# 6 HOUR ANNUAL FEDERAL TAX REFRESHER (AFTR) COURSE

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# Table of Contents

# Introduction

Thank you for choosing IRSTaxTraining.com, Inc. This is an intermediate self-study Annual Federal Tax Refresher (AFTR) course that is eligible for 6 hours of continuing professional education (CPE) credits. The AFTR course is based on general filing season concepts, tax updates and typical trouble areas identified by the IRS, and it is divided into three domains: New Tax Law/Recent Updates, General Review and Practices, Procedures and Professional Responsibility. It is designed for an existing tax professional that prepares returns on an annual basis. If you would like to become a tax professional, we have other entry level classes that are more appropriate.

Along with 10 Hours of Federal Tax Law and 2 Hours of Ethics CPE, the AFTR course is an integral part of completing your Annual Filing Season Program (AFSP). The Annual Filing Season Program - Record of Completion allows you to differentiate yourself in the marketplace. Annual Filing Season Program participants are included in a public database of return preparers on the IRS website. The Directory of Federal Tax Return Preparers with Credentials and Select Qualifications includes the name, city, state, zip code, and credentials of all attorneys, CPAs, enrolled agents, enrolled retirement plan agents and enrolled actuaries with a valid PTIN, as well as all Annual Filing Season Program – Record of Completion holders.

Also, as of January 1, 2016, there were changes to the representation rights of return preparers. Annual Filing Season Program participants will have limited representation rights, meaning they can 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.

We know your time is important to you so we have produced the most comprehensive and innovative tax education products on the market today. We focus on customer service and satisfaction and we strive to look for new and responsive ways to make earning your IRS continuing professional education as convenient as possible.

Since this is a self-study course, you can complete it at your own pace and on your own schedule with the exception of the final examination. The minimum passing requirement is 70% on the examination questions at the end of the material.

The exam must be taken online at www.IRSTaxTraining.com. The online exam has a **3-hour time limit and must be completed in one continuous sitting. Once the timer has started it cannot be stopped.**

Be sure you set aside at least 3 hours in advance to complete the examination. The exam will end after 3 hours, a timer will indicate the remaining time, regardless of whether you have finished or not. The exam is open book, so you are allowed to look up answers in the text we provide. After you submit the exam to us we will grade it and, upon successful completion, e-mail you a Certificate of Completion and notify the IRS that you earned AFTR course credits.

If you should fail the exam on your first attempt, you will have the option to re-take the exam. The exam must be reset by an administrator so you must wait until this occurs before you are able to re-take the exam.

Following the completion of all the AFSP Continuing Professional Education requirements, return preparers will receive a notice of their potential eligibility for the program. You will be asked by the IRS via email to log into your PTIN account for additional information on completing the process. Among the final steps, you will be a required to electronically sign a consent to adhere to specific practice obligations outlined in Subpart B and section 10.51 of Treasury Department Circular No. 230. Following successful completion of these steps, you will be issued an Annual Filing Season Program - Record of Completion by email to your PTIN account. Additionally, you will not be issued a Record of Completion until your PTIN is renewed for the upcoming tax year.

Please note that it may take up to four weeks following the completion of all requirements for return preparers to receive a Record of Completion and be placed on the Directory of Federal Tax Return Preparers with Credentials and Select Qualifications.

# Course Description

This intermediate course focuses on key Federal tax law provisions recently enacted or indexed for inflation. The course highlights major tax laws that are of significant importance to a tax practitioner.

As part of the Provisions of Tax Cuts and Jobs Act section you will find information about new individual and capital gains tax rates, increase in the standard deduction and change in filing requirements for each filing status, temporary reduction of the personal exemption to zero, the most common tax credits, Schedule C Provisions and itemized deductions for Schedule A.

Among other topics in the General Review section, this course includes information about annual inflation adjustments, taxability of earnings, Schedule B - Part III foreign accounts and trusts requirements, retirement income reporting and taxability, balance due and refund options, review of tax return due date and tax withholding and estimated tax payments.

The Ethics, Practices and Procedures section of the course highlights principals of professional conduct that are of significant importance to a tax practitioner. This section includes information about the tax-related identity theft, safeguarding taxpayer data and tax return preparer penalties.

**Please Note:** Due to the major tax reforms implemented by the Tax Cuts and Jobs Act, the IRS recommends students watch for additional IRS guidance as the year progresses and the 2019 filing season approaches. The IRS also recommends students do the appropriate research as they encounter issues affected by the Tax Cuts and Jobs Act. This specifically applies to the pass-through deduction for qualified trade or business. Please review the IRS Tax Reform webpage located at https://www.irs.gov/newsroom/tax-reform for updated guidance and the most current information.

The course includes a table of contents and comprehensive index to help guide your search for specific topics. Additionally, if you are using the electronic version of the course you can use the word search function by pressing “CTRL + F” on your keyboard and entering the word(s) you would like to look up. Along with the extensive course content you will also find a glossary and a bibliography you can use to find additional reference material when searching for particular topics or answers to review and examination questions. The numbers in parentheses at the end of a sentence correspond to the numbers in the bibliography.

**Completion Deadline & Exam:** This course, including the examination, must be completed prior to December 31, 2018.

**Course Level:** This intermediate course is appropriate for current tax professionals at all knowledge levels.
**CPE Credits:** 6 Hours
**Categories:** Annual Federal Tax Refresher
**Prerequisite**: Fundamentals of Taxation or equivalent entry level basic course in taxation
**Advanced Preparation**: None

# Course Learning Objectives

1. Develop a familiarity with the changes affected by inflation and recent tax law especially as they relate to the Tax Cuts and Jobs Act (TCJA), individual tax credits and deductions, certain retirement income and filing the tax return.
2. Learn about updates to Schedule C provisions, changes to itemized deductions on Schedule A and Schedule B - Part III foreign accounts and trusts requirements.
3. General review of important tax return preparation topics including filing status, taxable income, exclusions, the most common tax credits and deductions, capital gains and losses, self-employment income and payment and refund options.
4. Revisit various tax forms and their specific application to various taxpayer return scenarios. Analysis includes Form W-2, Form W-4, Form 1040, Form 1040X and various Form 1099s.
5. Improve your knowledge regarding tax preparer penalties and the varying sanctionable acts that trigger practitioner discipline.

## Review Questions and Feedback

Throughout the lessons there are several review questions that are designed to help you learn the material you have just studied. Review questions are for instructional use only and you will not be graded on these questions. We provide both the answers to each question and an explanation or feedback as to how we arrived at each answer at the end of the lesson. Review feedback also contains evaluative feedback explaining why incorrect answers are wrong.

Best practice suggests that you should try to answer these questions on your own first, and only then refer to the answer key and feedback to see how well you did in terms of learning the material. As with all self-study CPE courses, you can refer back to the course material to locate the answers - the so called 'open book' learning method is permissible.

## Final Examination

The final examination is intended to test your overall comprehension of the course. Each question will relate to topics found throughout the course so all of the answers can be found in the material. Passing the final exam from a self-study course is contingent upon scoring 70% or higher on the exam questions related to the course material. The examination consists of 100 multiple-choice questions, meaning you must correctly answer 70 in order to pass.

The exam must be completed and submitted online from your account at www.IRSTaxTraining.com.

The online exam has a **3-hour time limit and must be completed in one sitting. Once the timer has started it cannot be stopped.**

Make sure you have set aside this minimum block of time before beginning. A 3-hour clock will start counting down when you start your exam and once the clock reaches 0:00 the exam will be stopped whether you have finished or not**.**

After you submit the exam to us we will grade it and, upon successful completion, e-mail you a Certificate of Completion and notify the IRS that you earned AFTR course credits.

If you should fail the exam on your first attempt, you will have the option to re-take the exam at no additional charge. The exam must be reset by an administrator so you must wait until this occurs before you are able to re-take the exam.

We wish you every success and thank you for choosing IRSTaxTraining.com, Inc.

## Understanding the Icons Used in this Book

**Important**: Update or change

**Tip**: Significant information

**Note:** Additional information

**Review Question**: Learning opportunity

IRSTaxTraining.com, Inc. is an approved education provider for the California Tax Education Council (CTEC), the Internal Revenue Service (IRS) and the National Association of State Boards of Accountancy (NASBA). Our CTEC provider number is 6224 and can be confirmed at www.CTEC.org. Our IRS provider number is RP5CH and can be verified on the IRS list of Approved Continuing Education Providers under 101 Educations Services, Inc. dba IRSTaxTraining.com. Our NASBA National Registry Number is 125385 and can be verified by visiting the NASBA Confirm Registry CPE Sponsor Status website.

# Annual Filing Season Program Continuing Professional Education Requirements

| Return Preparer Categories | Description of Preparer Category | Annual Federal Tax Refresher (AFTR) Course and Exam | Tax Law Update CPE Credits | Federal Tax Law CPE Credits | Ethics CPE Credits | Total Federal CPE Credits |
|---|---|---|---|---|---|---|
| **1. AFTR Course Exempt Preparers:** | | | | | | |
| **- State based return preparer program participants** | | | | | | |
| Oregon Board of Tax Practitioners | Return preparers who are currently registered with OBTP. | N/A (Exempt) | 3 Hours | 10 Hours | 2 Hours | 15 Hours |
| California Tax Education Council (CTEC) | Return preparers who are currently registered with CTEC. | | | | | |
| Maryland State Board of Individual Tax Preparers | Return preparers who have passed the Maryland exam and are registered with Maryland by December 31. | | | | | |
| **- Organizations based return preparer program participants** | | | | | | |
| Former IRS Registered Tax Return Preparers | Return preparers who passed the RTRP exam. | N/A (Exempt) | 3 Hours | 10 Hours | 2 Hours | 15 Hours |
| IRS Special Enrollment Exam (SEE) Part 1 | Tax preparers who have passed the Special Enrollment Exam Part 1 within the past two calendar years. For example, for filing season 2019, return preparers must have passed within calendar years 2017 or 2018. | | | | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| IRS Volunteer Income Tax Assistance (VITA) volunteer | VITA quality reviewers, instructors and preparers who pass the basic and/or advanced VITA examination with active PTINs. | N/A (Exempt) | 3 Hours | 10 Hours | 2 Hours | 15 Hours |
| Accreditation Council for Accountancy and Taxation (ACAT) | Return preparers who hold either an Accredited Tax Preparer (ATP) or the Accredited Business Account/Advisor (ABA) credential. | | | | | |
| **2. Non-exempt preparers - AFTR Course - REQUIRED** | | | | | | |
| Non-exempt or non-credentialed preparer | All other non-credentialed return preparers who do not meet one of the exempt categories listed above. | 6 Hour AFTR course and exam is required annually | N/A | 10 Hours | 2 Hours | 18 Hours |
| **3. Credentialed preparers - AFTR Course Exempt** | | | | | | |
| Certified Public Accountant (CPA) | Exempt as long as preparer holds current credential. | N/A (Exempt) | 3 Hours | 10 Hours | 2 Hours | 15 Hours |
| Attorney | | | | | | |
| Enrolled Retirement Plan Agent (ERPA) | | | | | | |
| Enrolled Agent (EA) | Exempt as long as preparer holds current credential. | N/A (Exempt)<br><br>Note: If an Enrolled Agent opts to take an AFTR course, they will not receive credit toward their Enrolled Agent CPE requirements. | 3 Hours | 10 Hours | 2 Hours | 15 Hours |

In addition to completing his or her continuing professional education (CPE), the tax return preparer must also renew his or her preparer tax identification number (PTIN) for the upcoming year and consent to adhere to the obligations in Circular 230, Subpart B and Section 10.51. The tax preparer has until the tax filing due date (April 15th) to e-sign the Circular 230 consent and qualify for the AFSP. For more information about consenting to the Circular 230 requirements and printing your record of completion please visit the Annual Filing Season Program website on IRS.GOV and watch the How to Complete the Circular 230 Consent video.

# Domain 1 – Provisions of the Tax Cuts and Jobs Act (TCJA)

The Tax Cuts and Jobs Act (TCJA) is the largest piece of major tax reform legislation to be enacted in over three decades. The new law was approved by Congress on December 20, 2017 and signed into law by the President on December 22, 2017.

The TCJA is designed to cut taxes on individuals and businesses, and to stimulate the economy and create jobs. The tax cuts are projected to be nearly $1.5 trillion. The long-term impact on the deficit is unclear as the measure adds to the deficit in the short term but could reduce it in the long term if predictions of economic growth are realized.

According to the Tax Policy Center, taxes would fall for all income groups on average in 2018, increasing overall average after-tax income by 2.2%. In general, tax cuts as a percentage of after-tax income would be larger for higher-income groups, with the largest cuts as a share of income going to taxpayers in the 95th to 99th percentiles of the income distribution. However, about 5% of taxpayers should expect to see their taxes increase by about $2,800 in 2018 and the percentage of taxpayers with an increase is expected to rise to 9% in 2025 and 53% in 2027 compared with the current law. (1)

In 2018, taxes would be reduced by about $1,600 on average, increasing after-tax incomes 2.2%. Taxes would decline on average across all income groups. Taxpayers with income less than $25,000 would see an average tax cut of $60, or 0.4% of after-tax income. Taxpayers with income between about $49,000 and $86,000 would receive an average tax cut of about $900, or 1.6% of after-tax income. Taxpayers in the 95th to 99th income percentiles (those with income between about $308,000 and $733,000) would benefit the most as a share of after-tax income, with an average tax cut of about $13,500 or 4.1% of after-tax income. Taxpayers in the top 1% of the income distribution (those with income more than $733,000) would receive an average cut of $51,000, or 3.4% of after-tax income. (1)

With respect to individuals, among other items the TCJA:

- Changes the seven existing tax brackets.
- Increases the standard deduction.
- Repeals the deduction for personal exemptions.
- Increases the Child Tax Credit.
- Repeals the overall limitation on certain itemized deductions.
- Limits the mortgage interest deduction.
- Limits the deduction for state and local income or sales taxes.

The Tax Cuts and Jobs Act tax provisions for individuals, including the new tax rates, begin January 1, 2018, and will expire at the end of 2025. At that time, unless Congress extends the legislation, the law will go back to the way it is now.

# New Individual and Capital Gains Tax Rates

## Individual Tax Rate Schedules for 2018

The Tax Cuts and Jobs Act temporarily changes the structure of the individual income tax by modifying the rate structure. There are still seven (7) tax rates for individual tax payers. They are: 10%, 12%, 22%, 24%, 32%, 35% and 37%. The new tax rates affect individuals for eight years beginning on January 1, 2018 and through December 31, 2025, when many of the rates are scheduled to expire.

The tax rate of 37% applies to joint filers with taxable income over $600,000 (single filers over $500,000) The following are the tax rates schedules for tax year 2018 based on certain filing status. (2)

| Unmarried Individuals (other than Surviving Spouses and Heads of Households) | |
|---|---|
| **If Taxable Income Is:** | **The Tax Is:** |
| Not over $9,525 | 10% of the taxable income |
| Over $9,525 but not over $38,700 | $952.50 plus 12% of the excess over $9,525 |
| Over $38,700 but not over $82,500 | $4,453.50 plus 22% of the excess over $38,700 |
| Over $82,500 but not over $157,500 | $14,089.50 plus 24% of the excess over $82,500 |
| Over $157,500 but not over $200,000 | $32,089.50 plus 32% of the excess over $157,500 |
| Over $200,000 not over $500,000 | $45,689.50 plus 35% of the excess over $200,000 |
| Over $500,000 | $150,689.50 plus 37% of the excess over $500,000 |

Table 1-1 - Tax Cuts and Jobs Act (2018)

| Married Individuals Filing Joint Returns and Surviving Spouses | |
|---|---|
| **If Taxable Income Is:** | **The Tax Is:** |
| Not over $19,050 | 10% of the taxable income |
| Over $19,050 but not over $77,400 | $1,905 plus 12% of the excess over $19,050 |
| Over $77,400 but not over $165,000 | $8,907 plus 22% of the excess over $77,400 |
| Over $165,000 but not over $315,000 | $28,179 plus 24% of the excess over $165,000 |
| Over $315,000 but not over $400,000 | $64,179 plus 32% of the excess over $315,000 |
| Over $400,000 but not over $600,000 | $91,379 plus 35% of the excess over $400,000 |
| Over $600,000 | $161,379 plus 37% of the excess over $600,000 |

Table 1-2 - Tax Cuts and Jobs Act (2018)

| Married Individuals Filing Separate Returns | |
|---|---|
| **If Taxable Income Is:** | **The Tax Is:** |
| Not over $9,525 | 10% of the taxable income |
| Over $9,525 but not over $38,700 | $952.50 plus 12% of the excess over $9,525 |
| Over $38,700 but not over $82,500 | $4,453.50 plus 22% of the excess over $38,700 |
| Over $82,500 but not over $157,000 | $14,089.50 plus 24% of the excess over $82,500 |
| Over $157,000 but not over $200,000 | $32,089.50 plus 32% of the excess over $157,000 |
| Over $200,000 not over $300,000 | $45,689.50 plus 35% of the excess over $200,000 |
| Over $300,000 | $80,689.50 plus 37% of the excess over $300,000 |

Table 1-3 - Tax Cuts and Jobs Act (2018)

| Heads of Households | |
|---|---|
| **If Taxable Income Is:** | **The Tax Is:** |
| Not over $13,600 | 10% of the taxable income |
| Over $13,600 but not over $51,800 | $1,360 plus 12% of the excess over $13,600 |
| Over $51,800 but not over $82,500 | $5,944 plus 22% of the excess over $51,800 |
| Over $82,500 but not over $157,500 | $12,698 plus 24% of the excess over $82,500 |
| Over $157,500 but not over $200,000 | $30,698 plus 32% of the excess over $157,500 |
| Over $200,000 not over $500,000 | $44,298 plus 35% of the excess over $200,000 |
| Over $500,000 | $149,298 plus 37% of the excess over $500,000 |

Table 1-4 - Tax Cuts and Jobs Act (2018)

| Estates and Trusts | |
|---|---|
| **If Taxable Income Is:** | **The Tax Is:** |
| Not over $2,550 | 10% of the taxable income |
| Over $2,550 but not over $9,150 | $255 plus 24% of the excess over $2,550 |
| Over $9,150 but not over $12,500 | $1,839 plus 35% of the excess over $9,150 |
| Over $12,500 | $3,011.50 plus 37% of the excess over $12,500 |

Table 1-5 - Tax Cuts and Jobs Act (2018)

## Capital Gains Tax Rates

The TCJA generally retains the prior law maximum rates on net capital gains and qualified dividends. The breakpoints between the zero and 15% rates and the 15% and 20% rates are the same amounts as the breakpoints under prior law, except that the breakpoints are indexed using new inflation adjustment factors.

Long-term capital gains are still defined as gains made on assets that the taxpayer held for over a year, while short-term capital gains come from assets he or she held for a year or less. Long-term gains are taxed at rates of 0%, 15%, or 20%, depending on the taxpayer's tax bracket, while short-term gains are taxed as ordinary income.

| Rates for Long-Term Capital Gains and Qualified Dividends | | |
|---|---|---|
| **Tax Bracket** | **Short-term** | **Long-term** |
| 10%, 12% brackets | Ordinary rate | 0% |
| 22%, 24%, 32%, 35% brackets | Ordinary rate | 15% |
| 37% bracket | Ordinary rate | 20% |

Table 1-6 - Tax Cuts and Jobs Act (2018)

The way long-term capital gains rates are applied has changed slightly. Under previous tax law, the 0% rate was applied to the two lowest tax brackets, the 15% rate was applied to the next four, and the 20% rate was applied to the top bracket.

Under the Tax Cuts and Jobs Act, the three capital gains income thresholds do not match up perfectly with the tax brackets. Instead, they are applied to maximum taxable income levels, as follows:

| Long-term Capital Gains Rate | Single Taxpayers | Married Filing Jointly | Head of Household | Married Filing Separately |
|---|---|---|---|---|
| 0% | Up to $38,600 | Up to $77,200 | Up to $51,700 | Up to $38,600 |
| 15% | $38,600-$425,800 | $77,200-$479,000 | $51,700-$452,400 | $38,600-$239,500 |
| 20% | Over $425,800 | Over $479,000 | Over $452,400 | Over $239,500 |

Table 1-7 - Tax Cuts and Jobs Act (2018)

An additional 3.8% Federal Net Investment Income Tax (NIIT) applies to individuals on the lesser of net investment income or modified adjusted gross income (MAGI) in excess of $200,000 (single) or $250,000 (married/filing jointly and qualifying widow(er)s). The tax also applies to any trust or estate on the lesser of undistributed net income or AGI in excess of the dollar amount at which the estate/trust pays income taxes at the highest rate.

# Standard Deduction and Filing Requirements

## Standard Deduction

Under the Tax Cuts and Jobs Act, for 2018 the standard deduction amounts will increase to $12,000 for individuals (up from $6,350 in 2017), to $18,000 for heads of household (up from $9,350 in 2017), and to $24,000 for married couples filing jointly and surviving spouses (up from $12,700 in 2017). (2)

| Standard Deductions 2018 Tax Year | |
|---|---|
| **Filing Status** | **Standard Deduction Amount** |
| Single | $12,000 |
| Married Filing Jointly | $24,000 |
| Married Filing Separately | $12,000 |
| Heads of Household | $18,000 |
| Surviving Spouse | $24,000 |

Table 1-8 - Tax Cuts and Jobs Act (2018)

These standard deduction amounts are adjusted for inflation in tax years beginning after 2018. For 2018, the additional standard deduction amount for the aged or the blind increased to $1,300. The additional standard deduction amount also increased to $1,600 if the individual is also unmarried and not a surviving spouse. For 2018, the standard deduction amount for an individual who may be claimed as a dependent by another taxpayer cannot exceed the greater of $1,050 or the sum of $350 and the individual's earned income.

## Elderly and/or Blind Taxpayers

The standard deduction chart for people age 65 or older (shown below) lists the additional standard deduction for taxpayers who are age 65 or older and/or blind at the end of the tax year. The standard deduction is calculated by adding the person's standard deduction (based on their filing status), plus the additional amount. Additional standard deduction amounts for 2018 are $1,600 for single or head of household or $1,300 for married filing jointly, married filing separately, or qualifying widow.

For example, if the taxpayer is married, filing a joint return and both he and his wife are 68 years of age, what would their standard deduction amount come to for 2018? The taxpayer would check off the box for him as being 65 or older, as well as the same box for his spouse. Two boxes are checked, and looking at the married filing joint return section, we see that their available standard deduction would be $26,600. If one was also blind, the standard deduction for 2018 would be $27,900 having three boxes checked.

Partial blindness qualifies, with a certified statement from an eye doctor (ophthalmologist or optometrist) attesting that the vision in the taxpayer's better eye is 20/200 or worse after being corrected with glasses or contact lenses or that the taxpayer's field of vision is not more than 20 degrees. If the taxpayer's eye condition is not likely to improve beyond these limits, the statement should include this fact. The taxpayer should keep the statement with his or her records. If the taxpayer is blind on the last day of the year, he or she is entitled to the higher standard deduction.

| Standard Deduction Chart for People Age 65 or Older or Blind | | |
|---|---|---|
| Filing Status | Number from the box on Line 39a of 1040 | Standard Deduction for 2018 |
| Single | 1<br>2 | $13,600<br>$15,200 |
| Married filing jointly<br>or qualifying widow(er) | 1<br>2<br>3<br>4 | $25,300<br>$26,600<br>$27,900<br>$29,200 |

| | | |
|---|---|---|
| Married filing separately | 1<br>2<br>3<br>4 | $13,300<br>$14,600<br>$15,900<br>$17,200 |
| Head of household | 1<br>2 | $19,600<br>$21,200 |

Table 1-9 - Publication 501 - Table 7 – Standard Deduction Chart for People who are 65 or Older or Who are Blind, (2018)

For an individual taxpayer, he or she will be required to file a tax return if his or her gross income for the taxable year is more than the standard deduction. For a married taxpayer, he or she will be required to file a tax return if his or her gross income, when combined with his or her spouse's gross income, is more than the standard deduction for a joint return, provided that the taxpayer and his or her spouse lived in the same home; his or her spouse does not file a separate tax return; and neither the taxpayer nor his or her spouse is a dependent of another taxpayer who has income other than earned income in excess of $500 (indexed for inflation).

**Review Question 1**
For 2018, the additional standard deduction amount for married taxpayers age 65 and older or the blind is what amount?

A. $1,000
B. $1,300
C. $1,600
D. $1,800

See Review Feedback for answer.

## Filing Requirements

An individual must file a Federal income tax return if he or she is a citizen or resident of the United States or a resident of Puerto Rico and he or she meets the filing requirements for any of the following categories that apply to him or her:

- Individuals in general. (There are special rules for surviving spouses, executors, administrators, legal representatives, U.S. citizens and residents living outside the United States, residents of Puerto Rico, and individuals with income from U.S. possessions.)
- Dependents.
- Certain children under age 19 or full-time students.
- Self-employed persons.
- Aliens.

An individual files only one Federal income tax return for the year regardless of how many jobs he or she had, how many Forms W-2 he or she received, or how many states he or she lived in during the year. An individual does not file more than one original return for the same year, even if he or she has not gotten his or her refund or has not heard from the IRS since he or she filed.

The filing requirements apply even if the taxpayer does not owe tax. Also, age, occupation, and mental or physical conditions have no influence on who is subject to the tax. A minor must pay the tax on his or her income just like any adult, including the President of the United States.

Persons institutionalized because of mental incapacity are still subject to the tax. However, not every person has to file an annual tax return with the Internal Revenue Service (IRS). Taxpayers have to file a tax return only if their gross income exceeds the total of their standard deduction.

The amount varies depending on the taxpayer's filing status and, for tax year 2018, the minimum income requirements are:

| Filing Status | Minimum Income Requirements |
|---|---|
| Single individual | $12,000 |
| Single individual 65 or older | $13,600 |
| Married couple, filing jointly | $24,000 |
| Married couple, one spouse 65 or older | $25,300 |
| Married couple, both 65 or older | $26,600 |
| Head of household | $18,000 |
| Head of household 65 or over | $19,600 |
| Surviving spouse | $24,000 |
| Surviving spouse 65 or older | $25,300 |

Table 1-10 - Publication 17 - Filing Requirements for Most Taxpayers (2018)

Regardless of a taxpayer's gross income, he or she is generally required to file an income tax return if any of the following items apply:

- The taxpayer owes Alternative Minimum Tax.
- The taxpayer owes household employment taxes.
- The taxpayer owes additional taxes on a retirement plan (an individual retirement arrangement (IRA) or other tax-favored account) or health savings account.
- The taxpayer owes Social Security and Medicare taxes on unreported tip income.
- The taxpayer had net self-employment income of $400 or more.
- The taxpayer earned $108.28 or more from a tax-exempt church or church-controlled organization.
- The taxpayer received distributions from an Medical Savings Account (MSA) or Health Savings Account (HSA).

There are a number of reasons why a taxpayer may want to file a tax return even if he or she does not meet the minimum income requirements:

- If the taxpayer had taxes withheld from his or her pay, he or she must file a tax return to receive a tax refund.
- If the taxpayer qualifies, he or she must file a return to receive the refundable Earned Income Tax Credit.
- If the taxpayer is claiming education credits, he or she must file to be refunded the American Opportunity Credit.
- If the taxpayer has a qualifying child but owes no tax, he or she can file to be refunded the Additional Child Tax Credit.
- If the taxpayer qualifies, he or she must file to claim the refundable Health Coverage Tax Credit.
- If the taxpayer adopted a qualifying child, he or she must file to claim the Adoption Tax Credit.
- If the taxpayer overpaid estimated tax or applied a prior year overpayment to this year, he or she must file to receive the refund.

# Personal Exemption

Under the Tax Cuts and Jobs Act, for tax years beginning after December 31, 2017 until January 1, 2026, the deduction for personal exemptions is effectively suspended by reducing the exemption amount to zero. A number of corresponding changes are made throughout the Tax Code where specific provisions contain references to the personal exemption amount and, in each of these instances, the dollar amount to be used is $4,150 in 2018, as adjusted by inflation.

Since there will be no personal exemption amounts, the taxpayer will figure whether he or she needs to file a return either:

- For individual taxpayers, he or she will be required to file a tax return if his or her gross income for the taxable year is more than the standard deduction.

- For married taxpayers, he or she will be required to file a tax return if his or her gross income, when combined with his or her spouse's gross income, is more than the standard deduction for a joint return, provided that the taxpayer and his or her spouse lived in the same home; his or her spouse does not file a separate tax return; and neither the taxpayer nor his or her spouse is a dependent of another taxpayer who has income other than earned income in excess of $500 (indexed for inflation).

In 2026, taxpayers can claim personal and dependent exemptions again.

# Income

The taxpayer can receive income in the form of money, property, or services. Generally, an amount included in the taxpayer's income is taxable unless it is specifically exempted by law. Income that is taxable must be reported on the taxpayer's income tax return and is subject to tax. Income that is nontaxable may have to be shown on his or her tax return but is not taxable.

Generally, the taxpayer must include in gross income everything he or she receives in payment for personal services. In addition to wages, salaries, commissions, fees, and tips, this includes other forms of compensation such as fringe benefits and stock options. The taxpayer should receive a Form W-2 - Wage and Tax Statement, from his or her employer showing the pay he or she received for his or her services.

The taxpayer is generally taxed on income that is available to him or her, regardless of whether it is actually in his or her possession. A valid check that the taxpayer received or that was made available to him or her before the end of the tax year is considered income constructively received in that year, even if he or she does not cash the check or deposit it to his or her account until the next year. For example, if the postal service tries to deliver a check to the taxpayer on the last day of the tax year but he or she is not at home to receive it, the taxpayer must include the amount in his or her income for that tax year. If the check was mailed so that it could not possibly reach the taxpayer until after the end of the tax year, and he or she could not otherwise get the funds before the end of the year, the taxpayer includes the amount in his or her income for the next year.

Income received by an agent for the taxpayer is income he or she constructively received in the year the agent received it. If the taxpayer agrees by contract that a third party is to receive income for him or her, he or she must include the amount in his or her income when the party receives it.

Prepaid income, such as compensation for future services, is generally included in the taxpayer's income in the year he or she receives it. However, if the taxpayer uses an accrual method of accounting, he or she can defer prepaid income he or she receives for services to be performed before the end of the next tax year. In this case, the taxpayer includes the payment in his or her income as he or she earns it by performing the services.

# Adjustments to Income

## Changes to Above-the-line Deductions

The Tax Cuts and Jobs Act (TCJA) changed certain above-the-line deductions. The alimony deduction will be repealed but not until 2019. The change applies to any divorce or separation instrument executed or modified after December 31, 2018 (the modification must expressly state that the new rule applies). Also, the deduction for moving expenses is also repealed, except for members of the military. The domestic production activities deduction (DPAD) is also repealed. The educator expenses deduction, student loan interest deduction, health savings account (HSA) deduction, IRA deduction and deductions for self-employed taxpayers all stay the same. However, the tuition and fees deduction that expired under previous law and was not renewed by the TCJA.

## Alimony Deduction and Exclusion Repealed

Payments incident to divorce generally fall into one of two categories: alimony or property settlements. In general, alimony is a division of income, and property settlements are a division of marital property. A property settlement is not a taxable event and does not give rise to any gain or loss. In contrast, alimony and separate maintenance payments were deductible above-the-line by the payor spouse and includible in income by the recipient spouse. As

an above-the-line deduction, alimony was subtracted directly from the payor's gross income without being limited by the payor's adjusted gross income (AGI).

The Tax Cuts and Jobs Act (TCJA) provides that for any divorce or separation agreement executed after December 31, 2018, or executed before that date but modified after it (if the modification expressly provides that the new amendments apply), alimony and separate maintenance payments are not deductible by the payor-spouse and are not included in the income of the payee-spouse. Instead, income used for alimony payments is taxed at the rates applicable to the payor-spouse rather than the recipient spouse. The new law does not change the tax treatment of child support payments.

## Moving Expense Deduction Suspended Except in Limited Situations

When taxpayers made a work-related move, they were able to deduct qualified "moving expenses" paid or incurred during the tax year in connection with commencement of work at a new job. The deduction was available to both employees and self-employed taxpayers. Under the old law, taxpayers could claim a deduction for moving expenses incurred in connection with starting a new job if the new workplace was at least 50 miles farther from a taxpayer's former residence than the former place of work.

The Tax Cuts and Jobs Act (TCJA) provides that for tax years beginning after December 31, 2017 until January 1, 2026, the deduction for moving expenses is suspended, except for members of the Armed Forces (or their spouse or dependents) on active duty who move pursuant to a military order and incident to a permanent change of station.

## Recharacterization of Roth IRA Contributions

If a taxpayer makes a contribution to an individual retirement account (IRA) (traditional or Roth) for a tax year, the individual is allowed 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. Both regular contributions and conversion contributions to a Roth IRA can be recharacterized as having been made to a traditional IRA.

For tax years beginning after December 31, 2017, the Tax Cuts and Jobs Act (TCJA) repeals the special rule that allows IRA contributions to one type of IRA (either traditional or Roth) to be recharacterized as a contribution to the other type of IRA. For example, a conversion contribution establishing a Roth IRA during a tax year can no longer be recharacterized as a contribution to a traditional IRA which in effect results in unwinding the conversion.

Recharacterization is still permitted in other situations. For example, an individual can still 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. Also, a Roth IRA conversion made in 2017 may be recharacterized as a contribution to a traditional IRA if the recharacterization is made by October 15, 2018. A Roth IRA conversion made on or after January 1, 2018, cannot be recharacterized.

**Review Question 2**

Under the Tax Cuts and Jobs Act all of the following above-the-line deductions are unchanged except:

A. Student Loan Interest Deduction
B. Educator Expenses Deduction
C. Alimony Deduction
D. IRA Deduction

See Review Feedback for answer.

# Schedule C Provisions

## Elimination of Entertainment Expenses

Ordinary and necessary business expenses are generally deductible, whereas personal consumption expenses are not. Under previous law an entertainment event, such as attendance at a professional sports event, can constitute a deductible business expense rather than an item of personal consumption if the expenditure is business-oriented and it is ordinary and necessary in nature.

The Tax Cuts and Jobs Act (TCJA) provides that effective for amounts incurred or paid after December 31, 2017, no deduction will be allowed for:

- An activity generally considered to be entertainment, amusement or recreation.
- Membership dues paid to any club organized for business, pleasure, recreation or other social purposes.
- A facility or any portion of a facility used in connection with entertainment, amusement or recreation.

Therefore, the TCJA repeals the exception to the deduction disallowance for entertainment, amusement, or recreation that is directly related to the active conduct of the taxpayer's trade or business. The new law also repeals the related rule applying a 50% limit to such deductions. Taxpayers may still generally deduct 50% of the food and beverage expenses associated with operating their trade or business. For example, employers may deduct expenses incurred to provide meals consumed by employees on work travel.

For amounts incurred and paid after December 31, 2017 until December 31, 2025, the new law expands the 50% limit on the deductibility of business meals to include expenses associated with meals provided for the convenience of the employer on the employer's business premises, or provided on or near the employer's business premises through an employer-operated facility that meets certain requirements.

