash contributions**. This 100% limit does not apply to non-cash charitable contributions. Gifts of **appreciated property** or gifts **to certain organizations** are subject to additional limits of 50%, 30%, or 20%, depending on the circumstances. The limits apply to all charitable contributions made during the year and any carryover from a prior year.

A taxpayer can carry over any contributions he can't deduct in the current year because they exceed the AGI limits. The taxpayer may be able to deduct the excess in each of the next **5 years** until it is used up, but not beyond that time. A carryover of a ***qualified conservation contribution*** can be carried forward for **15 years**.

- **50% limit organizations** – The following is a partial list of the types of organizations that are 50% limit organizations:
  1. Churches and conventions or associations of churches.
  2. Educational organizations with a regular faculty and curriculum that normally have a regularly enrolled student body attending classes on-site.
  3. Hospitals and certain medical research organizations associated with these hospitals.
  4. Publicly-supported charities.

> A 2021 **cash** contribution to a 50% limit organization is limited to **100% of AGI**.

> A **non-cash** contribution to a 50% limit organization is limited to **50% of AGI**.

EXCEPTION: A **special 30% limit** applies to **gifts of capital gain property** to 50% limit organizations. The special 30% limit does not apply when using cost in place of FMV as the amount of the gift. Instead, only the 50% limit applies.

- **30% limit** – A 30% limit applies to the following gifts:
  1. Gifts to all qualified organizations other than 50% limit organizations. This includes gifts to veterans' organizations, fraternal societies, nonprofit cemeteries, and certain private non-operating foundations.
  2. Cash contributions **for the use of** any organization. A 30% limit applies to cash contributions that are "for the use of" the qualified organizations instead of "to" the qualified organization. A contribution is "for the use of" a qualified organization when it is held in a legally enforceable trust for the qualified organization or in a similar legal arrangement.
- **20% limit** – A 20% limit applies to all non-cash **gifts of capital gain property** to organizations other than 50% limit organizations, or **for the use of** any qualified organization.

TIP: The s**pecial 30% limit** for **capital gain property** is separate from the other 30% limit. Therefore, the deduction of a contribution subject to one 30% limit does not reduce the amount taxpayers can deduct for contributions subject to the other 30% limit. However, the total cannot be more than 50% of adjusted gross income.

> **EXAMPLE:** Your adjusted gross income is $50,000. During the year, you gave capital gain property with a fair market value of $15,000 to a 50% limit organization. You do not choose to reduce the property's fair market value by its appreciation in value. You also gave $10,000 cash to a qualified organization that is not a 50% limit organization. The $15,000 gift of property is subject to the special 30% limit. The $10,000 cash gift is subject to the

> other 30% limit. Both gifts are fully deductible because neither is more than the 30% limit that applies ($15,000 in each case) and together they are not more than the 50% limit ($25,000).

Limit if Benefit Received

If a taxpayer receives a benefit because of a contribution to a qualified organization, reduce the charitable deduction by the FMV of the benefit received.

> **EXAMPLE 1:** You pay $65 for a ticket to a dinner dance at a church. Your entire $65 payment goes to the church. The ticket to the dinner-dance has a fair market value of $25. When you buy your ticket, you know its value is less than your payment. To figure the amount of your charitable contribution, subtract the value of the benefit you receive ($25) from your total payment ($65). You can deduct $40 as a charitable contribution to the church.

> **EXAMPLE 2:** At a fundraising auction conducted by a charity, you pay $600 for a week's stay at a beach house. The amount you pay is no more than the fair rental value. You haven't made a deductible charitable contribution.

> A charitable deduction is not allowed for any payment to a higher education institution in exchange for the right to purchase tickets or seating at an athletic event.

Records for Cash Contributions

Cash contributions include those paid by cash, check, electronic funds transfer, credit card, debit card, or payroll deduction. To claim a cash contribution, taxpayers must have one of the following:

- Bank records (canceled check or statement)
- A receipt (or other written communication) from the qualified organization showing the name of the organization, the date of the contribution, and the amount of the contribution
- Payroll deduction records

> To deduct a cash contribution of **$250 or more**, the taxpayer must receive a **contemporaneous written acknowledgment** of the contribution from the qualified organization or have certain payroll deduction records.

Written acknowledgment required to substantiate a charitable contribution of $250 or more

The written acknowledgment required to substantiate a charitable contribution of $250 or more must contain the following information:

- Name of the organization;
- Amount of cash contribution;
- Description (but not value) of non-cash contribution;
- A statement that no goods or services were provided by the organization, if that is the case;
- Description and good faith estimate of the value of goods or services, if any, that organization provided in return for the contribution; and
- A statement that goods or services, if any, that the organization provided in return for the contribution consisted entirely of intangible religious benefits, if that was the case.

> A donor may claim a deduction for contributions of cash, check, or other monetary gifts only if the donor maintains certain written records.

Out-of-pocket Expenses in Giving Services

> The value of taxpayer-provided services given to a qualified organization is not deductible; however, costs (automobile or travel expenses, etc.) associated with providing the services may be. The 2021 standard mileage rate is **14 cents per mile** for use of an automobile in rendering gratuitous services to a charitable organization.

A taxpayer cannot deduct personal expenses for sightseeing, fishing parties, theater tickets, nightclubs, or expenses for family members. To receive a deduction, the expenses must be as follows:

- Unreimbursed
- Directly connected with the services
- Expenses incurred only because of the services provided
- Not personal, living, or family expenses

Conventions

If a taxpayer is a chosen representative attending a convention of a qualified charitable organization, he may deduct actual unreimbursed expenses for travel and transportation, including a reasonable amount for meals and lodging, while away from home overnight in connection with the convention. Expenses are not deductible if attending as a member of the organization rather than as a chosen representative.

CASUALTY AND THEFT LOSS DEDUCTION LIMITED TO ONLY FEDERALLY DECLARED DISASTER AREAS

> For tax years 2018 through 2025, the personal casualty and theft losses of an individual are deductible only to the extent they are attributable to a **federally declared disaster**.

EXCEPTION: An exception applies to the extent the personal casualty loss of an individual does not exceed the individual's personal casualty gains. In this case, you will reduce your personal casualty gains by any casualty losses not attributable to a federally declared disaster. Any excess gain is used to reduce losses from a federally declared disaster.

> **EXAMPLE:** Martin and Grace experienced multiple personal casualties. Grace's diamond necklace was stolen, resulting in a $15,500 casualty loss. Martin and Grace also lost their camper as a result of a lightning strike. They have replacement-value insurance on the camper, so they have a $13,000 gain. Finally, they lost their car in a flood determined to be a federally declared disaster, resulting in a casualty loss of $25,000. Because Martin and Grace experienced a $13,000 personal casualty gain as a result of the replacement-value insurance, they can offset that gain with a portion of their personal casualty loss attributable to the stolen necklace and can claim the full federally declared disaster casualty loss of $25,000 subject to the 10% of AGI and $100 limitations. Note: The remaining personal casualty loss from the stolen necklace is not deductible, since the loss was not from a federally declared disaster. Also, since the flood was classified as a federally declared disaster (but not a qualified disaster), the loss is deductible subject to the $100 and 10% of AGI limitations. If the flood had been a "qualified disaster loss (major disaster)" the loss would have only been subject to the $500 limitation.

> A ***casualty*** is the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual (e.g., terrorist attacks, earthquakes, fires, floods, hurricanes, and tornadoes). A taxpayer may have multiple losses from a single casualty. A taxpayer must use a **separate Form 4684** for each casualty or theft event involving personal use property.

An individual may claim an itemized deduction for a personal casualty loss only if such loss was attributable to a disaster declared by the President under section 401of the ***Robert T. Stafford Disaster Relief and Emergency Assistance Act***.

TIP: Victims of fraudulent investment schemes can claim a theft loss deduction if certain conditions apply.

GAIN OR LOSS

The taxpayer must determine if the result of a nonbusiness casualty or theft is a gain or a loss.

Figuring a Loss

The **loss** is the smaller of the adjusted basis in the property before the casualty or theft, or the decrease in FMV of the property because of the casualty or theft, minus any insurance or other reimbursements.

There are two types of disaster declarations provided for in the Stafford Act: ***emergency declarations*** and ***major disaster declarations***.

- For **emergency declarations**, there are two limits on the deductible amount for casualty or theft loss on personal-use property:
  1. Reduce each casualty or theft loss by $100 (**$100 rule**)
  2. The total of all casualty and theft losses is further reduced by 10% of AGI (**10% rule**)
- A **major disaster declaration** receives more favorable treatment as a ***qualified disaster loss.*** Net casualty losses from qualified disasters do not need to exceed 10% of adjusted gross income to qualify for the deduction but the $100 limit per casualty is increased to **$500** per casualty. A qualified disaster loss may be claimed in addition to the standard deduction if not itemizing.

  TIP: A **qualified disaster loss** is now expanded to include an individual's casualty and theft of personal-use property that is attributable to a **major disaster** that was declared before February 26, 2021. However, this change does not include those losses attributable to a major disaster that has been declared only by reason of COVID-19. Examples of major disasters include Hurricane Harvey, Irma, and Maria, or the California wildfires in 2017 and January 2018.

> **EXAMPLE:** In June, a tornado destroyed your lakeside cottage, which cost $144,800 (including $14,500 for the land) several years ago. (Your land wasn't damaged.) **The tornado was classified as a federally declared disaster by the President, but it is not a qualified disaster loss.** This was your only casualty or theft loss for the year. The FMV of the property immediately before the tornado was $180,000 ($145,000 for the cottage and $35,000 for the land). The FMV immediately after the tornado was $35,000 (value of the land). You collected $130,000 from the insurance company. Your adjusted gross income for the year the tornado occurred is $80,000. Your deduction for the casualty loss is $6,700, figured in the following manner:

1.	Adjusted basis of the entire property (cost in this example)	$144,800
2.	FMV of entire property before tornado	$180,000
3.	FMV of entire property after tornado	35,000
4.	Decrease in FMV of entire property (line 2 − line 3)	$145,000
5.	Loss (smaller of line 1 or line 4)	$144,800
6.	Subtract insurance proceeds received	– 130,000
7.	Loss after reimbursement	$14,800
8.	Subtract $100	– 100
9.	Loss after $100 rule	$14,700
10.	Subtract 10% of $80,000 AGI	– 8,000
11.	**Casualty loss deduction**	**$6,700**

If the result is a **loss** and the taxpayer is:

- **Itemizing deductions** – Use ***Schedule A*** to report the casualty and theft loss(es) from a federally declared disaster and attach a **separate Form 4684** for each **casualty or theft event** involving personal use property. The taxpayer reports casualty and theft loss(es) from a federally declared disaster (other than net qualified disaster losses) on line 15 of Schedule A as "Casualty and Theft Losses." The taxpayer reports net qualified disaster losses on line 16 of Schedule A as "Other Itemized Deductions."
- **Not itemizing deductions** – If a taxpayer has a **net qualified disaster loss** on Form 4684 and is not itemizing deductions, they can claim an **increased standard deduction** for the net qualified disaster loss. The taxpayer still files Form 4684 (for each casualty or theft event) along with Schedule A showing the net qualified disaster loss on Schedule A line 16 "Other Itemized Deductions."

TIP: It is important to recognize when a loss is a ***qualified disaster loss (major disaster)***, as that is the only type that may be claimed as an increase to the standard deduction. A qualified disaster loss must exceed $500 before it is deductible, but it is not subject to the 10% reporting threshold like other federal disaster losses. Other federal disaster losses can only be claimed as an itemized deduction.

Reporting increased standard deduction for a net qualified disaster loss

Non-itemizing taxpayers can claim an increased standard deduction using Schedule A by taking the following steps:

1. Enter the amount from Form 4684, line 15, on the dotted line next to line 16 on Schedule A and the description, "Net Qualified Disaster Loss.”
2. Enter on the dotted line next to line 16, the standard deduction amount and the description, “Standard Deduction Claimed With Qualified Disaster Loss.”
3. Combine these two amounts and enter on line 16 of Schedule A and on Form 1040 or 1040-SR, line 12.

Election to deduct loss in the preceding year

A taxpayer may deduct the loss from a federally declared disaster on his return for the tax year of the disaster or elect to deduct the loss in the preceding tax year on an amended return for the tax year immediately **preceding the tax year of the disaster**. If an individual chooses an amended return, treat the loss as having occurred in the preceding tax year. Claiming the loss on the previous year's return may result in a lower tax for that year, often producing or increasing a refund or overpayment.

TIP: To make this election for a loss in disaster year **2021**, complete Part I of Section D on the 2020 Form 4684, Casualties and Thefts, and attach it to the taxpayer's **2020 return** or **2020 amended return** that claims the disaster loss deduction on or before the date that is six months after the regular due date for filing the original return (without extensions) for the disaster year. For a calendar year taxpayer, a taxpayer can make the election to deduct a disaster loss sustained in 2021 on their 2020 return or amended return filed on or before October 15, 2022.

Figuring a gain

A taxpayer may have a **reportable gain** if he receives an insurance payment or other reimbursement that is more than his adjusted basis in the destroyed, damaged, or stolen property.

Gain is figured as follows:

- The amount received, minus
- The adjusted basis in the property at the time of the casualty or theft.

The amount received includes any money plus the value of any property received minus any expenses in obtaining the reimbursement. It also includes any reimbursement used to pay off a mortgage or other lien on the damaged, destroyed, or stolen property.

> **EXAMPLE:** A hurricane destroyed your personal residence and the insurance company awarded you $145,000. You received $140,000 in cash. The remaining $5,000 was paid directly to the holder of a mortgage on the property. The amount you received includes the $5,000 reimbursement paid on the mortgage. Therefore, the amount you received is $145,000 ($140,000 paid to you + $5,000 paid to mortgage holder).

> Even if the decrease in FMV of the property is smaller than its adjusted basis, **use the adjusted basis to figure the gain**.

If the result is gain, the taxpayer may elect to account for it is as a capital gain on Schedule D, or postpone reporting the gain (must acquire related replacement property within two tax years).

MOVING EXPENSE DEDUCTION SUSPENDED AND REIMBURSEMENT TAXABLE (EXCEPT ACTIVE MILITARY)

Prior law permitted an above-the-line deduction for 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. Such expenses are deductible only if the move meets certain conditions related to distance from the taxpayer's previous residence and the taxpayer's status as a full-time employee in the new location.

> The TCJA **suspends the deduction for moving expenses** for taxable years 2018 through 2025.

> The TCJA **repeals the exclusion of qualified moving expense reimbursements** from gross income and wages for taxable years beginning after December 31, 2017. All moving expenses paid or reimbursed beginning January 1, 2018, will be taxable to the employee and subject to tax withholding.

EXCEPTION: The TCJA retains the deduction for moving expenses and the rules providing for exclusions of amounts attributable to in-kind moving and storage expenses (and reimbursements or allowances for these expenses) for **members of the Armed Forces** (or their spouse or dependents) on active duty that move pursuant to a military order and incident to a permanent change of station.

RECORDKEEPING AND DOCUMENTATION OF DEDUCTIONS

A taxpayer must keep records as long as needed for the administration of any provision of the Internal Revenue Code. Generally, this means keeping records that support items shown on the return until the ***period of limitations*** for that return expires.

The period of limitations is the period of time in which the taxpayer can amend a return to claim a credit or refund, or the IRS can assess additional tax. This is generally 3 years from the date the taxpayer files the return. Returns filed before the due date are treated as filed on the due date.

A taxpayer must keep records relating to property until the period of limitations expires for the year he sells the property. A taxpayer who receives property in a nontaxable exchange must keep records for the original property until the period of limitations expires for the year he sells the replacement property. These records are necessary to figure any depreciation, amortization, or depletion deduction, and to figure basis for computing gain or loss when sold.

A taxpayer with employees must keep all employment tax records for at least 4 years after the date the tax becomes due or is paid, whichever is later.

Period of Limitations		
IF you…		**THEN the period is…**
1	Owe additional tax and (2), (3), and (4) do not apply	3 years
2	Do not report income and it is more than 25% of the gross income shown on return	6 Years
3	File a fraudulent return	No limit
4	Do not file a return	No limit
5	File a claim for credit or refund after filing return	Later of 3 years or 2 years after tax was paid
6	File a claim for a loss from a bad debt or worthless securities	7 years

TIP: It is good practice for taxpayers to maintain records, both basic and specific. Records do not need to be required to be of benefit. For example, a taxpayer who receives a Form W-2 should keep a copy until he begins receiving Social Security benefits. This will help protect his benefits in case there is a question about his work record or earnings in a particular year. The IRS does not require taxpayers to maintain records in a particular way. If using a computerized system, individuals must be able to produce legible records of the information needed to determine the correct tax liability. In addition, the taxpayer must keep proof of payment, receipts, and other documents to prove the amount shown.

TAX CREDIT ELIGIBILITY

CHILD TAX CREDIT AND CREDIT FOR OTHER DEPENDENTS

CHILD TAX CREDIT

A ***child tax credit (CTC)*** is available for each ***qualifying child***.

> Effective for tax years 2018 through 2025, the TCJA temporarily increased the child tax credit to **$2,000 per qualifying child** and provides a $500 nonrefundable credit for qualifying dependents other than qualifying children.

> The ***American Rescue Plan Act of 2021*** introduces Child Tax Credit improvements for 2021. For tax year 2021, the child tax credit ***increases to*** **$3,000** per qualifying child ($3,600 for children 5 and under) and is **fully refundable** for qualifying taxpayers. Currently, the improvement to the CTC applies only to the 2021 tax year.

Improvements include an increase to the eligibility age of a qualifying child, as well as an increase to the credit amount for qualifying taxpayers. For tax year 2021, an eligible child can be younger than 18 (previously 17), and the credit increases are as follows:

1. For qualifying children ***ages 6 - 17*** (not yet 6 and younger than 18), the CTC increases to **$3,000 per child**.
2. For qualifying children ***up to age 6*** (5 and under), the CTC increases to **$3,600 per child**.

Previously non-refundable (except the Additional Child Tax Credit portion when applicable), the 2021 improvements make the CTC refundable for ***qualifying taxpayers***. To qualify, the taxpayer (or spouse if MFJ):

- must have a principal abode in the US for more than half of the year; or
- must be a bona fide resident of Puerto Rico for such taxable year.

For all other taxpayers, the refundable amount remains capped at ***up to $1,400 per qualifying child***.

> To receive the CTC, a taxpayer must include a **Social Security number** for each qualifying child for whom the credit is claimed.

