ENROLLED AGENT
SPECIAL ENROLLMENT EXAM (SEE)
STUDY GUIDE

PART 1 - INDIVIDUALS

IRS Provider Number: RP5CH

IRSTAXTRAINING.COM, INC.

Email: Support@IRSTaxTraining.com
Voice: 800-214-4307
Fax: 877-674-3472

www.IRSTaxTraining.com

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Table of Contents

IRSTaxTraining.com, Inc. is pleased to provide our Enrolled Agent (EA) Exam Study Guide. This material is designed to prepare tax professionals for *Part 1 - Individuals* of the IRS Special Enrollment Exam (SEE) and provides an overview of the subject areas that are outlined for the examination period between May 1, 2021 – February 28, 2022. The study guide includes information about the administration of the examination and complete coverage of the categories that are on the exam. In addition, we have developed multiple practice tests for you to take that are simulations of the actual exam. They are timed just like the SEE and you will see your results upon completion, including the questions you missed and the correct answers. Before you sign up to take the SEE, the IRS asks you to read and follow the instructions in the Candidate Information Bulletin.

Course Description

This course, intended for exams taken between **May 1, 2021 – February 28, 2022**, is based on the **2020 tax year** and highlights major tax laws that are of significant importance to a tax practitioner. This section focuses on key Federal tax law provisions recently enacted or indexed for inflation. Among other topics, this part includes information about the Tax Cuts and Jobs Act (TCJA), taxable income, exclusions, the most common tax credits and deductions, capital gains and losses, and noteworthy tax filing documents and dates.

For exams taken between **May 1, 2021 – February 28, 2022,** all references on the examination are to the Internal Revenue Code, forms and publications, as amended through December 31, 2020. Also, unless otherwise stated, all questions relate to the calendar year 2020. Questions that contain the term ‘current tax year’ refer to the calendar year 2020. In answering questions, candidates should not take into account any legislation or court decisions after December 31, 2020.

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 bibliography you can use to find additional reference material when searching for particular topics or answers to examination questions. The numbers in parentheses at the end of a sentence correspond to the numbers in the bibliography.

IRS Special Enrollment Exam (SEE)

The examination contains three parts. Each part contains 100 multiple-choice questions. There are 85 questions that are scored and 15 questions that are experimental and not scored. The length of each part is 3½ hours (not including the pre-examination tutorial and post-examination survey). An on-screen timer is provided, showing the time remaining. The parts of the examination are:

- Part 1 - Individuals
  - Preliminary Work with Taxpayer Data – 14 questions
  - Income and Assets – 17 questions
  - Deductions and Credits – 17 questions
  - Taxation – 15 questions
  - Advising the Individual Taxpayer – 11 questions
  - Specialized Returns for Individuals – 11 questions
- Part 2 - Businesses
  - Business Entities and Considerations – 30 questions
  - Business Tax Preparation – 37 questions
  - Specialized Returns and Taxpayers – 18 questions
- Part 3 - Representation, Practice and Procedures
  - Practices and Procedures – 26 questions
  - Representation before the IRS – 25 questions
  - Specific Types of Representation – 20 questions
  - Completion of the Filing Process – 14 questions

Each part of the exam is 3½ hours long. The actual seat time is 4 hours to allow for a tutorial and survey. The examination parts can be taken in any order. Each exam part may be taken 4 times per testing window, which runs from May 1 to February 28. The test is not offered during the annual blackout period in March and April. During this time the test is updated for the most recent tax law. You have a total of two years from the time you pass your first exam to pass all three parts and become an Enrolled Agent.

The examinations are closed book, so no reference materials, papers or study materials are allowed at the test center. You will not be able to leave the testing room with a copy of any notes taken during the examination. Some examination questions may contain excerpts from the Internal Revenue Code or Income Tax Regulations.

You can schedule an examination appointment at any time online at www.prometric.com/test-takers/search/irs or by calling 800-306-3926 between 8 a.m. and 9 p.m. (ET), Monday through Friday. You will receive a number confirming your appointment. Keep this confirmation number for your records - you will need it to reschedule, cancel, or change your appointment.

You may take each part of the examination at your convenience and in any order. Parts do not have to be taken on the same day or on consecutive days. You may take examination parts up to four times each during each test window. The current test window is May 1, 2021 – February 28, 2022. Testing is not available in the months of March and April each year while the examination is updated.

A confirmation email is sent containing the date time and location of the exam. If any information on the confirmation notice is incorrect, if you have not received your confirmation notice before your exam date, or if you lose your confirmation email, you can log back into your dashboard and request a duplicate confirmation.

Keep in mind that you are not allowed to take anything into the room, including jewelry, purse, wallet or watch. A locked locker is available for your personal effects, and you must turn all of your pockets inside out for security. The test center provides you with scratch paper, 2 pencils and a handheld calculator. You will also be able to use an onscreen calculator during the examination.

After completing the exam, you press the "End" button. You will be asked about 5-10 evaluation questions. When you press "End" the second time, the results come up on your screen. If you pass, the score report will show a passing designation. It will not show a score. All score values above passing indicate that a candidate is qualified. You will also receive diagnostic information which will indicate areas where you may wish to consider professional development. When you pass all three parts of the examination, you may apply for enrollment with the IRS.

If you fail, your score report will show a scaled score between 40 and 104. You will also receive diagnostic information to assist you with future examination preparation. Diagnostic information will show an indicator of 1, 2, or 3 meaning:

1. Area of weakness - Additional study is necessary. It is important for you to focus on this area as you prepare to take the test again. You may want to consider taking a course or participating actively in a study group on this topic.
2. Marginal - You may need additional study in this area.
3. Strong - You clearly demonstrated an understanding of this subject area.

This information is designed to help you prepare for retaking the examination.

You may take each part of the examination at your convenience and in any order. Examination parts do not have to be taken on the same day or on consecutive days. You may take examination parts up to four times each during each test window. If you fail any part of the examination, you must allow a 24-hour waiting period before scheduling a retest. You must re-schedule with Prometric online at www.prometric.com/test-takers/search/irs or by calling 800-306-3926.

If you do not pass a part of the examination after four attempts during the May 1 to February 28 test window, you must wait until the next test window before attempting to retake any failed part of the examination again. The average passing rate for Part 1 of the exam in 2020 was about 80%. For Part 2 the average passing rate was about 60% and for Part 3 the average passing rate was about 85%. For this reason, we recommend that candidates attempt Part 1 first followed by Part 3 and then Part 2. We also strongly recommend extra time in your preparation for Part 2. When you pass all three parts of the examination you need to file Form 23 - Application for Enrollment to Practice Before the Internal Revenue Service. As part of the evaluation of your enrollment application, the Internal Revenue Service will conduct a suitability check that will include a review of your personal tax compliance.

FAQs

What is an enrolled agent?
An enrolled agent is a person who has earned the privilege of representing taxpayers before the Internal Revenue Service. Enrolled agents, like attorneys and certified public accountants (CPAs), are unrestricted as to which taxpayers they can represent, what types of tax matters they can handle, and which IRS offices they can represent clients before.

How do you become an enrolled agent?
Review the Candidate Information Bulletin to get started and follow these steps to become an EA:

1. Obtain a Preparer Tax Identification Number (PTIN).
2. Apply to take the Special Enrollment Examination (SEE).
3. Achieve passing scores on all 3 parts of the SEE.*
4. Apply for enrollment.
5. Pass a tax compliance check to ensure that you have filed all necessary tax returns and there are no outstanding tax liabilities.

*Certain IRS employees, by virtue of past technical experience, are exempt from the exam requirement.

How much does it cost to take the Special Enrollment Examination?
There is a $185 fee for each part of the examination paid at the time of appointment scheduling. The test fee is non-refundable and non-transferable. This fee is paid at the time you schedule your examination. Accepted forms of payment include MasterCard, Visa, American Express and Electronic checks. Money orders, paper checks and cash are not accepted. Please refer to the Candidate Information Bulletin to read the policy on rescheduling appointments.

What types of tax issues could negatively impact consideration of an application for enrollment?
In general, any overdue tax return that has not been filed or any unpaid taxes unless acceptable payment arrangements have been established. Refer to Circular 230, Sections 10.5(d)(1) and 10.51, for a complete explanation of the suitability requirements.

What types of criminal convictions would negatively impact consideration of an application for enrollment?
In general, any criminal offense resulting in a felony conviction under Federal tax laws or a felony conviction related to dishonesty or a breach of trust, that is less than ten years old. Refer to Circular 230, Sections 10.5(d)(1) and 10.51, for a complete explanation of the suitability requirements.

Do enrolled agents have any continuing education requirements?
Enrolled agents must obtain a minimum of 72 hours per enrollment cycle (every three years). Additionally, they must also obtain a minimum of 16 hours of continuing education (including 2 hours of ethics or professional conduct) each enrollment year.

If I live outside the U.S., am I required to obtain a PTIN prior to becoming an enrolled agent?
Yes, all applicants must have a Preparer Tax Identification Number (PTIN) issued by the Internal Revenue Service (IRS) in order to register to take the examination. Obtain a PTIN at www.irs.gov/ptin.

After I register to take the Special Enrollment Exam, how long do I have to schedule an appointment to test?
Your examination appointment must be scheduled within one year of the date of registration. If space permits, you may register and schedule up to 2 days prior to your test date. There is no fee if you reschedule at least 30 calendar days prior to your appointment date. There is a $35 fee if you reschedule 5 to 29 calendar days before your appointment date. Another full examination fee if you reschedule less than five calendar days before your appointment date. Rescheduling an examination must be done online at http://www.prometric.com/test-takers/search/irs or by calling 800-306-3926.

I previously passed parts of the exam, how long can I carryover those scores?

Generally, candidates who pass a part of the examination can carry over a passing score up to two years from the date they passed that part of the examination. To provide candidates flexibility in testing during this period of global emergency, the two-year period has been extended to three years. This applies to any examination parts that had not expired as of February 29, 2020 and any examination parts passed on June 1, 2020 and later. For example, assume a candidate passed Part 1 on November 15, 2019. Subsequently the candidate passed Part 2 on February 15, 2020. That candidate has until November 15, 2022 to pass the remaining part. Otherwise, the candidate loses credit for Part 1. The candidate has until February 15, 2023 to pass all other parts of the examination or will lose credit for Part 2.

In another example, assume a candidate passed Part 1 on June 1, 2020. Subsequently the candidate passed Part 2 on September 1, 2020. That candidate has until June 1, 2023 to pass the remaining part. Otherwise, the candidate loses credit for Part 1. The candidate has until September 1, 2023 to pass all other parts of the examination or will lose credit for Part 2.

How do I obtain my SEE results?

Candidates taking an examination between May 1, 2021 and approximately August 1, 2021 will not receive a test score immediately upon completion of the examination. During this period data will be collected and analyzed to establish the passing score. For tests taken during this period a score report will be e-mailed to the test candidate beginning August 5, 2021.

Beginning August 2, 2021, upon completion of the examination, a pass/fail message will appear on your computer screen. In addition, you will receive an email from Prometric containing your score report.

Do I have to send my test results to the IRS?

No. The test center (Prometric) will automatically share the test results with the IRS and the IRS records will be updated accordingly.

How does the IRS determine if a person passes or fails? What is the passing score?

The scoring methodology was determined by the IRS following a scoring study. A panel of subject matter experts composed of Enrolled Agents and IRS representatives established a passing score for a candidate who meets the minimum qualifications to be an Enrolled Agent. The scaled passing score is 105.

What is a scaled score system? How can I determine my score?

Scaled scores are determined by calculating the number of questions answered correctly and converting it to a scale that ranges from 40 to 130. The IRS has set the scaled passing score at 105. Failing candidates are provided a scaled score value so that they may see how close they are to being successful. Candidates that receive a scaled score of 104 are very close to passing. Candidates with a scaled score of 45 are far from being successful. You will also receive diagnostic information to assist you with future examination preparation. If you pass, the score report will show a passing designation. It will not show a score. All score values above passing indicate that a candidate *is* qualified — not *how* qualified. You will also receive diagnostic information which may indicate areas of weakness in your performance where you may need continuing education.

Once I have passed all three parts of the SEE, how do I officially become an Enrolled Agent?

You must apply for enrollment within one year of the date you passed the third examination part. You may electronically apply for enrollment and make secure payment of the $67 enrollment fee at www.pay.gov. Click Find an Agency, select Treasury (UST): Internal Revenue Service (IRS), then click Application for Enrolled Agents. You will be given the option to pay online from your bank account (ACH) or with a debit or credit card.

You may also apply for enrollment by mail by submitting a completed Form 23 - Application for Enrollment to Practice before the IRS, along with a check for $67 to the address listed on the Form. Please allow 60 days for processing (90-120 days if you are a former IRS employee). As part of the evaluation of your enrollment application, the IRS will conduct a suitability check that will include a review of your personal tax compliance.

IRS Special Enrollment Exam (SEE) Outline

The following is a list of topics for each part of the examination and the percentage of questions that will appear on the exam covering these areas. Not every topic on the list will necessarily appear on the examination and the list should not be viewed as all-inclusive. Some topics may appear in more than one examination part.

Part 1 - Individuals

Section 1: Preliminary Work and Taxpayer Data (14 Questions)

1.1. Preliminary work to prepare tax returns

- Use of prior years' returns for comparison, accuracy, and carryovers for current year's return
- Taxpayer personal information (e.g., date of birth, marital status, dependents, identity
- protection PIN, state issued photo ID)
- Residency status and/or citizenship (e.g., citizen, visas, green cards, resident alien or non-resident alien, ITIN)
- Filing requirements and due dates
- Taxpayer filing status (e.g., single, head of household)
- Sources of all worldwide taxable and non-taxable income (e.g., interest, wages, business, sales of property, dividends, rental income, flow-through entities, alimony received)
- Sources of applicable exclusions and adjustments to gross income (e.g., foreign earned income exclusion, retirement plans, HSAs, alimony paid, health insurance, self-employment tax)
- Sources of applicable deductions (e.g., itemized, standard)
- Qualification for dependency
- Sources of applicable credits (e.g., education, foreign tax, retirement, child and dependent care, credit for other dependents, child tax credit)
- Sources of tax payments and refundable credits (e.g., withholding, estimated payments, earned income tax credit)
- Previous IRS correspondence with taxpayer
- Additional required returns to be filed and taxes paid (e.g., employment, gifts, international information returns, and other information returns)
- Special filing requirements (e.g., foreign income, presidentially declared disaster areas, injured spouse)
- Foreign account and asset reporting (e.g., FBAR, Form 8938)
- Minor children's unearned income (Kiddie tax)
- ACA requirements (e.g., health insurance coverage, total household income, advanced premium tax credit, household size)

Section 2: Income and Assets (17 Questions)

2.1. Income

- Taxability of wages, salaries and other earnings (e.g., earned income, statutory employee, tips)
- Interest Income (e.g., taxable and non-taxable)
- Dividends and other distributions from mutual funds, corporations, and other entities (e.g., qualified dividends)
- Personal property rental
- Gambling income and allowable deductions (e.g., W-2G, documentation)
- Tax treatment of forgiveness of debt (e.g., 1099C, foreclosures, insolvency)
- Tax treatment of a U.S. citizen/resident with foreign income (e.g., individual tax treaties, Form 1116, Form 2555, Form 3520 and Form 5471)
- Other income (e.g., scholarships, barter income, hobby income, alimony, non-taxable combat pay, unearned income, taxable recoveries, NOL, illegal income)
- Constructive receipt of income (e.g., cash vs. accrual)
- Constructive dividends (e.g., payments of personal expenses form a business entity)
- Passive income and loss (e.g., loss limitations)
- Pass-through income (e.g., Schedule K-1, income, deductions, basis, qualified business income (QBI) items)
- Royalties and related expenses

- State/local income tax refund and other itemized deduction recoveries
- 1099 MISC, 1099 NEC, 1099 K reporting, irregularities, and corrections

2.2. Retirement income
- Basis in a traditional IRA (Form 8606)
- Comparison of and distributions from traditional and Roth IRAs
- Distributions from qualified and non-qualified plans (e.g., pre-tax, after-tax, rollovers, 1099R, qualified charitable distribution)
- Excess contributions and tax treatment (e.g., penalties)
- Penalties and exceptions on premature distributions from qualified retirement plans and IRAs
- Prohibited transactions and tax consequences
- IRA conversions and recharacterizations (Form 8606)
- Required minimum distributions
- Loans from qualified plans
- Taxability of Social Security and Railroad Retirement benefits
- Tax implications for inherited retirement accounts
- Foreign pensions and retirement income

2.3. Property, real and personal
- Sale or disposition of property including depreciation recapture rules and 1099A
- Capital gains and losses (e.g., netting effect, short-term, long-term, mark-to-market, virtual currency)
- Basis of assets (e.g., purchased, gifted or inherited)
- Basis of stock after stock splits and/or stock dividends (e.g., research, schedules, brokerage records)
- Publicly traded partnerships (PTP) (e.g., sales, dispositions, losses)
- Sale of a personal residence (e.g., IRC Section 121 exclusions)
- Installment sales (e.g., related parties, original cost, date of acquisition, possible recalculations and recharacterization)
- Options (e.g., stock, commodity, ISO, ESPP)
- Like-kind exchange
- Non-business bad debts (e.g., documentation required)
- Investor versus trader

2.4. Adjustments to income
- Self-employment tax
- Retirement contribution limits and deductibility (e.g., earned compensation requirements)
- Health savings accounts
- Other adjustments to income (e.g., student loan interest, alimony, moving expenses, write-in adjustments)
- Self-employed Health Insurance

Section 3: Deductions and Credits (17 Questions)

3.1. Itemized deductions
- Medical, dental, vision, long-term care expenses
- Various taxes (e.g., state income, personal property, real estate)
- Interest expense (e.g., mortgage interest, investment interest, tracing rules, points, indebtedness limitations)
- Charitable contributions (e.g., cash, non-cash, limitations, documentation required)
- Nonbusiness casualty and theft losses in presidentially declared disaster areas
- Other itemized deductions
- Allowed itemized deductions for Form 1040-NR
- Qualified Business Income (QBI) deduction

3.2. Credits
- Child and dependent care credit
- Child tax credit and credit for other dependents
- Education credits
- Foreign tax credit
- Earned income tax credit (e.g., paid preparer's earned income tax credit checklist, eligibility and disallowance)
- Retirement contribution credit
- Adoption credits (e.g., carryovers, limitations, special needs)

- ACA premium tax credit
- Other credits (refundable and non-refundable) (e.g., health coverage tax credit, energy credits, Retirement savings contribution credit)

Section 4: Taxation and Advice (15 Questions)

4.1. Taxation

- Alternative minimum tax and credit for prior year minimum tax
- Household employees
- Underpayment penalties and interest
- Self-employment tax
- Excess Social Security withholding
- Tax provisions for members of the clergy
- Tax provisions for members of the military
- Income in respect of decedent (e.g., allocations)
- Net investment income tax
- Additional Medicare tax
- Uncollected Social Security and Medicare tax
- Other taxes (e.g., first-time homebuyer credit repayment)

Section 5: Advising the individual taxpayer (15 Questions)

5.1. Advising the individual taxpayer

- Reporting obligations for individuals (e.g., 1099, bartering, cash)
- Property sales (e.g., homes, stock, businesses, antiques, collectibles)
- Education planning (e.g., lifetime learning credit, IRC Section 529 plans)
- Estate planning (e.g., gift versus inheritance, trusts, family partnerships, charitable giving, long-term care, life insurance)
- Retirement planning (e.g., annuities, IRAs, employer plans, early retirement rules, required minimum distribution, beneficiary ownership, charitable distributions from an IRA)
- Marriage and divorce (e.g., divorce settlement, common-law, community property, alimony)
- Items that will affect future/past returns (e.g., carryovers, net operating loss, Schedule D, Form 8801, negative QBI carryover)
- Injured spouse
- Innocent spouse
- Estimated tax and penalty avoidance (e.g., mid-year estimated tax planning)
- Adjustments, deductions, and credits for tax planning (e.g., timing of income and expenses)
- Character of transaction (e.g., use of capital gain rates versus ordinary income rates)
- Advantages and disadvantages of MFJ/MFS/HOH filing statuses in various scenarios (e.g., joint and several liability)
- Conditions for filing a claim for refund (e.g., amended returns)
- Penalty of perjury

Section 6: Specialized Returns for Individuals (11 questions)

6.1. Estate tax

- Gross estate, taxable estate (calculations and payments), unified credit
- Jointly held property
- Marital deduction and other marital issues (e.g., portability election)
- Life insurance, IRAs, and retirement plans
- Estate filing requirements and due dates (e.g., Form 706: Form 1041)

6.2. Gift tax

- Gift-splitting
- Annual exclusion
- Unified credit
- Effect on estate tax (e.g., Generation skipping transfer tax)
- Filing requirements (e.g., Form 709)

6.3. International Information Reporting

- Filing and reporting requirements and due dates (e.g., FBAR, Form 8938, Form 8865, Form 5471, Form 3520)
- Covered accounts (e.g., FBAR, Form 8938)
- Potential penalties (e.g., failure to file, underreporting, substantially incomplete, statute of limitations, reduction of tax attributes)
- Distinctions between FBAR and Form 8938 requirements

Contact Information

Prometric

Main: 1-800-306-3926
Prometric Test Center: www.prometric.com/test-takers/search/irs

IRSTaxTraining.com

Phone: 1-800-214-4307
Web: www.irstaxtraining.com
Email: Support@irstaxtraining.com

Understanding the Icons Used in this Book

Important: Update or Change

Tip: Significant information

Note: Additional information

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American Rescue Plan (ARP) Act of 2021

Unemployment Benefits

The Act makes the first $10,200 in unemployment benefits tax-free in 2020 for taxpayers making less than $150,000 per year. If both individuals in a married couple who file taxes jointly received unemployment insurance benefits in 2020, each will see taxes waived on the first $10,2000 of that income - for a total of $20,400 - as long as their combined adjusted gross income is less than $150,000. (1)

Coronavirus Aid, Relief, and Economic Security Act (CARES)

The Coronavirus Aid, Relief, and Economic Security (CARES) Act is a package of measures introduced in the U.S. Senate in March of 2020 in response to the COVID-19 pandemic.

The legislation, in part, provides for:

- Loans and assistance to companies and state and local governments.
- Low-interest and small business loans that can be partially forgiven.
- Individual Stimulus Payments.
- Additional unemployment benefits.
- Suspension of certain Federal student loan payments.
- Financial hardship forbearance on federally backed mortgage loans.
- Assistance to hospitals and veterans' care.
- Funding for national stockpile of pharmaceutical and medical supplies.
- Tax relief provisions.

Retirement Plans

The CARES Act waives the 10% early withdrawal penalty tax (under IRC Section 72(t)) and allows a taxpayer to take a "coronavirus-related distribution" of up to $100,000 from a retirement plan or IRA in the year 2020 free from penalty.

A "coronavirus-related distribution" is a distribution made during 2020:

- To an individual who is diagnosed with SRS-COV-2 or COVID-19 by a test approved by the CDC,
- Whose spouse or dependent is diagnosed with one of the two diseases, or
- Who experiences adverse financial consequences as a result of being quarantined, furloughed or laid off or having work hours reduced, or being unable to work due to lack of childcare.

The Act also permits those individuals to either pay tax on the income from the distribution ratably over a three-year period or allows individuals to repay that amount tax-free back into the plan over the next three years. Those repayments would not be subject to the retirement plan contribution limits.

The Act doubles the current retirement plan loan limits to the lesser of $100,000 or 100% of the participant's vested account balance in the plan. Individuals with an outstanding loan from their plan with a repayment due from the date of enactment of the Act through December 31, 2020, can delay their loan repayment(s) for up to one year.

In addition, the Act contains a temporary waiver of required minimum distribution rules (RMD) for certain retirement plans and accounts. This provision waives, for the 2020 calendar year, the RMD rules for certain defined contribution plans (not defined benefit plans) and IRAs. The Act also includes special rules regarding the waiver period to, in essence, hold harmless those individuals (and plans) who took advantage of the RMD waiver for 2020.

Charitable Contributions

The CARES Act enhances tax incentives for making charitable contributions for the 2020 tax year. First, the act allows an above-the-line deduction of up to $300 for charitable contributions made by individuals. This provision allows taxpayers to claim a deduction for a charitable contribution even if he or she does not itemize his or her deductions.

Additionally, the new law temporarily lifts the limits on charitable giving for 2020. After passage of the TCJA, cash contributions to public charities are generally limited to 60% of a taxpayer's adjusted gross income (AGI). The CARES Act allows such contributions to be deducted up to 100% of AGI for 2020, with any excess contributions available to be carried over to the next five years. Contributions made to a supporting organization or a donor-advised fund do not qualify for either the above-the-line deduction or the increased limits. These provisions apply to taxable years beginning after December 31, 2019.

Student Loans Paid by Employers

The CARES Act provides an income exclusion of up to $5,250 for employees receiving educational repayment assistance from an employer. The Act expands the definition of "educational assistance" to include payments made by an employer to either an employee or to a lender, of principal or interest, on a qualified education loan. Educational assistance includes (but is not limited to) payment for expenses incurred for tuition, books, supplies and equipment. The Act does not allow an employee to deduct interest paid on a student loan. The exclusion applies to payments made after the date of enactment and through December 31, 2020.

Net Operating Loss (NOL)

Prior to 2018, net operating losses of a business or individual could be carried back two years and forward 20, and when carried forward, they could offset 100% of taxable income. The TCJA altered these rules, disallowing all carrybacks related to post-2017 losses, providing for an indefinite carryforward period, and limiting the use of post-2017 losses when carried forward to 80% of taxable income.

The CARES Act retroactively suspends the 80% income limitation on use of NOL carryovers for taxable years beginning before January 1, 2021 and allows 100% of any such taxable income of offset the amount of such NOL carryforward. This 80% income limitation is reinstated (with slight modifications) for tax years beginning after December 31, 2021. Also, losses from 2018, 2019 and 2020, will be permitted to be carried back for up to five years. As was previously the case, a taxpayer will be permitted to forgo the carryback, and instead carry the loss forward. The bill also eliminates loss limitation rules applicable to sole proprietors and pass-through entities to allow them to take advantage of the NOL carryback.

Further Consolidated Appropriations Act

In December 2019 Congress passed a spending bill called the Further Consolidated Appropriations Act. It includes a wide range of provisions from healthcare tax repeal to tax extenders.

The Act included the repeal of three Affordable Care Act-related taxes: the so-called "Cadillac" tax on health insurance benefits, an excise tax on medical devices, and the Health Insurance Tax. The three taxes were originally part of the Patient Protection and Affordable Care Act, more commonly called Obamacare. The repeals of the excise tax on medical devices and the Cadillac tax begin January 1, 2020, while the repeal of the Health Insurance Tax is effective in 2021.

The Act also extended many expired tax provisions. These provisions, often referred to as tax extenders, are now renewed on a short-term basis (and some of them retroactively).

Here are some of the highlights: [2]

- If the taxpayer has qualified principal residence indebtedness (in other words, the taxpayer defaulted on a mortgage that he or she took out to buy, build, or substantially improve his or her main home), he or she was previously able to exclude that amount from income. The provision expired in 2017 but has been renewed.
- The mortgage insurance premium (sometimes called PMI) deduction had also been allowed to expire. It is now extended through 2020.

- The medical expenses deduction 7.5% floor has returned (it previously jumped to 10%) for 2019 and 2020.
- The above-the-line qualified tuition and related expenses deduction returned and has been extended through 2020.
- The employer Credit for Paid Family and Medical Leave and the Work Opportunity Tax Credit were expected to expire in 2019 but have been extended through 2020.
- The biodiesel credit has been extended.
- The law retroactively extended tax credits for alternative fuel vehicle refueling property, non-business energy property, new energy-efficient homes, and new energy-efficient commercial buildings. The extension is from December 31, 2017 through December 31, 2020.

Setting Every Community Up for Retirement Enhancement (SECURE) Act

As part of the spending bill Congress passed the Setting Every Community Up for Retirement Enhancement (SECURE) Act. The SECURE Act represents a major overhaul of the rules for retirement plans and IRAs and is generally effective on January 1, 2020. The following are several key provisions included in the SECURE Act: [3]

- **IRA contributions:** Previously, taxpayers were not allowed to contribute to a traditional IRA once they attained the age of 70½. The new law repeals this restriction based on the age of the IRA participant. For 2019 and for 2020, eligible individuals can contribute up to $6,000, plus a $1,000 catch-up contribution if they turn age 50 or older in the year for which the contribution is made.
- **Part-time workers:** Generally, employers were able to exclude part-time workers (i.e., those working less than 1,000 hours per year) from participating in their 401(k) plans. Now the new law opens up plans to employees who have completed one year of service (with the 1,000-hour rule) or three consecutive years of at least 500 hours of service.
- **Required minimum distributions:** Under long-standing rules, participants in qualified plans and IRAs were obligated to start taking required minimum distributions (RMD) in the year after the year they turned age 70½. The new law pushes back the RMD age to 72 to reflect longer life expectancies. The current life expectancy factors that apply for various ages will continue to apply when retirement account owners reach those ages. The factors are not 'pushed back'. Instead, retirement account owners just will not have to use the factors for an age-70 or age-71 individual anymore and will begin at age 72 instead.
- **Early withdrawals:** The tax law already exempts certain distributions from qualified plans from the usual 10% tax penalty on early withdrawals prior to age 59½. The SECURE Act adds to the list by allowing penalty-free distributions for qualified birth and adoption expenses. Within a year after a birth or adoption, new parents can take up to $5,000 from a 401(k) or IRA or other qualified retirement plan.
- **Stretch IRA:** The "stretch IRA" provision has generally been eliminated for non-spousal IRAs. For IRAs inherited from original owners who have passed away on or after January 1, 2020, the new law requires many beneficiaries to withdraw all assets from an inherited IRA or 401(k) plan within 10 years following the death of the account holder.
- **Using a Section 529 Plan To Pay Student Loans:** Section 529 plan account owners may now withdraw up to $10,000 tax-free for payments toward qualified education loans. The $10,000 limit is a lifetime limit that applies to the 529 plan beneficiary and each of their siblings.
- **Using a Section 529 Plan To Pay For Apprenticeship Programs:** The legislation expands Section 529 education savings accounts to cover costs associated with registered apprenticeships. Apprenticeship programs provide on-site training to prepare workers for careers in various fields, such as manufacturing, health care, information technology and construction. Students who are pursuing an apprenticeship may use tax-free 529 plan distributions to pay for fees, textbooks, supplies and equipment required for a registered apprenticeship.

Tax Cuts and Jobs Act (TCJA)

In general, the bill provides new tax brackets, larger standard deduction amounts and adjusted credit amounts. It scales back a popular deduction for state and local taxes, repeals a key tenet of the Affordable Care Act and cuts the corporate tax rate from 35% to 21%.

The bill also removed the personal exemption, permanently adjusted the alternative minimum tax (AMT) exemption amounts for inflation and doubled the Child Tax Credit from $1,000 to $2,000 per child, with up to $1,400 available in refunds for families who owe little or no taxes. The bill also increases the standard deduction, to $12,400 ($24,800 for married couples) for 2020. 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, began 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.

Preliminary Work and Collection of Taxpayer Data

Safeguarding Taxpayer Data

Data thefts at tax professionals' offices are on the rise. As the Security Summit makes progress, identity thieves need more taxpayer data to file fraudulent tax returns. And they have placed tax practitioners firmly in their sights. Data security is now a necessity for every tax professional, whether a partner in a large firm or a sole practitioner, and every Authorized IRS e-File Provider. Every employee, both professional and administrative staff, should be educated about security threats and safeguards. Everyone has a role to play in protecting taxpayer information.

Protecting taxpayer data is the law. Federal law gives the Federal Trade Commission authority to set data safeguard regulations for various entities, including professional tax return preparers. According to the FTC Safeguards Rule, tax return preparers must create and enact security plans to protect client data. Failure to do so may result in an FTC investigation. Online providers also must follow the six security and privacy standards in Publication 1345 - Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns.

Protecting taxpayer data is good business. Data security can protect your business as well as your clients. A theft may also mean a loss of reputation, a loss of clients or a loss of money. Consider engaging security professionals for assistance or check with your professional liability carrier about data theft coverage.
Here are some basic security steps that tax professionals can take today to make their clients' data and their businesses safer:

- Learn to recognize phishing emails, especially those pretending to be from the IRS, e-Services, a tax software provider or cloud storage provider. Never open an embedded link or any attachment from a suspicious email.
- Create a data security plan using IRS Publication 4557 - Safeguarding Taxpayer Data.
- Review internal controls:
  - Install anti-malware/anti-virus security software on all devices (laptops, desktops, routers, tablets and phones) and keep software set to automatically update.
  - Use strong passwords of 8 or more characters, use different passwords for each account, use special and alphanumeric characters, use phrases, password protect wireless devices and consider a password manager program.
  - Encrypt all sensitive files/emails and use strong password protections.
  - Back up sensitive data to a safe and secure external source not connected fulltime to a network.
  - Make a final review of return information – especially direct deposit information - prior to e-filing.
  - Wipe clean or destroy old computer hard drives and printers that contain sensitive data.
  - Limit access to taxpayer data to individuals who need to know.
  - Check IRS e-Services account weekly for number of returns filed with EFIN.
- Report any data theft or data loss to the appropriate IRS Stakeholder Liaison.
- Stay connected to the IRS through subscriptions to e-News for Tax Professionals, QuickAlerts and Social Media.

Cybercriminals work hard through various tactics to penetrate your network or trick you into disclosing passwords. They may steal the data, hold the data for ransom or use your own computers to complete and file fraudulent tax returns.

Here are a few basic steps to protect client data stored on your systems:

- Use drive encryption to lock files and all devices; encrypted files require a password to open.
- Backup encrypted copies of client data to external hard drives (USBs, CDs, DVDs) or use cloud storage; keep external drives in a secure location; encrypt data before uploading to the cloud.
- Avoid attaching USB drives and external drives with client data to public computers.
- Avoid installing unnecessary software or applications to the business network; avoid offers for “free” software, especially security software, which is often a ruse by criminals; download software or applications only from official sites.
- Perform an inventory of devices where client tax data are stored, i.e., laptops, smart phones, tablets, external hard drives, etc.; inventory software used to process or send tax data, i.e., operating systems, browsers, applications, tax software, web sites, etc.
- Limit or disable internet access capabilities for devices that have stored taxpayer data.
- Delete all information from devices, hard drives, USBs (flash drives), printers, tablets or phones before disposing of devices; some security software include a “shredder” that electronically destroys stored files.
- Physically destroy hard drives, tapes, USBs, CDs, tablets or phones by crushing, shredding or burning; shred or burn all documents containing taxpayer information before throwing away.

Tax practitioners should report data losses or thefts immediately to the IRS so that appropriate precautions can be made to protect clients from fraudulent returns being filed in their names. The Federal Trade Commission offers assistance to businesses who were victimized by data thefts and provides templates for letters that, for example, notify clients that a data loss has occurred.

Review of Prior Year’s Return for Accuracy, Comparison and Carryovers for Current Year Return

Before completing a tax return, be sure to review the taxpayer’s return from last year not just for accuracy but also for comparison to the current year return. This return will provide you with a wealth of information that can be valuable in the preparation of the current year's return, including:

- Tax loss carry forward information.
- Withholding information.
- Information about how certain income may have been treated, such as capital gains or traditional income.

Many tax preparers neglect to go over last year's return. But it is worth the time because very often he or she will find an applicable item that is not common for all individuals such as itemized deductions, sale of a residence, retirement pay, applicable taxes or some other important piece of information that might be beneficial to this year's return. Certain items from the prior year return may be needed to complete the current-year return (state income tax refund, AMT for credit, gain/loss carryover, charitable gift carryover, etc.).

A comparison may show that there were no important changes from the previous tax year. If this is the case, the current year return should total similar amounts and have a similar tax liability or refund. As you can see, the accuracy of the previous year’s return is significant as a resource. It can also increase efficiency when completing the current year’s return.

Collect Taxpayer’s Personal Information

Verify taxpayer’s identity, date of birth, citizenship, and age by examining government issued identification of taxpayer such as passport, driver’s license, or national identity card. Interview the taxpayer to determine filling and dependency exemptions. The age of a taxpayer determines if he or she qualifies for certain deductions, retirement distribution and/or dependency. Also, taxpayers using the married, filing jointly status often increase dollar limits for deductions, exemptions and credits.

Nationality

If an individual is an alien, he or she is considered to be a nonresident alien unless either the green card or substantial presence test for the calendar year is met. However, if the individual does not meet either of these tests he or she may choose to be treated as a U. S. resident for part of the year as a dual status alien. This usually occurs in the year of arrival or departure from the United States.

U.S. Citizen: (4)

- An individual born in the United States.
- An individual whose parent is a U.S. citizen.*
- A former alien who has been naturalized as a U.S. citizen
- An individual born in Puerto Rico.
- An individual born in Guam.
- An individual born in the U.S. Virgin Islands.

*The Child Citizenship Act, which applies to both adopted and biological children of U.S. citizens, amends Section 320 of the Immigration and Nationality Act (INA) to provide for the automatic acquisition of U.S. citizenship when certain conditions have been met.

Specifically, these conditions are: (4)

1. One parent is a U.S. citizen by birth or through naturalization.
2. The child is under the age of 18.
3. The child is residing in the United States as a lawful permanent resident alien and is in the legal and physical custody of the U.S. citizen parent.
4. If the child is adopted, the adoption must be final.

A **U.S. National** is an individual who owes his sole allegiance to the United States, including all U.S. citizens, and including some individuals who are not U.S. citizens. For tax purposes the term "U.S. national" refers to individuals who were born in American Samoa or the Commonwealth of the Northern Mariana Islands. (4)

An **Alien** is an individual who is not a U.S. citizen or U.S. national. An **Immigrant** is an alien who has been granted the right by the United States Citizenship and Immigration Services (USCIS) to reside permanently in the United States and to work without restrictions in the United States. Also known as a Lawful Permanent Resident (LPR). All immigrants are eventually issued a "green card" (USCIS Form I-551), which is the evidence of the alien's LPR status. LPR's who are awaiting the issuance of their green cards may bear an I-551 stamp in their foreign passports. (4)

Dual Status Aliens determine their residency status under both the Internal Revenue Code and tax treaties. If an individual changes status during the current year from a nonresident alien to a resident alien or from a resident alien to a nonresident alien he or she is a Dual Status Alien and must file a special tax return called a Dual Status Return described in Publication 519 - U.S. Tax Guide for Aliens. If the individual is a Nonresident Alien who will become a Resident Alien under the Substantial Presence test in the year following this taxable year, he or she may elect to be treated as a Dual Status Alien for this taxable year and a Resident Alien for the next taxable year if he or she meets certain tests. (Refer to section "Dual-Status Aliens" – "First Year Choice" in Publication 519 - U.S. Tax Guide for Aliens.)

Most Tax Treaties contain an article which defines tax residency for purposes of the Tax Treaty. Tax residency determined under the residency article of a tax treaty may differ from the residency provisions of the Internal Revenue Code.

A dual status alien married to a U.S. citizen or to a resident alien may elect to file a joint income tax return with his or her U.S. citizen or resident alien spouse.

If, at the end of the taxpayer's tax year, an individual is married and one spouse is a U.S. citizen or a resident alien and the other spouse is a nonresident alien, he or she can choose to treat the nonresident spouse as a U.S. resident. This includes situations in which one spouse is a nonresident alien at the beginning of the tax year, but a resident alien at the end of the year, and the other spouse is a nonresident alien at the end of the year. (5)

If the taxpayer makes this choice, he or she and his or her spouse are treated as residents for the entire tax year for the purpose of the Federal individual income tax return, and for the purpose of withholding U.S. Federal income tax from wages. However, for the purpose of Chapter 3 withholding the taxpayer may still be treated as a nonresident alien. In addition, the taxpayer may still be treated as a nonresident alien for the purpose of withholding Social Security and Medicare tax.

Generally, neither the taxpayer nor his or her spouse can claim tax treaty benefits as a resident of a foreign country for a tax year for which the choice is in effect and they are both taxed on worldwide income. However, the exception to the saving clause of a particular tax treaty might allow a resident alien to claim a tax treaty benefit on certain specified income. The taxpayer must file a joint income tax return for the year he or she makes the choice, but he or she and his or her spouse can file joint or separate returns in later years. [5]

Note

If the taxpayer files a joint return under this provision, the special instructions and restrictions for dual-status taxpayers do not apply.

An **Illegal Alien**, also known as an "Undocumented Alien," is an alien who has entered the United States illegally and is deportable if apprehended, or an alien who entered the United States legally but who has fallen "out of status" and is deportable.

A **Nonimmigrant Visa** allows a nonimmigrant to enter the United States in one of several different categories, which correspond to the purpose for which the nonimmigrant is being admitted to the United States. For example, a foreign student will usually enter the United States on an F-1 visa, a visitor for business on a B-1 visa, an exchange visitor (including students, teachers, researchers, trainees, alien physicians, au pairs, and others) on a J-1 visa, a diplomat on an A or G visa, etc. The categories of nonimmigrant visas correspond exactly to the "nonimmigrant status" assigned to each nonimmigrant upon his arrival, based on the purpose for which the nonimmigrant was admitted to the United States. For example, a foreign student who enters the United States on an F-1 visa is considered to be in F-1 student status after he enters the United States; and he will remain in that status until he violates the conditions prescribed for that status, or until he changes to another nonimmigrant or immigrant status with USCIS permission, or until he leaves the United States.