## Section 179 Deduction

Essentially, Section 179 of the IRS tax code allows businesses to deduct the full purchase price of qualifying equipment and or software purchased or financed during the tax year. That means that if the taxpayer buys (or leases) a piece of qualifying equipment, he or she can deduct the full purchase price from his or her gross income. The deduction is an incentive created by the U.S. government to encourage businesses to buy equipment and invest in themselves.

With the passage and signing into law of the Tax Cuts and Jobs Act, the deduction limit for Section 179 increases from $500,000 to $1,000,000 for 2018 and beyond. The limit on equipment purchases likewise has increased, from $2,000,0000 to $2,500,000. In addition, the deduction now includes any of the following improvements to existing nonresidential property (i.e., the improvement must be placed in service after the date the property itself was first placed in service): roofs; heating, air-conditioning, and ventilation systems; fire protection, alarm, and security systems. Further, the bonus depreciation increases from 50% to 100%. This part is retroactive to September 27, 2017, and is good through 2022. The bonus depreciation also now includes used equipment.

The total cost that can be deducted under Section 179 is also limited to the taxable income earned from the taxpayer's trade or business during the year. Taxable income (including salaries and wages paid to the taxpayer(s) from the business and reported as W-2 income) is figured without regard to any available Section 179 expense deduction. However, the amount of any disallowed deduction in this tax year can be carried over to next tax year and be added to the amount of qualified Section 179 property placed in service in that next tax year. To elect the Section 179 Deduction a taxpayer needs to fill out Part One of IRS Form 4562 - Depreciation and Amortization.

For passenger vehicles, trucks, and vans (not meeting the guidelines below), that are used more than 50% in a qualified business use, the total deduction for depreciation including both the Section 179 expense deduction as well as Bonus Depreciation is limited to $18,000 for passenger cars and $18,000 for trucks and vans during 2018. For automobiles placed in service during 2018 but not eligible for bonus depreciation, the deduction limit is $10,000 for passenger cars and $10,000 for trucks and vans. The guidance will be published in the Internal Revenue Bulletin sometime after mid-year).

For later years, the taxpayer must compute his or her depreciation on the car or truck using the usual methods. As long as the taxpayer continues to use the car more than 50% for business, he or she would multiply the business percentage of the car's cost by the percentage shown in the normal MACRS table for five-year property.

Exceptions include the following vehicles:

- Taxis, transport vans, and other vehicles used to specifically transport people or property for hire.
- Ambulance or hearse used specifically in a taxpayer's business.
- Qualified non-personal use vehicles specifically modified for business (i.e. van without seating behind driver, permanent shelving installed, and exterior painted with company's name).

Certain vehicles (with a gross vehicle weight rating above 6,000lbs but no more than 14,000lbs) qualify for expensing up to $25,000 if the vehicle is financed and placed in service prior to December 31st and meets other conditions.

Many vehicles that by their nature are not likely to be used for personal purposes qualify for full Section 179 deduction including the following vehicles:

1. Heavy non-SUV vehicles with a cargo area at least six feet in interior length (this area must not be easily accessible from the passenger area.).
2. Vehicles that can seat nine-plus passengers behind the driver's seat (i.e.: Hotel / Airport shuttle vans, etc.).
3. Vehicles with a fully-enclosed driver's compartment / cargo area, no seating at all behind the driver's seat, and no part of the body Section protruding more than 30 inches ahead of the leading edge of the windshield.

Some of the property and equipment that does not qualify for the Section 179 Deduction is:

- Property used outside the United States generally does not qualify for the Section 179 Deduction.
- Property that is used to furnish lodging is generally not qualified for the Section 179 Deduction.
- Real Property does not qualify for the Section 179 Deduction. Real Property is typically defined as land, buildings, permanent structures and the components of the permanent structures (including improvements). Other examples of property that would not qualify for the Section 179 Deduction include paved parking areas and fences.
- Air conditioning and heating equipment is generally not eligible for the Section 179 Deduction.
- Property acquired by gift or inheritance, as well as property purchased from related parties does not qualify for the Section 179 Deduction (No, a taxpayer cannot sell equipment to him or herself and qualify for Section 179).
- Any property that is not considered to be personal property, may not qualify for the Section 179 Deduction.
- Used Equipment (that is new to the taxpayer) qualifies for Section 179. Used equipment also qualifies for Bonus Depreciation.

## Bonus Depreciation

Under the Tax Cuts and Jobs Act, the bonus depreciation increases from 50% to 100%. This provision is retroactive to September 27, 2017, and is good through 2022. The bonus depreciation also now includes used equipment.

Bonus Depreciation is useful to very large businesses spending more than the Section 179 Spending Cap on new capital equipment. Also, businesses with a net loss are still qualified to deduct some of the cost of new equipment and carry-forward the loss.

When applying these provisions, Section 179 is generally taken first, followed by Bonus Depreciation - unless the business had no taxable profit, because the unprofitable business is allowed to carry the loss forward to future years.

Tip

To qualify for bonus depreciation, property that is classified as "listed property" under the tax code must be used more than 50% of the time for business. Another change brought by the Tax Cuts and Jobs Act is that computers are no longer classified as listed property. As a result, on the taxpayer's 2018 filing, he or she can use bonus depreciation to deduct computers used less than 50% of the time for business.

**Review Question 3**
Within the specified dollar limits of Section 179, a business can deduct, for the current tax year, what amount of the purchase price of financed or leased equipment and off-the-shelf software that was placed into service in the same tax year that the deduction is being taken and qualifies for the deduction?

A. 25% of the purchase price
B. 50% of the purchase price
C. 75% of the purchase price
D. 100% of the purchase price

See Review Feedback for answer.

# Itemized Deductions - Schedule A

Every deduction indicated on Schedule A of the taxpayer's individual income tax return has been modified to some extent under the Tax Cuts and Jobs Act (TCJA). Accordingly, if the taxpayer that has historically itemized deductions, the changes discussed below will, to some degree, have an impact to his or her taxable income in the coming years. Unless otherwise noted, these changes are in effect for tax years beginning after December 31, 2017 and before January 1, 2026.

## Changes to Deduction for Medical and Dental Expenses

Under pre-TCJA tax law, the deduction for qualified medical expenses was allowed for qualified medical expenses exceeding 10% of adjusted gross income (AGI). This floor was reduced to 7.5% of AGI for taxpayers 65 and older, however that provision expired on December, 31, 2016.

Under TCJA tax law, for tax years beginning after December, 31, 2016 and before January 1, 2019, a taxpayer that itemizes may deduct qualified medical expenses, so long as they exceed 7.5% of AGI. As such, the new law extends the 7.5% through 2018 and retroactively makes it available to taxpayers that itemize, regardless of age, during this period. Unless current law changes, for tax years beginning after December 31, 2018, the 10% of AGI floor for medical and dental expenses will return.

## State and Local Tax Deduction and Limit

Under pre-TCJA tax law, taxpayers were entitled to a deduction equal to the state and local taxes (SALT) paid during the year.

The deduction consisted of the following types of taxes paid:

- State, local, and/or foreign real property taxes.
- State and local personal property taxes (i.e. cars, boats).
- State, local, and/or foreign income taxes.

Under previous tax law the taxpayer could claim an itemized deduction for an unlimited amount of personal state and local income and property taxes. He or she could also choose to forego any deduction for state and local income taxes and instead deduct state and local general sales taxes.

The Tax Cuts and Jobs Act limits the taxpayer's deduction for state and local income and property taxes to a combined total of $10,000 ($5,000 if he or she uses married filing separate status). Foreign real property taxes can no longer be deducted. However, the taxpayer can still choose to deduct state and local sales taxes instead of state and local income taxes.

The new law provides that for tax years beginning after December 31, 2017 until January 1, 2026, state, local, and foreign property taxes, and state and local sales taxes, are fully deductible only when paid or accrued in carrying on a trade or business or an activity relating to expenses for the production of income. Therefore, taxpayers may only fully claim deductions for state, local and foreign property taxes, and sales taxes that are presently deductible in

computing income on an individual's Schedule C, Schedule E, or Schedule F on the individual's tax return. For example, an individual taxpayer may only deduct property taxes if these taxes were imposed on residential rental property which qualifies as a business asset.

## Home Mortgage Interest Deduction Changes

Under the Tax Cuts and Jobs Act (TCJA), mortgage interest on loans used to acquire a principal residence and/or a second home remains deductible, but only on debt up to $750,000. This represents an unfavorable increase of $250,000 since the limitation was $1 million under prior tax law. Taxpayers with existing acquisition debt, that is, debt acquired on or before December 15, 2017, would remain subject to the $1 million limitation, as the new law is not applied retroactively.

Additionally, mortgage refinances after 2017 will be considered incurred on the date of the original mortgage so long as the refinanced debt does not exceed the original debt. This will afford taxpayers with existing debt the option to refinance without being encumbered by the new limitations.

Also, for the eight tax years beginning after December 31, 2017 and before January 1, 2026 the deduction for interest paid on home equity loans and lines of credit is suspended, unless they are used to buy, build or substantially improve the taxpayer's home that secures the loan.

## Charitable Contribution Changes

Under the Tax Cuts and Jobs Act the 50% limitation for cash contributions to public charities and certain private foundations is increased to 60% of the taxpayer's adjusted gross income. Contributions exceeding the 60% limitation are generally allowed to be carried forward and deducted for up to five years, subject to the later year's ceiling. Additionally, no charitable deduction would be allowed for any payment to an institution of higher education in exchange for which the payor receives the right to purchase tickets or seating at an athletic event.

The new law also repeals the donee-reporting exemption from the contemporaneous written acknowledgment requirement for tax years beginning after December 31, 2017.

A taxpayer can only deduct gifts he or she gives to qualified charities. Gifts of money include those made in cash or by check, electronic funds transfer, credit card and payroll deduction. The taxpayer must have a bank record or a written statement from the charity to deduct any gift of money on his or her tax return. This is true regardless of the amount of the gift. The statement must show the name of the charity and the date and amount of the contribution. Bank records include canceled checks, or bank, credit union and credit card statements.

If the taxpayer gives by payroll deductions, he or she should retain a pay stub, a Form W-2 wage statement or another document from his or her employer. It must show the total amount withheld for charity, along with the pledge card showing the name of the charity.

Household items include furniture, furnishings, electronics, appliances and linens. If the taxpayer donates clothing and household items to charity they generally must be in at least good used condition to claim a tax deduction. If he or she claims a deduction of over $500 for an item it does not have to meet this standard if the taxpayer includes a qualified appraisal of the item with his or her tax return.

The taxpayer must get an acknowledgment from a charity for each deductible donation (either money or property) of $250 or more. Additional rules apply to the statement for gifts of that amount. This statement is in addition to the records required for deducting cash gifts. However, one statement with all of the required information may meet both requirements.

The taxpayer can deduct contributions in the year he or she makes them. If the taxpayer charges his or her gift to a credit card before the end of the year it will count for 2018. This is true even if he or she does not pay the credit card bill until 2019. Also, a check will count for 2018 as long as the taxpayer mails it in 2018.

Use the following lists for a quick check of whether the taxpayer can deduct a contribution.

| Examples of Charitable Contributions | |
|---|---|
| **Deductible As Charitable Contributions** | **Not Deductible As Charitable Contributions** |
| Money or property the taxpayer gives to:<br>• Churches, synagogues, temples, mosques, and other religious organizations.<br>• Federal, state, and local governments, if the taxpayer's contribution is solely for public purposes (for example, a gift to reduce the public debt or maintain a public park).<br>• Nonprofit schools and hospitals.<br>• The Salvation Army, American Red Cross, CARE, Goodwill Industries, United Way, Boy Scouts of America, Girl Scouts of America, Boys and Girls Clubs of America, etc.<br>• War veterans' groups. | Money or property the taxpayer gives to:<br>• Civic leagues, social and sports clubs, labor unions, and chambers of commerce.<br>• Foreign organizations (except certain Canadian, Israeli, and Mexican charities).<br>• Groups that are run for personal profit.<br>• Groups whose purpose is to lobby for law changes.<br>• Homeowners' associations.<br>• Individuals.<br>• Political groups or candidates for public office.<br>• Donations in exchange for college athletic event seating rights. |
| Expenses paid for a student living with the taxpayer, sponsored by a qualified organization. | Cost of raffle, bingo, or lottery tickets. |
| Out-of-pocket expenses when the taxpayer serves a qualified organization as a volunteer. | Dues, fees, or bills paid to country clubs, lodges, fraternal orders, or similar groups. |
| | Tuition |
| | Value of the taxpayer's time or services |
| | Value of blood given to a blood bank |

Table 1-11 - Publication 526 - Table 1 - Examples of Charitable Contributions - A Quick Check (2018)

## Casualty and Theft Loss Deduction

A casualty is defined as the complete or partial destruction of property from a sudden, unexpected, or unusual cause. Under the TCJA, casualty and theft losses are generally only deductible to the extent they are attributable to a "Federally declared disaster". There is a limited exception for taxpayers who have personal casualty gains, whereby losses not attributable to a disaster may be used to offset such gains, but not below zero. For the purposes of this provision, a "Federally declared disaster" is one that has been determined by the President to warrant Federal assistance under the Robert T. Stafford Disaster Relief and Emergency Assistance Act.

Additionally, the TCJA retroactively provides relief to taxpayers who incurred a disaster loss in tax years 2016 and 2017 by raising the $100-per-casualty limitation to $500 and waiving the 10% of AGI floor.

## Miscellaneous Itemized Deductions

Under the Tax Cuts and Jobs Act (TCJA) the provisions (which takes effect beginning with the 2018 tax year) dramatically affect employees who incur unreimbursed expenses related to their job (such as home office expenses, union dues, work-related education, job searches, legal fees, subscriptions to trade journals, etc.), it does not affect small business owners or self-employed persons, who would still be able to declare business expenses on IRS Form 1040, Schedule C (Profit or Loss from Business).

## Deductions Subject to the 2% Limit

Under the Tax Cuts and Jobs Act the deduction for miscellaneous itemized deductions that are subject to the 2% of adjusted gross income (AGI) floor is suspended. Therefore, no miscellaneous itemized deductions may be claimed by a taxpayer on Schedule A for tax years 2018 through 2025.

Suspended miscellaneous deductions subject to the 2% floor include unreimbursed employee expenses for:

- Travel.
- Lodging.

- Meals.
- Entertainment.
- Continuing education.
- Subscriptions to professional journals.
- Professional uniforms.
- Job hunting.
- Cost of business use of an employee's home.

Other suspended miscellaneous deductions subject to the 2% include: (3)

- Fees for investment and tax assistance
- Investment counsel fees and other related expenses.
- Investment services.
- Safe-deposit box rent (if used to store stocks and bonds and other documents relating to income-producing property).
- Fee for preparation of tax returns.
- Costs of defending or initiating a legal action or claim in connection with the determination, collection, or refund of any tax.
- Appraisal fees relating to tax planning.
- Trustee's fees for the client's IRA, if such fees were separately billed and paid by the taxpayer.

Deductions Not Subject to the 2% Limit:

- Amortizable premium on taxable bonds.
- Casualty and theft losses from income-producing property.
- Federal estate tax on income in respect of a decedent.
- Gambling losses up to the amount of gambling winnings.
- Impairment-related work expenses of persons with disabilities.
- Loss from other activities from Schedule K-1 (Form 1065-B), box 2.
- Losses from Ponzi-type investment schemes.
- Repayments of more than $3,000 under a claim of right.
- Unrecovered investment in an annuity.

## Changes to the Deduction for Gambling Losses

Historically, gambling losses have only been deductible to the extent of gambling winnings. However, a 2011 tax court ruling in Mayo vs. Commissioner (136 TC 181) allowed taxpayers engaged in the trade or business of gambling to exclude certain non-wagering expenses (i.e. travel, meals, entry fees, etc.) from "gambling losses" and report them on Schedule C.

The Tax Cuts and Jobs Act provides that for tax years beginning after December 31, 2017 until January 1, 2026, the limitation on wagering losses is modified to provide that all deductions for expenses incurred in carrying out wagering transactions, not just gambling losses, are limited to the extent of gambling winnings. The provision thus reverses the result reached by the Tax Court where the court held that a taxpayer's expenses incurred in the conduct of the trade or business of gambling, other than the cost of wagers, were not limited to the extent of gambling winnings, and were thus deductible as ordinary and necessary business expenses in the case of the "professional gambler."

## Itemized Deduction Phase-Out

Taxpayers are generally given the option to either claim a standard deduction or itemize deductions. Under the old law, the total amount of most otherwise allowable itemized deductions was limited for certain higher-income taxpayers. For taxpayers who exceed the threshold, the otherwise allowable amount of itemized deductions was reduced by 3% of the amount of the taxpayers' adjusted gross income (AGI) exceeding the threshold. The total reduction could not be greater than 80% of all itemized deductions, and certain itemized deductions were exempt from this Pease limitation. The Tax Cuts and Jobs Act repeals the phase-out of itemized deductions for high-income taxpayers. This suspension of the overall limitation on itemized deductions will apply to any taxable year beginning after December 31, 2017, and before January 1, 2026.

**Review Question 4**
Under the Tax Cuts and Jobs Act miscellaneous deductions which exceed 2% of the taxpayer's adjusted gross income (AGI) will be eliminated. This includes deductions for which of the following?

A. Impairment-related work expenses of persons with disabilities
B. Medical expenses
C. Federal estate tax on income in respect of a decedent
D. Tax preparation expenses

See Review Feedback for answer.

# Credits

## Child Tax Credit

Under the Tax Cuts and Jobs Act (TCJA), the amount of the Child Tax Credit (CTC) is increased to $2,000 per qualifying child; The income levels at which the credit phases out are increased to $400,000 for married taxpayers filing jointly ($200,000 for all other taxpayers) (not indexed for inflation). A $500 nonrefundable credit is provided for certain non-child dependent. The portion of the Child Tax Credit that is refundable after 2017 and before 2026 is still referred to as the Additional Child Tax Credit (ACTC) but is limited to $1,400 per qualifying child, and this amount is indexed for inflation, up to the $2,000 base credit amount. The earned income threshold for the refundable portion of the credit is decreased from $3,000 to $2,500.

A taxpayer will only be able to claim the Child Tax Credit or the Additional Child Tax Credit if the taxpayer includes a Social Security number (SSN) for each qualifying child for whom the credit is claimed on the tax return. The Social Security number must be issued before the due date for the filing of the tax return where the credit is claimed. If the taxpayer's dependent child has an Individual Taxpayer Identification Number (ITIN), but not an SSN, issued before the due date of his or her 2018 return (including extensions), he or she may be able to claim the new credit for that child.

In general, to be a qualifying child for purposes of the Child Tax Credit and Additional Child Tax credit, the child must be a citizen, national, or resident of the United States. Use Part I of Schedule 8812 - Child Tax Credit to document that any child for whom an IRS Individual Taxpayer Identification Number (ITIN) was issued meets the substantial presence test and is not otherwise treated as a nonresident alien.

To meet the substantial presence test, a child identified with an ITIN generally must be physically present in the United States on at least: (4)

1. 31 days during 2018, **and**
2. 183 days during the 3-year period that includes 2018, 2017, and 2016, counting:
    a. All the days the child was present in 2018, and
    b. 1/3 of the days the child was present in 2017, and
    c. 1/6 of the days the child was present in 2016.

Here are some important facts from the IRS about the Child Tax Credit and how it may benefit a taxpayer's family. (5)

1. *Amount* - With the Child Tax Credit, a taxpayer may be able to reduce his or her Federal income tax by up to $2,000 for each qualifying child under the age of 17.
2. *Qualification* - A qualifying child for this credit is someone who meets the qualifying criteria of six tests: age, relationship, support, dependent, citizenship, and residence.
3. *Age Test* - To qualify, a child must have been under age 17 – age 16 or younger – at the end of 2018.
4. *Relationship Test* - To claim a child for purposes of the Child Tax Credit, they must either be the taxpayer's son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister or a descendant of any of these individuals, which includes a grandchild, niece or nephew. An adopted child is always treated as a taxpayer's own child. An adopted child includes a child lawfully placed with him or her for legal adoption.
5. *Support Test* - In order to claim a child for this credit, the child must not have provided more than half of their own support.

6. *Dependent Test* - The taxpayer must claim the child as a dependent on his or her Federal income tax return.
7. *Citizenship Test* - To meet the citizenship test, the child must be a U.S. citizen, U.S. national, or U.S. resident alien and the taxpayer must provide a valid Social Security number (SSN) for the child by the tax return due date.
8. *Residence Test* - The child must have lived with the taxpayer for more than half of 2018. There are some exceptions to the residence test, which can be found in IRS Publication 972 - Child Tax Credit.

The Child Tax Credit is limited if the taxpayer's modified adjusted gross income (MAGI) is above a certain amount. The amount at which this phase-out begins varies depending on the filing status. Phase-out means that the credit is reduced as the taxpayer's income increases. In this case, the reduction is $50 for each $1,000 by which the taxpayer's MAGI exceeds the threshold amount. For married taxpayers filing a joint return, the phase-out begins at $400,000. For all other taxpayers, including married taxpayers filing a separate return, the phase-out begins at $200,000. The credit is completely phased out for married taxpayers when MAGI reaches $440,000 and $240,000 for all other taxpayers.

| 2018 Child Tax Credit Phase-out Amounts | | | |
|---|---|---|---|
| | Full Credit | Partial Credit | No Credit |
| Single | 0 - $200,000 | $200,001 - $240,000 | $240,001 + |
| Married Filing Jointly | 0 - $400,000 | $400,001 - $440,000 | $440,001 + |
| Head of Household | 0 - $200,000 | $200,001 - $240,000 | $240,001 + |
| Married Filing Separately | 0 - $200,000 | $200,001 - $240,000 | $240,001 + |

Table 1-12 - Tax Cuts and Jobs Act (2018)

### Credit for Non-Child Dependents

The Tax Cuts and Jobs Act provides a $500 Credit for Non-Child Dependents (e.g elderly or disabled dependents or children over 17). This credit is to provide some relief to those families who will lose the now defunct personal exemption and are not eligible for the expanded Child Tax Credit (CTC). Both the CTC and non-child credit can be claimed for eligible dependents from 2018 onwards (taxes filed in 2019). Like the CTC, this $500 "non-child" credit is subject to income eligibility thresholds and will phase out for taxpayers with adjusted gross incomes (AGI) above $200,000 (single) and $400,000 (married).

**Review Question 5**
Under the Tax Cuts and Jobs Act the amount of the Child Tax Credit (CTC) is increased to what amount per qualifying child?

A. $1,400
B. $1,500
C. $1,750
D. $2,000

See Review Feedback for answer.

# Overview Topics

### Alternative Minimum Tax (AMT) Exemption Amount

Following the passage of the Tax Cuts and Jobs Act, the tax rates for the alternative minimum tax (AMT) are retained, but the exemption amounts are increased.

A specified amount of Alternative Minimum Taxable Income (AMTI), is exempt from alternative minimum taxation. The amount varies according to the taxpayer's filing status and the tax year at hand. The exemption is subtracted from the

taxpayer's AMTI to determine the amount of his or her AMTI that is subject to tax at the AMT rates. The exemption amounts increase to $109,400 for joint filers, $54,700 for married filing separately, and $70,300 for individual filers. The alternative minimum tax (AMT) exemption amounts are permanently adjusted for inflation.

Additionally, the taxpayer's exemption phases out if his or her AMTI exceeds the thresholds indicated below. More specifically, the exemption is reduced by 25% of the amount by which his or her AMTI exceeds the applicable threshold for his or her filing status. The phase-out threshold for the exemption increases to $1,000,000 for joint filers and $500,000 for individual filers; phase-out amounts are indexed for inflation after 2018. The exemption phases out entirely at an AMTI of $1,437,600 for couples, $781,200 for singles and heads of household, or $718,800 for married individuals filing separately.

| **Filing Status** | AMT Exemption Amount |
|---|---|
| Joint Returns or Surviving Spouses | $109,400 |
| Singles | $70,300 |
| Married Individuals Filing Separate Returns | $54,700 |

Table 1-13 - Instructions for Form 6251 (2018)

If the taxpayer is not liable for AMT this year, but he or she paid AMT in one or more previous years, he or she may be eligible to take a special minimum tax credit against his or her regular tax this year. If eligible, the taxpayer should complete and attach Form 8801 - Credit for Prior Year Minimum Tax - Individuals, Estates, and Trusts, to claim the minimum tax credit. (6)

## Pass-Through Entities

Most American businesses are organized as "pass-through" companies in which the income from the business is "passed through" to the business owner's individual tax return. S corporations, LLCs, partnerships and sole proprietorships are all examples of pass-through businesses. Under the Tax Cuts and Jobs Act these entities will be taxed at their individual tax rates less a 20% deduction for qualified business income (QBI), subject to certain wage limits and exceptions. Qualified business income includes domestic income from a trade or business. Employee wages, capital gain, interest and dividend income are excluded.

The new deduction, referred to as the Section 199A deduction or the deduction for qualified business income, is available for tax years beginning after December 31, 2017. Eligible taxpayers can claim it for the first time on the 2018 Federal income tax return they file next year.

The deduction is generally available to eligible taxpayers whose 2018 taxable incomes fall below $315,000 for joint returns and $157,500 for other taxpayers. It is generally equal to the lesser of 20% of their qualified business income plus 20% of their qualified real estate investment trust dividends and qualified publicly traded partnership income or 20% of taxable income minus net capital gains.

The deduction would be disallowed for businesses offering "professional services", such as law firms, doctor's offices and investment offices, above certain threshold amounts. The W-2 wage limit does not apply in the case of a taxpayer with taxable income not exceeding $315,000 for married individuals filing jointly ($157,500 for other individuals). The application of the W-2 wage limit is phased in for individuals with taxable income exceeding these thresholds, over the next $100,000 of taxable income for married individuals filing jointly ($50,000 for other individuals).

The 20% deduction is not allowed in computing adjusted gross income (AGI), but rather is allowed as a deduction reducing taxable income.

## Tax on a Child's Investment and Other Unearned Income (Kiddie Tax)

Under the Tax Cuts and Jobs Act, the taxable income of a child attributable to earned income is taxed under the rates for single individuals, and taxable income of a child attributable to net unearned income (income from investments like dividends and interest) is taxed according to the brackets applicable to trusts and estates (10%, 24%, 35%, or 37%) rather than the rates of the child's parents. As a reminder, trusts and estates reach the highest tax bracket of 37% after only $12,500 of income, significantly faster than an individual. The kiddie tax applies to unearned income for children under the age of 19 and college students under the age of 24 and applies to the child's ordinary income and any income taxed at preferential rates. Therefore, under the new law, the child's tax is unaffected by the tax situation of the child's parent or the unearned income of any siblings.

## Section 529 Plans

A Section 529 plan is a tax-advantaged savings plan designed to encourage saving for future college costs. 529 plans, legally known as "qualified tuition plans," are sponsored by states, state agencies, or educational institutions and are authorized by Section 529 of the Internal Revenue Code. The Tax Cuts and Jobs Act expanded these plans in two ways:

- Tax-free distributions up to $10,000 can be made for tuition at elementary and secondary schools, whether public, private, or religious.
- Rollovers of funds from 529 plans to ABLE accounts, special savings accounts for the benefit of a qualified disabled individual, can be made on a tax-free basis.

Previously, 529 plans could be used only to cover costs for college. The new law expands the qualified use of 529 accounts by allowing withdrawals for public, private or religious schools. Home schooling families are also allowed to use 529 funds towards educational expenses. If the taxpayer plans to take advantage of this expanded ruling, note the limit of $10,000 per year, per child.

While not new in this tax bill, higher-income earners may want to note that 529 plan contributions are not subject to any income limits. While other tax-advantaged savings accounts like IRAs and Roth IRAs restrict higher-income families from contributing, 529 plans can be used regardless of the taxpayer's income level. With the flexibility provided by the new law, parents not currently setting aside money for education may want to reconsider earmarking some savings toward a 529 plan.

## Achieving a Better Life Experience (ABLE) Accounts

The new legislation also supports funding of Achieving a Better Life Experience (ABLE) accounts designed for use by people with disabilities. Under the new law, the taxpayer can roll over the Section 529 plan assets to an ABLE account. Both accounts must have the same beneficiary or a member of the same family, and the taxpayer can roll over up to the annual gift exclusion amount, which is $15,000 in 2018. Now families will have more flexibility in planning for special needs, where predicting the level of future needs can be a challenge. Also, beneficiaries who work and earn income will now be able to make contributions into their ABLE accounts in excess of the annual maximum contribution limit ($15,000). Lastly, individuals who are able to take advantage of contributing earned income to their ABLE account may be able to take advantage of the Saver's Credit.

## Discharge of Certain Student Loan Indebtedness

Income from discharge of indebtedness (also called cancellation of debt) is included in the general definition of gross income. The concept of discharge of indebtedness income is that a taxpayer has realized an accession to income, to the extent that he has been released from indebtedness, because assets previously offset by the liability arising from the indebtedness have been freed. Essentially, the taxpayer has earned money by not having to pay money. Therefore, based on these principles, taxpayers who have a commercial, private lender or employer discharge part or all of their debt must include the amount that was discharged in income as cancellation of debt (COD) income unless an exception or exclusion applies. Students whose loans are forgiven (in whole or in part) because they worked in a designated profession for any of a broad class of employers generally need not include the discharged debt in income.

The Tax Cuts and Jobs Act (TCJA) provides that effective January 1, 2018 and until January 1, 2026, student loan discharges will be excluded from gross income even if the student loans were discharged because of the student's death or total and permanent disability.

## Net Operating Loss (NOL)

In general, the passive loss rules limit deductions and credits from passive trade or business activities. The passive loss rules apply to individuals, estates and trusts, and closely-held corporations. A passive activity for this purpose is a trade or business activity in which the taxpayer owns an interest but does not materially participate. "Material participation" means that the taxpayer is involved in the operation of the activity on a basis that is regular, continuous, and substantial. Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income and are carried forward and treated as deductions and credits from passive activities in the next year.

For tax years beginning after December 31, 2017 and before January 1, 2026, the Tax Cuts and Jobs Act (TCJA) provides that the excess farm loss limitation does not apply, and instead a noncorporate taxpayer's "excess business loss" is disallowed. Under the new rule, excess business losses are not allowed for the tax year but are instead carried forward and treated as part of the taxpayer's net operating loss (NOL) carryforward in subsequent tax years. This limitation applies after the application of the passive loss rules described above. NOLs can no longer be carried back, and they can offset only 80% of tax liability when carried forward. NOLs can be carried forward indefinitely. Farming losses can continue to be carried back two years, while property and casualty insurance losses keep the old rules, with a two-year carryback and a 20-year carry forward.

An excess business loss for the tax year is the excess of aggregate deductions of the taxpayer attributable to the taxpayer's trades and businesses, over the sum of aggregate gross income or gain of the taxpayer plus a threshold amount. The threshold amount for a tax year is $500,000 for married individuals filing jointly, and $250,000 for other individuals, with both amounts indexed for inflation.

In the case of a partnership or S corporation, the provision applies at the partner or shareholder level. Each partner's or S corporation shareholder's share of items of income, gain, deduction, or loss of the partnership or S corporation is taken into account in applying the above limitation for the tax year of the partner or S corporation shareholder; and regulatory authority is provided to apply the new provision to any other pass-through entity to the extent necessary, as well as to require any additional reporting as the IRS determines is appropriate to carry out the purposes of the provision.

## Affordable Care Act (ACA) Provisions

The Affordable Care Act contains comprehensive health insurance reforms and includes tax provisions that affect individuals, families, businesses, insurers, tax-exempt organizations and government entities. The law requires the taxpayer and his or her dependents to have health care coverage, an exemption, or make a payment with his or her income tax return. If the taxpayer purchased coverage from the Health Insurance Marketplace, he or she may be eligible for the Premium Tax Credit. When the taxpayer files his or her 2018 tax return in 2019, he or she will need to either:

- Indicate on his or her Federal income tax return that he or she, his or her spouse (if filing jointly), and his or her dependents had health care coverage throughout 2018.
- Claim an exemption from the health care coverage requirement for some or all of 2018 and attach Form 8965 - Health Coverage Exemptions to his or her return.
- Make a shared responsibility payment if, for any month in 2018, the taxpayer, his or her spouse (if filing jointly), or his or her dependents did not have coverage and do not qualify for a coverage exemption.

The individual shared responsibility payment mandate, which is a penalty for not having required minimum essential health coverage and no exemption from the mandate, is repealed by the Tax Cuts and Jobs Act. However, this change does not take effect until 2019. Thus, it continues to apply for 2018. No changes have been made in the Premium Tax Credit for those who choose to buy health coverage from a government Marketplace. The Additional Medicare Tax and the Net Investment Income Tax also remain in place.

## Individual Shared Responsibility Payment

Most people are required to have health coverage. If they do not have coverage, they may be required to pay a fee. The fee is sometimes called the individual shared responsibility payment or penalty. The penalty in 2018 is calculated one of 2 ways.

An individual will pay whichever of these amounts is higher:

1. 2.5% of his or her yearly household income (to determine payment using the income formula, subtract filing threshold from household income). The maximum penalty is the national average yearly premium for a bronze plan.
2. $695 per person for the year ($347.50 per child under 18). The maximum penalty per family using this method is $2,085.

The taxpayer's payment amount is capped at the cost of the national average premium for a bronze level health plan available through the Marketplace. The fee may increase every year as it is adjusted for inflation. If an individual is uninsured for just part of the year, 1/12 of the yearly penalty applies to each month he or she uninsured. If the individual is uninsured for less than 3 months, he or she does not have a make a payment. The taxpayer will pay the fee on his or her Federal income tax return.

The following types of health plans that do not meet minimum essential coverage do not qualify as coverage in 2018. If the individual only has these types of coverage, he or she may have to pay the fee.

Examples include:

- Coverage only for vision care or dental care.
- Workers' compensation.
- Coverage only for a specific disease or condition.
- Plans that offer only discounts on medical services.

## Employee Achievement Awards

If an individual receives tangible personal property (other than cash, a gift certificate, or an equivalent item) as an award for length of service or safety achievement, he or she generally can exclude its value from income. However, the amount he or she can exclude is limited to the employer's cost and cannot be more than $1,600 ($400 for awards that are not qualified plan awards) for all such awards the person receives during the year. The employer can tell the individual whether the award is a qualified plan award. The employer must make the award as part of a meaningful presentation, under conditions and circumstances that do not create a significant likelihood of it being disguised pay.

However, the exclusion does not apply to the following awards: (7)

- A length-of-service award if the taxpayer received it for less than 5 years of service or if he or she received another length-of-service award during the year or the previous 4 years.
- A safety achievement award if the taxpayer is a manager, administrator, clerical employee, or other professional employee or if more than 10% of eligible employees previously received safety achievement awards during the year.

For amounts paid or incurred after December 31, 2017, the Tax Cuts and Jobs Act revises the definition of "tangible personal property" to provide that "tangible personal property" does not include cash, cash equivalents, gifts cards, gift coupons, 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-arranged by the employer) or vacations, meals, lodging, tickets to the theater or sporting events, stocks, bonds other securities or similar items. No inference is intended that this is a change from present law and guidance.

## Qualified Moving Expense Reimbursements

Qualified moving expense reimbursements are defined as any amount received either directly or indirectly by an employee from an employer as payment for, or a reimbursement of expenses that would be deductible as moving expenses if directly paid or incurred by the employee. An employee may exclude qualified moving expense reimbursements from his or her gross income for income tax purposes and from his or her wages for employment tax purposes.