A **qualifying child** for purposes of the child tax credit is a child who meets all the following criteria:

- Is the taxpayer's son, daughter, stepchild, foster child, adopted child, brother, sister, stepbrother, stepsister, or a descendant of any of them (a grandchild, niece, or nephew)
- Was younger than **age 18** at the end of the tax year and younger than the taxpayer (or spouse)
- Did not provide more than half of his own support for the year
- Lived with the taxpayer for more than half of the year
- Is claimed as a dependent on the return
- Is a U.S. citizen, a U.S. national, or a resident of the United States

TIP: 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.

> A **qualifying child** is an individual who has not attained **age 18** during the taxable year. A child who is not a citizen, national, or resident of the United States cannot be a qualifying child.

ADDITIONAL $500 CREDIT FOR OTHER DEPENDENTS

The TCJA also temporarily enhances 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. The $500 nonrefundable credit may be claimed only with respect to any dependent who is a citizen, national, or resident of the United States. Thus, non-U.S. citizens living in Canada and Mexico do not qualify for the $500 nonrefundable credit. The American Rescue Plan Act, 2021 did not modify this credit.

> **EXAMPLE:** Your 10-year-old nephew lives in Mexico and qualifies as your dependent. He is not a U.S. citizen, U.S. national, or U.S. resident alien. You cannot use him to claim ODC.

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. In order to claim the $500 nonrefundable credit with respect to any individual, however, the taxpayer must include such individual's **TIN** (SSN, ITIN, or ATIN) on the tax return.

> **EXAMPLE:** Robert and Susan file a joint return and they both have SSNs. Their tax liability is $2,000. They have three qualifying dependents. Tom is their 18-year-old son, has an SSN, and meets the qualifying child dependent test. Jill is their 17-year-old adopted child, has an ATIN, and meets the qualifying child dependent test. Robert's mother, Esther, is 65 years old, has an ITIN, and meets the qualifying relative test. They are all U.S. residents. Tom, Jill, and Esther are all qualifying dependents for the credit for other dependents.

LIMITS ON THE CREDITS

Under the TCJA, there was a modification to the adjusted gross income phaseout thresholds. The credit began to phase out for taxpayers with adjusted gross income in excess of **$400,000** (married taxpayers filing a joint return) and **$200,000** (for all other taxpayers). These phase-out thresholds are not indexed for inflation.

The ***American Rescue Plan Act, 2021*** also includes a modification to the phaseout thresholds for taxpayers based on modified adjusted gross income (MAGI). In general, the amount of the credit is reduced by $50 per $1,000 (or fraction thereof) that the taxpayer's 2021 MAGI exceeds the following thresholds:

- $150,000, in the case of a joint return or surviving spouse,
- $112,500, in the case of a head of household, and
- $75,000, in any other case (single and MFS)

Round income above these levels up to the nearest thousand and multiply by 5% ($50 per $1,000). Subtract the result from the maximum child tax credit.

CHILD AND DEPENDENT CARE TAX CREDIT

> The ***American Rescue Plan Act of 2021*** brought about significant changes to the Child and Dependent Care Credit. In addition to increasing the amount of qualified expenses that may be considered to **$8,000** for one qualifying child (**$16,000** for two or more), the act also makes the credit ***refundable***, increases the applicable percentage, and the income phaseout range.

To qualify for the newly **refundable** (for 2021) child and dependent care credit, a taxpayer must meet all the following tests:

- The filing status must be single, head of household, qualifying widow(er) with dependent child, or married filing jointly. Married couples must file a joint return unless an exception exists.
- The care must be for one or more ***qualifying person(s)***.
- The taxpayer (and spouse if married) must have earned income during the year.
- The taxpayer must pay the expenses so the taxpayer (and spouse if married) can work or look for work.
- Payments cannot go to the following individuals:
  1. A spouse
  2. A person who is a dependent of the taxpayer, or the taxpayer's child if under age 19 at the end of the year (even if not a dependent)
  3. The parent of the qualifying person if the qualifying person is the taxpayer's child (under age 13)
- The taxpayer must identify the care provider on the tax return (name, address, TIN).
- If a taxpayer excludes dependent care benefits provided by a dependent care benefits plan, the total exclusion must be less than the dollar limit for qualifying expenses (generally **$8,000** if one qualifying person was cared for or **$16,000** if two or more qualifying persons were cared for).

EXAMPLE: Randall is married and both he and his wife are employed. Each has earned income in excess of $16,000. They have two children, Anne and Andy, ages 2 and 4, who attend a daycare facility licensed and regulated by the state. Randall's work-related care expenses are $16,000 for the year.

Randall's employer has a dependent care assistance program as part of its cafeteria plan, which allows employees to make pre-tax contributions to a dependent care flexible spending arrangement. Randall has elected to take the maximum $10,500 exclusion from his salary to cover dependent care expenses through this program. (The maximum exclusion amount was increased to $10,500 under the American Rescue Plan Act, 2021.)

Although the dollar limit for his work-related care expenses is $16,000 (two or more qualifying persons), Randall figures his credit on only $5,500 of the $16,000 work-related expense paid. This is because his dollar limit is reduced as shown next.

Maximum allowable expenses for two qualifying persons	$16,000
Dependent care benefits cafeteria plan and excluded from income	–10,500
Reduced work-related expenses Randall can use for the credit	**$5,500**

QUALIFYING PERSON TEST

For purposes of the ***child and dependent care credit***, a "qualifying person" is:

- A dependent who was **under age 13** when the care was provided.
- An individual living with a taxpayer for more than half of a year who is physically or mentally unable to care for himself, if he is:
  1. A spouse
  2. A dependent
  3. Would have been a dependent except for one of the following:
     A. received gross income of $4,300 or more in 2021
     B. filed a joint return

C. Another person could claim the taxpayer or the taxpayer's spouse as a dependent

In determining whether a person is a qualifying person, treat a person who is born or dies as living with the taxpayer for the entire year if he lived in the taxpayer's home the entire time he was alive.

An individual is considered physically or mentally incapable if the person is incapable of caring for their own hygiene or nutritional needs or requires the full-time attention of another person for their own safety or the safety of others. An individual's inability to engage in any substantial gainful activity or to perform the normal household functions does not of itself establish physical or mental incapability. The status of whether a person is a qualifying individual is determined on a daily basis.

TIP: A qualifying person for this credit must meet different requirements than a qualifying person for purposes of a dependent or the EIC.

JOINT RETURN TEST

Generally, married couples must file a joint return to take the credit. However, those legally separated or living apart from a spouse may be able to file a separate return and still take the credit. Only the custodial parent can claim the credit. A married taxpayer living apart from a spouse is not considered married, and he can take the credit if all the following apply:

- The taxpayer files a separate return
- The taxpayer's home is the home of a qualifying person for more than half the year
- The taxpayer paid more than half of the cost of keeping up a home for the year
- A spouse did not live in the taxpayer's home for the last six months of the year

HOW TO FIGURE THE CREDIT

The credit is a percentage of ***work-related expenses,*** which allow the taxpayer to work or look for work.

> To claim the credit, the taxpayer (and spouse if filing jointly) **must have earned income** during the year. Child and dependent care **expenses must be work-related** to qualify for the credit. To be work-related, expenses must allow the taxpayer to work or look for work. If married, generally both spouses must work or look for work. One spouse is treated as working during any month he is a full-time student or isn't physically or mentally able to care for himself. Work also includes actively looking for work. However, if you don't find a job and have no earned income for the year, you can't take this credit.

The expenses to figure the credit on ***Form 2441 Child and Dependent Care Expenses*** cannot be more than any one of the following for 2021:

- **$8,000** if one qualifying person or **$16,000** if more than one qualifying person
- If single at the end of the year, the taxpayer's earned income for the year
- If married at the end of the year, the smaller of the taxpayer or a spouse's earned income for the year

TIP: A spouse who is a full-time student or incapable of self-care is treated as having earned income of at least $250/month if there is one qualifying person in the taxpayer's home or at least $500/month for two or more.

The credit is available only for employment-related expenses. The amount of employment-related expenses is capped to $8,000 for one qualifying individual or $16,000 for two or more qualifying individuals. The taxpayer may apply the limitations for two or more qualifying individuals in unequal proportions.

> **EXAMPLE:** Ida had employment-related expenses of $9,000 for her dependent young son Jimmy and $5,500 for her dependent elderly mother Jane (both are qualifying individuals). Ida may take the aggregate payment of $14,500 ($9,000 + $5,500) into account when determining the credit, even though the expenses related to one of the qualifying individuals exceeded $8,000.

To qualify for the credit, a taxpayer must have one or more qualifying persons. However, it is possible a qualifying child could have no expenses and a second qualifying child could have expenses exceeding $8,000. Since there are two qualifying children, the $16,000 limit would still be used to compute the credit. The taxpayer can use both qualifying children and the $16,000 limit to figure the credit. On Form 2441, list zero for the one child and the actual amount for the second child.

Both the applicable credit percentage and the AGI limit are increased for 2021. To determine the credit amount, multiply work-related expenses (after applying the earned income and dollar limits) by a percentage (based on AGI). The applicable percentage begins at **50%** (up from 35%) for taxpayers with AGI less than **$125,000** (up from $15,000) and decreases by 1% for each $2,000 increase in AGI.

Taxpayers with AGI more than $185,000 and up to $400,000 in AGI use an applicable percentage of **20%.** From $400,000, the applicable percentage continues to decrease by 1% for each $2,000 increase in AGI until completely phased out once AGI exceeds $440,000.

TIP: In figuring each $2,000 increase, treat any excess as a full $2,000. For example, a $9,000 increase is a 5% reduction.

> The **maximum amount of this credit** is **$4,000** (50% of $8,000) for one qualifying person or **$8,000** (50% of $16,000) for more than one qualifying person.

EDUCATION TAX CREDITS

There are two tax credits available to persons who pay expenses for higher (postsecondary) education. They are as follows:

- The ***Lifetime Learning credit***
- The ***American Opportunity credit***

Generally, a taxpayer may claim a credit if they meet all of the following three requirements:

- pays ***qualified education expenses*** of higher education
- pays the education expenses for an ***eligible student***
- The student is the taxpayer, a spouse, or a dependent

A taxpayer cannot claim a credit if any of the following applies:

- Filing status is married filing separately (MFS)
- The person qualifies as a dependent of another taxpayer
- Modified adjusted gross income (MAGI) is above the phase-out limit
- The taxpayer (or spouse) is a nonresident alien for any part of the year and did not elect to be treated as a resident alien for tax purposes
- The taxpayer claims another education credit for the same student in the same year

A taxpayer cannot claim multiple credits for the same student in the same year. The American opportunity credit will always be greater than or equal to the lifetime learning credit for any student who is eligible for both credits. A taxpayer who is eligible for more than one credit can choose to claim either credit, but not both. A taxpayer with education expenses for more than one student in the same year can choose to take the credits on a per-student, per-year basis.

> **EXAMPLE:** A taxpayer can claim both the American Opportunity credit and the Lifetime Learning credit—but not for the same student. A taxpayer can claim the American Opportunity credit for one student and the Lifetime Learning credit for another student in the same year.

A taxpayer uses ***Form 8863 Education Credits (American Opportunity and Lifetime Learning Credits)*** to figure and claim their education credits. Taxpayers must complete a separate Part III on page 2 for each student for whom they are claiming either the American opportunity credit or lifetime learning credit before completing either Part I or Part II (use additional copies of page 2 as needed for each student).

The ***Consolidated Appropriations Act, 2021*** brought about a change to the Lifetime Learning credit. For tax years beginning with 2021, the modified adjusted gross income phase-out limit is increased to the same limit as the American Opportunity credit and is no longer indexed for inflation.

2021 Education Credits

	American Opportunity Credit	**Lifetime Learning Credit**
Maximum credit	$2,500 credit **per eligible student**	$2,000 credit **per return**
Limit on MAGI	$180,000 MFJ and $90,000 S, HH, or QW (NOT indexed for inflation)	$180,000 if MFJ and $90,000 if S, HH, or QW (NOT indexed for inflation)
Refundable	**40% refundable**	**Non-refundable** credit limited to the amount of tax liability
Availability	Available **ONLY** for the **first 4 years**	Available **ALL years AND** for courses to acquire or improve job skills
Number of tax years' credit available	Available **ONLY** for **4 tax years** per eligible student	Available for an **UNLIMITED** number of years
Type of degree required	Student must be pursuing an undergraduate degree or other recognized education credential	Student does **not** need to be pursuing a degree or other recognized education credential
Number of courses	Student enrolled at least half-time for at least one academic period beginning in the tax year	Available for one or more courses
Felony drug conviction	**No felony** drug convictions on student's records	**Felony** drug convictions **permitted**
Qualified expenses	Books, supplies, and equipment **do not** need to be purchased from the institution in order to qualify	Tuition and required enrollment fees, including required amounts paid to the institution for course-related books, supplies, and equipment

QUALIFIED EDUCATION EXPENSES

For purposes of the education credits, consider only ***qualified education expenses*** in determining the credit amount. Qualified education expenses **must be required for enrollment or attendance** at an ***eligible educational institution*** and include tuition and required enrollment fees. Expenses include amounts paid to the institution for course-related books, supplies, and equipment.

- Only certain expenses for course-related books, supplies, and equipment qualify:
  1. **American Opportunity credit** – Qualified education expenses include amounts spent on books, supplies, and equipment needed for a course of study, whether or not the taxpayer purchases materials from the educational institution as a condition of enrollment or attendance.
  2. **Lifetime Learning credit** – Qualified education expenses include **only** amounts for books, supplies, and equipment **required to be paid to the institution as a condition of enrollment or attendance**.
- Qualified education expenses do not include amounts paid for:
  1. **Room and board**, insurance, medical expenses (including student health fees), transportation, or other similar personal, living, or family expenses.
  2. Any course or other education involving sports, games, or hobbies, or any noncredit course, unless such course or other education is part of the student's degree program or (for the Lifetime Learning credit only) helps the student acquire or improve job skills.
  3. Nonacademic fees, such as student activity fees, athletic fees, insurance expenses, or other expenses unrelated to the academic course of instruction.

TIP: Expenses paid or deemed paid by a dependent are considered paid by the taxpayer. Someone other than the taxpayer, spouse, or dependent (such as a relative or former spouse) may make a payment directly to an eligible educational institution to pay for an eligible student's qualified education expenses. In this case, treat the student as receiving the payment from the other person and, in turn, paying the institution. If the taxpayer is eligible to claim the student as a dependent on his tax return, he is considered to have paid the expenses.

AMERICAN OPPORTUNITY CREDIT

The American Opportunity credit replaces the Hope credit. Students must attend at least half-time for one academic period.

- The credit is available for the **first four years** of postsecondary education, and **40% of the credit is refundable** for most taxpayers (up to a maximum of $1,000).
- The **maximum credit per student is $2,500** (100% of first $2,000 and 25% of the next $2,000).
- The amount of the American Opportunity credit phases out based on a taxpayer's modified adjusted gross income (MAGI). The phase-out begins if MAGI is between $80,000 and $90,000 ($160,000 and $180,000 MFJ). A taxpayer cannot claim a credit if MAGI is $90,000 or more ($180,000 or more MFJ). These phase-out levels are not indexed for inflation.

A taxpayer may not claim the American Opportunity credit if **convicted of a drug-related felony** before the end of the taxable year.

> Paid preparers of federal income tax returns or claims for refund involving the American Opportunity Tax Credit (AOTC) must meet the due diligence requirements in determining if the taxpayer is eligible for, or the amount of, the AOTC. Failure to do so for a return filed in 2022 (generally 2021 tax returns filed in 2022) shall pay a penalty of **$545** for each failure (IRC Section 6695(g) Failure to be diligent in determining eligibility for certain tax benefits). A tax preparer can use ***Form 8867 Paid Preparer's Due Diligence Checklist*** to document due diligence.

LIFETIME LEARNING CREDIT

A Lifetime Learning credit of **up to $2,000** is available for ***qualified education expenses*** paid for students enrolled in ***eligible educational institutions***. The Lifetime Learning credit is computed on a family-wide basis. The amount of the Lifetime Learning credit is 20% of the first $10,000 of qualified education expenses paid for all eligible students. Differences from other credits include the following:

- Student does not need to pursue a degree or other credentials
- Available for an **unlimited number of years**
- Used for courses to acquire or improve job skills and all years of postsecondary education
- No half-year requirement for eligible students, available for one or more courses
- Felony drug conviction rule does not apply

The amount of the Lifetime Learning credit also phases out based on a taxpayer's modified adjusted gross income (MAGI). Just like the AOTC, the phase-out begins if MAGI is between $80,000 and $90,000 ($160,000 and $180,000 MFJ). A taxpayer cannot claim a credit if 2021 MAGI is $90,000 or more ($180,000 or more MFJ). These phase-out levels are not indexed for inflation.

EARNED INCOME TAX CREDIT

The ***earned income tax credit (EIC or EITC)*** is a **refundable tax credit** for certain people who work and have ***earned income***. This credit also underwent changes for tax year 2021 as a result of the ***American Rescue Plan Act, 2021***.

The maximum amount of the EIC in 2021 is:

Qualifying Children	Maximum Credit
0	$1,502
1	$3,618
2	$5,980
3 +	$6,728

Earned income includes all of the following:

- Wages, salaries, and tips
- Union strike benefits
- Long-term disability benefits received prior to minimum retirement age
- Net earnings from self-employment
- Non-taxable combat pay (only if elected and included in taxable income)

Earned income does not include:

- Interest and dividends
- Pensions
- Social Security
- Unemployment benefits
- Alimony
- Child support
- Pay received for work while in jail

> A taxpayer will base the credit on AGI if lower than earned income.

WHO MAY CLAIM THE EIC?