The **Visa Waiver Program** (VWP) enables citizens of participating countries to travel to the United States for tourism or business for 90 days or less without obtaining a United States visa. The VWP is administered by the Attorney General in consultation with the Secretary of State. The Visa Waiver Program (VWP) was created by an act of Congress as a pilot program in 1986 and implemented in 1988. Congress passed legislation to make the program permanent in October 2000, and the President signed the legislation on October 30, 2000.

Accuracy

The IRS reminds filers that e-filing their tax return greatly lowers the chance of errors. In fact, taxpayers are about twenty times more likely to make a mistake on their return if they file a paper return instead of e-filing their return.

Here are eight common errors to avoid: [6]

1. **Wrong or missing Social Security numbers**. Be sure to enter SSNs for the taxpayer and others on the tax return exactly as they are on the Social Security cards.
2. **Names wrong or misspelled**. Be sure to enter names of all individuals on the tax return exactly as they are on their Social Security cards.
3. **Filing status errors.** Choose the right filing status. There are five filing statuses: Single, Married Filing Jointly, Married Filing Separately, Head of Household and Qualifying Widow(er) With Dependent Child.
4. **Math mistakes.** When filing a paper tax return, double check the math. When e-filing, the software does the math. For example, if Social Security benefits are taxable, check to ensure the taxable portion is figured correctly.
5. **Errors in figuring credits, deductions.** Take time and read the instructions in the tax booklet carefully. Many filers make mistakes figuring their Earned Income Tax Credit, Child and Dependent Care Credit and the standard deduction. For example, if the taxpayer is age 65 or older or blind check to make sure to claim the correct, larger standard deduction amount.
6. **Wrong bank account numbers**. Direct deposit is the fast, easy and safe way to receive a tax refund. Make sure to enter the bank routing and account numbers correctly.

7. **Forms not signed, dated.** An unsigned tax return is like an unsigned check – it is invalid. Remember both spouses must sign a joint return.
8. **Electronic signature errors.** If the taxpayer e-files his or her income tax return, he or she will sign the return electronically using a Personal Identification Number. For security purposes, the software will ask him or her to enter the Adjusted Gross Income from the originally filed 2019 Federal tax return. Do not use the AGI amount from an amended 2019 return or an AGI provided to the taxpayer if the IRS corrected the return. The taxpayer may also use last year's PIN if he or she e-filed last year and remembers the PIN.

Tax Return Preparers Must Use IRS e-File

The law requiring paid tax return preparers to electronically file Federal income tax returns prepared and filed for individuals, trusts and estates started January 1, 2011. The e-file requirement phased in over two years starting in 2011. As a result of the rule, preparers who anticipate filing **11 or more** 1040, 1040-NR and 1041 during the year will be required to use IRS e-file.

The rule requires members of firms to compute the number of returns in the aggregate that they reasonably expect to file as a firm. If that number is 11 or more in a calendar year, then all members of the firm must e-file the returns they prepare and file. This is true even if a member prepares and files fewer than the threshold on an individual basis. Clients may independently choose to file on paper.

Tax Preparers Must have a Preparer Tax Identification Number

IRS regulations require all paid tax return preparers and enrolled agents (including attorneys, and CPAs if they prepare for compensation all or substantially all of a Federal tax return or claim for refund) to obtain a Preparer Tax Identification Number (PTIN) before preparing any Federal tax returns. A PTIN meets the requirements under Section 6109(a)(4) of furnishing a paid tax return preparer's identifying number on returns that you prepare.

In February of 2013, the United States District Court for the District of Columbia modified its order from January of 2013 to clarify that the order does not affect the requirement for all paid tax return preparers to obtain a preparer tax identification number (PTIN). You must renew your PTIN every year during the renewal season which generally starts in October and must be completed by December 31. Your PTIN is your Federal license to prepare taxes and it must be included on all returns you prepare.

Taxpayer Identification Numbers

A Taxpayer Identification Number (TIN) is an identification number used by the Internal Revenue Service (IRS) in the administration of tax laws. It is issued either by the Social Security Administration (SSA) or by the IRS. Most taxpayers will use a Social Security number (SSN) issued by the SSA. Additional TINs issued by the IRS include:

- Employer Identification Number "EIN".
- Individual Taxpayer Identification Number "ITIN".
- Taxpayer Identification Number for Pending U.S. Adoptions "ATIN".
- Preparer Taxpayer Identification Number "PTIN".

A taxpayer generally must list on his or her individual income tax return the Social Security number (SSN) of any person for whom he or she claims an exemption. If his or her dependent or spouse does not have and is not eligible to get an SSN, the taxpayer must list the ITIN instead of an SSN. The taxpayer does not need an SSN or ITIN for a child who was born and died in the same tax year. Instead of an SSN or ITIN, attach a copy of the child's birth certificate and write Died on the appropriate exemption line of the tax return.

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: (7)

- 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 an 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: [8]

- 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 consecutive years and those with middle digits of 88 will no longer be valid for use on a tax return as of December 31, 2020. In addition, ITINs with middle digits of 90, 91, 92, 94, 95, 96, 97, 98 or 99 (Example: 9NN-90-NNNN) that were assigned before 2013 will need to be renewed if the taxpayer will have a filing requirement in 2021. 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 2020 must submit a renewal application. Others do not need to take any action.

- ITINs with middle digits 90, 91, 92, 94, 95, 96, 97, 98 or 99 (For example: 9NN-90-NNNN) need to be renewed if the taxpayer will have a filing requirement in 2021.
- Those who must renew their ITIN can choose to renew their family's ITINs together, even if family members have an ITIN with middle digits other than 90, 91, 92, 94, 95, 96, 97, 98 or 99. Family members include the tax filer, spouse and any dependents claimed on the tax return.
- Taxpayers whose ITINs expired due to lack of use should only renew their ITIN if they will have a filing requirement in 2021.
- 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.

If the taxpayer needs to file a tax return and his or her ITIN has expired or will expire before he or she files, the IRS recommends the taxpayer submits his or her renewal application immediately to prevent potential delays in the processing of his or her return. If the taxpayer uses an expired ITIN on a U.S. tax return, it will be processed and treated as timely filed, but without any exemptions and/or credits claimed, and no refund will be paid at that time. The taxpayer will receive a notice explaining the delay in any refund and that the ITIN has expired. 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.

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: [9]

- 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 his or her account.

Note

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 2020 tax returns generally are sent in December 2020. A new CP01A notice will be issued each subsequent year in January for the new filing season as long as the taxpayer's tax account remains at risk for identity theft. 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.

Tax Forms

Form 1040-NR Revision

For 2020, the taxpayer will no longer use Form 1040-NR-EZ as he or she may have in the past. Instead, he or she will use the redesigned Form 1040-NR. The lines on Form 1040-NR have been rearranged so that, in most instances, they are for the same tax items as the lines on 2020 Form 1040 or 1040-SR. The taxpayer may also need the three Form 1040 numbered schedules: Schedule 1 (Form 1040), Additional Income and Adjustments to Income; Schedule 2 (Form 1040), Additional Taxes; and Schedule 3 (Form 1040), Additional Credits and Payments. Certain lines formerly found on Form 1040-NR are now on those schedules.

Form 1040 - U.S. Individual Income Tax Return

The Form 1040 - U.S. Individual Income Tax Return has been rewritten to only include the five most common types of income, Federal withholding, Earned Income Tax Credit (EITC), Additional Child Tax Credit and the Education Credit. The detail for all other types of income, adjustments to income, nonrefundable, refundable credits, other payments and other taxes that existed on the previous Form 1040 have been moved to one of three schedules:

- Schedule 1 - Additional Income and Adjustments to Income:
    - Includes the remaining income types such as from Schedule C, D, E and F, unemployment compensation, etc.
    - All adjustments to income such as Educator expenses, IRA contributions, student loan interest, etc.
- Schedule 2 - Additional Taxes:
    - Includes all lines that are used to calculate total tax such as the regular tax, tax on child's unearned income, alternative minimum tax, etc.
    - Includes all other taxes such as self-employment tax, household employment tax, etc.
- Schedule 3 - Additional Credits and Payments:
    - Includes nonrefundable credits such as the Foreign Tax Credit, Education credits, Retirement Savings Contributions Credit, and Residential energy credits.
    - Includes the lines for other payments and refundable credits such as, net Premium Tax Credit, excess Social Security and tier 1 RRTA tax withheld, and the Credit for Federal Tax on Fuels.

The Form 1040 also includes changes that are a result of the Tax Cuts and Jobs Act such as:

- Removal of exemption amount boxes and the total exemptions line.
- Line 13 for the qualified business income deduction (20% deduction for pass-through business income – Section 199A).

Here are some details about how the new forms are alike and how they differ from the previous version:

- **Names and Social Security Numbers.** The spaces for names and Social Security numbers remain the same.
- **Signatures.** The spaces for signatures and Third-Party Designee are on page two.
- **Filing Status.** Form 1040 retains the choices for the five filing statuses: Single, Married filing jointly, Married filing separately, Head of household or Qualifying widow(er).
- **Presidential election campaign.** The option to contribute to the Presidential election campaign is the same.
- **Personal exemptions.** There are no personal exemptions available for the tax years 2018 through 2025, so those line items have been removed on the first and second pages of the Form 1040.
- **Dependents.** There is space on the front page to list four dependents again.
- **Income reporting.** Income from each of Schedules C, D, E, and F are now reported on a Schedule 1.
- **Adjusted income reporting.** Adjusted gross income (AGI) is now line 11 of page one.
- **Standard deduction.** The taxpayer's standard deduction amounts appear on page one and are updated annually.
- **Qualified business deduction (Section 199A Deduction).** The qualified business income deduction gets just one line on the Form 1040 (line 13) with instructions to attach Form 8995 or Form 8995-A.

Note

Tax preparers who filed Federal tax return electronically last year may not notice any changes, as the tax return preparation software will automatically use their answers to the tax questions to complete the Form 1040 and any needed schedules.

Form 1040-NR - U.S. Nonresident Alien Income Tax Return

The U.S. imposes a tax on worldwide income for its citizens and residents. If the taxpayer is a nonresident alien, he or she pays Federal income tax only on U.S. source income. In most cases, the taxpayer must file a tax return if he or she is a nonresident alien even if he or she has no income from his or her trade or business in the U.S., he or she has no U.S. source income or if his or her income is exempt from U.S. tax under a tax treaty.

There is an exception: the taxpayer does not need to file if, as a nonresident alien, his or her only U.S. trade or business was the performance of personal services with wages of less than $4,300 and he or she does not need to file to claim a refund of over-withheld taxes, satisfy additional withholding or claim partially exempt income. Exceptions also apply if the taxpayer is a nonresident alien student, teacher, or trainee in the U.S. temporarily on an "F," "J," "M," or "Q" visa, and he or she has no taxable income.

The taxpayer must file Form 1040-NR if **any** of the following conditions apply: [10]

1. A nonresident alien individual engaged or considered to be engaged in a trade or business in the United States during the year.
2. A nonresident alien individual who is not engaged in a trade or business in the United States and has U.S. income on which the tax liability was not satisfied by the withholding of tax at the source.
3. A representative or agent responsible for filing the return of an individual described in (1) or (2),
4. A fiduciary for a nonresident alien estate or trust, or
5. A resident or domestic fiduciary, or other person, charged with the care of the person or property of a nonresident individual may be required to file an income tax return for that individual and pay the tax.

An individual does not need to file Form 1040-NR if: [10]

1. He or she was a nonresident alien student, teacher, or trainee who was temporarily present in the United States under an "F," "J," "M," or "Q" visa, and he or she has no income that is subject to tax under Section 871 (that is, the income items listed on page 1 of Form 1040-NR, lines 1a, 1b, 2b, 3b, 4b, 5b, 7, and 8, and Schedule NEC (Form 1040-NR), lines 1 through 12).

2. He or she was a student or business apprentice who was eligible for the benefits of Article 21(2) of the United States-India Income Tax Treaty, he or she is single or a qualifying widow(er), and his or her gross income for 2020 was less than or equal to $12,400 if single ($24,800 if a qualifying widow(er)). See chapter 5 of Publication 519 for more details on these treaty benefits.
3. He or she was a partner in a U.S. partnership that was not engaged in a trade or business in the United States during 2020 and his or her Schedule K-1 (Form 1065) includes only income from U.S. sources reportable on Schedule NEC (Form 1040-NR), lines 1 through 12.

As of 2020, the 1040NR-EZ had been made obsolete. The IRS has simplified the 1040-NR, which will be used instead. The 1040NR-EZ may be used for filing a previous year return.

Filing Dates

The Treasury Department and Internal Revenue Service announced today that the federal income tax filing due date for individuals for the 2020 tax year will be automatically extended from April 15, 2021, to May 17, 2021. Individual taxpayers can also postpone federal income tax payments for the 2020 tax year due on April 15, 2021, to May 17, 2021, without penalties and interest, regardless of the amount owed. This postponement applies to individual taxpayers, including individuals who pay self-employment tax. Penalties, interest and additions to tax will begin to accrue on any remaining unpaid balances as of May 17, 2021. Individual taxpayers will automatically avoid interest and penalties on the taxes paid by May 17.

Following the extension of the filing and payment deadline for individuals to May 17, 2021, the IRS announced other tax deadline extensions to the same date.

Contributions to IRAs and health savings accounts - People now automatically have until May 17, 2021, to make 2020 contributions to their:

- Individual retirement arrangements
- Health savings accounts
- Archer medical savings accounts
- Coverdell education savings accounts

The deadline for reporting and paying the 10% additional tax on amounts included in gross income from 2020 distributions from IRAs or workplace-based retirement plans is now May 17, 2021. Lastly, the due date for Form 5498 series returns related to these accounts is now June 30, 2021.

2017 unclaimed refunds - The law provides a three-year window to claim a refund. Normally, April 15, 2021, is the deadline to claim a refund from tax year 2017 but, the IRS has extended it to May 17, 2021. To get the unclaimed refund, a taxpayer must properly address and mail the tax return, postmarked by May 17, 2021. If a taxpayer doesn't file a return within three years, the money becomes property of the U.S. Treasury.

Foreign trusts and estates - Foreign trusts and estates with federal income tax filing or payment obligations, who file Form 1040-NR, now have until May 17, 2021.

2021 Annual Filing Season Program application deadline - Tax return preparers who would like to participate in the Annual Filing Season Program for calendar year 2021 now have until May 17, 2021, to file their application with the IRS.

No extension for estimated tax payments - April 15, 2021 is still the deadline to make first quarter estimated tax payments. Withholding is automatic for most employees, but some taxpayers' income is not subject to income tax withholding. These taxpayers must generally make quarterly estimated tax payments.

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. 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 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.

Also, as of December 31, 2015:

- Partnership tax returns are due March 15, not April 15 as in the past. If the taxpayer's partnership is not on a calendar year, the return is due on the 15th day of the third month following the close of his or her tax year.
- C corporation tax returns are due April 15, not March 15. For non-calendar year taxpayers, it is due on the 15th day of the fourth month following the close of the tax year.
- S corporation tax returns remain unchanged. The returns are still due March 15, or the third month following the close of the taxable year. If the S corporation is unable to file by March 15, it can obtain an automatic six-month extension of time to file by filing IRS Form 7004.
- C corporations with tax years ending on June 30 will continue to have a due date of September 15 until 2025. For years beginning after 2025, the due date for these returns will be October 15.
- FBARs (FINCEN Form 114) will be due on April 15th, not June 30th. An extension for six months will be available (until October 15th).

The deadline for filing tax returns, paying taxes, filing claims for refund, and taking other actions with the IRS is automatically extended if either of the following statements is true: (11)

- The taxpayer serves in the Armed Forces in a combat zone or he or she has qualifying service outside of a combat zone.
- The taxpayer serves in the Armed Forces on deployment outside the United States away from his or her permanent duty station while participating in a contingency operation. A contingency operation is a military operation that is designated by the Secretary of Defense or results in calling members of the uniformed services to active duty (or retains them on active duty) during a war or a national emergency declared by the President or Congress.

The deadline for taking actions with the IRS is extended for 180 days after the later of: (11)

- The last day the taxpayer is in a combat zone, have qualifying service outside of the combat zone, or serve in a contingency operation (or the last day the area qualifies as a combat zone or the operation qualifies as a contingency operation).
- The last day of any continuous qualified hospitalization for injury from service in the combat zone or contingency operation or while performing qualifying service outside of the combat zone.

In addition to the 180 days, the deadline is extended by the number of days that were left for the taxpayer to take the action with the IRS when he or she entered a combat zone (or began performing qualifying service outside the combat zone) or began serving in a contingency operation. If the person entered the combat zone or began serving in the contingency operation before the period of time to take the action began, the deadline is extended by the entire period of time he or she has to take the action.

For example, the individual has 3½ months (January 1– April 15, 2021) to file his or her 2020 tax return. Any days of this 3½ month period that were left when he or she entered the combat zone (or the entire 3½ months if he or she entered the combat zone by January 1, 2021) are added to the 180 days when determining the last day allowed for filing the 2020 tax return.

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.

A taxpayer may simplify the money listings on the return by rounding off to whole dollar amounts. Any amount less than $0.50 would be eliminated, and any amount from $0.50 through $0.99 would be increased to the next higher dollar.

Death of a Taxpayer

If a taxpayer died before filing a return for 2020, the taxpayer's spouse or personal representative may have to file and sign a return for that taxpayer. A personal representative can be an executor, administrator, or anyone who is in charge of the deceased taxpayer's property. If the deceased taxpayer did not have to file a return but had tax withheld, a return must be filed to get a refund. The person who files the return must enter “Deceased,” the deceased taxpayer's name, and the date of death across the top of the return. If this information is not provided, it may delay the processing of the return.

The final income tax return is due at the same time the decedent's return would have been due had death not occurred. A final return for a decedent who was a calendar year taxpayer is generally due on April 15 following the year of death, regardless of when during that year death occurred. However, when the due date falls on a Saturday, Sunday, or legal holiday, the return is filed timely if filed by the next business day.

The tax return must be prepared on a form for the year of death regardless of when during the year death occurred.

If the taxpayer’s spouse died in 2020 and he or she did not remarry in 2020, or if his or her spouse dies in 2021 before filing a return for 2020, the taxpayer can file a joint return. Enter “Filing as surviving spouse” in the area where the taxpayer signs the return. If someone else is the personal representative, he or she must also sign.

The surviving spouse or personal representative should promptly notify all payers of income, including financial institutions, of the taxpayer's death. This will ensure the proper reporting of income earned by the taxpayer's estate or heirs. A deceased taxpayer's social security number should not be used for tax years after the year of death, except for estate tax return purposes.

Electronic Filing (IRS e-File)

Many tax professionals electronically file (e-file) tax returns for their clients. The main advantage for e-filing a tax return, either by computer or by telephone, is that the taxpayer who is due a tax refund, will receive the refund much sooner, as opposed to mailing in a completed paper return. A refund can be directly deposited into the taxpayer’s checking or savings account.

Electronic filing is a method by which qualified tax filers electronically transmit tax return data directly to an IRS Service Center in the format the IRS has prescribed. The modern IRS e-file program allows tax professionals and taxpayers alike to file income tax returns through an electronic return originator or by using a personal computer, modem, and commercial tax preparation software. Taxpayers who e-file their income tax returns and owe taxes can authorize direct debit payment from their checking or savings account on a specified date—say on April 15th. Taxpayers now can also pay taxes due by credit card. Furthermore, taxpayers can now file a tax return electronically without submitting any paperwork or signature. This type of paperless filing can be used by taxpayers who use a personal identification number (PIN).

Rules require many paid tax return preparers to electronically file Federal income tax returns prepared and filed for individuals, trusts, and estates. Since January 1, 2012, preparers who anticipate filing **11 or more** 1040, 1040-NR and 1041 during the year will be required to use IRS e-file. [12]

The rules require members of firms to compute the number of returns in the aggregate that they reasonably expect to file as a firm. If that number is 11 or more in a calendar year, then all members of the firm must e-file the returns they prepare and file. This is true even if a member prepares and files fewer than the threshold on an individual basis.

IRS Correspondence

If your client receives a letter or notice from the IRS, it will explain the reason for the correspondence and provide instructions. Many of these letters and notices can be dealt with simply, without having to call or visit an IRS office. The notice your client receives covers a very specific issue about his or her account or tax return. Generally, the IRS will send a notice if it believes your client owes additional tax, is due a larger refund, if there is a question about the tax return or a need for additional information.

The notice number prints on the top right-hand side of each page of all the IRS notices and on the lower right-hand side of the tear-off stub included with most of them. That number identifies the message delivered in every notice. While the contents may vary somewhat, every notice with the same number has the same basic purpose. See Understanding Your IRS Notice or Letter for a complete list of notice numbers.

Here are eight things every taxpayer should know about IRS notices:

1. Many of these letters can be dealt with simply and painlessly.
2. There are number of reasons the IRS sends notices to taxpayers. The notice may request payment of taxes, notify the taxpayer of a change to his or her account or request additional information. The notice normally covers a very specific issue about the account or tax return.
3. Each letter and notice offers specific instructions on what the taxpayer needs to do to satisfy the inquiry.
4. If the taxpayer receives a correction notice, he or she should review the correspondence and compare it with the information on the return.
5. If the taxpayer agrees with the correction to the account, usually no reply is necessary unless a payment is due.
6. If the taxpayer does not agree with the correction the IRS made, it is important that he or she respond as requested. Write to explain why the taxpayer disagrees. Include any documents and information the taxpayer wishes the IRS to consider, along with the bottom tear-off portion of the notice. Mail the information to the IRS address shown in the lower left part of the notice. Allow at least 30 days for a response.
7. Most correspondence can be handled without calling or visiting an IRS office. However, if the taxpayer has questions, call the telephone number in the upper right corner of the notice. Have a copy of the tax return and the correspondence available when calling.
8. It is important that taxpayer keep copies of any correspondence with his or her records.

Filing Status

The tax law divides taxpayers into five status categories based on their family responsibilities. This is referred to as the taxpayer's filing status. Because the tax rates differ for each filing status, separate tax rate schedules and tax tables are prepared by the Internal Revenue Service. See Publication 17 - Chapter 2 - Filing Status for details.

Here are eight facts about the five filing status options the IRS wants the taxpayer to know so that he or she can choose the best option for their situation. [13]

1. Marital status on the last day of the year determines marital status for the entire year.
2. If more than one filing status applies, choose the status that gives the taxpayer the lowest tax obligation.
3. Single filing status generally applies to anyone who is unmarried, divorced or legally separated according to state law.
4. A married couple may file a joint return together. The couple’s filing status would be Married Filing Jointly.
5. If a spouse died during the year and the taxpayer did not remarry during the tax year, usually he or she may still file a joint return with that spouse for the year of death.
6. A married couple may elect to file their returns separately. Each person’s filing status would generally be Married Filing Separately.
7. Head of household generally applies to taxpayers who are unmarried. The taxpayer must also have paid more than half the cost of maintaining a home for him or her and a qualifying person to qualify for this filing status.

8. The taxpayer may be able to choose Qualifying Widow(er) with Dependent Child as his or her filing status if a spouse died during 2018 or 2019, he or she has a dependent child and he or she meets certain other conditions.

Single

A taxpayer's filing status is single if the person never married or if, on the last day of the year, the person is unmarried or legally separated under a divorce or separate maintenance decree. The taxpayer is considered unmarried for the whole year if, on the last day of his or her tax year, he or she is either: (14)

- Unmarried, or
- Legally separated from his or her spouse under a divorce or separate maintenance decree.

State law governs whether the taxpayer is married or legally separated under a divorce or separate maintenance decree.

If the taxpayer is divorced under a final decree by the last day of the year, he or she is considered unmarried for the whole year. If the taxpayer obtains a divorce for the sole purpose of filing tax returns as unmarried individuals, and at the time of divorce he or she intends to and does, in fact, remarry each other in the next tax year, the taxpayer and his or her spouse must file as married individuals in both years.

If the taxpayer obtains a court decree of annulment, which holds that no valid marriage ever existed, he or she is considered unmarried even if he or she filed joint returns for earlier years. The taxpayer must file amended returns (Form 1040X) claiming single or head of household status for all tax years that are affected by the annulment and not closed by the statute of limitations for filing a tax return.

Generally, for a credit or refund, the taxpayer must file Form 1040X within 3 years (including extensions) after the date he or she filed his or her original return or within 2 years after the date he or she paid the tax, whichever is later. If the taxpayer filed his or her original tax return early (for example, March 1), his or her return is considered filed on the due date (generally April 15). However, if the taxpayer had an extension to file (for example, until October 15) but he or she filed early and the IRS received it on July 1, his or her return is considered filed on July 1.

Married, Filing a Joint Return

The determination of whether an individual is married shall be made as of the close of his or her taxable year; except that if his or her spouse dies during the taxable year such determination shall be made as of the time of such death or an individual legally separated from his or her spouse under a decree of divorce or of separate maintenance shall not be considered as married. (3)

There are many advantages to filing a joint tax return. The IRS gives joint filers one of the largest standard deductions each year, allowing them to deduct a significant amount of their income immediately. Also married couples who file together qualify for multiple tax credits such as the Earned Income Tax Credit, the American Opportunity and Lifetime Learning Credits, the exclusion or credit for adoption expenses, and the Child and Dependent Care Credit. Joint filers also receive higher income thresholds for certain taxes and deductions which means they can earn a larger amount of income and still qualify for certain tax breaks. A joint return may be filed under the following conditions: (13)

- If the individuals are married as of the last day of the taxable year. A couple could be married at 11:59.59 p.m. on December 31 of the taxable year and still file a joint return for the entire year.
- If one spouse dies during the taxable year, provided that the surviving spouse has not remarried during the year. If remarried, the taxpayer may file jointly with his or her new spouse.
- If the individuals are not divorced or legally separated before the end of the taxable year under a final decree.
- If both spouses agree to file a joint return.
- If a non-resident alien is married to a citizen of the United States and they both elect to be taxed on their worldwide income.
- If the tax years of both spouses begin on the same date.

In some cases, one spouse may be relieved of joint responsibility for tax, interest, and penalties on a joint return for items of the other spouse that were incorrectly reported on the joint return. The taxpayer can ask for relief no matter how small the liability.

There are three types of relief available: [15]

1. Innocent spouse relief.
2. Separation of liability, (available only to joint filers who are divorced, widowed, legally separated, or have not lived together for the 12 months ending on the date the election for this relief is filed).
3. Equitable relief.

The taxpayer must file Form 8857 - Request for Innocent Spouse Relief, to request relief from joint responsibility. Publication 971 - Innocent Spouse Relief, explains these kinds of relief and who may qualify for them.

Qualifying Widow(er) With Dependent Child

Surviving spouses with a dependent child may also use the same tax tables and tax rate schedules as used by joint filers (up to 2 years after year of spouse's death). A surviving spouse is a widow or widower whose spouse died not earlier than the second preceding taxable year and who has a dependent child, stepchild, adopted child, or foster child living with him or her for the entire year.

To illustrate, a taxpayer's husband died in July 2020. The taxpayer has a dependent son who lives with her. For 2020, she may file a joint return because she was still married on the date of her spouse's death. For 2021 and 2022, she qualifies as a surviving spouse. For 2023 and later years, she is not a surviving spouse because her husband died earlier than the second preceding taxable year.

A taxpayer is eligible to file his or her 2020 income tax return as a qualifying widow(er) with dependent child if he or she meets all of the following tests: [16]

1. The taxpayer was entitled to file a joint return with his or her spouse for the year his or her spouse died. It does not matter whether the taxpayer actually filed a joint return.
2. The taxpayer's spouse died in 2018 or 2019 and the taxpayer did not remarry before the end of 2020.
3. The taxpayer has a child or stepchild for whom he or she can claim as a dependent.
4. This child lived in the taxpayer's home all year, except for temporary absences. There are exceptions for a child who was born or died during the year and for a kidnapped child.
5. The taxpayer paid more than half the cost of keeping up a home for the year.

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

Married Taxpayers Filing Separately

Taxpayers who are married but elect to file separate returns must use a rate schedule which provides for the highest tax of all the classes. Normally, it will not be advantageous for married taxpayers to make this election. One consideration, however, which might lead a married person to file separate return, is the joint liability for the tax on a joint return. If one spouse fails to pay the tax, the other will have to pay the spouse's portion. If the taxpayer chooses married filing separately as his or her filing status, the following special rules apply. Because of these special rules, the taxpayer usually pays more tax on a separate return than if he or she uses another filing status for which he or she qualifies: [17]

1. The taxpayer's tax rate generally is higher than on a joint return.
2. The taxpayer's exemption amount for figuring the alternative minimum tax is half that allowed on a joint return.
3. The taxpayer cannot take the Credit for Child and Dependent Care Expenses in most cases, and the amount he or she can exclude from income under an employer's dependent care assistance program is limited to $2,500 (instead of $5,000 on a joint return). If the taxpayer is legally separated or living apart from his or her spouse, the taxpayer may be able to file a separate return and still take the credit. See Joint Return Test in Publication 503 - Child and Dependent Care Expenses, for more information.
4. The taxpayer cannot take the Earned Income Tax Credit.
5. The taxpayer cannot take the exclusion or credit for adoption expenses in most cases.

6. The taxpayer cannot take the education credits (the American Opportunity Tax Credit and Lifetime Learning Credit) or the deduction for student loan interest.
7. The taxpayer cannot exclude any interest income from qualified U.S. savings bonds he or she used for higher education expenses.
8. If the taxpayer lived with his or her spouse at any time during the tax year:
    a. The taxpayer cannot claim the Credit for the Elderly or the Disabled.
    b. The taxpayer must include in income a greater percentage (up to 85%) of any Social Security or equivalent railroad retirement benefits he or she received.
9. The following credits are reduced at income levels half those for a joint return:
    a. The Child Tax Credit.
    b. The Retirement Savings Contributions Credit.
10. The taxpayer's capital loss deduction limit is $1,500 (instead of $3,000 on a joint return).
11. If the taxpayer's spouse itemizes deductions, the taxpayer cannot claim the standard deduction. If the taxpayer can claim the standard deduction, his or her basic standard deduction is half the amount allowed on a joint return.

Head of Household

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

To qualify as a head of household, a taxpayer must meet the following conditions: (18)

1. The taxpayer is unmarried or considered unmarried on the last day of the year.
2. The taxpayer paid more than half the cost of keeping up a home for the year.
3. A qualifying person lived with the taxpayer in the home for more than half the year (except for temporary absences, such as school). However, if the qualifying person is the taxpayer's dependent parent, he or she does not have to live with him or her.

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

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

Note

If the person is the taxpayer's qualifying child (such as a son, daughter, or grandchild who lived with him or her more than half the year and meets certain other tests), and he or she is married and the taxpayer cannot claim him or her as a dependent, then that person is not a qualifying person.

To qualify for head of household status, the taxpayer must be either unmarried or considered unmarried on the last day of the year. He or she is considered unmarried on the last day of the tax year if he or she meets all the following tests: (19)

1. The taxpayer files a separate return.
2. The taxpayer paid more than half the cost of keeping up his or her home for the tax year.
3. The taxpayer's spouse did not live in his or her home during the last 6 months of the tax year. The taxpayer's spouse is considered to live in his or her home even if he or she is temporarily absent due to special circumstances.

4. The taxpayer’s home was the main home of his or her child, stepchild, or foster child for more than half the year.
5. The taxpayer must be able to claim the child as a dependent. However, the taxpayer meets this test if he or she cannot claim the child as a dependent only because the noncustodial parent can claim the child.

To qualify for head of household status, the taxpayer must pay more than half of the cost of keeping up a home for the year. If the total amount the taxpayer paid is more than the amount others paid, he or she meets the requirement of paying more than half the cost of keeping up the home.

A taxpayer should include in the cost of keeping-up-a-home expenses such as rent, mortgage interest, real estate taxes, insurance on the home, repairs, utilities, and food eaten in the home. Do not include the costs of clothing, education, medical treatment, vacations, life insurance, or transportation. Also, do not include the rental value of a home the taxpayer owns or the value of his or her services or those of a member of his or her household. If the taxpayer used payments he or she received under Temporary Assistance for Needy Families (TANF) or other public assistance programs to pay part of the cost of keeping up the home, he or she cannot count them as money he or she paid. However, the taxpayer must include them in the total cost of keeping up the home to figure if he or she paid over half the cost.

Note

The taxpayer may be eligible to file as head of household even if the individual who qualifies him or her for this filing status is born or dies during the year. The taxpayer must have provided more than half the cost of keeping up a home that was the individual's main home for more than half the part of the year he or she was alive.

Qualifying Child for Head of Household Filing Status

Five tests must be met for a child to be the taxpayer’s qualifying child. The five tests are: [19]

1. Relationship.
2. Age.
3. Residency.
4. Support.
5. Joint return.

To meet the relationship test, a child must be: [19]

- The taxpayer’s son, daughter, stepchild, foster child, or a descendant (for example, his or her grandchild) of any of them.
- The taxpayer’s brother, sister, half-brother, half-sister, stepbrother, stepsister, or a descendant (for example, his or her niece or nephew) of any of them.
- An adopted child is always treated as the taxpayer’s own child. The term “adopted child” includes a child who was lawfully placed with him or her for legal adoption. A foster child is an individual who is placed with the taxpayer by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction.

To meet the age test, a child must be: [19]

- Under age 19 at the end of the year and younger than the taxpayer.
- A student under age 24 at the end of the year and younger than the taxpayer.
- Permanently and totally disabled at any time during the year, regardless of age.

To meet the residency test, the taxpayer’s child must have lived with him or her for more than half the year. There are exceptions for temporary absences, children who were born or died during the year, kidnapped children, and children of divorced or separated parents. For example, the taxpayer’s child is considered to have lived with him or her during periods of time when the taxpayer, the child, or both, are temporarily absent due to special circumstances such as illness, education, business, vacation or military service.

To meet the support test to be a qualifying child, the child cannot have provided more than half of his or her own support for the year.

To meet the joint return test, the child cannot file a joint return for the year. An exception to the joint return test applies if the taxpayer's child and his or her spouse file a joint return only to claim a refund of income tax withheld or estimated tax paid.

Qualifying Relative for Head of Household Filing Status

Four tests must be met for a person to be the taxpayer's qualifying relative. The four tests are: (19)

1. Not a qualifying child test.
2. Member of household or relationship test.
3. Gross income test.
4. Support test.

Unlike a qualifying child, a qualifying relative can be any age. There is no age test for a qualifying relative.

Tip

For the not a qualifying child test, a child is not the taxpayer's qualifying relative if the child is his or her qualifying child or the qualifying child of any other taxpayer.

To meet the member of household or relationship test, a person must either: (19)

- Live with the taxpayer all year as a member of his or her household.
- Be related to the taxpayer in one of the ways listed below who does not have to live with the taxpayer.

If at any time during the year the person was the taxpayer's spouse, that person cannot be his or her qualifying relative.

A person related to the taxpayer in any of the following ways does not have to live with the taxpayer all year as a member of the household to meet the relationship test: (19)

- The taxpayer's child, stepchild, foster child, or a descendant of any of them (for example, a grandchild). (A legally adopted child is considered the taxpayer's child.)
- The taxpayer's brother, sister, half-brother, half-sister, stepbrother, or stepsister.
- The taxpayer's father, mother, grandparent, or other direct ancestor, but not foster parent.
- The taxpayer's stepfather or stepmother.
- A son or daughter of the taxpayer's brother or sister.
- A son or daughter of the taxpayer's half-brother or half-sister.
- A brother or sister of the taxpayer's father or mother.
- The taxpayer's son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law.

To meet the gross income test, a person's gross income for the year must be less than $4,300 in 2020. To meet support test to be a qualifying relative, the taxpayer generally must provide more than half of a person's total support during the calendar year.

Examples of a Qualifying Person

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

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

Example 3 - Girlfriend
The taxpayer's girlfriend lived with him all year. Even though she may be a qualifying relative if the gross income and

support tests are met, she is not a qualifying person for head of household purposes because she is not related to the taxpayer in one of the ways listed above under relatives who do not have to live with the taxpayer.

Example 4 - Girlfriend's child
The facts are the same as in Example 3 except the taxpayer's girlfriend's 10-year-old son also lived with him all year. He is not a qualifying child and, because he is the taxpayer's girlfriend's qualifying child, he is not a qualifying relative. As a result, he is not the taxpayer's qualifying person for head of household purposes.

Due Diligence Requirements

The Tax Cuts and Jobs Act (TCJA) expands a paid preparer's due diligence and record keeping requirements under IRC Section 6695(g) to include determining a client's eligibility to file as head of household. It also imposes a penalty for each failure. Due diligence requirements are already in place on Form 8867 - Paid Preparer's Due Diligence Checklist for Child Tax Credit, American Opportunity Tax Credit and Earned Income Tax Credit.

Income

Generally, an amount included in a taxpayer's income is taxable unless it is specifically exempted by law. Income that is taxable must be reported on the return and is subject to tax. Income that is nontaxable may have to be shown on the tax return but is not taxable. See Publication 17 - Chapter 5 - Wages, Salaries, and Other Earnings for details.

Source of Personal Service Income

All wages and any other compensation for services performed in the United States are considered to be from sources in the United States. The place where the personal services are performed determines the source of the personal service income, regardless of where the contract was made, the place of payment, or the residence of the payer. However, under certain circumstances, payment for personal services performed in the United States is not considered income from sources within the United States. For example, personal services performed by an independent nonresident alien contractor specifically exempted by a tax treaty. For more examples, see the Pay for Personal Service section in Publication 515 - Withholding of Tax on Nonresident Aliens and Foreign Entities. [20]

Allocation of Personal Service Income

If the income is for personal services performed partly in the United States and partly outside the United States, the taxpayer must make an accurate allocation of income for services performed in the United States. In most cases, other than certain fringe benefits, he or she makes this allocation on a time basis. That is, U.S. source income is the amount that results from multiplying the total amount of pay by the fraction of days in which services were performed in the U.S. This fraction is determined by dividing the number of days services are performed in the United States by the total number of days of service for which the compensation is paid. [20]

Allocation of Fringe Benefits

If the personal services are performed partly in the United States and partly outside the United States by an employee, the allocation of pay, other than certain fringe benefits, is determined on a time basis. The following fringe benefits are sourced on a geographical basis, as shown in the following list: [20]

- Housing - employee's main job location.
- Education - employee's main job location.
- Local transportation - employee's main job location.
- Tax reimbursement - jurisdiction imposing tax.
- Hazardous or hardship duty pay - location of pay zone.
- Moving expense reimbursement - employee's new main job location.

An employee's main job location (principal place of work) is usually the place where the employee spends most of his or her working time. If there is no one place where most of the work time is spent, the main job location is the place where the work is centered, such as where the employee reports for work or is otherwise required to base his or her work.

An employee can use an alternative basis based on facts and circumstances, rather than the time or geographical basis. The employee, not the employer, must demonstrate that the alternative basis more properly determines the source of the pay or fringe benefits.

Territorial Limits

Wages received for services rendered inside the territorial limits of the United States, as well as wages of an alien seaman earned on a voyage along the coast of the United States, are regarded as from sources in the United States. Wages or salaries for personal services performed in a mine or on an oil or gas well located or being developed on the continental shelf of the United States are treated as from sources in the United States. [20]

Vessel or Aircraft Services

Income from the performance of services directly related to the use of a vessel or aircraft is treated as derived entirely from sources in the United States if the use begins and ends in the United States. This income is subject to nonresident alien withholding if it is not effectively connected with a U.S. trade or business. If the use of a vessel or aircraft either begins or ends in the United States, refer to Transportation Income in Publication 515 - Withholding of Tax on Nonresident Aliens and Foreign Entities. [20]

Crew Members

Income from the performance of services by a nonresident alien in connection with the individual's temporary presence in the United States as a regular member of the crew of a foreign vessel engaged in transportation between the United States and a foreign country or a U.S. possession is not income from U.S. sources. [20]

Scholarships, Fellowships, and Grants

Scholarships, fellowships, and grants are sourced according to the residence of the payer. Those made by entities created or domiciled in the United States are generally treated as income from sources within the United States. However, refer to Activities Outside the United States, below. Those made by entities created or domiciled in a foreign country are treated as income from foreign sources. [20]

A scholarship is generally an amount paid or allowed to a student at an educational institution for the purpose of study. A fellowship is generally an amount paid to an individual for the purpose of research.

If the taxpayer receives a scholarship or fellowship grant, all or part of the amounts received may be tax-free. Qualified scholarship and fellowship grants are treated as tax-free amounts if the following conditions are met: [21]

1. The taxpayer is a candidate for a degree at an educational institution that maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where it carries on its educational activities; and
2. Amounts the taxpayer receives as a scholarship or fellowship grant are used for tuition and fees required for enrollment or attendance at the educational institution, or for fees, books, supplies, and equipment required for courses at the educational institution.