For tax years beginning after December 31, 2017 until January 1, 2026, the exclusion for qualified moving expense reimbursements is suspended, except for members of the Armed Forces on active duty (and their spouses and dependents) who move pursuant to a military order and incident to a permanent change of station.

## Exclusion for Qualified Transportation Fringe Benefits

An employee may exclude from his or her gross income up to $20 per month in qualified bicycle commuting reimbursements. Qualified reimbursements are any amount received from an employer during a 15-month period beginning with the first day of the calendar year as payment for reasonable expenses during a calendar year. Reasonable expenses are those incurred in a calendar year for the purchase of a bicycle and bicycle improvements, repair and storage, if the bicycle is regularly used for travel between the employee's residence and place of employment. Amounts that are excludable from gross income for income tax purposes are also excluded from wages for employment tax purposes.

For tax years beginning after December 31, 2017 until January 1, 2026, the exclusion from gross income and wages for qualified bicycle commuting reimbursements is suspended.

## Real Property Depreciation

The Tax Cuts and Jobs Act (TCJA) shortens the write-off period for residential property under the alternative depreciation system (ADS) from 39 years to 30 years. Nonresidential property remains at 40 years. The ADS depreciation system requires use of the straight-line method over a longer life.

Under the new law, the ADS system is required if a real estate business opts out of the new 30% interest expense limitation.

**Review Question 6**

In 2018, a calendar-year taxpayer has a $95,000 NOL. In 2019, the taxpayer has taxable income of $100,000. The 2018 NOL can be carried forward to offset the 2019 income, but it can only offset $80,000. What amount of the unused NOL is carried forward?

A. $0
B. $5,000
C. $10,000
D. $15,000

See Review Feedback for answer.

# Review Feedback

Review feedback provides both the answers to each question and an explanation or feedback as to how we arrived at each answer at the end of the lesson. Review feedback also contains evaluative feedback explaining why incorrect answers are wrong. You are also provided the course topic from which we derived our answer and the external source material we used for verification.

If you are using the online version of the course, Ctrl+click on the topic to find the section from which we arrived at the answer for the question. You can also Ctrl+click on the question number to return to the specific review question.

**Question 1 - B. $1,300**
For 2018, the additional standard deduction amount for married taxpayers age 65 and older or the blind is $1,300. For a single taxpayer or head of household who is 65 or over or blind, the additional standard deduction for 2018 will be $1,600.

Topic - Standard Deduction
Source - Publication 17 - Chapter 20 - Standard Deduction

**Question 2 - C. Alimony Deduction**
Under the Tax Cuts and Jobs Act, the deductions for student loan interest and out-of-pocket teacher expenses will be retained with the current caps. The alimony deduction (Choice C) will be repealed - but not until 2019: The change applies to any divorce or separation instrument executed or modified after December 31, 2018 (the modification must expressly state that the new rule applies). The educator expenses deduction, student loan interest deduction, health savings account (HSA) deduction, IRA deduction and deductions for self-employed taxpayers all stay the same.

Topic - Changes to Above-the-line Deductions
Source - IRS.GOV - Topic 452 - Alimony

**Question 3 - D. 100% of the purchase price**
Section 179 of the IRS Tax Code allows a business to deduct, for the current tax year, the full purchase price of financed or leased equipment and off-the-shelf software that qualifies for the deduction. Therefore, Choice D, 100% of purchase price, is the only correct response. Also, the equipment purchased, financed or leased must be within the specified dollar limits of Section 179, and the equipment must be placed into service in the same tax year that the deduction is being taken.

Topic - Section 179 Deduction
Source - Publication 946 - Section 179 Deduction

**Question 4 - D. Tax preparation expenses**
Under the Tax Cuts and Jobs Act miscellaneous deductions which exceed 2% of taxpayer's adjusted gross income (AGI) will be eliminated. This includes deductions for unreimbursed employee expenses, home office expenses, and tax preparation expenses. Deductions Not Subject to the 2% Limit:

- Amortizable premium on taxable bonds.
- Casualty and theft losses from income-producing property.
- Federal estate tax on income in respect of a decedent.
- Gambling losses up to the amount of gambling winnings.
- Impairment-related work expenses of persons with disabilities.
- Loss from other activities from Schedule K-1 (Form 1065-B), box 2.
- Losses from Ponzi-type investment schemes.
- Repayments of more than $3,000 under a claim of right.
- Unrecovered investment in an annuity.

The medical expense deduction will remain in place with a lower floor of 7.5% for tax years 2017 and 2018.

Topic - Changes to Itemized Deductions
Source - Congress.GOV - Tax Cuts and Jobs Act

**Question 5** - **D. $2,000**
Under the Tax Cuts and Jobs Act (TCJA), the amount of the Child Tax Credit (CTC) is increased to $2,000 per qualifying child; The income levels at which the credit phases out are increased to $400,000 for married taxpayers filing jointly ($200,000 for all other taxpayers) (not indexed for inflation). A $500 nonrefundable credit is provided for certain non-child dependent.

Topic - Child Tax Credit
Source - Publication 972 - Child Tax Credit

**Question 6** - **D. $15,000**
The Tax Cuts and Jobs Act (TCJA) restricts net operating loss (NOL) deductions to 80% of taxable income starting in 2018. This means that NOLs can no longer completely offset taxable income.

Carryback of NOLs is no longer allowed, but they can be carried forward indefinitely. Farming losses can continue to be carried back two years, while property and casualty insurance losses keep the old rules, with a two-year carryback and a 20-year carry forward.

In this question, the 2018 NOL can be carried forward to offset the 2019 income, but it can only offset $80,000. The $15,000 unused NOL is carried forward.

Topic - Net Operating Loss (NOL)
Source - Publication 536 - Net Operating Losses (NOLs) for Individuals, Estates, and Trusts

# Domain 2 – General Review - Annual Inflation Adjustments

## Standard Mileage Rates

The following are the 2018 optional standard mileage rates used to calculate the deductible costs of operating an automobile for business, charitable, medical or moving purposes during 2018.

As of January 1, 2018, the standard mileage rates for the use of a car, van, pickup or panel truck are: (8)

- 54.5 cents per mile for business miles driven, up from 53.5 cents for 2017.
- 18 cents per mile driven for medical or moving purposes, up from 17 cents for 2017.
- 14 cents per mile driven in service of charitable organizations (currently fixed by Congress).

The business mileage rate and the medical and moving expense rates each increased 1 cent per mile from the rates for 2017. The charitable rate is set by statute and remains unchanged.

The standard mileage rate for business is based on an annual study of the fixed and variable costs of operating an automobile, including depreciation, insurance, repairs, tires, maintenance, gas and oil. The rate for medical and moving purposes is based on the variable costs, such as gas and oil. The charitable rate is set by law.

Taxpayers always have the option of claiming deductions based on the actual costs of using a vehicle rather than the standard mileage rates. A taxpayer may not use the business standard mileage rate for a vehicle after using any depreciation method under the Modified Accelerated Cost Recovery System (MACRS) or after claiming a Section 179 deduction for that vehicle. In addition, the business standard mileage rate cannot be used for more than four vehicles used simultaneously.

If the taxpayer wants to use the standard mileage rate for a car he or she owns, the taxpayer must choose to use it in the first year the car is available for use in his or her business. Then in later years, the taxpayer can choose to use either the standard mileage rate or actual expenses.

## Flexible Spending Accounts (FSA)

A Flexible Spending Account (also known as a flexible spending arrangement) is a special account the taxpayer puts money into that he or she uses to pay for certain out-of-pocket health care costs. The taxpayer does not have to pay taxes on this money. This means he or she will save an amount equal to the taxes he or she would have paid on the money he or she sets aside. The taxpayer can use funds in his or her FSA to pay for certain medical and dental expenses, including copayments and deductibles.

FSAs are available only with job-based health plans. Employers may make contributions to a taxpayer's FSA. However, a taxpayer cannot spend FSA funds on insurance premiums.

The annual dollar limit on contributions to employer-sponsored health care FSAs rises to $2,650 in 2018. Both employer and employee may contribute to an employee's health FSA, but contributions from all sources combined must not exceed the $2,650 annual limit for 2018. The statutory $2,650 limit under IRC Section 125(i) applies only to salary reduction contributions under a health FSA, and does not apply to certain employer non-elective contributions (sometimes called flex credits), to any types of contributions or amounts available for reimbursement under other types of FSAs, health savings accounts, or health reimbursement arrangements, or to salary reduction contributions to cafeteria plans that are used to pay an employee's share of health coverage premiums (or the corresponding employee share under a self-insured employer-sponsored health plan).

The U.S. Treasury Department and the IRS altered the long-standing "use it or lose it" rule, allowing employers to offer a carryover of up to $500 in unused health FSA funds to the following year or to continue a grace period option giving employees a two-and-a-half-month extension to spend remaining FSA funds.

FSAs cannot have both a carryover and a grace period option, and employers are not obligated to offer either extension.

## Health Savings Account (HSA)

2018 offers individuals and families additional opportunities to save for current and future health care with a Health Savings Account (HSA):

- HSA holders can choose to save up to $3,450 for an individual and $6,850 for a family (HSA holders 55 and older get to save an extra $1,000 which means $4,450 for an individual and $7,850 for a family) - and these contributions are 100% tax deductible from gross income.
- Minimum annual deductibles are $1,350 for self-only coverage or $2,700 for family coverage.
- Annual out-of-pocket expenses (deductibles, copayments, and other amounts, but not premiums) cannot exceed $6,650 for self-only coverage and $13,300 for family coverage.

| 2018 HSA Contribution Limits, Deductibles, and Out-of-Pocket Expenses | | | | |
|---|---|---|---|---|
| | **Minimum Deductible** | **Maximum Out-of-Pocket** | **Contribution Limit** | **55+ Contribution Limit** |
| **Single** | $1,350 | $6,650 | $3,450 | $4,450 |
| **Family** | $2,700 | $13,300 | $6,850 | $7,850 |

Table 2-1 - HSA Contribution Limits, Deductibles, and Out-of-Pocket Expenses (2018)

While the Affordable Care Act allows parents to add their adult children (up to age 26) to their health plans, the IRS definition of a qualified dependent (child or relative) who may be covered under an employee's HSA is different. For example, an employee whose 24-year-old child is covered on his HSA-qualified high-deductible health plan may not be eligible to use HSA funds to pay that child's medical bills (unless the child is a full-time student, and therefore a qualified dependent for tax purposes).

Those under age 65 (unless totally and permanently disabled) who use HSA funds for nonqualified medical expenses face a penalty of 20% of the funds used for such expenses. Funds spent for nonqualified purposes are also subject to income tax.

HSAs can pair with high deductible plans (HDHP). As long as the taxpayer holds an HSA eligible high deductible health plan (HDHP) he or she can contribute tax-advantaged dollars to the account up to the annual limit. In 2018 the out-of-pocket limits for HDHP minimum annual deductibles are $1,350 for self-only coverage or $2,700 for family coverage and annual out-of-pocket expenses (deductibles, copayments, and other amounts, but not premiums) cannot exceed $6,650 for self-only coverage and $13,300 for family coverage.

There are several important differences between FSAs and HSAs. Options such as the taxpayer's flexibility in contributing, the ability to keep his or her unused balance and additional tax benefits can make HSAs the wisest choice if the taxpayer has the option. However, both accounts can potentially save the taxpayer money and make budgeting for medical costs easier.

| Important Differences Between HSAs and FSAs | | |
|---|---|---|
| | **Health savings account (HSA)** | **Flexible spending account (FSA)** |
| **Eligibility requirements** | Eligibility requirements include having a high-deductible health plan (HDHP). | No eligibility requirements. |
| **Contribution limit** | 2018 contributions capped at $3,450 for individuals or $6,850 for families. | 2018 contributions capped at $2,650. |

| | | |
|---|---|---|
| **Changing contribution amount** | The taxpayer can change how much he or she contributes to the account at any point during the year. | Contribution amounts can be adjusted only at open enrollment or with a change in employment or family status. |
| **Rollover** | Unused balances roll over into the next year. | FSAs can allow an individual to carry over up to $500 per year to use in the following year. |
| **Connection to employer** | The taxpayer's HSA can follow him or her as he or she changes employment. | In most cases, the taxpayer will lose his or her FSA with a job change. One exception: if the taxpayer is eligible for FSA continuation through COBRA. |
| **Effect on taxes** | Contributions are tax-deductible, but can also be taken out of the taxpayer's salary pretax. Growth and distributions are tax-free. | Contributions are pretax, and distributions are untaxed. |

Table 2-2 - Using a Flexible Spending Account (FSA) - HealthCare.gov (2018)

**Review Question 1**

All of the following statements are true regarding a Health Saving Account (HSA) except:

A. Cash contributions to an HSA are 100% deductible from the taxpayer's Federal gross income (within legal limits)
B. Interest on savings accumulates tax deferred
C. Withdrawals from an HSA for "qualified medical expenses" are free from Federal income tax
D. The taxpayer will lose his or her HSA with a job change

See Review Feedback for answer.

## Qualified Long-Term Care Insurance Premiums

The amount of qualified long-term care insurance premiums a taxpayer can include is limited. He or she can include the following as medical expenses on Schedule A (Form 1040) as determined by age (as of the close of the tax year) of the taxpayer:

| Age Group | 2018 Eligible Premium Amount |
|---|---|
| Age 40 and under | $420 |
| Ages 41 through 50 | $780 |
| Ages 51 through 60 | $1,560 |
| Ages 61 through 70 | $4,160 |
| Age 71 and over | $5,200 |
| Note: The limit on premiums is for each person. | |

Table 2-3 - Publication 502 - Medical and Dental Expenses (2018)

Amounts received under a qualified long-term care insurance contract are generally excludible as amounts received for personal injuries and sickness, subject to a per diem limitation, which will be $360 in 2018.

## Series EE and I Savings Bonds Income Exclusion

For 2018, the exclusion under IRC Section 135, regarding income from United States Series EE and I Savings Bonds for taxpayers who pay qualified higher education expenses, begins to phase out for modified adjusted gross income (MAGI) above $119,300 for joint returns and $79,550 for all other returns. The exclusion phases out completely at MAGI levels of $149,300 for joint returns and $94,550 for other returns.

## Foreign Earned Income Exclusion

If the taxpayer is a U.S. citizen or a resident alien of the United States and he or she lives abroad, the taxpayer is taxed on his or her worldwide income. However, the taxpayer may qualify to exclude from income up to an amount of his or her foreign earnings that is adjusted annually for inflation. The foreign earned income exclusion rises to $103,900 for tax year 2018, up from $102,100 for 2017.

In addition to the foreign earned income exclusion, the taxpayer can also claim an exclusion or a deduction from gross income for his or her housing amount if his or her tax home is in a foreign country and he or she qualifies for the exclusions and deduction under either the bona fide residence test or the physical presence test.

The housing exclusion applies only to amounts considered paid for with employer-provided amounts, which includes any amounts paid to the taxpayer or paid or incurred on his or her behalf by his or her employer that are taxable foreign earned income to the taxpayer for the year (without regard to the foreign earned income exclusion). The housing deduction applies only to amounts paid for with self-employment earnings.

The taxpayer's housing amount is the total of his or her housing expenses for the year minus the base housing amount. The computation of the base housing amount (line 32 of Form 2555) is tied to the maximum foreign earned income exclusion. The amount is 16% of the maximum exclusion amount (computed on a daily basis) multiplied by the number of days in the taxpayer's qualifying period that fall within his or her tax year. The base amount for 2018 is $16,624 or $45.55 per day.

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

1. His or her tax home must be in a foreign country.
2. He or she must have foreign earned income.
3. He or she must be either:
    a. A U.S. citizen who is a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire tax year,
    b. A U.S. resident alien who is a citizen or national of a country with which the United States has an income tax treaty in effect and who is a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire tax year, or
    c. A U.S. citizen or a U.S. resident alien who is physically present in a foreign country or countries for at least 330 full days during any period of 12 consecutive months.

The taxpayer does not automatically acquire bona fide resident status merely by living in a foreign country or countries for 1 year. Also, the taxpayer cannot exclude income he or she receives after the end of the year following the year he or she does the work to earn it.

## Gift and Estate Tax

Although initial tax plan discussions considered complete elimination of taxes on estates, the Tax Cuts and Jobs Act keeps the Federal estate tax in place, but it doubles the threshold at which that tax applies. For an estate of any decedent dying during calendar year 2018, the basic exclusion from estate tax amount is $11,180,000 ($22,360,000 for married couples), up from a total of $5,490,000 for estates of decedents who died in 2017. The American Taxpayer Relief Act of 2012 permanently increased the top gift and estate tax rate from 35% to 40%. The annual exclusion for gifts also increases to $15,000.

| Decedents dying in: | Estate Tax Exemption Amount | Tax Rate |
|---|---|---|
| 2014 | $5,340,000 | 40% |
| 2015 | $5,430,000 | 40% |
| 2016 | $5,450,000 | 40% |
| 2017 | $5,490,000 | 40% |
| 2018 | $11,180,000 | 40% |

Table 2-4 - Estate Tax Exemption Amounts (2018)

The following is a list of gifts that are not considered "taxable gifts" and, therefore, do not count as part of the taxpayer's lifetime exemption total:

- *Present-interest gift of $15,000 in 2018*. "Present-interest" means that the person receiving the gift has an unrestricted right to use or enjoy the gift immediately. In 2018 the taxpayer could give amounts up to $15,000 to each person, gifting as many different people as he or she wants, without triggering the gift tax.
- *Charitable gift.*
- *Gifts to a political organization for its use.*
- *Gifts to the taxpayer's spouse.*
- *Gifts to a spouse who is a U.S. citizen*. Gifts to foreign spouses are subject to an annual limit of $152,000 in 2018. This amount is indexed for inflation and can change each year.
- *Gifts for educational expenses*. To qualify for the unlimited exclusion for qualified education expenses, the taxpayer must make a direct payment to the educational institution for tuition only. Books, supplies and living expenses do not qualify. If the taxpayer wants to pay for books, supplies and living expenses in addition to the unlimited education exclusion, he or she can make a 2018 gift of $15,000 to the student under the annual gift exclusion.
- *Gifts for medical expenses.*

**Review Question 2**

In 2018, an uncle who wants to help his nephew attend medical school sends $16,000 directly to the school for a year's tuition. He also sends his nephew $14,000 for books, supplies and other expenses. What amount of these payments is reportable for gift tax purposes?

A. $0
B. $14,000
C. $16,000
D. $30,000

See Review Feedback for answer.

# Taxability of Compensation

The most common forms of income reported by the average taxpayer are compensation, dividends, and interest. About 95% of the adjusted gross income, of individuals, is from these three sources. Income from compensation alone - salaries, wages, and all fringe benefits - accounts for about 85% of the total adjusted gross income.

## Compensation and Wages

Form W-2 – Wage and Tax Statement is used to report to employees the annual amount of salaries and withholdings. In some cases, taxable compensation is not subject to withholding of income taxes and the compensation is not reported on Form W-2. When taxable income is not subject to withholdings, the taxpayer must report the amount on Line 21 of Form 1040 unless it fits into one of the categories shown on Lines 7 through 20b. If the space on Line 21 is insufficient to state the nature and source, then the taxpayer must attach a supplementary schedule to Form 1040 to explain the amounts reported. The IRS does not provide a printed form for this purpose.

## Compensation Subject to the Tax

All compensation for personal services is subject to the income tax. Compensation means more than just salaries and wages. The term also includes tips, commissions, fees for personal services, overtime pay, vacation pay and every other payment for personal services. Virtually every payment made by an employer to an employee or by a customer for personal services, is compensation and is taxable income to the employee/recipient. Taxability of a payment is not affected by what the payment is called. For example, bonuses and performance awards are usually taxable as compensation.

The IRS provides the following list of items that do not have to be included as taxable income: (9)

- Adoption expense reimbursements for qualifying expenses.
- Child support payments.
- Gifts, bequests and inheritances (Subject to limits).
- Workers' compensation benefits (some exceptions may apply; see Publication 525 - Taxable and Nontaxable Income).
- Meals and lodging for the convenience of the taxpayer's employer.
- Compensatory damages awarded for physical injury or physical sickness.
- Welfare benefits.
- Cash rebates from a dealer or manufacturer.

## Gambling Income

Winnings or gains arising from gambling, betting, and lotteries are includible in gross income. Even winnings or gains arising from illegal transactions (such as bootlegging, extortion, embezzlement, or fraud) are includible in the taxpayer's gross income.

Income tax is withheld at a flat 25% rate from certain kinds of gambling winnings. Gambling winnings of more than $5,000 from the following sources are subject to income tax withholding: (10)

- Any sweepstakes; wagering pool, including payments made to winners of poker tournaments; or lottery.
- Any other wager if the proceeds are at least 300 times the amount of the bet.

It does not matter whether winnings are paid in cash, in property, or as an annuity. Winnings not paid in cash are taken into account at their fair market value.

Gambling winnings from bingo, keno, and slot machines generally are not subject to income tax withholding. However, the taxpayer may need to provide the payer with a Social Security number to avoid withholding. If the taxpayer receives gambling winnings not subject to withholding, he or she may need to pay estimated tax.

If a payer withholds income tax from a taxpayer's gambling winnings, he or she should receive a Form W-2G - Certain Gambling Winnings, showing the amount he or she won and the amount withheld. The taxpayer should report the tax withheld on his or her 2018 Form 1040, along with all other Federal income tax withheld, as shown on Forms W-2 and 1099.

If a taxpayer has any kind of gambling winnings and does not give the payer his or her Social Security number, the payer may have to withhold income tax at a flat 28% rate. This rule also applies to winnings of at least $1,200 from bingo or slot machines or $1,500 from keno, and to certain other gambling winnings of at least $600.

Gambling losses can be deducted to the extent of taxpayer's winnings. Gambling winnings are reported on Form 1040. Gambling losses are deducted as an Itemized Deduction on Form 1040 Schedule A. Only taxpayers that itemize can claim gambling losses. (11)

It is important to keep an accurate diary or similar record of gambling winnings and losses. To deduct losses, the taxpayer must be able to provide receipts, tickets, statements or other records that show the amount of both winnings and losses. (12)

## Tips

When employees receive cash tips of $20 or more in a calendar month, they are required to report to their employer the total amount of tips they received. The employees must give the employer written reports by the tenth of the following month. Employees who receive tips of less than $20 in a calendar month are not required to report their tips but must report these amounts as income on their tax returns and pay taxes. (13)

Cash tips include tips received directly from customers, tips from other employees under any tip-sharing arrangement, and charged tips (e.g., credit and debit card charges) that are distributed to an employee. Both directly and indirectly tipped employees must report tips received to their employer. (13)

Service charges added to a bill or fixed by the employer that the customer must pay, when paid to an employee, will not constitute a tip but rather constitute non-tip wages. These non-tip wages are subject to Social Security tax, Medicare tax, and Federal income tax withholding. In addition, the employer cannot use these non-tip wages when computing the credit available to employers under Section 45B of the Internal Revenue Code, because these amounts are not tips.

Common examples of service charges (sometimes called auto-gratuities) in service industries are: (13)

- Large Party Charge (restaurant)
- Bottle Service Charge (restaurant and night-club)
- Room Service Charge (hotel and resort)
- Contracted Luggage Assistance Charge (hotel and resort)
- Mandated Delivery Charge (pizza or other retail deliveries)

Employers are responsible for withholding the 0.9% Additional Medicare Tax on a tipped individual's wages paid in excess of $200,000 in a calendar year. An employer is required to begin withholding Additional Medicare Tax in the pay period in which it pays wages in excess of $200,000 to an employee. There is no employer match for Additional Medicare Tax.

If an individual received tips as a self-employed person, he or she should report these tips as income on Schedule C or C-EZ.

A taxpayer must report all tips he or she received in 2018 on his or her tax return, including both cash tips and noncash tips. Any tips the taxpayer reported to his or her employer for 2018 are included in the wages shown in box 1 of his or her Form W-2. The taxpayer should add to the amount in box 1 only the tips he or she did not report to his or her employer.

Generally, an individual must report all tips received during the tax year on the tax return, including both cash tips and noncash tips. If the taxpayer kept a daily tip record and reported tips to an employer as required, the employer will add the following tips to the amount in box 1 of the Form W-2: (14)

- Cash and charge tips received that totaled less than $20 for any month.
- The value of noncash tips, such as tickets, passes, or other items of value.

If the taxpayer received $20 or more in cash and charge tips in a month from any one job and did not report all of those tips to an employer, he or she must report the Social Security and Medicare taxes on the unreported tips as additional tax on the return. To report these taxes, the individual must file a return even if he or she would not otherwise have to file.

The taxpayer must use Form 1040, Form 1040NR, Form 1040NR-EZ, Form 1040-SS, or 1040-PR (as appropriate) for this purpose. (He or she cannot file Form 1040EZ or Form 1040A.) Use Form 4137 - Social Security and Medicare Tax on Unreported Tip Income, to figure these taxes. Enter the tax on the return as instructed, and attach the completed Form 4137 to the return.

## Allocated Tips

Allocated tips are tips that an employer assigned to an individual in addition to the tips he or she reported to the employer for the year. The employer will have done this only if: (14)

1. The taxpayer worked in an establishment (restaurant, cocktail lounge, or similar business) that must allocate tips to employees.
2. The tips the taxpayer reported to the employer were less than his or her share of 8% of food and drink sales.

Allocated tips are shown separately in box 8 of the Form W-2. They are not included in box 1 with wages and reported tips. An employer can use a tip rate lower than 8% (but not lower than 2%) to figure allocated tips only if the IRS approves the lower rate. Either the employer or the employees can request approval of a lower rate by filing a petition with the IRS. The petition must include specific information about the establishment that will justify the lower rate. A user fee must be paid with the petition.

The employee petition can be filed only with the consent of a majority of the directly tipped employees (waiters, bartenders, and others who receive tips directly from customers). The petition must state the total number of directly tipped employees and the number of employees consenting to the petition. Employees filing the petition must promptly notify the employer, and the employer must promptly give the IRS copies of all Form 8027 - Employer's Annual Information Return of Tip Income and Allocated Tips, filed for the establishment for the previous 3 years.

### Penalty for Not Reporting Tips

If a taxpayer does not report tips to his or her employer as required, he or she may be subject to a penalty equal to 50% of the Social Security and Medicare taxes or railroad retirement tax owed on the unreported tips. The penalty amount is in addition to the taxes the taxpayer owes. (14)

**Review Question 3**
Employees are required to report to their employer the total amount of tips they received when they receive cash tips of what amount or more in a calendar month?

A. $20
B. $50
C. $75
D. $100

See Review Feedback for answer.

# Foreign Trust Reporting Requirements

Although there are legitimate reasons why a U.S. person might create a foreign trust, or have transactions with a foreign trust, they can have tax consequences and result in filing responsibilities as well. Regardless of the taxpayer's motivation, failure to meet these reporting and filing requirements can result in very significant penalties.

In general, the reporting rules apply to a U.S. person who:

- Creates a foreign trust.
- Transfers any money or property to a foreign trust.
- Receives a distribution from a foreign trust.
- Is treated as the U.S. owner of a foreign trust.

Tax consequences can apply to the U.S. owners and U.S. beneficiaries of foreign trust, and to the foreign trust itself.

There are several situations in which a Form 3520 - Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts is required to be filed. The most common circumstances are where a U.S. person:

- Creates or transfers money or property to a foreign trust.
- Receives (directly or indirectly) any distributions from a foreign trust.
- Receives certain gifts or bequests from foreign entities.

Form 3520-A - Annual Information Return of Foreign Trust with a U.S. Owner provides information about the foreign trust, its U.S. beneficiaries, and any U.S. person who is treated as an owner of any portion of the foreign trust. Each U.S. person treated as an owner of any portion of a foreign trust under the grantor trust rules is responsible for ensuring that the foreign trust files Form 3520-A and furnishes the required annual statements to its U.S. owners and U.S. beneficiaries.

Form 1040, Schedule B - Part III - Foreign Accounts and Trusts, must be completed if the taxpayer receives a distribution from, or were grantor of, or a transferor to a foreign trust. The taxpayer should use Schedule B (Form 1040A or 1040) if any of the following applies:

- He or she had over $1,500 of taxable interest or ordinary dividends.

- He or she received interest from a seller-financed mortgage and the buyer used the property as a personal residence.
- He or she has accrued interest from a bond.
- He or she is reporting original issue discount (OID) in an amount less than the amount shown on Form 1099-OID.
- He or she is reducing his or her interest income on a bond by the amount of amortizable bond premium.
- He or she is claiming the exclusion of interest from series EE or I U.S. savings bonds issued after 1989.
- He or she received interest or ordinary dividends as a nominee.
- He or she had a financial interest in, or signature authority over, a financial account in a foreign country or he or she received a distribution from, or were a grantor of, or transferor to, a foreign trust. Part III of the schedule has questions about foreign accounts and trusts.

If the taxpayer has a financial interest in or signature authority over a foreign financial account, including a bank account, brokerage account, mutual fund, trust, or other type of foreign financial account, the Bank Secrecy Act may require him or her to report the account yearly to the U.S. Internal Revenue Service (IRS) by filing FinCEN Form 114 (formerly TD F 90-22.1), Report of Foreign Bank and Financial Accounts ("FBAR").

# Schedule C - Profit or Loss From Business

Schedule C - Profit or Loss From Business, is designed to report the profit (or loss) from a trade or business of a sole proprietor. Nevertheless, a sole proprietor is no different from any other individual. Such an individual may have non-business income (interest, dividends), gains and losses from property transactions, rent income, or even farm income to report. Likewise, this taxpayer must either elect to itemize deductions or use the standard deduction. Plus, the taxpayer is entitled to personal exemptions and any dependency exemptions that may be appropriate.

Business income may include income received from the sale of products or services. For example, fees received by a person from the regular practice of a profession are business income. Rents received by a person in the real estate business are business income. A business must include in income payments received in the form of property or services at the fair market value of the property or services

Small business owners can deduct all ordinary and necessary business expenses incurred in operating the business. This includes such expenses as advertising, depreciation, wages, car and truck expenses, utilities, etc., which are detailed on Schedule C. Generally, the taxpayer cannot deduct personal, living, or family expenses. However, if he or she has an expense for something that is used partly for business and partly for personal purposes, divide the total cost between the business and personal parts. The taxpayer can deduct the business part.

In short, Schedule C is only the place to start for the sole proprietor. The taxpayer may be subject to state and local taxes and other requirements such as business licenses and fees. Check with state and local governments for more information. Here are the key parts of Schedule C discussed in detail.

## Hobby Income versus Business Income

In order to use Schedule C, the taxpayer must be engaged in a for-profit business. A hobby is defined as an activity done regularly in one's leisure time for pleasure and not principally done with the goal of making a profit. A hobby may, in many instances, result in a profit but what is important is intent. Conversely, a for-profit business may end with a loss but that is not the intent.

In order to determine if the activity qualifies as a business, taxpayers should consider the following factors:

- Does the time and effort put into the activity indicate an intention to make a profit?
- Does the taxpayer depend on income from the activity?
- If there are losses, are they due to circumstances beyond the taxpayer's control or did they occur in the start-up phase of the business?
- Has the taxpayer changed methods of operation to improve profitability?
- Does the taxpayer or his or her advisors have the knowledge needed to carry on the activity as a successful business?

- Has the taxpayer made a profit in similar activities in the past?
- Does the activity make a profit in some years?
- Can the taxpayer expect to make a profit in the future from the appreciation of assets used in the activity?

Tip

The IRS presumes that an activity is carried on for profit if it makes a profit during at least three of the last five tax years, including the current year or at least two of the last seven years for activities that consist primarily of breeding, showing, training or racing horses. The following table summarizes how income and expenses are treated for hobby and for-profit business.

| | Sole Proprietor | Hobby |
|---|---|---|
| Report Expenses | Schedule C | No |
| Report Income | Schedule C | Line 21, Form 1040 |
| Income subject to SE Tax | Yes | No |

Table 2-5 – For-Profit vs. Hobby (2018)

Under the Tax Cuts and Jobs Act, the deduction for miscellaneous itemized deductions that are subject to the 2% floor is suspended. Therefore, no hobby related miscellaneous itemized deductions may be claimed by an individual on Schedule A of Form 1040 for tax years 2018 through 2025. These deductions include unreimbursed job expenses, tax preparation fees and investment fees and expenses.

## Schedule C Details

**Line 1: Gross receipts or sales**
Except as otherwise provided in the Internal Revenue Code, gross receipts or sales are the total amounts the organization received from all sources during its annual accounting period, without subtracting any costs or expenses. Enter gross receipts from a trade or business on Line 1. Include amounts the taxpayer received in a trade or business that were properly shown on Forms 1099-MISC. If the total amounts that were reported in box 7 of Forms 1099-MISC are more than the total the taxpayer is reporting on Line 1, attach a statement explaining the difference. Do not include any amount received for the sale of property used in a business or profession on Line 1. (15)

Bartering is an exchange of property or services. The taxpayer must include in his or her gross receipts, at the time received, the fair market value of property or services he or she receives in exchange for something else. If the taxpayer exchanges services with another person and 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.

If the taxpayer had both self-employment income and statutory employee income, he or she must file two Schedule Cs. The taxpayer cannot use Schedule C-EZ or combine these amounts on a single Schedule C. Also, Qualified joint ventures should report rental real estate income not subject to self-employment tax on Schedule E.

**Line 2: Returns and Allowances**
This line is only to be used by accrual based taxpayers who previously included an amount as income when earned, but were never paid. Cash basis taxpayers should never have an amount reported on Line 2.

**Line 4: Cost of Goods Sold**
If the taxpayer makes or buys goods to sell, they can deduct the cost of goods sold from the gross receipts on Line 4 Schedule C. However, to determine these costs, they must value the inventory at the beginning and end of each tax year. This applies if they are a manufacturer, wholesaler, or retailer or if are engaged in any business that makes, buys, or sells goods to produce income. This does not apply to a personal service business, such as the business of a doctor, lawyer, carpenter, or painter.

However, if the taxpayer works in a personal service business and also sells or charges for the materials and supplies normally used in business, this also applies to them. The cost of goods sold is determined in Lines 35-42 on Schedule C. If the taxpayer must account for an inventory in their business, then they must generally use an accrual method of accounting for purchases and sales. (16)

## Figuring Cost of Goods Sold on Schedule C

Line 35 - Inventory at beginning of year. If different from last year's closing inventory, attach explanation
Line 36 - Purchases less cost of items withdrawn for personal use.
Line 37 - Cost of labor. Do not include any amounts paid by the taxpayer to him or herself.
Line 38 - Materials and supplies.
Line 39 - Other costs.
Line 40 - Add lines 35 through 39.
Line 41 - Inventory at end of year.
Line 42 - Cost of goods sold. Subtract line 41 from line 40.

Part III of Schedule C is for businesses to determine their cost of goods sold which is reported on Line 4. The following is a summary of Schedule C Part III that explains how this determination is made.

**Line 35: Inventory at the Beginning of the Year**
Beginning inventory is the cost of merchandise on hand at the beginning of the year that will be available to sell to customers. If the taxpayer is a manufacturer or producer, it includes the total cost of raw materials, work in process, finished goods, and materials and supplies used in manufacturing the goods. Opening inventory usually will be identical to the closing inventory of the year before. Any difference between these numbers must be explained by the taxpayer in a schedule attached to the return.