To claim the EIC, taxpayers must meet all of the following rules:

- Investment income must be **$10,000 or less** for 2021
- Married taxpayers must file a **joint return (MFJ)** unless treated as unmarried.
  1. Married taxpayers may be treated as unmarried for EIC purposes if ***both*** of the following apply:
     A. The taxpayer lives with a qualifying child more than half the year; and
     B. The taxpayer either (i) doesn't live with their spouse during the last six months of the year, ***or*** (ii) has a legal decree (other than divorce decree) and doesn't live with their spouse by the end of the year.
- Taxpayer(s) and all qualifying children must have a valid Social Security number
- Taxpayer must be a U.S. citizen or a nonresident alien married to a U.S. citizen or resident alien and filing a joint return
- Taxpayer cannot file Form 2555 related to foreign-earned income
- Taxpayer cannot be the ***qualifying child*** of another person
- Taxpayer must have earned income; however, 2021 earned income and AGI **cannot be more than**:

Qualifying Children	S, QW, HH	MFJ
0	$21,430	$27,380
1	$42,158	$48,108
2	$47,915	$53,865
3 +	$51,464	$57,414

Taxpayers with **no qualifying children** must meet the following criteria:

- Be at **least age 19** (no maximum age limit), except:
  1. at least ***age 24*** in the case of specified students (eligible students during 5 calendar months of tax year), and
  2. at least ***age 18*** in the case of certain former foster and homeless youth
- Live in the United States for more than half of the year
- Not qualify as a dependent of another person

Taxpayers with a qualifying child must meet the ***relationship***, ***age***, and ***residency tests***:

- **Relationship Test** – To be a qualifying child, a child must fall into one of the following categories:
  1. Son, daughter, stepchild, foster child, adopted child, or a descendant of any of them (for example, a grandchild)
  2. Brother, sister, half-brother, half-sister, stepbrother, stepsister, or a descendant of any of them (for example, a niece or nephew)
- **Age Test** – A qualifying child must be as follows:
  1. Younger than the taxpayer or taxpayer’s spouse if filing a joint return, and
     A. Under age 19 at the end of the year, or
     B. A full-time (five months or more) student under age 24 at the end of the year
  2. Permanently and totally disabled at any time during the year, regardless of age
- **Residency Test** – Child must have lived with the taxpayer in the U.S. for more than half of the tax year

> Sometimes a child meets the rules to be a qualifying child of more than one person. However, only one person can treat that child as a qualifying child and claim the EIC using that child. Taxpayers can choose which person will claim the EIC. If the taxpayers do not reach an agreement and more than one person claims the EIC using the same child, the tiebreaker rule applies, and the parent with whom the child lived the longest during the year receives the credit. If the child lived with each parent the same amount of time, the parent with the higher AGI receives the credit.

A taxpayer uses ***Schedule EIC Earned Income Credit, Qualifying Child Information*** to give the IRS information about their qualifying child(ren).

> Paid preparers of federal income tax returns or claims for refund involving the Earned Income Credit must meet the due diligence requirements in determining if the taxpayer is eligible for, or the amount of, the EIC. Failure to do so for a return filed in 2022 (generally 2021 tax returns filed in 2022) shall pay a penalty of **$545** for each failure. See IRC Section 6695(g). A tax preparer can use ***Form 8867 Paid Preparer's Due Diligence Checklist*** to document due diligence.

> As part of the ***American Rescue Plan Act, 2021,*** taxpayers may substitute their 2019 earned income for their 2021 earned income for purposes of calculating the EIC, if the result is a higher tax credit.

OVERVIEW TOPICS

VIRTUAL CURRENCY TRANSACTIONS

Cryptocurrency (e.g., Bitcoin) is a common form of virtual currency. A **transaction** involving virtual currency must be included on the tax return and includes:

- The receipt or transfer of virtual currency for free (without providing any consideration)
- An exchange of virtual currency for goods or services
- A sale of virtual currency
- An exchange of virtual currency for other property, including for another virtual currency

The IRS provides guidance on virtual currency transactions in Notice 2014-21. For federal income tax purposes, virtual currency is **treated as property** and general tax principles applicable to property transactions apply to transactions using virtual currency.

- A taxpayer reports a transaction involving virtual currency that was held as a capital asset (such as an investment) using Form 8949 (and Schedule D) to figure **capital gain** or loss.
- A taxpayer who received virtual currency as compensation for services or disposed of any virtual currency held for sale to customers in a trade or business reports the income the same as other income of the same type (for example, W-2 wages on Form 1040, or inventory or services from Schedule C on Schedule 1). These transactions are subject to **ordinary rates.**

TIP: Mining cryptocurrency is ordinary income, and subject to SE tax if self-employed.

ALTERNATIVE MINIMUM TAX (AMT)

Alternative Minimum Tax (AMT) is caused by two types of adjustments and preferences—deferral items and exclusion items. Deferral items (for example, depreciation) generally do not cause a permanent difference in taxable income over time. Exclusion items (for example, the standard deduction) do cause a permanent difference.

One of the issues with the individual AMT over the years has been the fact that the exemptions weren't indexed for inflation. Initially, the intent of the AMT was to put a floor on the minimum amount of tax paid for high-income taxpayers who benefit from certain deductions and credits. Over time, the AMT began to affect a greater number of taxpayers, such as middle-income households, which was not the original intent of the law.

The TCJA temporarily increases both the exemption amount and the exemption amount phaseout thresholds for the individual AMT, for taxable years beginning after December 31, 2017, and beginning before January 1, 2026. These amounts are indexed for inflation.

Taxpayers with income or expenses that receive special treatment under the regular tax system may be subject to an additional tax known as the ***alternative minimum tax (AMT)***. Use Form 6251, Alternative Minimum Tax—Individuals, to figure AMT separately, after eliminating certain deductions and credits, to arrive at ***alternative minimum taxable income (AMTI)***. AMT liability exists if taxable income for regular tax purposes, combined with ***adjustments*** and ***tax preference items***, is more than the ***AMT exemption*** amount (which phases out at higher income levels).

For taxable years beginning in 2021, the AMT exemption amounts are:

- $114,600 Joint Returns or Surviving Spouses
- $73,600 Unmarried Individuals (other than Surviving Spouses)
- $57,300 Married Individuals Filing Separate
- $25,700 Estates and Trusts Returns

For taxable years beginning in 2021, the amounts used to determine the phaseout of the exemption amounts are (the exemption amounts above reduce by 25% of AMTI in excess of the following):

- $1,047,200 Joint Returns or Surviving Spouses
- $523,600 Unmarried Individuals (other than Surviving Spouses)
- $523,600 Married Individuals Filing Separate
- $85,650 Estates and Trusts Returns

For taxable years beginning in 2021, the excess taxable income above which the 28 percent tax rate applies is:

- $99,950 Married Individuals Filing Separate Returns
- $199,900 Joint Returns, Surviving Spouses, Unmarried Individuals, and Estates and Trusts

For 2021, the alternative minimum tax brackets are:

Filing Status	26% AMT Tax Rate	28% AMT Tax Rate
Married filing separately	AMTI up to $99,950	AMTI above $99,950
All other filers	AMTI up to $199,900	AMTI above $199,900

The exemption amount is subtracted from AMTI before calculating the tax. For 2021, apply a flat tax rate of **26%** up to $199,900 ($99,950 for MFS). A **28%** tax rate applies to the excess. This is the ***tentative minimum tax***. If the tentative minimum tax exceeds normal income tax liability the taxpayer reports the difference as AMT on the tax return.

CREDIT FOR PRIOR YEARS MINIMUM TAX

A taxpayer with AMT liability in the current year may recapture that amount in future years in the form of a credit. This **non-refundable credit** can offset future tax liability only to the extent prior AMT tax paid was due to **deferral items**. The credit cannot reduce tax below the ***tentative minimum tax*** for the year.

20% DEDUCTION FOR A QUALIFIED TRADE OR BUSINESS

With the passage of the ***Tax Cuts and Jobs Act of 2017 (TCJA)*** business taxpayers received a multitude of benefits. Perhaps the single biggest change is the permanent reduction of the corporate tax rate from a maximum of 35% down to 21%.

That's a sweet deal—if you happen to own a corporation!

A mere 5% of all businesses in the United States are taxed as corporations. While many corporations are classified as small (85% have less than 20 employees) the corporate form is often the entity of choice for big business.

So, you might wonder, is there anything in the "Cut Cut Cut Act" for the other 95%? Plumbers, doctors, contractors, dentists, lawyers, consultants, financial advisors... tax preparers? If the goal of the TCJA is to create jobs surely you cannot ignore the single biggest contributor—small business.

From a tax perspective, the most common forms of small business are sole proprietorships, partnerships, and S corporations. I have a hunch that most business returns you encounter will fall into one of these classifications.

TIP: A ***limited liability company (LLC)*** is a business structure allowed by state statute. Depending on elections made by the LLC, and the number of members, the IRS will treat an LLC as either a corporation ("C" or "S"), partnership, or as part of the LLC-owner's tax return (a "disregarded entity").

SECTION 199A

Lurking deep within the pages of the TCJA, there is something for the rest of us.

A temporary deduction—called the ***Section 199A deduction*** or ***QBI deduction***—is available for taxable years beginning after December 31, 2017, and before January 1, 2026.

TIP: Take note that the Section 199A deduction will expire unless extended. Pay close attention to this date as the planning implications are significant for business owners.

> Section 199A provides that a taxpayer **other than a corporation** generally may deduct:
>
> - **20 percent** of ***qualified business income (QBI)***, plus
> - **20 percent** of aggregate qualified real estate investment trust dividends and qualified publicly traded partnership (PTP) income.
>
> The deduction is subject to an **overall limitation** as it cannot exceed **20% of taxable income**, calculated before the QBI deduction, minus net capital gain.

NOTE: In an effort to avoid distracting you from the most important aspects of 199A that apply broadly, this course does not cover the many additional rules and regulations unique to specified agricultural and horticultural cooperatives and their patrons.

While this deduction is far more complex than the flat 21% corporate rate, you should familiarize yourself with it because many small businesses qualify. S corporations and partnerships (other than a PTP) are generally not taxpayers and cannot take the deduction themselves. Instead, these ***relevant passthrough entities (RPE)*** must report the necessary information to owners on Schedule K-1 so they may figure the deduction. Section 199A does not require a taxpayer's material participation in the business to qualify for the deduction.

Taxpayers eligible to claim the deduction generally include individuals and certain trusts and estates with QBI. An individual taxpayer claims the deduction on Form 1040 while a trust or estate with QBI uses Form 1041. For the remainder of the discussion, we will focus on individual taxpayers.

The deduction is subject to multiple limitations such as the type of trade or business, the taxpayer's taxable income, the amount of W-2 wages paid with respect to the qualified trade or business, and the unadjusted basis immediately after acquisition (UBIA) of qualified property held by the trade or business.

The business type limitation may eliminate the 199A deduction for certain large service businesses classified as a ***Specified Service Trade or Business (SSTB)***. A specified service trade or business is any trade or business involving the **performance of services** in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investing, trading or dealing in securities, and any trade or business where the principal asset is the reputation or skill of one or more of its employees or owners.

It is easy to assume that a taxpayer with an SSTB does not qualify, but that is a huge mistake!

TIP: If you think about it, most small service businesses rely on the "reputation or skill" of one or more employees or owners. The final regulations provide a narrow definition to businesses—where **reputation or skill is the principal asset**—generating income through licensing, endorsements and appearance fees.

> **EXAMPLE:** Gordon is a well-known chef and the sole owner of multiple restaurants each of which is owned in a disregarded entity. Due to Gordon's skill and reputation as a chef, Gordon receives an endorsement fee of $500,000 for the use of his name on a line of cooking utensils and cookware. Gordon is in the trade or business of being a chef and owning restaurants and such trade or business is not an SSTB. However, he is also in the trade or business of receiving endorsement income. Gordon's trade or business consisting of the receipt of the endorsement fee for his skill and/or reputation is an SSTB.

The **50% W-2 wage limitation** is also a potential deduction killer because a sole proprietor or partnership with no employees does not have W-2 wages.

> The **SSTB limitation** and the **W-2 wage limitation** that reduce or eliminate the deduction **do not apply** if taxable income is below **$164,900** for single filers (**$329,800** if filing jointly; **$164,925** if married filing separate) in 2021. A partial deduction is available below $214,900 ($429,800; $214,925).

TIP: It's easy to spot a missing deduction. Is there an amount entered for the QBI deduction on the 2021 Form 1040 (line 13)? If a taxpayer has a business that isn't a corporation and has taxable income (line 15) below the threshold amount it's time to dig deeper. It is good practice to review returns starting in 2018 for a missed QBI deduction.

FORMS 8995 AND 8995-A

A taxpayer **does not need to itemize** deductions to claim this deduction. The taxpayer claims the 199A deduction after calculating adjusted gross income (AGI).

Taxpayers must use ***Form 8995-A Qualified Business Income Deduction*** to claim the qualified business income deduction. A one-page simplified version (Form 8995) is available if:

- The taxpayer's taxable income is not more than the threshold amount.
- The taxpayer is not using the aggregation rules.
- The taxpayer is not a patron of an agricultural or horticultural cooperative.

Form 8995-A is filed if a taxpayer does not qualify to file the simplified Form 8995.

TAX ON INVESTMENT INCOME OF CERTAIN CHILDREN ('KIDDIE TAX')

> When a child has more than **$2,200** of ***unearned income*** (income from interest, dividends, or other investments) in 2021, part of that income is taxed at the **parent's tax rate** instead of the child's tax rate.

Parents can elect to **include a child's income on the parent's return** when a child's only income is **unearned income**. Unearned income includes all taxable income other than earned income. Unearned income includes taxable interest, ordinary dividends, capital gains (including capital gain distributions), rents, royalties, etc. It also includes taxable social security benefits, pension and annuity income, taxable scholarship and fellowship grants not reported on Form W-2, unemployment compensation, alimony, and income (other than earned income) received as the beneficiary of a trust.

Parents making the election file ***Form 8814 Parents' Election To Report Child's Interest and Dividends***, with the parent's return. If making this election, the child does not have to file a return.

The child must meet the following conditions to qualify:

- At the end of the year, must be younger than age 19 or a full-time student younger than age 24
- Must have only unearned income
- Must have gross income of less than $11,000 in 2021
- Must be required to file a return unless the election is made (gross income is more than $1,100 in 2021)
- Must not file a joint return for the year
- Must not have made estimated tax payments for the tax year, and no overpayment from the previous year can apply to the tax year under their name and Social Security number
- Must not have any federal income tax taken out of their income

This rule has been in place since the 1980s in order to prevent parents from shifting portfolio income to children for the purpose of reducing taxes.

If an election to include a child's income on the parent's return is not made, all net unearned income over **$2,200** in 2021 is taxed on the child's return at the **parent's rate.** The child must file ***Form 8615 Tax for Certain Children Who Have Unearned Income***, with the **child's return**.

SECTION 529 PLANS

A qualified tuition program (also known as a ***529 plan***) is a program set up to allow the taxpayer to either prepay or contribute to an account established for paying a student's qualified education expenses at an eligible educational institution. A state, a state agency, an instrumentality of a state, or an eligible educational institution can establish and maintain a QTP.

- The part of a distribution representing the amount paid or contributed to a QTP is not included in income. This is a return of the investment in the program.
- Earnings accumulate tax-free while in the account. The beneficiary generally does not include earnings distributed from a QTP in income if the total distribution is less than or equal to adjusted qualified education expenses. Income is reported to the recipient on Form 1099Q. The beneficiary is the recipient when distributions are made either directly to the beneficiary or to an eligible educational institution for his benefit. Consequently, taxable distributions constitute income to the beneficiary when paid either directly to the beneficiary or to an eligible educational institution for his benefit. Otherwise, the account owner is the recipient.
- The designated beneficiary is generally the student (or future student) for whom the QTP is intended to provide benefits. The taxpayer **can change the designated beneficiary**.
- Contributions to a QTP on behalf of any beneficiary cannot be more than the amount necessary to provide for the qualified education expenses of the beneficiary.
- There are **no income restrictions** on individual contributors.

TIP: An ESA and a QTP are similar in that neither offers a tax deduction for contributions to the plan, earnings accumulate free of tax until withdrawn, and withdrawals are excluded from income if used for qualified education expenses. A QTP is different from an ESA in the following ways: the beneficiary of a QTP can be any age and can even change, QTP does not have age-based distribution requirements, contributions can be far more than allowed in an ESA, and there are no income restrictions.

> The Tax Cuts and Jobs Act consolidates and modifies the education savings rules for distributions made after December 31, 2017. The act modifies Section 529 plans to allow such plans to distribute **not more than $10,000** in expenses for tuition incurred during the taxable year in connection with the enrollment or attendance of the designated beneficiary at a **public, private or religious elementary or secondary school**. The limitation applies on a per-student basis, rather than a per-account basis. Any excess distributions (over $10,000) received would be treated as a taxable distribution.

The Secure Act of 2019 expands the definition of qualified higher education expenses for 529 plans, allowing costs associated with **registered apprenticeships** and up to **$10,000 of principal or interest on qualified student loan repayments** for the beneficiary (and an additional $10,000 for each of the beneficiary's siblings).

For distributions made from qualified tuition programs (QTPs), Section 529 plans can make tax-free distributions of **not more than $10,000 per taxable year, per student,** for:

- Qualified higher-education expenses.
- Tuition incurred during the taxable year in connection with the enrollment or attendance of the designated beneficiary at a public, private or religious elementary or secondary school (i.e. kindergarten through grade 12).
- Certain expenses required for a designated beneficiary's participation in certain apprenticeship programs.
- Up to $10,000 paid as principal or interest on a qualified student loan of the designated beneficiary or the designated beneficiary's sibling (reduced by the amount of distributions so treated for all prior taxable years).

TIP: Amounts treated as a qualified higher education expense with respect to the loans of a sibling of the designated beneficiary shall be taken into account with respect to such sibling and not with respect to such designated beneficiary. The $10,000 cap on student loan repayments treated as qualified higher education expenses is a lifetime limit per beneficiary (reduced by the amount of distributions so treated for all prior taxable years).

TIP: A taxpayer can withdraw any amount from their 529 plan, but only qualified distributions are tax-free.

ACHIEVING A BETTER LIFE EXPERIENCE (ABLE) ACCOUNT

An ***Achieving a Better Life Experience (ABLE)*** account (also known as a ***529 ABLE*** or ***529A*** account) provides for a tax-favored savings program intended to benefit **disabled** individuals. Similar to a traditional 529 plan, a qualified ABLE program is a program established and maintained by a State or agency or instrumentality thereof.

A designated beneficiary must be an eligible individual. An eligible individual is an individual either:

- For whom a disability certification has been filed with the Secretary for the taxable year, or
- Who is entitled to Social Security Disability Insurance benefits or SSI benefits based on blindness or disability, and such blindness or disability occurred before the individual attained age 26.

A disability certification is made by the eligible individual or the parent or guardian, indicating that the individual has a medically determinable physical or mental impairment, which results in marked and severe functional limitations, and which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months, or is blind. Such blindness or disability must have occurred before the date the individual attained age 26. Such certification must include a copy of the diagnosis of the individual's impairment and be signed by a licensed physician.

Amounts in an ABLE account may be rolled over without income tax liability to another ABLE account for the same beneficiary or another ABLE account for the designated beneficiary's brother, sister, stepbrother or stepsister who is also an eligible individual. Once an ABLE account has been established by a designated beneficiary, no account subsequently established by such beneficiary shall be treated as an ABLE account.