A taxpayer must include in gross income amounts used for incidental expenses, such as room and board, travel, and optional equipment, and generally amounts received as payments for teaching, research, or other services required as a condition for receiving the scholarship or fellowship grant. Also, he or she must include in income any part of the scholarship or fellowship that represents payments for services. Generally, when reporting scholarship income on the tax return, a taxpayer will include the amounts on the same line as “Wages, salaries, tips, etc.”

Activities Outside the United States

A scholarship, fellowship, grant, targeted grant, or an achievement award received by a nonresident alien for activities conducted outside the United States is treated as foreign source income, even though the payer of the grant is a resident of the United States. [20]

Pension Payments

The source of pension payments is determined by the portion of the distribution that constitutes the compensation element (employer contributions) and the portion that constitutes the earnings element (the investment income). The compensation element is sourced the same as compensation from the performance of personal services. The portion attributable to services performed in the United States is U.S. source income, and the portion attributable to services performed outside the United States is foreign source income.

The earnings portion of a pension payment is U.S. source income if the trust is a U.S. trust. For details on how to apply these rules refer to Revenue Ruling 79-388, Revenue Ruling 79-389, and Revenue Procedure 2004-37 in Internal Revenue Bulletin: 2004-26. [20]

Taxable and Nontaxable Income

Most types of income are taxable, but some are not. Income can include money, property or services that the taxpayer receives. Here are some examples of income that are usually not taxable: [22]

- Child support payments.
- Gifts, bequests and inheritances (subject to limitations).
- Welfare benefits.
- Damage awards for physical injury or sickness.
- Cash rebates from a dealer or manufacturer for an item the taxpayer buys.
- Reimbursements for qualified adoption expenses.

Some income is not taxable except under certain conditions. Examples include: [22]

- Life insurance proceeds paid to the taxpayer because of an insured person's death are usually not taxable. However, if the taxpayer redeems a life insurance policy for cash, any amount that is more than the cost of the policy is taxable.
- Income the taxpayer gets from a qualified scholarship is normally not taxable. Amounts the taxpayer uses for certain costs, such as tuition and required course books, are not taxable. However, amounts used for room and board are taxable.

All income, such as wages and tips, is taxable unless the law specifically excludes it. This includes non-cash income from bartering - the exchange of property or services. Both parties must include the fair market value of goods or services received as income on their tax return.

If the taxpayer received a refund, credit or offset of state or local income taxes in 2020, he or she may be required to report this amount. If the taxpayer did not receive a 2020 Form 1099-G, check with the government agency that made the payments. That agency may have made the form available only in an electronic format. The taxpayer will need to get instructions from the agency to retrieve this document. Report any taxable refund received even if the taxpayer did not receive Form 1099-G.

Sources of Taxable and Non-Taxable Income

Wages

Wages, salaries, and tips a taxpayer received for performing services as an employee of an employer must be included in gross income. Amounts withheld for taxes, including but not limited to income tax, Social Security and Medicare taxes are considered "received" and must be included in gross income in the year they are withheld. If the taxpayer receives advance commissions or other amounts for services to be performed in the future and he or she is a cash-method taxpayer, the taxpayer must include these amounts in his or her income in the year received. Also, include in income amounts the taxpayer is awarded in a settlement or judgment for back pay. These include payments made to him or her for damages, unpaid life insurance premiums, and unpaid health insurance premiums. They should be reported to the taxpayer by his or her employer on Form W-2.

Bonuses or awards a taxpayer receives for outstanding work are included in income and should be shown on his or her Form W-2. These include prizes such as vacation trips for meeting sales goals. If the prize or award the taxpayer receives is goods or services, he or she must include the fair market value of the goods or services in his or her income. However, if the taxpayer's employer merely promises to pay a bonus or award at some future time, it is not taxable until he or she receives it or it is made available.

If the taxpayer 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 his or her employer's cost and cannot be more than $1,600 ($400 for awards that are not qualified plan awards) for all such awards the taxpayer receives during the year.

Interest

Interest is rent on money, paid by the borrower to the lender. With few exceptions, interest is fully taxable to the taxpayer receiving it. Taxable interest includes interest received from bank accounts, loans made to others, and other sources. See Publication 17 - Chapter 7 - Interest Income for details.

Business Income

Business income is income received from the sale of products or services. For example, fees received by a professional person are considered business income. Rents received by a person in the real estate business are business income. Payments received in the form of property or services must be included in income at their fair market value.

Normally a business is organized as a sole proprietorship, partnership, or corporation. A sole proprietorship is an unincorporated business owned by an individual. A sole proprietorship has no existence apart from its owner. Business debts are personal debts of the owner. A limited liability company (LLC) with one individual owner generally is treated as a sole proprietorship for Federal income tax purposes, unless the owner elects to treat the LLC as a corporation. A sole proprietor files Form 1040 - Schedule C - Profit or Loss From Business to report the income and expenses of the business.

A partnership is an unincorporated business organization that is the result of two or more persons joining together to carry on a trade or business. Each person contributes money, property, services, or a combination thereof, in return for a right to share in the profits and losses of the partnership. An LLC with more than one owner is generally treated as a partnership for tax purposes. A partnership's income and expenses are generally reported on Form 1065 - U.S. Return of Partnership Income, annually.

The term "corporation," for Federal income tax purposes, generally includes legal entities separate from the people who formed them under Federal or state law or the shareholders who own them. It also includes certain businesses that elect to be taxed as a corporation by filing Form 8832 - Entity Classification Election. The tax on a corporation's income is figured on Form 1120 - U.S. Corporation Income Tax Return. [23]

Sale of Personal Residence

A taxpayer may exclude from income up to $250,000 of gain ($500,000 on a joint return in most situations) realized on the sale or exchange of a principal residence if all of the following are true: [24]

- He or she meets the ownership test.
- He or she meets the use test.
- During the 2-year period ending on the date of the sale, taxpayer did not exclude gain from the sale of another home.

If the taxpayer has gain that cannot be excluded, it is taxable. Report it on Form 8949 - Sales and Other Dispositions of Capital Assets and Schedule D (Form 1040) - Capital Gains and Losses. The taxpayer may also have to complete Form 4797 - Sales of Business Property. See Publication 17 - Chapter 15 - Selling Your Home for details.

Do not report the 2020 sale of a main home on the tax return unless: [24]

- The taxpayer has a gain and does not qualify to exclude all of it.

- The taxpayer has a gain and chooses not to exclude it.
- The taxpayer received Form 1099-S.

If the taxpayer has a gain that he or she cannot or chooses not to exclude, if he or she received a Form 1099-S, or if he or she has a deductible loss, report the sale on the tax return. Report the sale on Part I, line 1 or Part II, line 3 of Form 8949 as a short-term or long-term transaction, depending on how long the taxpayer owned the home. Report the proceeds from the sale (Worksheet 2, line 1) in column (d) and the cost or other basis (Worksheet 2, line 4) in column (e). If there are any selling expenses, enter "E" in column (f) and the necessary adjustment in column (g). See the Instructions for Form 8949.

Separate a taxpayer's capital gains and losses according to how long he or she held or owned the property. The holding period for short-term capital gains and losses is 1 year or less. Report these transactions on Part I of Form 8949. The holding period for long-term capital gains and losses is more than 1 year. Report these transactions on Part II of Form 8949. To figure the holding period, begin counting on the day after the taxpayer received the property and include the day he or she disposed of it.

Generally, if the taxpayer disposed of property that he or she acquired by inheritance, report the disposition as a long-term gain or loss regardless of how long he or she held the property. However, if the taxpayer acquired the property from someone who died in 2010 and the executor of the estate made the election to file Form 8939, see Publication 4895 - Tax Treatment of Property Acquired From a Decedent Dying in 2010.

Dividends

For many years, millions of people have invested in corporate stocks. For this reason, dividends are a popular source of income. A dividend on stock is similar to an interest payment received on a savings account, note or bond, but with two important differences. Unlike interest, the amount of the dividend is not specified by contract and dividends are not necessarily paid at regular intervals but depend upon the decision of the corporate directors to make a distribution.

The most common kinds of distributions are: (25)

- Ordinary dividends.
- Capital gain distributions.
- Non-dividend distributions.

Most distributions are paid in cash (check). However, distributions can consist of more stock, stock rights, other property or services. See Publication 17 - Chapter 8 - Dividends and Other Distributions for details.

Distributions by a corporation of its own stock are commonly known as stock dividends. Stock rights (also known as stock options) are distributions by a corporation of rights to acquire the corporation's stock. Generally, stock dividends and stock rights are not taxable to an individual. However, there are some exceptions. If the stock dividends are not taxable, a taxpayer must divide his or her basis for the old stock between the old and new stock.

The basis of stock must be adjusted for certain events that occur after purchase. For example, if the taxpayer receives more stock from nontaxable stock dividends or stock splits, he or she must reduce the basis of the original stock. The taxpayer must also reduce the basis when he or she receives non-dividend distributions. These distributions, up to the amount of the basis, are a nontaxable return of capital.

Example
Eddie bought 100 shares of stock of XYZ Corporation in 2005 for $10 a share. In January 2006 he bought another 200 shares for $11 a share. In July 2006 he gave his son 50 shares. In December 2008 he bought 100 shares for $9 a share. In April 2020 he sold 130 shares. Eddie cannot identify the shares he disposed of, so he must use the stock he acquired first to figure the basis. The shares of stock he gave his son had a basis of $500 (50 × $10).

Eddie figures the basis of the 130 shares of stock he sold in 2020 as follows:

- 50 shares (50 × $10) balance of stock bought in 2005 - $500.
- 80 shares (80 × $11) stock bought in January 2006 - $880.
- Total basis of stock sold in 2020 = $1,380.

The basis of shares in a mutual fund (or other regulated investment company) or a real estate investment trust (REIT) is generally figured in the same way as the basis of other stock and usually includes any commissions or load charges paid for the purchase.

Example
The taxpayer bought 100 shares of Fund A for $10 a share. She paid a $50 commission to the broker for the purchase. Her cost basis for each share is $10.50 ($1,050 ÷ 100).

Rental Income

Generally, cash or the fair market value of property a taxpayer receives for the use of real estate or personal property is taxable to him or her as rental income. Most individuals operate on a cash basis, which means they count their rental income as income when it is actually or constructively received and deduct their expenses as they are paid.

Some specific types of income are: [26]

- *Amounts paid to cancel a lease* – If a tenant pays a taxpayer to cancel a lease, this money is also rental income and is reported in the year received.
- *Advance rent* – Generally the taxpayer includes any advance rent paid in income in the year he or she receives it regardless of the period covered or the method of accounting used.
- *Expenses paid by a tenant* – If the tenant pays any of the taxpayer's expenses, those payments are rental income. The taxpayer may be allowed to deduct the expenses if they are considered deductible expenses.
- *Security deposits* – Do not include a security deposit in taxpayer's income if he or she may be required to return it to the tenant at the end of the lease. But if the taxpayer keeps part or all of the security deposit because the tenant did not live up to the terms of the lease, this money is taxable income in the year the determination is made. If the taxpayer keeps the security deposit because the tenant damaged the property, the security deposit is not taxable. If the security deposit is to be used as the tenant's final month's rent, include the money as income when received, rather than when it is applied to the last month's rent.

Note

If the rental agreement gives the tenant the right to buy the rental property, the payments received under the agreement are generally rental income. If the tenant exercises the right to buy the property, the payments received for the period after the date of sale are considered part of the selling price. [27]

If the taxpayer uses a dwelling unit as a home and he or she rents it less than 15 days during the year, its primary function is not considered to be a rental and it should not be reported on Schedule E (Form 1040). However, if the taxpayer uses a dwelling unit as a home and rents it 15 days or more during the year, include all rental income in his or her income. Since the taxpayer used the dwelling unit for personal purposes, he or she must divide the expenses between the rental use and the personal use. The expenses for personal use are not deductible as rental expenses. If the taxpayer had a net profit from renting the dwelling unit for the year (that is, if rental income is more than the total of rental expenses, including depreciation), deduct all of the rental expenses. However, if the taxpayer had a net loss from renting the dwelling unit for the year, the deduction for certain rental expenses is limited. See Publication 527 - Residential Rental Property to figure the deductible rental expenses and any carryover to the next year.

Some examples of expenses that may be deducted from total rental income are: [27]

- *Depreciation* - the taxpayer begins to depreciate his or her rental property when it is placed in service. The taxpayer can recover some or all of his or her original acquisition cost and improvements by using Form 4562 - Depreciation and Amortization beginning in the year the rental property is first placed in service, and beginning in any year the taxpayer makes improvements or adds furnishings. The rental is considered placed in service when it was ready and available for rent.
- *Repairs* - repairs to keep the property in good working condition but do not add to the value of the property.
- *Operating Expense* - other expenses necessary for the operation of the rental property, such as the salaries of employees or fees charged by independent contractors (groundkeepers, bookkeepers, accountants, attorneys, etc.) for services provided.
- *Uncollected rents* - unless taxpayer is a cash basis taxpayer and cannot deduct uncollected rents as an expense because he or she has not included those rents in income.

If the taxpayer uses a dwelling unit for both rental and personal purposes, divide the expenses between the rental use and the personal use based on the number of days used for each purpose. When dividing the expenses, follow these rules: (27)

- Any day that the unit is rented at a fair rental price is a day of rental use even if the taxpayer used the unit for personal purposes that day. (This rule does not apply when determining whether the taxpayer used the unit as a home.)
- Any day that the unit is available for rent but not actually rented is not a day of rental use.

Flow-Through Entities

The payees of payments (other than income effectively connected with a U.S. trade or business) made to a foreign flow-through entity are the owners or beneficiaries of the flow-through entity. This rule applies for purposes of Nonresident Alien (NRA) withholding and for Form 1099 reporting and backup withholding. Income that is, or is deemed to be, effectively connected with the conduct of a U.S. trade or business of a flow-through entity, is treated as paid to the entity. All of the following are flow-through entities: (28)

- A foreign partnership (other than a withholding foreign partnership and partnerships claiming treaty benefits as entities that are not fiscally transparent).
- A foreign simple or foreign grantor trust (other than a withholding foreign trust), and foreign simple and foreign grantor trusts claiming treaty benefits as entities that are not fiscally transparent.
- An entity receiving income for which treaty benefits are claimed by an interest holder in the entity and the entity is considered fiscally transparent.

Generally, an individual treats a payee as a flow-through entity if it provides him or her with a Form W-8IMY - Certificate of Foreign Intermediary, Foreign Flow-Through Entity, or Certain U.S. Branches for United States Tax Withholding on which it claims such status. The person may also be required to treat the entity as a flow-through entity under the presumption rules.

Alimony

After the divorce or legal separation, the wife or husband loses the right to participate in the former spouse's earnings. If many years of marriage have intervened, he or she may have lost marketable job skills, and advanced age could place such a person at a disadvantage in the labor market. This person may be entitled to alimony. A spouse or former spouse who is receiving alimony must report the full amount as income on Form 1040 or Form 1040 NR. If the spouse or former spouse does not give his or her Social Security number to the spouse or former spouse who is making the alimony payments, he or she may have to pay a $50 penalty. See Publication 17 - Chapter 18 - Alimony for details.

An amendment to a divorce decree may change the nature of the taxpayer's payments. Amendments are not ordinarily retroactive for Federal tax purposes. However, a retroactive amendment to a divorce decree correcting a clerical error to reflect the original intent of the court will generally be effective retroactively for Federal tax purposes.

Certain Government Payments

Federal, state, or local governments file Form 1099-G - Certain Government Payments if they made taxable payments of unemployment compensation; state or local income tax refunds, credits, or offsets; reemployment trade adjustment assistance (RTAA) payments; taxable grants; or agricultural payments. They also file this form if they received payments on a Commodity Credit Corporation (CCC) loan.

Pensions and Annuities

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: (29)

- 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. See Publication 17 - Chapter 10 - Retirement Plans, Pensions, and Annuities for details.

Illegal Activities

Income from illegal activities, such as money from dealing illegal drugs, must be included in the taxpayer income on Schedule 1 (Form 1040), line 8, or on Schedule C (Form 1040) if from his or her self-employment activity.

The Standard Deduction

The standard deduction is based upon the principle that every taxpayer should be allowed some deduction for personal living expenses. This deduction will be allowed even if the taxpayer cannot prove that he or she spent the amount involved. In passing this part of the tax law, Congress was well aware that many taxpayers do not keep complete records of their expenditures. Without such a provision, these taxpayers might, unjustly, not be allowed to take any deduction at all. The standard deduction is more than just an escape hatch for those who are unable to itemize for want of proof; it also serves as a minimum deduction for all taxpayers. The law provides that this minimum deduction will be adjusted annually to prevent inflation-caused tax increases. See Publication 17 - Chapter 20 - Standard Deduction for details.

If the taxpayer(s) check any of the boxes on page 1 of Form 1040, they MUST use the standard deduction chart for people age 65 or older (unless Schedule A - Itemized Deductions is used) to determine their correct standard deduction amount. There is also a standard deduction for dependents. If none of the boxes on page 1 are checked, then the standard deduction amount shown below which applies to the filing status of the taxpayer(s) is selected from the options on line 12 of Form 1040 and entered on line 12.

Under the Tax Cuts and Jobs Act (TCJA) the standard deduction amounts increased to $12,400 for individuals, to $18,650 for heads of household, and to $24,800 for married couples filing jointly and surviving spouses in 2020. [30]

Standard Deductions 2020 Tax Year	
Filing Status	**Standard Deduction Amount**
Single	$12,400
Married Filing Jointly	$24,800
Married Filing Separately	$12,400
Heads of Household	$18,650
Surviving Spouse	$24,800

Table 1-1 - Publication 501 - Table 6 – Standard Deduction Chart for Most People (2020)

For 2020, the additional standard deduction for married taxpayers 65 or over or blind will be $1,300 (same as for 2019). For a single taxpayer or head of household who is 65 or over or blind, the additional standard deduction for 2020 will be $1,650 (same as for 2019). A person is considered to reach age 65 on the day before his or her 65th birthday. The taxpayer cannot claim the higher standard deduction for an individual other than him or herself and his or her spouse. For 2020, the standard deduction amount for an individual who may be claimed as a dependent by another taxpayer cannot exceed the greater of $1,100 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 2020 are $1,650 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 2020? When completing his or her income tax return, 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 $27,400. If one was also blind, the standard deduction for 2020 would be $28,700 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 of boxes checked on Page 1 of Form 1040	Standard Deduction for 2020
Single	1 2	$14,050 $15,700
Married filing jointly or qualifying widow(er)	1 2 3 4	$26,100 $27,400 $28,700 $30,000
Married filing separately	1 2 3 4	$13,700 $15,000 $16,300 $17,600
Head of household	1 2	$20,300 $21,950

Table 1-2 - Publication 501 - Table 7 – Standard Deduction Chart for People who are 65 or Older or Who are Blind, (2020)

Example 1
Larry, 46, and Carolyn, 33, are filing a joint return for 2020. Neither is blind, and neither can be claimed as a dependent. They decide not to itemize their deductions. Their standard deduction is $24,800.

Example 2
Scott and Mary Jane are filing a joint return for 2020. Both are over age 65. Neither is blind, and neither can be claimed as a dependent. If they do not itemize deductions their standard deduction is $27,400.

Tip

If the taxpayer's spouse died in 2020 before reaching age 65, he or she cannot take a higher standard deduction because of his or her spouse. Even if his or her spouse was born before January 2, 1956, he or she is not considered 65 or older at the end of 2020 unless he or she was 65 or older at the time of death. A person is considered to reach age 65 on the day before his or her 65th birthday.

Special Rules on the Standard Deduction

Taxpayers Not Eligible for the Standard Deduction

A taxpayer's standard deduction is zero and the taxpayer should itemize his or her deductions if:

- The taxpayer is married and filed a separate return and the taxpayer's spouse itemized his or her deductions when filing. This rule prevents shifting of itemized deductions between spouses in a way which will reduce the tax burden.
- The taxpayer files a tax return for a short tax year due to a change in the taxpayer's annual accounting period.
- The taxpayer is a non-resident or a dual status alien during the tax year. But, if the non-resident alien is married to a U.S. citizen or is a resident at the end of the tax year, such a taxpayer can choose to be treated as a U.S. resident and, as such, would be eligible to take the standard deduction.

Dependents of Other Taxpayers

The 2020 standard deduction for an individual who can be claimed as a dependent on another person's tax return is generally limited to the greater of: (31)

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

If the taxpayer (or his or her spouse if filing jointly) can be claimed as a dependent on someone else's return, use the Standard Deduction Worksheet for Dependents (see below) to determine the standard deduction.

Earned income is salaries, wages, tips, professional fees, and other amounts received as pay for work the taxpayer actually perform. For purposes of the standard deduction, earned income also includes any part of a scholarship or fellowship grant that he or she must include in gross income.

Standard Deduction Worksheet for Dependents		
Use this worksheet **only** if someone can claim the taxpayer, or his or her spouse if filing jointly, as a dependent.		
Check the correct number of boxes below. **Taxpayer:** Born before January 2, 1956 ☐ Blind☐ **Taxpayer's Spouse:** Born before January 2, 1956 ☐ Blind☐ **Total number of boxes the taxpayer checked:** ☐		
1.	Enter taxpayer's earned income (defined below). If none, enter -0-.	1.________
2.	Additional amount.	2.________$350
3.	Add lines 1 and 2.	3.________
4.	Minimum standard deduction.	4. ________
5.	Enter the larger of line 3 or line 4.	5.________
6.	Enter the amount shown below for the taxpayer's filing status. • Single or Married filing separately - $12,400 • Married filing jointly - $24,800 • Head of household - $18,650	6. ________
7.	**Standard deduction.**	
	a. Enter the smaller of line 5 or line 6. If born after January 1, 1956, and not blind, stop here. This is the taxpayer's standard deduction. Otherwise, go on to line 7b.	7a. ________
	b. If born before January 2, 1956, or blind, multiply line 1 by $1,650 ($1,300 if married) by the number in the box above.	7b. ________
	c. Add lines 7a and 7b. This is the taxpayer's standard deduction for 2020.	7c. ________
Earned income includes wages, salaries, tips, professional fees, and other compensation received for personal services the taxpayer performed. It also includes any taxable scholarship or fellowship grant.		

Table 1-3 - Publication 501 - Standard Deduction Worksheet for Dependents (2020)

Example 1
Joe, a 22-year-old full-time college student, can be claimed as a dependent on his parents' 2020 tax return. Joe is married and files a separate return. His wife does not itemize deductions on her separate return. Joe has $1,500 in interest income and wages of $3,800. He has no itemized deductions. Joe enters his earned income, $3,800, on line 1. He adds lines 1 and 2 and enters $4,150 on line 3. On line 5, he enters $4,150, the larger of lines 3 and 4. Because Joe is married filing a separate return, he enters $12,400 on line 6. On line 7a, he enters $4,150 as his standard deduction because it is smaller than $12,400, the amount on line 6.

Example 2
Amy, who is single and 18 years old, can be claimed as a dependent on her parents' 2020 tax return. She is 18 years old and blind and checks the appropriate box and enters 1 on line 1. She has interest income of $1,300 and wages of $2,900. She has no itemized deductions. Amy enters her wages of $2,900 on line 1. She adds lines 1 and 2 and enters $3,250 on line 3. On line 5, she enters $3,250, the larger of lines 3 and 4. Because she is single, Amy enters $12,400 on line 6. She enters $3,250 on line 7a. This is the smaller of the amounts on lines 5 and 6. Because she checked one box in the top part of the worksheet, she enters $1,650 on line 7b. She then adds the amounts on lines 7a and 7b and enters her standard deduction of $4,900 on line 7c.

Example 3
Ed is 18 years old and single. His parents can claim him as a dependent on their 2020 tax return. He has wages of $7,000, interest income of $500, and a business loss of $3,000. He has no itemized deductions. Ed enters $4,000 ($7,000 − $3,000) on line 1. He adds lines 1 and 2 and enters $4,350 on line 3. On line 5, he enters $4,350, the larger of lines 3 and 4. Because he is single, Ed enters $12,400 on line 6. On line 7a, he enters $4,350 as his standard deduction because it is smaller than $12,400, the amount on line 6.

Itemized Deductions

There are certain personal expenses which Congress has allowed as deductions. These are called itemized expenses, or often called Schedule A deductions, as this is the form that is attached to the return to claim the itemized deductions.

Schedule A Categories	
Category	**Line(s)**
Medical and Dental Expenses	1-4
Taxes Paid	5-7
Interest Paid	8-10
Gifts to Charity	11-14
Casualty and Theft Losses (only for those losses attributable to a Federal disaster as declared by the President)	15
Other Miscellaneous Deductions	16

Table 1-4 - Schedule A (Form 1040) (2020)

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.

In response to this new limitation, some state legislatures are considering or have adopted legislative proposals that would allow taxpayers to make transfers to funds controlled by state or local governments, or other transferees specified by the state, in exchange for credits against the state or local taxes that the taxpayer is required to pay. The aim of these proposals is to allow taxpayers to characterize such transfers as fully deductible charitable contributions for Federal income tax purposes, while using the same transfers to satisfy state or local tax liabilities.

Despite these state efforts to circumvent the new statutory limitation on state and local tax deductions, taxpayers should be mindful that Federal law controls the proper characterization of payments for Federal income tax purposes.

State and Local General Sales Taxes

State and local income taxes withheld from the taxpayer's wages during the year appear on his or her Form W-2 - Wage and Tax Statement. The taxpayer can elect to deduct state and local general sales taxes instead of state and local income taxes, but he or she cannot deduct both. If the taxpayer elects to deduct state and local general sales taxes, he or she can use either his or her actual expenses or the optional sales tax tables. The following amounts are also deductible:

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

Generally, the taxpayer can take either a deduction or a tax credit for foreign income taxes imposed on him or her by a foreign country or a United States possession.

State and Local Real Estate Taxes

Deductible real estate taxes are generally any state or local taxes on real property levied for the general public welfare. The charge must be uniform against all real property in the jurisdiction at a like rate.

There are popular loan programs that finance energy saving improvements through government-approved programs. The taxpayer signs up for a home energy system loan and use the proceeds to make energy improvements to his or her home. In some programs, the loan is secured by a lien on his or her home and appears as a special assessment or special tax on his or her real estate property tax bill over the period of the loan. The payments on these loans may appear to be deductible real estate taxes; however, they are not deductible real estate taxes. Assessments or taxes associated with a specific improvement benefitting one home are not deductible. However, the interest portion of the taxpayer's payment may be deductible as home mortgage interest.

Many states and counties also impose local benefit taxes for improvements to property, such as assessments for streets, sidewalks, and sewer lines. The taxpayer cannot deduct these taxes. However, he or she can increase the cost basis of his or her property by the amount of the assessment.

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

State and Local Personal Property Taxes

Under the Tax Cuts and Jobs Act (TCJA), state, local and foreign property taxes, and state and local sales taxes, are fully deductible only if paid or accrued in carrying on a trade or business or an activity relating to the expenses for the production of income. Therefore, taxpayers may only fully claim deductions for these taxes that are currently deductible when figuring income on Schedule C, Schedule E or Schedule F.

However, a taxpayer may claim an itemized deduction of up to $10,000 ($5,000 for a married, filing separately taxpayer) for the aggregate of state and local property taxes not paid or accrued in carrying on a trade or business activity and state and local income, war profits and excess profits taxes (or sales taxes rather than income taxes) paid or accrued during the year. Foreign real property taxes may not be deducted under this exception.

Deductible personal property taxes are those based only on the value of personal property such as a boat or car. Personal property tax is deductible if it is a state or local tax that is: [32]

- Charged on personal property.
- Based only on the value of the personal property.
- Charged on a yearly basis, even if it is collected more or less than once a year.

Some taxes and fees the taxpayer cannot deduct on Schedule A include Federal income taxes, Social Security taxes, transfer taxes (or stamp taxes) on the sale of property, homeowner's association fees, estate and inheritance taxes, and service charges for water, sewer, or trash collection.

Under the TCJA, a taxpayer who makes payments or transfers property to an entity eligible to receive tax deductible contributions must reduce their charitable deduction by the amount of any state or local tax credit the taxpayer receives or expects to receive.

For example, if a state grants a 70% state tax credit and the taxpayer pays $1,000 to an eligible entity, the taxpayer receives a $700 state tax credit. The taxpayer must reduce the $1,000 contribution by the $700 state tax credit, leaving an allowable contribution deduction of $300 on the taxpayer's Federal income tax return. The regulations also apply to payments made by trusts or decedents' estates in determining the amount of their contribution deduction.

Charitable Contribution Changes

The Coronavirus Aid, Relief, and Economic Security Act (CARES) allows an individual to make a cash contribution of up to $300 made to certain qualifying charities and deduct the contribution "above-the-line" in computing adjusted gross income. Thus, the taxpayer receives the deduction in addition to the standard deduction. This above-the-line deduction is here for 2020 and beyond but is available only to a taxpayer who does not itemize their deductions.

For taxpayers that do itemize their deductions, the new law temporarily lifts the limits on charitable giving for 2020. After passage of the TCJA, cash contributions to public charities are generally limited to 60% of a taxpayer's adjusted gross income (AGI). The CARES Act allows such contributions to be deducted up to 100% of adjusted gross income (AGI) for 2020, with any excess contributions available to be carried over to the next five years.

Also, under the Tax Cuts and Jobs Act 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 TCJA 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 and Tax 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.

Noncash contributions over $5,000 must be substantiated with a contemporaneous written acknowledgement, with a qualified appraisal prepared by a qualified appraiser, and a completed Form 8283, Section B, that is filed with the return claiming the deduction. However, the taxpayer does not need a written appraisal for a qualified vehicle - such as a car, boat, or airplane- if his or her deduction for the qualified vehicle is limited to the gross proceeds from its sale and he or she obtained a contemporaneous written acknowledgment.

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 2020. This is true even if he or she does not pay the credit card bill until 2021. Also, a check will count for 2020 as long as the taxpayer mails it in 2020. 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: • Churches, synagogues, temples, mosques, and other religious organizations. • 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). • Nonprofit schools and hospitals. • 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. • War veterans' groups.	Money or property the taxpayer gives to: • Civic leagues, social and sports clubs, labor unions, and chambers of commerce. • Foreign organizations (except certain Canadian, Israeli, and Mexican charities). • Groups that are run for personal profit. • Groups whose purpose is to lobby for law changes. • Homeowners' associations. • Individuals. • Political groups or candidates for public office. • 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 1-5 - Publication 526 - Table 1 - Examples of Charitable Contributions - A Quick Check (2020)

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.

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 decrease 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.

Mortgage interest is any interest that a person pays on a loan that is secured by his or her principal residence. Secured debt, for purposes of the mortgage interest deduction, means that there is a signed written document:

1. That makes ownership in a qualified home security, or collateral for the mortgage debt.
2. That, in case of default on the loan, the home could be taken by the creditor to satisfy the debt.
3. That is recorded or otherwise protected under state or local law.

This includes a mortgage, a second mortgage, a line of credit loan, or a home equity loan. In most cases, the entire amount of interest paid on a mortgage is deductible as an itemized deduction on Schedule A. However, there are some limitations. We will consider only those rules for mortgages taken out after October 13, 1987. First, the home mortgage must be on a qualified home. The qualified home is where the taxpayer lives most of the time. It can be a house, cooperative apartment, condominium, mobile home, house trailer, or houseboat that has sleeping, cooking, and toilet facilities. [(33)]

A second home can include any other residence the taxpayer owns and treats as a second home. The taxpayer does not have to use the home during the year. However, if he or she rents it to others, the taxpayer must also use it as a home during the year for more than the greater of 14 days or 10% of the number of days it is rented, for the interest to qualify as qualified residence interest. Qualified residence interest and points are generally reported on Form 1098 - Mortgage Interest Statement by the financial institution to which the taxpayer made the payments.

The following mortgages yield qualified residence interest and the taxpayer can deduct all of the interest on these mortgages: [(33)]

- A mortgage taken out on or before October 13, 1987 (grandfathered debt).
- A mortgage taken out after October 13, 1987, to buy, build, or improve a home (called home acquisition debt) up to a total of $750,000 for this debt plus any grandfathered debt. The limit is $375,000 if the taxpayer is married filing separately.
- Home equity debt other than home acquisition debt taken out after October 13, 1987, up to a total of $100,000. The limit is $50,000 if married filing separately. Home equity debt other than home acquisition debt is further limited to the home's fair market value reduced by the grandfathered debt and home acquisition debt.

The taxpayer may be able to take a credit against Federal income tax if he or she was issued a mortgage credit certificate by a state or local government for low-income housing. Use Form 8396 - Mortgage Interest Credit to figure the amount. However, the taxpayer may be subject to a limit (phase-out) on some of the itemized deductions including mortgage interest.

Rules for Deduction of Medical Expenses

Under the Tax Cuts and Jobs Act (TCJA), the medical expense deduction remained in place with a lower floor of 7.5% for tax years 2017 (retroactively) and 2018 for all taxpayers regardless of age. Under the Further Consolidated Appropriations Act the 7.5% floor has returned (it was previously changed to 10%) for 2019 and 2020. The Consolidated Appropriations Act, 2021 makes permanent the lower threshold of 7.5% for all taxpayers.

For 2020, a taxpayer can deduct only the part of his or her medical and dental expenses that exceed 7.5% of his or her adjusted gross income (AGI). However, the current cost of medical insurance is so high that many families can exceed this limitation. Not only is the entire amount of medical or health insurance added with other medical expenses, but all prescription drugs and insulin are included. (34)

Medical care expenses include the insurance premiums the taxpayer paid for policies that cover medical care or for a qualified long-term care insurance policy covering qualified long-term care services. If the taxpayer is an employee, medical expenses do not include that portion of his or her premiums treated as paid by the employer under its sponsored group accident or health policy or qualified long-term care insurance policy. Further, medical expenses do not include the premiums that the taxpayer paid under his or her employer-sponsored policy under a premium conversion policy.

If the taxpayer is self-employed and has a net profit for the year, he or she may be able to deduct (as an adjustment to income) the premiums paid on a health insurance policy covering medical care including a qualified long-term care insurance policy for him or herself and their spouse and dependents. The taxpayer cannot take this deduction for any month in which he or she was eligible to participate in any subsidized health plan maintained by an employer, a former employer, his or her spouse's employer, or a former spouse's employer.

If the taxpayer does not claim 100% of the self-employed health insurance deduction, he or she can include the remaining premiums with other medical expenses as an itemized deduction on Schedule A (Form 1040). The taxpayer may not deduct insurance premiums paid by an employer-sponsored health insurance plan (cafeteria plan) unless the premiums are included in Box 1 of Form W-2. (35)

Work-Related Educational Expenses

The taxpayer may be able to deduct work-related education expenses paid during the year. To be deductible, his or her expenses must be for education that (1) maintains or improves his or her job skills or (2) a law requires to keep his or her status or occupation. However, even if the education meets either of these tests, the education cannot be part of a program that will qualify the taxpayer for a new trade or business or that he or she needs to meet the minimal educational requirements of his or her trade or business.

Although the education must relate to the taxpayer’s present work, education expenses incurred during temporary absence from his or her job may also be deductible. After his or her temporary absence, the taxpayer must return to the same kind of work. Usually, absence from work for one year or less is considered temporary. Expenses that the taxpayer can deduct include: (36)

- Tuition, books, supplies, lab fees, and similar items.
- Certain transportation and travel costs, and
- Other educational expenses, such as the cost of research and typing.

The taxpayer can deduct the costs of qualifying work-related education as a business expense even if the education could lead to a degree. Also, if the taxpayer’s education is not required by his or her employer or the law, it can be qualifying work-related education only if it maintains or improves skills needed in his or her present work. This could include refresher courses, courses on current developments and academic or vocational courses. Self-employed individuals include education expenses on Schedule C - Profit or Loss From Business (Sole Proprietorship) or Schedule F - Profit or Loss From Farming.

Limit on Itemized Deductions

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.

Making the Election Between Using the Standard Deduction or Itemized Deductions

Each year the taxpayer must decide whether the standard deduction amount or the total of allowed itemized deductions provides him or her with the lowest tax liability. This election is made each year and does not depend on what was done in past years. The taxpayer is entitled to select the most favorable alternative each year.

Note

If the taxpayer elects to itemize deductions even though the total is less than the amount of the Standard Deduction to which the taxpayer is entitled, the taxpayer must check the box on line 18, Schedule A, Form 1040.

Also, some taxpayers are not eligible for the standard deduction. A taxpayer's standard deduction is zero and he or she should itemize any deductions he or she has if:

- His or her filing status is married filing separately, and his or her spouse itemizes deductions on their return.
- He or she is filing a tax return for a short tax year because of a change in his or her annual accounting period.
- He or she is a nonresident or dual-status alien during the year. He or she is considered a dual-status alien if he or she was both a nonresident and resident alien during the year.

If the taxpayer was a nonresident alien who is married to a U.S. citizen or resident alien at the end of the year, he or she can choose to be treated as a U.S. resident. If he or she makes this choice, he or she can take the standard deduction.

Personal Exemptions

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. Therefore, for 2020, the taxpayer cannot claim a personal exemption deduction for him or herself, his or her spouse, or his or her dependents. 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).

Also, 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 $4,300, as adjusted by inflation. In 2026, taxpayers can claim personal and dependent exemptions again.

Dependents

Rules for Claiming for a Dependent

The term "dependent" means a qualifying child, or a qualifying relative.

- A taxpayer cannot claim any dependents if he or she, or his or her spouse if filing jointly, could be claimed as a dependent by another taxpayer.
- A taxpayer cannot claim a married person who files a joint return as a dependent unless that joint return is filed only to claim a refund of withheld income tax or estimated tax paid.
- A taxpayer cannot claim a person as a dependent unless that person is a U.S. citizen, U.S. resident alien, U.S. national, or a resident of Canada or Mexico (There is an exception for certain adopted children).
- A taxpayer cannot claim a person as a dependent unless that person is a qualifying child or qualifying relative.

Tests to Be a Qualifying Child

1. The child must be the taxpayer's son, daughter, stepchild, foster child, brother, sister, half-brother, half-sister, stepbrother, stepsister, or a descendant of any of them.
2. The child must be:
    a. Under age 19 at the end of the year and younger than the taxpayer (or his or her spouse, if filing jointly).

  b. Under age 24 at the end of the year, a full-time student, and younger than the taxpayer (or his or her spouse, if filing jointly).
  c. Any age if permanently and totally disabled.
3. The child must have lived with the taxpayer for more than half of the year (there are exceptions for temporary absences, children who were born or died during the year, children of divorced or separated parents (or parents who live apart), and kidnapped children).
4. The child must not have provided more than half of his or her own support for the year.
5. The child is not filing a joint return for the year (unless that return is filed only to get a refund of income tax withheld or estimated tax paid).

A taxpayer must provide over one-half of the support for a person to be considered a dependent. The term support includes food, shelter, clothing, medical and dental care, education, and other items contributing to the individual's maintenance and livelihood. Although medical care is an item of support, medical insurance benefits are not included. Medical insurance premiums are included. See Publication 501 - Dependents, Standard Deduction and Filing Information for complete details.

Example 1 - Age Test
The taxpayer's son turned 19 on December 10. Unless he was permanently and totally disabled or a full-time student, he does not meet the age test because, at the end of the year, he was not under age 19.

Example 2 - Child not younger than the taxpayer or his or her spouse
The taxpayer's 23-year-old brother, who is a student and unmarried, lives with the taxpayer and his or her spouse. He is not disabled. Both the taxpayer and his or her spouse are 21 years old and file a joint return. The taxpayer's brother is not a qualifying child because he is not younger than the taxpayer or his or her spouse.

Example 3 - Child younger than the taxpayer's spouse but not younger than the taxpayer
The facts are the same as in Example 2 except the taxpayer's spouse is 25 years old. Because the taxpayer's brother is younger than the taxpayer's spouse and they are filing a joint return, the taxpayer's brother is a qualifying child, even though he is not younger than the taxpayer. To qualify as a student, the taxpayer's child must be, during some part of each of any 5 calendar months of the year: [17]

- A full-time student at a school that has a regular teaching staff, course of study, and a regularly enrolled student body at the school.
- A student taking a full-time, on-farm training course given by a school, or by a state, county, or local government agency.

The 5 calendar months do not have to be consecutive.

Support Test Example
Adam provided $4,000 toward his 16-year-old son's support for the year. His son has a part-time job and provided $6,000 to his own support. Adam's son provided more than half of his own support for the year. He is not Adam's qualifying child.

Tests to Be a Qualifying Relative

Four tests must be met for a person to be a qualifying relative.

1. The person cannot be a qualifying child or the qualifying child of any other taxpayer.
2. The person either:
  a. Be related to taxpayer in one of the ways listed:
    i. Taxpayer's child, stepchild, foster child, or a descendant of any of them (for example, a grandchild). (A legally adopted child is considered the taxpayer's child).
    ii. Taxpayer's brother, sister, half-brother, half-sister, stepbrother, or stepsister.
    iii. Taxpayer's father, mother, grandparent, or other direct ancestor, but not foster parent.
    iv. Taxpayer's stepfather or stepmother.
    v. A son or daughter of taxpayer's brother or sister.
    vi. A son or daughter of taxpayer's half-brother or half-sister.
    vii. A brother or sister of taxpayer's father or mother.

viii. Taxpayer's son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law.

b. Must live with the taxpayer all year as a member of the household (and the taxpayer's relationship must not violate local law).