**Line 36: Purchases Less Cost of Items Withdrawn for Personal Use**
If the taxpayer is a merchant, use the cost of all merchandise bought for sale. If the taxpayer is a manufacturer or producer, include the cost of all raw materials or parts purchased for manufacture into a finished product.

**Line 37: Cost of Labor**
Labor costs are usually an element of cost of goods sold only in a manufacturing or mining business. Small merchandisers (wholesalers, retailers, etc.) usually do not have labor costs that can properly be charged to cost of goods sold and are taken as a business expense deduction. In a manufacturing business, labor costs properly allocable to the cost of goods sold include both the direct and indirect labor used in fabricating the raw material into a finished, saleable product.

**Line 38: Materials and Supplies**
Materials and supplies, such as hardware and chemicals, used in manufacturing goods are charged to cost of goods sold. Those that are not used in the manufacturing process are treated as deferred charges and deducted as a business expense.

**Line 39: Other Costs**
Examples of other costs incurred in a manufacturing or mining process that can be charged to the cost of goods sold are as follows:

- *Freight* - Freight-in, express-in, and cartage-in on raw materials, supplies used in production, and merchandise purchased for sale are all part of cost of goods sold.
- *Containers* - Containers and packages that are an integral part of the product manufactured are a part of the cost of goods sold. If they are not an integral part of the manufactured product, their costs are shipping or selling expenses.
- *Overhead expenses* - Overhead expenses include expenses such as rent, heat, light, power, insurance, depreciation, taxes, maintenance, labor, and supervision. Overhead expenses that are direct and necessary expenses of the manufacturing operation are included in the cost of goods sold.

Subtract the value of taxpayer's closing inventory (including, as appropriate, the allocable parts of the cost of raw materials and supplies, direct labor, and overhead expenses) from line 40. Inventory at the end of the year is also known as closing or ending inventory. Ending inventory will usually become the beginning inventory of the next tax year. When the closing inventory (inventory at the end of the year) is subtracted from the cost of goods available for sale, the remainder is the cost of goods sold during the tax year. Report this on Line 4 of Schedule C.

## Expenses

This section provides an overview of business expenses that can be deducted on Schedule C. A sole proprietor can deduct the costs of operating the business and these costs are known as business expenses. These are costs that do not have to be capitalized or included in the cost of goods sold but can deducted in the current year. To be deductible, a business expense must be both ordinary and necessary. An ordinary expense is one that is common and accepted in the particular field of business. A necessary expense is one that is helpful and appropriate for the business. An expense does not have to be indispensable to be considered necessary. (16)

Tip

If the taxpayer has an expense that is partly for business and partly personal, separate the personal part from the business part. The personal part is not deductible.

**Advertising**

Promoting a business through paid advertisements in newspapers, trade magazines, television, radio, or on the internet are all deductible. Include the normal and necessary expenses associated with these promotions. In addition, the cost of business cards, promotional items, flyers and the cost of distributing them, etc. can also be deducted as business expense. Advertising with the intention of influencing political legislation is not deductible.

**Car and Truck Expenses**

A sole proprietor can deduct the actual expenses of operating a car or truck or take the standard mileage rate. This is true even if the vehicle was used for hire (such as a taxicab). Actual expenses must be used if there were five or more vehicles simultaneously in active use for the business (such as in fleet operations). Actual expenses cannot be used for a leased vehicle if the taxpayer previously used the standard mileage rate for that vehicle.

A taxpayer can take the standard mileage rate of 54.5 cents for 2018 only if he or she: (15)

- Owned the vehicle and used the standard mileage rate for the first year it was placed in service.
- Leased the vehicle and are using the standard mileage rate for the entire lease period (except the period, if any, before 1998).

If the taxpayer takes the standard mileage rate, multiply the number of business miles driven by 54.5 cents for 2018 and add to this amount of parking fees and tolls, and enter the total on line 9. Taxpayer should keep a log of business miles driven as well as tolls and parking fees paid. Do not deduct depreciation, rent or lease payments, or the actual operating expenses.

A taxpayer cannot use the standard mileage rate if he or she:

- Uses five or more cars at the same time (such as in fleet operations).
- Claimed a depreciation deduction for the car using any method other than straight line, for example, MACRS.
- Claimed a Section 179 deduction on the car.
- Claimed the special depreciation allowance on the car.
- Claimed actual car expenses after 1997 for a car he or she leased.
- Is a rural mail carrier who received a qualified reimbursement.

The taxpayer can elect to use the standard mileage rate if he or she used a car for hire (such as a taxi) unless the standard mileage rate is otherwise not allowed, as discussed above.

If the taxpayer deducts actual expenses, include on line 9 the business portion of expenses for gasoline, oil, repairs, insurance, tires, license plates, etc., and show depreciation on line 13 and rent or lease payments on line 20a. If the taxpayer owns or leases five or more cars that are used for business at the same time, he or she must use the actual expense method. The taxpayer may also be required to provide additional information by completion of Part IV of Schedule C or Part III of Schedule C-EZ.

Tip

Placing the company logo, displays, or advertisements on a vehicle does not change the use from personal to business use.

Expenses incurred for use of a vehicle to get from the taxpayer's home to the place of business are treated as personal commuting expenses and are not deductible. If the taxpayer does not have a regular office, mileage driven between

home and the first stop is considered to be commuting to work and is not deductible. In addition, mileage driven between the last business stop and their home is also treated as commuting mileage and is not deductible. If the taxpayer qualifies for an office within the home, however, all of their business mileage driven outside of the home is deductible.

Additional information that should be maintained and logged in order to deduct expenses for business use of a vehicle includes:

- Basis of vehicle.
- Date vehicle was placed into service.
- Total number of business miles driven for the year.
- Total number of commuting miles driven for the year.
- Total overall miles driven for the year.

To determine the business use percentage, divide the total number of business miles driven for the year by the total overall miles driven for the year.

**Employee Benefit Programs**
Deduct contributions to employee benefit programs that are not an incidental part of a pension or profit-sharing plan included on line 19. Examples are accident and health plans, group-term life insurance, and dependent care assistance programs. The sole proprietor cannot deduct contributions made on his or her behalf as a self-employed person to any benefit plan. However, they may be able to deduct on Form 1040 or Form 1040NR the amount paid for health insurance on behalf of the taxpayer, his or her spouse, and dependents, even if the taxpayer does not itemize deductions.

The taxpayer can usually deduct insurance premiums in the tax year to which they apply. If he or she uses the cash method of accounting, he or she generally deducts insurance premiums in the tax year he or she actually paid them, even if he or she incurred them in an earlier year. If the taxpayer uses an accrual method of accounting, he or she cannot deduct insurance premiums before the tax year in which he or she incurs a liability for them. In addition, the taxpayer cannot deduct insurance premiums before the tax year in which he or she actually pay them (unless the exception for recurring items applies). Also, the taxpayer cannot deduct expenses in advance, even if he or she pays them in advance. This rule applies to any expense paid far enough in advance to, in effect, create an asset with a useful life extending substantially beyond the end of the current tax year. Expenses such as insurance are generally allocable to a period of time. The taxpayer can deduct insurance expenses for the year to which they are allocable.

**Insurance (other than health)**
Deduct premiums paid for business insurance on line 15. Not all forms of business insurance are deductible. Refer to the table for some examples of business insurance can be deducted on Line 15.

| Deductible Premiums | Non-Deductible Premiums |
|---|---|
| Insurance that covers fire, storm, theft, accident, or similar losses. | Self-insurance reserve funds. |
| Credit insurance that covers losses from business bad debts. | Loss of earnings. |
| Group hospitalization and medical insurance for employees, including long-term care insurance. | Certain life insurance and annuities. |
| Liability insurance. | Insurance to secure a loan. |
| Malpractice insurance. | |
| Workers' compensation insurance. | |
| Overhead insurance that pays for business overhead expenses the taxpayer has during long periods of disability caused by his or her injury or sickness. | |
| Car and other vehicle insurance that covers vehicles used in the taxpayer's business for liability, damages, and other losses. | |

| | |
|---|---|
| Life insurance covering the taxpayer's officers and employees if he or she not directly or indirectly a beneficiary under the contract. | |
| Business interruption insurance that pays for lost profits if the taxpayer's business is shut down due to a fire or other cause. | |

Table 2-6 - Publication 535 – Chapter 6 - Insurance (2018)

## Business Use of the Home

Form 8829 - Expenses For Business Use of Your Home is used when a taxpayer can claim deductions for the business use of a portion of his or her home. The general rule is that taxpayers who use a part of the home for legitimate business purposes can deduct expenses allocable to that portion of the home used for those business purposes. This is the so-called home office deduction rule.

Generally, the taxpayer can deduct business expenses that apply to a part of the home only if that part is exclusively used on a regular basis: (17)

- As the principal place of business for any of the trades or businesses.
- As a place of business used by patients, clients or customers to meet or deal with the taxpayer in the normal course of the trade or business.
- In connection with the trade or business if it is a separate structure that is not attached to the home.

Exceptions to this rule apply to space used on a regular basis for:

- Storage of inventory or product samples.
- Certain Daycare facilities.

A home office qualifies as a principal place of business if the taxpayer meets the following requirements:

- The taxpayer uses it exclusively and regularly for administrative or management activities of the trade or business.
- The taxpayer has no other fixed location where he or she conducts substantial administrative or management activities of the trade or business.

Tip

If the part of the property being used for a home office is not attached to the living area of the home, that is, it is a separate building, then the taxpayer must show that the separate building is used in connection with his trade or business. But it does **not** have to be the principal place of business.

The key is to be sure that the part of the home being claimed as the home office is used exclusively for the business activity. Thus, if the room in the house doubles as a home office and family room used by the rest of the family for entertainment, it does not qualify as being exclusively used for business. There are two exceptions to the exclusive use rule. The first is where part of the home is used for storing inventory.

Then, the taxpayer can deduct the expenses related to using that room if:

- The inventory is kept for use in the taxpayer's trade or business.
- The trade or business in question is the wholesale or retail of selling of goods.
- The home is the only fixed location of the taxpayer's trade or business.
- The storage space is used on a regular basis.
- The space being used is a separately identifiable space suitable for storage.

The second exception to the exclusive use rule is for homes that are used for providing daycare services. Then the rooms can be used for both business and personal use, but the taxpayer has to allocate out the personal use portion, which is nondeductible.

If the taxpayer qualifies for a home office deduction, the taxpayer can deduct both direct and indirect expenses for that office. Direct expenses are those that only benefit the particular room in the house used for business purposes, such as painting or repairing the room. Indirect expenses are those that benefit the entire home, including those parts of the home not being used for business.

## Utilities

Business expenses for heat, lights, power, telephone service, and water and sewerage are deductible. However, any part due to personal use is not deductible. Deductions for internet-related expenses include domain registrations fees and webmaster consulting costs. When starting a business, the taxpayer may have to amortize these expenses as start-up costs. (18)

A taxpayer is denied a business deduction for basic local telephone service charges on the first line in the residence. Additional charges for long-distance telephone calls, equipment, optional services (such as call waiting or message-taking) or additional telephone lines may be deductible.

## Part of the Home Used for Business

Tip

To determine what percentage of expenses can be deducted, we must discuss the business-use percentage of the home**.** Do this by dividing the area used for business by the total area of the home, in square feet. If the rooms in the home are about the same in size, simply divide the number of rooms used for business by the total number of rooms in the home.

## Daycare Services

Taxpayers who use their personal residences on a regular basis in the business of providing qualifying day care services do not have to meet the exclusive use test in order to deduct business-related expenses. But, the daycare business expenses are available only if the taxpayer has applied for and has been granted a license, or certification, or approval as a daycare center under the provisions of applicable state law.

## Depreciation - Business Use of the Home

If the taxpayer owns his or her home and qualifies to deduct expenses for its business use, he or she can claim a deduction for depreciation. Depreciation is an allowance for the wear and tear on the part of the taxpayer's home used for business. The taxpayer cannot depreciate the cost or value of the land. He or she recovers its cost when he or she sells or otherwise dispose of the property. Before the taxpayer figures his or her depreciation deduction, he or she needs to know the following information: (19)

- The month and year he or she started using his or her home for business.
- The adjusted basis and fair market value of his or her home (excluding land) at the time he or she began using it for business.
- The cost of any improvements before and after he or she began using the property for business.
- The percentage of his or her home used for business.

The adjusted basis of the taxpayer's home is generally its cost, plus the cost of any permanent improvements he or she made to it, minus any casualty losses or depreciation deducted in earlier tax years. A permanent improvement increases the value of property, adds to its life, or gives it a new or different use. Examples of improvements are replacing electric wiring or plumbing, adding a new roof or addition, paneling, or remodeling.

The fair market value of the taxpayer's home is the price at which the property would change hands between a buyer and a seller, neither having to buy or sell, and both having reasonable knowledge of all necessary facts. Sales of similar property, on or about the date the taxpayer begin using his or her home for business, may be helpful in determining the property's fair market value.

If the taxpayer first used his or her home for business before 2011 but after 1986, see IRS Publication 946 - How To Depreciate Property. If first used prior to 1987, see IRS Publication 534 - Depreciating Property Placed in Service Before 1987. Additional help can be found in Publication 587 - Business Use of Your Home.

## Carryover of Non-Allowed Expenses to Next Year

There is a limit on the amount of otherwise nondeductible expenses, such as utilities, insurance, and depreciation that the taxpayer can take as a home office deduction. The total amount of deductions, with depreciation taken last, cannot be more than the gross income earned from the business use of the home.

The gross income limit is determined by deducting the following from gross income:

- The business percentage of expenses that would be deductible by any taxpayer regardless of whether or not he is using the home in a trade or business, such as deductible mortgage interest, real estate taxes and casualty losses.
- All other business deductions such as wages and supplies that are not directly related to the use of the home office.

The home office deduction cannot be used to create or increase a loss from the taxpayer's business. The amount of the deduction available is limited to the net income for the year from the business. Any excess loss can only be carried forward and used next year, using the same limitations. Form 8829 is completed to determine the allowable expenses for business use of the home. This figure is entered on the appropriate line on Schedule C.

## Simplified Option for Home Office Deduction

Tip

Taxpayers may use a simplified option when figuring the deduction for business use of their home. This simplified option does not change the criteria for who may claim a home office deduction. It merely simplifies the calculation and recordkeeping requirements of the allowable deduction. Some key points of the simplified option are: (20)

- Standard deduction of $5 per square foot of home used for business (maximum 300 square feet or $1,500).
- Allowable home-related itemized deductions claimed in full on Schedule A. (For example: Mortgage interest, real estate taxes).
- No home depreciation deduction or later recapture of depreciation for the years the simplified option is used.

The taxpayer may choose to use either the simplified method or the regular method for any taxable year. He or she chooses a method by using that method on his or her timely filed, original Federal income tax return for the taxable year. Once the taxpayer has chosen a method for a taxable year, he or she cannot later change to the other method for that same year.

If the taxpayer uses the simplified method for one year and uses the regular method for any subsequent year, he or she must calculate the depreciation deduction for the subsequent year using the appropriate optional depreciation table. This is true regardless of whether the taxpayer used an optional depreciation table for the first year the property was used in business.

| Comparison of Methods | |
|---|---|
| **Simplified Option** | **Regular Method** |
| Deduction for home office use of a portion of a residence allowed only if that portion is exclusively used on a regular basis for business purposes | Same |
| Allowable square footage of home use for business (not to exceed 300 square feet) | Percentage of home used for business |
| Standard $5 per square foot used to determine home business deduction | Actual expenses determined and records maintained |
| Home-related itemized deductions claimed in full on Schedule A | Home-related itemized deductions apportioned between Schedule A and business schedule (Schedule C or Schedule F) |
| No depreciation deduction | Depreciation deduction for portion of home used for business |

| No recapture of depreciation upon sale of home | Recapture of depreciation on gain upon sale of home |
|---|---|
| Deduction cannot exceed gross income from business use of home less business expenses | Same |
| Amount in excess of gross income limitation may not be carried over | Amount in excess of gross income limitation may be carried over |
| Loss carryover from use of regular method in prior year may not be claimed | Loss carryover from use of regular method in prior year may be claimed if gross income test is met in current year |

Table 2-7 - Comparison of Methods (2018)

**Review Question 4**
The Internal Revenue Service has a simplified option that many owners of home-based businesses and some home-based workers may use to figure their deductions for the business use of their homes as they consider tax planning in 2018. This simplified option is capped at what amount per year?

A. $500
B. $1,000
C. $1,500
D. $2,000

See Review Feedback for answer.

## Recordkeeping

Everyone in business must keep records. Good records will help the business owner monitor the progress of his or her business, prepare his or her financial statements, identify source of receipts, keep track of deductible expenses, prepare tax returns and support items reported on tax returns. Except in a few cases, the law does not require any specific kind of records. The taxpayer can choose any recordkeeping system suited to his or her business that clearly shows his or her income and expenses. The 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 his or her recordkeeping system using an accounting method that clearly shows his or her income for his or her tax year.

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

All requirements that apply to hard copy books and records also apply to electronic storage systems that maintain tax books and records. When a taxpayer replaces hard copy books and records, he or she must maintain the electronic storage systems for as long as they are material to the administration of tax law.

Purchases, sales, payroll, and other transactions the taxpayer has in his or her business generate supporting documents. Supporting documents include sales slips, paid bills, invoices, receipts, deposit slips, and canceled checks. These documents contain information the taxpayer needs to record in his or her books. It is important to keep these documents because they support the entries in the taxpayer's books and on his or her tax return.

Gross receipts are the income the taxpayer receives from his or her business. He or she should keep supporting documents that show the amounts and sources of his or her gross receipts. Documents that show gross receipts include the following:

- Cash register tapes.
- Bank deposit slips.
- Receipt books.
- Invoices.

- Credit card charge slips.
- Forms 1099-MISC.

Expenses are the costs the taxpayer incurs (other than the cost of inventory) to carry on his or her business. The taxpayer's supporting documents should show the amount paid and that the amount was for a business expense.

Documents for expenses include the following:

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

Tip

A petty cash fund allows the taxpayer to make small payments without having to write checks for small amounts. Each time he or she makes a payment from this fund, the taxpayer should make out a petty cash slip and attach it to his or her receipt as proof of payment.

# Social Security and Medicare Taxes

The Federal Insurance Contributions Act (FICA) tax includes two separate taxes. One is Social Security tax and the other is Medicare tax. Different rates apply for each of these programs. For 2018, the tax rate for Social Security is 6.2% for employees, 6.2% for employers and 12.4% for self-employed people. The Social Security tax applies only to the first $128,400 of wages, for a maximum of $7,960.80 for employees and for employers, and $15,921.60 for self-employed people. The current rate for Medicare is 1.45% for the employer and 1.45% for the employee, or 2.9% total. There is not a wage base limit for Medicare tax. All covered wages are subject to Medicare tax.

Social Security and Medicare taxes apply to the wages of household workers the taxpayer pays $2,000 or more in cash or an equivalent form of compensation. Social Security and Medicare taxes apply to election workers who are paid $1,700 or more in cash or an equivalent form of compensation. (21)

The 2013 Additional Medicare Tax (imposed by the Patient Protection and Affordable Care Act) requires individuals to pay a supplemental 0.9% tax (in addition to the 1.45% contribution that applies to all wages) on wages in excess of $200,000 ($250,000 if married, filing jointly). (22)

Any excess Social Security tax withheld over these maximums (usually from having two or more employers), is taken in additional paid-in income taxes and is combined with amounts withheld from wages or with estimates. If a joint return is filed, these amounts withheld from each spouse cannot be added together to exceed the maximums.

## Taxation of Social Security Benefits

If the only income the taxpayer received during the year was his or her Social Security or the Social Security Equivalent Benefit (SSEB) portion of tier 1 railroad retirement benefits, his or her benefits generally are not taxable and the taxpayer probably does not have to file a return. If the taxpayer has income in addition to his or her benefits, he or she may have to file a return even if none of his or her benefits are taxable. If any portion of the benefits is taxable, the taxpayer should file using Form 1040 or Form 1040A; Form 1040EZ **cannot** be used.

The base amounts used to figure the tax on Social Security benefits are: (23)

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

How much of the benefits are taxable depends on the total amount of the taxpayer's benefits and other income. Generally, the higher the income amount, the greater the taxable portion of the taxpayer's benefits.

## Maximum Taxable Part

Some people have to pay Federal income taxes on their Social Security benefits. This usually happens only if the taxpayer has other substantial income (such as wages, self-employment, interest, dividends and other taxable income that must be reported on his or her tax return) in addition to his or her benefits. No one pays Federal income tax on more than 85% of his or her Social Security benefits based on Internal Revenue Service (IRS) rules.

In order to determine the taxability of Social Security benefits, it's first necessary to calculate "combined income" – a measurement of income used specifically for these purposes. Combined income is calculated as the taxpayer's total income from taxable sources (essentially the net amounts included on the front page of his or her tax return in calculating Adjusted Gross Income), plus any tax-exempt interest (i.e., from municipal bonds) and excluded foreign income, plus one half of his or her Social Security benefits. If this total exceeds $25,000 for individuals ($32,000 for married couples), then 50% of the excess is the amount of Social Security benefits that must be included in income. If provisional income exceeds $34,000 for individuals ($44,000 for married couples), then 85% of the excess amount is included in income.

If the taxpayer files a single, Federal tax return and his or her combined income is: (21)

- Between $25,000 and $34,000, he or she may have to pay income tax on up to 50% of his or her benefits.
- More than $34,000, up to 85% of his or her benefits may be taxable.

If the taxpayer files a joint, Federal tax return and his or her combined income is:

- Between $32,000 and $44,000, he or she may have to pay income tax on up to 50% of his or her benefits
- More than $44,000, up to 85% of his or her benefits may be taxable.

If the taxpayer is married and files a separate tax return, he or she probably will pay taxes on his or her benefits.
To find out whether any of the taxpayer's benefits may be taxable, compare the base amount for his or her filing status with his or her combined income which is the total of: (23)

1. One-half of his or her benefits, plus
2. The taxpayer's adjusted gross, including tax-exempt interest.

When making this comparison, do not reduce the taxpayer's other income by any exclusions for:

- Interest from qualified U.S. savings bonds.
- Employer-provided adoption benefits.
- Foreign earned income or foreign housing.
- Income earned by bona fide residents of American Samoa or Puerto Rico.

Tip

Any repayment of benefits the taxpayer made during 2018 must be subtracted from the gross benefits he or she received in 2018. It does not matter whether the repayment was for a benefit the taxpayer received in 2018 or in an earlier year.

## Joint Return

If the taxpayer is married and files a joint return for 2018, the taxpayer and his or her spouse must combine incomes and benefits when figuring if the combined benefits are taxable. Even if the taxpayer's spouse did not receive any benefits, he or she must add the spouse's income to his or hers when figuring if any of the benefits are taxable. The IRS provides a Social Security Benefits Worksheet upon which the taxpayer can calculate taxable Social Security benefits.

# Pensions, Annuities and Individual Retirement Accounts (IRA)

The pension or annuity payments that a taxpayer receives are fully taxable if he or she has no cost in the contract because any of the following situations: (24)

- The taxpayer did not pay anything or is not considered to have paid anything for the pension or annuity. Amounts withheld from his or her pay on a tax-deferred basis are not considered part of the cost of the pension or annuity payment.
- The taxpayer's employer did not withhold contributions from his or her salary.
- The taxpayer received all of his or her contributions tax free in prior years.

If a taxpayer contributed after-tax dollars to a pension or annuity, the pension payments are partially taxable. He or she will not pay tax on the part of the payment that represents a return of the after-tax amount paid. This amount is the taxpayer's investment in the contract, and includes the amounts his or her employer contributed that were taxable to him or her when contributed. Partly taxable pensions are taxed under either the General Rule or the Simplified Method. If the starting date of the pension or annuity payments is after November 18, 1996, the taxpayer generally must use the Simplified Method to determine how much of the annuity payments are taxable and how much is tax free.

Under the Simplified Method, the taxpayer figures the tax-free part of each annuity payment by dividing the cost by the total number of anticipated monthly payments. For an annuity that is payable for the lives of the annuitants, this number is based on the annuitants' ages on the annuity starting date and is determined from a table. For any other annuity, this number is the number of monthly annuity payments under the contract.

The taxpayer must use the Simplified Method if the annuity starting date is after November 18, 1996, and he or she meets both of the following conditions: (24)

1. The taxpayer receives his or her pension or annuity payments from any of the following plans:
    a. A qualified employee plan.
    b. A qualified employee annuity.
    c. A tax-sheltered annuity plan (403(b) plan).
2. On the annuity starting date, at least one of the following conditions applies to the taxpayer:
    a. He or she is under age 75.
    b. He or she is entitled to less than 5 years of guaranteed payments.

The General Rule is used to figure the tax treatment of various types of pensions and annuities, including nonqualified employee plans. A nonqualified employee plan is an employer's plan that does not meet Internal Revenue Code requirements. It does not qualify for most of the tax benefits of a qualified plan.

The taxpayer can use the General Rule if he or she receives pension or annuity payments from:

- A **nonqualified plan** (for example, a private annuity, a purchased commercial annuity, or a nonqualified employee plan),
- A qualified plan if:
    - The annuity starting date is before November 19, 1996 (and after July 1, 1986), and the taxpayer does not qualify to use, or chooses not to use, the Simplified Method.
    - The taxpayer is 75 or over and the annuity payments are guaranteed for at least 5 years (regardless of the annuity starting date).

The following are qualified plans:

- A qualified employee plan.
- A qualified employee annuity.
- A tax-sheltered annuity (TSA) plan or contract.

If the taxpayer receives pension or annuity payments before age 59 ½, he or she may be subject to an additional 10% tax on early distributions unless the distribution qualifies for an exemption.

The additional tax does not apply to any part of a distribution that is tax free or to any of the following types of distributions: (25)

- Distributions made as a part of a series of substantially equal periodic payments from a qualified plan that begins after the taxpayer's separation from service.
- Distributions made because the taxpayer is totally and permanently disabled.
- Distributions made on or after the death of the plan participant or contract holder.
- Distributions made from a qualified retirement plan after the taxpayer's separation from service in or after the year he or she reached age 55.

The taxpayer may choose not to have income tax withheld from the pension or annuity payments (unless they are eligible rollover distributions) or want to specify how much tax is withheld. If so, provide the payer Form W-4P - Withholding Certificate for Pension or Annuity Payments, or a similar form provided by the payer. Withholding from periodic payments of a pension or annuity is generally figured the same way as for salaries and wages.

If the taxpayer does not submit the withholding certificate, the payer must withhold tax as if the taxpayer is married and claiming three withholding allowances. If the taxpayer does not provide the payer with the correct Social Security number, tax will be withheld as if the taxpayer is single and claiming no withholding allowances, even if the taxpayer submitted a Form W-4P and elected a lower amount.

A taxpayer should receive Form 1099-R - Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., from each person to whom he or she has received a designated distribution or was treated as having made a distribution of $10 or more from profit-sharing or retirement plans, any individual retirement arrangements (IRAs), annuities, pensions, insurance contracts, survivor income benefit plans, permanent and total disability payments under life insurance contracts, charitable gift annuities, etc.

## Elective Deferral (Contribution) Limits

The elective deferral limit for employees who participate in 401(k), 403(b), most 457 plans, and the Federal government's Thrift Savings Plan increases to $18,500 in 2018. The catch-up contribution limit for employees aged 50 and over who participate in 401(k), 403(b), most 457 plans, and the Federal government's Thrift Savings Plan is will stay the same at $6,000 in 2018. If the taxpayer is self-employed, the total employer plus employee contributions to all defined contribution plans under Section 415(c)(1)(A) is increased in 2018 from $54,000 to $55,000. (26)

## Contributions to Traditional IRAs

There are two requirements necessary for setting up a traditional IRA. First, the taxpayer must have received some taxable compensation income during the year, and, second, he or she has not reached age 70 ½ by the end of the year. Taxable compensation includes wages, salaries, alimony, tips, commissions and the like.

However, the following are **not** considered compensation income for purposes of setting up or contributing to an IRA: (27)

- Earnings and profits from property, such as rental income, interest income, and dividend income.
- Pension or annuity income.
- Deferred compensation income.
- Any other income that is an exclusion from gross income.

Tip

An IRA can be set up either in the name of the taxpayer or the taxpayer and his or her spouse, in a so called spousal IRA. Contributions can be made to a spousal IRA even if the spouse has no compensation income. There are specific limitations on the amount that he or she can contribute to a traditional IRA during the year.

The maximum amount of contribution is limited to the *smaller* of: (28)

- For tax year 2018, $5,500 if the taxpayer is under age 50. If he or she is over the age of 50 the catch-up contribution limit is $1,000 for a total contribution of $6,500.
- The taxpayer's compensation income for the tax year.

The IRA contribution limit does not apply to rollover contributions or qualified reservist repayments.

For 2018, the limit on annual contributions to an Individual Retirement Arrangement (IRA) remains unchanged at $5,500. 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.

There are established time frames during which a taxpayer can make an IRA contribution. An IRA contribution can be made at any time during the tax year or by the due date of the tax return for the year in which he or she wants the contribution to apply, not including any extensions in time to file requests. In other words, most taxpayers can make an IRA contribution for 2018 by April 15, 2019 (not including holidays or weekends). In fact, the taxpayer can even claim an IRA contribution and file his or her tax return before the contribution is actually made, as long as it in fact is made before the due date of the return. However, if contributions to the traditional IRA for a year were less than the limit, the taxpayer cannot contribute more after the due date of his or her return for that year to make up the difference.

Line 32 on Form 1040, under "Adjusted Gross Income" is where the taxpayer claims a deduction for an IRA contribution for the year. The rules for claiming this deduction have become remarkably complicated over the last several years. Specifically, if either the taxpayer or his spouse is covered by an employer provided retirement plan, the amount of available deduction may be reduced or even eliminated.

Not only is the amount of available IRA deduction dependent on filing status, but it may also be subject to certain income limitations. The amount of available IRA deduction can be determined by using an IRS supplied IRA worksheet.

## Deductible Phase-Out Range

A taxpayer's deduction may be limited if he or she (or his or her spouse, if married) is covered by a retirement plan at work and the taxpayer's income exceeds certain levels. The deductible IRA income 2018 phase-out limits, for individuals who are active participants, are increased as follows:

| 2018 IRA Deduction Limits - Effect of Modified AGI on Deduction if the Taxpayer is Covered by a Retirement Plan at Work | | |
|---|---|---|
| **Filing Status** | **Modified AGI Amount** | **Deduction Amount** |
| Single or Head of Household | $63,000 or less | Full Deduction to Contribution Limit |
| | $63,000 - $73,000 | Partial Deduction |
| | $73,000 or more | No Deduction |
| Married filing jointly or Qualifying Widow(er) | $101,000 or less | Full Deduction to Contribution Limit |
| | $101,000 - $121,000 | Partial Deduction |
| | $121,000 or more | No Deduction |
| Married filing separately | Less than $10,000 | Partial Deduction |
| | $10,000 or more | No Deduction |
| If the taxpayer files separately and did not live with his or her spouse at any time during the year, the taxpayer's IRA deduction is determined under the single filing status. | | |

Table 2-8 - IRA Deduction Limits - Effect of MAGI on Deduction if You Are Covered by a Retirement Plan at Work. (2018)

If the taxpayer is not covered by a retirement plan at work, he or she should use the following table to determine if his or her modified AGI affects the amount of his or her deduction. The deduction is limited only if his or her spouse is covered by a retirement plan.

| 2018 IRA Deduction Limits - Effect of Modified AGI on Deduction if the Taxpayer is not Covered by a Retirement Plan at Work | | |
|---|---|---|
| **Filing Status** | **Modified AGI Amount** | **Deduction Amount** |
| Single, Head of Household or Qualifying widow(er) | Any Amount | Full Deduction to Contribution Limit |
| Married filing jointly or separately with a spouse who is **not** covered by a plan at work | Any Amount | Full Deduction to Contribution Limit |
| Married filing jointly with a spouse who **is** covered by a plan at work | $189,000 or less | Full Deduction to Contribution Limit |
| | $189,000 - $199,000 | Partial Deduction |
| | $199,000 or more | No Deduction |
| Married filing separately with a spouse who **is** covered by a plan at work | Less than $10,000 | Partial Deduction |
| | $10,000 or more | No Deduction |
| If the taxpayer files separately and did not live with his or her spouse at any time during the year, the taxpayer's IRA deduction is determined under the single filing status. | | |

Table 2-9 - IRA Deduction Limits - Effect of MAGI on Deduction if You Are NOT Covered by a Retirement Plan at Work (2018)

The taxpayer's deduction is allowed in full if he or she (and his or her spouse, if married) are not covered by a retirement plan at work.

## Rollovers

An IRA rollover occurs when the taxpayer withdraws cash or other assets from one eligible retirement plan and contributes all or part of it, within 60 days, to another eligible retirement plan. (29)

This rollover transaction is not taxable but it is reportable on the Federal tax return. A taxpayer can roll over most distributions from an eligible retirement plan except for: (29)

- The nontaxable part of a distribution, such as an after-tax contribution to a retirement plan (in certain situations after-tax contributions can be rolled over).
- A distribution that is one of a series of payments made for a life (or life expectancy), or the joint lives (or joint life expectancies) of the taxpayer and his or her beneficiary, or made for a specified period of 10 years or more.
- A required minimum distribution.
- A hardship distribution.
- Dividends on employer securities.
- The cost of life insurance coverage.

If an eligible rollover distribution is paid, the taxpayer has 60 days from the date he or she received it to roll it over to another eligible retirement plan. Any taxable eligible rollover distribution paid from an employer-sponsored retirement plan to an individual is subject to a mandatory income tax withholding of 20%, even if he or she intends to roll it over later. If the taxpayer does roll it over, and wants to defer tax on the entire taxable portion, he or she will have to add funds from other sources equal to the amount withheld. The taxpayer can choose to have the payer transfer a

distribution directly to another eligible retirement plan or to an IRA. Under this direct rollover option, the 20% mandatory withholding does not apply.

## IRA One-Rollover-Per-Year Rule

As of January 1, 2015, a taxpayer can make only one rollover from a traditional IRA to another (or the same) traditional IRA in any 12-month period, regardless of the number of IRAs he or she owns. A similar limitation will apply to rollovers between Roth IRAs. The taxpayer can, however, continue to make as many trustee-to-trustee transfers between IRAs as he or she wants. Amounts transferred between traditional IRAs, either by rollover or trustee-to-trustee transfer, are excluded from the taxpayer's gross income.

The one-per year limit does not apply to: (30)

- Rollovers from traditional IRAs to Roth IRAs (conversions).
- Trustee-to-trustee transfers to another IRA.
- IRA-to-plan rollovers.
- Plan-to-IRA rollovers.
- Plan-to-plan rollovers.

Once this rule took effect, the tax consequences are: (30)

1. The taxpayer must include in gross income any previously untaxed amounts distributed from an IRA if he or she made an IRA-to-IRA rollover (other than a rollover from a traditional IRA to a Roth IRA) in the preceding 12 months.
2. The taxpayer may be subject to the 10% early withdrawal tax on the amount he or she includes in gross income.