Contributions to an ABLE account must be made in cash and are not deductible for Federal income tax purposes. An ABLE account must provide that it may not receive aggregate contributions during a taxable year in excess of the annual gift tax exclusion ($15,000 for 2021), except in the case of a rollover contribution from another ABLE account. Amounts in an ABLE account accumulate on a tax-deferred basis.

A contribution to an ABLE account is treated as a completed gift of a present interest to the designated beneficiary of the account. Such contributions qualify for the per-donee annual gift tax exclusion ($15,000 for 2021) and, to the extent of such exclusion, are exempt from the generation-skipping transfer (GST) tax. A distribution from an ABLE account generally is not subject to gift tax or GST tax.

Distributions from an ABLE account are generally includible in the distributee's income to the extent consisting of earnings on the account. Distributions from an ABLE account are excludable from income to the extent that the total distribution does not exceed the qualified disability expenses of the designated beneficiary during the taxable year. If a distribution exceeds the qualified disability expenses of the designated beneficiary, a pro-rata portion of the distribution is excludable from income. The portion of any distribution that is includible in income is subject to an additional 10% tax unless the distribution is made after the death of the beneficiary.

The earnings on distributions from an ABLE account are excluded from income only to the extent total distributions do not exceed the qualified disability expenses of the designated beneficiary. For this purpose, qualified disability expenses are any expenses related to the eligible individual's blindness or disability that are made for the benefit of the designated beneficiary. Such expenses include the following expenses: education, housing, transportation, employment training and support, assistive technology and personal support services, health, prevention and wellness, financial management and administrative services, legal fees, expenses for oversight and monitoring, funeral and burial expenses, and other expenses, which are approved by the Secretary under regulations and consistent with the purposes of section 529A.

This provision applies to distributions after the date of enactment of the Tax Cuts and Jobs Act (December 22, 2017) and is not effective for distributions after December 31, 2025:

- The act allows a designated beneficiary of an ABLE account to claim the saver's credit for contributions made to his/her ABLE account.
- Under the act, the limitation is increased with respect to contributions made by the designated beneficiary of the ABLE account. After the overall limitation on contributions (the per-donee annual gift tax exclusion) is reached, an ABLE account's **designated beneficiary may contribute an additional amount**, up to the lesser of, the Federal poverty line for a one-person household or the individual's compensation for the taxable year.
- Effective for distributions after the date of enactment, the act allows for amounts from qualified tuition programs (529 accounts) to be rolled over to a qualified ABLE account without penalty, provided that the ABLE account is owned by the designated beneficiary of that 529 account or a member of such designated beneficiary's family. Such rolled-over amounts count towards the overall limitation on amounts that can be contributed to an ABLE account within a taxable year. Any amount rolled over that is in excess of this limitation shall be includible in the gross income of the distributee.

CANCELLATION OF STUDENT DEBT – WHEN TO EXCLUDE FROM INCOME

The TCJA temporarily modifies the exclusion of student loan discharges from gross income, by including within the exclusion certain discharges on account of death or disability. Loans eligible for the exclusion under the provision are loans made by:

- The United States (or an instrumentality or agency thereof),

- A state (or any political subdivision thereof),
- Certain tax-exempt public benefit corporations that control a State, county, or municipal hospital and whose employees have been deemed to be public employees under state law,
- An educational organization that originally received the funds from which the loan was made from the United States, a State, or a tax-exempt public benefit corporation, or
- Private education loans (for this purpose, private education loan is defined in section 140(7) of the Consumer Protection Act).

Under the provision, the discharge of a loan as described above is excluded from gross income if the discharge was pursuant to the death or total and permanent disability of the student.

The provision is effective for discharges of indebtedness after December 31, 2017, and does not apply to discharges of indebtedness after December 31, 2025.

NET OPERATING LOSS

NET OPERATING LOSS (NOL)

A taxpayer with annual business deductions that exceed business income may have a ***net operating loss (NOL)***. Some typical losses that may produce an NOL include losses incurred from the following:

- A trade or business
- A casualty or theft
- Moving expenses (for military)
- Rental property

A loss from operating a business is the most common reason for an NOL. Individuals, Estates, and Trusts follow similar rules. Partnerships and S corporations generally cannot use an NOL, but partners or shareholders can use their separate shares of pass-through loss to figure their individual NOLs.

How to Figure NOL

There are rules that limit which deductions from income are allowed for NOL purposes. Calculate the NOL only on the income and expenses directly related to a trade or business. In general, the following items are not allowed when figuring an NOL:

- Capital losses in excess of capital gains of taxpayers other than corporations
- The Section 1202 exclusion of the gain from the sale of qualified small business stock
- Non-business deductions in excess of non-business income
- Net operating loss deduction

A loss resulting from non-business deductions that are not connected to a trade or business or employment cannot contribute to the NOL. Examples of ***non-business deductions*** include:

- Alimony paid
- Deductions for contributions to an IRA or a self-employed retirement plan
- Health savings account deduction for a taxpayer, spouse, or dependents
- Most itemized deductions (except for casualty and theft losses and state income tax on business profit)

Carryforward Period

A net operating loss may be **carried forward indefinitely** and used as a deduction in the future period.

> Under the TCJA, the general 2-year net operating loss (NOL) carryback rule does not apply to NOLs arising in taxable years beginning after December 31, 2017. The taxpayer may carry the loss forward indefinitely. Exceptions apply to certain farming losses (2-year carryback) and NOLs of property and casualty insurance companies. There is also a provision that limits the NOL deduction to **80% of taxable income** (determined without regard to the deduction) for losses arising in taxable years beginning after December 31, 2017.

TIP: NOLs arising in taxable years beginning before 2018 remain subject to **prior law**. Accordingly, such NOLs are not subject to the 80-percent limitation and remain subject to the prior law carryback rules and the 20-year carryover limitation.

MODIFICATION OF NET OPERATING LOSS DEDUCTION, CARRYOVERS AND CARRYBACKS

> **CARES ACT UPDATE:** As a result of COVID-19, the IRS issued Revenue Procedure 2020-24 providing guidance on procedures for carrying back NOLs arising in 2018, 2019, or 2020 to each of the five preceding tax years, as authorized by the CARES Act. The CARES Act also temporarily removes the 80% taxable income limitation. Taxpayers with losses that were limited in these years may want to file an amended return to claim a refund. The TCJA rules once again apply for tax years beginning with 2021 through 2025.

HEALTH INSURANCE PREMIUM TAX CREDIT

Individuals and families can take a premium tax credit to help them afford health insurance coverage **purchased through an Affordable Insurance Exchange** (also known as a Health Insurance Marketplace). The premium tax credit is **refundable** so taxpayers who have little or no income tax liability can still benefit. The credit also can be paid in advance to a taxpayer's insurance company to help cover the cost of premiums.

> Premium tax credits are available only to individuals and families with household incomes of **at least 100—but no more than 400—percent of the federal poverty level**.

2021 POVERTY GUIDELINES FOR THE 48 CONTIGUOUS STATES AND THE DISTRICT OF COLUMBIA	
PERSONS IN FAMILY/HOUSEHOLD	POVERTY GUIDELINE
For families/households with more than 8 persons, add $4,540 for each additional person.	
1	$12,880
2	$17,420
3	$21,960
4	$26,500
5	$31,040
6	$35,580
7	$40,120
8	$44,660

Household income includes the income of the taxpayer and any dependents who reside with the taxpayer. Furthermore, individuals who meet this income level are only eligible for the premium tax credit if they purchase coverage through the Health Insurance Marketplace, sometimes referred to as the Health Insurance Exchange, or simply the "Exchange". **The credit is not available for the purchase of insurance outside of the Exchange.**

> A taxpayer cannot receive the credit if he or she files a **married filing separate** return or if he or she can be **claimed as a dependent of another taxpayer**.

Also, no credit is available with respect to a taxpayer or family member who is able to obtain affordable coverage through an eligible employer-sponsored plan that provides minimum value or through a government program, like Medicaid, Medicare, CHIP or TRICARE.

The Exchanges are responsible for the initial determination of eligibility for the premium tax credit. During enrollment through the Exchange, the Exchange will also determine if the taxpayer is eligible for advance payments of the premium tax credit. Advance credit payments are amounts paid directly to the insurance company on the taxpayer's behalf; the taxpayer is responsible for paying the balance of the premium, if any.

If a taxpayer is eligible for, and chooses to receive the benefit of, an advance credit payment, the taxpayer must file a tax return to reconcile the amount of advance credit payments (which is always based on an estimate made by the Exchange) with the amount of the actual premium tax credit allowable determined at the end of the tax year. **A taxpayer must file an income tax return for this purpose even if he or she is not otherwise not required to file a return.**

The Exchange will issue the taxpayer a Health Insurance Marketplace Statement, **Form 1095-A**, by January 31 following the tax year. This form shows the amount of the premiums for the health care plan or plans the taxpayer and their family members enrolled in and certain other information that is needed to compute the premium tax credit. Form 1095-A also reports any advance credit payments made on the taxpayer's behalf.

Form 8962 Premium Tax Credit (PTC), is filed with the taxpayer's return and is used to reconcile the amount of the advance credit payments to the amount of the actual premium tax credit allowable to the taxpayer. If the actual allowable premium tax credit computed on the return is more than the advance credit payments made during the year, the difference will be listed on the tax return as an additional tax payment (thereby increasing the refund or decreasing the amount of tax owed). If the advance credit payments are more than the amount of the actual allowable premium tax credit, the difference is reflected on the return as an additional tax amount. However, if the taxpayer's household income is below 400 percent of the poverty level, limitations as to the amount of the excess credit that has to be repaid are applicable.

EMPLOYEE FRINGE BENEFITS

Prior to the TCJA, certain employer-provided fringe benefits were excluded from an employee's gross income and wages for employment tax purposes, including, but not limited to, de minimis fringes, qualified transportation fringes, on-premises athletic facilities, and meals provided for the "convenience of the employer."

A ***de minimis fringe*** generally means any property or service the value of which is (taking into account the frequency with which similar fringes are provided by the employer) so small as to make accounting for it unreasonable or administratively impracticable, and also includes food and beverages provided to employees through an eating facility operated by the employer that is located on or near the employer's business premises and meets certain requirements.

On-premises athletic facilities are gyms or other athletic facilities located on the employer's premises, operated by the employer, and substantially all the use of which is by employees of the employer, their spouses, and their dependent children.

The TCJA **disallows a deduction** for amounts paid or incurred after December 31, 2017, with respect to:

- an activity generally considered to be entertainment, amusement, or recreation
- membership dues with respect to any club organized for business, pleasure, recreation, or other social purposes
- a facility or portion thereof used in connection with any of the previous items

QUALIFIED TRANSPORTATION FRINGE BENEFITS

Qualified transportation fringes include qualified parking (parking on or near the employer's business premises or on or near a location from which the employee commutes to work by public transit), transit passes, vanpool benefits, and qualified bicycle commuting reimbursements.

The TCJA **disallows a deduction** for expenses associated with providing any qualified transportation fringe to employees of the taxpayer, and except as necessary for **ensuring the safety** of an employee, any expense incurred for providing transportation (or any payment or reimbursement) for commuting between the employee's residence and place of employment.

QUALIFIED BICYCLE COMMUTING REIMBURSEMENT

Prior to the TCJA, employers could exclude qualified bicycle commuting reimbursements of up to $20 per month from an employee's gross income for income tax purposes. The TCJA **suspends the exclusion** from gross income and wages for qualified bicycle commuting reimbursements. The exclusion does not apply to taxable years beginning after December 31, 2017, and before January 1, 2026.

QUALIFIED MOVING EXPENSE REIMBURSEMENT

Prior to the TCJA employers could exclude qualified moving expense reimbursements from an employee's gross income. A qualified moving expense reimbursement is defined as any amount received (directly or indirectly) from an employer as payment for (or reimbursement of) expenses which would be deductible as moving expenses under section 217 if directly paid or incurred by the employee. However, any such amount actually deducted by the individual was not eligible for this exclusion. Amounts that are excludable from gross income for income tax purposes are also excluded from wages for employment tax purposes.

The TCJA **repeals the exclusion** from gross income and wages for qualified moving expense reimbursements except in the case of a member of the **Armed Forces of the United States** on active duty who moves pursuant to a military order. The exclusion does not apply to taxable years beginning after December 31, 2017, and before January 1, 2026.

EMPLOYER-PROVIDED MEALS AND ENTERTAINMENT

The value of meals furnished to an employee or the employee's spouse or dependents by or on behalf of an employer for the convenience of the employer is excludable from the employee's gross income, but only if such meals are **provided on the employer's business premises**.

For amounts incurred and paid after December 31, 2017, and until December 31, 2025, the provision expands this 50 percent limitation to expenses of the employer associated with providing food and beverages to employees through an eating facility that meets requirements for de minimis fringes and for the convenience of the employer. Such amounts incurred and paid after December 31, 2025, are not deductible. Although the deduction for other business meals increases to 100% for food and beverages purchased from a restaurant and for immediate consumption in tax years 2021 and 2022, the business meal deduction for de minimis meals and meals for the employer's convenience remains deductible at 50%.

EMPLOYEE ACHIEVEMENT AWARDS

An employee achievement award is an item of ***tangible personal property*** given to an employee in recognition of either length of service or safety achievement and presented as part of a meaningful presentation. An employer may exclude the value of an employee achievement award from an employee's income. The amount the taxpayer may exclude is limited to an employer's cost and cannot be more than **$1,600 ($400** for awards that are not qualified plan awards) for all such awards received during the year.

The TCJA adds a definition of "tangible personal property" that may be considered a deductible employee achievement award. It provides that tangible personal property shall not include cash, cash equivalents, gift cards, gift coupons or gift certificates (other than arrangements conferring only the right to select and receive tangible personal property from a limited array of such items pre-selected or pre-approved by the employer), or vacations, meals, lodging, tickets to theater or sporting events, stocks, bonds, other securities, and other similar items.

DEPRECIATION OF RENTAL PROPERTY

Generally, a taxpayer must use the ***Modified Accelerated Cost Recovery System (MACRS)*** to depreciate residential rental property placed in service after 1986. MACRS consists of two systems that determine how property may be depreciated:

- **General Depreciation System (GDS)** – Generally, taxpayers must use GDS for property used in most rental activities. Recovery periods generally are shorter than under ADS.
- **Alternative Depreciation System (ADS)** – ADS uses the **straight-line** method of depreciation. A taxpayer electing to use ADS may not change the election, which applies to all property in the same class that is placed in service during the tax year of the election. However, the election applies on a property-by-property basis for residential rental property and nonresidential real property.

Taxpayers must continue to use the same depreciation method unless the IRS grants approval to change accounting methods. The methods under MACRS for depreciating property are as follows:

- **Straight-line depreciation** – Deduct equal amounts throughout the recovery period.
  1. A taxpayer must use the straight-line method and a mid-month convention for residential rental property. In the first year of claiming depreciation for residential rental property, take depreciation only for the number of months the property is in use.
- **200% or 150% declining balance** – This allows for greater depreciation percentages in early years. Use the straight-line method in place of accelerated depreciation in the first tax year it provides an equal or larger deduction than either the 200% or 150% declining balance (DB) method.

RECOVERY PERIODS

Under regular MACRS (GDS), depreciable property generally falls into one of the following classes:

- **5-year property** – Computers and peripheral equipment, office machinery (typewriters, calculators, copiers, etc.), automobiles, light trucks, appliances, carpeting, furniture, etc., used in a residential rental real estate activity. Depreciation on automobiles and light trucks is limited. Taxpayers may use 200% or 150% DB.
- **7-year property** – Office furniture and fixtures (desks, file cabinets, etc.). This class also includes any property that does not have a class life and that has not been designated by law as being in any other class. Taxpayers may use 200% or 150% DB.
- **15-year property** – Roads, fences, and shrubbery. Taxpayers may use 150% DB.
- **20-year property** – Includes improvements such as utilities and sewers.
- **Residential rental property (27.5-year property)** – Real property that is a rental building or structure (including mobile homes) for which 80% or more of the gross rental income for the tax year is from dwelling units. It does not include a unit in a hotel, motel, inn, or other establishments where more than half of the units are used on a transient basis. Depreciate additions or improvements to the structure over the same period. In a case like this, the straight-line method is necessary along with a mid-month convention. For the first year, take depreciation only for the number of months the property was in use.

- **Non-residential rental property (39-year property)** – Commercial buildings and structures. Includes Section 1250 property. Must use the straight-line method and mid-month convention.

Depreciation begins when the taxpayer places the property in service for the production of income. Depreciation ends when either the taxpayer fully recovers the cost, or the property is retired from service, whichever happens first. Property is placed in service in a rental activity when it is ready and available for a specific use in that activity. Even if unused, it is in service when it is ready and available for its specific use. A ***convention*** is a method established under MACRS to set the beginning and end of the recovery period. Use the mid-month convention for residential rental property and nonresidential real property. For all other property, use the half-year or mid-quarter convention, as appropriate.

- **Mid-month convention** – Use a mid-month convention for all residential rental property and nonresidential real property. Treat all property placed in service, or disposed of, during the month as placed in service, or disposed of, at the midpoint of that month.

> The Section 179 deduction is **not** allowed for property held for the production of income, such as rental property.

> The TCJA expands the definition of Section 179 property to include certain depreciable tangible personal property used predominantly to furnish lodging or in connection with furnishing lodging.
>
> For property placed in service in taxable years beginning after December 31, 2017, a provision expands the definition of qualified real property eligible for Section 179 expensing to include any of the following improvements to **nonresidential** real property—roofs; heating, ventilation, and air-conditioning property; fire protection and alarm systems; and security systems.

> Under the TCJA, a taxpayer may take an additional **100% *special depreciation allowance***, often referred to as “bonus depreciation” on certain qualified property. The special depreciation allowance applies only for the first year the property is in service. The allowance is an additional deduction taken after any Section 179 expense deduction and before the taxpayer figures regular depreciation under MACRS. Qualified property includes **tangible property depreciated in 20 years or less under MACRS**.
>
> The 100% special depreciation allowance now applies to both **new and used property**.
>
> For the 100% special depreciation allowance, the qualified property must be acquired and placed in service after September 27, 2017, and before January 1, 2023 (January 1, 2024, for longer production period property and certain aircraft).

WITHHOLDING AND ESTIMATED TAX PAYMENTS

WITHHOLDING

Federal income tax is a “pay-as-you-go” system. Failure to pay or a significant underestimation of the amount owed may lead to the assessment of penalties and interest. There are two payment methods—withholding and estimated tax.

An employer withholds income tax from an employee’s pay and deposits with the IRS in the name of the employee. In order to determine the proper amount of withholding, an employee completes ***Form W-4, Employee's Withholding Allowance Certificate***.

TIP: Allowances are no longer used for the redesigned Form W-4.