3. The person's gross income for the year must be less than $4,300 (Tax-exempt income, such as certain Social Security benefits, is not included in gross income).
4. The taxpayer must provide more than half of the person's total support for the year.

Unlike a qualifying child, a qualifying relative can be any age. There is no age test for a qualifying relative. Also, a child is not a qualifying relative if the child is a qualifying child or the qualifying child of any other taxpayer. Additionally, a cousin meets this test only if he or she lives with the taxpayer all year as a member of his or her household. A cousin is a descendant of a brother or sister of the taxpayer's father or mother. However, a taxpayer cannot claim housekeepers, maids, or servants if they work for the taxpayer.

If the taxpayer files a joint return, the person can be related to either him or her or his or her spouse. Also, the person does not need to be related to the spouse who provides support. For example, the taxpayer's spouse's uncle who receives more than half of his support from the taxpayer may be a qualifying relative, even though he does not live with the taxpayer. However, if the taxpayer and his or her spouse file separate returns, the spouse's uncle can be a qualifying relative only if he lives with the taxpayer all year as a member of his or her household.

Gross income is all income in the form of money, property, and services that is not exempt from tax. In a manufacturing, merchandising, or mining business, gross income is the total net sales minus the cost of goods sold, plus any miscellaneous income from the business.

Gross receipts from rental property are gross income. Do not deduct taxes, repairs, etc., to determine the gross income from rental property. Gross income also includes a partner's share of the gross (not a share of the net) partnership income. Gross income also includes all taxable unemployment compensation and certain scholarship and fellowship grants. Scholarships received by degree candidates and used for tuition, fees, supplies, books, and equipment required for particular courses generally are not included in gross income.

Example 1
The taxpayer's 22-year-old daughter, who is a student, lives with the taxpayer and meets all the tests to be a qualifying child. She is not a qualifying relative.

Example 2
The taxpayer's 2-year-old son lives with the taxpayer's parents and meets all the tests to be their qualifying child. He is not the taxpayer's qualifying relative.

Example 3
The taxpayer's son lives with the taxpayer but is not the taxpayer's qualifying child because he is 30 years old and does not meet the age test. He may be a qualifying relative if the gross income test and the support test are met.

Example 4
The taxpayer's 13-year-old grandson lived with his mother for 3 months, with his uncle for 4 months, and with the taxpayer for 5 months during the year. He is not the taxpayer's qualifying child because he does not meet the residency test. He may be a qualifying relative if the gross income test and the support test are met.

Exceptions

Even if the taxpayer has a qualifying child or qualifying relative, he or she can claim that person as a dependent only if these three tests are met:

1. Dependent taxpayer test.
2. Joint return test.
3. Citizen or resident test.

Dependent Taxpayer Test

If the taxpayer can be claimed as a dependent by another person, the taxpayer cannot claim anyone else as a dependent. Even if he or she has a qualifying child or qualifying relative, he or she cannot claim that person as a dependent. If the taxpayer is filing a joint return and his or her spouse can be claimed as a dependent by someone else, the taxpayer and his or her spouse cannot claim any dependents on their joint return.

Joint Return Test

The taxpayer generally cannot claim a married person as a dependent if he or she files a joint return. However, the taxpayer can claim a person as a dependent who files a joint return if that person and his or her spouse file the joint return only to claim a refund of income tax withheld or estimated tax paid.

Citizen or Resident Test

A taxpayer generally cannot claim a person as a dependent unless that person is a U.S. citizen, U.S. resident alien, U.S. national, or a resident of Canada or Mexico. However, there is an exception for certain adopted children. If the taxpayer is a U.S. citizen or U.S. national who has legally adopted a child who is not a U.S. citizen, U.S. resident alien, or U.S. national, this test is met if the child lived with the taxpayer as a member of his or her household all year. This exception also applies if the child was lawfully placed with the taxpayer for legal adoption.

Children usually are citizens or residents of the country of their parents. If the taxpayer was a U.S. citizen when his or her child was born, the child may be a U.S. citizen and meet this test even if the other parent was a nonresident alien and the child was born in a foreign country.

Foreign students brought to this country under a qualified international education exchange program and placed in American homes for a temporary period generally are not U.S. residents and do not meet this test. However, if he or she provided a home for a foreign student, he or she may be able to take a charitable contribution deduction.

A U.S. national is an individual who, although not a U.S. citizen, owes his or her allegiance to the United States. U.S. nationals include American Samoans and Northern Mariana Islanders who chose to become U.S. nationals instead of U.S. citizens. Five tests must be met for a child to be the taxpayer's qualifying child. The five tests are:

1. Relationship.
2. Age.
3. Residency.
4. Support.
5. Joint return.

Relationship Test

To meet this test, a child must be the taxpayer's son, daughter, stepchild, foster child, or a descendant (for example, his or her grandchild) of any of them; or the taxpayer's brother, sister, half-brother, half-sister, stepbrother, stepsister, or a descendant (for example, his or her niece or nephew) of any of them.

Age Test

To meet this test, a child must be:

- Under age 19 at the end of the year and younger than the taxpayer (or his or her spouse if filing jointly),
- A student under age 24 at the end of the year and younger than the taxpayer (or his or her spouse if filing jointly), or
- Permanently and totally disabled at any time during the year, regardless of age.

Age Test Example
The taxpayer's son turned 19 on December 10. Unless he was permanently and totally disabled or a student, he does not meet the age test because, at the end of the year, he was not under age 19.

Residency Test

To meet this test, the taxpayer's child must have lived with him or her for more than half the year. There are exceptions for temporary absences, children who were born or died during the year, kidnapped children, and children of divorced or separated parents.

Residency Test Example
The taxpayer provides all the support of his children, ages 6, 8, and 12, who live in Mexico with his mother and have no income. The taxpayer is single and lives in the United States. His mother is not a U.S. citizen and has no U.S. income, so she is not a taxpayer. His children are not his qualifying children because they do not meet the residency test. Also, they are not the qualifying children of any other taxpayer, so they are his qualifying relatives and he can claim them as dependents if all the tests are met. The taxpayer may also be able to claim his mother as a dependent if all the tests are met, including the gross income test and the support test.

Support Test

To meet this test, the qualifying child cannot have provided more than half of his or her own support for the year. For a qualifying relative to meet this test, the taxpayer generally must provide more than half of a person's total support during the calendar year.

To figure if the taxpayer provided more than half of a person's support, he or she must first determine the total support provided for that person. Total support includes amounts spent to provide food, lodging, clothing, education, medical and dental care, recreation, transportation, and similar necessities. Generally, the amount of an item of support is the amount of the expense incurred in providing that item. For lodging, the amount of support is the fair rental value of the lodging. Expenses not directly related to any one member of a household, such as the cost of food for the household, must be divided among the members of the household.

Medical insurance premiums the taxpayer pays, including premiums for supplementary Medicare coverage, are included in the support he or she provides. However, medical insurance benefits, including basic and supplementary Medicare benefits, are not part of support.

Support Test Example
The taxpayer's mother received $2,400 in Social Security benefits and $300 in interest. She paid $2,000 for lodging and $400 for recreation. She put $300 in a savings account. Even though the taxpayer's mother received a total of $2,700 ($2,400 + $300), she spent only $2,400 ($2,000 + $400) for her own support. If the taxpayer spent more than $2,400 for her support and no other support was received, the taxpayer has provided more than half of her support.

Total Support Example
Grace Brown, mother of Mary Miller, lives with Frank and Mary Miller and their two children. Grace gets Social Security benefits of $2,400, which she spends for clothing, transportation, and recreation. Grace has no other income. Frank and Mary's total food expense for the household is $5,200. They pay Grace's medical and drug expenses of $1,200. The fair rental value of the lodging provided for Grace is $1,800 a year, based on the cost of similar rooming facilities.

Figure Grace's total support as follows:

Fair rental value of lodging - $1,800
Clothing, transportation, and recreation - $2,400
Medical expenses - $1,200
Share of food (1/5 of $5,200) - $1,040
Total support - $6,440

The support Frank and Mary provide ($1,800 lodging + $1,200 medical expenses + $1,040 food = $4,040) is more than half of Grace's $6,440 total support.

Payments the taxpayer receives for the support of a foster child from a child placement agency are considered support provided by the agency. Similarly, payments the taxpayer receives for the support of a foster child from a state or county are considered support provided by the state or county. If the taxpayer is not in the trade or business of providing foster care and his or her unreimbursed out-of-pocket expenses in caring for a foster child were mainly to benefit an organization qualified to receive deductible charitable contributions, the expenses are deductible as charitable contributions but are not considered support he or she provided.

If the taxpayer's unreimbursed expenses are not deductible as charitable contributions, they may qualify as support he or she provided. If the taxpayer is in the trade or business of providing foster care, his or her unreimbursed expenses are not considered support provided by him or her. A scholarship received by a child who is a student is not taken into account in determining whether the child provided more than half of his or her own support.

Joint Return Test

A taxpayer generally cannot claim a married person as a dependent if he or she files a joint return. The only exception is a taxpayer can claim a person as a dependent who files a joint return if that person and his or her spouse file the joint return only to claim a refund of income tax withheld or estimated tax paid.

Example 1 - Child files joint return
The taxpayer supported his or her 18-year-old daughter, and she lived with the taxpayer all year while her husband was in the Armed Forces. The couple files a joint return. The taxpayer cannot claim his or her daughter as a dependent.

Example 2 - Child files joint return only as claim for refund of withheld tax
The taxpayer's 18-year-old son and his 17-year-old wife had $800 of wages from part-time jobs and no other income. Neither is required to file a tax return. They do not have a child. Taxes were taken out of their pay so they file a joint return only to get a refund of the withheld taxes. The exception to the joint return test applies, so the taxpayer is not disqualified from claiming each of them as a dependent just because they file a joint return. The taxpayer can claim each of them as dependents if all the other tests to do so are met.

Example 3 - Child files joint return to claim American Opportunity Tax Credit
The facts are the same as in Example 2 except no taxes were taken out of the taxpayer's son's pay. He and his wife are not required to file a tax return. However, they file a joint return to claim an American Opportunity Tax Credit of $124 and get a refund of that amount. Because claiming the American Opportunity Tax Credit is their reason for filing the return, they are not filing it only to get a refund of income tax withheld or estimated tax paid. The exception to the joint return test does not apply, so the taxpayer cannot claim either of them as a dependent. [37]

Multiple-Support Agreements

Sometimes no one provides more than half of the support of a person. Instead, two or more persons, each of whom would be able to claim the person as a dependent but for the support test, together provide more than half of the person's support.

When this happens, the taxpayers can agree that any one of them who individually provides more than 10% of the person's support, but only one, can claim that person as a dependent. Each of the others must sign a statement agreeing not to claim the person as a dependent for that year. The person who claims the person as a dependent must keep these signed statements for his or her records. A multiple support declaration identifying each of the others who agreed not to claim the person as a dependent must be attached to the return of the person claiming the person as a dependent. Form 2120 - Multiple Support Declaration can be used for this purpose.

Note

The taxpayer can claim someone as a dependent under a multiple support agreement for someone related to him or her or for someone who lived with him or her all year as a member of the taxpayer's household.

Example 1
The taxpayer, her sister, and her two brothers provide the entire support of their mother for the year. The taxpayer provides 45%, her sister 35%, and her two brothers each provide 10%. Either the taxpayer or her sister can claim their mother as a dependent. The other, either the taxpayer or the sister, must sign a statement agreeing not to claim their mother as a dependent. The one who claims the person as a dependent must attach Form 2120, or a similar declaration, to her return and must keep the statement signed by the other for her records. Because neither brother provides more than 10% of the support, neither can claim their mother as a dependent and neither has to sign a statement.

Example 2
The taxpayer's father lives with her and receives 25% of his support from Social Security, 40% from the taxpayer, 24% from his brother (the taxpayer's uncle), and 11% from a friend. Either the taxpayer or her uncle can claim her father as a dependent if the other signs a statement agreeing not to. The one who claims the father as a dependent must attach Form 2120, or a similar declaration, to his or her return and must keep for his or her records the signed statement from the one agreeing not to claim the father as a dependent.

Children of Divorced or Separated Parents (or Parents Who Live Apart)

In most cases, a child of divorced or separated parents (or parents who live apart) will be a qualifying child of one of the parents. However, if the child does not meet the requirements to be a qualifying child of either parent, the child may be a qualifying relative of one of the parents. In that case, the following rules must be used in applying the support test.

A child will be treated as being the qualifying relative of his or her noncustodial parent if all four of the following statements are true: [38]

1. The parents:
    a. Are divorced or legally separated under a decree of divorce or separate maintenance.
    b. Are separated under a written separation agreement.
    c. Lived apart at all times during the last 6 months of the year, whether or not they are or were married.
2. The child received over half of his or her support for the year from the parents (and the rules on multiple support agreements do not apply).
3. The child is in the custody of one or both parents for more than half of the year.
4. Either of the following applies:
    a. The custodial parent signs a written declaration, that he or she will not claim the child as a dependent for the year, and the non-custodial parent attaches this written declaration to his or her return (If the decree or agreement went into effect after 1984).
    b. A pre-1985 decree of divorce or separate maintenance or written separation agreement that applies to 2020 states that the non-custodial parent can claim the child as a dependent, the decree or agreement was not changed after 1984 to say the non-custodial parent cannot claim the child as a dependent, and the non-custodial parent provides at least $600 for the child's support during the year.

The custodial parent is the parent with whom the child lived for the greater number of nights during the year. The other parent is the noncustodial parent. If the parents divorced or separated during the year and the child lived with both parents before the separation, the custodial parent is the one with whom the child lived for the greater number of nights during the rest of the year.

A child is treated as living with a parent for a night if the child sleeps:

- At that parent's home, whether or not the parent is present, or
- In the company of the parent, when the child does not sleep at a parent's home (for example, the parent and child are on vacation together).

If the child lived with each parent for an equal number of nights during the year, the custodial parent is the parent with the higher adjusted gross income. The night of December 31 is treated as part of the year in which it begins. For example, the night of December 31, 2020, is treated as part of 2020.

If a child is emancipated under state law, the child is treated as not living with either parent. For example, when a child turned age 18 in May 2020, he or she became emancipated under the law of the state where he or she lives. As a result, he or she is not considered in the custody of his or her parents for more than half of the year. The special rule for children of divorced or separated parents (or parents who live apart) does not apply.

If a child was not with either parent on a particular night (because, for example, the child was staying at a friend's house), the child is treated as living with the parent with whom the child normally would have lived for that night, except for the absence. But if it cannot be determined with which parent the child normally would have lived or if the child would not have lived with either parent that night, the child is treated as not living with either parent that night.

If, due to a parent's nighttime work schedule, a child lives for a greater number of days but not nights with the parent who works at night, that parent is treated as the custodial parent. On a school day, the child is treated as living at the primary residence registered with the school.

If the taxpayer is the custodial parent, he or she can use Form 8332 - Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent to make the written declaration to release a claim to an exemption for a child to the noncustodial parent. Although the exemption amount is zero for tax year 2020, this release allows the noncustodial parent to claim the Child Tax Credit, Additional Child Tax Credit, and Credit for Other Dependents, if applicable, for the child. The noncustodial parent must attach a copy of the form or statement to his or her tax return. The release can be for 1 year, for a number of specified years (for example, alternate years), or for all future years, as specified in the declaration.

Example 1 - Child lived with one parent for a greater number of nights
The taxpayer and the child's other parent are divorced. In 2020, the child lived with the taxpayer 210 nights and with the other parent 155 nights. The taxpayer is the custodial parent.

Example 2 - Child is away at camp
In 2020, the taxpayer's daughter lives with each parent for alternate weeks. In the summer, she spends 6 weeks at summer camp. During the time she is at camp, she is treated as living with the taxpayer for 3 weeks and with her other parent, the taxpayer's ex-spouse, for 3 weeks because this is how long she would have lived with each parent if she had not attended summer camp.

Example 3 - Child lived same number of nights with each parent
The taxpayer's son lived with him or her 180 nights during the year and lived the same number of nights with his other parent, the taxpayer's ex-spouse. The taxpayer's AGI is $40,000. His or her ex-spouse's AGI is $25,000. The taxpayer is treated as his or her son's custodial parent because he or she has the higher AGI.

Example 4 - Child is at parent's home but with other parent
The taxpayer's son normally lives with him or her during the week and with his other parent, the taxpayer's ex-spouse, every other weekend. The taxpayer becomes ill and is hospitalized. The other parent lives in the taxpayer's home with his or her son for 10 consecutive days while the taxpayer is in the hospital. The taxpayer's son is treated as living with the taxpayer during this 10-day period because he was living in the taxpayer's home.

Example 5 - Child emancipated in May
When the taxpayer's son turned age 18 in May 2020, he became emancipated under the law of the state where he lives. As a result, he is not considered in the custody of his parents for more than half of the year. The special rule for children of divorced or separated parents does not apply.

Example 6 - Child emancipated in August
The taxpayer's daughter lives with the taxpayer from January 1, 2020, until May 31, 2020, and lives with her other parent, the taxpayer's ex-spouse, from June 1, 2020, through the end of the year. She turns 18 and is emancipated under state law on August 1, 2020. Because she is treated as not living with either parent beginning on August 1, she is treated as living with the taxpayer the greater number of nights in 2020. The taxpayer is the custodial parent.

Special Rule for Qualifying Child of More Than One Person

Sometimes, a child meets the relationship, age, residency, support, and joint return tests to be a qualifying child of more than one person. Although the child is a qualifying child of each of these persons, only one person can actually treat the child as a qualifying child to take all of the following tax benefits (provided the person is eligible for each benefit): (17)

- The Child Tax Credit or Credit for Other Dependents.
- Head of household filing status.
- The Credit for Child and Dependent Care Expenses.
- The exclusion from income for dependent care benefits.
- The Earned Income Tax Credit.

The other person cannot take any of these benefits based on this qualifying child. In other words, the taxpayer and the other person cannot agree to divide these tax benefits. The other person cannot take any of these benefits for a child unless he or she has a different qualifying child. To determine which person can treat the child as a qualifying child to claim these six tax benefits, the following tiebreaker rules apply: [17]

- If only one of the persons is the child's parent, the child is treated as the qualifying child of the parent.
- If the parents do not file a joint return together but both parents claim the child as a qualifying child, the IRS will treat the child as the qualifying child of the parent with whom the child lived for the longer period of time during the year. If the child lived with each parent for the same amount of time, the IRS will treat the child as the qualifying child of the parent who had the higher adjusted gross income (AGI) for the year.
- If no parent can claim the child as a qualifying child, the child is treated as the qualifying child of the person who had the highest AGI for the year.
- If a parent can claim the child as a qualifying child but no parent does so claim the child, the child is treated as the qualifying child of the person who had the highest AGI for the year, but only if that person's AGI is higher than the highest AGI of any of the child's parents who can claim the child. If the child's parents file a joint return with each other, this rule can be applied by dividing the parents' combined AGI equally between the parents.

Subject to these tiebreaker rules, the taxpayer and the other person may be able to choose which one claims the child as a qualifying child.

Example

The taxpayer and her 3-year-old daughter, Jill, lived with the taxpayer's mother all year. The taxpayer is 25 years old, unmarried, and has an AGI of $9,000. The taxpayer's mother's AGI is $15,000. Jill's father did not live with the taxpayer or her daughter. The taxpayer has not signed Form 8832 (or a similar statement).

Jill is a qualifying child of both the taxpayer and her mother because she meets the relationship, age, residency, support, and joint return tests for both. However, only one can claim her. Jill is not a qualifying child of anyone else, including her father. The taxpayer agrees to let her mother claim Jill. This means the taxpayer's mother can claim Jill as a qualifying child for all of the six tax benefits listed earlier, if she qualifies (and if the taxpayer does not claim Jill as a qualifying child for any of those tax benefits).

Tax Credits and Payments

There are several credits that can be taken to further offset tax liability. The major tax credits are as follows:

- Earned Income Tax Credit (EITC).
- Credit for the Elderly or the Disabled.
- Education credits.
- Retirement Savings Contributions Credit.
- Adoption Credit.
- Foreign Tax Credit.
- Child Tax Credit.
- Child and Dependent Care Credit.

Tax credits do not have the same effect as deductions. Deductions such as IRA deductions and excess itemized deductions reduce the income amount on which the tax is levied. Credits, on the other hand, are subtracted directly from the gross tax liability. If a taxpayer, for example, is in the 15% bracket on the applicable tax table, a $100 deduction reduces their tax liability by only $15. If, on the other hand, he or she has a tax credit of $100, this will reduce their tax liability by a full $100. See Publication 17 - Part Six - Figuring Your Taxes and Credits for complete details.

Tax Payments

Most taxpayers who earned income will have already paid some portion of their tax liability during the course of the year.

Examples include: [39]

- Federal income tax withheld from Forms W-2 and 1099.
- 2020 estimated tax payments and amount applied from 2019 return.
- Earned Income Tax Credit (EITC).
- Nontaxable combat pay election.
- Additional Child Tax Credit.
- American Opportunity Tax Credit.
- Amount paid with request for extension to file.
- Excess Social Security and tier 1 RRTA tax withheld.

The most obvious subtraction in this category is the amount of Federal income tax that has been withheld from the employee's pay (reported by employers on Form W-2 - Wage and Tax Statement). Other forms of payments are estimated taxes paid by self-employed individuals, and excess amounts of Social Security taxes that have been withheld from an employee's pay. Also included here is the amount for Earned Income Tax Credit, the additional Child Tax Credit, and the American Opportunity Tax Credit.

Form W-2 - Wage and Tax Statement

Every employer engaged in a trade or business who pays remuneration, including noncash payments of $600 or more for the year (all amounts if any income, Social Security, or Medicare tax was withheld) for services performed by an employee must file a Form W-2 for each employee (even if the employee is related to the employer) from whom: [40]

- Income, Social Security, or Medicare tax was withheld.
- Income tax would have been withheld if the employee had claimed no more than one withholding allowance or had not claimed exemption from withholding on Form W-4, Employee's Withholding Allowance Certificate.

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 amount of income tax the employer withholds from regular pay depends on two things: [41]

- 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: [41]

- 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.

Note

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.

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. [42]

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 2021 when both of the following apply: (42)

1. The taxpayer expects to owe at least $1,000 in tax for 2021, 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 2021 tax return.
    b. 100% of the tax shown on the taxpayer's 2020 tax return (there are special rules for farmers, fishermen, and higher income taxpayers). The taxpayer's 2020 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.

The taxpayer does not have to pay estimated tax for the current year if he or she meets all three of the following conditions:

1. The taxpayer had no tax liability for the prior year.
2. The taxpayer was a U.S. citizen or resident for the whole year.
3. The taxpayer's prior tax year covered a 12-month period.

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:

- 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.

Taxpayers should be encouraged to do some midyear tax planning, especially given the many changes in the Internal Revenue Code recently enacted. Also, if the taxpayer's business income has increased substantially, he or she may discover that he or she still owes more money to the IRS when he or she prepares his or her income tax return. If the taxpayer finds him or herself in this situation, a good choice is to pay additional estimated taxes ahead of time, to avoid a underpayment penalty at tax time. (42)

Presidential Election Campaign Fund

This fund helps pay for Presidential election campaigns. If the taxpayer would like $3 to go to this fund, check the box on the tax return. If the taxpayer is filing a joint return, his or her spouse can also have $3 go to the fund. If the taxpayer checks a box on the tax return, his or her tax or refund will not change.

Computations

The taxpayer can round off cents to whole dollars on his or her return and schedules. If he or she does round to whole dollars, he or she must round all amounts. To round, drop amounts under 50 cents and increase amounts from 50 to 99 cents to the next dollar. For example, $1.39 becomes $1 and $2.50 becomes $3. If the taxpayer has to add two or more amounts to figure the amount to enter on a line, include cents when adding the amounts and round off only the total.

Special Filing Requirements

Injured Spouse

The taxpayer may be an injured spouse if he or she files a joint return and all or part of his or her portion of the overpayment was, or is expected to be, applied (offset) to his or her spouse's legally enforceable past-due Federal tax, state income tax, state unemployment compensation debts, child support, or a Federal nontax debt, such as a student loan. A Notice of Offset for Federal tax debts is issued by the IRS.

Form 8379 - Injured Spouse Allocation is filed by one spouse (the injured spouse) on a jointly filed tax return when the joint overpayment was (or is expected to be) applied (offset) to a past-due obligation of the other spouse. By filing Form 8379, the injured spouse may be able to get back his or her share of the joint refund. The taxpayer must file Form 8379 within 3 years from the due date of the original return (including extensions) or within 2 years from the date you paid the tax that was later offset, whichever is later.

Nonresident and Dual Status Aliens

If the taxpayer is an alien (not a U.S. citizen), he or she is considered a nonresident alien unless he or she meets one of two tests: (43)

- The green card test.
- The substantial presence test for the calendar year (January 1-December 31).

For tax purposes, the taxpayer is a Lawful Permanent Resident of the United States, at any time, if he or she has been given the privilege, according to the immigration laws, of residing permanently in the United States as an immigrant. He or she generally has this status if the U.S. Citizenship and Immigration Service (USCIS) issued the taxpayer an alien registration card, Form I-551, also known as a green card. The taxpayer will be considered a U.S. resident for tax purposes if he or she meets the substantial presence test for the calendar year.

To meet this test, the taxpayer must be physically present in the United States on at least: (43)

1. 31 days during the current year, **and**
2. 183 days during the 3-year period that includes the current year and the 2 years immediately before that, counting:
    a. All the days he or she was present in the current year, and
    b. 1/3 of the days he or she was present in the first year before the current year, and
    c. 1/6 of the days he or she was present in the second year before the current year.

If the individual meets the green card test at any time during the calendar year but does not meet the substantial presence test for that year, his or her residency starting date is the first day on which he or she is present in the United States as a Lawful Permanent Resident. However, an alien who has been present in the United States at any time during a calendar year as a Lawful Permanent Resident may choose to be treated as a resident alien for the entire calendar year.

The taxpayer is a dual status alien when he or she has been both a resident alien and a nonresident alien in the same tax year. Dual status does not refer to citizenship, only to resident status for tax purposes in the United States. In determining U.S. income tax liability for a dual-status tax year, different rules apply for the part of the year the taxpayer is a resident of the United States and the part of the year he or she is a nonresident. The most common dual-status tax years are the years of arrival and departure.

For the part of the year the taxpayer is a resident alien, he or she is taxed on income from all sources. Income from sources outside the United States is taxable if he or she receives it while a resident alien. The income is taxable even if the taxpayer earned it while he or she was a nonresident alien or if he or she became a nonresident alien after receiving it and before the end of the year. For the part of the year the taxpayer is a nonresident alien, he or she is taxed on income from U.S. sources only.

If a taxpayer is a nonresident alien, he or she may file a joint return if he or she is married to a U.S. citizen or resident at the end of the year. If the couple files a joint return, both spouses are treated as U.S. residents for the entire year and both spouses are taxed on worldwide income. Most types of U.S. source income received by a foreign taxpayer are subject to a tax rate of 30%.

Note

A scholarship, fellowship or grant received by a nonresident alien for activities conducted outside the United States is treated as foreign source income.

If the taxpayer is an employee and receive compensation for labor or personal services performed both inside and outside the United States, special rules apply in determining the source of the compensation. Compensation (other than certain fringe benefits) is sourced on a time basis. Certain fringe benefits (such as housing and education) are sourced on a geographical basis.

The taxpayer uses a time basis to figure his or her U.S. source compensation (other than the fringe benefits). He or she does this by multiplying his or her total compensation (other than the fringe benefits) by the following fraction:

$$\frac{\text{Number of days he or she performed services in the United States during the year.}}{\text{Total number of days he or she performed services during the year.}}$$

The taxpayer can use a unit of time less than a day in the above fraction, if appropriate. The time period for which the compensation is made does not have to be a year. Instead, he or she can use another distinct, separate, and continuous time period if he or she can establish to the satisfaction of the IRS that this other period is more appropriate.

Compensation the taxpayer receives as an employee in the form of the following fringe benefits is sourced on a geographical basis: (43)

- Housing.
- Education.
- Local transportation.
- Tax reimbursement.
- Hazardous or hardship duty pay as defined in Regulations Section 1.861-4(b)(2)(ii)(D)(5).
- Moving expense reimbursement.

The amount of fringe benefits must be reasonable, and the taxpayer must substantiate them by adequate records or by sufficient evidence.

If the taxpayer is a resident alien on the last day of the tax year and reports income on a calendar year basis, he or she must file no later than April 15 of the year following the close of the tax year. If the taxpayer reports his or her income on other than a calendar year basis, file the return no later than the 15th day of the 4th month following the close of the tax year. In either case, file the return with the Internal Revenue Service indicated in the Form 1040 Instructions.

If the taxpayer is a nonresident alien on the last day of the tax year and reports income on a calendar year basis, he or she must file no later than April 15 of the year following the close of the tax year if he or she receives wages subject to withholding. If the taxpayer reports income on other than a calendar year basis, file the return no later than the 15th day of the 4th month following the close of the tax year.

If the taxpayer did not receive wages subject to withholding and reports income on a calendar year basis, he or she must file no later than June 15 of the year following the close of the tax year. If the taxpayer reports income on other than a calendar year basis, file the return no later than the 15th day of the 6th month following the close of the tax year. In any case, file the return with the Internal Revenue Service indicated in the Form 1040-NR Instructions. (44)

Taxation of Nonresident Aliens

An alien is any individual who is not a U.S. citizen or U.S. national. A nonresident alien is an alien who has not passed the green card test or the substantial presence test.

Any of these individuals must file a return: (45)

1. A nonresident alien individual engaged or considered to be engaged in a trade or business in the United States during the year. The taxpayer must file even if:
    a. The taxpayer's income did not come from a trade or business conducted in the United States.
    b. The taxpayer has no income from U.S. sources.
    c. The taxpayer's income is exempt from income tax.
2. A nonresident alien individual not engaged in a trade or business in the United States with U.S. income on which the tax liability was not satisfied by the withholding of tax at the source.
3. A representative or agent responsible for filing the return of an individual described in (1) or (2).
4. A fiduciary for a nonresident alien estate or trust.
5. A resident or domestic fiduciary, or other person, charged with the care of the person or property of a nonresident individual may be required to file an income tax return for that individual and pay the tax (Refer to Treas. Reg. 1.6012-3(b)).

Tip

If the taxpayer was a nonresident alien student, teacher, or trainee who was temporarily present in the United States on an "F", "J", "M", or "Q" visa, he or she is considered engaged in a trade or business in the United States. The individual must file Form 1040-NR only if he or she has income that is subject to tax, such as wages, tips, scholarship and fellowship grants, dividends, etc.

A nonresident alien must also file an income tax return if he or she wants to: (45)

- Claim a refund of overwithheld or overpaid tax.
- Claim the benefit of any deductions or credits. For example, if the individual has no U.S. business activities but has income from real property that he or she chooses to treat as Effectively Connected Income (ECI), the individual must timely file a true and accurate return to take any allowable deductions against that income.

A nonresident alien's income that is subject to U.S. income tax must generally be divided into two categories: (45)

- Income that is Effectively Connected with a trade or business in the United States.
- U.S. source income that is Fixed, Determinable, Annual, or Periodical (FDAP).

Effectively Connected Income, after allowable deductions, is taxed at graduated rates. These are the same rates that apply to U.S. citizens and residents. FDAP income generally consists of passive investment income; however, in theory, it could consist of almost any sort of income. FDAP income is taxed at a flat 30% (or lower treaty rate) and no deductions are allowed against such income. Effectively Connected Income should be reported on page one of Form 1040-NR. FDAP income should be reported on page four of Form 1040-NR.

Nonresident aliens who are required to file an income tax return must use Form 1040-NR (if qualified). If the individual is an employee or self-employed person and received wages or non-employee compensation subject to U.S. income tax withholding, or he or she has an office or place of business in the United States, the individual must generally file by the 15th day of the 4th month after the tax year ends. For a person filing using a calendar year this is generally April 15.

If the taxpayer is not an employee or self-employed person who receives wages or non-employee compensation subject to U.S. income tax withholding, or if he or she does not have an office or place of business in the United States, the individual must file by the 15th day of the 6th month after the tax year ends. For a person filing using a calendar year this is generally June 15.

If the taxpayer cannot file the return by the due date, he or she should file Form 4868 - Application for Automatic Extension of Time To File U.S. Individual Income Tax Return to request an automatic extension of time to file. The individual should file Form 4868 by the regular due date of the return.

To get the benefit of any allowable deductions or credits, the taxpayer must timely file a true and accurate income tax return. For this purpose, a return is timely if it is filed within 16 months of the due date discussed. The Internal Revenue Service has the right to deny deductions and credits on tax returns filed more than 16 months after the due dates of the returns.

Before leaving the United States, all aliens (with certain exceptions) must obtain a certificate of compliance. This document, also popularly known as the sailing permit or departure permit, must be secured from the IRS before leaving the U.S. The individual will receive a sailing or departure permit after filing a Form 1040-C or Form 2063 - U.S. Departing Alien Income Tax Statement.

Even if the person has left the United States and filed a Form 1040-C - U.S. Departing Alien Income Tax Return on departure, he or she still must file an annual U.S. income tax return. If the taxpayer is married and both he and she and his or her spouse are required to file, the individual must each file a separate return, unless one of the spouses is a U.S. citizen or a resident alien, in which case the departing alien could file a joint return with his or her spouse.

Residents of Puerto Rico

Generally, if a taxpayer is a U.S. citizen and a bona fide resident of Puerto Rico, he or she must file a U.S. income tax return if he or she meets the income requirements. This is in addition to any legal requirement the person may have to file an income tax return with Puerto Rico. If the individual is a bona fide resident of Puerto Rico for the whole year, his or her U.S. gross income does not include income from sources within Puerto Rico. However, include in his or her U.S. gross income any income the person received for his or her services as an employee of the United States or any U.S. agency.

If the taxpayer receives income from Puerto Rican sources that is not subject to U.S. tax, he or she must reduce the standard deduction, which reduces the amount of income he or she can have before he or she must file a U.S. income tax return. For more information, see Publication 570 - Tax Guide for Individuals With Income From U.S. Possessions.

Individuals With Income From U.S. Possessions

If the taxpayer had income from Guam, the Commonwealth of Northern Mariana Islands, American Samoa, or the U.S. Virgin Islands, special rules may apply when determining whether he or she must file a U.S. Federal income tax return. In addition, the person may have to file a return with the individual possession government. See Publication 570 - Tax Guide for Individuals With Income From U.S. Possessions for more information.

Foreign Account and Asset Reporting

A filing requirement generally applies even if a taxpayer qualifies for tax benefits, such as the foreign earned income exclusion or the foreign tax credit, that substantially reduce or eliminate their U.S. tax liability. These tax benefits are not automatic and are only available if an eligible taxpayer files a U.S. income tax return.

The filing deadline is June 15 for U.S. citizens and resident aliens whose tax home and abode are outside the United States and Puerto Rico, and for those serving in the military outside the U.S. and Puerto Rico, on the regular due date of their tax return. To use this automatic two-month extension, taxpayers must attach a statement to their return explaining which of these two situations applies.

Nonresident aliens who received income from U.S. sources during the tax year also must determine whether they have a U.S. tax obligation. The filing deadline for nonresident aliens can be April 15 or June 15 depending on sources of income.

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

Taxpayers with an interest in, or signature or other authority over, foreign financial accounts whose aggregate value exceeded $10,000 at any time during the tax year must file with the Treasury Department a Financial Crimes Enforcement Network (FinCEN) Form 114 - Report of Foreign Bank and Financial Accounts (FBAR). It is due to the Treasury Department by April 15, must be filed electronically and is only available online through the BSA E-Filing System website. In addition, certain taxpayers may also have to complete and attach to their return Form 8938, Statement of Foreign Financial Assets. Generally, U.S. citizens, resident aliens and certain nonresident aliens must report specified foreign financial assets on this form if the aggregate value of those assets exceeds certain thresholds.

Presidentially Declared Disaster Area

Affected Taxpayers

For the purposes of this tax relief, affected taxpayers include individuals and businesses located in the disaster area, those whose tax records are located in the disaster area, and relief workers. The same relief will also apply to any places added to the disaster area.

Extensions to File or Pay Taxes

The IRS gives affected taxpayers until the last day of the Extension Period to file tax returns or make tax payments, including estimated tax payments, that have either an original or extended due date falling within this Period. The IRS will abate interest and any late filing or late payment penalties that would apply during these dates to returns or payments subject to these extensions.

The IRS also gives affected taxpayers until the last day of the Extension Period to perform certain other time-sensitive actions described in Treasury Regulation Section 301.7508A-1(c)(1) and Revenue Procedure 2002-71, 2002-46 I.R.B. 850, that are due to be performed during this Period. This relief includes the filing of Form 5500 series returns, in the manner described in Section 8 of Revenue Procedure 2002-71.

This extension to file and pay does not apply to information returns, or to employment and excise tax deposits. However, the IRS may abate penalties on such deposits for affected taxpayers due to reasonable cause during the Failure to Deposit (FTD) Penalty Waiver Period, provided they make the payment by the last day of that Period.

To qualify for this relief, affected taxpayers should put the assigned Disaster Designation in red ink at the top of the return, except for Form 5500, where filers should check Box D in Part 1 and attach a statement, following the form's instructions. Individuals or businesses located in the disaster area, or taxpayers outside the area that were directly affected by this disaster, should contact the IRS if they receive penalties for filing returns or paying taxes late.

Casualty Losses

Affected taxpayers in a Presidential Disaster Area have the option of claiming disaster-related casualty losses on their Federal income tax return for either this year or last year. Claiming the loss on an original or amended return for last year will get the taxpayer an earlier refund but waiting to claim the loss on this year's return could result in a greater tax saving, depending on other income factors.

Individuals may deduct personal property losses that are not covered by insurance or other reimbursements, but they must first subtract $100 for each casualty event and then subtract 10% of their adjusted gross income from their total casualty losses for the year. For details on figuring a casualty loss deduction, see IRS Publication 547 - Casualties, Disasters and Thefts.

Affected taxpayers claiming the disaster loss on a last year's return should put the Disaster Designation in red ink at the top of the form so that the IRS can expedite the processing of the refund.

Other Relief

The IRS will waive the usual fees and expedite requests for copies of previously filed tax returns for affected taxpayers who need them to apply for benefits or to file amended returns claiming casualty losses. Such taxpayers should put the assigned Disaster Designation in red ink at the top of Form 4506 - Request for Copy of Tax Return, or Form 4506-T - Request for Transcript of Tax Return, as appropriate, and submit it to the IRS. Affected taxpayers who are contacted by the IRS on a collection or examination matter should explain how the disaster impacts them so that the IRS can provide appropriate consideration to their case.

Tax for Certain Children Who Have Unearned Income (Kiddie Tax)

The Tax Cuts and Jobs Act changed the Kiddie Tax, which taxes a child's unearned income at the tax rates of the child's parents. Starting in 2018, however, the Kiddie Tax was based on the much higher tax rates for estates and trusts. This significantly increased the tax rates that apply to the taxable portion of college grants, scholarships and fellowships and to military survivor benefits of Gold Star families. It also caused low- and middle-income children to be taxed at much higher rates than their parents.

The Setting Every Community Up for Retirement Enhancement (SECURE) Act repeals the change to the Kiddie Tax, reverting to the rules that were in effect before 2018. This change is effective for tax years that begin after December 31, 2019. However, the legislation allows taxpayers to elect to have the change apply retroactively to the 2018 and/or 2019 tax years. Taxpayers will probably have to file amended Federal income tax returns to claim a refund of the excess tax.

Kiddie Tax	
Tax Bracket	**Tax**
$0 to $1,100	0%
Earned income > $1,100	Child's tax rate
Unearned income > $1,100 ≤ $2,200	Child's tax rate
Unearned income > $2,200	Generally, the parent's highest marginal tax rate

Table 1-6 - Publication 929 - Tax for Certain Children Who Have Unearned Income (2020)

The exemption from the Kiddie Tax for 2020 will be $2,200 (the same as 2019). A parent will be able to elect to include a child's income on the parent's return for 2020 if the child's income is more than $1,100 and less than $11,000 (the same as 2019). The alternative minimum tax (AMT) exemption for 2020 for a child subject to the kiddie tax will be the lesser of (1) $7,900 (up from $7,750 for 2019) plus the child's earned income, or (2) $72,900 (up from $71,700 for 2019).

Unearned income is generally all income other than salaries, wages, and other amounts received as pay for work actually performed. It includes taxable interest, dividends, capital gains (including capital gain distributions), the taxable part of social security and pension payments, certain distributions from trusts, and unemployment compensation. Unearned income includes amounts produced by assets the taxpayer's child obtained with earned income (such as interest on a savings account into which the taxpayer deposited wages).

For this purpose, unearned income includes only amounts the taxpayer's child must include in gross income. Nontaxable unearned income, such as tax-exempt interest and the nontaxable part of Social Security and pension payments, is not included in gross income.