If the taxpayer has not elected a direct rollover, in the case of a distribution from a retirement plan, or he or she has not elected out of withholding in the case of a distribution from an IRA, the plan administrator or IRA trustee will withhold taxes from the distribution. If the taxpayer later rolls the distribution over within 60 days, he or she must use other funds to make up for the amount withheld.

If the taxpayer rolls over the full amount of any eligible rollover distribution he or she receives, the entire distribution would be tax-free and he or she would avoid the 10% additional tax on early distributions.

This change will not affect the taxpayer's ability to transfer funds from one IRA trustee directly to another, because this type of transfer is not a rollover (Revenue Ruling 78-406, 1978-2 C.B. 157). The one-rollover-per-year rule of Internal Revenue Code Section 408(d)(3)(B) applies only to rollovers.

The IRS intends to follow the Tax Court's interpretation of Internal Revenue Code Section 408(d)(3)(B). However, to give IRA owners and trustees time to adjust, the IRS delayed implementation until January 1, 2015. Proposed Treasury Regulation Section 1.408-4(b)(4)(ii) will be withdrawn and Publication 590-B - Distributions from Individual Retirement Arrangements (IRAs) has been revised to reflect the new interpretation.

## Additional Tax on Early Distributions

To discourage the use of IRAs for purposes other than retirement, the law imposes an additional 10% tax on early distributions from traditional and Roth IRAs unless an exception applies. Generally, early distributions are those the taxpayer receives from an IRA before reaching age 59½. The additional 10% tax applies to the part of the distribution that he or she has to include in gross income. It is in addition to any regular income tax on that amount.

The additional 10% tax is reported on Form 5329 - Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts. However, the taxpayer does not have to file Form 5329 if his or her Form 1099-R - Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., shows distribution code 1 in Box 7. In this instance, the taxpayer needs only enter the additional 10% tax directly on the appropriate line of his or her Form 1040. If the taxpayer meets one of the exceptions to the tax, and his or her Form 1099-R does not have a distribution code 2, 3, or 4 in the box labeled distribution code(s), or if the code shown is incorrect, the taxpayer must file Form 5329 to claim the exception.

Federal income tax withholding is required for distributions from IRAs unless the taxpayer elects out of withholding on the distribution. If he or she elects out of withholding, he or she may have to make estimated tax payments.

There are exceptions to this 10% additional tax for early distributions that are:

- Made to a beneficiary or estate on account of the IRA owner's death.
- Made on account of disability.
- Made as part of a series of substantially equal periodic payments for the taxpayer's life (or life expectancy) or the joint lives (or joint life expectancies) of him or her and his or her designated beneficiary.
- Qualified first-time homebuyer distributions.
- Not in excess of the taxpayer's qualified higher education expenses.
- Not in excess of certain medical insurance premiums paid while unemployed.
- Not in excess of the taxpayer's unreimbursed medical expenses that are more than a certain percentage of his or her adjusted gross income.
- Due to an IRS levy.
- A qualified reservist distribution.

Distributions that a taxpayer rolls over or transfer to another IRA or qualified retirement plan are not subject to this 10% additional tax. Also, the additional 10% tax on early distributions from qualified retirement plans does not qualify as a penalty for withdrawal of savings and cannot be deducted.

**Review Question 5**
Jordan, age 42, received a $10,000 eligible rollover distribution from her 401(k) plan. Her employer withheld $2,000 from her distribution. Within 60 days Jordan decides to roll over the full $10,000 to another IRA. Which of the following is true regarding Jordan's rollover?

A. She must contribute $2,000 from other sources
B. Only $8,000 of the distribution would be tax-free
C. She must pay the 10% additional tax on early distributions on the $2,000
D. She must report $2,000 as a nontaxable rollover

See Review Feedback for answer.

# Capital Gains and Losses

The Tax Cuts and Jobs Act (TCJA) did not change the capital gains tax. Long-term capital gains are still defined as gains made on assets that the taxpayer held for over a year, while short-term capital gains come from assets he or she held for a year or less. Long-term gains are taxed at rates of 0%, 15%, or 20%, depending on the taxpayer's tax bracket, while short-term gains are taxed as ordinary income.

The 3.8% Net Investment Income Tax (NIIT) that applies to certain high earners will stay in place, with the exact same income thresholds. This is part of the Affordable Care Act, which Congress has not successfully repealed or replaced, so this tax remains.

Under the new provisions in the TCJA the long-term capital gains tax rates of 0%, 15%, and 20% still apply. However, the way they are applied has changed slightly. Under previous tax law, the 0% rate was applied to the two lowest tax brackets, the 15% rate was applied to the next four, and the 20% rate was applied to the top bracket.

Under the Tax Cuts and Jobs Act, the three capital gains income thresholds do not match up perfectly with the tax brackets. Instead, they are applied to maximum taxable income levels, as follows:

| 2018 Long-Term Capital Gains Rate Income Levels | | | | | |
|---|---|---|---|---|---|
| **Rate** | **Single** | **Married Filing Jointly** | **Head of Household** | **Married Filing Separately** | **Estates and Trusts** |
| 0% | Up to $38,600 | Up to $77,200 | Up to $51,700 | Up to $38,600 | Up to $2,600 |
| 15% | $38,600-$425,800 | $77,200-$479,000 | $51,700-$452,400 | $38,600-$239,500 | $2,600-$12,700 |
| 20% | Over $425,800 | Over $479,000 | Over $452,000 | Over $239,500 | Over $12,700 |

Table 2-10 - Publication 544 - Sales and Other Dispositions of Assets (2018)

The tax treatment of capital gains and losses depends on how long a taxpayer has owned the capital asset. This is called the taxpayer's holding period. The rule is fairly straightforward. If the taxpayer holds an asset for more than one year, we say that it is a long-term asset. If the taxpayer holds the asset for one year or less, we say that it is a short-term asset.

Here are 10 facts from the IRS on current capital gains and losses: (31)

1. Almost everything the taxpayer owns and use for personal purposes, pleasure or investment is a capital asset. Capital assets include the home, household furnishings, and stocks and bonds that the taxpayer holds as investments.
2. A capital gain or loss is the difference between the taxpayer's basis of an asset and the amount he or she receives when it is sold. The taxpayer basis is usually what he or she paid for the asset (a capital gain or loss does not impact the basis of an investment).
3. The taxpayer must include all capital gains in income.
4. The taxpayer may deduct capital losses on the sale of investment property. He or she cannot deduct losses on the sale of personal-use property.
5. Capital gains and losses are long-term or short-term, depending on how long the taxpayer holds on to the property. If he or she holds the property more than one year, the capital gain or loss is long-term. If the taxpayer holds it one year or less, the gain or loss is short-term.
6. If the long-term gains exceed the long-term losses, the difference between the two is a net long-term capital gain. If the net long-term capital gain is more than the net short-term capital loss, the taxpayer has a 'net capital gain'.
7. The tax rates that apply to net capital gains are generally lower than the tax rates that apply to other types of income. The maximum capital gains rate for most people is 15%. For lower-income individuals, the rate may be 0% on some or all of their net capital gains. For high-income individuals, the rate may be 20% on some or all of their net capital gains. Rates of 25% or 28% can also apply to special types of net capital gains.
8. If the capital losses are greater than the capital gains, the taxpayer can deduct the difference between the two on the tax return. The annual limit on this deduction is $3,000, or $1,500 if married filing separately.
9. If the total net capital loss is more than the limit the taxpayer can deduct, he or she can carry over the losses he or she is not able to deduct to next year's tax return. The taxpayer will treat those losses as if they occurred that year.
10. Form 8949 - Sales and Other Dispositions of Capital Assets, will help the taxpayer calculate capital gains and losses. He or she will carry over the subtotals from this form to Schedule D, Capital Gains and Losses.

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 called the maximum capital gain rates. The term net capital gain means the amount by which the taxpayer's net long-term capital gain for the year is more than his or her net short-term capital loss.

If the taxpayer calculates his or her tax using the maximum capital gain rate and the regular tax computation results in a lower tax, the regular tax computation applies.

## Mutual Funds

A mutual fund is a regulated investment company that pools funds of investors allowing them to take advantage of a

diversity of investments and professional asset management. The taxpayer owns shares in the fund, but the fund owns assets such as shares of stock, corporate bonds, government obligations, etc. One of the ways the fund makes money for the taxpayer is to sell these assets at a gain. If the asset was held by the mutual fund for more than one year, the nature of the income is capital gain, which gets passed on to the taxpayer. These are called capital gain distributions, which are distinguished on Form 1099-DIV from other types of income such as ordinary dividends.

Capital gains distributions are taxed as long-term capital gains regardless of how long the taxpayer has owned the shares in the mutual fund. For short-term gains, the capital gains tax rate is the taxpayer's ordinary tax rate, which could be in the 33% to 40% range if he or she is a high earner. For most taxpayers, the short-term capital gains tax rate will be 25% or 28%.

## Money Market Funds

Money market funds pay dividends and are offered by nonbank financial institutions, such as mutual funds and stock brokerage houses. Generally, amounts the taxpayer receives from money market funds should be reported as dividends, not as interest.

## Property Inherited Before 2010 and after 2010

The basis of property inherited before 2010 and after 2010 is generally the Fair Market Value (FMV) of the property on the date of the decedent's death. However, this can vary if the personal representative of the estate elects to use an alternate valuation date or other acceptable method. If the taxpayer inherits investment property, his or her gain or loss on any subsequent disposition of such property is generally treated as a long-term gain or loss regardless of how long he or she may have actually held the property. This being the case, the taxpayer is considered to have held the inherited property for more than one year even if he or she disposes of the property within one year of the decedent's death.

## Property Inherited During 2010 (after December 31, 2009, and before January 1, 2011)

Special rules may apply to property inherited from a decedent who died in 2010. Determining the basis of such property can be complex. For more information on the special rules, see Publication 4895 - Tax Treatment of Property Acquired From a Decedent Dying in 2010. Generally, if the taxpayer inherited investment property, his or her capital gain or loss on any later disposition of that property is long-term capital gain or loss. This is true regardless of how long he or she actually held the property.

## Determining the Holding Period

To decide if the taxpayer has held property more than one year, he or she must know how to calculate a one-year period. The first day of the period begins **the day after the day** the taxpayer acquired the asset. The last day of the period **includes the day** on which the taxpayer disposes of the asset. For example, if the taxpayer bought an asset on June 19, 2017, the first day of the period is June 20. If the taxpayer sells the asset on June 19, 2018, this is a short-term asset. The taxpayer did not have it for **more than** one year. If the taxpayer sells the asset on June 20, 2018, that is now more than one year and the asset was held long-term.

If a taxpayer inherits property, he or she is considered to have held the property longer than 1 year, regardless of how long he or she actually held it.

## Calculating Capital Gains and Losses – Netting Process

The calculation of capital gains and losses is usually reported on a Schedule D through a so-called netting process. In general, here's how it's done:

1. First net the short-term (assets held one year or less) capital gain property with the short-term capital loss property. This is done by adding together all of the capital transactions involving short-term property gain, with all of the capital transactions involving short-term property losses. Subtract the total amount of short-term capital losses from the total amount of short-term capital gains. This will result in either a net short-term capital loss or a net short-term capital gain. Report it in Part I of Form 8949.
2. Follow the same step as we did above for all long-term capital property transactions. This will result in either a net long-term capital gain or a net long-term capital loss. Report it in Part II of Form 8949.

3. Now, net the total short-term and long-term transactions together. This will result in a net capital gain or a net capital loss. (Schedule D (Form 1040), line 15).

## Tax on Capital Gains - Individuals (After May 5, 2003)

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 called the maximum capital gain rates. The term net capital gain means the amount by which the net long-term capital gain for the year is more than the net short-term capital loss. (32)

| IF net capital gain is from ... | Maximum capital gain rate is ... |
|---|---|
| A collectibles gain includes a work of art, rug, antique, metal (such as gold, silver, and platinum bullion), gem, stamp, coin, bullion or alcoholic beverage held more than 1 year and gain from sale of an interest in a partnership, S corporation, or trust due to unrealized appreciation of collectibles. | 28% |
| An eligible gain on qualified small business stock minus the Section 1202 exclusion. | 28% |
| An unrecaptured Section 1250 gain. | 25% |

Table 2-11 - IRS Publication 550 - Table 4-4: What is Your Maximum Capital Gain Rate? (2018)

The rates apply when a taxpayer is computing the income tax under the Alternative Minimum Tax (AMT).

Qualified dividends are the ordinary dividends subject to the same 0%, 15%, or 20% maximum tax rate that applies to net capital gain. Net short-term capital gains are subject to taxation at the ordinary income tax rate. These capital gains rates apply to individuals, and also apply when a taxpayer is computing the income tax under the Alternative Minimum Tax. Again, a capital asset must be held more than 12 months in order for the realized gain to be classified as a long-term capital gain. To help calculate the tax on Capital Gains (and Qualifying Dividends) the IRS provides a Qualified Dividends and Capital Gain Tax Worksheet. (33)

## Holding Period of Stock for Purposes of Claiming a Qualified Dividend

To qualify for lower rates, investors are required to hold the stock from which the dividend is paid for more than 60 days in the 121-day period beginning 60 days before ex-dividend date. In the case of preferred stock, investors must have held the stock more than 90 days during the 181-day period that begins 90 days before the ex-dividend date if the dividends are due to periods totaling more than 366 days. If the preferred dividends are due to periods totaling less than 367 days, the holding period in the preceding paragraph applies. (33)

## Capital Loss Deduction

If the taxpayer ends up with a net capital loss for the year, not only is it deductible, it must be deducted. This is true even if he or she does not have enough other ordinary income (such as wages, interest, dividends, etc.) to offset the net capital loss. The maximum amount of net capital loss that an individual can deduct is $3,000 per year, or $1,500 if filing status is married filing separately. The taxpayer's allowable capital loss deduction, figured on Schedule D (Form 1040), is the lesser of: (32)

- $3,000 ($1,500 if he or she is married and file a separate return).
- His or her total net loss as shown on line 16 of Schedule D (Form 1040).

The taxpayer can use his or her total net loss to reduce his or her income dollar for dollar, up to the $3,000 limit.

What if the net capital loss is more than $3,000 for the year? Then the taxpayer may carry the excess amount of the loss over to next year's tax return. The taxpayer will continue this carryover process until all of the net capital losses are finally deducted. When the taxpayer carries over a loss, it retains its original character as either a net long-term or a net short-term loss.

A short-term loss carried over to next year is added to short-term losses that may have occurred in that next year. Likewise, long-term losses carried over to next year are added to long-term losses that may have been incurred in that following year. This means that a long-term loss that is carried over to next year must first be used to reduce any long-term gains in that next year. The same is true for carried over short-term losses.

Long-term items are netted separately from short-term items. To figure the taxpayer's total net gain or loss, combine his or her net short-term capital gain or loss from Schedule D, line 7 with his or her net long-term capital gain or loss from Schedule D, line 15. Enter the result on Schedule D (Form 1040), Part III, line 16.

# Credits

## Child and Dependent Care Credit

The American Taxpayer Relief Act made the Child and Dependent Care Credit permanent. The Dependent Care credit is also an important tax credit that may be worth up to $1,050 or 35% of $3,000 of eligible expenses in 2018. For two or more qualifying dependents, the taxpayer can claim up to 35% of $6,000 (or $2,100) of eligible expenses. For higher income earners, the credit percentage is reduced, but not below 20%, regardless of the amount of adjusted gross income. A taxpayer's child and dependent care expenses must be for the care of one or more qualifying persons. A qualifying person is: (34)

- A taxpayer's qualifying child who is his or her dependent and who was under age 13 when the care was provided.
- A spouse who was not physically or mentally able to care for himself or herself and lived with the taxpayer for more than half the year.
- A person who was not physically or mentally able to care for himself or herself, lived with the taxpayer for more than half the year, and either:
    - Was his or her dependent.
    - Would have been his or her dependent except that:
        - He or she received gross income above annual threshold level.
        - He or she filed a joint return.
        - He or she, or his or her spouse if filing jointly, could be claimed as a dependent on someone else's 2018 return.

An expense is not considered work-related merely because the taxpayer had it while he or she was working. The purpose of the expense must be to allow him or her to work. Whether the taxpayer's expenses allow him or her to work or look for work depends on the facts.

## Adoption Credit

The American Taxpayer Relief Act of 2012 (H.R.8) passed on January 2, 2013 permanently extended the Adoption Credit and the adoption assistance programs for tax years beginning after December 31, 2012. Tax benefits for adoption include both a tax credit for qualified adoption expenses paid to adopt an eligible child and an exclusion for employer-provided adoption assistance. The credit is nonrefundable, which means it is limited to the taxpayer's tax liability for the year. The maximum amount (dollar limit) for 2018 is $13,810 per child. For both the credit and the exclusion, qualified adoption expenses, defined in section 23(d)(1) of the Code, include: (35)

- Reasonable and necessary adoption fees,
- Court costs and attorney fees,
- Traveling expenses (including amounts spent for meals and lodging while away from home), and
- Other expenses that are directly related to and for the principal purpose of the legal adoption of an eligible child.
- An eligible child is an individual who is under the age of 18, or is physically or mentally incapable of self-care.

An eligible child is an individual who is under the age of 18, or is physically or mentally incapable of self-care.

Qualified adoption expenses do not include: (35)

- Expenses for which the taxpayer received funds under any state, local, or Federal program.
- Expenses that violate state or Federal law.
- Expenses for carrying out a surrogate parenting arrangement.
- Expenses for the adoption of a taxpayer's spouse's child.
- Expenses paid or reimbursed by a taxpayer's employer or any other person or organization.
- Expenses allowed as a credit or deduction under any other provision of Federal income tax law.

If the taxpayer is filing Form 8839 - Qualified Adoption Expenses, he or she cannot file the income tax return and Form 8839 electronically. The taxpayer must file a paper return. Mail the return to the address listed in the tax return instructions. (35)

The credit and exclusion are each subject to an income limitation and a dollar limitation. The income limit on the adoption credit or exclusion is based on taxpayer's modified adjusted gross income (MAGI). For tax year 2018, the MAGI phase-out begins at $207,140 and ends at $247,140. Thus, if the taxpayer's MAGI amount is below $207,140 for 2018, his or her credit or exclusion will not be affected by the MAGI phase-out but if the taxpayer's MAGI amount for 2018 is above $247,140, his or her credit or exclusion will be zero.

The taxpayer should reduce the dollar limit for a particular year by the amount of qualified adoption expenses used in the previous years for the same adoption effort. Also, when computing the dollar limitation, qualified adoption expenses paid and claimed in connection with an unsuccessful domestic adoption effort must be combined with qualified adoption expenses paid in connection with a subsequent domestic adoption attempt, whether or not the subsequent attempt is successful.

The dollar limitation applies separately to both the credit and the exclusion, and the taxpayer may be able to claim both the credit and the exclusion for qualified expenses. However, he or she must claim any allowable exclusion before claiming any allowable credit. Expenses used for the exclusion reduce the amount of qualified adoption expenses available for the credit. As a result, the taxpayer cannot claim both a credit and an exclusion for the same expenses.

Because the adoption credit is not refundable after 2011, the taxpayer may be able to carry-forward any unused credit amounts to future tax years. The 2018 Form 8839 and its instructions will have information on the credit carry-forward. (35)

## Earned Income Tax Credit

The Protecting Americans from Tax Hikes Act of 2015 made the Earned Income Tax Credit (EITC) permanent. The bill contained provisions that include an increased amount for families with three or more children and an increased phase-out range for married taxpayers filing jointly. The phase-out range is indexed for inflation for years after 2015.

For tax year 2018, the maximum Earned Income Tax Credit (EITC) for low and moderate-income workers and working families rises to $6,431, up from $6,318 in 2017. The EITC is a refundable tax credit for certain people who work and have earned income under $54,884. The credit varies by family size, filing status and other factors, with the maximum credit going to joint filers with three or more qualifying children. The maximum amount of income a taxpayer can earn and still get the credit has increased: (36)

- Taxpayer has three or more qualifying children and he or she earned less than $49,194 ($54,884 if married filing jointly).
- Taxpayer has two qualifying children and he or she earned less than $45,802 ($51,492 if married filing jointly).
- Taxpayer has one qualifying child and he or she earned less than $40,320 ($46,010 if married filing jointly).
- Taxpayer does not have a qualifying child and he or she earned less than $15,270 ($20,950 if married filing jointly).

For tax year 2018 the maximum Earned Income Tax Credit is: (36)

- $6,431 with three or more qualifying children.
- $5,716 with two qualifying children.
- $3,461 with one qualifying child.
- $519 with no qualifying children.

The maximum amount of investment income a taxpayer can have and still get the credit has increased to $3,500. Therefore, for 2018, a taxpayer can use Form 1040EZ - Income Tax Return for Single and Joint Filers With No Dependents when claiming the Earned Income Tax Credit (EITC) only if he or she does not have a qualifying child and his or her investment income is less than $3,500. The taxpayer should use Publication 596 - Earned Income Tax Credit (EITC) to determine eligibility.

The qualifying child must have specific relationships (i.e. son, daughter, stepchild, etc.) with the taxpayer to satisfy the relationship test. For the residency test, the child must have the same principal place of abode, which must be located within the United States, for more than one-half of the year. For the age test, the child must be either under the age of 19 at the end of the calendar year, or a full-time student under the age of 24 at the end of the calendar year, or permanently and totally disabled at any time during the tax year.

The credit is based on earned income, which includes all wages, salaries, tips, and other employee compensation, plus the amount of the taxpayer's net earnings from self-employment (determined with regard to the deduction for one-half of self-employment taxes). Earned income is determined without regard to community property laws. Earned income does not include: (131)

- Interest and dividends.
- Welfare benefits.
- Veterans' benefits.
- Pensions or annuities.
- Alimony and child support.
- Social Security benefits.
- Workers' compensation.
- Unemployment compensation.
- Taxable scholarships or fellowships that are not reported on Form W-2.

Paid preparers must complete Form 8867 - Paid Preparer's Due Diligence Checklist when filing Federal income tax returns or claims for refund involving the EITC. Paid preparers must meet due diligence requirements in determining the taxpayer's eligibility for, and the amount of, the EITC. Failure to do so could result in a $520 penalty for each failure in 2018. The penalty was $510 per return, however, the IRS adjusted the penalty for taxable year returns beginning in 2015 for cost of living.

## Retirement Savings Contributions Credit (Saver's Credit)

A taxpayer can claim the credit for 50%, 20% or 10% of the first $2,000 ($4,000 if married filing jointly) contributed during the year to a retirement account. Therefore, the maximum credit amounts that can be claimed are $1,000, $400 or $200 per person. The maximum credit a married couple filing jointly can claim together is $2,000. The applicable percentage is determined by the taxpayer's filing status and adjusted gross income (AGI).

The credit may be used against the taxpayer's regular and alternative minimum tax liability. For 2018, the maximum applicable percentage is 50%, which is completely phased out when AGI exceeds $63,000 for joint filers, $47,250 for head of household filers, and $31,500 for single and married filing separately filers. (37)

The applicable percentage is the percentage as determined in accordance with the following table:

| 2018 Saver's Credit AGI Thresholds | | | | | | |
|---|---|---|---|---|---|---|
| Joint Return | | Head of Household | | Single or Married Filing Separately | | Credit Rate |
| Over | Not Over | Over | Not Over | Over | Not Over | |
| $0 | $38,000 | $0 | $28,500 | $0 | $19,000 | 50% |
| $38,000 | $41,000 | $28,500 | $30,750 | $19,000 | $20,500 | 20% |
| $41,000 | $63,000 | $30,750 | $47,250 | $20,500 | $31,500 | 10% |
| $63,000 | ----- | $47,250 | ------ | $31,500 | ---- | 0% |

Table 2-12 - Retirement Savings Contributions Credit (Saver's Credit) (2018)

## American Opportunity Tax Credit

The American Opportunity Tax Credit (AOC) modifies the existing Hope Scholarship Credit. The AOC makes the Hope Credit available to a broader range of taxpayers, including many with higher incomes and those who owe no tax. It also adds required course materials to the list of qualifying expenses and allows the credit to be claimed for four post-secondary education years instead of two. Many of those eligible will qualify for the maximum annual credit of $2,500 per student.

The Protecting Americans from Tax Hikes Act of 2015 made the American Opportunity Tax Credit permanent. The bill also adds a provision barring individuals from claiming the credit for 10 years if they fraudulently claim the credit and for two years if they are found to have claimed the credit with reckless or intentional disregard of the rules.

The American Opportunity Tax Credit is a partially refundable tax credit for undergraduate college education expenses. This credit provides up to $2,500 in tax credits on the first $4,000 of qualifying educational expenses. The amount of the American Opportunity tax credit is comprised of:

- 100% of the first $2,000 in qualifying education expenses, plus
- 25% of the next $2,000 in qualifying expenses.

Thus, the taxpayer's maximum credit could be $2,500 based on $4,000 in qualifying expenses. Also, a taxpayer's modified adjusted gross income (AGI) in excess of $80,000 ($160,000 for a joint return) is used to determine a reduction in the amount of the American Opportunity Tax Credit. The credit is completely phased out and not available for taxpayers with AGI of $90,000 ($180,000 for joint filers).

Up to 40% of the American Opportunity credit is refundable. Therefore, up to $1,000 of the American Opportunity Tax Credit can be refunded to a taxpayer, even if his or her tax liability is zero. This potential refund could make the American Opportunity Tax Credit more valuable than the Lifetime Learning Credit, which is non-refundable.

### Lifetime Learning Credit

The Lifetime Learning Credit equals 20% of adjusted qualified education expenses, up to a maximum of $10,000 of adjusted qualified education expenses per return. Therefore, the maximum Lifetime Learning Credit the taxpayer can claim on his or her return for the year is $2,000, regardless of the number of students for whom he or she paid qualified education expenses. The amount of the taxpayer's credit for 2018 is gradually reduced (phased out) if his or her modified adjusted gross income (MAGI) is between $57,000 and $67,000 ($114,000 and $134,000 if he or she files a joint return). The taxpayer cannot claim a credit if his or her MAGI is $67,000 or more ($134,000 or more if he or she files a joint return).

In general, qualified tuition and related expenses for the education tax credits include tuition and required fees for the enrollment or attendance at eligible post-secondary educational institutions (including colleges, universities and trade schools). The expenses paid during the tax year must be for: an academic period that begins in the same tax year or an academic period that begins in the first three months of the following tax year. The taxpayer cannot claim the Lifetime Learning Credit for any student if he or she claims the American Opportunity Credit for that student for the same tax year.

# Important Filing Topics

### Tax Withholding

The Federal income tax is a "pay-as-you-go" tax. There are two ways to pay-as-you-go. The first is withholding. If the taxpayer is an employee, his or her employer probably withholds income tax from his or her pay. Tax may also be withheld from certain other income - including pensions, bonuses, commissions, and gambling winnings. In each case, the amount withheld is paid to the IRS in the taxpayer's name. See Publication 17 - Chapter 4 - Tax Withholding and Estimated Tax for complete information.

The Tax Cuts and Jobs Act (TCAJ) made some changes to the tax law. Following those, it is especially important for certain people to make sure they have the right amount of withholding in 2018. These groups are:

- Two-income families.
- People working two or more jobs or who only work for part of the year.
- People with children who claim credits such as the Child Tax Credit.
- People with older dependents, including children age 17 or older.
- People who itemized deductions in 2017.
- People with high incomes and more complex tax returns.
- People with large tax refunds or large tax bills for 2017.

The amount of income tax the employer withholds from regular pay depends on two things: (38)

- The amount the taxpayer earns.
- The information the taxpayer gives his or her employer on Form W-4 - Employee's Withholding Allowance Certificate.

Form W-4 includes three types of information that the employer will use to figure the withholding: (38)

- Whether to withhold at the single rate or at the lower married rate.
- How many withholding allowances the taxpayer claims. (Each allowance reduces the amount withheld.)
- Whether the taxpayer wants an additional amount withheld.

The taxpayer must specify a filing status and a number of withholding allowances on Form W-4. He or she cannot specify only a dollar amount of withholding.

If the taxpayer claims an exemption from withholding, his or her employer will not withhold Federal income tax from his or her wages. The exemption applies only to income tax, not to Social Security or Medicare tax. The taxpayer can claim exemption from withholding for the current year only if both the following situations apply.

1. For the prior year, the taxpayer had a right to a refund of all Federal income tax withheld because he or she had no tax liability.
2. For the current year, the taxpayer expects a refund of all Federal income tax withheld because he or she expects to have no tax liability.

If the taxpayer is a student, he or she is not automatically exempt. If he or she works only part time or only during the summer, he or she may qualify for exemption from withholding.

## Estimated Tax Payments

The second pay-as-you-go method is estimated tax payments. Estimated tax is the method used to pay tax on income that is not subject to withholding. This includes income from self-employment, interest, dividends, alimony, rent, gains from the sale of assets, prizes and awards. The taxpayer may also have to pay estimated tax if the amount of income tax being withheld from his or her salary, pension, or other income is not enough. (39)

Estimated tax is used to pay income tax and self-employment tax, as well as other taxes and amounts reported on the tax return. If the taxpayer does not pay enough through withholding or estimated tax payments, he or she may be charged a penalty. If the taxpayer does not pay enough by the due date of each payment period he or she may be charged a penalty even if he or she is due a refund when the tax return is filed. U.S. citizens with no tax liability in the previous full 12-month tax year are not required to pay estimated tax. Estimated tax liability exists for 2018 when both of the following apply: (39)

1. The taxpayer expects to owe at least $1,000 in tax for 2018, after subtracting his or her withholding and refundable credits.
2. The taxpayer expects his or her withholding plus his or her refundable credits to be less than the smaller of either:
    a. 90% of the tax to be shown on the taxpayer's 2018 tax return
    b. 100% of the tax shown on the taxpayer's 2017 tax return (there are special rules for farmers, fishermen, and higher income taxpayers). The taxpayer's 2017 tax return must cover all 12 months.

If the taxpayer is filing as a sole proprietor, partner, S corporation shareholder, and/or a self-employed individual, he or she generally will have to make estimated tax payments if he or she expects to owe tax of $1,000 or more when filing the return. If the taxpayer is filing as a corporation he or she generally has to make estimated tax payments for the corporation if he or she expects it to owe tax of $500 or more when filing its return.

Generally, the taxpayer will not have to pay estimated tax for 2018 if any of the following conditions apply: (39)

- The total of his or her withholding and estimated tax payments was at least as much as his or her 2017 tax (or 110% of his or her 2017 tax if his or her adjusted gross income (AGI) was more than $150,000, $75,000 if his or her 2018 filing status is married filing separately) and he or she paid all required estimated tax payments on time.

- The tax balance due on his or her 2018 return is no more than 10% of his or her total 2018 tax, and he or she paid all required estimated tax payments on time.
- His or her total 2018 tax minus his or her withholding and refundable credits is less than $1,000.
- He or she did not have a tax liability for 2017 and his or her 2017 tax year was 12 months.
- He or she did not have any withholding taxes and his or her current year tax less any household employment taxes is less than $1,000.

When figuring the estimated tax for the current year, it may be helpful to use the taxpayer's income, deductions, and credits for the prior year as a starting point. Use the worksheet in Form 1040-ES - Estimated Tax for Individuals to figure the estimated tax. It is important to remember to make adjustments both for changes in the taxpayer's work situation and for recent changes in the tax law. See Publication 17 - Chapter 4 - Tax Withholding and Estimated Tax for complete information.

For estimated tax purposes, the year is divided into four payment periods. Each period has a specific payment due date. If the taxpayer does not pay enough tax by the due date of each of the payment periods, he or she may be charged a penalty even if he or she is due a refund when the taxpayer files the income tax return. 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. The penalty may also be waived if: (39)

- The failure to make estimated payments was caused by a casualty, disaster, or other unusual circumstance and it would be inequitable to impose the penalty.
- The taxpayer 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.

As of January 1, 2013, a Net Investment Income Tax (NIIT) applies at a rate of 3.8% to individuals, estates, and trusts that have certain investment income above threshold amounts. When calculating the 2018 estimated tax payments, the taxpayer may need to take account of any additional tax liability associated with the NIIT.

# Paying the Tax

## Balance Due Returns

Taxpayers who owe additional tax must pay their balances due by the original due date of the return or be subject to interest and penalties. An extension of time to file may be filed electronically by the original return due date, but it is an extension of time to file the return, not an extension of time to pay a balance due. Providers should inform taxpayers of their obligations and options for paying balances due. Taxpayers have several choices when paying any taxes owed on their returns as well as estimated tax payments. The taxpayer is considered to have reasonable cause for the period covered by an automatic extension if at least 90%of the current tax year's actual tax liability is paid before the regular due date of the return through withholding, estimated tax payments, or payments made with Form 4868.

## Electronic Funds Withdrawal

Taxpayers can e-file and, at the same time, authorize an electronic funds withdrawal (EFW). Taxpayers who choose this option must provide account numbers and routing transit numbers for qualified savings, checking or share draft accounts to the Provider. The IRS tax return instructions describe how to find and identify these numbers. Providers should encourage their clients to confirm their account numbers and routing transit numbers with their financial institution. If a financial institution is unable to locate or match the numbers entered in a payment record with account information they have on file for a given taxpayer, they reject (return) the direct debit request.

Taxpayers can schedule a payment for withdrawal on a future date. Scheduled payments must be effective on or before the return due date. For example, the Provider may transmit an individual income tax return in March and the taxpayer can specify that the withdrawal be made on any day on or before the return due date. The taxpayer does not have to remember to do anything at a later date. For returns transmitted after the due date, the payment date must be the same as the date the Provider transmitted the return. The taxpayer must authorize EFW payments by completion of a payment record at the time the balance due return or form is e-filed.

Taxpayers can make payments by EFW for the following:

- Current year - Form 1040 series return.
- *Form 4868 - Application for Automatic Extension of Time to File U.S. Individual Income Tax Return.*
- *Form 2350 - Application for Extension of Time to File U.S. Income Tax Return for Citizens and Resident Aliens Abroad Who Expect to Qualify for Special Tax Treatment.*
- *Form 1040-ES - Estimated Tax for Individuals* (Taxpayers can make up to four estimated tax payments at the time that they electronically file the Form 1040 series return).

Providers should be careful to ensure that all the information needed for the EFW request is included with the return.

## Penalty for Underpayment

If the taxpayer did not pay enough tax, either through withholding or by making timely estimated tax payments, he or she will have underpaid his or her estimated tax and may have to pay a penalty. Because the penalty is figured separately for each payment period, the taxpayer may owe a penalty for an earlier payment period even if he or she later paid enough to make up the underpayment. This is true even if the taxpayer is due a refund when he or she files his or her income tax return.

The taxpayer will owe a penalty for any 2018 payment period for which his or her estimated tax payment plus his or her withholding for the period and overpayments for previous periods was less than the smaller of: (40)

- 22.5% of his or her 2018 tax.
- 25% of his or her 2017 tax. (The taxpayer's 2017 tax return must cover a 12-month period.)

If the taxpayer thinks he or she owes the penalty, but does not want to figure it when he or she files the tax return, the taxpayer may not have to. Generally, the IRS will figure the penalty for him or her and send a bill. The taxpayer only needs to figure his or her penalty in the following three situations: (40)

- The taxpayer is requesting a waiver of part, but not all, of the penalty.
- The taxpayer is using the annualized income installment method to figure the penalty.
- The taxpayer is treating the Federal income tax withheld from his or her income as paid on the dates actually withheld.