Individuals may withhold tax on income sources like pensions, bonuses, commissions, and gambling winnings. Recipients of pensions, annuities (including commercial annuities), and certain other deferred compensation will use ***Form W-4P, Withholding Certificate for Pension or Annuity Payments*** to tell payers the correct amount of federal income tax to withhold, to choose not to have any federal income tax withheld, or to have an additional amount of tax withheld. The withholding agent does not send these forms to the IRS unless there is a written request.

ESTIMATED TAX

Income from dividends, interest, capital gains, rent, royalties, and self-employment is not subject to withholding. A taxpayer with income from these sources must make estimated quarterly payments. Estimated tax payments may also have to be made whenever the taxpayer does not have a sufficient amount of tax withheld from his or her wages or other payments. Using the Electronic Federal Tax Payment System ("EFTPS") is the easiest way to pay estimated federal taxes for individuals as well as businesses.

An individual with no tax liability in the previous full year is not required to pay estimated tax. Estimated tax liability exists when both of the following conditions exist:

- An individual will owe at least **$1,000** in tax, after subtracting withholding and credits, and
- Withholding and credits will be less than the smaller of one of the following:
  1. **90%** of the tax to be shown on **this year's tax return**, or
  2. **100%** of the tax shown on **last year's tax return** (110% if AGI more than $150,000).

EXAMPLE: Jason earns $130,000, and his tax liability for the current year is $10,000, double what it was the prior year. He can avoid a penalty if his combined payments are at least $5,000 (100% of prior year liability).

For estimated tax purposes, the year is divided into four payment periods. Each period has a specific payment due date. The IRS may issue a penalty even if a refund is due when a sufficient amount of tax is unpaid by the due date for each of the periods as indicated in the following table (next business day if on Saturday, Sunday, or legal holiday). Non-business taxpayers use Form 1040-ES to make estimated payments to the IRS.

Estimated Tax Due Dates for Individuals	
For the period:	**Due date:**
Jan. 1 – Mar. 31 (3 months)	April 15 (fourth month)
Apr. 1 – May 31 (2 months)	June 15 (sixth month)
Jun. 1 – Aug. 31 (3 months)	September 15 (ninth month)
Sep. 1 – Dec. 31 (4 months)	January 15 (first month following tax year)*
*The January 15 installment is not required for a taxpayer who pays all tax due and files Form 1040 or 1040-SR by January 31.	

EXAMPLE: Janet does not pay any estimated tax for 2021. She files her 2021 income tax return and pays the balance due shown on her return on January 26, 2022. Janet's estimated tax for the fourth payment period is considered to have been paid on time. However, she may owe a penalty for not making the first three estimated tax payments, if required; any penalty for not making those payments will be figured up to January 26, 2022.

> **EXAMPLE:** Margaret sold an investment property in July. She has no other income and did not owe taxes the prior year. She estimates owing $25,000 in taxes because of the transaction. If she is required to pay estimated tax, she must make her first payment by September 15. However, she had no tax liability in the prior year and is not required to make estimated payments.

If a taxpayer does not pay enough tax throughout the year in withholding and estimated payments, he or she may be subject to a penalty for underpayment of estimated tax. Generally, most taxpayers will avoid this penalty if they owe less than $1,000 in tax after subtracting their withholdings and credits, or if they paid at least 90% of the tax for the current year, or 100% of the tax shown on the return for the prior year, whichever is smaller. There are special rules for farmers and fishermen.

Furthermore, the penalty may also be waived if the underpayment was caused by a casualty, disaster, or other unusual circumstance and it would be inequitable to impose the penalty, or if the taxpayer is retired (after reaching age 62) or became disabled during the tax year for which estimated payments were required to be made or in the preceding tax year, and the underpayment was due to reasonable cause and not willful neglect. Form 2210 can be used to request a waiver of the penalty under any of these circumstances.

The Internal Revenue Service urges two-income families and those who work multiple jobs to complete a "paycheck checkup" to verify they are having the right amount of tax withheld from their paychecks. The IRS Withholding Calculator (https://www.irs.gov/individuals/irs-withholding-calculator) can help them navigate the complexities of multiple employer tax situations and determine the correct amount of tax for each of their employers to withhold.

The Withholding Calculator is the easiest, most accurate way for taxpayers with these complicated tax situations to determine their correct withholding amount. The tool allows users to enter income from multiple jobs or from two employed spouses. It also ensures that these taxpayers apply their 2021 tax deductions, adjustments, and credits only once—rather than multiple times with different employers.

BALANCE DUE AND REFUND OPTIONS

PAYMENTS

Taxpayers may submit payments through the mail to the IRS or may deliver payments to an IRS office. A non-business taxpayer with tax due from a tax return can pay by check, money order, credit card, or debit card. If an individual taxpayer, IRS Direct Pay offers a free, electronic payment method directly from the taxpayer's bank account. Online payments are available at https://www.irs.gov/payments. Checks should be made payable to the "United States Treasury". The IRS instructs taxpayers to write identifying information on the check, including the first SSN used on the return. Payment by mail should include a ***Form 1040-V Payment Voucher***, although it is not a requirement.

If a taxpayer owes taxes but cannot pay the full amount by the due date, the taxpayer should always still file the return on time and pay as much as possible to avoid penalties and interest. There are several options that may be available to make payments. For example, the taxpayer may be granted a short additional time to pay his or her tax in full. Such brief additional amounts of time to pay can be requested through the Online Payment Agreement application or by calling 800-829-1040, without the need to go through a formal Installment Agreement. Taxpayers who request and are granted an additional 60 to 120 days to pay the tax in full generally will pay less in penalties and interest than if the debt were repaid through an installment agreement over a greater period of time.

INSTALLMENTS

A taxpayer may request a monthly installment plan if they are unable to pay the full amount of tax owed. Before applying for any payment agreement, a taxpayer must file all required tax returns. Installment agreements generally provide up to **72 months** to pay the tax. In certain circumstances, the payment period could be longer or the amount agreed to could be less than the amount of tax owed. An installment plan is not valid unless accepted by the IRS.

However, if a taxpayer **owes $10,000 or less** and meets certain other criteria, **the IRS must accept the request.** Those requirements are:

- During the past five tax years, the taxpayer (and spouse if filing jointly) has timely filed all income tax returns and paid any tax due, and has not entered into an installment agreement for payment of income tax.
- The taxpayer agrees to pay the full amount owed within three years and to comply with the tax laws while the agreement is in effect.
- The taxpayer is financially unable to pay the liability in full when due.

An ***installment agreement*** generally requires equal monthly payments, and the taxpayer must fully pay all of the tax owed within the time left in the 10-year period during which the IRS can collect the tax. If a taxpayer cannot pay in full by the end of the collection period but can pay some of the tax owed, they may qualify for a partial payment installment agreement. To request an installment agreement a taxpayer can attach ***Form 9465 Installment Agreement Request*** to the front of their tax return, or—in cases where the return is already filed—mail it directly to the IRS.

If the IRS approves a request, they send a notice detailing the terms of the agreement and request a user fee to establish the plan. The user fee is reduced if the taxpayer is able to apply online.

> If the balance due is **$50,000 or less**, the taxpayer can apply for an installment agreement online instead of filing Form 9465. To do that, go to IRS.gov/opa.

For a long-term payment plan installment agreement (paying in more than 120 days), the payment method options include:

- Pay through ***Direct Debit*** (automatic monthly payments from your checking account), also known as a Direct Debit Installment Agreement (DDIA)
- Make monthly payment directly from a checking or savings account (***Direct Pay***)
- Make monthly payment electronically online or by phone using the Electronic Federal Tax Payment System (***EFTPS***), enrollment required
- Make monthly payment by check, money order, or debit/credit card (fees apply when paying by card)

The installment agreement applicable fees for a long-term payment agreement (paying in more than 120 days) are based on if the payment method is ***Direct Debit*** or not.

Long-term Agreement User Fees (paying in more than 120 days) (effective for installment agreements entered into on or after April 10, 2018)			
Long-term Payment Plan Installment Agreement	Apply online	Apply by phone, mail, or in-person	***Low income:*** Apply online, by phone, mail, or in-person
Direct Debit	$31	$107	fee waived
Non-Direct Debit	$149	$225	$43*
*fee may be reimbursed if certain conditions are met			

A taxpayer whose adjusted gross income is at or below 250% of the applicable federal poverty level (low-income taxpayer) that enters into long-term payment plans may qualify to pay the low-income reduced fee. The IRS will waive or may reimburse the user fee for ***low-income taxpayers*** only. The IRS will waive the user fee if the low-income taxpayer agrees to make electronic debit payments by entering into a direct debit installment agreement. The IRS will reimburse the user fee that was paid for the installment agreement upon completion for low-income taxpayers who are unable to make electronic debit payments through a direct debit installment agreement.

A taxpayer that can pay the full amount owed within **120 days** should not request an installment agreement on Form 9465. Instead, they can call or apply online to establish a request to pay in full. A taxpayer who can pay within the 120-day period can avoid paying the fee to set up the agreement.

Once approved, a taxpayer may submit a request to modify or terminate the installment agreement. This request will not suspend the statute of limitations on collection. While the IRS considers a request to modify or terminate the installment agreement, the taxpayer **must comply with the existing agreement.**

A taxpayer with outstanding tax liability (including penalties and interest) of $50,000 or less may file Form 9465. This is known as a ***streamlined installment agreement*** because the IRS **does not require a financial statement** (Form 433-F, Collection Information Statement) or substantial disclosure of financial information. A liability greater than $50,000 can be considered if the taxpayer pays down the liability to $50,000 or less prior to the agreement being granted. Generally, a taxpayer must pay off the balance due on a streamlined installment agreement within a 72-month period.

If the total amount the taxpayer owes is greater than $25,000 but not more than $50,000, the taxpayer must agree to a Direct Debit Installment Agreement (DDIA) or make payments by payroll deduction to request an installment agreement without completing a financial statement (Form 433-F, Collection Information Statement).

> The taxpayer will be charged interest and late payment penalties on any tax not paid by its due date, even if a request to pay in installments is granted. Interest and any applicable penalties will be charged until the balance is paid in full. To limit interest and penalty charges, the taxpayer should file the return on time and pay as much of the tax as possible with the return.

REFUNDS

Taxpayers have three options for receiving their individual federal income tax refund:

1. Direct deposit (electronic funds transfer) into a checking or savings account, including an individual retirement arrangement (IRA);
2. Purchase of U.S. Series I Savings Bonds; or
3. Paper check.

If the taxpayer chooses to receive his or her refund by direct deposit, they can request that the refund be deposited in up to three separate accounts by completing ***Form 8888 Allocation of Refund (Including Savings Bond Purchases)***.

A taxpayer who e-files a complete and accurate tax return should receive their refund within 21 days of the date the return is received by the IRS. A complete and accurate paper tax return refund will usually be issued within six to eight weeks from the date the return is received by the IRS.

In an effort to combat fraud and identity theft, new IRS procedures effective January 2015 limit the number of refunds electronically deposited into a single financial account or pre-paid debit card to three. The fourth and subsequent refunds automatically will convert to a paper refund check and be mailed to the taxpayer. Taxpayers will also receive a notice informing them that the account has exceeded the direct deposit limits and that they will receive a paper refund check in approximately four weeks if there are no other issues with the return.

The purpose of the direct deposit limit is to prevent criminals from easily obtaining multiple refunds. The limit applies to financial accounts, such as bank savings or checking accounts, and to prepaid, reloadable cards or debit cards. However, the limitation may also affect some taxpayers, such as families in which the parent’s and children’s refunds are deposited into a family-held bank account. Taxpayers in this situation should make other deposit arrangements or expect to receive paper refund checks.

Note that direct deposit must only be made to accounts bearing the taxpayer's name. Preparer fees cannot be recovered by using Form 8888 to split the refund or by preparers opening a joint bank account with taxpayers. These actions by preparers are subject to penalty under the Internal Revenue Code and to discipline under Treasury Circular 230.

TAX RETURN DUE DATES AND FILING FOR EXTENSIONS

INDIVIDUAL INCOME TAX RETURN

The individual income tax return is due by the **15th day of the 4th month** after the close of the tax year. Usually, this falls on April 15. If the due date falls on a Saturday, Sunday, or legal holiday, the due date is delayed until the next business day.

The regular due date for the 2021 individual federal income tax return (Form 1040 or 1040-SR) is **April 15, 2022**.

If the taxpayer's return is not filed by the initial due date or by the extended due date (assuming an extension request is timely filed), the law imposes on the taxpayer a penalty of 5% of the amount of tax required to be shown on the return (less any earlier payments and credits) for the first month it is overdue, plus an additional 5% for each month (or fraction of a month) the failure continues without reasonable cause. However, the penalty is capped at 25% of the amount of tax required to be shown on the return (less any earlier payments and credits).

There is a minimum penalty for failure to file an income tax return within 60 days of the due date (including extensions), except if due to reasonable cause and not willful neglect. In the case of any return required to be filed in 2022 (generally 2021 tax returns filed in 2022), the amount of the addition to tax shall not be less than the ***lesser*** of **$435** or 100 percent of the amount required to be shown as tax on such returns. Thus, the minimum penalty cannot be imposed unless there is an underpayment of tax, and taxpayers who owe no taxes can file late and still avoid this penalty; there is also no penalty for failure to file if a taxpayer is due a refund.

The 5% failure-to-file penalty is reduced (but not below the above minimum) by the amount of any failure-to-pay penalty (which is one-half of 1%) for that month. If the failure to file is fraudulent, however, the penalty is increased to 15% for each month (or fraction of a month) the return is overdue, up to a 75% maximum.

AUTOMATIC 6-MONTH EXTENSION TO FILE

A taxpayer may request an **automatic 6-month extension** by filing Form 4868 (via paper or electronically) by the due date of the return or by paying all or part of the income tax due using a credit or debit card. For most taxpayers, this extends the due date until October 15.

> Please note that this is **not an extension of time to pay** taxes. The taxpayer must estimate the taxes due and can submit the payment with the extension request.

SERVING IN A COMBAT ZONE EXTENSION

Deadlines are extended for certain taxpayers serving in a combat zone or a contingency operation in support of the Armed Forces. When individuals serve in a qualified combat zone, the deadline for **filing and payment** increases by **180 days** after the latter of the last day in a qualified combat zone or the last day of a continuous hospitalization related to injury from service. In addition to the 180 days, a service member in a qualified combat zone can receive a deadline extension of up to three and a half months, based on the number of days remaining to file upon entering the combat zone. This period is representative of the time normally allotted for filing taxes (January 1–April 15). If entering the combat zone before the first of the year, the servicemember may add the entire three and a half months to the 180-day extension.

The term ***combat zone*** is a general term that includes all of the following hostile areas where the military may serve—actual combat areas, direct combat support areas, and contingency operations areas. A ***contingency operation*** is a military operation that is designated by the Secretary of Defense or results in calling members of the uniformed services to active duty (or retains them on active duty) during a war or a national emergency declared by the President or Congress.

There are multiple classes that qualify for the same treatment:

- Armed forces such as the Army, Navy, Air Force, Marine Corps, and Coast Guard
- Uniformed services, which includes the armed forces, and the commissioned corps of the National Oceanic and Atmospheric Administration (NOAA) and the Public Health Service
- Support personnel, such as the Red Cross

INDIVIDUALS OUTSIDE THE UNITED STATES EXTENSION

A taxpayer who is a U.S. citizen (or resident) may receive an **automatic 2-month extension to file a return and pay** any federal income tax due if—on the due date of the return—he or she is in the military or naval service on duty outside the United States and Puerto Rico, or lives and maintains a main place of business outside the United States and Puerto Rico. Interest applies from the due date until paid. The taxpayer must attach a statement to their return explaining which situation applies.

LESSON 3

Domain 3 - Practices, Procedures and Professional Responsibility

TAX-RELATED IDENTITY THEFT

Tax preparers play a critical role in assisting clients, both individuals and businesses, who are victims of tax-related identity theft. The IRS is working hard to prevent and detect identity theft as well as reduce the time it takes to resolve these cases. Tax-related identity theft occurs when someone uses a stolen social security number to file a tax return claiming a fraudulent refund. Thieves may also use a stolen EIN from a business client to create false Forms W-2 to support refund fraud schemes.

> The IRS does not initiate contact with taxpayers by email to request personal or financial information. This includes any type of electronic communication, such as text messages and social media channels. The IRS does not call taxpayers with threats of lawsuits or arrests.

Tax-related identity theft occurs when someone uses a stolen Social Security number ("SSN") to file a tax return claiming a fraudulent refund. Thieves also may use stolen Employer Identification Numbers ("EINs") to create false Forms W-2 to support refund fraud schemes. Among the warning signs that an individual taxpayer's SSN has been compromised is when a return is rejected with an IRS reject code indicating that the taxpayer's SSN has already been used on a filed return. Other warning signs are when the taxpayer receives IRS notices regarding a tax return after all tax issues have been resolved, refund paid or account balances have been paid, or when the taxpayer receives a notice stating that they received wages from an employer unknown to them.

Warning signs for business taxpayers include when a notice is received that the return is accepted as an amended return, but the taxpayer has not filed a return for that year. Also, be on the lookout for IRS notices about fictitious employees and notices regarding a defunct, closed, or dormant business after all account balances have been paid.

Preparers themselves also have to be cautious regarding potential identity theft problems. Safeguarding of IRS e-file from fraud and abuse is the shared responsibility of the IRS and practitioners who are Authorized IRS e-file Providers ("Providers"). Providers must be diligent in recognizing and preventing fraud and abuse in IRS e-file and must report fraud and abuse to the IRS.

Providers must also cooperate with the IRS investigations by making information and documents related to returns with potential fraud or abuse available to the IRS upon request. Providers must appoint an individual as a ***Responsible Official*** who is responsible for ensuring the firm meets IRS e-file rules and requirements. Providers with problems involving fraud and abuse may be suspended or expelled from participation in IRS e-file, be assessed civil and preparer penalties, or be subject to legal action.

WHAT TO DO IF YOU SUSPECT IDENTITY THEFT

The Federal Trade Commission (FTC), the lead federal agency on general identity theft issues, has recommended steps identity theft victims should take to protect their credit. See identitytheft.gov for general recommendations for your clients. The FTC recommends these steps for victims of identity theft:

- File a complaint with the FTC at identitytheft.gov.
- Contact financial institutions, and close any financial or credit accounts opened without permission or tampered with by identity thieves.