The taxpayer's child's capital losses are taken into account in figuring their unearned income. Capital losses are first applied against capital gains. If the capital losses are more than the capital gains, the difference (up to $3,000) is subtracted from the taxpayer's child's interest, dividends, and other unearned income. Any difference over $3,000 is carried to the next year.

Also, the taxpayer's child's unearned income includes all income produced by property belonging to the child. This is true even if the property was transferred to the child, regardless of when the property was transferred or purchased or who transferred it. Additionally, the child's unearned income includes income produced by property given as a gift to the taxpayer's child. This includes gifts to the child from grandparents or any other person and gifts made under the Uniform Gift to Minors Act.

Form 8615 - Tax for Certain Children Who Have Unearned Income must be filed for anyone who meets all of the following conditions:

1. The taxpayer had more than $2,200 of unearned income.
2. The taxpayer is required to file a tax return.
3. The taxpayer was either:
    a. Under age 18 at the end of 2020,
    b. Age 18 at the end of 2020 and did not have earned income that was more than half of his or her support, or
    c. A full-time student at least age 19 and under age 24 at the end of 2020 and did not have earned income that was more than half of his or her support.
4. At least one of the taxpayer's parents was alive at the end of 2020.
5. The taxpayer did not file a joint return for 2020.

These rules apply if the taxpayer was legally adopted and a stepchild. These rules also apply whether or not the taxpayer is a dependent. These rules do not apply if neither of taxpayer's parents were living at the end of the year.

The taxpayer can use Form 8814 - Parents' Election To Report Child's Interest and Dividends if he or she elects to report his or her child's income on his or her return. If the taxpayer does file Form 8814, his or her child will not have to file a return. The taxpayer can make this election if his or her child meets all of the following conditions:

1. The child was under age 19 (or under age 24 if a full-time student) at the end of 2020.
2. The child's only income was from interest and dividends, including capital gain distributions and Alaska Permanent Fund dividends.
3. The child's gross income for 2020 was less than $11,000.
4. The child is required to file a 2020 return.
5. The child does not file a joint return for 2020.
6. There were no estimated tax payments for the child for 2020 (including any overpayment of tax from his or her 2019 return applied to 2020 estimated tax).
7. There was no federal income tax withheld from the child's income.

The taxpayer qualifies to make this election if he or she files Form 1040 or Form 1040-NR and any of the following apply:

- He or she is filing a joint return for 2020 with the child's other parent.
- He or she and the child's other parent were married to each other but file separate returns for 2020 and the taxpayer had the higher taxable income.
- He or she was unmarried, treated as unmarried for Federal income tax purposes, or separated from the child's other parent by a divorce or separate maintenance decree. The child must have lived with the taxpayer for most of the year (he or she was the custodial parent). If the taxpayer was the custodial parent and he or she remarried, he or she can make the election on a joint return with his or her new spouse. But if the taxpayer and his or her new spouse do not file a joint return, the taxpayer qualifies to make the election only if he or she had higher taxable income than his or her new spouse.

If the taxpayer and the child's other parent were not married but lived together during the year with the child, he or she qualifies to make the election only if the taxpayer is the parent with the higher taxable income.

Affordable Care Act Tax Provisions

The Tax Cuts and Jobs Act (TCJA) made significant changes to the Federal tax code. The bill does not impact the majority of the Affordable Care Act (ACA) tax provisions. However, it does reduce the ACA's individual shared responsibility (or individual mandate) penalty to zero. This action effectively eliminated the individual mandate penalty for the 2019 tax year and beyond. As a result, individuals will no longer be penalized for failing to obtain acceptable health insurance coverage for themselves and their family members.

Also, despite the repeal of the individual mandate penalty, employers and individuals must continue to comply with all other ACA provisions. The tax reform bill does not impact any other ACA provisions, including the Patient-Centered Outcomes Research Institute (PCORI) fees and the health insurance provider's fee. In addition, the employer shared responsibility (pay or play) rules and related Section 6055 and Section 6056 reporting requirements are still in place.

The taxpayer may be eligible to claim the Premium Tax Credit if he or she, his or her spouse (if filing jointly), and his or her dependents enrolled in health insurance through the Health Insurance Marketplace. Advance payments of the Premium Tax Credit may have been made to a health insurer to help pay for the insurance coverage of the taxpayer, his or her spouse (if filing jointly), or his or her dependents. If advance payments of the Premium Tax Credit were made, the taxpayer must file a 2020 income tax return and Form 8962 - Premium Tax Credit (PTC).

If the taxpayer, his or her spouse (if filing jointly), or his or her dependents enrolled in health insurance through the Health Insurance Marketplace, the taxpayer should have received Form 1095-A - Health Insurance Marketplace Statement. If the taxpayer receives Form(s) 1095-A, he or she should save it. Form(s) 1095-A will help the taxpayer figure his or her Premium Tax Credit. If the taxpayer did not receive a Form 1095-A, he or she should contact the Marketplace.

Medical Device Excise Tax

The Further Consolidated Appropriations Act included the repeal of the excise tax on medical devices. The repeal of the excise tax on medical devices begins January 1, 2020.

Cadillac Tax

The Further Consolidated Appropriations Act included the repeal of the so-called “Cadillac” tax on health insurance benefits. The repeal of the Cadillac tax begins January 1, 2020.

Health Coverage for Older Children

Health coverage for an employee's children under 27 years of age is now generally tax-free to the employee. This expanded health care tax benefit applies to various workplace and retiree health plans. These changes immediately allow employers with cafeteria plans (plans that allow employees to choose from a menu of tax-free benefit options and cash or taxable benefits) to permit employees to begin making pre-tax contributions to pay for this expanded benefit. This also applies to self-employed individuals who qualify for the self-employed health insurance deduction on their Federal income tax return. [46]

Tax-Exempt 501(c)(29) Qualified Nonprofit Health Insurance Issuers

The Affordable Care Act requires the Department of Health and Human Services (HHS) to establish the Consumer Operated and Oriented Plan program (CO-OP program). It also provides for tax exemption for recipients of CO-OP program grants and loans that meet additional requirements under Section 501(c)(29). [47]

Retiree Drug Subsidies

Under 26 USC Section 139A of the Internal Revenue Code, certain special subsidy payments for retiree drug coverage made under the Social Security Act are not included in the gross income of plan sponsors. Plan sponsors receive these retiree drug subsidy payments based on the allowable retiree costs for certain qualified retiree prescription drug plans. For taxable years beginning on or after January 1, 2013, new statutory rules affect the ability of plan sponsors to deduct costs that are reimbursed through these subsidies.

Generally, taxpayers may not deduct costs that are reimbursed, for which they have a right of reimbursement, or that relate to income on which the taxpayers were not taxed (excluded income). However, for taxable years beginning on or before December 31, 2012, 26 USC Section 139A provides an exception that allows plan sponsors to disregard the excluded income for purposes of determining the deductibility of their costs for the plan year for which they received the subsidy. This exception generally results in a greater deductible amount than if the exception did not apply.

For taxable years beginning after December 31, 2012, 26 USC Section 139A has been amended to remove the language that allows plan sponsors to disregard the excluded income for purposes of determining whether a deduction is allowable for subsidized costs. Accordingly, plan sponsors may continue to exclude the RDS payments from gross income but will be subject to the normal rules disallowing a deduction for expenses for which the sponsors are reimbursed, have a right of reimbursement, or relate to excluded income. (48)

Online Resources

The IRS has launched an Affordable Care Act Tax Provisions website at irs.gov/aca to educate individuals and businesses on how the health care law may affect them. The new home page has three sections, which explain the tax benefits and responsibilities for individuals and families, employers, and other organizations, with links and information for each group. The site provides information about tax provisions that are in effect now and those that went into effect in 2014 and beyond. Topics include the Premium Tax Credit for individuals, new benefits and responsibilities for employers, and tax provisions for insurers, tax-exempt organizations and certain other business types. Visitors to the site will find information about the law and its provisions, legal guidance, the latest news, frequently asked questions and links to additional resources.

Several other Federal agencies have a role in implementing the health care law, including the Department of Health and Human Services, which has primary responsibility. To help locate additional online resources from the Department of Health and Human Services, the Department of Labor and the Small Business Administration, the IRS has issued a web-based flyer - Publication 5093 - Healthcare Law Online Resources.

Income and Assets

Generally, a taxpayer must file a return if his or her gross income equals or exceeds the standard deduction amount applicable to the taxpayer. The Standard Deduction is based on filing status, age and eyesight. Gross income is income from all sources, except for items specifically excluded by the Internal Revenue Code. Income on an individual's annual income tax return typically is the sum of wages and other items of income less the exclusions. The precise amount of gross income is important in order to determine whether the taxpayer must file a return. Except as otherwise provided, gross income means all income from whatever source derived, including (but not limited to) the following items: (49)

- Compensation for services, including fees, commissions, fringe benefits, and similar items.
- Gross income derived from business.
- Gains derived from dealings in property.
- Interest.
- Rents.
- Royalties.
- Dividends.
- Alimony and separate maintenance payments.
- Annuities.
- Income from life insurance and endowment contracts.
- Pensions.
- Income from discharge of indebtedness.
- Distributive share of partnership gross income.
- Income in respect of a decedent.

Gross Income

Gross Income

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- Gains derived from dealings in property.
- Interest.
- Rents.
- Royalties.
- Dividends.
- Alimony and separate maintenance payments.
- Annuities.
- Income from life insurance and endowment contracts.
- Pensions.
- Income from discharge of indebtedness.
- Distributive share of partnership gross income.
- Income in respect of a decedent.
- Income from an interest in an estate or trust.

Adjustments to Gross Income

The following are major items, within limits, allowed by law to be subtracted from gross income:

- Educator Expenses.
- Health savings account deduction.
- One-half of self-employment tax.
- Self-employed SEP, SIMPLE, and qualified plans.
- Self-employed health insurance deduction.
- IRA deduction.
- Student loan interest deduction.

Adjusted Gross Income (AGI)

Adjusted gross income is the remainder of gross income after subtraction of allowed adjustments above. This intermediate amount is important because it is used for computing deductions, tax credits, and other tax benefits that are based on or limited by income. The deductions for medical expenses, contributions, casualty losses and miscellaneous itemized deductions are all based on or limited by the amount of adjusted gross income.

Deductions from Adjusted Gross Income

Some deductions are allowed for expenses of a personal nature. These are divided into five categories:

1. Certain Medical and Dental Expenses.
2. Paid interest and taxes on the home.
3. Gifts to Charity.
4. Casualty and Theft Losses (only for those losses attributable to a Federal disaster as declared by the President).

Deductions from adjusted gross income are sometimes referred to as personal deductions; however, calling these expenses personal deductions can result in confusion. Most personal expenses, such as food, clothing, shelter, entertainment, and the like, are not deductible. A more appropriate designation is itemized deductions.

Earned Income

Earned income includes all the taxable income and wages the taxpayer gets from working or from certain disability payments. A taxpayer receives earned income by working for someone who pays him or her or owning or running a business or farm. Taxable earned income includes: [(50)]

- Wages, salaries, tips, and other taxable employee pay.
- Union strike benefits.
- Long-term disability benefits received prior to minimum retirement age.
- Net earnings from self-employment if:
    - The taxpayer owns or operates a business or a farm.
    - The taxpayer is a minister or member of a religious order.
    - The taxpayer is a statutory employee and has income.

Examples of income that are **not** earned income: [(50)]

- Pay received for work while an inmate in a penal institution.
- Interest and dividends.
- Retirement income.
- Social Security benefits.
- Unemployment benefits.
- Alimony.
- Child support.

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 8 of Schedule 1 (Form 1040) unless it fits into one of the categories shown on lines 1 through 7. If the space on line 8 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: (51)

- 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.

Statutory Employees

If workers are independent contractors under the common law rules, such workers may nevertheless be treated as employees by statute (statutory employees) for certain employment tax purposes if they fall within any one of the following four categories and meet the three conditions described under Social Security and Medicare taxes, below:

- A driver who distributes beverages (other than milk) or meat, vegetable, fruit, or bakery products; or who picks up and delivers laundry or dry cleaning, if the driver is another individual's agent or is paid on commission.
- A full-time life insurance sales agent whose principal business activity is selling life insurance or annuity contracts, or both, primarily for one life insurance company.
- An individual who works at home on materials or goods that another individual supplies and that must be returned to said individual or to a person named by said individual, if the other individual also furnish specifications for the work to be done.
- A full-time traveling or city salesperson who works on another individual's behalf and turns in orders to said individual from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments. The goods sold must be merchandise for resale or supplies for use in the buyer's business operation. The work performed for the said individual must be the salesperson's principal business activity.

Withhold Social Security and Medicare Taxes if all three of the following conditions apply: (52)

- The service contract states or implies that substantially all the services are to be performed personally by them.
- They do not have a substantial investment in the equipment and property used to perform the services (other than an investment in transportation facilities).
- The services are performed on a continuing basis for the same payer.

Bonuses and Awards

Bonuses or awards a taxpayer receives for outstanding work are included in income and should be shown on his or her Form W-2. These include prizes such as vacation trips for meeting sales goals. If the prize or award the taxpayer receives is goods or services, he or she must include the fair market value of the goods or services in his or her income. However, if the taxpayer’s employer merely promises to pay a bonus or award at some future time, it is not taxable until he or she receives it, or it is made available.

If the taxpayer 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 his or her employer's cost and cannot be more than $1,600 ($400 for awards that are not qualified plan awards) for all such awards the taxpayer receives during the year.

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: [53]

- 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.

Example
Ben Roth received three employee achievement awards during the year: a nonqualified plan award of a watch valued at $250, and two qualified plan awards of a stereo valued at $1,000 and a set of golf clubs valued at $500. Assuming that the requirements for qualified plan awards are otherwise satisfied, each award by itself would be excluded from income. However, because the $1,750 total value of the awards is more than $1,600, Ben must include $150 ($1,750 − $1,600) in his income.

Foreign Earned Income

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. Foreign earned income for this purpose means wages, salaries, professional fees, and other compensation received for personal services the taxpayer performed in a foreign country during the period for which he or she met the tax home test and either the bona fide residence test or the physical presence test. It also includes noncash income (such as a home or car) and allowances or reimbursements. [54]

A taxpayer qualifies for the tax benefits available to taxpayers who have foreign earned income if both of the following apply: [54]

- The taxpayer meets the tax home test.
- The taxpayer meets either the bona fide residence test or the physical presence test.

Note

Income from working abroad as an employee of the U.S. Government does not qualify for either of the exclusions or the housing deduction.

To meet the tax home test, the taxpayer’s tax home must be in a foreign country throughout his or her period of bona fide residence or physical presence, whichever applies. For this purpose, the period of physical presence is the 330 full days during which the taxpayer was present in a foreign country, not the 12 consecutive months during which those days occurred.

Foreign earned income does not include amounts that are actually a distribution of corporate earnings or profits distribution of corporate earnings or profits rather than a reasonable allowance as compensation for the taxpayer's personal services. It also does not include the following types of income: (54)

- Pay received as a military or civilian employee of the U.S. Government or any of its agencies.
- Pay for services conducted in international waters (not a foreign country).
- Pay in specific combat zones, as designated by an Executive Order from the President, that is excludable from income.
- Payments received after the end of the tax year following the year in which the services that earned the income were performed.
- The value of meals and lodging that are excluded from income because it was furnished for the convenience of the employer.
- Pension or annuity payments, including social security benefits.

Certain U.S. citizens or resident aliens, specifically contractors or employees of contractors supporting the U.S. Armed Forces in designated combat zones, may now qualify for the foreign earned income exclusion. The Bipartisan Budget Act of 2018, enacted in February, changed the tax home requirement for eligible taxpayers, enabling them to claim the foreign earned income exclusion even if their "abode" is in the United States. The new law applies for tax year 2018 and subsequent years. This means that these taxpayers, if eligible, will be able to claim the foreign earned income exclusion on their income tax return for 2020 when they file. Under the exclusion, taxpayers can choose to exclude their foreign earned income from gross income, up to a certain dollar amount. For tax year 2020, that dollar amount limit is $107,600.

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

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

Table 2-1 - Publication 54 - Chapter 4 - Foreign Earned Income (2020)

The source of the taxpayer's earned income is the place where he or she performs the services for which he or she received the income. Foreign earned income is income the taxpayer receives for working in a foreign country. Where or how he or she is paid has no effect on the source of the income. For example, income the taxpayer receives for work done in Austria is income from a foreign source even if the income is paid directly to his or her bank account in the United States and his or her employer is located in New York City.

Foreign Earned Income Exclusion

To claim the Foreign Earned Income Exclusion, the foreign housing exclusion, or the foreign housing deduction, the taxpayer must have foreign earned income, his or her tax home must be in a foreign country, and he or she must be one of the following:

- 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.
- 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.
- 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 maximum amount of the Foreign Earned Income Exclusion under Internal Revenue Code (IRC) Section 911 is indexed to inflation. The exclusion amount is $107,600 for 2020. In addition, the taxpayer can exclude or deduct certain foreign housing amounts. The taxpayer may also be entitled to exclude from income the value of meals and lodging provided to him or her by his or her employer.

Tip

A qualifying individual may claim the foreign earned income exclusion on foreign earned self-employment income. The excluded amount will reduce the individual's regular income tax but will not reduce the individual's self-employment tax. Also, the foreign housing deduction – instead of a foreign housing exclusion – may be claimed.

If the taxpayer qualifies, he or she can use Form 2555 - Foreign Earned Income to figure his or her foreign earned income exclusion and his or her housing exclusion or deduction. The taxpayer cannot exclude or deduct more than his or her foreign earned income for the year.

U.S. persons (and executors of estates of U.S. decedents) file Form 3520 - Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts to report:

- Certain transactions with foreign trusts.
- Ownership of foreign trusts under the rules of Sections 671 through 679.
- Receipt of certain large gifts or bequests from certain foreign persons.

A separate Form 3520 must be filed for transactions with each foreign trust.

Form 5471 - Information Return of U.S. Persons With Respect To Certain Foreign Corporations is used by certain U.S. citizens and residents who are officers, directors, or shareholders in certain foreign corporations. The form and schedules are used to satisfy the reporting requirements of Sections 6038 and 6046, and the related regulations.

Interest Subject to the Tax

Interest is rent on money, paid by the borrower to the lender. With few exceptions, interest is fully taxable to the taxpayer receiving it. Taxable interest includes interest received from bank accounts, loans made to others, and other sources. The major problem connected with interest is the determination of the year when it is included in gross income. To a cash-basis taxpayer, interest is taxable under the doctrine of constructive receipt of income when it is unqualifiedly made subject to the demand of the taxpayer. Under this rule, interest is received when it is credited to the taxpayer's account.

Taxable interest income is reported on line 2b, Form 1040. For 2020, if interest and dividend income exceed $1,500, a listing of all sources and amounts would have to be shown on Part I of Schedule B. Otherwise, if the taxpayer had interest income and dividends of less than $1,500 the total amount may be placed directly on the Form 1040, line 2b.

Interest income is generally reported to taxpayers on Form 1099-INT- Interest Income, or a similar statement, by banks, savings and loans, and other payers of interest. Form 1099-INT does not have to be attached to the submitted tax return unless it has tax withholding. (55)

Certain distributions commonly called dividends are actually interest. A taxpayer must report as interest so-called dividends on deposits or on share accounts in: (56)

- Cooperative banks.
- Credit unions.
- Domestic building and loan associations.
- Domestic savings and loan associations.
- Federal savings and loan associations.
- Mutual savings banks.

U.S. Savings Bonds

Series HH bonds were issued at face value. Interest is paid twice a year by direct deposit to the taxpayer's bank account. If the taxpayer is a cash method taxpayer, he or she must report interest on these bonds as income in the year received. Series HH bonds were first offered in 1980 and last offered in August 2004. Before 1980, series H bonds were issued. Series H bonds are treated the same as series HH bonds. If the taxpayer is a cash method taxpayer, he or she must report the interest when received.

Series H bonds have a maturity period of 30 years. Series HH bonds mature in 20 years. The last series H bonds matured in 2009.

Interest on series EE and series I bonds is payable when the taxpayer redeems the bonds. The difference between the purchase price and the redemption value is taxable interest. Series EE bonds were first offered in January 1980 and have a maturity period of 30 years.

Series E bonds were issued before July 1980. The original 10-year maturity period of series E bonds has been extended to 40 years for bonds issued before December 1965 and 30 years for bonds issued after November 1965. Paper series EE and series E bonds are issued at a discount. The face value is payable to the taxpayer at maturity.

Electronic series EE bonds are issued at their face value. The face value plus accrued interest is payable to the taxpayer at maturity. As of January 1, 2012, paper savings bonds will no longer be sold at financial institutions. Owners of paper series EE bonds can convert them to electronic bonds. These converted bonds do not retain the denomination listed on the paper certificate but are posted at their purchase price (with accrued interest).

Series I bonds were first offered in 1998. These are inflation-indexed bonds issued at their face amount with a maturity period of 30 years. The face value plus all accrued interest is payable to the taxpayer at maturity.

If the taxpayer uses the cash method of reporting income, he or she can report the interest on series EE, series E, and series I bonds in either of the following ways:

- **Method 1** - Postpone reporting the interest until the earlier of the year he or she cashes or disposes of the bonds or the year they mature.
- **Method 2** - Choose to report the increase in redemption value as interest each year.

The taxpayer must use the same method for all series EE, series E, and series I bonds he or she owns. If the taxpayer does not choose method 2 by reporting the increase in redemption value as interest each year, he or she must use method 1.

Note

If the taxpayer uses an accrual method of accounting, he or she must report interest on U.S. savings bonds each year as it accrues. The taxpayer cannot postpone reporting interest until it is received or until the bonds mature.

Discount on Debt Instruments

A debt instrument, such as a bond, note, debenture, or other evidence of indebtedness, that bears no interest or bears interest at a lower than current market rate will usually be issued at less than its face amount. This discount is, in effect, additional interest income.

The following are some types of discounted debt instruments.

- U.S. Treasury bonds.
- Corporate bonds.
- Municipal bonds.
- Certificates of deposit.
- Notes between individuals.
- Stripped bonds and coupons.
- Collateralized debt obligations (CDOs).

The discount on these instruments (except municipal bonds) is taxable in most instances. The discount on municipal bonds generally is not taxable.

Gift for Opening Account

If the taxpayer receives noncash gifts or services for making deposits or for opening an account in a savings institution, he or she may have to report the value as interest. For deposits of less than $5,000, gifts or services valued at more than $10 must be reported as interest. For deposits of $5,000 or more, gifts or services valued at more than $20 must be reported as interest. The value is determined by the cost to the financial institution.

Interest on Insurance Dividends

Interest on insurance dividends left on deposit with an insurance company that can be withdrawn annually is taxable to an individual in the year it is credited to his or her account. However, if the taxpayer can withdraw it only on the anniversary date of the policy (or other specified date), the interest is taxable in the year that date occurs.

Prepaid Insurance Premiums

Any increase in the value of prepaid insurance premiums, advance premiums, or premium deposit funds is interest if it is applied to the payment of premiums due on insurance policies or made available to the taxpayer for withdraw.

U.S. Obligations

Interest on U.S. obligations, such as U.S. Treasury bills, notes, and bonds, issued by any agency or instrumentality of the United States is taxable for Federal income tax purposes.

Installment Sale Payments

If a contract for the sale or exchange of property provides for deferred payments, it also usually provides for interest payable with the deferred payments. That interest is taxable when the taxpayer receives it. If little or no interest is provided for in a deferred payment contract, part of each payment may be treated as interest.

Other Taxable Interest

Interest a taxpayer receives on tax refunds, accumulated interest on an annuity contract sold before its maturity date and the interest a condemning authority pays to compensate for a delay in payment of an award is taxable income.

Excluded Interest

Note

Interest received on the obligations of a state, a territory, or any political subdivision of a state or territory, such as a city or a county, is excluded fully from Federal income taxation. This exclusion makes an investment in state and local bonds attractive for taxpayers that are in higher tax brackets. However, tax-exempt interest must be reported on line 2a, Form 1040 even though it is not taxed. [56]

Even if interest on the obligation is not subject to income tax, the taxpayer may have to report a capital gain or loss when he or she sells it. Estate, gift, or generation-skipping tax may apply to other dispositions of the obligation.

Interest on a bond used to finance government operations generally is not taxable if the bond is issued by a state, the District of Columbia, a U.S. possession, or any of their political subdivisions. Political subdivisions include: [57]

- Port authorities.
- Toll road commissions.
- Utility services authorities.
- Community redevelopment agencies.
- Qualified volunteer fire departments (for certain obligations issued after 1980).

Capital Gain Distributions

Capital gain distributions (also called capital gain dividends) are paid to a taxpayer or credited to his or her account by mutual funds (or other regulated investment companies) and real estate investment trusts (REITs). They will be shown in box 2a of the Form 1099-DIV received from the mutual fund or REIT. Report capital gain distributions as long-term capital gains, regardless of how long the taxpayer owned his or her shares in the mutual fund or REIT.

Money Market Funds

Money market funds are offered by nonbank financial institutions such as mutual funds and stock brokerage houses and pay dividends. Generally, amounts a taxpayer receives from money market funds should be reported as dividends, not as interest. Exempt-interest dividends taxpayer receives from a mutual fund or other regulated investment company, including those received from a qualified fund of funds in any tax year beginning after December 22, 2010, are not included in taxable income.

Certificates of Deposit and Other Deferred Interest Accounts

If the taxpayer opens a certificate of deposit and other deferred interest account, interest may be paid at fixed intervals of 1 year or less during the term of the account. The taxpayer generally must include this interest in his or her income when he or she actually receives it or is entitled to receive it without paying a substantial penalty. The same is true for accounts that mature in 1 year or less and pay interest in a single payment at maturity.

If the taxpayer withdraws funds from a deferred interest account before maturity, he or she may have to pay a penalty. The taxpayer must report the total amount of interest paid or credited to his or her account during the year, without subtracting the penalty.

The interest a taxpayer pays on money borrowed from a bank or savings institution to meet the minimum deposit required for a certificate of deposit from the institution and the interest he or she earns on the certificate are two separate items. The taxpayer must report the total interest he or she earns on the certificate in his or her income. If the taxpayer itemizes deductions, he or she can deduct the interest he or she pays as investment interest, up to the amount of his or her net investment income.

Tax Exempt Bonds

This is an obligation issued by or on behalf of a governmental issuer for which the interest paid is excluded from the holder's gross income under Section 103. For this purpose, a bond can be in any form of indebtedness under Federal tax law, including a bond, note, loan, or lease-purchase agreement such as a municipal bond.

Interest on a bond used to finance government operations generally is not taxable if the bond is issued by a state, the District of Columbia, a U.S. possession, or any of their political subdivisions. Political subdivisions include: [25]

- Port authorities.
- Toll road commissions.
- Utility services authorities.
- Community redevelopment agencies.
- Qualified volunteer fire departments (for certain obligations issued after 1980).

There are other requirements for tax-exempt bonds. Contact the issuing state or local government agency or see Sections 103 and 141 through 150 of the Internal Revenue Code and the related regulations.

Interest on a state or local government obligation may be tax exempt even if the obligation is not a bond. For example, interest on a debt evidenced only by an ordinary written agreement of purchase and sale may be tax exempt. Also, interest paid by an insurer on default by the state or political subdivision may be tax exempt. Interest on Federally guaranteed state or local obligations issued after 1983 is generally taxable.

This rule does not apply to interest on obligations guaranteed by the following U.S. Government agencies: [25]

- Bonneville Power Authority (if the guarantee was under the Northwest Power Act as in effect on July 18, 1984).
- Department of Veterans Affairs.
- Federal home loan banks. (The guarantee must be made after July 30, 2008, in connection with the original bond issue during the period beginning on July 30, 2008 and ending on December 31, 2010 (or a renewal or extension of a guarantee so made) and the bank must meet safety and soundness requirements).
- Federal Home Loan Mortgage Corporation.
- Federal Housing Administration.

- Federal National Mortgage Association.
- Government National Mortgage Corporation.
- Resolution Funding Corporation.
- Student Loan Marketing Association.

Individual Retirement Arrangements (IRAs)

Interest earned on an Individual Retirement Arrangement (IRA) is excluded from income until withdrawals are made from the account. This exclusion also applies to interest earned by Keogh retirement plans and other qualified pension or profit-sharing plans.

Education Savings Bond Program

Interest income can be excluded on qualified U.S. Savings Bonds redeemed to pay for qualified higher education expenses. These are expenses for tuition and required fees at an eligible educational institution (such as an accredited college, university or eligible vocational school) or to a Coverdell education savings account for the taxpayer, his or her spouse, or his or her dependent(s).

A qualified U.S. Savings bond is a Series EE savings bond that was issued after December 31, 1989, to an individual who has reached age 24 before the date of issuance and which was issued at a discount (Series I or EE bonds).

The exclusion is subject to a phase-out in the years in which the bonds are cashed and the tuition is paid. The phase-out based on the taxpayer's modified adjusted gross income (MAGI) for 2020 begins at $82,350 for taxpayers filing single or head of household, and $123,550 for married taxpayers filing jointly or for a qualifying widow(er) with dependent child. The taxpayer does not qualify for the interest exclusion if MAGI is equal to or more than the upper limit for his or her filing status. In 2020, the exclusion phases out completely at MAGI levels of $153,550 for joint returns and $97,350 for other returns. This exclusion is not available to married individuals who file separate returns.

If the total proceeds (interest and principal) from the qualified U.S. savings bonds the taxpayer redeems during the year are not more than his or her adjusted qualified higher educational expenses for the year, he or she may be able to exclude all of the interest. If the proceeds are more than the expenses, the taxpayer may be able to exclude only part of the interest.

If the total proceeds (interest and principal) from the qualified U.S. savings bonds the taxpayer redeems during the year are not more than his or her adjusted qualified higher educational expenses for the year, he or she may be able to exclude all of the interest. If the proceeds are more than the expenses, the taxpayer may be able to exclude only part of the interest.

To determine the excludable amount, multiply the interest part of the proceeds by a fraction. The numerator of the fraction is the qualified higher educational expenses the taxpayer paid during the year. The denominator of the fraction is the total proceeds the taxpayer received during the year. To figure the interest exclusion when the bonds are redeemed, use Form 8815 - Exclusion of Interest From Series EE and I U.S. Savings Bonds Issued After 1989.

Interest Income on Frozen Deposits

Exclude from gross income interest on frozen deposits. A deposit is frozen if, at the end of the year, the taxpayer cannot withdraw any part of the deposit because: [58]

- The financial institution is bankrupt or insolvent.
- The state where the institution is located has placed limits on withdrawals because other financial institutions in the state are bankrupt or insolvent.

The amount of interest a taxpayer must exclude is the interest that was credited on the frozen deposits minus the sum of: [58]

- The net amount the taxpayer withdrew from these deposits during the year.
- The amount the taxpayer could have withdrawn as of the end of the year (not reduced by any penalty for premature withdrawals of a time deposit).

If the taxpayer receives a Form 1099-INT for interest income on deposits that were frozen at the end of 2020, see frozen deposits under How To Report Interest Income in Chapter 1 of Publication 550, for information about reporting this interest income exclusion on a tax return. The interest a taxpayer excludes is treated as credited to his or her account in the following year. The taxpayer must include it in income in the year he or she can withdraw it.

Nonresident Aliens

Nonresident aliens are not taxed on certain kinds of interest income as follows, per Internal Revenue Code subsections 871(h) and (i), provided that such interest income arises from one of the following sources:

- A U.S. bank.
- A U.S. savings and loan association.
- A U.S. credit union.
- A U.S. insurance company.
- Portfolio Interest.

If the nonresident alien individual uses Form 1040-NR to report his or her income, then such nontaxable interest income shall not be reported anywhere on Form 1040-NR.

A nonresident alien individual should not deliver Form W-9 - Request for Taxpayer Identification Number and Certification to a U.S. bank, U.S. savings and loan association, U.S. credit union, or U.S. insurance company. Instead, he or she should deliver Form W-8BEN - Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding to such institutions in order to put them on notice that he is a nonresident alien and that the interest income accruing to his account at such institutions is not reportable to the IRS, except in the case of U.S. bank accounts held by residents of Canada. Refer to Treasury Regulation 1.6049-8(a).

How To Report Interest Income

Most interest that the taxpayer either receives or is credited to his or her account and that can be withdrawn without penalty is taxable income. Examples of taxable interest are interest on bank accounts, money market accounts, certificates of deposit, and deposited insurance dividends.

If the taxpayer uses this method, he or she generally reports his or her interest income in the year in which he or she actually or constructively receives it. A taxpayer constructively receives income when it is credited to his or her account or made available to him or her. The taxpayer does not need to have physical possession of it. For example, he or she is considered to receive interest, dividends, or other earnings on any deposit or account in a bank, savings and loan, or similar financial institution, or interest on life insurance policy dividends left to accumulate, when they are credited to his or her account and subject to his or her withdrawal. This is true even if they are not yet entered in the taxpayer's passbook.

The taxpayer constructively receives income on the deposit or account even if he or she must: [58]

- Make withdrawals in multiples of even amounts.
- Give a notice to withdraw before making the withdrawal.
- Withdraw all or part of the account to withdraw the earnings.
- Pay a penalty on early withdrawals, unless the interest he or she is to receive on an early withdrawal or redemption is substantially less than the interest payable at maturity.

If the taxpayer uses an accrual method, he or she reports his or her interest income when he or she earns it, whether or not he or she has received it. Interest is earned over the term of the debt instrument. Generally, the taxpayer reports all taxable interest income on Form 1040, line 2b.

The taxpayer uses Schedule B (Form 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.

Reporting Tax-Exempt Interest

Total tax-exempt interest (such as interest or accrued OID on certain state and municipal bonds, including tax-exempt interest on zero coupon municipal bonds) and exempt-interest dividends from a mutual fund as shown in box 8 of Form 1099-INT. Add this amount to any other tax-exempt interest received. Report the total on line 2a of Form 1040.

Form 1099-INT, box 9, and Form 1099-DIV, box 11, show the tax-exempt interest subject to the alternative minimum tax on Form 6251. These amounts are already included in the amounts on Form 1099-INT, box 8, and Form 1099-DIV, box 10. Do not add the amounts in Form 1099-INT, box 9 and Form 1099-DIV, box 11 to, or subtract them from, the amounts on Form 1099-INT, box 8, and Form 1099-DIV, box 10.

Form 1099-DIV - Dividends and Distributions

An individual should file Form 1099-DIV - Dividends and Distributions, for each person: (59)

- To whom he or she has paid dividends (including capital gain dividends and exempt-interest dividends) and other distributions on stock of $10 or more.
- For whom he or she has withheld and paid any foreign tax on dividends and other distributions on stock.
- For whom he or she has withheld any Federal income tax on dividends under the backup withholding rules.
- To whom he or she has paid $600 or more as part of a liquidation.

If an individual makes a payment that may be a dividend but he or she is unable to determine whether any part of the payment is a dividend by the time he or she must file Form 1099-DIV, the entire payment must be reported as a dividend. See the regulations under Section 6042 for a definition of dividends.

Dividends

For many years, millions of people have invested in corporate stocks. For this reason, dividends are a popular source of income. A dividend on stock is similar to an interest payment received on a savings account, note or bond, but with two important differences. Unlike interest, the amount of the dividend is not specified by contract and dividends are not necessarily paid at regular intervals but depend upon the decision of the corporate directors to make a distribution. The most common kinds of distributions are: (55)

- Ordinary dividends.
- Capital gain distributions.
- Non-dividend distributions.

Note

Most distributions are paid in cash (check). However, distributions can consist of more stock, stock rights, other property or services.

Distributions by a corporation of its own stock are commonly known as stock dividends. Stock rights (also known as stock options) are distributions by a corporation of rights to acquire the corporation's stock. Generally, stock dividends and stock rights are not taxable to an individual. However, there are some exceptions. If the stock dividends are not taxable, a taxpayer must divide his or her basis for the old stock between the old and new stock.

The basis of stock must be adjusted for certain events that occur after purchase. For example, if the taxpayer receives more stock from nontaxable stock dividends or stock splits, he or she must reduce the basis of the original stock. The taxpayer must also reduce the basis when he or she receives non-dividend distributions. These distributions, up to the amount of the basis, are a nontaxable return of capital.

Example
Bruce bought 100 shares of stock of XYZ Corporation in 2004 for $10 a share. In January 2005 he bought another 200 shares for $11 a share. In July 2005 he gave his son 50 shares. In December 2007 he bought 100 shares for $9 a share. In April 2020 he sold 130 shares. Bruce cannot identify the shares he disposed of, so he must use the stock he acquired first to figure the basis. The shares of stock he gave his son had a basis of $500 (50 × $10).

Bruce figures the basis of the 130 shares of stock he sold in 2020 as follows:

- 50 shares (50 × $10) balance of stock bought in 2004 - $500.
- 80 shares (80 × $11) stock bought in January 2005 - $880.
- Total basis of stock sold in 2020 = $1,380.

The basis of shares in a mutual fund (or other regulated investment company) or a real estate investment trust (REIT) is generally figured in the same way as the basis of other stock and usually includes any commissions or load charges paid for the purchase.

Example
The taxpayer bought 100 shares of Fund A for $10 a share. She paid a $50 commission to the broker for the purchase. Her cost basis for each share is $10.50 ($1,050 ÷ 100).

Dividends Subject to the Tax

For tax purposes, a dividend is any distribution of property made by a corporation to its stockholders, provided it is paid out of earnings and profits accumulated since March 1, 1913. When a corporation has no profits prior to a distribution, or when all accumulated profits have already been distributed to the stockholders, a distribution is nothing more than a return of the stockholders' capital investment. Such a distribution amounts to a partial liquidation of the corporation, and these distributions must receive treatment different from that given ordinary dividends. In addition, some distributions from certain corporations are taxed as capital gains.

The form in which a dividend is received (cash or property) has no effect on its taxation. Most dividends are paid in cash. When a distribution is of some property other than cash, the fair market value of the property at the time of the distribution is the measure of the dividend. Small, closely held corporations frequently make non-cash distributions in order to preserve their working capital.

Section 61(a)(7) lists dividends as being included in gross income. They are included in their entirety unless there is a specific exclusion. There is no exclusion for dividends received by an individual from a taxable domestic corporation (provided the dividends are paid out of earnings and profits, which is the assumed case unless other information is provided). An eligible domestic corporation can avoid double taxation (once to the shareholders and again to the corporation) by electing to be treated as an S corporation.

Ordinary Dividends and Qualified Dividends

Since January 1, 2003, dividends have been split into ordinary dividends and qualified dividends.

Ordinary Dividends

Tip

Ordinary dividends received by a taxpayer are included in gross income and continue to be taxed as ordinary income. A taxpayer can assume that any dividend he or she receives on common or preferred stocks is an ordinary dividend, unless the paying corporation on its Form 1099-DIV - Dividends and Distributions states otherwise. The dividend tax on these dividends is the same as an investor's personal income tax bracket. If the taxpayer is in the 24% tax bracket, for instance, he or she will pay a 24% dividend tax on ordinary (also known as non-qualified) dividends.

Ordinary dividends are entered on line 3b, Form 1040, and are usually shown in box 1a of the taxpayers' Form(s) 1099-DIV. If the total ordinary dividends exceed $1,500 all ordinary dividends must be reported on Part II, Schedule B.

Qualified Dividends

Qualified dividends are eligible to be taxed at a lower tax rate than other ordinary income. Generally, qualified dividends are taxed at long-term capital gains rates. For 2020, this means that qualified dividends are subject to the same 0%, 15%, or 20% maximum tax rate that applies to net capital gains.

The maximum rate of tax on qualified dividends is:

- 0% on any amount that otherwise would be taxed at a 10% or 12% rate.
- 15% on any amount that otherwise would be taxed at rates greater than 12% but less than 37%.
- 20% on any amount that otherwise would be taxed at a 37% rate.

To qualify for the maximum rate, all of the following requirements must be met:

1. The dividends must have been paid by a U.S. corporation or a qualified foreign corporation.
2. The dividends are not of the type listed below under *Dividends that are not Qualified Dividends*.
3. The taxpayer must meet the holding period.

Additional 3.8% Federal Net Investment Income Tax (NIIT) applies to individuals on the lesser of net investment income or modified AGI 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 adjusted gross income (AGI) in excess of the dollar amount at which the estate/trust pays income taxes at the highest rate. To help calculate the tax on qualified dividends (and capital gains) the IRS provides a Qualified Dividends and Capital Gain Tax Worksheet.

Holding Period

The taxpayer must have held the stock for more than 60 days during the 121-day period that begins 60 days before the ex-dividend date. The ex-dividend date is the first date following the declaration of a dividend on which the buyer of a stock is not entitled to receive the next dividend payment. When counting the number of days the taxpayer held the stock, include the day he or she disposed of the stock, but not the day he or she acquired it (there are minor exceptions to these requirements). In the case of preferred stock, the taxpayer 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 previous paragraph applies.