However, if these situations do not apply to the taxpayer, and he or she thinks he or she can lower or eliminate his or her penalty, complete Form 2210 - Underpayment of Estimated Tax by Individuals, Estates, and Trusts or Form 2210-F - Underpayment of Estimated Tax by Farmers and Fishermen and attach it to the return.

## Electronic Federal Tax Payment System (EFTPS)

Electronic Federal Tax Payment System (EFTPS) is a system for paying Federal taxes electronically using the Internet, or by phone using the EFTPS Voice Response System. EFTPS is offered free by the U.S. Department of Treasury. Once enrolled, individual and business taxpayers can use the internet to make all their Federal tax payments or via the phone using the EFTPS Voice Response System. Both payment methods are interchangeable. (41)

## Debit or Credit Card

A taxpayer can pay by debit or credit card whether he or she e-files, paper files or is responding to a bill or notice. The IRS uses standard service providers and commercial card networks. (42)

- The payment will be processed by a payment processor who will charge a processing fee, which may be tax deductible. The fees vary by service provider.
- The taxpayer's information will only be used to process the payment.
- No part of the service fee goes to the IRS.
- The types of payments (Individual or Business) and limits on how many debit or credit card payments a taxpayer can make in a year, quarter, or month, vary according to the type of tax he or she is paying.

When a taxpayer is using a debit or credit card for payment, keep in mind these additional considerations: (42)

- High balance payments of $100,000 or greater may require special coordination with the service provider chosen.
- The taxpayer cannot make Federal tax deposits with a debit or credit card.
- The taxpayer cannot get an immediate release of a Federal Tax Lien by making a debit or credit card payment.
- Making an electronic payment eliminates the need to use a voucher.
- On the monthly debit or credit card statement, the payment to the IRS will be listed as "United States Treasury Tax Payment." The convenience fee paid to the service provider will be listed as "Tax Payment Convenience Fee" or something similar.
- If the taxpayer made an overpayment, IRS will refund it after the return is processed, except in circumstances such as offsets or debt on the account.

## Check or Money Order

If the taxpayer chooses to mail the tax payment: (43)

- Make the check, money order or cashier's check payable to U.S. Treasury. Enter the amount on the check using all numbers ($###.##), and do not use staples or paper clips to affix a payment to a voucher or return.
- Include the taxpayer's name, address, daytime phone number, Social Security number (the SSN shown first if it's a joint return) or employer identification number, tax period and related tax form or notice number on the form of payment.
- Mail the payment to the address listed on the notice or instructions.

The taxpayer should not send cash through the mail. Check the services provided at the local IRS office to see if cash payments are accepted.

## Cash Payment Option

The Internal Revenue Service announced a new payment option for individual taxpayers who need to pay their taxes with cash. In partnership with ACI Worldwide's OfficialPayments.com and the PayNearMe Company, individuals can now make a payment without the need of a bank account or credit card at over 7,000 7-Eleven stores nationwide.

Individuals wishing to take advantage of this payment option should visit the IRS.gov payments page, select the "Cash" option in the "Other Ways You Can Pay" section and follow the instructions:

- Taxpayers will receive an email from OfficialPayments.com confirming their information.
- Once the IRS has verified the information, PayNearMe sends the taxpayer an email with a link to the payment code and instructions.
- Individuals may print the payment code provided or send it to their smart phone, along with a list of the closest 7-Eleven stores.
- The retail store provides a receipt after accepting the cash and the payment usually posts to the taxpayer's account within two business days.
- There is a $1,000 payment limit per day and a $3.99 fee per payment.

Because PayNearMe involves a three-step process, the IRS urges taxpayers choosing this option to start the process well ahead of the tax deadline to avoid interest and penalty charges. PayNearMe is currently available at participating 7-Eleven stores in 34 states. Most stores are open 24 hours a day, seven days a week.

## Installment Agreements

For the taxpayer(s) who cannot pay the entire balance due by April 15, the IRS also has the authority to enter into a written agreement with the taxpayer, allowing for periodic partial payments of any taxes owed, if such an agreement would facilitate the collection of all taxes due. An installment agreement allows the taxpayer to make a series of monthly payments over time.

The IRS offers various options for making monthly payments, such as: (44)

- Direct debit from a bank account.

- Payroll deduction from an employer.
- Payment via check or money order.
- Payment by Electronic Federal Tax Payment System (EFTPS).
- Payment by credit card via phone or Internet.
- Payment by Online Payment Agreement (OPA).

The taxpayer may request a pre-assessment installment agreement on current tax liabilities by using the Online Payment Agreement (OPA) application on the www.irs.gov website. The taxpayer may also submit Form 9465 - Installment Agreement Request, or attach a written request for a payment plan to the front of the return.

The IRS has revised the user fee schedule for installment agreements. The new fee schedule applies to installment agreements entered into, restructured or reinstated on or after January 2, 2017. The final regulations increase the existing user fees (except for low-income taxpayers) and create two new types of online installment agreements, each subject to a separate fee. Five of these rates are based on the full cost of establishing and monitoring installment agreements, while the sixth rate is for low-income taxpayers.

The new fees are:

1. A top rate of $225 applies to taxpayers who enter into installment agreements in person, over the phone, by mail, or by filing Form 9465 - Installment Agreement Request, with the IRS. This includes taxpayers requesting installment agreements with their e-filed returns.
2. A reduced rate of $107 applies to a direct debit agreement.
3. A taxpayer who sets up an installment agreement through IRS.gov and agrees to make payments either by mailing a check or through the Electronic Federal Tax Payment System (EFTPS) will pay $149.
4. A taxpayer who sets up an installment agreement online and agrees to make automatic payments through direct debit will pay a $31 fee.
5. The fee for a restructured/reinstated installment agreement is $89.
6. A low-income taxpayer pays a $43 fee, when setting up any type of installment agreement, other than a direct debit online payment agreement or when restructuring or reinstating any installment agreement.

Taxpayers with income at or below 250% of the Department of Health and Human Services poverty guidelines may apply for a reduced user fee of $43.

The IRS Form 1040 V Payment Voucher should be completed and sent in with the payment with a tax return having a balance due to the IRS. Taxpayer(s) must simply fill in the amount he or she is paying, their name, address and Social Security number(s).

The IRS can deny the request, and a request cannot be made if the taxpayer is already making payments on an existing installment agreement.

## IRS Direct Pay

IRS Direct Pay is a payment application that allows individual taxpayers with a valid Social Security number to make IRS payments directly from their checking or savings accounts. It is free, secure and provides an electronic payment confirmation while reducing processing costs. IRS Direct Pay currently only accepts 1040 series payments, including the 4868 (1040 Extension) and the 1040-ES (1040 Estimated Tax). Beginning in April, Direct Pay will also accept Form 5329 payments and Shared Responsibility payments. Other form types may be added in the future.

The taxpayer must have a valid Social Security number (SSN) to use this application. This application cannot accommodate Individual Taxpayer Identification Numbers (ITINs).

Taxpayers receive instant confirmation that the payment has been submitted, and the system is available 24 hours a day, 7 days a week. Bank account information is not retained in any IRS systems after payments are completed. IRS Direct Pay also offers 30-day advance payment scheduling, payment rescheduling or cancellations, and a payment status search. Future plans include an option for e-mailed payment confirmation, a Spanish version and one-time registration with a login and password to allow quick access on return visits.

The taxpayer can only submit one payment at a time using IRS Direct Pay. Alternatively, if he or she is making a payment against an installment agreement, the taxpayer should consider using the Online Payment Agreement application to set up recurring payments.

The taxpayer's payment takes two business days to process, and payments submitted after 8 p.m. eastern will begin processing the next business day. If the taxpayer's payment is returned, he or she will receive a payment return notice in the mail notifying him or her to resubmit his or her payment.

IRS Direct Pay requires a U.S. bank routing number (ABA). This nine-digit number is generally printed on checks or is available from the taxpayer's bank. If he or she has an account with an international bank that has a U.S. affiliate, the bank may be able to provide the routing number. Please note that IRS Direct Pay does not accept SWIFT codes.

# Refunds

Taxpayers have three options for receiving their individual Federal income tax refund: (45)

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

If the taxpayer chooses to receive his or her refund by direct deposit, he or she can request that the refund be deposited in up to three separate accounts, such as checking, savings, or retirement accounts – just complete Form 8888 - Allocation of Refund (Including Savings Bond Purchases).

However, if the taxpayer files Form 8379 - Injured Spouse Allocation, he or she cannot have his or her refund direct-deposited into more than one account. The refund should only be deposited directly into accounts that are in the taxpayer's own name, his or her spouse's name or both if it's a joint account. Please note that to receive the refund by direct deposit (whether into one account or more) the total refund amount must be $1.00 or more.

Providers should caution taxpayers that some financial institutions do not permit the deposit of joint individual income tax refunds into individual accounts. The IRS is not responsible if the financial institution refuses Direct Deposit for this reason. Check or share draft accounts that are "payable through" another institution may not accept Direct Deposit. Taxpayers should verify their financial institution's Direct Deposit policy before they elect the Direct Deposit option.

In an effort to combat fraud and identity theft, new IRS procedures that were 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.

If the taxpayer files a complete and accurate tax return, the refund should be issued within 21 days of the received date. This time-frame does not include mail and IRS handling time for paper returns. Even though the IRS issues most refunds in less than 21 days, it's possible the tax return may require review and take longer.

# Filing Dates

The annual income tax return for individuals is due by the 15th day of the fourth month after the close of the tax year, usually April 15th. However, when the 15th falls on a weekend (Saturday or Sunday) or a holiday, the due date becomes the next regular working day. Therefore, if the 15th happened to be Saturday, the return would be due on Monday, April 17th. Most individuals, sole proprietorships, and single-member LLCs will have until **Monday, April 15, 2019** to file their income tax return for the 2018 tax year. Note that this also affects the deadline for the first installment payment of estimated income tax.

If the individual taxpayer uses a fiscal year, the return is due the 15th day of the fourth month after the close of the fiscal year. For example, if the fiscal year ends June 30, his or her tax return due date would be October 15.

If the taxpayer is a U.S. citizens or resident alien abroad and files on a fiscal year basis (a year ending on the last day of any month except December), the due date is 3 months and 15 days after the close of the fiscal year. If the taxpayer is a U.S. citizen or resident alien residing overseas, or is in the military on duty outside the U.S., on the regular due date of the return, he or she is allowed an automatic 2-month extension to file the return and pay any amount due without requesting an extension. For a calendar year return, the automatic 2-month extension is to June 15.

If individuals, sole proprietorships, and single-member LLCs file for an extension, their return is due October 15, 2019. Special rules may apply if an individual taxpayer is in the military or lives outside the U.S.

Generally, a corporation must file its income tax return by the 15th day of the 4th month after the end of its tax year. A new corporation filing a short-period return must generally file by the 15th day of the 4th month after the short period ends. A corporation that has dissolved must generally file by the 15th day of the 4th month after the date it dissolved. A corporation can file Form 7004 - Application for Automatic Extension of Time To File Certain Business Income Tax, Information, and Other Returns, to request a 6-month extension of time to file. Generally, the corporation must file Form 7004 by the regular due date of the return.

Partnership tax returns, filed on Form 1065, must be filed by the 15th day of the third month after the tax year end date. For most partnership returns, that's March 15. The earlier deadline gives partners a chance to receive Schedule K-1's before the personal tax return due date. The S corporation extension deadline is September 15.

S corporation tax returns, filed on Form 1120S, must be filed by the 15th day of the third month after the tax year end date. For most S corp returns, that's March 15. The extension deadline for an S corp return September 15.

If the return is mailed, it must be placed in the mail and postmarked on or before the due date. The practice of filing sooner is encouraged by the IRS. Generally, the earliest possible date is January 1, although few, if any, taxpayers are in a position to file this soon. Employees, for example, must wait for Form W-2 to be issued by the employer. The tax law allows the employer until January 31 to prepare and issue the necessary Forms 1099 or W-2 for the previous year. If the taxpayer anticipates a refund, the sooner the tax return is filed, the sooner results can be expected. Because of the increased workload of the IRS as April 15 approaches, an early filing of a return means that a refund will be processed in less time.

If a taxpayer sends his or her return by registered or certified mail, the date of the filing is the postmark date. The registration receipt is evidence that the return was filed on the postmarked date. If a taxpayer sends a return by certified mail and has a receipt postmarked by a postal employee, the date on the receipt is the postmark date. The postmarked certified mail receipt is evidence that the return was delivered and postmarked on the date stamped by the United States Post Office. Most returns are filed at regional centers geographically dispersed across the United States. The address of the Internal Revenue Service Office serving the states in which the taxpayer lives can be found in the instructions to Form 1040.

## Extensions

If the taxpayer is not able to file his or her Federal individual income tax return by the due date, he or she may be able to get an automatic 6-month extension of time to file. To do so, the taxpayer must file Form 4868 - Application for Automatic Extension of Time To File U.S. Individual Income Tax Return by the due date for filing his or her calendar year return (usually April 15) or fiscal year return.

If the taxpayer served or is serving in a combat zone or a contingency operation, or becomes hospitalized resulting from an injury received while serving in such an area or operation, after the end of his or her tax year but before the normal filing due date of his or her return, he or she may have additional time to file and pay taxes. The taxpayer has at least 180 days after he or she leaves the designated combat zone/contingency operation to file and pay taxes. Calculating the extension starts with the day that the taxpayer leaves the combat zone. Then he or she should add 180 days, then he or she adds the number of tax filing days that he or she was in the combat zone (January 1 to April 15). The result is the date that taxpayer's return is due. He or she does not need to file for this extension, but rather note the name of the operation he or she was supporting at the top of the return.

The deadline extension provisions do not only apply to members of the U.S. Armed Forces serving in the combat zone. Unlike the combat zone military pay exclusion, the deadline extensions also apply to individuals serving in the

combat zone in support of the U.S. Armed Forces, such as merchant marines serving aboard vessels under the operational control of the Department of Defense, Red Cross personnel, accredited correspondents, and civilian personnel acting under the direction of the U.S. Armed Forces in support of those forces.

If the taxpayer is a U.S. citizen or resident alien residing overseas, or is in the military on duty outside the U.S., on the regular due date of his or her return, the taxpayer is allowed an automatic 2-month extension to file his or her return and pay any amount due without requesting an extension. For a calendar year return, the automatic 2-month extension is to June 15. If the taxpayer qualifies for this 2-month extension, penalties for paying any tax late are assessed from the 2-month extended due date of the payment (June 15 for calendar year taxpayers).

However, even if the taxpayer is allowed an extension, he or she will have to pay interest on any tax not paid by the regular due date of his or her return (April 15 for calendar year taxpayers). If the taxpayer is unable to file the return by the automatic 2-month extension date, he or she can request an additional extension to October 15 by filing Form 4868 before the automatic 2-month extension date. However, any tax due payments made after June 15 will be subject to both interest charges and failure to pay penalties.

## Interest and Penalties

The late payment penalty is usually ½ of 1% of any tax (other than estimated tax) not paid by April 15, 2018 (not including weekends or holidays). It is charged for each month or part of a month the tax is unpaid. The maximum penalty is 25%. The late payment penalty will not be charged if the taxpayer can show reasonable cause for not paying on time. He or she should attach a statement to the return fully explaining the reason. The taxpayer does not attach the statement to Form 4868.

The taxpayer is considered to have reasonable cause for the period covered by this automatic extension if at least 90% of the total tax on his or her 2018 return is paid on or before the regular due date of his or her return through withholding, estimated tax payments, or payments made with Form 4868 and the remaining balance is paid with his or her return.

A late filing penalty is usually charged if the taxpayer's return is filed after the due date (including extensions). The penalty is usually 5% of the amount due for each month or part of a month the return is late. The maximum penalty is 25%. If the taxpayer's return is more than 60 days late, the minimum penalty is $210 in 2018 (adjusted annually for inflation) or the balance of the tax due on the return, whichever is smaller. The taxpayer might not owe the penalty if he or she has a reasonable explanation for filing late. The taxpayer should attach a statement to the return fully explaining the reason for filing late. The taxpayer does not attach the statement to Form 4868.

The IRS will charge the taxpayer interest on taxes not paid by their due date, even if he or she had an extension of time to file. The IRS will also charge interest on penalties imposed for failure to file, negligence, fraud, substantial valuation misstatements, substantial understatements of tax, and reportable transaction understatements. Interest is charged on the penalty from the due date of the return (including extensions). (46)

If the taxpayer does not pay the additional tax due on Form 1040X within 21 calendar days from the date of notice and demand for payment (10 business days from that date if the amount of tax is $100,000 or more), the penalty is usually ½ of 1% of the unpaid amount for each month or part of a month the tax is not paid. The penalty can be as much as 25% of the unpaid amount and applies to any unpaid tax on the return. This penalty is in addition to interest charges on late payments. The taxpayer will not have to pay the penalty if he or she can show reasonable cause for not paying the tax on time. (46)

If the taxpayer files a claim for refund or credit in excess of the amount allowable, he or she may have to pay a penalty equal to 20% of the disallowed amount, unless the taxpayer can show a reasonable basis for the way he or she treated an item. The penalty will not be figured on any part of the disallowed amount of the claim that relates to the Earned Income Tax Credit or on which accuracy-related or fraud penalties are charged. (46)

In addition to any other penalties, the law imposes a penalty of $5,000 for filing a frivolous return. A frivolous return is one that does not contain information needed to figure the correct tax or shows a substantially incorrect tax because the taxpayer takes a frivolous position or desire to delay or interfere with the tax laws. This includes altering or striking out the preprinted language above the space where the taxpayer signs. (46)

**Review Question 6**

If Brian, a U.S. citizen, uses a fiscal year that ends on July 30 to file his income tax return. His income tax return due date would be what date?

A. January 1
B. January 30
C. April 15
D. November 15

See Review Feedback for answer.

# Review Feedback

Review feedback provides both the answers to each question and an explanation or feedback as to how we arrived at each answer at the end of the lesson. Review feedback also contains evaluative feedback explaining why incorrect answers are wrong. You are also provided the course topic from which we derived our answer and the external source material we used for verification.

If you are using the online version of the course, Ctrl+click on the topic to find the section from which we arrived at the answer for the question. You can also Ctrl+click on the question number to return to the specific review question.

**Question 1 - D. The taxpayer will lose his or her HSA with a job change**
There are three major tax advantages to a taxpayer's Health Saving Account (HSA):

1. Cash contributions to an HSA are 100% deductible from his or her Federal gross income (within legal limits) (Choice A).
2. Interest on savings accumulates tax deferred (Choice B).
3. Withdrawals from an HSA for "qualified medical expenses" are free from Federal income tax (Choice C).

Also, the taxpayer's HSA can follow him or her as he or she changes employment therefore Choice D is false and the correct answer.

Topic - Health Savings Account (HSA)
Source - Publication 969 - Health Savings Accounts and Other Tax-Favored Health Plans

**Question 2 - A. $0**
To qualify for the unlimited exclusion for qualified education expenses, the taxpayer must make a direct payment to the educational institution for tuition only. Books, supplies and living expenses do not qualify. If the taxpayer wants to pay for books, supplies and living expenses in addition to the unlimited education exclusion, he or she can make a 2018 gift of $15,000 to the student under the annual gift exclusion. In this case neither payment is reportable for gift tax purposes.

Topic - Gift and Estate Tax
Source - Publication 559 - Gift Tax

**Question 3 - A. $20**
When employees receive cash tips of $20 or more in a calendar month, they are required to report to their employer the total amount of tips they received. The employees must give the employer written reports by the tenth of the following month. Employees who receive tips of less than $20 in a calendar month are not required to report their tips but must report these amounts as income on their tax returns and pay taxes.

Topic - Tips
Source - IRS.GOV - Topic 761 - Tips - Withholding and Reporting

**Question 4 - C. $1,500**
The Internal Revenue Service has a simplified option that many owners of home-based businesses and some home-based workers may use to figure their deductions for the business use of their homes as they consider tax planning in 2018. The optional deduction is capped at $1,500 per year based on $5 a square foot for up to 300 square feet. This new simplified option does not alter the criteria for who may claim a home office deduction.

Topic - Simplified Option for the Home Office Deduction
Source - IRS.GOV - Simplified Option for Home Office Deduction

**Question 5 - A. She must contribute $2,000 from other sources**
If Jordan decides to roll over the full $10,000, she must contribute $2,000 from other sources. Jordan will report $10,000 as a nontaxable rollover and $2,000 as taxes paid. Also, when she rolls over the full amount of the eligible rollover distribution the entire distribution would be tax-free, and she would avoid the 10% additional tax on early distributions. Therefore, only Choice A is true.

Topic - Rollovers
Source - IRS.GOV - Rollovers of Retirement Plan and IRA Distributions

**Question 6 - D. November 15**
If the taxpayer uses a fiscal year, the return is due the 15th day of the fourth month after the close of the fiscal year. For example, if the fiscal year ends July 30, his or her tax return due date would be November 15.

Topic - Filing Dates
Source - IRS.GOV - Topic 301 - When, How, and Where to File

# Domain 3 – Practices, Procedures and Professional Responsibility

## Identity Theft

Identity theft occurs when another person uses the taxpayer's personal information such as his or her name, Social Security number (SSN) or other identifying information, without the taxpayer's permission, to commit fraud or other crimes. Usually, an identity thief utilizes a legitimate taxpayer's identity to fraudulently file a tax return and claim a refund. Generally, the identity thief will use a stolen SSN to file a forged tax return and try to get a fraudulent refund early in the filing season. The taxpayer may not be aware that an identity theft has happened to him or her until he or she files a return later in the filing season and discovers that two returns have been filed using the same SSN. The taxpayer should be alert to possible identity theft if he or she gets an IRS notice or letter stating: (47)

- More than one tax return for the taxpayer was filed.
- The taxpayer has a balance due, refund offset or has had collection actions taken against him or her for a year he or she did not file a tax return.
- IRS records indicate the taxpayer received wages from an employer unknown to him or her.

If the taxpayer receives a notice from the IRS, respond immediately. If he or she believes someone may have used his or her SSN fraudulently, the taxpayer should notify the IRS immediately by responding to the name and number printed on the notice or letter. The taxpayer will need to fill out the Form 14039 - Identity Theft Affidavit.

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.

### Identity Protection Personal Identification Number (IP PIN)

If a taxpayer received an IRS notice providing him or her with an Identity Protection Personal Identification Number (IP PIN), enter it in the IP PIN spaces provided below daytime phone number on the tax return form. The taxpayer must enter the IP PIN exactly as it is shown on the Notice CP01A. If the taxpayer did not receive a notice containing an IP PIN, leave these spaces blank. An IP PIN is a number the IRS gives to taxpayers who have: (48)

- Reported to the IRS they have been victims of identity theft.
- Given the IRS information that verifies their identity.
- Had an identity theft indicator applied to their account.

The IP PIN helps to prevent the misuse of a taxpayer's Social Security number or Taxpayer Identification Number on income tax returns. New IP PINs are issued every year. An IP PIN should be used only for the tax year it was issued. IP PINs for 2019 tax returns generally will be sent in December 2018. A new IP PIN will be issued every year for three years after the identity theft incident. If the taxpayer is filing a joint return and both taxpayers receive an IP PIN, only the taxpayer whose Social Security number (SSN) appears first on the tax return should enter his or her IP PIN.

### Individual Taxpayer Identification Numbers (ITIN)

In January of 2013 the IRS implemented new procedures that affect the Individual Taxpayer Identification Number (ITIN) application process. The information below highlights improvements to the ITIN program: (49)

- If the taxpayer is applying directly to the IRS for an ITIN, they will only accept original identification documents or certified copies of these documents from the issuing agency along with a completed Form W-7 - Application for IRS Individual Taxpayer Identification Number and Federal tax return.

- In addition to direct submission of documents to the IRS centralized site or use of Certifying Acceptance Agents (CAAs), ITIN applicants will have several other avenues for verification of key documents. These options include some key IRS Taxpayer Assistance Centers (TACs), U.S. Tax Attachés in London, Paris, Beijing and Frankfurt and at Low-Income Taxpayer Clinics (LITCs) and Volunteer Income Tax Assistance (VITA) Centers that use CAAs.
- New ITINs will now be issued for a five-year period rather than an indefinite period. This change will help ensure that ITINs are being used for legitimate tax purposes.
- There are four exceptions to this new documentation requirement. Applicants who are not impacted by these changes include:
    - U.S. military spouses and U.S. military dependents.
    - Non-resident aliens applying for ITINs for the purpose of claiming tax treaty benefits.
    - Noncitizens that have approved TY 2011 extensions to file their tax returns. These are temporary ITINs.
    - Student Exchange Visitors Program (SEVP) participants.

The IRS issues ITINs to foreign nationals and others who have Federal tax reporting or filing requirements and do not qualify for SSNs. A non-resident alien individual not eligible for a SSN who is required to file a U.S. tax return only to claim a refund of tax under the provisions of a U.S. tax treaty needs an ITIN.

Other examples of individuals who need ITINs include: (50)

- A nonresident alien required to file a U.S. tax return.
- A U.S. resident alien (based on days present in the United States) filing a U.S. tax return.
- A dependent or spouse of a U.S. citizen/resident alien.
- A dependent or spouse of a nonresident alien visa holder.

The IRS processes returns showing SSNs or ITINs in the blanks where tax forms request SSNs. IRS no longer accepts, and will not process, forms showing "SSA205c," "applied for," "NRA," blanks, etc.

All ITINs not used on a Federal tax return at least once in the last three years will no longer be valid for use on a tax return as of January 1, 2018. Additionally, all ITINs issued before 2013 began expiring in 2016. In 2017, ITINs with middle digits of 70, 71, 72 or 80 (Example: 9NN-70-NNNN) need to be renewed if the taxpayer will have a filing requirement in 2018. No action is needed by ITIN holders who do not need to file a tax return next year. Also, there are new documentation requirements when applying for or renewing an ITIN for certain dependents.

If taxpayers have an expired ITIN and do not renew before filing a tax return next year, they could face a refund delay and may be ineligible for certain tax credits, such as the Child Tax Credit and the American Opportunity Tax Credit, until the ITIN is renewed. The ITIN changes are required by the Protecting Americans from Tax Hikes (PATH) Act enacted by Congress in December 2015. The IRS emphasizes that no action is needed by ITIN holders if they do not need to file a tax return next year.

Taxpayers with ITINs set to expire at the end of the year and who need to file a tax return in 2018 must submit a renewal application. Others do not need to take any action.

- ITINs with middle digits 70, 71, 72, or 80 (For example: 9NN-70-NNNN) need to be renewed if the taxpayer will have a filing requirement in 2018.
- Taxpayers whose ITINs expired due to lack of use should only renew their ITIN if they will have a filing requirement in 2018.
- Taxpayers who are eligible for, or who have, a Social Security number (SSN) should not renew their ITIN, but should notify IRS both of their SSN and previous ITIN, so that their accounts can be merged.
- Taxpayers whose ITINs have middle digits 78 or 79 that have expired should renew their ITIN if they will have a filing requirement in 2018.

A taxpayer whose ITIN has been deactivated and needs to file a U.S. return can reapply using Form W-7 - Application for IRS Individual Taxpayer Identification Number. As with any ITIN application, original documents, such as passports, or copies of documents certified by the issuing agency must be submitted with the form.

# Safeguarding Taxpayer Information

Safeguarding taxpayer information is a top priority for the Internal Revenue Service. It is the responsibility of governments, businesses, organizations, and individuals that receive, maintain, share, transmit, or store taxpayers' personal information. Tax return information is all the information tax return preparers obtain from taxpayers or other sources in any form or manner that is used to prepare tax returns or is obtained in connection with the preparation of returns. It also includes all computations, worksheets, and printouts preparers create; correspondence from IRS during the preparation, filing and correction of returns; statistical compilations of tax return information; and tax return preparation software registration information. Authorized IRS e-file Providers must safeguard taxpayer information from unauthorized disclosure, use, and destruction.

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:

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

Further, 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.

Authorized IRS e-file Providers must have security systems in place to prevent unauthorized access by third parties to taxpayer accounts and personal information. The Gramm-Leach-Bliley Act, codified at 15 U.S.C. Section 6801-6827, and the implementing rules and regulations promulgated by the Federal Trade Commission include rules that are designed to ensure the security and privacy of taxpayer information and are applicable to Providers. (51)

An information security incident is an adverse event or threat of an event that can result in an unauthorized disclosure, misuse, modification or destruction of taxpayer information. If you believe an information security incident has occurred that affects the confidentiality, integrity, or availability of taxpayer data or the ability for the taxpayer to prepare or file a return, you may need to report the incident. The following are examples of types of incidents:

- *Theft:* Unauthorized removal of computers, data/records on computer media or paper files.
- *Loss/Accident:* Accidental misplacement or loss of computers, data/records on computer media or paper files.
- *Unauthorized Access*: A person or computer gains logical or physical access without permission to a network, system, application, data, or other resource.
- *Unauthorized Disclosure/Usage:* A person violates disclosure or use policies such as IRC Sections 6713 and 7216.
- *Computer System/Network Attack:* A virus, worm, Trojan horse, or other code-based malicious entity infects a host and causes a problem such as disclosure of sensitive data or denial of services.

The Safeguards Rule requires financial institutions, which include return preparers, data processors, transmitters, affiliates, service providers, and others who are significantly engaged in providing financial products or services that include preparation and filing of tax returns, to ensure the security and confidentiality of customer records and information. Financial institutions must develop, implement, and maintain a written Information Security Program that contains administrative, physical, and technical safeguards that are appropriate. (51)

The Financial Privacy Rule requires financial institutions, which include return preparers, data processors, transmitters, affiliates, service providers, and others who are significantly engaged in providing financial products or services that include preparation and filing of tax returns, 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. (51)

Title 26 - Internal Revenue Code (IRC) Section 301 7216.1 imposes criminal penalties on any person engaged in the business of preparing or providing services in connection with the preparation of tax returns who knowingly or recklessly makes unauthorized disclosures or uses of information furnished to them in connection with the preparation of an income tax return. (51)

Title 26 - Internal Revenue Code (IRC) Section 6713 imposes monetary penalties on the unauthorized disclosures or uses of taxpayer information by any person engaged in the business of preparing or providing services in connection with the preparation of tax returns. (51)

26 USC Section 6713 states "if any person who is engaged in the business of preparing, or providing services in connection with the preparation of, returns of tax imposed by chapter 1, or any person who for compensation prepares any such return for any other 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, shall pay a penalty of $250 for each such disclosure or use, but the total amount imposed under this subsection on such a person for any calendar year shall not exceed $10,000". (52)

Providers must implement security and privacy practices that are appropriate for the size, complexity, nature, and scope of their business activities. The IRS Publication 4600 - Safeguarding Taxpayer Information and Publication 4557 - Safeguarding Taxpayer Data contain information to help non-governmental businesses, organizations, and individuals to understand and meet their responsibility to safeguard taxpayer information.

# Tax Return Preparer Penalties

The IRS has penalty and injunctive authority to address improper tax return preparation, and abusive transaction promoters. The Internal Revenue Code (IRC) contains penalties to stop fraudulent, unscrupulous and/or incompetent tax return preparers, abusive transaction promoters, and material advisors whose failure to furnish information or maintain lists with respect to reportable transactions. Penalty assertion is one enforcement vehicle for noncompliant return preparers, promoters, and material advisors.

## Sanctionable Acts

The Secretary of the Treasury, or delegate, has the authority to disbar or censure a practitioner from practice before the IRS for violations of the rules or for misleading clients or potential clients. Additionally, the authority extends to imposing monetary penalties on the practitioner or on the practitioner's employer if the employer was responsible for the infraction. The amount of any monetary penalty is not to be greater that the gross income derived from the conduct giving rise to the penalty.

Examples of incompetence and disreputable conduct include: (53)

- Conviction of any criminal offense under the Federal tax laws.
- Conviction of any criminal offense involving dishonesty or breach of trust.
- Conviction of any felony under Federal or State law for which the conduct involved renders the practitioner unfit to practice before the Internal Revenue Service.
- Giving false or misleading information to the Department of the Treasury.
- The use of false or misleading representations with intent to deceive a client or prospective client in order to procure employment.
- Willfully failing to make a Federal tax return in violation of the Federal tax laws.
- Willfully assisting, counseling, encouraging a client or prospective client in violating, or suggesting to a client or prospective client to violate, any Federal tax law, or knowingly counseling or suggesting to a client or prospective client an illegal plan to evade Federal taxes or payment.
- Misappropriation of, or failure properly or promptly to remit, funds received from a client for the purpose of payment of taxes or other obligations due the United States.

- Directly or indirectly attempting to influence, or providing or agreeing to attempt to influence, the official action of any officer or employee of the Internal Revenue Service by the use of threats, false accusations, duress or coercion, by providing any special inducement or promise of an advantage or by the bestowing of any gift, favor or thing of value.
- Disbarment or suspension from practice as an attorney, certified public accountant, public accountant, or actuary by any duly constituted authority of any State, territory, or possession of the United States.
- Knowingly aiding and abetting another person to practice before the Internal Revenue Service during a period of suspension, disbarment or ineligibility of such other person.
- Contemptuous conduct in connection with practice before the Internal Revenue Service, including the use of abusive language, making false accusations or statements, knowing them to be false, or circulating or publishing malicious or libelous matter.
- Giving a false opinion, knowingly, recklessly, or through gross incompetence, including an opinion which is intentionally or recklessly misleading, or engaging in a pattern of providing incompetent opinions on questions arising under the Federal tax laws.
- Willfully failing to sign a tax return prepared by the practitioner when the practitioner's signature is required by Federal tax laws unless the failure is due to reasonable cause and not due to willful neglect.
- Willfully disclosing or otherwise using a tax return or tax return information in a manner not authorized by the Internal Revenue Code.
- Willfully failing to file on magnetic or other electronic media a tax return prepared by the practitioner when the practitioner is required to do so by the Federal tax laws unless the failure is due to reasonable cause and not due to willful neglect.
- Willfully preparing all or substantially all of, or signing, a tax return or claim for refund when the practitioner does not possess a current or otherwise valid preparer tax identification number or other prescribed identifying number.
- Willfully representing a taxpayer before an officer or employee of the Internal Revenue Service unless the practitioner is authorized to do so pursuant to this part.

**Review Question 1**

All of the following are considered examples of disreputable conduct for which an enrolled agent can be censured or suspended except:

A. Directly or indirectly attempting to influence the official action of any employee of the Internal Revenue Service by use of threats, false accusations, or by bestowing any gift, favor or thing of value
B. Misappropriation or failure to remit funds received from a client for the purpose of payment of taxes or other obligations due the United States
C. Knowingly aiding and abetting another person to practice before the Internal Revenue Service during a period of suspension or disbarment
D. Failure to timely pay personal income taxes

See Review Feedback for answer.