TIP: Contact one of the three major credit bureaus to place a fraud alert on your credit records:

- **Equifax** – www.Equifax.com, 1-800-525-6285
- **Experian** – www.Experian.com, 1-888-397-3742
- **TransUnion** – www.TransUnion.com, 1-800-680-7289

If your client's SSN has been compromised, whether from a data breach, computer hack, or stolen wallet, and they have reason to believe they are at risk for tax-related identity theft, you should take these steps:

- If your client received an IRS notice, respond immediately to the telephone number provided.
- Complete ***Form 14039, Identity Theft Affidavit***. Fax or mail to the IRS according to the instructions.
- To inquire about specific client's return information, you must have a power of attorney on file, and you must authenticate your identity with the IRS customer service representative.

A victim of identity theft or a person authorized to obtain the identity theft victim's tax information may request a redacted copy (one with some information blacked-out) of a fraudulent return that was filed and accepted by the IRS using the identity theft victim's name and SSN. Due to federal privacy laws, the victim's name and SSN must be listed as either the primary or secondary taxpayer on the fraudulent return; otherwise, the IRS cannot disclose the return information. For this reason, the IRS cannot disclose return information to any person listed only as a dependent. Visit irs.gov for more information on how to make this request.

IDENTITY PROTECTION PIN OPT-IN PROGRAM

New for the tax year 2021, the IRS expanded the Identity Protection PIN program to include an optional opt-in for all taxpayers who can verify their identities (they don't have to be victims of ID theft to opt-in).

Key information regarding the Identity Protection (IP) PIN Opt-In Program:

- This is a voluntary program.
- You must pass a rigorous identity verification process.
- Spouses and dependents are eligible for an IP PIN if they can verify their identities.
- An IP PIN is valid for a calendar year.
- You must obtain a new IP PIN each filing season.
- The online IP PIN tool is offline between November and mid-January each year.
- Correct IP PINs must be entered on electronic and paper tax returns to avoid rejections and delays.
- Never share your IP PIN with anyone but your trusted tax provider. The IRS will never call, text, or email requesting your IP PIN. Beware of scams to steal the IP PIN.
- There currently is no opt-out option but the IRS is working on one for 2022.

SAFEGUARDING TAXPAYER DATA

FTC STANDARDS FOR SAFEGUARDING CUSTOMER INFORMATION RULE (16 CFR PART 314)

This ***Federal Trade Commission (FTC)*** Rule, (otherwise known as the ***Safeguards Rule***) requires financial institutions, as defined, which includes professional tax preparers, data processors, affiliates, and service providers to ensure the security and confidentiality of customer records and information. It protects against any anticipated threats or hazards to the security or integrity of such records. In addition, it protects against unauthorized access to or use of such records or information which could result in substantial harm or inconvenience to any customer.

> This Safeguards Rule requires that financial institutions develop, implement and maintain an ***Information Security Program***.

The plan should be written in one or more accessible parts and contain administrative, technical and physical safeguards that are appropriate to the business' size and complexity, nature, and scope of activities and sensitivity of customer information handled.

A checklist available in IRS Publication 4557 includes many activities that can be included in an information security program.

FTC PRIVACY OF CONSUMER FINANCIAL INFORMATION RULE (16 CFR PART 313)

This rule (otherwise known as the ***Financial Privacy Rule***) aims to protect the privacy of the consumer by requiring financial institutions, as defined, which includes professional tax preparers, data processors, affiliates, and service providers to **give their customers privacy notices** that explain the financial institution's information collection and sharing practices. In turn, customers have the right to limit some sharing of their information. Also, financial institutions and other companies that receive personal financial information from a financial institution may be limited in their ability to use that information.

BEST PRACTICES

If you handle taxpayer information, you may be subject to the Gramm-Leach Bliley Act (GLB Act) and the Federal Trade Commission (FTC) Financial Privacy and Safeguards Rules. Whether or not you are subject to the GLB Act and the FTC Rules, you could benefit from implementing the general processes and best practices outlined in FTC information privacy and safeguards guidelines. Financial institutions as defined by FTC include professional tax preparers, data processors, their affiliates, and service providers who are significantly engaged in providing financial products or services. They must take the following steps to protect taxpayer information. Other businesses, organizations, and individuals handling taxpayer information should also follow these steps because they represent best practices for all.

- Take responsibility or assign an individual or individuals to be responsible for safeguards;
- Assess the risks to taxpayer information in your office, including your operations, physical environment, computer systems, and employees, if applicable. Make a list of all the locations where you keep taxpayer information (computers, filing cabinets, bags, and boxes taxpayers may bring you);
- Write a plan of how you will safeguard taxpayer information.
- Put appropriate safeguards in place;
- Use only service providers who have policies in place to also maintain an adequate level of information protection defined by the Safeguards Rule; and
- Monitor, evaluate, and adjust your security program as your business or circumstances change.

To safeguard taxpayer information, you must determine the appropriate security controls for your environment based on the size, complexity, nature, and scope of your activities. Security controls are the management, operational, and technical safeguards you may use to protect the confidentiality, integrity, and availability of your customers' information. Examples of security controls are:

- Locking doors to restrict access to paper or electronic files;
- Requiring passwords to restrict access to computer files;
- Encrypting electronically stored taxpayer data;
- Keeping a backup of electronic data for recovery purposes;
- Shredding paper containing taxpayer information before throwing it in the trash;
- Do not email unencrypted sensitive personal information.

The FTC has fact sheets and guidelines on privacy and safeguards for businesses on their Web site at www.ftc.gov. In addition, you may seek outside professional help to assess your information security needs.

IRS E-FILE SECURITY AND PRIVACY STANDARDS

Authorized IRS e-file Providers that participate in the role as an Online Provider must follow the IRS six security, privacy, and business standards to better serve taxpayers and protect their individual income tax information collected, processed, and stored. Compliance with these standards is mandatory. The standards are based on industry best practices and are intended to supplement the Gram-Leach-Bliley Act and the implementing rules and regulations promulgated by the Federal Trade Commission.

- **Extended Validation SSL Certificate.** This standard applies to Authorized IRS e-file Providers participating in online filing of individual income tax returns that collect taxpayer information via the Internet. These Providers must possess a valid and current Extended Validation Secure Socket Layer ("SSL") certificate using SSL 3.0 / TLS 1.0 or later and minimum 1024-bit RSA/128-bit AES.
- **External Vulnerability Scan.** This standard applies to Providers participating in the online filing of individual income tax returns that collect, transmit, process or store taxpayer information. These Providers must contract with an independent third-party vendor to run **weekly external network vulnerability scans** of all their "system components" in accordance with the applicable requirements of the Payment Card Industry Data Security Standards ("PCIDSS"). A scanning vendor certified by the Payment Card Industry Security Standards Council and listed on their current list of Approved Scanning Vendors must perform all scans. In addition, Providers whose systems are hosted must ensure that their host complies with all applicable requirements of the PCIDSS. For purposes of this standard, "system components" are defined as any network component, server or application that is included in or connected to the taxpayer data environment. The taxpayer data environment is that part of the network that possesses taxpayer data or sensitive authentication data. If scan reports reveal vulnerabilities, action must be taken to address the vulnerabilities in line with the scan report's recommendations. Providers must retain weekly scan reports for at least one year. The ASV and the host (if present) must be located in the United States.
- **Information Privacy and Safeguard Policies.** Applies to Providers participating in online filing of individual income tax returns that own or operate a Web site through which taxpayer information is collected, transmitted, processed or stored. These Providers must have a written information privacy and safeguard policy consistent with the applicable government and industry guidelines and include the following statement: "We maintain physical, electronic and procedural safeguards that comply with applicable law and federal standards." In addition, a privacy seal vendor acceptable to the IRS shall certify Providers' compliance with these policies.
- **Web Site Challenge-Response Test.** This standard applies to Providers participating in online filing of individual income tax returns that own or operate a Web site through which taxpayer information is collected, transmitted, processed, or stored. These Providers must implement an effective challenge-response protocol (e.g., CAPTCHA) to protect their Web site against malicious bots. Taxpayer information must not be collected, transmitted, processed, or stored unless the user successfully completes this challenge-response test.
- **Public Domain Name Registration.** Applies to Providers participating in online filing of individual income tax returns that own or operate a Web site through which taxpayer information is collected, transmitted, processed or stored. These Providers must have their Web site's domain name registered with a domain name registrar that is located in the United States and accredited by the Internet Corporation for Assigned Names and Numbers ("ICANN"). The domain name must be locked and not be private.
- **Reporting of Security Incidents.** This standard applies to Providers participating in the online filing of individual income tax returns that collect, transmit, process, or store taxpayer information. These Providers must report security incidents to the IRS as soon as possible but no later than the next business day after confirmation of the incident. For purposes of this standard, an event that can result in unauthorized disclosure, misuse, modification, or destruction of taxpayer information must be considered a reportable security incident. In addition, if the Provider's Web site is the proximate cause of the incident, the Provider must cease collecting taxpayer information via their Web site immediately upon detection of the incident and until the underlying causes of the incident are successfully resolved.

Preparers and taxpayers should be aware that the IRS does not initiate contact with taxpayers by email, text messages, or social media channels to request personal or financial information. This includes requests for PIN numbers, passwords, or similar access information for credit cards, banks, or other financial accounts. "Phishing" is a scam typically carried out through unsolicited email and/or websites that pose as legitimate sites and lure unsuspecting victims to provide personal and financial information. Taxpayers and preparers should report all unsolicited emails claiming to be from the IRS or an IRS-related function to: phishing@irs.gov.

INDIVIDUAL TAXPAYER IDENTIFICATION NUMBERS (ITINS)

Any individual filing a U.S. tax return is required to state his or her taxpayer identification number on such a return. Generally, a taxpayer identification number is the individual's SSN. However, in the case of an individual who is not eligible to be issued an SSN, but who has a tax filing obligation, the IRS issues an ITIN for use in connection with the individual's tax filing requirements. An individual who is eligible to receive an SSN may not obtain an ITIN for purposes of his or her tax filing obligations. An ITIN does not provide eligibility to work in the United States or claim Social Security benefits.

Examples of individuals who are not eligible for SSNs, but potentially need ITINs in order to file U.S. returns include a nonresident alien filing a claim for a reduced withholding rate under a U.S. income tax treaty, a nonresident alien required to file a U.S. tax return, an individual who is a U.S. resident alien under the substantial presence test and who therefore must file a U.S. tax return, a dependent or spouse of the prior two categories of individuals, or a dependent or spouse of a nonresident alien visa holder.

ITINs are issued regardless of immigration status because both resident and nonresident aliens may have a U.S. filing or reporting requirement under the Internal Revenue Code.

Individuals generally must have a filing requirement and file a valid federal income tax return to receive an ITIN. There are four exceptions to this income tax return requirement. The first exception is for information reporting and/or tax withholding requirements of third parties (such as banks) who need an SSN or ITIN from an individual to comply with U.S. Treasury Regulations. The second exception is when tax withholding is required on wages, scholarships, etc. for payments to foreign individuals who otherwise do not have to file a U.S. tax return. The third exception is for mortgage interest reporting and the final exception relates to when a U.S. real property interest is acquired from a foreign person.

ITINs are for federal tax reporting only and are not intended to serve any other purpose. The IRS issues ITINs to help individuals comply with the U.S. tax laws and to provide a means to efficiently process and account for tax returns and payments for those not eligible for Social Security Numbers.

> An ITIN does not authorize work in the U.S. or provide eligibility for Social Security benefits or the Earned Income Tax Credit.

A taxpayer applies for an ITIN by filing ***Form W-7, Application for IRS Individual Taxpayer Identification Number***. Generally, Form W-7 must be attached to a valid federal income tax return. The taxpayer must also include originals of his or her proof of identity (or copies certified by issuing agency and foreign status documents). Individuals may also apply for an ITIN using the services of an IRS-authorized "Acceptance Agent."

If an individual has an application for an SSN pending, they should not file Form W-7. Rather, they should complete Form W-7 only if and when notified by the Social Security Administration that an SSN cannot be issued. Under such circumstances, proof that the request for an SSN was denied must be included with Form W-7.

A taxpayer can't electronically file (e-file) a return using an ITIN in the calendar year the ITIN is assigned. Once an ITIN is assigned, the taxpayer can e-file returns in the following years. For example, a taxpayer that receives an ITIN in 2021 may not e-file any tax return using that ITIN (including prior-year returns) until 2022.

> Any ITIN that is not used on a federal tax return for **three consecutive tax years**, either as the ITIN of an individual who files the return or as the ITIN of a dependent included on a return, will **expire on December 31 of the third consecutive tax year of nonuse**.

An ITIN only needs to be renewed if it will be included on a U.S. federal tax return and it is expiring or has expired.

PREPARER PENALTIES

UNDERSTATEMENT OF LIABILITY PENALTIES UNDER §6694

Circular 230 §10.34 outlines standards with respect to tax returns and documents, affidavits, and other papers. A practitioner must not sign a tax return or claim for refund that the practitioner knows or reasonably should know contains an unreasonable position. Preparer penalties under §6694 apply to the following circumstances:

- **Unreasonable positions** – A penalty of **$1,000 or 50%** of the 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 a ***reasonable cause*** and the tax return preparer acted in ***good faith***.
- **Willful or reckless conduct** – A penalty of **$5,000 or 75%** of the 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 understate 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.

FAILURE PENALTIES UNDER §6695

A tax return preparer is someone who prepares tax returns ***for compensation***. Any tax return preparer who fails to take certain actions may be assessed other penalties with respect to the preparation of tax returns for other persons. In the case of any failure relating to a return or claim for refund filed in 2022 (generally 2021 tax returns filed in 2022), the penalty amounts under §6695 are:

- A penalty of **$50 for each occurrence** up to a maximum of **$27,000 a year** unless it is shown that such failure is due to reasonable cause and not willful neglect:
  - **§6695(a) Failure to furnish copy of return to taxpayer** – The tax preparer must furnish a completed copy of the return or claim for refund to the taxpayer no later than the time it is presented for the taxpayer's signature.
  - **§6695(b) Failure to sign return** – The tax preparer must sign a tax return or claim for refund if the tax preparer has primary responsibility for the overall substantive accuracy of the preparation of the tax return or claim for refund.
  - **§6695(c) Failure to furnish identifying number** – A tax return preparer must obtain and exclusively use a PTIN, rather than a social security number (SSN), as the identifying number to be included with the tax return preparer's signature on a tax return or claim for refund.
  - **§6695(d) Failure to retain copy or list** – A tax return preparer must keep a copy of the tax return, or retain, on a list, the name and taxpayer identification number of the taxpayer for whom the return was prepared. The

records must be available for inspection for the 3-year period following the close of the return period during which the return or claim for refund was presented for signature to the taxpayer. A "return period" is the 12-month period beginning on July 1 of each year and ending on June 30.

- **§6695(e) Failure to file correct information returns** – Each person who employs (or engages) one or more income tax return preparers to prepare any return of tax is responsible for retaining a record of the name, taxpayer identification number, and principal place of work during the return period of each income tax return preparer employed (or engaged) by the person at any time during that period. The record must be available for inspection upon request by the district director for the 3-year period following the close of the return period. (A penalty of $50 per return and $50 per item in return.)

- **§6695(f) Negotiation of check** – Any tax return preparer who endorses or otherwise negotiates (directly or through an agent) a refund check (including an electronic version of a check) issued to a taxpayer (other than the preparer), shall pay a penalty of **$545** with respect to each check. The penalty does not vary based on how much compensation the preparer receives from the taxpayer, the amount of the refund check, or the direct deposit. The penalty applies to a tax return preparer who directs the IRS to deposit a taxpayer's refund into a bank account in the preparer's name or into a bank account under the preparer's control. The preparer may not endorse or negotiate a check for a taxpayer even though the preparer was designated as the taxpayer's representative on Form 2848, Power of Attorney. (A penalty of **$545 per check**, with **no limit to a maximum penalty**.)

> A tax return preparer will not be considered to have endorsed or otherwise negotiated a check as a result of having affixed the taxpayer's name to a refund check for the purpose of depositing the check into an account in the name of the taxpayer or in the joint names of the taxpayer and one or more other persons (excluding the tax return preparer). See Treas. Reg. 1.6695-1(f)(1).

TIP: Taxpayers sometimes request that their refunds be directly deposited into a bank account in the preparer's name or into a bank account under the preparer's control when taxpayers do not have their own bank account. Even if a taxpayer has requested the direct deposit to be made in this manner, the preparer is still subject to the IRC 6695(f) penalty for complying with the request.

- **§6695(g) Failure to be diligent in determining eligibility for certain tax benefits** – Any return preparer who fails to comply with due diligence requirements imposed to determine eligibility for, or the amount of, the credit allowable shall pay a penalty of **$545** for each failure. Those who prepare returns that claim ***Earned Income Credit (EIC)***, ***American Opportunity Tax Credit (AOTC)***, ***Child Tax Credit (CTC)*** (including the ***Additional Child Tax Credit (ACTC)*** and the ***Credit for Other Dependents (ODC)***), and ***Head of Household (HOH)*** filing status must not only ask all the questions required on ***Form 8867, Paid Preparer's Due Diligence Checklist***, but must also ask additional questions when information seems incorrect, inconsistent or incomplete. In addition, the preparer must verify identity, prepare a computational checklist (Form 8867 or equivalent), and meet a recordkeeping requirement. (A penalty of **$545 per failure**, with **no limit to a maximum penalty**.)

> A **separate penalty applies** with respect to each eligibility for, and amount of, credit claimed on a return or claim for refund for which the due diligence requirements are not satisfied. The §6695(g) penalty of $545 applies to each failure relating to a return or claim for refund filed in 2022 (generally 2021 tax returns filed in 2022), with no limit to a maximum penalty.

To meet the due diligence requirements, a tax preparer must retain records for **three years** from the latest of the following dates:

- The due date of the tax return (not including extensions).
- The date the return was filed (for a signing tax return preparer electronically filing the return).

- The date the return was presented to the taxpayer for signature (for a signing tax return preparer not electronically filing the return).
- The date a nonsigning tax return preparer submits the part of the return he is responsible for to the signing tax return preparer.

DISCLOSING OR USING TAXPAYER INFORMATION PENALTIES

> A taxpayer must provide written consent before a tax return preparer **uses the taxpayer's tax return information**. Additionally, a tax return preparer may not request a taxpayer's consent to use tax return information for purposes of solicitation after the tax return preparer provides a completed tax return to the taxpayer for signature.

Internal Revenue Code **§7216** is a **criminal provision** 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.**

In addition to criminal penalties, a **civil penalty** for unauthorized disclosure or use of tax return information by a tax return preparer is imposed by **§6713**. The penalty is **$250** for each unauthorized disclosure or use. The maximum penalty on any person **shall not exceed $10,000** in a calendar year.

Internal Revenue Code **§6713** imposes a penalty 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.