Dividends that are not Qualified Dividends

The following dividends are not qualified dividends. They are not qualified dividends even if they are shown in box 1b of Form 1099-DIV: [60]

- Capital gain distributions.
- Dividends paid on deposits with mutual savings banks, cooperative banks, credit unions, U.S. building and loan associations, U.S. savings and loan associations, Federal savings and loan associations, and similar financial institutions.
- Dividends from a corporation that is a tax-exempt organization or farmer's cooperative during the corporation's tax year in which the dividends were paid or during the corporation's previous tax year.
- Dividends paid by a corporation on employer securities held on the date of record by an employee stock ownership plan (ESOP) maintained by that corporation.
- Dividends on any share of stock to the extent the taxpayer is obligated (whether under a short sale or otherwise) to make related payments for positions in substantially similar or related property.
- Payments in lieu of dividends.
- Payments shown in Form 1099-DIV, box 1b, from a foreign corporation to the extent the taxpayer knows or has reason to know the payments are not qualified dividends.

How To Report Dividend Income

Generally, the taxpayer should use Form 1040 to report dividend income. Report the total of the ordinary dividends on line 3b of Form 1040. Report qualified dividends on line 3a. If the taxpayer received capital gain distributions, he or she should use Form 1040. If the taxpayer received non-dividend distributions required to be reported as capital gains, he or she must use Form 1040. Use Schedule B - Interest and Ordinary Dividends if the taxpayer had over $1,500 of taxable interest or ordinary dividends.

If the taxpayer owned stock on which he or she received $10 or more in dividends and other distributions, the taxpayer should receive a Form 1099-DIV. Even if the taxpayer does not receive a Form 1099-DIV, he or she must report all taxable dividend income.

Stock Spilt

A stock split occurs when a company creates additional shares, thus reducing the price per share. If the taxpayer owns stock that has split and now owns additional shares, he or she must adjust his or her basis per share or per the lots of the stock he or she owns. If the old shares of stock and the new shares are uniform and identical: (61)

- The basis of the old shares must be allocated to the old and new shares.
- The per share basis is determined by dividing the adjusted basis of the old stock by the number of shares of old and new stock.

If the old shares were purchased in separate lots for differing amounts of money (a different basis per lot) the adjusted basis of the old stock must be allocated between the old and new stock on a lot-by-lot basis. In a stock split, a corporation issues additional shares to current shareholders, but the total basis does not change. Following a stock split, a taxpayer must reallocate his or her basis between the original shares and the shares newly acquired in the stock split. (61)

- Stock splits do not create a taxable event; the taxpayer merely receives more stock evidencing the same ownership interest in the corporation that issued the stock. He or she does not report income until he or she sells the stock.
- The taxpayer's overall basis is not changed as a result of a stock split, but his or her per share basis is changed. The taxpayer will need to adjust his or her basis per share of the stock.

Example
If the taxpayer owns 100 shares of a corporation with a $15 per share basis, the total basis is $1,500. In a 2-for-1 stock split, every shareholder is issued an additional share of stock for each share the shareholder owns. The taxpayer now owns 200 shares, but his or her total basis is still $1,500. Following the stock split, the taxpayer must reallocate the basis between the original shares and the shares newly acquired in the stock split. The basis per share is now $7.50 ($1,500 divided by 200) for each of the 200 shares.

Stock Options

If the taxpayer receives an option to buy stock, he or she may have income when he or she receives the option, when he or she exercises the option, or when he or she disposes of the option or stock received when he or she exercises the option. There are two types of stock options: statutory stock options and non-statutory stock options. Generally, options granted under an employee stock purchase plan (ESPP) or an incentive stock option (ISO) plan are considered statutory stock options. Non-statutory stock options are not granted under an employee stock purchase plan or an ISO plan.

If the taxpayer is granted a statutory stock option, he or she generally does not include any amount in his or her gross income when he or she is granted or exercises the option. However, the taxpayer may be subject to Alternative Minimum Tax in the year he or she exercises an ISO. The taxpayer has taxable income or deductible loss when he or she sells the stock received by exercising the option. The taxpayer generally treats this amount as a capital gain or loss. However, if he or she does not meet special holding period requirements, he or she will have to treat income from the sale as ordinary income.

If the taxpayer is granted a non-statutory stock option, the amount of income to include and the time to include it depends on whether the fair market value of the option can be readily determined. If an option is actively traded on an established market, the fair market value of the option can be readily determined. Most non-statutory options do not have a readily determinable fair market value. For non-statutory options without a readily determinable fair market value, there is no taxable event when the option is granted but the fair market value of the stock received on exercise, less the amount paid, is included in income when the option is exercised. The taxpayer has taxable income or deductible loss when he or she sells the stock received by exercising the option. The taxpayer generally treats this amount as a capital gain or loss. [62]

Non-Dividend Distributions

A non-dividend distribution is a distribution that is not paid out of the earnings and profits of a corporation or a mutual fund. The taxpayer should receive a Form 1099-DIV or other statement showing the non-dividend distribution. On Form 1099-DIV, a non-dividend distribution will be shown in box 3. If the taxpayer does not receive such a statement, he or she reports the distribution as an ordinary dividend.

A non-dividend distribution reduces the basis of the taxpayer's stock. It is not taxed until his or her basis in the stock is fully recovered. This nontaxable portion is also called a return of capital; it is a return of the taxpayer's investment in the stock of the company. If the taxpayer buys stock in a corporation in different lots at different times, and he or she cannot definitely identify the shares subject to the non-dividend distribution, reduce the basis of the earliest purchases first.

When the basis of the stock has been reduced to zero, report any additional non-dividend distribution the taxpayer receives as a capital gain. Whether he or she reports it as a long-term or short-term capital gain depends on how long he or she has held the stock.

Example
Francisco bought stock in 2005 for $100. In 2009, he received a non-dividend distribution of $80. He did not include this amount in his income, but he reduced the basis of his stock to $20. Francisco received a non-dividend distribution of $30 in 2020. The first $20 of this amount reduced his basis to zero. He reports the other $10 as a long-term capital gain for 2020. Francisco must report as a long-term capital gain any non-dividend distribution he receives on this stock in later years.

Passive Income

Passive income can only be generated by a passive activity. Just because the taxpayer did not work for the income does not mean it is passive. There are only two sources for passive income: [63]

- A rental activity.
- A business in which the taxpayer does not materially participate.

The following incomes may seem passive, but generally, none are passive income: [63]

- Portfolio income, including interest, dividends, royalties, annuities and gains on stocks and bonds.
- Lottery winnings.
- Salaries, wages, Form 1099-MISC commissions and retirement income.
- Guaranteed payments for services.
- Income from any activity in which the taxpayer materially participates.

Note

Regardless of whether income is deemed to be passive or non-passive, it must always be reported somewhere on the return, most typically on Schedule E - Supplemental Income and Loss. Form 8582 - Passive Activity Loss Limitations is computational only, figuring the amount of passive loss deductible for the current year. It is **not** the form used to report income.

Form 8582 is filed by individuals, estates, and trusts who have passive activity deductions (including prior year unallowed losses). However, the taxpayer does not have to file Form 8582 if he or she meets the following exception.

The taxpayer actively participated in rental real estate activities and he or she meets all of the following conditions:

- Rental real estate activities with active participation were the taxpayer's only passive activities.
- The taxpayer has no prior year unallowed losses from these (or any other passive) activities.
- The taxpayer's total loss from the rental real estate activities was not more than $25,000 ($12,500 if married filing separately).

- If the taxpayer is married filing separately, he or she lived apart from his or her spouse all year.
- The taxpayer has no current or prior year unallowed credits from a passive activity.
- The taxpayer modified adjusted gross income was not more than $100,000 (not more than $50,000 if married filing separately).
- The taxpayer does not hold any interest in a rental real estate activity as a limited partner or as a beneficiary of an estate or trust.

Tip

For tax year 2020, if a taxpayer actively participated in a passive rental real estate activity, he or she may be able to deduct up to $25,000 of loss from the activity from his or her non-passive income. This special allowance is an exception to the general rule disallowing losses in excess of income from passive activities. The taxpayer is not considered to actively participate in a rental real estate activity if at any time during the tax year his or her interest (including his or her spouse's interest) in the activity was less than 10% (by value) of all interests in the activity. Also, the special allowance is not available if the taxpayer was married, is filing a separate return for the year, and lived with his or her spouse at any time during the year. (64)

Rental Income

In most cases, a taxpayer must include in gross income all amounts he or she receives as rent. Rental income is any payment an individual receives for the use or occupation of property. In addition to amounts he or she receives as normal rental payments, there are other amounts that may be rental income.

When To Report

When to report rental income on the tax return generally depends on whether the taxpayer is a cash basis taxpayer or uses an accrual method. Most individual taxpayers use the cash method.

Cash Method

An individual is a cash basis taxpayer if he or she reports income on the return in the year it was actually or constructively received, regardless of when it was earned. The taxpayer constructively receives income when it is made available to him or her, for example, by being credited to a bank account.

Accrual Method

If an individual is an accrual basis taxpayer, he or she generally reports income when he or she earns it, rather than when he or she receives it. The person generally deducts expenses when incurred, rather than when the person pays them.

Advance Rent

Advance rent is any amount received before the period that it covers. Include advance rent in the rental income in the year the taxpayer receives it regardless of the period covered or the method of accounting used.

Canceling a Lease

If the tenant pays to cancel a lease, the amount received is rent. Include the payment in the income in the year the taxpayer receives it regardless of method of accounting.

Expenses Paid by Tenant

If the tenant pays any of the expenses, those payments are rental income. Because the taxpayer must include this amount in income, he or she can also deduct the expenses if they are deductible rental expenses.

Property or Services

If an individual receives property or services as rent, instead of money, include the fair market value of the property or services in the rental income. If the services are provided at an agreed upon or specified price, that price is the fair market value unless there is evidence to the contrary.

Security Deposits

Do not include a security deposit in income when it is received if the taxpayer plans to return it to the tenant at the end of the lease. But if the taxpayer keeps part or all of the security deposit during any year because the tenant does not live up to the terms of the lease, include the amount kept in the rental income in that year. If an amount called a security deposit is to be used as a final payment of rent, it is advance rent. Include it in income when received.

If the rental agreement gives the tenant the right to buy the rental property, the payments received under the agreement are generally rental income. If the tenant exercises the right to buy the property, the payments received for the period after the date of sale are considered part of the selling price.

If the taxpayer uses a dwelling unit as a home and he or she rents it less than 15 days during the year, its primary function is not considered to be a rental and it should not be reported on Schedule E (Form 1040). However, if the taxpayer uses a dwelling unit as a home and rents it 15 days or more during the year, include all rental income in his or her income. Since the taxpayer used the dwelling unit for personal purposes, he or she must divide the expenses between the rental use and the personal use. The expenses for personal use are not deductible as rental expenses. (65)

Rental Expenses

If the taxpayer had a net profit from renting the dwelling unit for the year (that is, if rental income is more than the total of rental expenses, including depreciation), deduct all of the rental expenses. However, if the taxpayer had a net loss from renting the dwelling unit for the year, the deduction for certain rental expenses is limited. See Publication 527 - Residential Rental Property and Publication 17 - Chapter 9 - Rental Income and Expenses to figure the deductible rental expenses and any carryover to the next year.

Some examples of expenses that may be deducted from total rental income are: [27]

- *Depreciation* - the taxpayer begins to depreciate his or her rental property when it is placed in service. The taxpayer can recover some or all of his or her original acquisition cost and improvements by using Form 4562 - Depreciation and Amortization beginning in the year the rental property is first placed in service, and beginning in any year the taxpayer makes improvements or adds furnishings. The rental is considered placed in service when it was ready and available for rent.
- *Repairs* - repairs to keep the property in good working condition but do not add to the value of the property.
- *Operating Expense* - other expenses necessary for the operation of the rental property, such as the salaries of employees or fees charged by independent contractors (groundkeepers, bookkeepers, accountants, attorneys, etc.) for services provided.
- *Uncollected rents* - unless taxpayer is a cash basis taxpayer and cannot deduct uncollected rents as an expense because he or she has not included those rents in income.

If the taxpayer uses a dwelling unit for both rental and personal purposes, divide the expenses between the rental use and the personal use based on the number of days used for each purpose.

When dividing the expenses, follow these rules: [27]

- Any day that the unit is rented at a fair rental price is a day of rental use even if the taxpayer used the unit for personal purposes that day. (This rule does not apply when determining whether the taxpayer used the unit as a home.)
- Any day that the unit is available for rent but not actually rented is not a day of rental use.

Certain expenses the taxpayer pays to obtain a mortgage on a rental property cannot be deducted as interest. These expenses, which include mortgage commissions, abstract fees, and recording fees, are capital expenses that are part of the basis in the property.

Points are prepaid interest; the taxpayer generally cannot deduct the full amount in the year paid but must deduct the interest over the term of the loan.

Canceled Debts

A debt includes any indebtedness whether a taxpayer is personally liable or liable only to the extent of the property securing the debt. Cancellation of all or part of a debt that is secured by property may occur because of a foreclosure, a repossession, a voluntary return of the property to the lender, abandonment of the property, or a principal residence loan modification.

In general, if the taxpayer is liable for a debt that is canceled, forgiven, or discharged, he or she will receive a Form 1099-C - Cancellation of Debt, and must include the canceled amount in gross income unless the taxpayer meets an exclusion or exception. If a person receives a Form 1099-C but the creditor is continuing to try to collect the debt, then the debt has not been cancelled and he or she does not have taxable cancellation of debt income.

The taxpayer must report any taxable amount of a cancelled debt for which he or she is personally liable, as ordinary income from the cancellation of debt, on Form 1040 or Form 1040-NR and associated schedules, as advised in Publication 4681 - Canceled Debts, Foreclosures, Repossessions, and Abandonments (for Individuals) and Publication 17 - Chapter 12 - Other Income. An individual must report the taxable amount of a taxable debt whether or not he or she receives a Form 1099-C.[66]

Canceled debts that meet the requirements for any of the following exceptions or exclusions are not taxable: [67]

Canceled debt that qualifies for **exception** to inclusion in gross income:

- Amounts specifically excluded from income by law such as gifts or bequests.
- Cancellation of certain qualified student loans.
- Canceled debt, if paid by a cash basis taxpayer, would be deductible.
- A qualified purchase price reduction given by a seller.
- Any Pay-for-Performance Success Payments that reduce the principal balance of a home mortgage under the Home Affordable Modification Program.

Canceled debt that qualifies for **exclusion** from gross income:

- Debt canceled in a Title 11 bankruptcy case (including all chapters in title 11 such as chapters 7, 11, and 13).
- Debt canceled during insolvency.
- Cancellation of qualified farm indebtedness.
- Cancellation of qualified real property business indebtedness.

The Bipartisan Budget Act of 2018 retroactively extended the exclusion for qualified principal residence indebtedness that provides tax relief on canceled debt for many homeowners involved in the mortgage foreclosure through 2017. The Further Consolidated Appropriations Act extended the deduction through 2020. Up to $2 million of forgiven debt was eligible for this exclusion ($1 million if married filing separately). The exclusion did not apply if the discharge was due to services performed for the lender or any other reason not directly related to a decline in the home's value or the taxpayer's financial condition.

Unemployment and Other Compensation

A taxpayer must include on his or her return all items of income he or she receives in the form of money, property, and services unless the tax law states that he or she does not include them. Some items, however, are only partly excluded from income. See Publication 17 - Chapter 12 - Other Income for additional information.

Cafeteria Plans

A cafeteria plan, including a flexible spending arrangement, is a written plan that allows employees to choose between receiving cash or taxable benefits instead of certain qualified benefits for which the law provides an exclusion from wages. If an employee chooses to receive a qualified benefit under the plan, the fact that the employee could have received cash or a taxable benefit instead will not make the qualified benefit taxable. Generally, a cafeteria plan does not include any plan that offers a benefit that defers pay. However, a cafeteria plan can include a qualified 401(k) plan as a benefit. Also, certain life insurance plans maintained by educational institutions can be offered as a benefit even though they defer pay.

A cafeteria plan can include the following benefits: (68)

- Accident and health benefits (but not Archer medical savings accounts (Archer MSAs) or long-term care insurance).
- Adoption assistance.
- Dependent care assistance.
- Group-term life insurance coverage (including costs that cannot be excluded from wages).
- Health savings accounts (HSAs). Distributions from an HSA may be used to pay eligible long-term care insurance premiums or qualified long-term care services.

A cafeteria plan cannot include the following benefits: (68)

- Archer MSAs.
- Athletic facilities.
- De minimis (minimal) benefits.
- Educational assistance.
- Employee discounts.
- Employer-provided cell phones.
- Lodging on the business premises.
- Meals.
- No-additional-cost services.
- Transportation (commuting) benefits.
- Tuition reduction.
- Working condition benefits.

A cafeteria plan also cannot include scholarships or fellowships.

For plan years beginning after December 31, 2012, a cafeteria plan may not allow an employee to request salary reduction contributions for a health flexible spending arrangement (FSA) in excess of the annual limit. For 2020, the annual dollar limit on employee contributions to employer-sponsored healthcare flexible spending arrangements (FSA) increases to $2,750. Amounts contributed are not subject to Federal income tax, Social Security tax or Medicare tax. If the plan allows, the employer may also contribute to an employee's FSA.

The Consolidated Appropriations Act, 2021, signed into law near the end of 2020, gives employers the option to allow participants to roll over all unused amounts in their health and dependent care flexible spending accounts (FSAs) from 2020 to 2021 and from 2021 to 2022. All unused amounts in a health or dependent care FSA may be carried over from the 2020 plan year to the 2021 plan year, and from the 2021 plan year to the 2022 plan year. This rule applies to dependent care FSAs even though carry-overs are otherwise not permitted for these accounts.

Also, under the Consolidated Appropriations Act, 2021, the grace period for a health FSA or dependent care FSA for a plan year ending in 2020 or 2021 may be extended from two-and-a-half months to 12 months and for plan years ending in 2021, participants may prospectively modify their health FSA or dependent care FSA contributions for any reason. A similar rule is already in place for plan years ending in 2020. Plan sponsors may, however, decide to limit permitted election changes for health FSAs to avoid overspending in these accounts.

Lastly, under the Consolidated Appropriations Act, 2021, an employee who stops participating in a health FSA during 2021 may continue to receive reimbursements from unused amounts through the end of the plan year, including any grace period. Unlike reimbursements available to participants who have elected COBRA coverage following their termination, this rule does not require that the participants make further contributions to access their unspent funds.

In most cases, if an individual is covered by an accident or health insurance plan through a cafeteria plan, and the amount of the insurance premiums was not included in income, he or she is not considered to have paid the premiums and must include any benefits received in income. If the amount of the premiums was included in income, the individual is considered to have paid the premiums and any benefits received are not taxable.

The Affordable Care Act requires employers to report the cost of coverage under an employer-sponsored group health plan. However, there is nothing about the reporting requirement that causes or will cause excludable employer-provided health coverage to become taxable. The purpose of the reporting requirement is to provide employees useful and comparable consumer information on the cost of their health care coverage.

For tax purposes, the taxpayer can generally exclude from his or her income any health insurance premiums (including Medicare) paid by his or her employer. The premiums can be for insurance covering the taxpayer, his or her spouse, and any dependents. It does not matter whether the premiums paid for an employer-sponsored group policy or an individual policy.

If the taxpayer pays the premiums on his or her health insurance policy and receives a reimbursement from his or her employer for those premiums, the amount of the reimbursement is not taxable income. However, if the taxpayer's employer simply pays him or her a lump sum that may be used to pay health insurance premiums but is not required to be used for this purpose, that amount is taxable.

The deductibility of health insurance premiums follows the rules for deducting medical expenses. Usually, the premiums a taxpayer pays on an individual health insurance policy will not be deductible. However, in 2020, if the taxpayer itemizes deductions on Schedule A, and his or her unreimbursed medical expenses exceed 7.5% of adjusted gross income (AGI) in any tax year, the taxpayer may be able to take a deduction. He or she can deduct the amount by which his or her unreimbursed medical expenses exceed this 7.5% threshold. Unreimbursed medical expenses include premiums paid for major medical, hospital, surgical, and physician's expense insurance, and amounts paid out-of-pocket for treatment not covered by the taxpayer's health insurance.

Under the Tax Cuts and Jobs Act (TCJA), the medical expense deduction remained in place with a lower floor of 7.5% for tax years 2017 (retroactively) and 2018 for all taxpayers regardless of age. The Consolidated Appropriations Act, 2021 makes permanent the lower threshold of 7.5% for all taxpayers, originally restored for 2017 and 2018 and then extended for 2019 and 2020.

Unemployment Compensation

The term "unemployment compensation" means any amount received under a law of the United States, or of a State, which is in the nature of unemployment compensation. Thus, Section 85 applies only to unemployment compensation paid pursuant to governmental programs and does not apply to amounts paid pursuant to private nongovernmental unemployment compensation plans (which are includible in income without regard to Section 85). Generally, unemployment compensation programs are those designed to protect taxpayers against the loss of income caused by involuntary layoff. Ordinarily, unemployment compensation is paid in cash and on a periodic basis. The amount of the payments is usually computed in accordance with a formula based on the taxpayer's length of prior employment and wages. Such payments, however, may be made in a lump sum or other than in cash or on some other basis.

At present, Federal law requires that all unemployment compensation received from governmental units must be reported as income. If unemployment compensation was received during the year, the taxpayer should receive Form 1099-G - Certain Government Payments showing the amount he or she was paid. Any unemployment compensation received must be included in his or her income. (69)

The American Rescue Plan (ARP) Act makes the first $10,200 in unemployment benefits tax-free in 2020 for taxpayers making less than $150,000 per year. Each spouse can get this benefit with respect to their own unemployment benefits whether filing jointly or separately ($20,400 for married couples, filing jointly). States must decide if they will also offer the break on state income taxes. Some like California, Montana, New Jersey, Pennsylvania and Virginia already exempt taxes on unemployment. The IRS advised taxpayers who already filed their tax returns for 2020, but who are eligible for the break on unemployment income, not to file an amended tax return to claim the benefit. The agency is working on a fix and plans to automatically process refunds for eligible individuals.

Unemployment compensation generally includes the following benefits: (70)

- Benefits paid by a state or the District of Columbia from the Federal Unemployment Trust Fund.
- State unemployment insurance benefits.
- Railroad unemployment compensation benefits.

- Disability payments from a government program paid as a substitute for unemployment compensation (Amounts received as workers' compensation for injuries or illness are not unemployment compensation).
- Trade readjustment allowances under the Trade Act of 1974.
- Unemployment assistance under the Disaster Relief and Emergency Assistance Act of 1974.
- Unemployment assistance under the Airline Deregulation Act of 1974 Program.

The taxpayer must include benefits from regular union dues paid to him or her as an unemployed member of a union in his or her income. However, other rules apply if the taxpayer contributes to a special union fund and the contributions are not deductible. If this applies, only include in income the amount the taxpayer received from the fund that is more than his or her contributions.

The taxpayer can choose to have Federal income tax withheld from the unemployment benefits. He or she makes this choice using Form W-4V - Voluntary Withholding Request. If the taxpayer completes the form and gives it to the paying office, they will withhold tax at 10% of the payments. If the taxpayer chooses not to have tax withheld, he or she may have to make estimated tax payments throughout the year. (71)

Sickness and Injury Benefits

In most cases, the taxpayer must report as income any amount he or she receives for personal injury or sickness through an accident or health plan that is paid for by his or her employer. If both the taxpayer and the employer pay for the plan, only the amount the taxpayer receives that is due to the employer's payments is reported as income. However, certain payments may not be taxable. If the taxpayer retired on disability, he or she must include in income any disability pension he or she receives under a plan that is paid for by his or her employer. The taxpayer must report taxable disability payments as wages until he or she reaches minimum retirement age. Minimum retirement age generally is the age at which the taxpayer can first receive a pension or annuity if he or she is not disabled. (72)

The taxpayer may be able to exclude from income amounts he or she receives as a pension, annuity, or similar allowance for personal injury or sickness resulting from active service in one of the following government services:

- The armed forces of any country.
- The National Oceanic and Atmospheric Administration.
- The Public Health Service.
- The Foreign Service.

The taxpayer should not include the disability payments in his or her income if any of the following conditions apply: (73)

- The taxpayer was entitled to receive a disability payment before September 25, 1975.
- The taxpayer was a member of a listed government service or its reserve component or was under a binding written commitment to become a member, on September 24, 1975.
- The taxpayer received the disability payments for a combat-related injury. This is a personal injury or sickness that:
    - Results directly from armed conflict.
    - Takes place while the taxpayer was engaged in extra-hazardous service.
    - Takes place under conditions simulating war, including training exercises such as maneuvers.
    - Is caused by an instrumentality of war.
- The taxpayer would be entitled to receive disability compensation from the Department of Veterans Affairs (VA) if he or she filed an application for it. The exclusion under this condition is equal to the amount the taxpayer would be entitled to receive from the VA.

Workers' Compensation

Amounts in the nature of unemployment compensation also include cash disability payments made pursuant to a governmental program as a substitute for case unemployment payments to an unemployed taxpayer who is ineligible for such payments solely because of the disability. Usually, these disability payments are paid in the same weekly amount and for the same period as the unemployment compensation benefits to which the unemployed taxpayer otherwise would have been entitled. Amounts received under workmen's compensation acts as compensation for personal injuries or sickness are not amounts in the nature of unemployment compensation.

Amounts the taxpayer receives as workers' compensation for an occupational sickness or injury are fully exempt from tax if they are paid under a workers' compensation act or a statute in the nature of a workers' compensation act. The exemption also applies to his or her survivors. The exemption, however, does not apply to retirement plan benefits the taxpayer receives based on his or her age, length of service, or prior contributions to the plan, even if he or she retired because of an occupational sickness or injury.

If part of the taxpayer's workers' compensation reduces his or her Social Security or equivalent railroad retirement benefits received, that part is considered Social Security (or equivalent railroad retirement) benefits and may be taxable. If the taxpayer returns to work after qualifying for workers' compensation, salary payments he or she receives for performing light duties are taxable as wages.

Reimbursement for Medical Care

A reimbursement for medical care generally is not taxable. However, it may reduce the taxpayer's medical expenses deduction if he or she receives reimbursement for an expense he or she deducted in an earlier year.

If a taxpayer receives an advance reimbursement or loan for future medical expenses from his or her employer without regard to whether he or she suffered a personal injury or sickness or incurred medical expenses, that amount is included in income, whether or not the taxpayer incurs uninsured medical expenses during the year. Reimbursements received under the taxpayer's employer's plan for expenses incurred before the plan was established are included in income.

Amounts a taxpayer receives under a reimbursement plan that provides for the payment of unused reimbursement amounts in cash or other benefits are included in income. However, a qualified HSA distribution from a health flexible spending account or health reimbursement account can be made to a health savings account.

Sick Pay

The IRS defines sick pay as any amount paid under a plan for employees because of an employee's temporary absence from work due to injury, sickness or disability. The sick pay may be paid by either the employer or by a third party, such as an insurance company. Based on this definition, the IRS classifies Long-Term Disability Insurance (LTD), Short-Term Disability Insurance (STD) and State Disability Insurance (SDI) benefits paid to employees as sick pay. Pay a taxpayer receives from his or her employer while he or she is sick or injured is part of his or her salary or wages.

In addition, the taxpayer must include in his or her income sick pay benefits received from any of the following payers: (74)

- A welfare fund.
- A state sickness or disability fund.
- An association of employers or employees.
- An insurance company, if his or her employer paid for the plan.

However, if the taxpayer paid the premiums on an accident or health insurance policy, the benefits he or she receives under the policy are not taxable.

Life Insurance and Disability Insurance Proceeds

A taxpayer must report as income any amount he or she receives for disability through an accident or health insurance plan paid for by his or her employer: (75)

- If both the taxpayer and the employer have paid the premiums for the plan, only the amount he or she receives for disability that is due to his or her employer's payments is reported as income.
- If the taxpayer pays the entire cost of a health or accident insurance plan, do not include any amounts he or she receives for disability as income on the tax return.
- If the taxpayer pays the premiums of a health or accident insurance plan through a cafeteria plan, and the amount of the premium was not included as taxable income to him or her, the premiums are considered paid by the employer, and the disability benefits are fully taxable.
- If the amounts are taxable:

- The taxpayer can submit a Form W-4S - Request for Federal Income Tax Withholding From Sick Pay to the insurance company.
- Make estimated tax payments by filing Form 1040-ES - Estimated Tax for Individuals.

Amounts a taxpayer receives from an employer while he or she is sick or injured are part of his or her salary or wages.

Taxation of Disability Benefits		
Who Pays the Insurance Premium	**Is the Benefit Taxable?**	**How Much of the Benefit is Taxable?**
Employer pays 100%	Yes	100%
Employer pays portion and employee pays balance with post-tax dollars	Yes	Percentage of premium paid by employer
Employer pays portion and employee pays balance with pre-tax dollars	Yes	100%
Employee pays 100% with post-tax dollars	No	None
Employee pays 100% with pre-tax dollars	Yes	100%

Table 2-2 - Internal Revenue Code (IRC) Section 105 (2020)

Military and Government Disability Pensions

Certain military and government disability pensions are not taxable. The taxpayer may be able to exclude from income amounts he or she receives as a pension, annuity, or similar allowance for personal injury or sickness resulting from active service in one of the following government services:

- The armed forces of any country.
- The National Oceanic and Atmospheric Administration.
- The Public Health Service.
- The Foreign Service.

The taxpayer does not include the disability payments in his or her income if any of the following conditions apply:

1. He or she was entitled to receive a disability payment before September 25, 1975.
2. He or she was a member of a listed government service or its reserve component or was under a binding written commitment to become a member, on September 24, 1975.
3. He or she receives the disability payments for a combat-related injury. This is a personal injury or sickness that:
    a. Results directly from armed conflict,
    b. Takes place while he or she is engaged in extra-hazardous service,
    c. Takes place under conditions simulating war, including training exercises such as maneuvers, or
    d. Is caused by an instrumentality of war.
4. He or she would be entitled to receive disability compensation from the Department of Veterans Affairs (VA) if he or she filed an application for it. The taxpayer's exclusion under this condition is equal to the amount he or she would be entitled to receive from the VA.

If the taxpayer receives a disability pension based on years of service, in most cases he or she must include it in his or her income. However, if the pension qualifies for the exclusion for a service-connected disability, the taxpayer does not include in income the part of his or her pension that he or she would have received if the pension had been based on a percentage of disability. The taxpayer must include the rest of his or her pension in his or her income.

In most cases, under the statute of limitations a claim for credit or refund must be filed within 3 years from the time a return was filed. However, if the taxpayer receives a retroactive service-connected disability rating determination, the statute of limitations is extended by a 1-year period beginning on the date of the determination. This 1-year extended period applies to claims for credit or refund filed after June 17, 2008 and does not apply to any tax year that began more than 5 years before the date of the determination.

Prizes and Awards

Almost all contest awards and prizes are now taxable compensation. They usually represent a payment for services rendered. For example, if the taxpayer wins a photography contest, he must have taken the time and invested in the supplies necessary to produce the winning photograph. Although he must include the prize income, he is entitled to reduce the amount of the prize by direct costs. The winner of a lucky number drawing or other contest of chance must report this income on line 8, Schedule 1 (Form 1040).

Prizes and awards in goods or services must be included in income at their fair market value. Fair market value is the price that property would sell for on the open market.

Prizes awarded in recognition of accomplishments in religious, charitable, scientific, artistic, educational, literary, or civic fields, generally must be included in income. However, do not include the prize in income if: (76)

- The taxpayer was selected without any action on his or her part to enter the contest or proceeding.
- The taxpayer is not required to perform substantial future services as a condition to receiving the prize or award.
- The prize or award is transferred by the payer directly to a governmental unit or tax-exempt charitable organization as designated by the taxpayer.

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: (53)

- 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.

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 24% rate from certain kinds of gambling winnings.

Gambling winnings of more than $5,000 from the following sources are subject to income tax withholding: (77)

- 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 2020 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 24% 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.

The Tax Cuts and Jobs Act 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 winning. The provision reverses the result reached by the Tax Court where the court held that a taxpayer's expenses incurred in the conduct of wagers, were not limited to the extent of gambling winnings, and were deductible as ordinary and necessary business expenses in the case of a "professional gambler". [78]

The taxpayer cannot reduce gambling winnings by gambling losses and report the difference. He or she must report the full amount of winnings as income and claim losses (up to the amount of winnings) as an itemized deduction. Therefore, the taxpayer's records should show winnings separately from losses. The taxpayer must keep an accurate diary or similar record of losses and winnings. 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. [79]

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.

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.

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: [80]

- 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).

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

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.

A taxpayer must report all tips he or she received in 2020 on his or her tax return, including both cash tips and noncash tips. Any tips the taxpayer reported to his or her employer for 2020 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: [81]

- 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 1040-NR, Form 1040-SS, or 1040-PR (as appropriate) for this purpose. He or she should 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: (81)

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. (81)

Royalties

The most common types of royalties are from copyrights and patents. Additional common royalties are from oil, gas, and mineral properties extracted from the taxpayer's property. Royalties from copyrights on literary, musical, or artistic works, and similar property, or from patents on inventions, are amounts paid to the taxpayer for the right to use his or her work over a specified period of time.

Royalties generally are based on the number of units sold, such as the number of books, tickets to a performance, or machines sold. Royalty income from oil, gas, and mineral properties is the amount the taxpayer receives when natural resources are extracted from the property. The royalties are based on units, such as barrels and tons and are paid to the taxpayer by a person or company who leases the property from him or her.

Royalties from copyrights, patents, and oil, gas, and mineral properties are taxable as ordinary income and should be reported on Part I of Schedule E - Supplemental Income and Loss. However, if the taxpayer holds an operating oil, gas, or mineral interest or is in business as a self-employed writer, inventor or artist, report his or her income and expenses on Schedule C (Form 1040). (53)

Bartering

Bartering occurs when a taxpayer exchanges goods or services without exchanging money. If the taxpayer barters for someone else's products or services, he or she will have to report the fair market value of the products or services on his or her tax return. If the taxpayer barters his or her products or services through a barter exchange, the taxpayer should receive a Form 1099-B - Proceeds From Broker and Barter Exchange Transactions. The amount shown in 1099-B, Box 3, Bartering, is the barter transaction's proceeds and is generally reportable as income included on the tax return. Generally, the taxpayer reports bartering income on Schedule C (Form 1040). (82)

Tip

The IRS reminds all taxpayers that the fair market value of property or services received through barter is taxable income. Both parties must report as income the value of the goods and services received in the exchange.

Here are four facts about bartering: (83)

1. *Barter exchanges* - A barter exchange is an organized marketplace where members barter products or services. Some exchanges operate out of an office and others over the Internet. All barter exchanges are required to issue Form 1099-B, Proceeds from Broker and Barter Exchange Transactions, annually. The exchange must give a copy of the form to its members and file a copy with the IRS.
2. *Bartering income* - Barter and trade dollars are the same as real dollars for tax reporting purposes. If the taxpayer barters, he or she must report on the tax return the fair market value of the products or services received.
3. *Tax implications* - Bartering is taxable in the year it occurs. The tax rules may vary based on the type of bartering that takes place. Barterers may owe income taxes, self-employment taxes, employment taxes or excise taxes on their bartering income.
4. *Reporting rules* - How the taxpayer reports bartering varies depending on which form of bartering takes place. Generally, if he or she is in a trade or business the taxpayer reports bartering income on Schedule C - Profit or Loss from Business. The taxpayer may be able to deduct certain costs incurred to perform the bartering.

Life Insurance Proceeds

Generally, if a taxpayer receives the proceeds under a life insurance contract as a beneficiary due to the death of the insured person, the benefits are not includable in gross income and do not have to be reported. However, any interest received is taxable and needs to be reported just like any other interest received. Additionally, if the policy was transferred to the taxpayer for cash or other valuable consideration, the exclusion for the proceeds is limited to the sum of the consideration paid, additional premiums paid, and certain other amounts. (84)

Recovery

A recovery is a return of an amount the taxpayer deducted or took a credit for in an earlier year. The most common recoveries are refunds, reimbursements, and rebates of itemized deductions. The taxpayer also may have recoveries of non-itemized deductions (such as payments on previously deducted bad debts) and recoveries of items for which he or she previously claimed a tax credit.

The taxpayer must include a recovery in his or her income in the year he or she received it up to the amount by which the deduction or credit he or she took for the recovered amount reduced the tax in the earlier year. For this purpose, any increase to an amount carried over to the current year that resulted from the deduction or credit is considered to have reduced the taxpayer's tax in the earlier year.

Refunds of Federal income taxes are not included in a taxpayer's income because they are never allowed as a deduction from income. If the taxpayer received a state or local income tax refund (or credit or offset) in 2020, he or she generally must include it in income if he or she deducted the tax in an earlier year. The payer should send Form 1099-G - Certain Government Payments to the taxpayer by January 31, 2021. The IRS also will receive a copy of the Form 1099-G. If the taxpayer files Form 1040, use the State and Local Income Tax Refund Worksheet in the 2020 Form 1040 instructions for Schedule 1, line 1 to figure the amount (if any) to include in his or her income.

If the taxpayer could choose to deduct for a tax year either state and local income taxes, or state and local general sales taxes, then the maximum refund that the taxpayer may have to include in income is limited to the excess of the tax he or she chooses to deduct for that year over the tax he or she did not choose to deduct for that year. (53)

Note

If the refund or other recovery and the expense occur in the same year, the recovery reduces the deduction or credit and is not reported as income. If the taxpayer receives a refund or other recovery that is for amounts he or she paid in 2 or more separate years, he or she must allocate, on a pro rata basis, the recovered amount between the years in which he or she paid it. This allocation is necessary to determine the amount of recovery from any earlier years and to determine the amount, if any, of the allowable deduction for this item for the current year.

Repayments

If a taxpayer had to repay an amount that he or she included as income in an earlier year, he or she may be able to deduct the amount repaid from the income for the year in which he or she repaid it. Or, if the amount the taxpayer repaid is more than $3,000, he or she may be able to take a credit against the tax for the year in which he or she repaid it. In most cases, the taxpayer can claim a deduction or credit only if the repayment qualifies as an expense or loss incurred in trade or business or in a for-profit transaction. [53]

Partnerships

A partnership generally is not a taxable entity. The income, gains, losses, deductions, and credits of a partnership are passed through to the partners based on each partner's distributive share of these items. The distributive share of partnership income, gains, losses, deductions, or credits generally is based on the partnership agreement. The taxpayer must report his or her distributive share of these items on the tax return whether or not they actually are distributed to him or her. However, the taxpayer's distributive share of the partnership losses is limited to the adjusted basis of the partnership interest at the end of the partnership year in which the losses took place. [53]

An organization formed after 1996 is classified as a partnership for Federal tax purposes if it has two or more members and it is **none** of the following: [85]

- An organization formed under a Federal or state law that refers to it as incorporated or as a corporation, body corporate, or body politic.
- An organization formed under a state law that refers to it as a joint-stock company or joint-stock association.
- An insurance company.
- Certain banks.
- An organization wholly owned by a state or local government.
- An organization specifically required to be taxed as a corporation by the Internal Revenue Code (for example, certain publicly traded partnerships).
- Certain foreign organizations identified in Section 301.7701-2(b)(8) of the regulations.
- A tax-exempt organization.
- A real estate investment trust.
- An organization classified as a trust under Section 301.7701-4 of the regulations or otherwise subject to special treatment under the Internal Revenue Code.
- Any other organization that elects to be classified as a corporation by filing Form 8832 - Entity Classification Election.

Tip

An organization formed before 1997 and classified as a partnership under the old rules will generally continue to be classified as a partnership as long as the organization has at least two members and does not elect to be classified as a corporation by filing Form 8832.

Allocation of Personal Service Income

If the income is for personal services performed partly in the United States and partly outside the United States, the taxpayer must make an accurate allocation of income for services performed in the United States. In most cases, other than certain fringe benefits, he or she makes this allocation on a time basis. That is, U.S. source income is the amount that results from multiplying the total amount of pay by the fraction of days in which services were performed in the U.S. This fraction is determined by dividing the number of days services are performed in the United States by the total number of days of service for which the compensation is paid. [86]

S Corporations

In most cases, an S corporation does not pay tax on its income. Instead, the income, losses, deductions, and credits of the corporation are passed through to the shareholders based on each shareholder's pro rata share. The taxpayer must report his or her share of these items on the tax return. In most cases, the items passed through to the taxpayer will increase or decrease the basis of the S corporation stock as appropriate. [53]

Estates and Trusts

An estate or trust, unlike a partnership, may have to pay Federal income tax. If the taxpayer is a beneficiary of an estate or trust, he or she may be taxed on his or her share of its income distributed or required to be distributed to the taxpayer. However, there is never a double tax. Estates and trusts file their returns on Form 1041 - U.S. Income Tax Return for Estates and Trusts and the taxpayer's share of the income is reported to him or her on Schedule K-1 (Form 1041) - Beneficiary's Share of Income, Deductions, Credits.

The decedent's estate fiduciary (or one of the joint fiduciaries) must file Form 1041 for a domestic estate that has: (87)

- Gross income for the tax year of $600 or more.
- A beneficiary who is a nonresident alien.