## Reporting Requirements for Tax Return Preparers

Section 6060, Reporting Requirements for Tax Return Preparers, applies to any person who employs one or more income tax return preparers to prepare any return of tax under the IRC. The general rule states any person who employs a tax return preparer to prepare any return or claim for refund other than for such person at any time during a return period shall make a return setting forth the name, taxpayer identification number, and place of work of each tax return preparer employed by him at any time during such period. For purposes of this section, any individual who in acting as a tax return preparer is not the employee of another tax return preparer shall be treated as his own employer. The return required by this section shall be filed, in such manner as the Secretary may by regulations prescribe, on or before the first July 31 following the end of such return period. In lieu of the return required by subsection (a), the Secretary may approve an alternative reporting method if he determines that the necessary information is available to him from other sources. The term return period means the 12-month period beginning on July 1 of each year, except that the first return period shall be the 6-month period beginning on January 1, 1977, and ending on June 30, 1977. (54)

## Preparer Penalties for IRC Sections 6694 and 6695

Tax return preparers are subject to penalties under Section 6694 for understatements due to unreasonable positions and due to willful, reckless, or intentional conduct and Section 6695 for failing to perform certain duties or for engaging in prohibited conduct (e.g., failing to provide a copy of a return to the taxpayer or negotiating a tax refund check). Below is a summary of the Preparer Penalties under Title 26 of Internal Revenue Code, Sections 6694 and 6695. (55)

Section 6694 delineates penalties for paid preparers who take unreasonable positions on tax returns or refund claims that result in an understatement of a taxpayer's liability. Section 6694 provides specific details regarding who has responsibility for a position on a return, what is considered an unreasonable position, information verification requirements, and the basis for penalty assessment.

## Understatement of Taxpayer's Liability

Several potential penalties may be assessed against tax return preparers. Below is a summary of the Preparer Penalties under Title 26 of Internal Revenue Code, Sections 6694 and 6695. (55)

- *Due to unreasonable position* – a first-tier penalty for an understatement due to unreasonable position is the greater of $1,000 or 50% of income derived with respect to the refund claim.
- *Due to willful or reckless conduct* – a second-tier penalty for an understatement due to willful or reckless conduct is the greater of $5,000 or 75% of income derived with respect to the refund claim.

The Protecting Americans from Tax Hikes Act of 2015 expands the penalty for tax preparers who engage in willful or reckless conduct, which was the greater of $5,000 or 50% of the preparer's income with respect to the return, by increasing the 50% amount to 75% (IRC 6694(b)).

## Failure to Follow Procedures

Section 6695 provides for assessable penalties when a preparer fails to complete specific responsibilities such as failing to retain a copy of the return, to sign the return, or to furnish a copy to the taxpayer. Penalties assessable for failure to meet the requirements, unless such failure is due to reasonable cause and not to willful neglect, are:

- *Failure to furnish copy to taxpayer (IRC Section 6695(a)* - $50 for each failure to furnish a copy of a return or claim with a maximum penalty of $26,000 in a calendar year.
- *Failure to sign return (IRC Section 6695(b)* - $50 for each failure to sign a return for refund with a maximum penalty of $26,000 in a calendar year.
- *Failure to furnish identifying number (IRC Section 6695(c)* - $50 for each failure to furnish an identifying number on a return with a maximum penalty of $26,000 in a calendar year.
- *Failure to retain copy or list (IRC Section 6695(d)* - $50 for each failure to comply with IRC Section 6107(b) to retain a copy or list of a return or claim for the period ending 3 years after the close of the return. There is a maximum penalty of $26,000 in a return period.
- *Failure to file correct information (IRC Section 6695(e)* - $50 for each failure with a maximum penalty of $26,000 in a return period.

## Negotiation of Taxpayer Checks

Under IRC Section 6695(f), a $520 penalty, with no maximum dollar limitation, may be imposed for a tax preparer who endorse or otherwise negotiate any check (including directing or accepting payment by any means, electronic or otherwise into an account owned or controlled by the practitioner or any firm or other entity with whom the practitioner is associated) issued to a client by the government in respect to a Federal tax liability.

## Failure to Exercise Due Diligence

The 2015 PATH Act extends the tax return preparer's Earned Income Tax Credit (EITC) due-diligence requirements to include returns and refunds on which a Child Tax Credit, Additional Child Tax Credit, or American Opportunity Tax Credit is claimed (IRC Section 6695(g)). The expanded due-diligence requirements are effective for tax years beginning after 2015. There is a $520 penalty for each failure, with no maximum dollar limitation.

## Promoting Abusive Tax Shelters

The penalty for promoting abusive tax shelters is generally equal to $1,000 or, if lesser, 100% of income derived from each organization or sale of the abusive plan. IRS, the Office of Chief Counsel and Treasury issue formal guidance on certain tax avoidance transactions that are referred to as listed transactions. Taxpayers are required to disclose their participation in listed transactions.

## Aiding or Abetting in Tax Liability Understatement

Tax return preparers also may be penalized $1,000 for aiding or abetting in an understatement of tax liability on a return. The penalty is $10,000 if conduct relates to a corporation's tax return.

## Disclosure or Use of Information

Internal Revenue Code Section 7216 is a criminal provision enacted by the U.S. Congress in 1971 that prohibits preparers of tax returns from knowingly or recklessly disclosing or using tax return information. Tax return information consists of all the information tax return preparers obtain from taxpayers or other sources in any form or manner that is used to prepare tax returns or is obtained in connection with the preparation of returns.

Tax return information also includes all computations, worksheets, and printouts preparers create; correspondence from IRS during the preparation, filing and correction of returns; statistical compilations of tax return information; and tax return preparation software registration information. Penalties include:

- *Unauthorized disclosure* - The penalty is $250 for each unauthorized disclosure or use of information furnished in connection with a taxpayer return with a maximum penalty of $10,000 per calendar year.
- *Knowing or reckless disclosure* – Upon conviction of a misdemeanor a fine of up to $1,000 or imprisonment for up to one year or both along with the costs of prosecution.

## Willful Preparation of a False or Fraudulent Return

- *Guilty of a felony* – Upon conviction, the practitioner may face a fine of up to $100,000 or imprisonment for up to 3 years or both. The practitioner may also be responsible for costs of prosecution. A fine amount up to $500,000 may be imposed if fraud involves a corporation.
- *Guilty of a misdemeanor* – Upon conviction, the practitioner may face a fine up to $10,000 or imprisonment of up to 1 year or both. A fine amount up to $50,000 may be imposed if fraud involves a corporation.

Please see the Internal Revenue Code, corresponding Treasury Regulations, and other related published guidance for additional information on each penalty section.

**Review Question 2**

A promoter offers a taxpayer a $10,000 investment that he or she will lose, but the taxpayer will get $50,000 in tax write-offs. All of the following are true regarding this investment except:

A. The taxpayer should have the offer reviewed by his or her own tax adviser
B. The IRS would consider this offer an abusive tax shelter
C. The offer is a legitimate tax shelter
D. The offer is an attempt to reduce the amount of taxes owed, but it does not provide any means to gain actual money, it has no economic substance

See Review Feedback for answer.

# Paid Preparer's Due Diligence Checklist

Due to changes in the tax law, the paid tax return preparer Earned Income Tax Credit (EITC) due diligence requirements have been expanded to also cover the American Opportunity Tax Credit (AOC), the Child Tax Credit (CTC) and/or the Additional Child Tax Credit (ACTC). Form 8867 - Paid Preparer's Due Diligence Checklist, has been modified to account for these changes. In addition, Form 8867 has been streamlined. Completing the form is not a

substitute for actually performing the necessary due diligence and completing all required forms and schedules when preparing the return.

Also, the paid tax return preparer due diligence penalty under IRC Section 6695(h) is now indexed for inflation. Therefore, the penalty for failure to meet the due diligence requirements with respect to returns and claims for refund filed in 2018 is $520 per credit per return.

A paid tax return preparer is required to exercise due diligence when preparing any client's return or claim for refund. As part of exercising due diligence, the tax preparer must interview the client, ask adequate questions, and obtain appropriate and sufficient information to determine correct reporting of income, claiming of tax benefits (such as deductions and credits), and compliance with the tax laws.

A paid tax return preparer must meet specific due diligence requirements set forth in Treasury Regulations when he or she prepares returns and claims for refund involving the EITC, the AOTC and/or the CTC/ACTC. To meet these due diligence requirements, the tax preparer may need to ask additional questions and obtain additional information to determine eligibility for and the amount of the EITC, AOTC, and CTC/ACTC.

A tax preparer has complied with the due diligence requirements set forth in Treasury Regulations with respect to the EITC, AOTC, and/or CTC/ACTC claimed on a return or claim for refund if he or she: (56)

1. Completes Form 8867 truthfully and accurately and completes the actions described on Form 8867 for each credit claimed for which he or she is the paid tax return preparer.
2. Submits Form 8867 in the manner required.
3. Meets the knowledge requirement by interviewing the taxpayer, asking adequate questions, documenting the taxpayer's responses on the return or in his or her notes, reviewing adequate information to determine if the taxpayer is eligible to claim the credit(s) and in what amount(s), **and**
4. The tax preparer keeps all five of the following records for three years from lasts of the due date of the tax return (without extensions), the date the return was filed, the date the return was presented to the taxpayer for signature or the date the tax preparer submitted to the signing tax return preparer:
    a. A copy of Form 8867.
    b. The applicable worksheet(s) or his or her own worksheet(s) for any credits claimed.
    c. Copies of any taxpayer documents you may have relied upon to determine eligibility for and the amount of the credit(s).
    d. A record of how, when, and from whom the information used to prepare Form 8867 and worksheet(s) was obtained.
    e. A record of any additional questions he or she may have asked to determine eligibility for and amount of the credits, and the taxpayer's answers.

## Completing Form 8867

Form 8867 covers the EITC, the AOTC, and the CTC/ACTC. A tax preparer should only complete columns corresponding to credits actually claimed on the taxpayer's return that he or she prepared. Only paid tax return preparers should complete Form 8867. Form 8867 is divided into questions that relate to all three credits and questions that are specifically related to EITC only, Child Tax Credit only, and the American Opportunity Tax Credit only.

Beginning with 2018 Federal returns the Tax Cuts and Jobs Act (TCJA) added a requirement that preparer due diligence will apply to tax returns where the taxpayer uses the head of household filing status. Form 8867 - Paid Preparer's Due Diligence Checklist contains additional questions to ensure that paid preparers are performing their due diligence in determining that the taxpayer is eligible to file using the head of household filing status. Also, the $520 penalty for any preparers where the IRS determines that they did not following the due diligence requirements will apply.

## Due Diligence Requirements

The tax preparer completes the appropriate column for each credit for which he or she was the paid tax return preparer determining the taxpayer's eligibility for and amount of the credit. Columns for credits for which he or she was not the paid tax return preparer should be left blank.

## Due Diligence Questions for Returns Claiming EITC

A paid tax return preparer must exercise due diligence to determine whether a taxpayer meets all of the eligibility requirements for the EITC. Although lines 9a and 9b only ask two specific questions about EITC eligibility related to claiming a qualifying child, the tax preparer's client must meet all of the eligibility requirements for claiming the EITC. Therefore, the tax preparer's client cannot claim the EITC if all of the eligibility requirements for the EITC are not satisfied, even if the tax preparer answers "yes" to 9a and 9b.

## Due Diligence Questions for Returns Claiming CTC and/or ACTC

A paid tax return preparer must exercise due diligence to determine whether a taxpayer meets all of the eligibility requirements for the CTC and/or ACTC. Lines 10a, 10b, and 10c only ask three specific questions about CTC and ACTC eligibility. However, the tax preparer's client must meet all of the eligibility requirements for claiming the CTC and/or ACTC. Therefore, the tax preparer's client cannot claim the CTC and/or ACTC if all of the eligibility requirements for these credits are not satisfied, regardless of the answers to questions on line 10.

## Due Diligence Questions for Returns Claiming AOTC

A paid tax return preparer must exercise due diligence to determine whether a taxpayer meets all of the eligibility requirements for the AOTC. Although line 11 only asks about substantiation of qualified tuition and related expenses, the tax preparer's client must meet all of the eligibility requirements for claiming the AOTC. Therefore, the tax preparer's client cannot claim the AOTC if all of the eligibility requirements for the AOTC are not satisfied, even if the tax preparer answers "yes" on line 11.

## Credit Eligibility Certification

The tax preparer must certify that all of the answers on Form 8867 are, to the best of his or her knowledge, true, correct and complete. Failure to meet due diligence requirements with respect to claiming the EITC, the AOTC, and the CTC/ACTC could result in a $520 penalty for each failure. For example, if a paid tax return preparer prepares a return claiming the EITC, the AOTC and the CTC/ACTC and he or she failed to meet the due diligence requirements for all of these credits, the tax preparer could be subject to a penalty of $1,560.

## Document Retention

To meet the due diligence requirements for the EITC, the AOTC, and the CTC/ACTC, you must keep all of the following records: (57)

1. A copy of Form 8867.
2. The applicable worksheet(s) or your own worksheet(s) for any credits claimed specified in Due Diligence Requirements.
3. Copies of any taxpayer documents you may have relied upon 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.
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.

You must keep those records for three years from the latest of the following dates: (57)

- The due date of the tax return (not including extensions).
- The date the return was filed (if you are a signing tax return preparer electronically filing the return).
- The date the return was presented to the taxpayer for signature (if you are a signing tax return preparer not
- electronically filing the return).
- The date you submitted to the signing tax return preparer the part of the return for which you were responsible (if you are a nonsigning tax return preparer).

These records may be kept on paper or electronically in the manner described in Revenue Procedure 97-22 (or later update). (58)

## Consequences of Filing EITC Returns Incorrectly

People who come to you, a tax return preparer, expect you to know the tax law and prepare an accurate return. Also, if you are paid and prepare EITC claims, you must meet EITC due diligence requirements.

If the IRS examines your client's return and denies all or a part of EITC, your client: (35)

- Must pay back the amount in error with interest.
- May need to file the Form 8862 - Information to Claim Earned Income Tax Credit after Disallowance.
- May be banned from claiming EITC for the next two years if the IRS finds the error is because of reckless or intentional disregard of the rules.
- May be banned from claiming EITC for the next ten years if the IRS finds the error is because of fraud.

If the IRS examines the EITC claims you prepared and finds you did not meet all four due diligence requirements, you can get: (59)

- A $520 penalty for each failure to comply with EITC due diligence requirements. The penalty amounts are covered in IRC Section 6695(g). (The IRS adjusted the penalty for taxable year returns beginning in 2015 for cost of living.)
- A minimum penalty of $1,000 if you prepare a client return and IRS finds any part of the amount of taxes owed is due to an, unreasonable position (For reference see IRC Section 6694(a)).
- A minimum penalty of $5,000 if you prepare a client return and IRS finds any part of the amount of taxes owed is due to your reckless or intentional disregard of rules or regulations (For reference see IRC Section 6694(b)).

The IRS can also penalize an employer or employing firm if an employee fails to comply with the EITC due diligence requirements.

However, there are only specific circumstances when an employer is subject to the due diligence penalty: (60)

- Management participated in or, prior to the time the return was filed, knew of the failure to comply with the due diligence requirements.
- The firm failed to establish reasonable and appropriate procedures to ensure compliance with the due diligence requirements.
- The firm establishes appropriate compliance procedures but disregards those procedures through willfulness, recklessness, or gross indifference, including ignoring facts that would lead a person of reasonable prudence and competence to investigate or figure out the employee was not complying.

**Review Question 3**

Beginning with 2018 Federal returns the Tax Cuts and Jobs Act (TCJA) added a requirement that preparer due diligence will apply to tax returns where the taxpayer uses which of the following filing status?

A. Married Filing Jointly
B. Married Filing Separately
C. Head of Household
D. Surviving Spouse

See Review Feedback for answer.

# Significance of Signatures

## Penalty of Perjury

You must explain to the taxpayer that by signing their return that they are declaring that they have examined a copy of their individual income tax return and accompanying schedules and statements for the tax year, and to the best of their knowledge and belief, it is true, correct, and complete. By signing their return, the taxpayer is doing so ‘under

penalty of perjury". Perjury is the willful act of swearing a false oath or affirmation to tell the truth, whether spoken or in writing and is punishable by Federal law. The rules for perjury also apply when a person has made a statement "under penalty of perjury".

An example of this is the United States' income tax return, which, by law, must be signed as true and correct under penalty of perjury. Federal tax law provides criminal penalties of up to three years in prison for violation of the tax return perjury statute.

## Filing Instructions

A person filling out an 8879 form either declares on the form that he or she will enter the personal identification number on an electronically filed tax return or authorizes another party such as an electronic return originator, to do so. All 8879 forms are to be retained by the taxpayer/signee for a minimum of 3 years. Form 8879 is not sent to the IRS unless the department requests it.

## Form 8879 IRS e-file Signature Authorization

Form 8879 - IRS e-file Signature Authorization is the declaration document and signature authorization for an e-filed return filed by an electronic return originator (ERO). Complete Form 8879 when the Practitioner PIN method is used or when the taxpayer authorizes the ERO to enter or generate the taxpayer's personal identification number (PIN) on his or her e-filed individual income tax return. Many types of these forms are available, and the form used depends on the business type. When completing Form 8879 the Electronic Return Originator (ERO) has specific responsibilities.

The ERO will do the following: (61)

1. Enter the name(s) and Social Security number(s) of the taxpayer(s) at the top of the form.
2. Complete Part I using the amounts (zeros may be entered when appropriate) from the taxpayer's 2018 tax return. Form 1040-SS filers leave lines 1 through 3 and line 5 blank.
3. Enter or generate, if authorized by the taxpayer, the taxpayer's PIN and enter it in the boxes provided in Part II.
4. Enter on the authorization line in Part II the ERO firm name (not the name of the individual preparing the return) if the ERO is authorized to enter the taxpayer's PIN.
5. After completing items (1) through (4) above, give the taxpayer Form 8879 for completion and review. This can be done in person or by using the U.S. mail, a private delivery service, fax, email, or an Internet website.
6. Enter the 14-digit Declaration Control Number (DCN) assigned to the tax return, after the taxpayer completes Part II. See Part I of Publication 1346 - Electronic Return File Specifications for Individual Income Tax Returns.

Taxpayers have the following responsibilities for completing Form 8879 correctly: (61)

1. Verify the accuracy of the prepared income tax return, including direct deposit information.
2. Check the appropriate box in Part II to authorize the ERO to enter or generate their PIN or to do it themselves.
3. Indicate or verify their PIN when authorizing the ERO to enter or generate it (the PIN must be five numbers other than all zeros).
4. Sign and date Form 8879. Taxpayers must sign Form 8879 by handwritten signature.
5. Return the completed Form 8879 to the ERO in person, or by U.S. mail, private delivery service, fax, email, or an Internet website.

## Form 8879-C - IRS e-file Signature Authorization for Form 1120

A corporate officer and an electronic return originator (ERO) use Form 8879-C when the corporate officer wants to use a personal identification number (PIN) to electronically sign a corporation's electronic income tax return and, if applicable, consent to electronic funds withdrawal. A corporate officer who does not use Form 8879-C must use Form 8453-C - U.S. Corporation Income Tax Declaration for an IRS e-file Return. Do not send this form to the IRS. The ERO must retain Form 8879-C. (62)

## Form 8879-PE - IRS e-file Signature Authorization for Form 1065

A general partner or limited liability company member manager and an electronic return originator (ERO) use Form 8879-PE when the general partner or limited liability company member manager wants to use a personal identification number (PIN) to electronically sign a partnership's electronic return of partnership income. A general partner or limited liability company member manager who does not use Form 8879-PE must use Form 8453-PE - U.S. Partnership Declaration for an IRS e-file Return. Do not send this form to the IRS. The ERO must retain Form 8879-PE. (63)

## Form 8879-EO - IRS e-file Signature Authorization for an Exempt Organization

An organization officer and an electronic return originator (ERO) use Form 8879-EO when the organization officer wants to use a personal identification number (PIN) to electronically sign an organization's electronic return and, if applicable, authorize an electronic funds withdrawal. An organization officer who does not use Form 8879-EO must use Form 8453-EO - Exempt Organization Declaration and Signature for Electronic Filing. The ERO must retain Form 8879-EO. An organization may qualify for exemption from Federal income tax if it is organized and operated exclusively for one or more of the following purposes: (64)

- Religious.
- Charitable.
- Scientific.
- Testing for public safety.
- Literary.
- Educational.
- Fostering national or international amateur sports competition (but only if none of its activities involve providing athletic facilities or equipment).
- The prevention of cruelty to children or animals.

To qualify, the organization must be a corporation, community chest, fund, articles of association, or foundation. A trust is a fund or foundation and will qualify. However, an individual or a partnership will not qualify.

Qualifying organizations include:

- Nonprofit old-age homes.
- Parent-teacher associations.
- Charitable hospitals or other charitable organizations.
- Alumni associations.
- Schools.
- Chapters of the Red Cross.
- Boys' or Girls' Clubs.
- Churches.

## Return of Organization Exempt From Income Tax

Form 990 - Return of Organization Exempt From Income Tax is used by tax-exempt organizations, nonexempt charitable trusts, and section 527 political organizations to provide the IRS with the information required by section 6033. Most organizations exempt from income tax under section 501(a) must file an annual information return (Form 990 or 990-EZ) or submit an annual electronic notice (Form 990-N), depending upon the organization's gross receipts and total assets.

An organization does not have to file Form 990 or 990-EZ even if it has at least $200,000 of gross receipts for the tax year or $500,000 of total assets at the end of the tax year if they are: (65)

- A church, an interchurch organization of local units of a church, a convention or association of churches, or an integrated auxiliary of a church as described in Regulations section 1.6033-2(h) (such as a men's or women's organization, religious school, mission society, or youth group).
- A church-affiliated organization that is exclusively engaged in managing funds or maintaining retirement programs and is described in Revenue Procedure 96-10, 1996-1 C.B. 577. But see the filing requirements for Section 509(a)(3) supporting organizations in A, Who Must File.

- A school below college level affiliated with a church or operated by a religious order described in Regulations section 1.6033-2(g)(1)(vii).
- A mission society sponsored by, or affiliated with, one or more churches or church denominations, if more than half of the society's activities are conducted in, or directed at, persons in foreign countries.
- An exclusively religious activity of any religious order described in Revenue Procedure 91-20, 1991-1 C.B. 524.
- A state institution whose income is excluded from gross income under section 115.
- A governmental unit or affiliate of a governmental unit described in Revenue Procedure 95-48, 1995-2 C.B. 418. But see the filing requirements for Section 509(a)(3) supporting organizations.
- An organization described in section 501(c)(1). A section 501(c)(1) organization is a corporation organized under an Act of Congress that is an instrumentality of the United States, and exempt from Federal income taxes.
- Certain political organizations that are:
  - A state or local committee of a political party;
  - A political committee of a state or local candidate;
  - A caucus or association of state or local officials; or
  - Required to report under the Federal Election Campaign Act of 1971 as a political committee (as defined in section 301(4) of such Act).
- An organization whose gross receipts are normally $50,000 or less.
- Foreign organizations and organizations located in U.S. possessions, whose gross receipts from sources within the United States are normally $50,000 or less and which did not engage in significant activity in the United States (other than investment activity). But if a foreign organization or U.S. Possessions organization is required to file Form 990 or Form 990-EZ, then its worldwide gross receipts, as well as assets, are taken into account in determining whether it qualifies to file Form 990-EZ.
- A private foundation (including a private operating foundation) exempt under section 501(c)(3) and described in section 509(a). The taxpayer should use Form 990-PF - Return of Private Foundation. The taxpayer should also use Form 990-PF for a taxable private foundation, a section 4947(a)(1) nonexempt charitable trust treated as a private foundation, and a private foundation terminating its status by becoming a public charity under section 507(b)(1)(B) (for tax years within its 60-month termination period). If the organization successfully terminates, then it files Form 990 or 990-EZ in its final year of termination.
- A black lung benefit trust described in section 501(c)(21). Use Form 990-BL, Information and Initial Excise Tax Return for Black Lung Benefit Trusts and Certain Related Persons.
- A religious or apostolic organization described in section 501(d). Use Form 1065, U.S. Return of Partnership Income.
- A stock bonus, pension, or profit-sharing trust that qualifies under section 401. Use Form 5500 - Annual Return/Report of Employee Benefit Plan.

**Review Question 4**

Brian Jones claimed the Earned Income Tax Credit (EITC) on his 2016 tax return, which he filed in March 2017. The IRS determined he was not entitled to the EITC and that his error was due to reckless or intentional disregard of the EITC rules. In September 2017, Brian received a statutory notice of deficiency telling him an adjustment would be made and tax assessed unless he filed a petition with the Tax Court within 90 days. Brian did not act on this notice within 90 days. Therefore, Brian's EITC was denied in December 2017. Consequently, Brian cannot claim the EITC for which of the following tax years?

A. 2017 or 2018
B. 2017 through 2022
C. 2017 through 2024
D. 2017 through 2026

See Review Feedback for answer.

# e-File for Tax Professionals

Since January 1, 2011, the law requires many paid tax return preparers to electronically file Federal income tax returns prepared and filed for individuals, trusts and estates. Preparers who anticipate filing 100 or more Forms 1040, 1040A, 1040EZ and 1041 during the year must use IRS e-file. The requirement also applies to firms, which must compute the number of returns prepared by its members in the aggregate.

An Authorized IRS e-file Provider is a business or organization authorized by the IRS to participate in IRS e-file. It may be a sole proprietorship, partnership, corporation, or other entity. The firm submits an e-file application, meets the eligibility criteria, and must pass a suitability check before the IRS assigns an Electronic Filing Identification Number (EFIN). Applicants accepted for participation in IRS e-file are Authorized IRS e-file Providers. A Provider may be an Electronic Return Originator (ERO), Intermediate Service Provider, Transmitter, Software Developer, or Reporting Agent. These roles are not mutually exclusive. For example, a Provider that is an ERO may also be a Transmitter. Providers may also be tax return preparers, but the activities and responsibilities for IRS e-file and return preparation are distinct and different from each other. (66)

The IRS conducts a suitability check on the applicant and on all Principals and Responsible Officials listed on the application. The IRS does not complete suitability checks on applicants only applying to be Software Developers.

Suitability checks may include the following: (66)

- A criminal background check.
- A credit history check.
- A tax compliance check to ensure that all required returns are filed and paid, and to identify assessed penalties.
- A check for prior non-compliance with IRS e-file requirements.

All Authorized IRS e-file Providers must adhere to IRS e-file rules and requirements to continue participation in IRS e-file. Requirements are included in Revenue Procedure 2007-40 - e-file Providers of Individual Income Tax Returns, Publication 1345 - Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns and in other publications and notices that govern IRS e-file. All Providers must adhere to all rules and requirements, regardless of where published. Some rules and requirements are specific to the activities performed by the Provider and are included in Electronic Return Origination, Transmission and e-file Provider. The following list, while not all-inclusive, applies to all Providers of Individual Income Tax Returns, except Software Developers that do not engage in any other IRS e-file activity other than software development.

Generally e-file can be used to file any return of income tax imposed by subtitle A of the Internal Revenue Code on individuals, trusts, or estates, such as Forms 1040, 1040A, 1040EZ, and 1041. Forms 1040NR, 1041QFT, and 990T (when the exempt organization is a trust subject to tax on unrelated business taxable income under section 511(b)) also meet the definition of a return of income tax, but these forms cannot be electronically filed at this time. Additionally, production filing generally ends on October 15 and the last day to retransmit rejected returns is October 19 so tax returns for prior years are not eligible for the e-file program. Also, an amended tax return cannot be filed electronically under the e-file system.

A Provider must: (67)

1. Maintain an acceptable cumulative error or reject rate.
2. Adhere to the requirements for ensuring that tax returns are properly signed.
3. Properly use the standard/non-standard Form W-2 indicator.
4. Properly use the Refund Anticipation Loan (RAL) indicator.
5. Include the Electronic Return Originator's (ERO's) Electronic Filing Identification Number (EFIN) as the return EFIN for returns the ERO submits to an Intermediate Service Provider or Transmitter.
6. Include the Intermediate Service Provider's EFIN in the designated Intermediate Service Provider field in the electronic return record.
7. Submit an electronic return to the IRS with information that is identical to the information provided to the taxpayer on the copy of the return.

A Refund Anticipation Loan (RAL) is money borrowed by a taxpayer from a lender based on the taxpayer's anticipated income tax refund. Financial Institutions also offer a variety of other financial products to taxpayers based on their refunds. The IRS is in no way involved in or responsible for RALs or the other financial products. Providers that assist taxpayers in applying for a RAL or other financial product have additional responsibilities and may be sanctioned by the IRS if they fail to adhere to certain requirements.

## Electronic Filing Identification Number (EFIN)

The IRS assigns an EFIN to identify firms that have completed the IRS e-file Application to become an Authorized IRS e-file Provider. After the provider completes the application and passes a suitability check, the IRS sends an acceptance letter, including the EFIN, to the provider. Providers need the EFIN to electronically file tax returns. The firm owns the EFIN. The principals of the firm use either their Social Security Number or Employer Identification Number to apply for an EFIN. On their application, the firm's "Doing Business As" name and business address should be used, not a personal address.

The IRS announced that effective October 1, 2012, they will no longer be accepting paper applications to become an IRS e-file provider and that all applications must be submitted online. Until October 1, 2012, the IRS has allowed tax professionals to fill out Form 8633 - Application to Participate in the IRS e-file Program. With all tax preparers now submitting their applications online, the IRS estimates that the online application process takes four to six weeks to complete and urges tax professionals not to delay.

Authorized IRS e-file Providers do not have to reapply each year as long as they continue to e-file returns. However, if a Provider does not e-file returns for two consecutive years, the IRS will notify the Provider of removal from the IRS active Provider list. The IRS may reactivate a Provider if the Provider replies within sixty days and requests reactivation. Otherwise, the Provider will have to complete and submit a new application. Providers must update their application information within 30 days of the date of any changes to the information on their current application. Make all changes using the IRS e-file Application. See Changes to Your IRS e-file Application.

The EFIN is not transferable and neither is the password. Even if an Authorized IRS e-file Provider transfers his or her business by sale, gift or other disposition, he or she may not transfer his or her EFIN. The Provider must protect his or her EFINS, Electronic Transmitter Identification Numbers (ETINs) and passwords from unauthorized use.

## Electronic Return Originator

An Electronic Return Originator (ERO) is the Authorized IRS e-file Provider that originates the electronic submission of a return to the IRS. The ERO is usually the first point of contact for most taxpayers filing a return. Although an ERO may also engage in return preparation, that activity is separate and different from the origination of the electronic submission of the return to the IRS. An ERO originates the electronic submission of a return after the taxpayer authorizes the filing of the return via IRS e-file. An ERO must originate the electronic submission of only returns that the ERO either prepared or collected from a taxpayer. An ERO originates the electronic submission by either of the following: (68)

- Electronically sending the return to a Transmitter that will transmit the return to the IRS.
- Directly transmitting the return to the IRS.
- Providing a return to an Intermediate Service Provider for processing prior to transmission to the IRS.

In originating the electronic submission of a return, the ERO has a variety of responsibilities, including, but not limited to: (68)

- Timely originating the electronic submission of returns.
- Submitting any required supporting paper documents to the IRS.
- Providing copies to taxpayers.
- Retaining records and making records available to the IRS.
- Accepting returns only from taxpayers and Authorized IRS e-file Providers.
- Having only one Electronic Filing Identification Number (EFIN) for the same firm for use at one location, unless the IRS issued more than one EFIN to the firm for the same location. For this purpose, the business entity is generally the entity that reports on its return the income derived from electronic filing. The IRS may issue more than one EFIN to accommodate a high volume of returns, or as it determines appropriate.

An ERO must clearly display the firm's "doing business as" name at all locations and sites including websites at which the ERO or a third party obtains information from taxpayers for electronic origination of returns by the ERO using IRS e-file.

## Form 8879 IRS e-File Signature Authorization

Form 8879 - IRS e-file Signature Authorization is the declaration document and signature authorization for an e-filed return filed by an electronic return originator (ERO). Complete Form 8879 when the Practitioner PIN method is used or when the taxpayer authorizes the ERO to enter or generate the taxpayer's personal identification number (PIN) on his or her e-filed individual income tax return. Many types of these forms are available, and the form used depends on the business type. Use this chart to determine when and how to complete Form 8879.

| Complete Form 8879 | |
|---|---|
| If the ERO is… | Then… |
| Not using the Practitioner PIN method and the taxpayer enters his or her own PIN | Do not complete Form 8879. |
| Using the Practitioner PIN method and is authorized to enter or generate the taxpayer's PIN | Complete Form 8879, Parts I, II, and III. |
| Using the Practitioner PIN method and the taxpayer enters his or her own PIN | Complete Form 8879, Parts I, II, and III. |
| Not using the Practitioner PIN method and is authorized to enter or generate the taxpayer's PIN | Complete Form 8879, Parts I and II. |

Table 3-1 - When and How To Complete Form 8879 (2018)

A person filling out an 8879 form either declares on the form that he or she will enter the personal identification number on an electronically filed tax return or authorizes another party such as an electronic return originator, to do so. An ERO must retain the completed Form 8879 for 3 years from the return due date or the date the IRS received the return, whichever is later. Form 8879 may be retained electronically in accordance with the recordkeeping guidelines in Revenue Procedure 97-22.

Tip

Form 8879 is not sent to the IRS unless the department requests it. The ERO must provide the taxpayer with a copy of the signed Form 8879 for his or her records upon request.EROs can sign Form 8879 using a rubber stamp, mechanical device (such as a signature pen), or computer software program.

## ERO Fees

An ERO can charge a fee for providing the e-file service to their clients while others may offer it free of charge. However, this fee must be identical for all customers and cannot be based on any figure from the tax return. An ERO must never charge a separate fee for Direct Deposit and must accept any Direct Deposit election by a taxpayer to any eligible financial institution. (69)

When assisting a taxpayer in applying for a RAL or other financial product, the ERO may charge a flat fee for that assistance. The fee must be identical for all customers and must not relate to the amount of the refund or the financial product. The Provider must not accept a fee that is contingent upon the amount of the refund or a RAL or other financial product from a financial institution for any service connected with a financial product. The IRS has no responsibility for the payment of any fees associated with the preparation of a return, the transmission of the electronic portion of a return or a RAL or another financial product.

## ERO Advertising

An ERO must comply with the advertising and solicitation provisions of Circular 230. This circular prohibits the use or participation in the use of any form of public communication containing a false, fraudulent, misleading, deceptive, unduly influencing, coercive, or unfair statement or claim. Providers must not use improper or misleading advertising in relation to IRS e-file, including the time frames for refunds and RALs or other financial products. Any claims by Providers concerning faster refunds by virtue of electronic filing must be consistent with the language in official IRS publications.

If Providers advertise the availability of a RAL or financial product, the Provider and financial institution must clearly refer to or describe the funds they advance as a loan or other financial product, not as a refund. The advertisement on a RAL or other financial product must be easy to identify and in readable print. That is, it must make clear in the advertising that the taxpayer is borrowing against the anticipated refund or receiving another financial product and is not obtaining the refund itself from the financial institution.

A Provider must not advertise that individual income tax returns may be electronically filed prior to the Provider's receipt of Forms W-2, W-2G and 1099-R, as the Provider is generally prohibited from electronically filing returns prior to receipt of Forms W-2, W-2G, and 1099-R. Advertisements must not imply that the Provider does not need Forms W-2, W-2G and 1099-R, or that it can use pay stubs or other documentation of earnings to e-file individual income tax returns.