The §6713 penalty does not require that the disclosure be knowing or reckless as it does under §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.

OTHER PENALTIES AND CONSIDERATIONS

IRC §6700 – PROMOTING ABUSIVE TAX SHELTERS

The penalty is for a promoter of an abusive tax shelter and is generally equal to $1,000 for each organization or sale of an abusive plan or arrangement (or, if lesser, 100 percent of the income derived from the activity).

IRC §6701 – PENALTIES FOR AIDING AND ABETTING UNDERSTATEMENT OF TAX LIABILITY

The penalty is $1,000 ($10,000 if the conduct relates to a corporation's tax return) for aiding and abetting in an understatement of tax liability. Any person subject to the penalty shall be penalized only once for documents relating to the same taxpayer for a single tax period or event.

IRC §7206 – FRAUD AND FALSE STATEMENTS

Guilty of a felony and, upon conviction, a fine of not more than $250,000 ($500,000 in the case of a corporation), imprisonment of not more than three years, or both (together with the costs of prosecution).

IRC §7207 – FRAUDULENT RETURNS, STATEMENTS, OR OTHER DOCUMENTS

Guilty of a misdemeanor and, upon conviction, a fine of not more than $10,000 ($50,000 in the case of a corporation), imprisonment of not more than one year, or both.

IRC §7407 – ACTION TO ENJOIN TAX RETURN PREPARERS

A federal district court may enjoin a tax return preparer from engaging in certain proscribed conduct, or in extreme cases, from continuing to act as a tax return preparer altogether.

IRC §7408 – ACTION TO ENJOIN SPECIFIED CONDUCT RELATED TO TAX SHELTERS AND REPORTABLE TRANSACTIONS

A federal district court may enjoin a person from engaging in certain proscribed conduct (including any action, or failure to take action, which is in violation of Circular 230).

TAX PREPARATION DUE DILIGENCE

The due diligence process involves interview the client, asking adequate questions, and obtaining appropriate and sufficient information to determine the correct reporting of income, claiming of tax benefits (such as deductions and credits), and compliance with the tax laws.

> Paid tax return preparers have elevated due diligence requirements in preparing returns and claims for refund involving the ***Earned Income Credit (EIC)***, the ***American Opportunity Tax Credit (AOTC)***, the ***Child Tax Credit (CTC)*** (including the ***Additional Child Tax Credit (ACTC)*** and the ***Credit for Other Dependents (ODC)***), and the ***Head of Household (HOH)*** filing status. Any return preparer who fails to comply with due diligence requirements relating to a return or claim for refund filed in 2022 (generally 2021 tax returns filed in 2022) shall pay a penalty of **$545** for each failure.

To meet these due diligence requirements, a preparer may need to ask additional questions and obtain additional information to determine eligibility for, and the amount of, EIC, AOTC, CTC (including ACTC and ODC), and HOH filing status. The position taken with respect to these items must be based on current and reasonable information that the paid preparer develops, either directly from the taxpayer or by other reasonable means. The preparer may not ignore the implications of information provided by taxpayers and is expected to make reasonable inquiries about incorrect, inconsistent, or incomplete information. In addition, the preparer must verify identity, prepare a computational checklist (Form 8867 or equivalent), and meet a recordkeeping requirement.

Specifically, the tax return preparer must complete ***Form 8867, Paid Preparer's Earned Income Credit Checklist***. Form 8867 must be physically submitted with the tax return or claim for refund. Form 8867 is a checklist paid preparers are **required to complete** to meet their due diligence requirements with respect to EIC, AOTC, CTC (including ACTC and ODC), and HOH filing status. Completing Form 8867 is an important aspect of the due diligence process for preparers working on returns that claim EIC, AOTC, CTC (including ACTC and ODC), and HOH filing status, but it is not the only requirement, as discussed below. Furthermore, preparers are cautioned that tax preparation software cannot be depended upon to comply with these due diligence requirements. Tax software is merely a tool to assist in the preparation of the return and is not a substitute for knowledge of tax law and professional responsibility.

As a paid tax return preparer, when determining the taxpayer’s eligibility for, or the amount of, a credit claimed on a return or claim for refund, you must not use information that you know, or have reason to know, is incorrect. You may not ignore the implications of information provided to, or known by you, and you must make reasonable inquiries if the information provided to you appears to be incorrect, inconsistent, or incomplete. You must make reasonable inquiries if a reasonable and well-informed tax return preparer, knowledgeable in tax law, would conclude that the information provided to you appears to be incorrect, inconsistent, or incomplete. You must also contemporaneously document in your files any reasonable inquiries made and the responses to these inquiries.

You must know the tax law for each credit claimed on a return or claim for refund you prepare and use that knowledge to ask your client the right questions to get all the relevant facts to determine your client's eligibility for the credit(s) and the correct amount of the credit(s).

> **§6695(g) Failure to be diligent in determining eligibility for certain tax benefits** – A penalty of **$545 per failure**, with no limit to a maximum penalty.
>
> A **separate penalty applies** with respect to each eligibility for, and amount of, credit claimed on a return or claim for refund for which the due diligence requirements are not satisfied. The $545 penalty applies to each failure relating to a return or claim for refund filed in 2022 (generally 2021 tax returns filed in 2022).

COMPLIANCE

To meet the due diligence requirements, a tax preparer must:

- Meet the knowledge requirement by interviewing the taxpayer, asking adequate questions, contemporaneously documenting the questions and the taxpayer's responses in your notes, reviewing adequate information to determine if the taxpayer is eligible to claim the credit(s) and in what amount(s).
- Complete Form 8867 truthfully and accurately and complete the actions described on Form 8867 for each credit claimed for which you are the paid tax return preparer.
- Submit Form 8867 in the manner required.
- Keep all five of the following records:
  1. A copy of Form 8867,
  2. The applicable worksheet(s) or your own worksheet(s) for any credits claimed,
  3. Copies of any documents provided by the taxpayer on which you relied to determine eligibility for, and the amount of, the credit(s),
  4. A record of how, when, and from whom the information used to prepare Form 8867 and worksheet(s) was obtained, and
  5. A record of any additional questions you may have asked to determine eligibility for, and amount of, the credits, and the taxpayer's answers.
- Retain records for **three years** from the latest of the following dates:
  - The due date of the tax return (not including extensions).
  - The date the return was filed (for a signing tax return preparer electronically filing the return).
  - The date the return was presented to the taxpayer for signature (for a signing tax return preparer not electronically filing the return).
  - The date a nonsigning tax return preparer submits the part of the return he is responsible for to the signing tax return preparer.

Given the additional responsibility imposed on preparers with regard to EIC, AOTC, CTC (including ACTC and ODC), and HOH filing status returns, preparers may want to consider actually examining the taxpayer's social security card when preparing Form 8867. A social security number issued by the Social Security Administration is not valid for purposes of the EIC if "Not Valid for Employment" is printed on the card and the number was issued solely to allow the taxpayer to apply for or receive a federally funded benefit. If the social security card specifies "Valid for Work Only with DHS Authorization," the taxpayer can take the EIC as long as the taxpayer's Department of Homeland Security ("DHS") authorization is still valid.

E-FILE REQUIREMENTS

ELECTRONIC RETURN REQUIREMENTS

> Paid preparers—or the preparer's firm in the aggregate—who prepare and expect to file **11 or more** income tax returns for individuals, trusts, and estates are **required to file these returns electronically**.

Notwithstanding these requirements, a taxpayer for whom a preparer prepares a return may choose instead to submit their own return to the IRS on paper. Preparers in this situation should obtain and keep a signed and dated statement from the client specifying the client's desire and intent to do so. Also, in this situation and in the cases of administratively exempt returns or returns filed by a tax return preparer with an approved hardship waiver, the preparer should attach ***Form 8948, Preparer Explanation for Not Filing Electronically,*** to the client's paper return.

Although hardship waivers are not frequently granted, a preparer may request an undue hardship waiver from the e-file requirement using ***Form 8944, Preparer e-file Hardship Waiver Request***. Form 8944 must be submitted to the IRS no later than February 15 of the year for which a waiver is being requested.

ELECTRONIC RETURN ORIGINATOR (ERO)

An Electronic Return Originator (ERO) originates the electronic submission of returns for taxpayers who want to e-file their returns. An ERO originates the electronic submission of a return after the taxpayer authorizes (Form 8879) the filing of the return via IRS e-file. The ERO must have either prepared the return or collected it from a taxpayer. Duties of the ERO include the following:

- **Safeguarding IRS *e-file* from fraud and abuse** – An ERO who is also the paid preparer should exercise due diligence in the preparation of returns involving the Earned Income Tax Credit (EITC) because it is a popular target for fraud and abuse. EROs must not electronically file individual income tax returns **prior to receiving Forms W-2, W-2G, or 1099-R**.
- **Verifying Taxpayer Identification Numbers (TIN)** – Confirm identities on the return.
- **Be aware of non-standard information documents** – Look for suspicious or altered documents.
- **Be careful with addresses** – Verify the taxpayer's address has not changed.
- **Avoiding refund delays** – Recommend taxpayers supply current information and check their returns.

ELECTRONIC SIGNATURE REQUIREMENTS

> As with an income tax return submitted to the IRS on paper, the taxpayer and paid preparer must sign an electronic income tax return. Electronic signatures are required for returns using e-file.

Taxpayers must sign and date the Declaration of Taxpayer to authorize the origination of the electronic submission of the return to the IRS prior to the transmission of the return to the IRS. The Declaration of Taxpayer includes the taxpayer's declaration under penalties of perjury that the return is true, correct, and complete, as well as the taxpayer's Consent to Disclosure. The Consent to Disclosure authorizes the IRS to disclose information to the taxpayer's providers. Taxpayers authorize Intermediate Service Providers, Transmitters, and EROs to receive from the IRS an acknowledgment of receipt or reason for rejection of the electronic return, an indication of any refund offset, and the reason for any delay in processing the return or refund and the date of the refund.

There are currently two methods for signing individual income tax returns electronically. Both methods allow taxpayers to use a Personal Identification Number (PIN) to sign the return and the ***Declaration of Taxpayer***. The Declaration of Taxpayer includes the taxpayer's declaration under penalties of perjury that the return is true, correct, and complete, as well as the taxpayer's ***Consent to Disclosure***, authorizing the IRS to disclose information to the taxpayer's providers.

- The ***Self-select PIN*** method requires a taxpayer to provide his **prior year Adjusted Gross Income** (AGI) amount or prior year PIN for use by the IRS to authenticate the taxpayer. This method may be completely paperless if taxpayers enter their own PIN directly into the electronic return record using keystrokes after reviewing the completed return. Taxpayers may also authorize the ERO to enter the PIN on their behalf, in which case the taxpayers must review and sign a completed signature authorization form (Form 8879) after reviewing the return.
- The ***Practitioner PIN*** method does not require the taxpayer to provide their **prior year AGI** amount or prior year PIN. When using the Practitioner PIN method, a taxpayer must sign a completed **signature authorization** form (Form 8879). A taxpayer, who uses the Practitioner PIN method and enters his own PIN in the electronic return record using keystrokes after reviewing the completed return, must still appropriately sign the signature authorization form.
- Regardless of the method of electronic signature used a taxpayer may enter his own PIN, the ERO may select and enter the taxpayer's PIN, or the software may generate the taxpayer's PIN in the electronic return.

IRS E-FILE SIGNATURE AUTHORIZATION

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

> The ERO may enter the taxpayer's PIN in the electronic return record before the taxpayer signs Form 8879 or 8878, but the taxpayer must sign and date the appropriate form before the ERO originates the electronic submission of the return. The taxpayer must sign and date Form 8879 or Form 8878 after reviewing the return and ensuring the tax return information on the form matches the information on the return. The ERO may sign Forms 8879 and 8878 by rubber stamp, mechanical device (such as a signature pen), or computer software program. Taxpayers must sign Form 8879 or Form 8878 but may sign by handwritten signature, ***or by electronic signature*** if supported by the computer software.

ELECTRONIC SIGNATURES FOR EROS

The ERO must also sign with a PIN. The ERO should use the same PIN for the entire tax year. The ERO may manually input his PIN, or the software can generate the PIN in the electronic record in the location designated for the ERO Electronic Filing Identification Number (EFIN)/PIN. By entering a PIN in the ERO EFIN/PIN field, the ERO is attesting to the ERO Declaration. For returns prepared by the ERO firm, return preparers are declaring under the penalties of perjury that they reviewed the returns and they are true, correct, and complete. An ERO may authorize members of the firm or designated employees to sign for them, but the ERO is still responsible.

REJECTED RETURNS AND RESOLUTION

The IRS electronically acknowledges the receipt of all transmissions. Returns in each transmission are either accepted or rejected for specific reasons. Accepted returns meet the processing criteria and IRS considers them "filed" as soon as the return is signed electronically or through the receipt by the IRS of a paper signature. Rejected returns fail to meet processing criteria and the IRS considers them "not filed."

> If the IRS rejects the electronic portion of a taxpayer's individual income tax return for processing, and the ERO cannot rectify the reason for the rejection, the ERO must take reasonable steps to inform the taxpayer of the rejection **within 24 hours**.
>
> The ERO may resubmit, without additional signatures, a return where the amounts do not differ by **more than $50** to ***Total Income*** or ***AGI***, or **$14** to Total Tax, Federal Income Tax Withheld, or Amount You Owe.

When the ERO advises the taxpayer of an unfiled return, the ERO must provide the taxpayer with the reject code(s) accompanied by an explanation. If the taxpayer chooses not to have the electronic portion of the return corrected and transmitted to the IRS, or if the IRS cannot accept the return for processing, the taxpayer must file a paper return. In order to timely file the return, the taxpayer must file the paper return by the later of the due date of the return or **10 calendar days** after the date the IRS gives notification that it rejected the electronic portion of the return or that the return cannot be accepted for processing. A taxpayer should include an explanation in the paper return as to why he is filing the return after the due date.

ANNUAL FILING SEASON PROGRAM REQUIREMENTS

IRS ANNUAL FILING SEASON PROGRAM REQUIREMENTS

The IRS generally permits anyone with an active ***preparer tax id number (PTIN)*** to prepare tax returns for compensation. This is the only authority they have. They have no authority to represent clients before the IRS. There is an exception for preparers who participate in the IRS Annual Filing Season Program (AFSP).

This voluntary program recognizes the efforts of return preparers who are generally not attorneys, certified public accountants, or enrolled agents. It was designed to encourage education and filing season readiness. Those who aspire to a higher level of professionalism and choose to participate can meet the requirements by obtaining 10 hours of continuing education on federal tax subjects and 2 hours of ethics, along with a 6-hour annual federal tax refresher course (AFTR). The return preparer must also renew their PTIN for the upcoming year and consent to adhere to the obligations in Circular 230. Upon completion of these requirements, the return preparer receives an AFSP Record of Completion from the IRS.

Preparers that complete the AFSP requirements receive **limited practice rights**. They may only represent clients whose returns they prepared and signed, but only before revenue agents, customer service representatives, and similar IRS employees, including the Taxpayer Advocate Service. They cannot represent clients whose returns they did not prepare and they cannot represent clients regarding appeals or collection issues even if they did prepare the return in question.

TIP: This is a major distinction from other unenrolled tax return preparers who have no representation rights because they didn't earn the AFSP Record of Completion.

CONSENT TO CIRCULAR 230 RULES

The Annual Filing Season Program is a program of the IRS intended to recognize and encourage return preparers who are not attorneys, CPAs, or enrolled agents to voluntarily increase their knowledge and improve their filing season competency through continuing education.

To participate in the Annual Filing Season Program these preparers must have an **active preparer tax identification number** ("PTIN") and generally must take **18 hours of continuing education** from IRS-approved continuing education ("CE") providers.

> In addition, all preparers must consent to adhere to specific practice obligations outlined in Subpart B and section 10.51 of Circular 230.

After PTIN renewal season begins in October, a Record of Completion will be generated once all requirements have been met, including renewal of your PTIN for the next calendar year and consent to the Circular 230 obligations.

If you have an online PTIN account, **you will receive an e-mail from TaxPro_PTIN@irs.gov with instructions on how to sign the Circular 230 consent** and receive your certificate in your online secure mailbox. (Note: The TaxPro_PTIN@irs.gov mailbox only sends messages. It does not accept or process messages.)

If you don't have an online PTIN account, you will receive a letter with instructions for completing the application process and obtaining your certificate.

CIRCULAR 230 DUTIES AND RESTRICTIONS

Subpart B of Circular 230 covers the duties and restrictions relating to practice before the IRS. This section highlights some of the provisions of Subpart B.

RESPONDING TO IRS REQUEST FOR INFORMATION

A practitioner must, upon request, promptly submit records or information in any matter before the IRS unless the practitioner believes in good faith and on reasonable grounds that the records or information are privileged. If the requested records or information are not in the possession of the practitioner or the practitioner's client, the practitioner must promptly notify the requesting IRS officer or employee and the practitioner must provide any information that the practitioner has regarding the identity of any person who the practitioner believes may have possession or control of the requested records or information.

The practitioner must also make reasonable inquiry of their client regarding the identity of any person who may have possession or control of the requested records or information, but the practitioner is not required to make inquiry of any other person or independently verify any information provided by the practitioner's client regarding the identity of such persons. Furthermore, a practitioner may not interfere or attempt to interfere, with any proper and lawful effort by the IRS, its officers or employees, to obtain any record or information unless the practitioner believes in good faith and on reasonable grounds that the record or information is privileged.

RESPONSIBILITIES WHEN THERE IS AN ERROR ON A RETURN

A practitioner who, having been retained by a client with respect to a matter administered by the IRS, knows that the client has not complied with the revenue laws of the United States or has made an error in or omission from any return, document, affidavit, or other paper which the client submitted or executed under the revenue laws of the United States, must advise the client promptly of the fact of such noncompliance, error, or omission. The practitioner must advise the client of the consequences as provided under the Code and regulations of such noncompliance, error, or omission.

DUE DILIGENCE REQUIREMENTS

Circular 230 requires that a practitioner exercise due diligence not only in preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers relating to IRS matters, but also in determining the correctness of oral or written representations made by the practitioner to the IRS and in determining the correctness of oral or written representations made by the practitioner to clients with reference to any matter administered by the IRS. Generally, a practitioner will be presumed to have exercised due diligence if he or she relies on the work product of another person and the practitioner used reasonable care in engaging, supervising, training, and evaluating the person, taking proper account of the nature of the relationship between the practitioner and the person.