The trust's fiduciary (or one of the joint fiduciaries) must file Form 1041 for a domestic trust taxable under Section 641 that has: (87)

- Any taxable income for the tax year.
- Gross income of $600 or more (regardless of taxable income).
- A beneficiary who is a nonresident alien.

Scholarships, Fellowships, and Grants

Scholarships, fellowships, and grants are sourced according to the residence of the payer. Those made by entities created or domiciled in the United States are generally treated as income from sources within the United States. Those made by entities created or domiciled in a foreign country are treated as income from foreign sources. A scholarship is generally an amount paid or allowed to a student at an educational institution for the purpose of study. A fellowship is generally an amount paid to an individual for the purpose of research.

The amount of a scholarship or fellowship includes the following: (88)

- The value of contributed services and accommodations. This includes such services and accommodations as room (lodging), board (meals), laundry service, and similar services or accommodations that are received by an individual as a part of a scholarship or fellowship.
- The amount of tuition, matriculation, and other fees that are paid or remitted to the student to aid the student in pursuing study or research.
- Any amount received in the nature of a family allowance as a part of a scholarship or fellowship.

If the taxpayer receives a scholarship or fellowship grant, all or part of the amounts received may be tax-free. Qualified scholarship and fellowship grants are treated as tax-free amounts if the following conditions are met: (89)

1. The taxpayer is a candidate for a degree at an educational institution that maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where it carries on its educational activities; and
2. Amounts the taxpayer receives as a scholarship or fellowship grant are used for tuition and fees required for enrollment or attendance at the educational institution, or for fees, books, supplies, and equipment required for courses at the educational institution.

Also, a scholarship or fellowship is tax free only to the extent: (89)

1. It does not exceed the taxpayer's expenses.
2. It is not designated or earmarked for other purposes (such as room and board) and does not require (by its terms) that it cannot be used for qualified education expenses.
3. It does not represent payment for teaching, research, or other services required as a condition for receiving the scholarship.

The taxpayer is a candidate for a degree if he or she: (89)

1. Attends a primary or secondary school or are pursuing a degree at a college or university, or

2. Attends an educational institution that:
   a. Provides a program that is acceptable for full credit toward a bachelor's or higher degree, or offers a program of training to prepare students for gainful employment in a recognized occupation; and
   b. Is authorized under Federal or state law to provide such a program and is accredited by a nationally recognized accreditation agency.

An eligible educational institution is one whose main function is the presentation of formal instruction and that typically maintains a regular faculty and curriculum and generally has a regularly enrolled body of students in attendance at the place where it carries on its educational activities.

For purposes of tax-free scholarships and fellowships, these are expenses for: (89)

1. Tuition and fees required to enroll at or attend an eligible educational institution.
2. Course-related expenses, such as fees, books, supplies, and equipment that are required for the courses at the eligible educational institution. These items must be required of all students in the taxpayer's course of instruction.

Qualified education expenses do not include the cost of room and board, travel, research, clerical help, equipment or other expenses that are not required for enrollment in or attendance at an eligible educational institution.

A taxpayer must include in gross income amounts used for incidental expenses, such as room and board, travel, and optional equipment, and generally amounts received as payments for teaching, research, or other services required as a condition for receiving the scholarship or fellowship grant. Generally, the taxpayer cannot exclude from his or her gross income the part of any scholarship or fellowship that represents payment for teaching, research, or other services required as a condition for receiving the scholarship. This applies even if all candidates for a degree must perform the services to receive the degree. Also, when reporting scholarship income on the tax return, a taxpayer will include the amounts on the same line as "Wages, salaries, tips, etc."

However, the taxpayer does not have to treat as payment for services the part of any scholarship or fellowship that represents payment for teaching, research or other services if he or she receives the amount under: (89)

- The National Health Service Corps Scholarship Program.
- The Armed Forces Health Professions Scholarship and Financial Assistance Program.

Whether the taxpayer must report his or her scholarship or fellowship depends on whether he or she must file a return and whether any part of his or her scholarship or fellowship is taxable.

If the taxpayer's only income is a completely tax-free scholarship or fellowship, he or she does not have to file a tax return and no reporting is necessary. If all or part of the taxpayer's scholarship or fellowship is taxable and he or she is required to file a tax return, the taxpayer must report the taxable amount whether or not he or she received a Form W-2. If the taxpayer receives an incorrect Form W-2, he or she should ask the payer for a corrected one.

Athletic Scholarships

Athletic scholarships are tax-free only if they meet the requirements discussed above. For example, if the taxpayer's son or daughter were to receive an athletic scholarship in an amount that paid for tuition and fees, room and board, books and supplies, and miscellaneous expenses, two thirds of the scholarship would be taxable to the student-athlete in the year the funds were received. An athletic scholarship, as with other scholarships, is only tax-free when used to pay for qualified expenses. The same rules apply to any scholarship that the student may receive that is used to pay educational expenses.

Fulbright Grants

A Fulbright grant is generally treated as any other scholarship or fellowship in figuring how much of the grant is tax-free. If the taxpayer receives a Fulbright grant for lecturing or teaching, it is payment for services and is taxable. A special rule applies if the grant was paid in nonconvertible foreign currency. A Fulbright grant is a grant under the Mutual Educational and Cultural Exchange Act of 1961, known as the Fulbright-Hays Act. If the taxpayer receives a supplemental grant under the U.S. Information and Educational Exchange Act of 1948 (Smith-Mundt Act) for study, research, or teaching abroad, it is treated like a Fulbright grant.

Pell Grants and Other Title IV Need-Based Education Grants

These need-based grants are treated as scholarships for purposes of determining their tax treatment. They are tax-free to the extent used for qualified education expenses during the period for which a grant is awarded.

Payment to Service Academy Cadets

An appointment to a United States military academy is not a scholarship or fellowship. Payment the taxpayer receives as a cadet or midshipman at an armed services academy is pay for personal services and will be reported to him or her in box 1 of Form W-2.

Veterans' Benefits

Payments the taxpayer receives for education, training, or subsistence under any law administered by the Department of Veterans Affairs (VA) are tax free. The taxpayer does not include these payments as income on his or her Federal tax return. If the taxpayer qualifies for one or more of the education benefits, he or she may have to reduce the amount of education expenses qualifying for a specific benefit by part or all of his or her VA payments. This applies only to the part of the taxpayer’s VA payments that is required to be used for education expenses.

Example
Stephanie returned to college and is receiving two education benefits under the latest GI Bill. She receives a $1,534 monthly basic housing allowance (BHA) that is directly deposited to her checking account, and $3,840 paid directly to her college for tuition. Neither of these benefits is taxable and Stephanie does not report them on her tax return. She also wants to claim an American Opportunity Tax Credit on her return. She paid $5,000 in qualified education expenses. To figure the amount of credit, Stephanie must first subtract the $3,840 from her qualified education expenses because this payment under the GI Bill was required to be used for education expenses. She does not subtract any amount of the BHA because it was paid to her and its use was not restricted.

Qualified Tuition Reduction

If the taxpayer is allowed to study tuition free or for a reduced rate of tuition, he or she may not have to pay tax on this benefit. This is called a “tuition reduction.” The taxpayer does not have to include a qualified tuition reduction in his or her income.

A tuition reduction is qualified only if the taxpayer receives it from, and uses it at, an eligible educational institution. The taxpayer does not have to use the tuition reduction at the eligible educational institution from which he or she received it. In other words, if the taxpayer works for an eligible educational institution and the institution arranges for him or her to take courses at another eligible educational institution without paying any tuition, he or she may not have to include the value of the free courses in his or her income. The rules for determining if a tuition reduction is qualified, and therefore tax free, are different if the education provided is below the graduate level or is graduate education. Also, a taxpayer must include in his or her income any tuition reduction he or she receives that is payment for his or her services.

Qualified tuition reductions apply to officers, owners, or highly compensated employees only if benefits are available to employees on a nondiscriminatory basis. This means that the tuition reduction benefits must be available on substantially the same basis to each member of a group of employees. The group must be defined under a reasonable classification set up by the employer. The classification must not discriminate in favor of owners, officers, or highly compensated employees.

Traders in Securities

This topic explains if an individual who buys and sells securities qualifies as a trader in securities for tax purposes and how traders must report the income and expenses resulting from the trading business. This topic also discusses the mark-to-market election under Internal Revenue Code Section 475(f) for a trader in securities. In general, under Section 475(c)(2), the term security includes a share of stock, beneficial ownership interests in certain partnerships and trusts, evidence of indebtedness, and certain notional principal contracts, as well as evidence of an interest in, or a derivative financial instrument in, any of these items and certain identified hedges of these items.

Investors typically buy and sell securities and expect income from dividends, interest, or capital appreciation. They buy and sell these securities and hold them for personal investment; they are not conducting a trade or business. Most investors are individuals and hold these securities for a substantial period of time. Sales of these securities result in capital gains and losses that must be reported on Form 1040, Schedule D - Capital Gains and Losses and on Form 8949 - Sales and Other Dispositions of Capital Assets as appropriate. Investors are subject to the capital loss limitations described in Section 1211(b), in addition to the Section 1091 wash sales rules. Commissions and other costs of acquiring or disposing of securities are not deductible but must be used to figure gain or loss upon disposition of the securities. Investment income is not subject to self-employment tax. For more information on investors, refer to Publication 550 - Investment Income and Expenses.

Dealers in securities may be individuals or business entities. Dealer's purchase, hold, and sell securities to their customers in the ordinary course of their trade or business. Dealers also can hold themselves out as willing to enter into, assume, offset, assign or otherwise terminate positions in securities with customers in the ordinary course of the trade or business. Sometimes they maintain an inventory. Dealers are distinguished from investors and traders because they have customers and derive their income from marketing securities for sale to customers or from being compensated for services provided as an intermediary or market-maker. Section 475 requires dealers to keep and maintain records that clearly identify securities held for personal gain versus those held for use in their business activity. Dealers must report gains and losses associated with dispositions of securities by using the mark-to-market rules discussed below.

Special rules apply if the taxpayer is a trader in securities, in the business of buying and selling securities for his or her own account. The law considers this to be a business, even though a trader does not maintain an inventory and does not have customers. To be engaged in business as a trader in securities, the taxpayer must meet all of the following conditions:

- He or she must seek to profit from daily market movements in the prices of securities and not from dividends, interest, or capital appreciation;
- His or her activity must be substantial; and
- He or she must carry on the activity with continuity and regularity.

The following facts and circumstances should be considered in determining if the taxpayer's activity is a securities trading business:

- Typical holding periods for securities bought and sold;
- The frequency and dollar amount of his or her trades during the year;
- The extent to which he or she pursues the activity to produce income for a livelihood; and
- The amount of time he or she devotes to the activity.

If the nature of the taxpayer's trading activities does not qualify as a business, he or she is considered an investor and not a trader. It does not matter whether he or she calls him or herself a trader or a day trader, he or she is an investor. A taxpayer may be a trader in some securities and may hold other securities for investment. The special rules for traders do not apply to those securities held for investment. A trader must keep detailed records to distinguish the securities held for investment from the securities in the trading business. The securities held for investment must be identified as such in the trader's records on the day he or she acquires them (for example, by holding them in a separate brokerage account).

Traders report their business expenses on Form 1040, Schedule C - Profit or Loss From Business (Sole Proprietorship). Commissions and other costs of acquiring or disposing of securities are not deductible but must be used to figure gain or loss upon disposition of the securities. Gains and losses from selling securities from being a trader aren't subject to self-employment tax.

Traders can choose to use the mark-to-market rules, investors cannot. If a trader does not make a valid mark-to-market election under Section 475(f), then he or she must treat the gains and losses from sales of securities as capital gains and losses and report the sales on Form 1040, Schedule D - Capital Gains and Losses and on Form 8949 - Sales and Other Dispositions of Capital Assets as appropriate. When reporting on Schedule D, both the limitations on capital losses and the wash sales rules continue to apply. However, if a trader makes a timely mark-to-market election, then he or she can treat the gains and losses from sales of securities as ordinary gains and losses (except for securities held for investment - see above) that must be reported on Part II of Form 4797 - Sales of Business Property. Neither the limitations on capital losses nor the wash sale rules apply to traders using the mark-to-market method of accounting.

A trader must make the mark-to-market election by the original due date (not including extensions) of the tax return for the year prior to the year for which the election becomes effective. He or she can make the election by attaching a statement either to his or her income tax return if filed without an extension or to a request for an extension of time to file his or her return. The statement should include the following information:

- That he or she is making an election under Section 475(f);
- The first tax year for which the election is effective; and
- The trade or business for which he or she is making the election.

Refer to the Form 1040, Schedule D Instructions, Capital Gains and Losses for more information on how to make the mark-to-market election. It is important to note that in general, late Section 475(f) elections are not allowed.

After making the election to change to the mark-to-market method of accounting, the taxpayer must change his or her method of accounting for securities under Revenue Procedure 2018-31. In addition to making the election, he or she will also be required to file a Form 3115 - Application for Change in Accounting Method. Publication 550 describes the procedures for making an election under the section called "Special Rules for Traders in Securities." Non-filing of the Form 3115 mentioned above will not invalidate a timely and valid election.

If the taxpayer has made a valid election under Section 475(f), the only way to stop using mark-to-market accounting for securities is to file an automatic request for revocation under Revenue Procedure 2018-31, Section 24.02. Under that revenue procedure, the request for revocation must be filed by the original due date of the return (without regard to extensions) for the taxable year preceding the year of change (the year of change is the first taxable year the revocation is to be effective). This revocation notification statement must be attached to either that return or if applicable, to a request for extension of time to file that return. Late revocations will not generally be allowed except in unusual and compelling circumstances.

Itemized Deduction Recoveries

If a taxpayer recovers any itemized deduction that he or she claimed in an earlier year, he or she generally must include the full amount of the recovery in his or her income in the year he or she receives it. This rule applies if, for the earlier year, all of the following statements are true:

1. The taxpayer's itemized deductions exceeded the standard deduction by at least the amount of the recovery.
2. The taxpayer had taxable income.
3. The taxpayer's deduction for the item recovered equals or exceeds the amount recovered.
4. The taxpayer's itemized deductions were not subject to the limit on itemized deductions.
5. The taxpayer had no unused tax credits.
6. The taxpayer was not subject to alternative minimum tax.

In addition to the previous six items, the taxpayer must include in his or her income the full amount of a refund of state or local income tax or general sales tax if the excess of the tax he or she deducted over the tax he or she did not deduct is more than the refund of the tax deducted.

Form 1099-MISC

If the total of all the payments the taxpayer receives from a client over the course of a year is $600 or more, the client must complete and file IRS Form 1099-MISC reporting the payments. The client should file Form 1099-MISC - Miscellaneous Income, for each person in the course of his or her business to whom he or she has paid during the year:

- At least $10 in royalties or broker payments in lieu of dividends or tax-exempt interest.
- At least $600 in:
    1. Rents.
    2. Services performed by someone who is not his or her employee (including parts and materials).
    3. Prizes and awards.

4. Other income payments.
5. Medical and health care payments.
6. Crop insurance proceeds.
7. Cash payments for fish (or other aquatic life) he or she purchases from anyone engaged in the trade or business of catching fish.
8. Generally, the cash paid from a notional principal contract to an individual, partnership, or estate.
9. Payments to an attorney.
10. Any fishing boat proceeds.

In addition, the client uses Form 1099-MISC to report that he or she made direct sales of at least $5,000 of consumer products to a buyer for resale anywhere other than a permanent retail establishment.

The client must also file Form 1099-MISC for each person from whom he or she has withheld any Federal income tax under the backup withholding rules regardless of the amount of the payment. The client must complete and file a copy of Form 1099 with:

1. The IRS.
2. The taxpayer's state tax office if his or her state has income tax.
3. The taxpayer.

Additionally, the taxpayer should receive all of his or her 1099 forms for the previous year by January 31st of the current year. He or she should make sure the hiring firms he or she worked for have his or her current address, or the forms might not arrive on time (or at all). The taxpayer should check the amount of compensation his or her clients say they paid him or her in each Form 1099 against his or her own records to make sure they are consistent. If there is a mistake, call the client immediately and request a corrected Form 1099. The client may not have filed the 1099 with the IRS yet, because they are not due until February 28th (March 31st if filed electronically). If the 1099 has been filed with the IRS, ask the client to send the IRS a corrected 1099. The taxpayer does not want the IRS to think he or she was paid more than he or she really was. The 1099-MISC form has a special box that should be checked to show that it is correcting a prior 1099 form.

Whether or not the taxpayer receives a Form 1099, it is his or her responsibility to report all the self-employment income he or she earns each year to the IRS.

Form 1099-NEC

The IRS has reintroduced Form 1099-NEC - Nonemployee Compensation as the new way to report self-employment income instead of Form 1099-MISC as traditionally had been used. This was done to help clarify the separate filing deadlines on Form 1099-MISC and the new 1099-NEC form will be used starting with the 2020 tax year.

Beginning with the 2020 tax year, the IRS requires business taxpayers to report nonemployee compensation on the new Form 1099-NEC instead of on Form 1099-MISC. Businesses need to use this form if they made payments totaling $600 or more to a nonemployee, such as an independent contractor.

In general, a business must report payments it makes if it meets the following four conditions:

1. The payment is made to someone who is not an employee.
2. The payment is made for services in the course of trade or business.
3. The payment is made to an individual, partnership, estate, or corporation.
4. The payment total is at least $600 for the year.

Additionally, businesses will need to file Form 1099-NEC:

- When they pay an individual at least $10 in royalties, or
- If the business has withheld any federal income tax under the backup withholding rules regardless of the amount of payments for the year to the nonemployee.

Nonemployee compensation can include:

- Fees.

- Benefits.
- Commissions.
- Prizes and awards for services performed by a nonemployee.
- Other forms of compensation for services performed for trade or business by an individual who is not an employee.

Generally, payers need to file these forms by January 31 and have no automatic 30-day extensions to file unless the business meets certain hardship conditions.

Form 1099-K

Form 1099-K - Payment Card and Third Party Network Transactions is an IRS information return used to report certain payment transactions to improve voluntary tax compliance. The taxpayer should receive Form 1099-K by January 31st if, in the prior calendar year, he or she received payments:

- From payment card transactions (e.g., debit, credit or stored-value cards), and/or
- In settlement of third-party payment network transactions above the minimum reporting thresholds of:
  - Gross payments that exceed $20,000, AND
  - More than 200 such transactions.

Separation or Divorce Income

Whenever a husband and wife are legally separated or divorced, property and money may change hands. These exchanges fall into one of three categories: child support payments, alimony, or property settlements. The difference between the three is more than a matter of legal terminology; they involve distinct tax consequences.

Child Support

These payments are nontaxable to the recipient and nondeductible by the taxpayer making the payments. If a taxpayer is in arrears in payments for both alimony and child support, payments are first applied to child support. For tax purposes, one can never pay alimony as long as child support is still owed. A recent law now allows the government to divert income tax refunds of taxpayers in arrears on child support payments. In addition, child support payments may now be withheld from the taxpayer's salary checks by employers who are so ordered by the courts. (38)

Alimony

Child support and alimony differ as to basic objectives. After the divorce or legal separation, the wife (or husband) loses the right to participate in the former spouse’s earnings. If many years of marriage have intervened, he or she may have lost marketable job skills, and advanced age could place such a person at a disadvantage in the labor market.

Money paid from one spouse to another for day-to-day support of the spouse with fewer financial resources is alimony (sometimes also referred to as "spousal support"). The law allows courts to award alimony or spousal support to one of the former spouses when a married couple divorces. Payments made to a third party are considered alimony. Indirect alimony may include cash payments to a third party to provide a residence for a former spouse (i.e., rent, mortgage, utilities, etc.) medical cost payments or other such expenses incurred by the recipient.

Alimony does not include: (90)

- Child support.
- Noncash property settlements.
- Payments that are taxpayer’s spouse's part of community property income.
- Payments to keep up the payer's property.
- Use of the payer's property.

Alimony, then, is in the nature of monetary reparations to compensate for the former spouse’s loss of earning power. Consideration of alimony as supplemental compensation is the key to determining its tax treatment. Alimony is taxable to the ex-spouse and deductible by the paying former spouse. The treatment of alimony is the opposite of that for child support. Taxpayers deducting alimony paid must report the amount paid on line 18a of Schedule 1 (Form 1040) and the former spouse's Social Security number on line 18b of Schedule 1 (Form 1040). This additional information will make it possible for the Internal Revenue Service to determine that amounts being deducted by an ex-spouse are being reported as income by the recipient. [38]

If the taxpayer does not provide his or her former spouse's Social Security number, he or she may have to pay a $50 penalty and the deduction may be disallowed.

An amendment to a divorce decree may change the nature of the taxpayer's payments. Amendments are not ordinarily retroactive for Federal tax purposes. However, a retroactive amendment to a divorce decree correcting a clerical error to reflect the original intent of the court will generally be effective retroactively for Federal tax purposes.

If both alimony and child support payments are called for by the taxpayer's divorce or separation instrument, and he or she pays less than the total required, the payments apply first to child support and then to alimony.

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.

Property Settlements

Generally, there is no recognized gain or loss on the transfer of property between spouses, or between former spouses if the transfer is because of a divorce.

A property transfer is incident to a taxpayer's divorce if the transfer: [38]

- Occurs within 1 year after the date the marriage ends.
- Is related to the ending of the marriage.

A divorce, for this purpose, includes the ending of a marriage by annulment or due to violations of state laws.

A property transfer is related to the ending of a marriage if **both** of the following conditions apply: [38]

- The transfer is made under an original or modified divorce or separation instrument.
- The transfer occurs within 6 years after the date the marriage ends.

Unless these conditions are met, the transfer is presumed not to be related to the ending of a marriage. However, this presumption will not apply if the taxpayer can show that the transfer was made to carry out the division of property owned by the taxpayer and his or her spouse at the time the marriage ended. For example, the presumption will not apply if the taxpayer can show that the transfer was made more than 6 years after the end of the marriage because of business or legal factors which prevented earlier transfer of the property and the transfer was made promptly after those factors were resolved. [38]

Retirement Income

Qualified Retirement Plans

There are two broad categories of qualified retirement plans, a defined benefit plan and a defined contribution plan.

Defined benefit plans include employer contributed pension and annuity plans that provide a specific retirement benefit to employees. The benefit is usually in the form of a monthly retirement pension that is based on the employee's wages and years of service with the employer. An employer's annual contributions to the plan are based on actuarial assumptions and are not allocated to individual accounts maintained for employees.

Defined contribution plans include contributions by the employee and/or the employer to the employee's individual account under the plan. Examples of defined contribution plans include 401(k) plans, 403(b) plans, employee stock ownership plans, and profit-sharing plans. A separate account must be provided for each employee covered by the plan and the employee's retirement benefit will be based solely on contributions to the account, as well as its investment gains and earnings. The amount for self-employed SEP, SIMPLE, and qualified plans is typically entered on line 15, Schedule 1 (Form 1040). (91)

Social Security Benefits

Social Security benefits are considered income, and if found to be taxable income, must be reported to the IRS. However, not all of the Social Security benefits are taxable. Tax liability depends on filing status, total Social Security benefits and other taxable income. The total Social Security benefits for 2020 are usually reported in January 2021 on Form SSA-1099 - Social Security Benefit Statement.

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. The base amounts used to figure the tax on Social Security benefits are: (92)

- $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: (93)

- 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: [92]

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 2020 must be subtracted from the gross benefits he or she received in 2020. It does not matter whether the repayment was for a benefit the taxpayer received in 2020 or in an earlier year.

Joint Return

If the taxpayer is married and files a joint return for 2020, 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.

Repayments

If the taxpayer received benefits during the year, he or she should receive a Form SSA-1099 - Social Security Benefit Statement or Form RRB-1099 - Payments by the Railroad Retirement Board. These forms show the amounts received and repaid, and taxes withheld for the year. The taxpayer may receive more than one of these forms for the same year. He or she should add the amounts shown on all the Forms SSA-1099 and Forms RRB-1099 he or she receives for the year to determine the total amounts received and repaid, and taxes withheld for that year.

Any repayment of benefits the taxpayer made during the current year must be subtracted from the gross benefits he or she received. It does not matter whether the repayment was for a benefit he or she received in the current year or in an earlier year. The taxpayer's gross benefits are shown in box 3 of Form SSA-1099 or RRB-1099. His or her repayments are shown in box 4. The amount in box 5 shows his or her net benefits for the current (box 3 minus box 4). Use the amount in box 5 to figure whether any of taxpayer's benefits are taxable.

Pensions and Annuities

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: [94]

- 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: (94)

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: (95)

- 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.

Foreign Pension and Annuity Distributions

A foreign pension or annuity distribution is a payment from a pension plan or retirement annuity received from a source outside the United States. The taxpayer might receive it from a:

- Foreign employer.
- Trust established by a foreign employer.
- Foreign government or one of its agencies (including a foreign social security pension).
- Foreign insurance company.
- Foreign trust or other foreign entity designated to pay the annuity.

Just as with domestic pensions or annuities, the taxable amount generally is the Gross Distribution minus the Cost (investment in the contract). Income received from foreign pensions or annuities may be fully or partly taxable, even if the taxpayer does not receive a Form 1099 or other similar document reporting the amount of the income.

As a general rule, the pension/annuity articles of most tax treaties allow the country of residence (as determined by the residency article) to tax the pension or annuity under its domestic laws. This is true unless a treaty provision specifically amends that treatment. Some treaties, for example, provide that the country of residence may not tax amounts that would not have been taxable by the other country if the taxpayer was a resident of that country. In some cases, government pensions/annuities or social security payments may be taxable by the government making the payments. There also may be special rules for lump-sum distributions. The taxpayer needs to look at each treaty carefully.

Individual Retirement Arrangements (IRAs)

The main purpose for a taxpayer to set up an *Individual Retirement Arrangement (IRA)* is to save for future retirement. The main tax advantage for taxpayers is that any earnings on the deposits remain tax-free until distributions are taken from the IRA, and at retirement age the taxpayer would probably be in a lower tax-bracket. The taxpayer's basis in traditional IRAs is the total of all nondeductible contributions and nontaxable amounts included in rollovers made to traditional IRAs minus the total of all nontaxable distributions, adjusted if necessary.

Here are nine important tips from the IRS about setting aside money for a taxpayer's retirement in an Individual Retirement Arrangement:

1. The taxpayer must have taxable compensation to contribute to an IRA. This includes income from wages, salaries, tips, commissions, and bonuses. It also includes net income from self-employment. If he or she files a joint return, generally only one spouse needs to have taxable compensation.
2. The taxpayer can contribute to a traditional IRA at any time during the year. He or she must make all contributions by the due date for filing the tax return. This due date does not include extensions. For most people this means the taxpayer must contribute for 2020 by April 15, 2021. If he or she contributes between January 1 and April 15, contact the IRA plan sponsor to make sure they apply it to the right year.
3. For 2020, the most a taxpayer can contribute to an IRA is the smaller of either taxable compensation for the year or $6,000. If the taxpayer was 50 or older at the end of 2020 the maximum amount increases to $7,000.
4. Generally, the taxpayer will not pay income tax on the funds in a traditional IRA until he or she begins taking distributions from it.
5. The taxpayer may be able to deduct some or all of the contributions to a traditional IRA.
6. Use the worksheets in the instructions for Form 1040 to figure the amount of the contributions that can be deducted.
7. The taxpayer may also qualify for the Savers Credit, formally known as the Retirement Savings Contributions Credit. The credit can reduce taxes up to $1,000 (up to $2,000 if filing jointly). Use Form 8880 - Credit for Qualified Retirement Savings Contributions, to claim the Saver's Credit.
8. The taxpayer must file Form 1040 to deduct IRA contribution or to claim the Saver's Credit.

9. See Publication 590-A - Contributions to Individual Retirement Arrangements (IRAs), for more about IRA contributions.

Contributions to Traditional IRAs

The Setting Every Community Up for Retirement Enhancement (SECURE) Act eliminates the prohibition on traditional IRA contributions for those age 70½ and older beginning January 1, 2020. Additionally, the Act increases the age for required minimum distributions (RMD) from individual retirement accounts to age 72 (from age 70½). It also allows part-time workers to participate in 401(k) plans. (96)

The only requirement for setting up a traditional IRA is the taxpayer must have received some taxable compensation income during 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: (97)

- 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: (98)

- For tax year 2020, $6,000 if the taxpayer is under age 50. If he or she is over 50 years old the catch-up contribution limit is $7,000.
- The taxpayer's compensation income for the tax year.

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

For 2020, the limit on annual contributions to an Individual Retirement Arrangement (IRA) increased to $6,000. The additional catch-up contribution limit for individuals aged 50 and over is not subject to an annual cost-of-living adjustment and remains $1,000.

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 2020 by April 15, 2021. 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 19 on Schedule 1 (Form 1040) 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 2020 phase-out limits, for individuals who are active participants, are increased as follows:

2020 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	$65,000 or less	Full Deduction to Contribution Limit
	$65,000 - $75,000	Partial Deduction
	$75,000 or more	No Deduction
Married filing jointly or Qualifying Widow(er)	$104,000 or less	Full Deduction to Contribution Limit
	$104,000 - $124,000	Partial Deduction
	$124,000 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 2-3 - IRA Deduction Limits - Effect of MAGI on Deduction if You Are Covered by a Retirement Plan at Work. (2020)

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.

2020 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	$196,000 or less	Full Deduction to Contribution Limit
	$196,000 - $206,000	Partial Deduction
	$206,000 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 2-4 - IRA Deduction Limits - Effect of MAGI on Deduction if You Are NOT Covered by a Retirement Plan at Work (2020)

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.

Kay Bailey Hutchison Spousal IRA Limit

For 2020, if the taxpayer files a joint return and his or her taxable compensation is less than that of his or her spouse, the most that can be contributed for the year to his or her IRA is the smaller of the following two amounts:

1. $6,000 ($7,000 if the taxpayer is age 50 or older).

2. The total compensation includible in the gross income of both the taxpayer and his or her spouse for the year, reduced by the following two amounts:
    a. The taxpayer's spouse's IRA contribution for the year to a traditional IRA.
    b. Any contributions for the year to a Roth IRA on behalf of the taxpayer's spouse.

This means that the total combined contributions that can be made for the year to a taxpayer's IRA and his or her spouse's IRA can be as much as $12,000 ($13,000 if only one person is age 50 or older or $14,000 if both people are age 50 or older).

Nondeductible IRAs

A nondeductible IRA is like a traditional IRA in all respects but one: an individual cannot take a tax deduction for contributions made to the IRA. An individual can set up a Nondeductible IRA if that person is covered by a pension, 401(k) or other retirement plan, and that person's income is above the limits for a Traditional (Deductible) IRA. Although the money that a person puts into the IRA is not tax-deductible, that individual will not be taxed on the investment earnings on their contributions until that person withdraws the money. This allows the individual to accumulate more than if the investment earnings were taxed immediately. If a taxpayer makes a nondeductible contribution, he or she must fill out Form 8606 - Nondeductible IRAs.

Use Form 8606 to report: (99)

- Nondeductible contributions made to traditional IRAs.
- Distributions from traditional, SEP, or SIMPLE IRAs, if the taxpayer has ever made nondeductible contributions to traditional IRAs.
- Conversions from traditional, SEP, or SIMPLE IRAs to Roth IRAs.
- Distributions from Roth IRAs.

Penalty for Not Filing Form 8606

If the taxpayer is required to file Form 8606 to report a nondeductible contribution to a traditional IRA for 2020, but does not do so, he or she must pay a $50 penalty, unless he or she can show reasonable cause.

Overstatement Penalty

If the taxpayer overstates the nondeductible contributions for 2020, he or she must pay a $100 penalty, unless he or she can show reasonable cause.

Amending Form 8606

After the taxpayer files the return, he or she can change a nondeductible contribution to a traditional IRA to a deductible contribution or vice versa. The taxpayer also may be able to make a recharacterization. If necessary, complete a new Form 8606 showing the revised information and file it with Form 1040X - Amended U.S. Individual Income Tax Return.

Recharacterizations

Generally, a taxpayer can recharacterize (correct) an IRA contribution, Roth IRA conversion, or a Roth IRA rollover from a qualified retirement plan by making a trustee-to-trustee transfer from one IRA to another type of IRA. Trustee-to-trustee transfers are made directly between financial institutions or within the same financial institution. The taxpayer generally must make the transfer by the due date of the return (including extensions) and reflect it on the return. However, if the taxpayer filed a timely return without making the transfer, he or she can make the transfer within 6 months of the due date of the return, excluding extensions. If necessary, file an amended return reflecting the transfer.

Recordkeeping

To verify the nontaxable part of distributions from IRAs, including Roth IRAs, the taxpayer should keep a copy of the following forms and records until all distributions are made: (99)

- Page 1 of Form 1040 (or Forms 1040-NR or 1040-T) filed for each year the taxpayer made a nondeductible contribution to a traditional IRA.

- Forms 8606 and any supporting statements, attachments, and worksheets for all applicable years.
- Forms 5498 or similar statements the taxpayer received each year showing contributions made to a traditional IRA or Roth IRA.
- Forms 5498 or similar statement received showing the value of the taxpayer's traditional IRAs for each year he or she received a distribution.
- Forms 1099-R or W-2P received for each year the taxpayer received a distribution.

Penalty-Free Withdrawals from IRAs

Generally, if the taxpayer is under the age of 59½, he or she must pay a 10% additional tax (10% in addition to any regular income tax on the amount) on the distribution of any assets (money or other property) from a traditional IRA. Distributions before age 59½ are called early distributions. The 10% additional tax applies to the part of the distribution that is included in gross income. There are certain distributions a taxpayer can receive before age 59½ without paying the early distribution penalty.

A taxpayer may not have to pay the additional tax for one of the following situations: [100]

- The taxpayer has unreimbursed medical expenses that are more than 7.5% of adjusted gross income.
- The distributions are not more than the cost of medical insurance due to a period of unemployment.
- The taxpayer is totally and permanently disabled.
- The taxpayer is the beneficiary of a deceased IRA owner.
- The taxpayer is receiving distributions in the form of an annuity.
- The distributions are not more than qualified higher education expenses.
- The taxpayer uses the distributions to buy, build, or rebuild a first home.
- The distribution is due to an IRS levy of the qualified plan.
- The distribution is a qualified reservist distribution.

Penalty-Free Withdrawals from IRAs for Unreimbursed Medical Expenses

The taxpayer does not have to pay the 10% additional tax on distributions that are not more than the amount he or she paid for unreimbursed medical expenses during the year of the distribution minus 7.5% of adjusted gross income for the year of the distribution. The taxpayer can only take into account unreimbursed medical expenses that he or she would be able to include in figuring a deduction for medical expenses on Schedule A (Form 1040). The taxpayer does not have to itemize deductions to take advantage of this exception to the 10% additional tax. [100]

Penalty-Free Withdrawal from IRAs for Medical Insurance Premiums

Certain unemployed persons who make an early distribution to pay for qualifying medical insurance premiums are not subject to the 10% penalty. Eligible unemployed individuals are those who have received Federal or state unemployment compensation for 12 consecutive weeks. Qualifying premiums are deductible premiums for the medical care of the unemployed individual, spouse and dependents. To be excludable, the distributions must be received in the tax year during which unemployment compensation is received or in the following year. In determining whether the premiums are deductible, the 7.5% medical expense floor is ignored. This exception to the 10% penalty imposed on certain early distribution ceases to apply after the person has been reemployed for 60 days (not necessarily consecutive) after initial unemployment. [100]

Penalty-Free Withdrawals from IRAs for Disability

If the taxpayer becomes disabled before reaching the age 59½, any distributions from a traditional IRA because of the disability are not subject to the 10% additional tax. A taxpayer is considered disabled if he or she can furnish proof that he or she cannot do any substantial gainful activity because of physical or mental condition. A physician must determine that the condition can be expected to result in death or to be of long, continued, and indefinite duration. [100]

Penalty-Free Withdrawals from IRAs for a Beneficiary

If a person dies before reaching age 59½, the assets in a traditional IRA can be distributed to a beneficiary or to an estate without either having to pay the 10% additional tax. However, if the taxpayer inherits a traditional IRA from a deceased spouse and elects to treat it as his or her own, any distribution the taxpayer later receives before he or she reaches age 59½ may be subject to the 10% additional tax. [100]

Penalty-Free Withdrawals from IRAs for an Annuity

The taxpayer can receive distributions from a traditional IRA that are part of a series of substantially equal payments over his or her life (or his or her life expectancy), or over the lives (or the joint life expectancies) of the taxpayer and his or her beneficiary, without having to pay the 10% additional tax, even if the taxpayer receives such distributions before the taxpayer is age 59½. The taxpayer must use an IRS approved distribution method and he or she must take at least one distribution annually for this exception to apply. The required minimum distribution method, when used for this purpose, results in the exact amount required to be distributed, not the minimum amount.

There are two other IRS-approved distribution methods that the taxpayer can use. They are generally referred to as the fixed amortization method and the fixed annuitization method. These two methods are not fully discussed in this publication because they are more complex and generally require professional assistance. (100)

Example:
Bob, age 50, is the owner of an IRA from which he would like to start taking distributions beginning in 2020. He would like to avoid the additional 10% tax imposed on early distributions by taking advantage of the substantially-equal-periodic-payment exception: (101)

- Bob's IRA account balance is $400,000 as of December 31, 2019 (the last valuation prior to the first distribution).
- 120% of the applicable Federal mid-term rate is assumed to be 2.98%, and this will be the interest rate Bob uses under the amortization and annuitization methods.
- Bob will determine distributions over his own life expectancy only.

Penalty-Free Withdrawals from IRAs for Qualified Higher Educational Expenses

Penalty-free distributions from IRAs may be made for qualified educational purposes. The penalty-free withdrawal is available for qualified higher education expenses including tuition, fees, supplies, and equipment required for enrollment or attendance at a post-secondary educational institution. They also include expenses for special needs services incurred by or for special needs students in connection with their enrollment or attendance. (102)

This penalty-free withdrawal (up to the amount of the IRA) is available to the taxpayer, the taxpayer's spouse, or any child or stepchild or grandchild of taxpayer or the taxpayer's spouse. When determining the amount of the distribution that is not subject to the 10% additional tax, include qualified higher education expenses paid with any of the following funds: (102)

- Payment for services, such as wages.
- A loan.
- A gift.
- An inheritance given to either the student or the individual making the withdrawal.
- A withdrawal from personal savings (including savings from a qualified tuition program).

Do not include expenses paid with any of the following funds: (102)

- Tax-free distributions from a Coverdell education savings account.
- Tax-free part of scholarships and fellowships.
- Pell grants.
- Employer-provided educational assistance.
- Veterans' educational assistance.
- Any other tax-free payment (other than a gift or inheritance) received as educational assistance.

In addition, if the student is at least a half-time student, room and board are qualified education expenses. The expense for room and board qualifies only to the extent that it is not more than the greater of the following two amounts:

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

The taxpayer may need to contact the eligible educational institution for qualified room and board costs.

Penalty-Free Withdrawal from IRAs for First-time Homebuyer Expenses

The 10% early distribution penalty will not be charged if the taxpayer uses the money from his or her IRA for qualified expenses associated with buying a principal residence. A maximum of $10,000 during the individual's lifetime may be withdrawn without a penalty for this purpose. Qualified expenses include acquisition costs, settlement charges and closing costs. The principal residence may be for the individual or the individual's spouse, child, grandchild, or ancestor of the individual or the individual's spouse. In order to be considered a first-time homebuyer, the individual (and spouse, if married) must not have had an ownership interest in a principal residence during the two-year period ending on the date that the new home is acquired. [(100)]

Penalty-Free Withdrawal from IRAs for Qualified Reservist Distributions

A qualified reservist distribution is not subject to the additional tax on early distributions if the following requirements are met:

- The taxpayer was ordered or called to active duty after September 11, 2001.
- The taxpayer was ordered or called to active duty for a period of more than 179 days or for an indefinite period because he or she is a member of a reserve component.
- The distribution is from an IRA or from amounts attributable to elective deferrals under a Section 401(k) or 403(b) plan or a similar arrangement.
- The distribution was made no earlier than the date of the order or call to active duty and no later than the close of the active-duty period.

The term reserve component includes the: [(100)]

- Army National Guard of the United States.
- Army Reserve.
- Naval Reserve.
- Marine Corps Reserve.
- Air National Guard of the United States.
- Air Force Reserve.
- Coast Guard Reserve.
- Reserve Corps of the Public Health Service.

Penalty-Free Withdrawal from IRAs for Qualified Birth and Adoption Expenses

As part of the spending bill Congress passed the Setting Every Community Up for Retirement Enhancement (SECURE) Act. The SECURE Act represents a major overhaul of the rules for retirement plans and IRAs and is generally effective on January 1, 2020. The SECURE Act allows penalty-free distributions for qualified birth and adoption expenses. Within a year after a birth or adoption, new parents can take up to $5,000 from a 401(k) or IRA or other qualified retirement plan.