In using the Direct Deposit name and logo in advertisement, the Provider must use the name "Direct Deposit" with initial capital letters or all capital letters, use the logo/graphic for Direct Deposit whenever feasible and may change the color or size of the Direct Deposit logo/graphic when it uses it in advertising pieces.

## Other ERO Information

Participants in Online Filing must also adhere to the following: (67)

1. Ensure that no more than five electronic returns are filed from one software package or one e-mail address.
2. Supply a taxpayer with an accurate Declaration Control Number (DCN) (Exception: Submission Identification Number (SID) for MeF).
3. Provide effective instructions to a taxpayer concerning the entry of the DCN on Form 8453, if required.
4. Submit any changes to the following information to the IRS Headquarters Online Filing Analyst, SE:W:CAS:SP:ES:I, 5000 Ellin Road, Lanham, MD 20706, by the 31st day of December preceding the filing season:
    a. The brand name of the software the Provider will be using, has developed or will use for transmission. Required information about the software includes its Software Developer, Transmitter, retail cost and any additional costs for transmitting the electronic portion of the taxpayer's return. Additionally, software changes involving its use to file Federal/State returns, Internet availability (including the Internet address), successful completion of Participants Acceptance Testing (PATS) (Exception: Assurance Testing System (ATS) for MeF) and the Professional Package name under which the software was tested must be reported.
    b. The Provider's point of contact for matters relating to Online Filing and the telephone number for the point of contact.
    c. The applicant's customer service number.
    d. The procedures the applicant will use to ensure that one software package or one e-mail address transmits no more than five returns.

## Submitting a Timely Filed Electronic Tax Return

All prescribed due dates for filing of returns apply to e-file returns. All Providers must ensure that returns are promptly processed. However, a Provider that receives a return for electronic filing on or before the due date of the return must ensure that it transmits the electronic portion of the return on or before the due date (including extensions). An electronically filed return is not considered filed until the IRS acknowledges acceptance of the electronic portion of the tax return for processing.

The IRS accepts individual income tax returns electronically only if the taxpayer signs the return using a Personal Identification Number (PIN). If Providers transmit the electronic portion of a return on or shortly before the due date and the IRS ultimately rejects it, but the Provider and the taxpayer comply with the requirements for timely resubmission of a correct return, the IRS considers the return timely filed. (70)

Once signed, an ERO must originate the electronic submission of a return as soon as possible. However, authorized IRS e-file Providers are prohibited from submitting electronic returns to the IRS prior to the receipt of all Forms W-2, W-2G, and 1099-R from the taxpayer. If the taxpayer is unable to secure and provide a correct Form W-2, W-2G, or 1099-R, the return may be electronically filed after Form 4852 - Substitute for Form W-2, Wage and Tax Statement, or Form 1099-R - Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance

Contracts, etc. is completed in accordance with the use of that form. This is the only time information from Pay stubs or Leave and Earning Statements (LES) is allowed. The IRS monitors Authorized IRS e-file Providers for compliance with the Revenue Procedure 2007-40 and IRS e-file rules and requirements. Monitoring visits will be conducted to investigate complaints and to ensure compliance.

Violations of IRS e-file requirements may result in warning or sanctioning an Authorized IRS e-file Provider. Sanctioning may be a written reprimand, suspension or expulsion from participation from IRS e-file, or other sanctions, depending on the seriousness of the infraction. The IRS categorizes the seriousness of infractions as Level One, Level Two, and Level Three. Providers may appeal sanctions through the Administrative Review Process. Un-reversed suspensions make Authorized IRS e-file Providers ineligible to participate in IRS e-file for a period of either one or two years from the effective date of the sanction. (70)

### Submission of Paper Documents to the IRS

IRS e-file returns must contain all the same information as returns filed completely on paper. EROs are responsible for ensuring that they submit to the IRS all paper documents required to complete the filing of returns. Attach all appropriate supporting documents that the IRS requires to the Form 8453 - U.S. Individual Income Tax Transmittal for an IRS e-file Return and send them to the IRS. (70)

Use Form 8453 to send any required paper forms or supporting documentation listed next to the checkboxes on Form 8453 (do not send Forms W-2, W-2G, or 1099-R). If you are an ERO, you must mail Form 8453 to the IRS within 3 business days after receiving acknowledgement that the IRS has accepted the electronically filed tax return.

### Recordkeeping and Documentation Requirements

EROs must retain the following material until the end of the calendar year at the business address from which it originated the return or at a location that allows the ERO to readily access the material as it must be available at the time of an IRS request. An ERO may retain the required records at the business address of the Responsible Official or at a location that allows the Responsible Official to readily access the material during any period of time the office is closed, as it must be available at the time of an IRS request through the end of the calendar year.

## Rejected Electronically Filed Returns

A rejected electronic return (from E-file) is usually the result of an identity problem which triggers IRS correspondence and slows down processing of tax returns. This unique feature of e-file enables preparers and taxpayers to fix mistakes before returns are processed, decreasing overall processing time and shortening the time it takes to receive a refund. If the reject is for a simple mistake, correct the error and resubmit the return electronically. If a mistake was made when entering a Social Security number, a payer's identification number, omitting a form, or misspelling a name; the errors can be corrected and the return can be resubmitted electronically with the IRS.

However, you may not be able to correct some rejects. For example, if the return is rejected because an exemption has been claimed on another taxpayer's return, check that the Social Security number of the exemption was entered correctly on the return. If the SSN is correct, you will not be able to file this return electronically unless the exemption is removed from the return. If you believe the taxpayer is entitled to claim the exemption, it is not necessary to remove the exemption, but the return must be filed on paper. Attach Form 8948 - Preparer Explanation for Not Filing Electronically, to the paper return; check box 4 and enter the reject code number.

There are other situations where the rejected return may or may not be corrected but it takes one or more tries to resolve. For example, some rejects are based on information on file with the Social Security Administration (SSA). Tax returns often require that both the name and date of birth associated with an SSN match SSA records. Taxpayers sometimes forget to update their records with SSA when they marry or divorce and this can cause their tax returns to reject. This can be resolved by matching SSA records, but if there is some other problem at SSA like a problem with the date of birth, the reject sometimes cannot be resolved. When this happens the return must be filed on paper. Attach Form 8948 to the paper return and check box 4; enter the reject code number and the number of attempts you made to resolve the reject before deciding that the error could not be fixed.

## Resubmission of Rejected Tax Returns

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. When the ERO advises the taxpayer that it has not filed the 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 ten 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. Taxpayers should include an explanation in the paper return as to why they are filing the return after the due date. (71)

Notice 2010-13 provides that a taxpayer required to e-file can request a waiver from the electronic filing requirement when it cannot meet the electronic filing requirements. Before filing a paper return, corporations, partnerships and tax-exempt organizations required to e-file must contact the e-Help Desk (1-866-255-0654) to attempt to resolve the rejection conditions. If the rejection conditions cannot be resolved, these taxpayers must receive authorization from the e-Help Desk before filing a paper return.

To be considered timely filed, the paper return must be postmarked by the later of the due date of the return, including extensions, or 10 calendar days after the date the IRS last gives notification the return was rejected as long as: (72)

1. The first transmission was made on or before the due date of the return (including extensions).
2. The last transmission was made within 10 calendar days of the first transmission.

**Review Question 5**
e-File can be used to file any return of income tax imposed by subtitle A of the Internal Revenue Code on individuals, trusts, or estates with all of the following forms except:

A. Form 1040
B. Form 1040A
C. Form 1040EZ
D. Form 1040X

See Review Feedback for answer.

# Annual Filing Season Program (AFSP)

The IRS is offering a voluntary Annual Filing Season Program (AFSP) to return preparers. The AFSP is intended to recognize and encourage the voluntary efforts of non-credentialed tax return preparers to increase their knowledge and improve their filing season competency through continuing education. To obtain the voluntary certification, credentialed tax preparers (CPA, attorney, enrolled agent, etc.) or tax return preparers who have successfully completed a national or state test (RTRP, CTEC, OBTP, DLLR, Part 1 of the SEE, etc.) would need to have an active Preparer Tax Identification Number (PTIN) and complete 15 credit hours of continuing professional education annually through an IRS approved provider.

Non-credentialed/non-exempt or unenrolled tax preparers must complete an 18-hour course consisting of 2 hours of Ethics and Professional Conduct, 10 hours of Federal taxation and a 6-hour Annual Federal Tax Refresher (AFTR) course that includes a 100-question comprehension test with a 3-hour time limit.

Unenrolled return preparers can elect to voluntarily take continuing professional education each year in preparation for the filing season and receive an Annual Filing Season Program – Record of Completion.

The program is important for a number of reasons. It encourages unregulated return preparers who do not have to meet continuing professional education requirements to stay up-to-date on tax laws and changes. It helps lessen the risk to taxpayers from preparers who have no education in Federal tax law or filing requirements. And it allows

preparers without professional credentials to stand out from the competition by giving them a recognizable record of completion that they can show to their clients.

Preparers who complete the AFSP will also be included in a public directory that will be added to IRS.gov each year for taxpayers to use in searching for qualified tax return preparers. The Directory of Federal Tax Return Preparers with Credentials and Select Qualifications will only include attorneys, certified public accountants (CPAs), enrolled agents, enrolled retirement plan agents (ERPAs), enrolled actuaries and individuals who have received an Annual Filing Season Program – Record of Completion.

Also, as of 2016, there were changes to the representation rights of return preparers. Attorneys, CPAs, and enrolled agents will continue to be the only tax professionals with unlimited representation rights, meaning they can represent their clients on any matters including audits, payment/collection issues, and appeals.

AFSP participants will have limited representation rights, meaning they can 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. PTIN holders without an AFSP – Record of Completion or other professional credential will only be permitted to prepare tax returns. They will not be allowed to represent clients before the IRS.

Established state-based return preparer program participants with current testing requirements such as return preparers who are active members of the Maryland State Board of Individual Tax Preparers, the Oregon Board of Tax Practitioners and/or the California Tax Education Council are exempt from taking the Annual Federal Tax Refresher (AFTR) course. For example, the IRS has exempted California Registered Tax Preparers (CRTP) from having to take the Annual Federal Tax Refresher (AFTR) course and passing the course's competency examination to obtain a Record of Completion because they have already demonstrated their competency by passing a 60-hour qualifying education course and annually maintaining their continuing professional education. These exempt groups are still required to meet other program requirements, including 15 CPE credits (10 Federal Tax Law, 3 Federal Tax Law Updates, and 2 Ethics).

Return preparers who can obtain the AFSP – Record of Completion without taking the AFTR course are:

- Anyone who passed the Registered Tax Return Preparer test administered by the IRS between November 2011 and January 2013.
- Established state-based return preparer program participants currently with testing requirements: Return preparers who are active registrants of the Oregon Board of Tax Practitioners, California Tax Education Council, and/or Maryland State Board of Individual Tax Preparers.
- SEE Part I Test-Passers: Tax practitioners who have passed the Special Enrollment Exam Part I within the past two years as of the first day of the upcoming filing season.
- VITA volunteers: Quality reviewers and instructors with active PTINs.
- Other accredited tax-focused credential-holders: The Accreditation Council for Accountancy and Taxation's Accredited Business Accountant/Advisor (ABA) and Accredited Tax Preparer (ATP) programs.

After PTIN renewal season begins in October, a Record of Completion will be generated for the tax practitioner once all requirements have been met, including renewal of his or her PTIN and Consent to adhere to specific practice obligations outlined in Subpart B and Section 10.51 of Treasury Department Circular No. 230. If the tax practitioner has an online PTIN account, he or she will receive an e-mail from TaxPro_PTIN@irs.gov with instructions on how to sign the Circular 230 consent and receive his or her certificate in his or her online secure mailbox. If the tax practitioner does not have an online PTIN account, he or she will receive a letter with instructions for completing the application process and obtaining his or her certificate.

To be eligible for an AFSP – Record of Completion, a return preparer must complete and pass the AFTR course and obtain their other CPE by December 31st prior to the start of the tax season. As AFTR courses are offered by CPE providers, return preparers are subject to the schedule of courses offered by these providers. In no circumstance will the AFSP – Record of Completion be issued before a return preparer has registered or renewed their PTIN for the upcoming year.

Tip

The consent to certain Circular 230 requirements for the Annual Filing Season Program Record of Completion for 2019 is especially important for those who want to continue to have limited representation rights for clients whose returns they prepare after December 31, 2018. All participants should log in to their PTIN account and sign the Circular 230 Consent statement in order to participate in the Annual Filing Season Program.

## AFSP Record of Completion

You will receive an email from the IRS that indicates that you have completed the educational requirement for the program. Follow these steps to complete the process:

1. Visit http://www.irs.gov/ptin and log into your PTIN account.
2. Select "AFSP Record of Completion – Circular 230 Consent." If you already have an IRS credential, such as an Enrolled Agent (EA) or a Registered Tax Return Preparer (RTRP) designation, this option will read "Elect to Participate in AFSP.
3. Agree to agree to the Circular 230 regulations of practice for the period covered by this Record of Completion.
4. Sign your application under penalty of perjury.
5. In about 24 hours after you sign and submit your consent, you should be able to log into your PTIN account again and have a printable "Record of Completion" in your mailbox.

You have until the tax filing due date (April 15th) to e-sign the Circular 230 consent and qualify for the AFSP. For more information about consenting to the Circular 230 requirements and printing your record of completion please visit the Annual Filing Season Program website on IRS.GOV and watch the How to Complete the Circular 230 Consent video.

**Review Question 6**

All of the following statements are true regarding the Annual Filing Season Program (AFSP) except:

A. Tax preparers who complete the AFSP will be included in a public directory that will be added to IRS.gov each year for taxpayers to use in searching for qualified tax return preparers
B. AFSP participants will have limited representation rights, meaning they can 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
C. The AFSP is a mandatory course required by the IRS that must be completed by all paid tax preparers
D. Non-credentialed/non-exempt or unenrolled tax preparers must complete an 18-hour course consisting of 2 hours of Ethics and Professional Conduct, 10 hours of Federal taxation and a 6-hour Annual Federal Tax Refresher (AFTR) course that includes a 100-question comprehension test with a 3-hour time limit

See Review Feedback for answer.

# Review Feedback

Review feedback provides both the answers to each question and an explanation or feedback as to how we arrived at each answer at the end of the lesson. Review feedback also contains evaluative feedback explaining why incorrect answers are wrong. You are also provided the course topic from which we derived our answer and the external source material we used for verification.

If you are using the online version of the course, Ctrl+click on the topic to find the section from which we arrived at the answer for the question. You can also Ctrl+click on the question number to return to the specific review question.

**Question 1 - D. Failure to timely pay personal income taxes**
Section 10.51 of Circular 230 lists several examples of disreputable conduct for which an enrolled agent may be disbarred or suspended from practice before the Internal Revenue Service. Failure to timely pay personal income taxes is not disreputable conduct under Section 10.51 of Circular 230.

Topic - Sanctionable Acts
Source - Circular 230 - Section 10.51

**Question 2 - C. The offer is a legitimate tax shelter**
The IRS states abusive tax shelters are "marketing schemes that involve artificial transactions with little or no economic reality. They often make use of unrealistic allocations, inflated appraisals, losses in connection with non-recourse loans, mismatching of income and deductions, financing techniques which do not conform to standard commercial business practices, or the mischaracterization of the substance of the transaction." If the taxpayer is offered a deal he or she thinks might be questionable, have it reviewed by his or her own tax adviser. If the promoter hesitates, the taxpayer has a clear indication that the offer may not be legitimate.

Topic - Promoting Abusive Tax Shelters
Source - Publication 550 - Chapter 2 - Abusive Tax Shelters

**Question 3 - C. Head of Household**
Beginning with 2018 Federal returns the Tax Cuts and Jobs Act (TCJA) added a requirement that preparer due diligence will apply to tax returns where the taxpayer uses the head of household filing status. Form 8867 - Paid Preparer's Due Diligence Checklist contains additional questions to ensure that paid preparers are performing their due diligence in determining that the taxpayer is eligible to file using the head of household filing status. Also, the $520 penalty for any preparers where the IRS determines that they did not following the due diligence requirements will apply.

Topic - Completing Form 8867
Source - Form 8867 - Paid Preparer's Due Diligence Checklist

**Question 4 - A. 2017 or 2018**
If a taxpayer's Earned Income Tax Credit (EITC) for any year after 1996 was denied and it was determined that his or her error was due to reckless or intentional disregard of the EITC rules, then he or she cannot claim the EITC for the next 2 years. Brian cannot claim the EITC for tax year 2017 or 2018 (Choice A). To claim the EITC on his return for 2019, Brian must complete and attach *Form 8862 - Information To Claim Earned Income Credit After Disallowance* to his return for that year.

Topic - Consequences of Filing EIC Returns Incorrectly
Source - Publication 596 - Chapter 5 - Are You Prohibited From Claiming the EIC for a Period of Years?

**Question 5 - D. Form 1040X**
Generally, e-file can be used to file any return of income tax imposed by subtitle A of the Internal Revenue Code on individuals, trusts, or estates, such as Forms 1040, 1040A, 1040EZ, and 1041. The *Form 1040X - Amended U.S. Individual Income Tax Return*, is not accepted electronically; only an original tax return may be electronically filed. The taxpayer must file a paper Form 1040X.

Topic - e-File for Tax Professionals
Source - IRS.GOV - Topic 308 - Amended Returns

**Question 6 - C. The AFSP is a mandatory course required by the IRS that must be completed by all paid tax preparers**
The Annual Filing Season Program (AFSP) is a voluntary program offered by the IRS to tax return preparers. The AFSP is intended to recognize and encourage the voluntary efforts of non-credentialed tax return preparers to increase their knowledge and improve their filing season competency through continuing education.

Tax preparers who complete the AFSP will be included in a public directory that will be added to IRS.gov each year. AFSP participants will also have limited representation rights. Additionally, to qualify for the AFSP non-credentialed/non-exempt or unenrolled tax preparers must complete an 18-hour course consisting of 2 hours of Ethics and Professional Conduct, 10 hours of Federal taxation and a 6-hour Annual Federal Tax Refresher (AFTR) course that includes a 100-question comprehension test with a 3-hour time limit.

Topic - Annual Filing Season Program (AFSP)
Source - IRS.GOV - Frequently Asked Questions: Annual Filing Season Program

# Glossary

**Accountant:** A practitioner of accounting or accountancy, which is the measurement, disclosure or provision of assurance about financial information that helps managers, investors, tax authorities and others make decisions about allocating resources.

**Accrual method of accounting:** The accounting method under which revenues are recognized on the income statement when they are earned (rather than when the cash is received).

**Adjusted gross income (AGI):** Gross income minus adjustments to income.

**Alternative minimum tax (AMT):** An income tax imposed by the United States Federal government on individuals, corporations, estates, and trusts. AMT is imposed at a nearly flat rate on an adjusted amount of taxable income above a certain threshold (also known as exemption). This exemption is substantially higher than the exemption from regular income tax.

**American Institute of Certified Public Accountants (AICPA):** The national professional organization of Certified Public Accountants (CPAs) in the United States.

**Attorney:** Any person who is a member in good standing of the bar of the highest court of any state, territory or possession of the United States, including a Commonwealth and the District of Columbia.

**Basis:** Generally the amount of the taxpayer's capital investment in a property for tax purposes. The taxpayer uses his or her basis to figure depreciation, amortization, depletion, casualty losses, and any gain or loss on the sale, exchange or other disposition of the property.

**Candidate:** An applicant for a CPA license.

**Cash method of accounting:** The accounting method that recognizes revenues and expenses at the time physical cash is actually received or paid out.

**Certified Public Accountant:** The statutory title of qualified accountants in the United States who have passed the Uniform Certified Public Accountant Examination and have met additional state education and experience requirements for certification as a CPA. All CPAs are accountants, but not all accountants are CPAs.

**Circular 230:** A tax regulation detailing the requirements and responsibilities of those who prepare Federal tax returns for compensation.

**Client:** Any person or entity, other than an employer, that engages a practitioner or practitioner's firm to perform professional services.

**Commissioner:** The Commissioner of the Internal Revenue Service.

**Confidential client information:** Any information disclosed by the client that is not available to the public.

**Conflict of interest:** Representation of one client that is directly adverse to that of another client, or representing a client in circumstances creating 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.

**Contingent fees:** The practice under which a professional bases his or her fee for services upon the results thereof. The American Institute of Certified Public Accountants has held that the performance of services for a contingent fee can be unethical; one exception is available, though, where (as in tax practice) the results are subject to third-party actions (here the government, in an audit setting). Several states are relaxing this restriction, allowing certified public accountants to mix the form of their compensation between fixed and contingent fees.

**Covered opinion:** A Covered Opinion is written advice (including electronic communications) by a tax practitioner concerning one or more Federal tax issues arising from: (1) an IRS listed tax-avoidance transaction, (2) any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, the principal purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code (IRC), or (3) any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, a significant purpose of which is the avoidance or evasion of tax imposed by the IRC if the written advice is (A) a reliance opinion, (B) a marketed opinion, (C) is subject to conditions of confidentiality, or (D) is subject to contractual protection.

**Depreciation:** An income tax deduction that allows a taxpayer to recover the cost or other basis of certain property. It is an annual allowance for the wear and tear, deterioration, or obsolescence of the property.

**Due diligence:** The care a reasonable person should take in preparing or assisting in the preparation of, approving, and filing of tax returns, documents, and other papers relating to Internal Revenue Service matters. See Circular 230 Subpart B, Section 10.22.

**Durable power of attorney:** A power of attorney that is not subject to a time limit and that will continue in force after the incapacitation or incompetence of the grantor (the taxpayer).

**Earned income:** All the taxable income and wages a taxpayer gets from working or from certain disability payments. The two ways a taxpayer can get earned income are working for someone who pays him or her or owning or running a business or farm. Taxable earned income includes wages, salaries, tips, and other taxable employee pay, union strike benefits, long-term disability benefits received prior to minimum retirement age and net earnings from self-employment.

**Enrolled Agent:** Any individual who is enrolled under the provisions of Treasury Department Circular 230 to practice before the IRS.

**Filing status:** Used to determine a taxpayer's filing requirements, standard deduction, eligibility for certain credits, and his or her correct tax. There are five filing statuses: Single, Married Filing Jointly, Married Filing Separately, Head of Household and Qualifying Widow(er) with Dependent Child.

**Frivolous Position:** A tax position that is knowingly advanced in bad faith and is patently improper.

**General power of attorney:** A power of attorney that authorizes the attorney-in-fact to perform any and all acts the taxpayer can perform.

**Government officer or employee:** An individual who is an officer or employee of the executive, legislative or judicial branch of a state or of the United States Government; an officer or employee of the District of Columbia; a Member of Congress.

**Gross income:** All income from any sources a taxpayer derives.

**Head of household:** One of five filing status options from which a taxpayer must chose when filing his or her taxes. To qualify for the head of household filing status the taxpayer must be unmarried or considered unmarried on the last day of the year, have paid more than half the cost of keeping up a home for the year and have had a qualifying person live with him or her in the home for more than half the year (except for temporary absences, such as school). However, if the qualifying person is the taxpayer's dependent parent, he or she does not have to live with taxpayer.

**Health Insurance Marketplace:** Also known as the Exchange, is the place where an individual will find information about private health insurance options, purchase health insurance, and obtain help with premiums and out-of-pocket costs if he or she is eligible.

**Household income:** Household income is the taxpayer's modified adjusted gross income (MAGI) plus the MAGI of each individual in his or her tax household whom the taxpayer claims as a dependent and who is required to file his or her own tax return.

**Identity theft:** Occurs when someone uses the taxpayer's personal information such as his or her name, Social Security number (SSN) or other identifying information, without his or her permission, to commit fraud or other crimes.

**Income tax:** Is a government levy (tax) imposed on individuals or entities (taxpayers) that varies with the income or profits (taxable income) of the taxpayer.

**Internal Revenue Code (The Code)**: The Internal Revenue Code (IRC), or "the Code", is the domestic portion of Federal statutory tax law in the United States, published separately as Title 26 of the United States Code (USC). The code is organized according to topic, and covers all relevant rules pertaining to income, gift, estate, sales, payroll and excise taxes.

**Itemized deduction:** An itemized deduction is an eligible expense that individual taxpayers in the United States can report on their Federal income tax returns in order to decrease their taxable income. Most taxpayers are allowed a choice between the itemized deductions and the standard deduction.

**Limited power of attorney**: A power of attorney that limits the attorney-in-fact to certain specified act(s).

**Marketed opinion:** Tax advice that is intended to be used or referred to by someone other than the tax practitioner in promoting, marketing or recommending a partnership or other entity, an investment plan or arrangement, or any other plan or arrangement, to one or more other taxpayers.

**Medicare:** The Federal health insurance program for people who are 65 or older, certain younger people with disabilities, and people with End-Stage Renal Disease (permanent kidney failure requiring dialysis or a transplant, sometimes called ESRD).

**Minimum value standards:** A health plan meets this standard if it is designed to pay at least 60% of the total cost of medical services for a standard population. As of 2014, individuals offered employer-sponsored coverage that provides minimum value and that is affordable will not be eligible for a premium tax credit.

**More Likely Than Not standard:** The chances are better than 50% that one or more significant Federal tax issues will be resolved in the taxpayer's favor.

**National Association of State Boards of Accountancy (NASBA):** An association dedicated to serving the 55 state boards of accountancy.

**Necessary expense:** Expense that is helpful and appropriate for the taxpayer's business. An expense does not have to be required to be considered necessary**.**

**Ordinary expense:** Expense that is common and accepted in the taxpayer's field of trade, business, or profession.

**Personal exemption**: The now defunct exemption was a tax deduction composed of amounts for the individual taxpayer, the taxpayer's spouse, and the taxpayer's child. The personal exemption was deducted against the taxpayer's income to arrive at the taxable income - the amount against which the tax rates are applied to compute the total tax liability.

**Placed in service:** The point in time when an asset that can be depreciated is first placed in use. The date the asset is placed in service marks the beginning of the depreciation period. The date of purchase usually marks when an asset is placed in service.

**Practice before the Internal Revenue Service:** All matters connected with a presentation to the IRS or any of its offices or employees relating to a taxpayer's rights, privileges or liabilities under laws or regulations administered by the IRS. Such presentations include, but are not limited to, preparing and filing documents, corresponding and communicating with the IRS, rendering written advice with respect to any entity, transaction, plan or arrangement, or other plan or arrangement having a potential for tax avoidance or evasion, and representing a client at conferences, hearings and meetings.

**Practitioner:** Generally an attorney, CPA, enrolled agent, or enrolled actuary authorized to practice before the IRS. Other individuals may qualify to practice temporarily or engage in limited practice before the IRS, however, they are not referred to as practitioners.

**Qualifying child:** May enable a taxpayer to claim several tax benefits, such as head of household filing status, the exemption for a dependent, the child tax credit, the child and dependent care credit and the earned income tax credit. In general, to be a taxpayer's qualifying child, a person must satisfy four tests: relationship, residence, age and support.

**Qualifying relative:** Four tests must be met for a person to be a taxpayer's qualifying relative. The four tests are: not a qualifying child test, member of household or relationship test, gross income test and support test. Unlike a qualifying child, a qualifying relative can be any age. There is no age test for a qualifying relative.

**Realistic possibility:** Formerly the standard by which a tax preparer conduct penalty was applied under IRC Section 6694 and the current standard for tax return positions under the AICPA's SSTS No. 1. Under SSTS No. 1, a practitioner should have a good-faith belief that the position has at least a realistic possibility of being sustained administratively or judicially on its merits if challenged. In other words, the standard has a one-in-three possibility of success if challenged by the IRS.

**Reasonable basis:** Significantly higher than not frivolous and lower than realistic possibility of success.

**Recapture:** The procedure for collecting income tax on a gain realized by a taxpayer when the taxpayer disposes of an asset that had previously provided an offset to ordinary income for the taxpayer through depreciation.

**Recognized representative:** An individual who is recognized to practice before the IRS.

**Reliance opinion:** Tax advice that concludes at a confidence level of at least "more likely than not" that one or more significant Federal tax issues will be resolved in the taxpayer's favor.

**Same-sex marriage:** Marriage between two people of the same biological sex and/or gender identity. For Federal tax purposes, the IRS looks to state or foreign law to determine whether individuals are married. The IRS has a general rule recognizing a marriage of same-sex spouses that was validly entered into in a domestic or foreign jurisdiction whose laws authorize the marriage of two individuals of the same sex even if the married couple resides in a domestic or foreign jurisdiction that does not recognize the validity of same-sex marriages. For tax year 2013 and going forward, same-sex spouses generally must file using a married filing separately or jointly filing status.

**Sanctions**: Penalties or other means of enforcement used to provide incentives for obedience with the law, or with rules and regulations.

**Service:** The Internal Revenue Service

**Social Security:** The foundation of economic security for millions of Americans - retirees, disabled persons, and families of retired, disabled or deceased workers. About 158 million Americans pay Social Security taxes and 57 million collect monthly benefits in 2013. About one household in four receives income from Social Security.

**Standard deduction**: A dollar amount that reduces the amount of income on which taxpayers are taxed. In general, the standard deduction is adjusted each year for inflation and varies according to the taxpayer's filing status. A taxpayer cannot take the standard deduction if he or she itemizes deductions.

**Substantial authority standard**: Weight of authorities in support of a position is substantial in relation to the weight of authorities in opposition to the position (40%). In other words, substantial authority is more stringent than the one-in-three, realistic- possibility standard but less so than the more-likely-than-not standard.

**Suitability checks**: Criteria used when determining if an applicant possesses the properties that are necessary for tax practice. Suitability checks include verification on filing personal and/or business tax returns, payment of any tax liabilities and inquiry regarding any conduct which would justify suspension or disbarment from practice.

**Tax avoidance:** The process whereby an individual plans his or her finances so as to apply all exemptions and deductions provided by tax laws to reduce taxable income.

**Tax evasion:** The reduction of one's tax liability by illegal means.

**Tax household:** A tax household generally includes the taxpayer, his or her spouse (if filing a joint return), and any individual he or she claims as a dependent on his or her tax return. It also generally includes each individual the taxpayer can, but does not, claim as a dependent on his or her tax return.

**Tax return:** Reports filed with the IRS or with the state or local tax collection agency containing information used to calculate income tax or other taxes. Tax return also includes an amended tax return and a claim for refund.

**Tax year:** An annual accounting period for keeping records and reporting income and expenses.

**Taxable income:** Taxable income is adjusted gross income less personal exemptions and itemized deductions.

**Treasury Regulations (The Regs):** "The Regs" are the tax regulations issued by the United States Internal Revenue Service (IRS), a bureau of the United States Department of the Treasury. These regulations are the Treasury Department's official interpretations of the Internal Revenue Code (the Code) and are one source of U.S. Federal income tax law.

**Unenrolled return preparer:** An individual other than an attorney, CPA, enrolled agent, enrolled retirement plan agent, or enrolled actuary who prepares and signs a taxpayer's return as the preparer, or who prepares a return but is not required (by the instructions to the return or regulations) to sign the return.

**Unemployment compensation:** Any amounts received under the unemployment compensation laws of the United States or of a state. It includes state unemployment insurance benefits and benefits paid to a taxpayer by a state or the District of Columbia from the Federal Unemployment Trust Fund. It also includes railroad unemployment compensation benefits, but not worker's compensation.

**Written advice:** Tax advice in print (including electronic communications) by a tax practitioner concerning one or more Federal tax issues written simply and objectively.

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# Index

## A



## B



## C



## D



## E



## F

## G



## H



## I

## K



## L



## M



## N



## P



## Q



## R



## S

## T



## U



## W

# Examination Instructions - 6 Hour Annual Federal Tax Refresher Course

This is the end of the 6-hour AFTR text and review questions/feedback. If you feel you are ready to take the online examination you may do so at any time by going to www.IRSTaxTraining.com and logging into your account. Please make sure you have reserved or blocked off **at least 3 hours** to complete the examination as it must be finished in one continuous session. You are allowed to use the course to locate answers on the examination and a timer will be displayed indicating how much time you have remaining. When the timer reaches 0:00 the exam will be stopped regardless of whether you completed all the questions or not.

Here are some useful strategies we recommend when you are ready to take your examination:

- Read the entire question and all the answers carefully before answering.
- Answer the questions you can first and come back to those you cannot later.
- Your first instinct is often correct.
- If you are running out of time it is better to answer the questions rather than leave them blank.

Earning your Annual Federal Tax Refresher Course (AFTR) credits from a self-study course is contingent upon scoring 70% or higher on the exam questions related to the course material. This examination covering Federal general tax law and tax law updates including ethics consists of 100 multiple-choice questions, meaning you must correctly answer 70 in order to pass.

The exam must be completed and submitted online at www.IRSTaxTraining.com. The online exam has a **3-hour time limit and must be completed in one sitting. Once the timer has started it cannot be stopped.** The exam is open book, so you are allowed to look up answers in the text we provide.

After you submit the exam to us we will grade it and, upon successful completion, e-mail you a Certificate of Completion. Additionally, we notify the IRS that you earned AFTR credits from IRSTaxTraining.com. If you should fail the exam on your first attempt, you will have the option to re-take the exam at no additional charge. Keep in mind, the exam must be reset by an administrator so you must wait until this occurs before you are able to re-take the exam.

We wish you every success and thank you for choosing IRSTaxTraining.com, Inc.

**Submit your exam:**

*How To:*

- Log into www.IRSTaxTraining.com
- Enter your email address and your password
- Click link to take online exam
- Answer questions
- Submit answers (within the 3-hour time limit)
- Verify PTIN*
- Get certificate by email within 24 hours
- We electronically notify the IRS that you earned Annual Federal Tax Refresher (AFTR) course credits

*** Important: Your PTIN and name must match EXACTLY what is in the IRS system.**

# IRSTAXTRAINING.COM, INC.

IRS Provider Number: RP5CH
NASBA National Registry Number: 125385

## 6 Hour Annual Federal Tax Refresher (AFTR) Course Evaluation

IRS Course Number: RP5CH-A-00048-18-S - 6 hours Annual Federal Tax Refresher

**Instructions:** Please comment on all of the following evaluation points for this course and select a number grade, using the 1-5 scale, with 5 being the highest.

| | |
|---|---|
| Were the stated learning objectives met?..... | 5 4 3 2 1 |
| Were the course materials accurate and relevant, and did they contribute to the achievement of the learning objectives?..... | 5 4 3 2 1 |
| Was the time allocated to learning adequate?..... | 5 4 3 2 1 |
| Were the facilities/equipment appropriate (if applicable)?..... | 5 4 3 2 1 |
| Was the course syllabus or handout materials satisfactory?..... | 5 4 3 2 1 |
| Were the audio and visual materials effective (if applicable)?..... | 5 4 3 2 1 |
| If applicable, were individual instructors knowledgeable and effective? | |
| Instructor (enter name) ..... | 5 4 3 2 1 |
| Instructor (enter name) ..... | 5 4 3 2 1 |

Number of Hours/Minutes it took you to study and complete course. ☐

Additional comments:

_____

_____

Part of the course you found *most* beneficial:

_____

_____

Part of the course you found *least* beneficial:

_____

_____

Would you like us to contact you about your comments after the course? ☐ YES ☐ NO

Name: _____ Phone: _____

**Please complete and include with exam at the conclusion of the course.**