ASSISTANCE FROM OR TO DISBARRED OR SUSPENDED PERSONS

Practitioners may not, knowingly and directly or indirectly accept assistance from or assist any person who is under disbarment or suspension from practice before the IRS if the assistance relates to a matter or matters constituting practice before the IRS

Furthermore, no former government employee may, subsequent to government employment, represent anyone in any matter administered by the IRS if the representation would violate any laws of the United States. No former government employee who personally and substantially participated in a particular matter involving specific parties may, subsequent to government employment, represent or knowingly assist, in that particular matter, any person who is or was a specific party to that particular matter.

A former government employee who, within a period of one year prior to the termination of government employment, had official responsibility for a particular matter involving specific parties may not, within two years after government employment is ended, represent in that particular matter any person who is or was a specific party to that particular matter.

No former government employee may, within one year after government employment is ended, communicate with or appear before, with the intent to influence, any employee of the Treasury Department in connection with the publication, withdrawal, amendment, modification, or interpretation of a rule the development of which the former government employee participated in, or for which, within a period of one year prior to the termination of government employment, the former government employee had official responsibility. This does not, however, preclude any former employee from appearing on one's own behalf or from representing a taxpayer before the IRS in connection with a particular matter involving specific parties involving the application or interpretation of a rule with respect to that particular matter, provided that the representation is otherwise consistent with the other provisions of this section and the former employee does not utilize or disclose any confidential information acquired by the former employee in the development of the rule.

Although many tax preparers are notaries, a practitioner may not take acknowledgments, administer oaths, certify papers, or perform any official act as a notary public with respect to any matter administered by the IRS and for which he or she is employed as counsel, attorney, or agent, or in which he or she may be in any way interested.

FEES

A practitioner may not charge an unconscionable fee in connection with any matter before the IRS. Circular 230 also prohibits a practitioner from charging a contingent fee for services rendered in connection with any matter before the IRS. However, in 2014 the U.S. District Court for the District of Columbia called into question the IRS's ability to police return filing practice. The court in ***Ridgely v. Lew*** (1:12-cv-00565 D.D.C. 2014) ruled that a CPA who prepares an original or amended return is not engaged in the representation of taxpayers and thus is not engaged in practice subject to Circular 230. Thus, in the court's opinion Circular 230 regulates CPAs, attorneys, and enrolled agents only when they are involved in examination or appeals representation. As a result, the court invalidated and permanently enjoined the IRS from prohibiting contingent fee arrangements for refund claims and amended returns. The IRS decided not to appeal that decision.

Even under the pre-Ridgely provisions of Circular 230, a practitioner was permitted to charge a contingent fee for services rendered in connection with the Service's examination of, or challenge to an original tax return or an amended return or claim for refund or credit where the amended return or claim for refund or credit was filed within 120 days of the taxpayer receiving written notice of the examination of, or a written challenge to the original tax return. Furthermore, a practitioner may charge a contingent fee for services rendered in connection with a claim for credit or refund filed solely in connection with the determination of statutory interest or penalties assessed by the IRS, as well as for services rendered in connection with any judicial proceeding arising under the Internal Revenue Code.

CLIENT RECORDS

In general, a practitioner must, at the request of a client, promptly return any and all records of the client that are necessary for the client to comply with their federal tax obligations. The practitioner may retain copies of the records returned to a client. The existence of a dispute over fees generally does not relieve the practitioner of their responsibility under this section. Nevertheless, if applicable state law allows or permits the retention of a client's records by a practitioner in the case of a dispute over fees for services rendered, the practitioner need only return those records that must be attached to the taxpayer's return. The practitioner, however, must provide the client with reasonable access to review and copy any additional records of the client retained by the practitioner under state law that are necessary for the client to comply with their federal tax obligations.

"Records of the client" for this purpose include all documents or written or electronic materials provided to the practitioner or obtained by the practitioner in the course of the practitioner's representation of the client, that pre-existed the retention of the practitioner by the client. The term also includes materials that were prepared by the client or a third party (not including an employee or agent of the practitioner) at any time and provided to the practitioner with respect to the subject matter of the representation. The term also includes any return, claim for refund, schedule, affidavit, appraisal, or any other document prepared by the practitioner or their employee or agent, that was presented to the client with respect to a prior representation if such document is necessary for the taxpayer to comply with their current federal tax obligations. The term does not include any return, claim for refund, schedule, affidavit, appraisal, or any other document prepared by the practitioner or the practitioner's firm, employees, or agents if the practitioner is withholding such document pending the client's performance of its contractual obligation to pay fees with respect to such document.

CONFLICTS OF INTEREST

A practitioner must not represent a client before the IRS if the representation involves a conflict of interest. A conflict of interest exists if either the representation of one client will be directly adverse to another client or there is a significant risk that the representation of one or more clients will be materially limited by the practitioner's responsibilities to another client, a former client or a third person, or by a personal interest of the practitioner.

Notwithstanding the existence of a conflict of interest, the practitioner may represent a client if: (1) the practitioner reasonably believes that the practitioner will be able to provide competent and diligent representation to each affected client; (2) the representation is not prohibited by law; and (3) each affected client waives the conflict of interest and gives informed consent, confirmed in writing by each affected client, at the time the existence of the conflict of interest is known by the practitioner. The confirmation may be made within a reasonable period of time after the informed consent but in no event later than 30 days.

Copies of the written consents must be retained by the practitioner for at least 36 months from the date of the conclusion of the representation of the affected clients, and the written consents must be provided to any officer or employee of the IRS on request.

ADVERTISING

A practitioner may not, with respect to any IRS matter, in any way use or participate in the use of any form of public communication or private solicitation containing a false, fraudulent, or coercive statement or claim; or a misleading or deceptive statement or claim. Enrolled agents and enrolled retirement plan agents, in describing their professional designation, may not utilize the term "certified" or imply an employer/employee relationship with the IRS. Examples of acceptable descriptions for enrolled agents are "enrolled to represent taxpayers before the IRS," "enrolled to practice before the IRS," and "admitted to practice before the IRS." Similarly, examples of acceptable descriptions for enrolled retirement plan agents are "enrolled to represent taxpayers before the IRS as a retirement plan agent" and "enrolled to practice before the IRS as a retirement plan agent."

A practitioner may not make, directly or indirectly, an uninvited written or oral solicitation of employment in matters related to the IRS if the solicitation violates Federal or State law or other applicable rules. Any lawful solicitation made by or on behalf of a practitioner eligible to practice before the IRS must, nevertheless, clearly identify the solicitation as such and, if applicable, identify the source of the information used in choosing the recipient.

Fee information may be communicated in professional lists, telephone directories, print media, mailings, and electronic mail, facsimile, hand-delivered flyers, radio, television, and any other method. The method must not cause the communication to become untruthful, deceptive, or otherwise in violation of this part. A practitioner may not persist in attempting to contact a prospective client if the prospective client has made it known to the practitioner that he or she does not desire to be solicited. In the case of radio and television broadcasting, the broadcast must be recorded and the practitioner must retain a recording of the actual transmission. In the case of direct mail and e-commerce communications, the practitioner must retain a copy of the actual communication, along with a list or other description of persons to whom the communication was mailed or otherwise distributed. The copy must be retained by the practitioner for a period of at least 36 months from the date of the last transmission or use.

BEST PRACTICES

Tax advisors should provide clients with the highest quality representation concerning Federal tax issues by adhering to best practices in providing advice and in preparing or assisting in the preparation of a submission to the IRS. In addition to compliance with the standards of practice provided elsewhere in this part, best practices include the following:

1. Communicating clearly with the client regarding the terms of the engagement. For example, the advisor should determine the client's expected purpose for and use of the advice and should have a clear understanding with the client regarding the form and scope of the advice or assistance to be rendered.
2. Establishing the facts, determining which facts are relevant, evaluating the reasonableness of any assumptions or representations, relating the applicable law (including potentially applicable judicial doctrines) to the relevant facts, and arriving at a conclusion supported by the law and the facts.
3. Advising the client regarding the import of the conclusions reached, including, for example, whether a taxpayer may avoid accuracy-related penalties under the Internal Revenue Code if a taxpayer acts in reliance on the advice.
4. Acting fairly and with integrity in practice before the IRS.

TAX RETURNS

A practitioner may not willfully, recklessly, or through gross incompetence sign a tax return or claim for refund, or advise a client to take a position on a return or claim for refund, that the practitioner knows or reasonably should know contains a position that lacks a reasonable basis, is an unreasonable position, or is a willful attempt by the practitioner to understate the liability for tax or a reckless or intentional disregard of rules or regulations by the practitioner

A practitioner may not advise a client to submit a document, affidavit, or other paper to the IRS the purpose of which is to delay or impede the administration of the federal tax laws, that is frivolous, or that contains or omits information in a manner that demonstrates an intentional disregard of a rule or regulation unless the practitioner also advises the client to submit a document that evidences a good faith challenge to the rule or regulation.

A practitioner must inform a client of any penalties that are reasonably likely to apply to the client with respect to a position taken on a tax return if the practitioner advised the client with respect to the position, or the practitioner prepared or signed the tax return or any document, affidavit, or other paper submitted to the IRS. The practitioner also must inform the client of any opportunity to avoid any such penalties by disclosure, if relevant, and of the requirements for adequate disclosure.

A practitioner advising a client to take a position on a tax return, document, affidavit, or other paper submitted to the IRS, or preparing or signing a tax return as a preparer, generally may rely in good faith without verification upon information furnished by the client. The practitioner may not, however, ignore the implications of information furnished to, or actually known by, the practitioner, and must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete.

COMPETENCE

A practitioner must possess the necessary competence to engage in practice before the IRS. Competent practice requires the appropriate level of knowledge, skill, thoroughness, and preparation necessary for the matter for which the practitioner is engaged. A practitioner may become competent for the matter for which the practitioner has been engaged through various methods, such as consulting with experts in the relevant area or studying the relevant law.

REQUIREMENTS FOR WRITTEN TAX ADVICE

Limited practice does not include the authority to provide tax advice to a client or another person except as necessary to prepare a tax return, claim for refund, or other document intended to be submitted to the Internal Revenue Service.

In providing written advice concerning any Federal tax matter, you must (i) base your advice on reasonable assumptions, (ii) reasonably consider all relevant facts that you know or should know, and (iii) use reasonable efforts to identify and ascertain the relevant facts. You cannot rely upon representations, statements, findings, or agreements that are unreasonable or that you know to be incorrect, inconsistent, or incomplete. You must not take into account the possibility that a tax return will not be audited or that a matter will not be raised on audit in evaluating a Federal tax matter (audit lottery). In providing your written advice, you may rely in good faith on the advice of another practitioner only if that advice is reasonable considering all facts and circumstances. You cannot rely on the advice of a person whom you know or should know is not competent to provide the advice or who has an unresolved conflict of interest as defined in §10.29.

CIRCULAR 230 SECTION 10.51

Section 10.51 of Circular 230 covers actions that are considered incompetence or disreputable conduct. Circular 230 does not differentiate between the concepts of “incompetence” and “disreputable conduct,” but rather provides a laundry list of fifteen specific instances that fall under those general concepts. This list is intended to be illustrative rather than comprehensive and “disreputable conduct” is meant to include “any conduct that is violative of the ordinary standard of professional obligation and honor.” The list of incompetent or disreputable activities contained in section 10.51 of Circular 230 includes:

- Conviction of any criminal offense under federal tax law;
- Conviction of any criminal offense involving dishonesty or breach of trust;
- Conviction of a felony rendering the practitioner unfit to practice before the IRS;
- Giving false or misleading information to federal tax authorities;
- Indicating that special treatment can be obtained from the IRS;
- Willfully failing to file a federal return or pay federal taxes;
- Willfully assisting, counseling, encouraging the violation of federal tax law;
- Mishandling funds received from a client for the payment of taxes;
- Threats, false accusations, duress, coercion, or bribery of an IRS employee;
- Disbarment or suspension from practice by any state or by a federal agency;
- Knowingly assisting another who is suspended or disbarred from practice;
- Using abusive, malicious, or libelous language in a matter before the IRS;
- Inappropriate actions regarding the issuance of opinions;

- Willfully failing to sign a tax return prepared by the practitioner; and
- The inappropriate and willful disclosure or use of tax information.

LIMITED REPRESENTATION

Any tax professional with an IRS Preparer Tax Identification Number (PTIN) is authorized to prepare federal tax returns. However, tax professionals have differing levels of skills, education, and expertise. An important difference in the types of practitioners is "representation rights." Here is guidance on each credential and qualification:

UNLIMITED REPRESENTATION RIGHTS

Enrolled agents, certified public accountants, and attorneys have unlimited representation rights before the IRS. Tax professionals with these credentials may represent their clients on any matters including audits, payment/collection issues, and appeals.

- **Enrolled Agents** – Licensed by the IRS. Enrolled agents are subject to a suitability check and must pass a three-part Special Enrollment Examination, which is a comprehensive exam that requires them to demonstrate proficiency in federal tax planning, individual and business tax return preparation, and representation. They must complete 72 hours of continuing education every 3 years.
- **Certified Public Accountants** – Licensed by state boards of accountancy, the District of Columbia, and U.S. territories. Certified public accountants have passed the Uniform CPA Examination. They have completed a study in accounting at a college or university and also met experience and good character requirements established by their respective boards of accountancy. In addition, CPAs must comply with ethical requirements and complete specified levels of continuing education in order to maintain an active CPA license. CPAs may offer a range of services; some CPAs specialize in tax preparation and planning.
- **Attorneys** – Licensed by state courts, the District of Columbia, or their designees, such as the state bar. Generally, they have earned a degree in law and passed a bar exam. Attorneys generally have ongoing continuing education and professional character standards. Attorneys may offer a range of services; some attorneys specialize in tax preparation and planning.

LIMITED REPRESENTATION RIGHTS

Some preparers without one of the mentioned credentials have limited practice rights. They may only represent clients whose returns they prepared and signed, but only before revenue agents, customer service representatives, and similar IRS employees, including the Taxpayer Advocate Service. They cannot represent clients whose returns they did not prepare and they cannot represent clients regarding appeals or collection issues even if they did prepare the return in question. Tax return preparers with limited representation rights include:

- **Annual Filing Season Program Participants** – This voluntary program recognizes the efforts of return preparers who are generally not attorneys, certified public accountants, or enrolled agents. It was designed to encourage education and filing season readiness. The IRS issues an Annual Filing Season Program Record of Completion to return preparers who obtain a certain number of continuing education hours in preparation for a specific tax year. Beginning with returns filed after December 31, 2015, only Annual Filing Season Program participants have limited practice rights.
- **PTIN Holders** – Tax return preparers who have an active preparer tax identification number, but no professional credentials and do not participate in the Annual Filing Season Program, are authorized to prepare tax returns. Beginning January 1, 2016, this is the only authority they have. They have no authority to represent clients before the IRS (except regarding returns they prepared and filed December 31, 2015, and prior).

ENROLLED AGENTS

An Enrolled Agent ("EA") is a person who is authorized to represent any taxpayer before any office of the Internal Revenue Service. Enrolled Agents are admitted to practice and therefore do not need to participate in the IRS Annual Filing Season Program.

A BRIEF HISTORY

1862 Congress enacts a "temporary" income tax with the passage of the Revenue Act of 1862 in order to fund the Civil War.

1872 Ten years later, this war-time tax was repealed.

1884 The Treasury Department is having a difficult time with claims arising from property confiscated for use in the war effort. Congress gave the Secretary of the Treasury the authority to regulate the attorneys and agents representing taxpayers in these claims with the passage of the Enabling Act of 1884, also known as the "Horse Act" because the property in question was usually a horse. The intent of Congress at that time was not to regulate "tax return preparers" as the modern-day income tax regime did not exist. Rather, this law was created to regulate representatives who were helping people prepare cases and file claims with the Treasury Department for losses resulting from the Civil War. Many of these claims were fraudulent, and regulation was deemed necessary to protect the public interest.

1913 The income tax reappeared in 1913 with the ratification of the 16th amendment to the United States Constitution when it became apparent that another major war was upon us—WW1. The first Form 1040 was introduced at this time with a top tax rate of 6%. The form was far less complex than its modern-day equivalent with no additional schedules and one page of instructions. The role of the Enrolled Agent evolved with the needs of citizens as many sought monetary relief from income tax, and audits became more prevalent. Enrolled agents began to assist taxpayers with the preparation of the multitude of tax forms that would arise in the years to follow.

1918 The Revenue Act of 1918 imposed a progressive income-tax rate structure of up to 77 percent.

1921 In 1921, the Treasury Department released Circular 230 to address "the laws and regulations governing the recognition of agents, attorneys, and other persons representing claimants before the Treasury Department."

1959 In 1959, the Treasury Department implemented the first "Special Enrollment Examination."

1966 In 1966, "Enrolled Agent" became the official name for representatives able to demonstrate special skills and expertise in tax matters by passing the Special Enrollment Examination.

TODAY'S ENROLLED AGENT

The EA designation is the highest credential issued by the IRS (technically, the United States Department of the Treasury issues the enrollment card). Enrolled Agents, along with Attorneys and CPAs, are the only tax professionals with unlimited representation rights, meaning they can represent any client on any matter before the IRS. This is true even if the EA did not preparer the tax return involved.

The United States Tax Court was established by Congress to provide a forum in which people can dispute tax issues. Most tax disputes never reach the courthouse steps. An EA does not handle criminal matters or represent clients in tax court unless the EA also happens to be an attorney or is one of the few non-attorneys admitted to practice before the tax court. What you may find interesting is that docketed tax court cases represent only 3% of cases annually. That means an EA is able to handle 97% of the issues that arise.

Simply put, an enrolled agent can perform all of the same functions as a CPA or Attorney before any office of the IRS. The role of an enrolled agent extends beyond simply preparing tax returns. Enrolled agents can charge a fee for tax advice, help taxpayers navigate audits, request payment agreements with the IRS, settle tax debts and various collection issues, and handle taxpayer appeals.

IRS DIVISION	WHAT CAN AN EA DO?
Examinations – When the IRS is investigating the facts and trying to determine if a taxpayer owes money. This is called an "audit." • **2,259,853** new taxpayer delinquency investigations in 2019	• Represent the taxpayer before the IRS. • Corresponding and communicating with the IRS. • Representing a taxpayer at conferences, hearings, or meetings with the IRS.
Collections – When the IRS is attempting to collect a tax debt that is enforceable. • **543,604** notices of Federal tax liens filed in 2019 • **782,735** notices of levy requested on third parties in 2019	• Offer in compromise – Offer to pay less. • Executing installment agreements (payment plan) on behalf of client. • Extending the collection period. • Abatements, releasing liens, preventing a levy (seizure of property).
Office of Appeals Appealing an IRS enforcement decision.	• Collection Due Process (CDP). • Collection Appeals Program (CAP).