Penalty-Free Withdrawal from IRAs for Coronavirus-Related Distributions

The Coronavirus Aid, Relief, and Economic Security Act (CARES) waives the 10% early withdrawal penalty tax on early withdrawals up to $100,000 from a retirement plan or IRA for an individual who is diagnosed with COVID-19; whose spouse or dependent is diagnosed with COVID-19; who experiences adverse financial consequences as a result of being quarantined, furloughed, laid off, having work hours reduced, being unable to work due to lack of child care due to COVID-19, closing or reducing hours of a business owned or operated by the individual due to COVID-19; or other factors as determined by the Treasury Secretary.

The CARES Act allows the taxpayer to spread the income over a 3-year period beginning with 2020. The taxpayer also has the choice to avoid any income recognition by repaying the distribution to the retirement plan within three years of receiving it. In addition, the amount an individual may borrow from his or her retirement plan is increased from $50,000 to $100,000 for the 180-day period beginning after the enactment of the Act. Also, for those required to withdraw a "required minimum distribution" from their retirement plan in 2020, the CARES Act temporary waives the requirement for 2020 only.

Roth IRAs

Tip

Contributions to a Roth IRA are never deductible. The advantage of the Roth IRA is that the buildup within the IRA (e.g., interest, dividends, and/or price appreciation) may be free from Federal income tax when the individual withdraws money from the account. In general, a Roth IRA is subject to the same rules that apply to a traditional IRA.

For tax year 2020, the Roth IRA allows individuals under the age of 50 to make a maximum annual nondeductible contribution of up to $6,000 ($7,000 if age 50 or older). However, no more than $6,000 ($7,000 if age 50 or older) can be contributed to all of an individual's IRAs, whether they are traditional (deductible) or Roth (not deductible).

Basically, a Roth IRA is an IRA that is subject to the rules that apply to a traditional IRA with the following exceptions: (196)

- The taxpayer cannot deduct contributions to a Roth IRA.
- The taxpayer can leave amounts in the Roth IRA as long as he or she lives.
- The account or annuity must be designated as a Roth IRA when it is set up.
- Distributions for any of the following purposes are not taxable if:
    - 5 year holding period has been met.
    - Made on or after age 59½.
    - Made to an individual's beneficiary or estate at death.
    - Made when the individual becomes disabled.
    - Made for a qualified purpose, such as first-time home buyer expenses, subject to a $10,000 lifetime cap.

There are several restrictions that the taxpayer should be aware of. One restriction is that a payment or distribution is not a qualified distribution if it is made less than 5 tax years from the first tax year in which the individual made a contribution to a Roth IRA. Another restriction is that a rollover from a deductible IRA to a Roth IRA will be taxable. (103)

The following table shows whether a taxpayer's contribution to a Roth IRA is affected by the amount of his or her modified AGI as computed for Roth IRA purpose.

Amount of Roth IRA Contributions That a Taxpayer Can Make For 2020		
Filing Status	**Modified AGI Amount**	**Contribution Amount**
Single, Head of Household or Married Filing Separately (taxpayer did not live with his or her spouse at any time during the year)	$124,000 or less	Up to Contribution Limit
	$124,000 - $139,000	Reduced Amount
	$139,000 or more	$0
Married filing jointly or Qualifying Widow(er)	$196,000 or less	Up to Contribution Limit
	$196,000 - $206,000	Reduced Amount
	$206,000 or more	$0
Married filing separately (taxpayer lived with his or her spouse at any time during the year)	Less than $10,000	Reduced Amount
	$10,000 or more	$0

Table 2-5 - Amount of Roth IRA Contributions (2020)

If the amount the taxpayer can contribute must be reduced, figure his or her reduced contribution limit as follows:

1. Start with his or her modified AGI.
2. Subtract from the amount in (1):
    a. $196,000 if filing a joint return or qualifying widow(er),
    b. $0 if married filing a separate return, and the taxpayer lived with his or her spouse at any time during the year, or
    c. $124,000 for all other individuals.
3. Divide the result in (2) by $15,000 ($10,000 if filing a joint return, qualifying widow(er), or married filing a separate return and the taxpayer lived with his or her spouse at any time during the year).
4. Multiply the maximum contribution limit (before reduction by this adjustment and before reduction for any contributions to traditional IRAs) by the result in (3).

5. Subtract the result in (4) from the maximum contribution limit before this reduction.
6. The result is the taxpayer's reduced contribution limit.

Designated Roth Accounts - In-Plan Rollovers to Designated Roth Accounts

A plan with a designated Roth program may allow participants to transfer eligible rollover distributions to a designated Roth account from another account in the same plan. The Roth contribution program must be in place before a plan can offer in-plan Roth rollovers. A Roth program cannot be set up solely to accept in-plan rollovers - it must also accept elective deferrals from participants.

Not all pre-tax plan balances can be transferred to a designated Roth account. To be eligible for an in-plan rollover, the amount must be eligible for distribution to the participant under the terms of the plan and must be otherwise eligible for rollover (an eligible rollover distribution).

In general, an eligible rollover distribution is a distribution that is not: [104]

- A required minimum distribution.
- A corrective distribution of excess contributions or deferrals.
- A hardship distribution.
- A loan treated as a distribution.
- A distribution that is one of a series of substantially equal payments made at least annually over a lifetime or 10 years.
- Dividends on employer securities.
- The cost of life insurance coverage.

The value of the distribution less the participant's basis, if any (the taxable amount of the distribution) must be included in the participant's gross income. For a typical rollover of money from a pre-tax 401(k) account, the entire amount of the rollover, including earnings, will be taxable.

The additional 10% early withdrawal tax does not apply to an in-plan Roth rollover. However, there are special rules that could make the rollover subject to this tax if it is withdrawn from the designated Roth account within five years.

Note

20% mandatory withholding does not apply to an in-plan Roth direct rollover. However, if the taxpayer receives his or her distribution in cash, 20% withholding will apply even if the amount is rolled over to a designated Roth account within 60 days. [104]

IRA Catch-Up Amounts

A taxpayer who will be at least age 50 by the end of the tax year is able to make an additional contribution to a traditional IRA (or Roth IRA). For tax year 2020, the maximum annual amount of the catch-up contribution is $1,000, so the total contribution maximum is $7,000. In future years, the maximum catch-up amount will remain at $1,000.

SIMPLE IRA

A SIMPLE IRA plan (Savings Incentive Match Plan for Employees) allows employees and employers to contribute to traditional IRAs set up for employees. It is ideally suited as a start-up retirement savings plan for small employers not currently sponsoring a retirement plan. SIMPLE IRA plans can provide a significant source of income at retirement by allowing employers and employees to set aside money in retirement accounts. SIMPLE IRA plans do not have the start-up and operating costs of a conventional retirement plan.

The amount the employee contributes to a SIMPLE IRA cannot exceed $13,500 in 2020. If an employee participates in any other employer plan during the year and has elective salary reductions under those plans, the total amount of the salary reduction contributions that an employee can make to all the plans he or she participates in is limited to $19,500 in 2020.

SIMPLE IRA contributions include: [105]

- Salary reduction contributions.

- Employer contributions:
  - Matching contributions.
  - Nonelective contributions.

No other contributions can be made to a SIMPLE IRA plan.

The following are specifics regarding a SIMPLE IRA: (105)

- Available to any small business – generally with 100 or fewer employees.
- Easily established by adopting Form 5304-SIMPLE, Form 5305-SIMPLE, a SIMPLE IRA prototype or an individually designed plan document.
- Employer cannot have any other retirement plan.
- No filing requirement for the employer.

The following are specifics regarding contributions to a SIMPLE IRA: (105)

- Employer is required to contribute each year either a:
  - Matching contribution up to 3% of compensation.
  - 2% non-elective contribution for each eligible employee.
    - Under the non-elective contribution formula, even if an eligible employee does not contribute to his or her SIMPLE IRA, that employee must still receive an employer contribution to his or her SIMPLE IRA equal to 2% of his or her compensation.
- Employees may elect to contribute.
- Employee is always 100% vested in (or, has ownership of) all SIMPLE IRA money.

Employers must deposit employees' salary reduction contributions to the SIMPLE IRA within 30 days after the end of the month in which the employee would have received them in cash. They must make matching contributions or nonelective contributions by the due date (including extensions) of their Federal income tax return for the year.

SIMPLE Plan Catch-Up Amounts

A SIMPLE IRA or a SIMPLE 401(k) plan may permit catch-up contributions up to $3,000 in 2020 for individuals aged 50 or over. Salary reduction contributions in a SIMPLE IRA plan are not treated as catch-up contributions for 2020 until they exceed $13,500.

Catch-Up Contributions

Individuals who are age 50 or over at the end of the calendar year can make annual catch-up contributions. Catch-up contributions up to $6,500 in 2020 may be permitted by these plans: (106)

- 401(k) (other than a SIMPLE 401(k)).
- 403(b).
- SARSEP.
- Governmental 457(b).

Elective deferrals are not treated as catch-up contributions until they exceed the $19,500 limit in 2020, the ADP test limit of Section 401(k)(3) or the plan limit (if any).

A participant can make catch-up contributions for a year up to the lesser of the following amounts:

- The catch-up contribution dollar limit.
- The excess of the participant's compensation over the elective deferral contributions that are not catch-up contributions.

Plan participants must make catch-up contributions to a retirement plan via elective deferrals. Catch-up contributions must be made before the end of the plan year.

Lump-Sum Distributions

A lump-sum distribution is the distribution or payment, within one tax year, of a plan participant's entire balance from all of the employer's qualified pension, profit-sharing, or stock bonus plans. All of the participant's accounts under the employer's qualified pension, profit-sharing, or stock bonus plans must be distributed in order to be a lump-sum distribution. If a taxpayer received a lump-sum distribution from a qualified retirement plan or a qualified retirement annuity and he or she was born before January 2, 1936, he or she may be able to elect optional methods of figuring the tax on the distribution. These optional methods can be elected only once after 1986 for any eligible plan participant.

Additionally, a lump-sum distribution is a distribution that was paid: (107)

- Because of the plan participant's death.
- After the participant reaches age 59½.
- Because the participant, if an employee, separates from service.
- After the participant, if a self-employed individual, becomes totally and permanently disabled.

A distribution from a nonqualified plan (such as a privately purchased commercial annuity or a Section 457 deferred compensation plan of a state or local government or tax-exempt organization) cannot qualify as a lump-sum distribution. The participant's entire balance from a plan does not include certain forfeited amounts. It also does not include any deductible voluntary employee contributions allowed by the plan after 1981 and before 1987.

The taxpayer should receive a Form 1099-R - Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., from the payer of the lump-sum distribution showing his or her taxable distribution and the amount eligible for capital gain treatment. If the taxpayer does not receive Form 1099-R by January 31st of the year following the year of the distribution, he or she should contact the payer of the lump-sum distribution.

The part from active participation in the plan before 1974 may qualify as capital gain subject to a 20% tax rate. The part from participation after 1973 (and any part from participation before 1974 that the taxpayer does not report as capital gain) is ordinary income. He or she may be able to use the 10-year tax option to figure tax on the ordinary income part. Use Form 4972 - Tax on Lump-Sum Distributions to figure the separate tax on a lump-sum distribution using the optional methods. The tax figured on Form 4972 is added to the regular tax figured on the taxpayer's other income. This may result in a smaller tax than he or she would pay by including the taxable amount of the distribution as ordinary income in figuring the regular tax.

Net Unrealized Appreciation (NUA)

If the lump-sum distribution includes employer securities and the payer reported an amount in box 6 of the taxpayer's Form 1099-R - Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc. (PDF) for net unrealized appreciation (NUA) in employer securities, the NUA is generally not subject to tax until the taxpayer sells the securities. However, he or she may elect to include the NUA in his or her income in the year the securities are distributed to him or her.

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. 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: (108)

- 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.

In Revenue Procedure 2016-47, effective August 2016, the IRS has created a new "self-certification" procedure that allows someone who misses the 60-day deadline for rollovers to avoid the expense and delay of obtaining a private letter ruling. Instead, a taxpayer submits a model IRS letter to the new retirement account custodian, checking in that letter one of 11 acceptable excuses for missing the deadline.

A self-certification is not a waiver by the IRS of the 60-day rollover requirement. However, a taxpayer may report the contribution as a valid rollover unless later informed otherwise by the IRS. The IRS, in the course of an examination, may consider whether a taxpayer's contribution meets the requirements for a waiver.

The taxpayer must have missed the 60-day deadline because of his or her inability to complete a rollover due to one or more of the following reasons:

- An error was committed by the financial institution receiving the contribution or making the distribution to which the contribution relates.
- The distribution, having been made in the form of a check, was misplaced and never cashed.
- The distribution was deposited into and remained in an account that the taxpayer mistakenly thought was an eligible retirement plan.
- The taxpayer's principal residence was severely damaged.
- A member of the taxpayer's family died.
- The taxpayer or a member of the taxpayer's family was seriously ill.
- The taxpayer was incarcerated.
- Restrictions were imposed by a foreign country.
- A postal error occurred.
- The distribution was made on account of a levy under Section 6331 and the proceeds of the levy have been returned to the taxpayer.
- The party making the distribution to which the rollover relates delayed providing information that the receiving plan or IRA required to complete the rollover despite the taxpayer's reasonable efforts to obtain the information.

While the reasons are comprehensive, they only apply if the taxpayer was initially eligible to complete a 60-day rollover. As a result of a 2014 U.S. Tax Court decision, taxpayers may only perform one 60-day IRA rollover every 12 months, no matter how many IRAs they have.

The contribution must be made to the plan or IRA as soon as practicable after the reason or reasons listed above no longer prevent the taxpayer from making the contribution. This requirement is deemed to be satisfied if the contribution is made within 30 days after the reason or reasons no longer prevent the taxpayer from making the contribution.

One reason the IRS will not allow is that the taxpayer was using his or her retirement money as a short-term loan for some non-retirement purpose, such as a down payment on a house, and missed the 60-day deadline because of a complication or delay.

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. The limit will apply by aggregating all of an individual's IRAs, including SEP and SIMPLE IRAs as well as traditional and Roth IRAs, effectively treating them as one IRA for purposes of the limit. However, trustee-to-trustee transfers between IRAs and rollovers from traditional to Roth IRAs ("conversions") are not limited.

If the taxpayer receives a distribution from an IRA of previously untaxed amounts:

1. He or she must include the amounts in gross income if he or she made an IRA-to-IRA rollover in the preceding 12 months, and
2. He or she may be subject to the 10% early withdrawal tax on the amounts he or she includes in gross income.

Additionally, if the taxpayer pays the distributed amounts into another (or the same) IRA, the amounts may be:

1. Treated as an excess contribution, and
2. Taxed at 6% per year as long as they remain in the IRA.

The one-per year limit does not apply to:

- 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.

Partial Rollovers

If the taxpayer withdraws assets from a traditional IRA, he or she can roll over part of the withdrawal tax free and keep the rest of it. The amount the taxpayer keeps will generally be taxable (except for the part that is a return of nondeductible contributions). The amount he or she keeps may be subject to the 10% additional tax on early distributions.

Direct Rollovers

The taxpayer’s employer's qualified plan must give him or her the option to have any part of an eligible rollover distribution paid directly to a traditional IRA. The plan is not required to give the taxpayer this option if his or her eligible rollover distributions are expected to total less than $200 for the year. If he or she chooses the direct rollover option, no tax is withheld from any part of the designated distribution that is directly paid to the trustee of the traditional IRA. If any part is paid to the taxpayer, the payer must withhold 20% of that part's taxable amount.

SEP-IRA Deduction

A Simplified Employee Pension Plan (SEP) plan allows employers to contribute to traditional IRAs (SEP-IRAs) set up for employees. A business of any size, even self-employed, can establish a SEP. An employee eligible to participate in an SEP is an individual (including a self-employed individual) who meets all the following requirements:

- Has reached age 21.
- Has worked for the employer in at least 3 of the last 5 years.
- Received at least $600 in compensation from the employer during 2020.

An employer can use less restrictive participation requirements than those listed, but not more restrictive ones.

An employer can exclude the following employees from a SEP:

- Employees covered by a union agreement and whose retirement benefits were bargained for in good faith by the employees' union and the employer.
- Nonresident alien employees who do not have U.S. wages, salaries, or other personal services compensation from the employer.

Contributions an employer can make for 2020 to an employee's SEP-IRA cannot exceed the lesser of: [109]

1. 25% of the compensation, limited to $285,000 per participant, paid to the participants during 2020 from the business that has the plan.
2. $57,000 per participant.

An employee cannot contribute to SEPs because SEPs only permit employer contributions. SEPs do not include a salary reduction arrangement.

Participants in Salary Reduction Simplified Employee Pension (SARSEP) plans established before 1997 were entitled to elective deferral contributions. For these plans, a participant's elective deferral contributions are further limited to $19,500 in 2020 or 100% of their compensation, whichever is less. Catch-up contributions are not subject to this limit.

Qualified Retirement Plans

There are two broad categories of qualified retirement plans, a defined benefit plan and a defined contribution plan.

Defined benefit plans include employer contributed pension and annuity plans that provide a specific retirement benefit to employees. The benefit is usually in the form of a monthly retirement pension that is based on the employee's wages and years of service with the employer. An employer's annual contributions to the plan are based on actuarial assumptions and are not allocated to individual accounts maintained for employees.

Defined contribution plans include contributions by the employee and/or the employer to the employee's individual account under the plan. Examples of defined contribution plans include 401(k) plans, 403(b) plans, employee stock ownership plans, and profit-sharing plans. A separate account must be provided for each employee covered by the plan and the employee's retirement benefit will be based solely on contributions to the account, as well as its investment gains and earnings. The amount for self-employed SEP, SIMPLE, and qualified plans is typically entered on line 15, Schedule 1 (Form 1040). [(91)]

Charitable Donations from IRAs

The Protecting Americans from Tax Hikes Act of 2015 made permanent the tax exemption of distributions from individual retirement accounts for charitable purposes. Individuals age 70½ or over can exclude up to $100,000 from gross income for donations paid directly to a qualified charity from their IRA. Key points about qualified charitable distributions (QCD) include:

- Married individuals filing a joint return could exclude up to $100,000 donated from each spouse's own IRA ($200,000 total).
- The donation satisfies any IRA required minimum distributions for the year.
- The amount excluded from gross income is not deductible.
- Donations from an inherited IRA are eligible if the beneficiary is at least age 70½.
- Donations from a SEP or SIMPLE IRA are not eligible.
- Donations from a Roth IRA are eligible.

The SECURE Act preserved the ability to make qualified charitable distributions (QCDs) at age 70½ even though the required minimum distribution age was increased to age 72. Qualified charitable distributions can satisfy all or part the amount of the taxpayer's required minimum distribution (RMD) from his or her IRA. IRA owners reported charitable donations from an IRA on Form 1040.

Required Minimum Distributions (RMD)

A taxpayer cannot keep retirement funds in his or her account indefinitely. The taxpayer generally has to start taking withdrawals from his or her IRA or retirement plan account when he or she reaches age 72. Roth IRAs do not require withdrawals until after the death of the owner.

These minimum distribution rules apply to: [(110)]

- Traditional IRAs.
- SEP IRAs.
- SIMPLE IRAs.
- 401(k) plans.
- 403(b) plans.
- 457(b) plans.
- Profit sharing plans.
- Other defined contribution plans.

The required minimum distribution is the minimum amount a taxpayer must withdraw from his or her account each year. The taxpayer can withdraw more than the minimum required amount. His or her withdrawals will be included in his or her taxable income except for any part that was taxed before (the taxpayer's basis) or that can be received tax-free (such as qualified distributions from designated Roth accounts).

The required minimum distribution for any year is the account balance as of the end of the immediately preceding calendar year divided by a distribution period from the IRS's Uniform Lifetime Table. A separate table is used if the sole beneficiary is the owner's spouse who is ten or more years younger than the owner.

The beginning date for the first required minimum distribution for IRAs (including SEP and SIMPLE IRAs) is April 1 of the year following the calendar year in which the taxpayer reaches age 72. The beginning date for the first required minimum distribution for 401(k), profit-sharing, 403(b), or other defined contribution plan is generally, April 1 following the later of the calendar year in which the taxpayer reaches age 72 or retires.

Note

The plan's terms may allow the taxpayer to wait until the year he or she actually retires to take his or her first RMD (unless he or she is a 5% owner). Alternatively, a plan may require the taxpayer to begin receiving distributions by April 1 of the year after he or she reaches age 72, even if he or she has not retired. If the taxpayer owns 5% or more of the business sponsoring the plan, then he or she must begin receiving distributions by April 1 of the year after the calendar year in which he or she reaches age 72.

For each subsequent year after the taxpayer's required beginning date, he or she must withdraw his or her RMD by December 31. If the taxpayer does not take any distributions, or if the distributions are not large enough, he or she may have to pay a 50% excise tax on the amount not distributed as required. To report the excise tax, the taxpayer may have to file Form 5329 - Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts.

For the year of the account owner's death, use the RMD the account owner would have received. For the year following the owner's death, the RMD will depend on the identity of the designated beneficiary. The account balance is divided by this life expectancy to determine the RMD.

Spouses who are the sole designated beneficiary can: (110)

- Treat an IRA as their own.
- Base RMDs on their own current age.
- Base RMDs on the decedent's age at death, reducing the distribution period by one each year. Withdraw the entire account balance by the end of the 5th year following the account owner's death, if the account owner died before the required beginning date.

If the account owner died before the required beginning date, the surviving spouse can wait until the owner would have turned 72 to begin receiving RMDs.

Individual beneficiaries other than a spouse can: (110)

- Withdraw the entire account balance by the end of the 5th year following the account owner's death, if the account owner died before the required beginning date.
    - Calculate RMDs using the distribution period from the Single Life Table based on:
    - If the owner died after RMDs began, the longer of the:
        - Beneficiary's remaining life expectancy determined in the year following the year of the owner's death reduced by one for each subsequent year.
        - Owner's remaining life expectancy at death, reduced by one for each subsequent year.

If the account owner died before RMDs began, the beneficiary's age at year-end following the year of the owner's death, reducing the distribution period by one for each subsequent year.

The Setting Every Community Up for Retirement Enhancement (SECURE) Act eliminates the prohibition on traditional IRA contributions for those age 70½ and older beginning January 1, 2020. Additionally, the Act increases the age for required minimum distributions (RMD) from individual retirement accounts to age 72 (from age 70½).

Additional Tax on Excess Accumulation in Qualified Retirement Plans (Including IRAs)

A taxpayer owes this tax if he or she does not receive the required minimum distribution from his or her qualified retirement plan, including an IRA or an eligible Section 457 deferred compensation plan. The additional tax is 50% of the excess accumulation, which is the difference between the amount that was required to be distributed and the amount that was actually distributed. The tax is due for the tax year that includes the last day by which the minimum required distribution must be taken.

The excess accumulation penalty is calculated on Form 5329 - Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts (under the section labeled "Additional Tax on Excess Accumulation in Qualified Retirement Plans (Including IRAs)" and reported in the 'other taxes' section of the individual's tax return (Form 1040). If the taxpayer files Form 5329, he or she must file Form 1040.

The IRS can waive the penalty, if the owner or beneficiary can show 'reasonable cause' for not taking the required minimum distribution (RMD) or demonstrate that the shortfall was due to 'reasonable error'. Taxpayers who feel that they qualify for a waiver should File Form 5329 and attach a letter of explanation to the IRS. The letter should explain why the RMD deadline was missed, or why less than the RMD amount was withdrawn. The taxpayer must also show that have steps have been taken to remedy the RMD short fall, such as including a copy of the account statement showing that the RMD has since been taken from the account. An individual who applies for the waiver should not pay the penalty unless the IRS informs him or her that the waiver-request was denied.

If the taxpayer is unable to take required distributions because he or she has a traditional IRA invested in a contract issued by an insurance company that is in state insurer delinquency proceedings, the 50% excise tax does not apply if the conditions and requirements of Revenue Procedure 92-10 are satisfied. To qualify for exemption from the tax, the assets in the taxpayer's traditional IRA must include an affected investment.

Real and Personal Property

Almost everything an individual owns and uses for personal or investment purposes is a capital asset. Examples include a home, personal use items like household furnishings, and stocks or bonds held as investments. When a capital asset is sold, the difference between the basis in the asset and the amount it is sold for is a capital gain or a capital loss. Generally, an asset's basis is its original cost. A person has a capital gain if he or she sells the asset for more than the basis. The person has a capital loss if he or she sells the asset for less than the basis. Losses from the sale of personal-use property, such as a home or car, are not deductible.

Sales and Other Dispositions of Capital Assets

Form 8949 - Sales and Other Dispositions of Capital Assets is an IRS form used by individuals, partnerships, corporations, trusts, and estates to report capital gains and losses from investment. Taxpayers must use the form to report short- and long-term capital gains and losses from sales or investment exchanges. Individuals must us Form 8949 to report: (111)

- The sale or exchange of a capital asset not reported on another form or schedule.
- Gains from involuntary conversions (other than from casualty or theft) of capital assets not held for business or profit.
- Nonbusiness bad debts.
- Worthlessness of a security.
- The election to defer capital gain invested in a Qualified Opportunity Fund.
- The disposition of interests in Qualified Opportunity Funds.

Along with the list above, corporations can report on Form 8949 the sale of stock of a specified 10%-owned foreign corporation, adjusted for the dividends-received deduction under Section 245A, but only if the sale would otherwise generate a loss.

If the taxpayer is filing a joint return, he or she completes as many copies of Form 8949 as he or she needs to report all of his or her and his or her spouse's transactions. The taxpayer and his or her spouse may list the transactions on separate forms or the taxpayer and his or her spouse may combine them. However, the taxpayer must include on his or her Schedule D the totals from all Forms 8949 for both him or herself and his or her spouse.

Form 8949 allows the taxpayer and the IRS to reconcile amounts that were reported to him or her and the IRS on Form 1099-B or 1099-S (or substitute statement) with the amounts he or she reports on his or her return. If the taxpayer receives Form 1099-B or 1099-S (or substitute statement), always report the proceeds (sales price) shown on that form (or statement) in column (d) of Form 8949. If Form 1099-B (or substitute statement) shows that the cost or other basis was reported to the IRS, always report the basis shown on that form (or statement) in column (e). If any correction or adjustment to these amounts is needed, make it in column (g).

If all Forms 1099-B the taxpayer received (and all substitute statements) show basis was reported to the IRS and if no correction or adjustment is needed, he or she may not need to file Form 8949 as it is not required for certain transactions. The taxpayer may be able to aggregate those transactions and report them directly on either line 1a (for short-term transactions) or line 8a (for long-term transactions) of Schedule D. This option applies only to transactions (other than sales of collectibles) for which:

1. He or she received a Form 1099-B (or substitute statement) that shows basis was reported to the IRS and does not show any adjustments in box 1f or 1g.
2. The Ordinary box in box 2 is not checked.
3. He or she does not need to make any adjustments to the basis or type of gain or loss (short term or long term) reported on Form 1099-B (or substitute statement), or to his or her gain or loss.
4. The taxpayer is not electing to defer income due to an investment in a qualified opportunity fund (QOF) and is not terminating deferral from an investment in a QOF.

If the taxpayer chooses to report these transactions directly on Schedule D, he or she does not need to include them on Form 8949 and does not need to attach a statement.

Corporations and partnerships use Form 8949 to report: (112)

- The sale or exchange of a capital asset not reported on another form or schedule.
- Sale of stock of a specified 10%-owned foreign corporation, adjusted for the dividends-received deduction under Section 245A, but only if the sale would otherwise generate a loss.
- Nonbusiness bad debts.
- Undistributed long-term capital gains from Form 2439 - Notice to Shareholder of Undistributed Long-Term Capital Gains.
- Worthlessness of a security.
- The election to defer capital gain invested in a Qualified Opportunity Fund.
- The disposition of interests in Qualified Opportunity Funds.

Electing large partnerships and corporations also use Form 8949 to report their share of gain or (loss) from a partnership, S corporation, estate or trust.

The taxpayer completes all necessary pages of Form 8949 before completing line 1, 2, 3, 8, 9, or 10 of Schedule D. He or she uses Schedule D: (111)

- To figure the overall gain or loss from transactions reported on Form 8949.
- To report certain transactions the taxpayer does not have to report on Form 8949.
- To report a gain from Form 2439 or 6252 or Part I of Form 4797.
- To report a gain or loss from Form 4684, 6781, or 8824.
- To report a gain or loss from a partnership, S corporation, estate, or trust.
- To report capital gain distributions not reported directly on Form 1040, line 7 (or effectively connected capital gain distributions not reported directly on Form 1040-NR, line 7).
- To report a capital loss carryover from 2019 to 2020.

Use Form 4797 - Sales of Business Property to report the following: (113)

- The sale or exchange of:
  - Real property used in the taxpayer's trade or business.
  - Depreciable and amortizable tangible property used in the taxpayer's trade or business.
  - Oil, gas, geothermal, or other mineral property.
  - Section 126 property.

- The involuntary conversion (from other than casualty or theft) of property used in the taxpayer's trade or business and capital assets held for more than 1 year in connection with a trade or business or a transaction entered into for profit.
- The disposition of noncapital assets other than inventory or property held primarily for sale to customers in the ordinary course of a trade or business.
- The disposition of capital assets not reported on Schedule D.
- The gain or loss (including any related recapture) for partners and S corporation shareholders from certain Section 179 property dispositions by partnerships (other than electing large partnerships) and S corporations.
- The computation of recapture amounts under Sections 179 and 280F(b)(2) when the business use of Section 179 or listed property decreases to 50% or less.
- Gains or losses treated as ordinary gains or losses if the taxpayer is a trader in securities or commodities and made a mark-to-market election under Internal Revenue Code Section 475(f).

Use Form 4684 - Casualties and Thefts to report involuntary conversions of property due to casualty or theft. Use Form 6781 - Gains and Losses From Section 1256 Contracts and Straddles to report any gain or loss on Section 1256 contracts under the mark-to-market rules and gains and losses under Section 1092 from straddle positions.
A Section 1256 contract is any: (114)

- Regulated futures contract.
- Foreign currency contract.
- Non-equity option.
- Dealer equity option.
- Dealer securities futures contract.

A Section 1256 contract does not include any interest rate swap, currency swap, basis swap, commodity swap, equity swap, equity index swap, credit default swap, interest rate cap, interest rate floor, or similar agreement.

Use Parts I, II, and III of Form 8824 - Like-Kind Exchanges to report each exchange of business or investment property for property of a like kind. Certain members of the executive branch of the Federal Government and judicial officers of the Federal Government use Part IV to elect to defer gain on conflict-of-interest sales. Judicial officers of the Federal Government are the following: (115)

- Chief Justice of the United States.
- Associate Justices of the Supreme Court.
- Judges of the:
  - United States courts of appeals.
  - United States district courts, including the district courts in Guam, the Northern Mariana Islands, and the Virgin Islands.
  - Court of Appeals for the Federal Circuit.
  - Court of International Trade.
  - Tax Court.
  - Court of Federal Claims.
  - Court of Appeals for Veterans Claims.
  - United States Court of Appeals for the Armed Forces.
  - Any court created by Act of Congress, the judges of which are entitled to hold office during good behavior.

See the instructions for the Schedule D the taxpayer is filing for detailed information about the following: (112)

- Other forms he or she may have to file.
- The definition of capital asset.
- Reporting capital gain distributions, undistributed capital gains, the sale of a main home, the sale of capital assets held for personal use, or the sale of a partnership interest.
- Capital losses, nondeductible losses, and losses from wash sales.
- Traders in securities.
- Short sales.
- Gain or loss from options.
- Installment sales.

- Demutualization of life insurance companies.
- Exclusion or rollover of gain from the sale of qualified small business stock.
- Any other rollover of gain, such as gain from the sale of publicly traded securities.
- Exclusion of gain from the sale of DC Zone assets or qualified community assets.
- Certain other items that get special treatment.
- Special reporting rules for corporations and partnerships in certain situations.

Basis

Basis is the amount of the investment in property for tax purposes. The basis of property the taxpayer buys is usually its cost. The taxpayer needs to know his or her basis to figure any gain or loss on the sale or other disposition of the property. The basis of property a taxpayer buys is usually its cost. The cost is the amount he or she pays for it in cash, in debt obligation, in other property, or in services. The cost also includes:

- Sales tax charged on the purchase.
- Freight charges to obtain the property.
- Installation and testing charges.

If the taxpayer buys real property, such as a building and land, certain fees and other expenses he or she pays are part of the cost basis in the property. If the taxpayer agrees to pay real estate taxes on a property that were owed by the seller and the seller does not reimburse him or her, the taxes he or she pays are treated as part of the basis in the property. The taxpayer cannot deduct them as taxes paid.

If the taxpayer reimburses the seller for real estate taxes the seller paid for him or her, the taxpayer can usually deduct that amount. Do not include that amount in the basis in the property. The following settlement fees and closing costs for buying the property are part of the basis in the property: [27]

- Abstract fees.
- Charges for installing utility services.
- Legal fees.
- Recording fees.
- Surveys.
- Transfer taxes.
- Title insurance.
- Any amounts the seller owes that the taxpayer agrees to pay, such as back taxes or interest, recording or mortgage fees, charges for improvements or repairs, and sales commissions.

The following are settlement fees and closing costs a taxpayer **cannot** include in the basis in the property: [27]

- Fire insurance premiums.
- Rent or other charges relating to occupancy of the property before closing.
- Charges connected with getting or refinancing a loan, such as:
    - Points (discount points, loan origination fees),
    - Mortgage insurance premiums,
    - Loan assumption fees,
    - Cost of a credit report, and
    - Fees for an appraisal required by a lender.

Also, do not include amounts placed in escrow for the future payment of items such as taxes and insurance.

If the taxpayer buys buildings and the land on which they stand for a lump sum, he or she allocates the basis of the property among the land and the buildings so he or she can figure the depreciation allowable on the buildings. If the taxpayer buys a tract of land and subdivides it, he or she must determine the basis of each lot. This is necessary because the taxpayer must figure the gain or loss on the sale of each individual lot. As a result, he or she does not recover the entire cost in the tract until he or she has sold all of the lots.

To determine the basis of an individual lot, multiply the total cost of the tract by a fraction. The numerator is the fair market value (FMV) of the lot and the denominator is the FMV of the entire tract. If the taxpayer made a mistake in figuring the cost basis of subdivided lots sold in previous years, he or she cannot correct the mistake for years for which the statute of limitations (generally 3 tax years) has expired. The taxpayer figures the basis of any remaining lots by allocating the correct original cost basis of the entire tract among the original lots.

Recordkeeping

Basis is the amount of the investment in property for tax purposes. The basis of property the taxpayer buys is usually its cost. The taxpayer needs to know his or her basis to figure any gain or loss on the sale or other disposition of the property. The taxpayer must keep accurate records that show the basis and, if applicable, adjusted basis of the property. The records should show the purchase price, including commissions; increases to basis, such as the cost of improvements; and decreases to basis, such as depreciation, non-dividend distributions on stock, and stock splits.

Capital Asset

For the most part, everything a taxpayer owns and uses for personal purposes, pleasure, or investment is a capital asset. For example: (116)

- Stocks or bonds held in a personal account.
- A house owned and used by the taxpayer and his or her family.
- Household furnishings.
- A car used for pleasure or commuting.
- Coin or stamp collections.
- Gems and jewelry.
- Gold, silver, or any other metal.

Any property the taxpayer owns is a capital asset, except the following noncapital assets: (116)

- Stock in trade or other property included in inventory or held mainly for sale to customers.
- Accounts or notes receivable for services performed in the ordinary course of the trade or business or as an employee, or from the sale of stock in trade or other property held mainly for sale to customers.
- Depreciable property used in the trade or business, even if it is fully depreciated.
- Real estate used in the trade or business.
- Copyrights, literary, musical, or artistic compositions, letters or memoranda, or similar property:
    - Created by the taxpayer's personal efforts.
    - Prepared or produced for the taxpayer (in the case of letters, memoranda, or similar property).
    - That the taxpayer received from someone who created them or for whom they were created, as mentioned above, in a way (such as by gift) that entitled him or her to the basis of the previous owner.
- U.S. Government publications, including the Congressional Record, that the taxpayer received from the Government, other than by purchase at the normal sales price, or that he or she received from someone who had received it in a similar way, if the basis is determined by reference to the previous owner's basis.
- Certain commodities derived by financial instruments held by a dealer and not connected to the dealer's activities as a dealer.
- Certain hedging transactions entered into in the normal course of the trade or business.
- Supplies regularly used in the trade or business.

The taxpayer can elect to treat as capital assets certain musical compositions or copyrights he or she sold or exchanged if:

- The taxpayer's personal efforts created the property.
- The taxpayer acquired the property under circumstances (for example, by gift) entitling him or her to the basis of the person who created the property or for whom it was prepared or produced.

The taxpayer must make a separate election for each musical composition (or copyright in a musical work) sold or exchanged during the tax year. He or she must make the election on or before the due date (including extensions) of the income tax return for the tax year of the sale or exchange. The taxpayer must make the election on Form 8949 by treating the sale or exchange as the sale or exchange of a capital asset, according to the Instructions for Form 8949 and Instructions for Schedule D (Form 1040). See Publication 550 - Investment Income and Expenses for details.

Publicly Traded Partnerships (PTP)

A publicly traded partnership is any partnership an interest in which is regularly traded on an established securities market regardless of the number of its partners. This does not include a publicly traded partnership treated as a corporation under Section 7704 of the Internal Revenue Code.

A publicly traded partnership that has effectively connected income, gain, or loss must pay withholding tax on any distributions of that income made to its foreign partners. In this situation, a publicly traded partnership must use Form 1042 - Annual Withholding Tax Return for U.S. Source Income of Foreign Persons, and Form 1042-S - Foreign Person's U.S. Source Income Subject to Withholding, (Income Code 27) to report withholding from distributions. The rate of withholding is 37% for noncorporate partners and 21% for corporate partners. This rate is subject to future tax law changes. The taxpayer uses Form 1042 to report the following:

- The tax withheld on certain income of foreign persons, including nonresident aliens, foreign partnerships, foreign corporations, foreign estates, and foreign trusts.
- The tax withheld on withholdable payments.
- The tax withheld pursuant to Section 5000C on specified Federal procurement payments.
- Payments that are reported on Form 1042-S.

Partnership distributions are first considered to be paid out of the following types of income in the order listed. To the extent the partnership has this type of income, it is excluded from the distributions subject to withholding discussed in this section.

1. Amounts of noneffectively connected income (also known as Fixed, Determinable, Annual, Periodical (FDAP)) distributed by the partnership and subject to NRA withholding.
2. Amounts attributable to recurring dispositions of crops and timber that are subject to NRA withholding.
3. Amounts attributable to the disposition of a U. S. real property interest subject to the withholding rules discussed under U. S. Real Property Interest.

The publicly traded partnership must withhold tax on any actual distributions of money or property to foreign partners. In the case of a partnership that receives a partnership distribution from another partnership (a tiered partnership), the distribution also includes the tax withheld from that distribution. If the distribution is in property other than money, the partnership cannot release the property until it has enough funds to pay over the withholding tax.

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.

Note

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:

2020 Long-Term Capital Gains Rate Income Levels					
Rate	Single	Married Filing Jointly	Head of Household	Married Filing Separately	Estates and Trusts

0%	Up to $40,000	Up to $80,000	Up to $53,600	Up to $40,000	Up to $2,650
15%	$40,000-$441,450	$80,000-$496,600	$53,600-$469,050	$40,000-$248,300	$2,650-$13,150
20%	Over $441,450	Over $496,600	Over $469,050	Over $248,300	Over $13,150

Table 2-6 - Publication 544 - Sales and Other Dispositions of Assets (2020)

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 capital gains and losses: [117]

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 in 2020 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. For 2020, the maximum capital gain rates are 0%, 15%, 20%, 25%, and 28%.

Note

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.

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.

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, 2019, the first day of the period is June 20. If the taxpayer sells the asset on June 19, 2020, 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, 2020, that is now more than one year, and the asset was held long-term.

Note

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. For a nontaxable exchange, the taxpayer's holding period starts the day after date he or she acquired old property.

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 is 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. In 2020, the tax rate on long-term capital gains is 15% for most taxpayers, while those in the top bracket of pay 20% and those in the 10% or 12% tax brackets pay 0%. [116]

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, 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%
Other gain[1] and the regular tax rate that would apply is 37%	20%
Other gain[1] and the regular tax rate that would apply is 22%, 24%, 32%, or 35%	15%
Other gain[1] and the regular tax rate that would apply is lower than 10% or 12%.	0%
[1] Other gain means any gain that is not collectibles gain, gain on qualified small business stock, or un-recaptured Section 1250 gain.	

Table 2-7 - IRS Publication 550 - Table 4-4: What is Your Maximum Capital Gain Rate? (2020)

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. (118)

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. (118)

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: (116)

- $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.

Worthless Securities

Securities such as stocks, stock rights, bonds, etc., which are capital assets should they become worthless, are considered as a loss dating from the last day of the taxable year in which they became worthless. Thus, monetary losses from worthless securities are subject to the same deduction limitations ($3,000 per year for an individual; $1,500 per year for married filing separately) of capital losses. Also, bad debt losses developed from non-business (personal) transactions are considered short-term capital losses.

Worthless securities also include securities that the taxpayer abandoned after March 12, 2008. To abandon a security, the taxpayer must permanently surrender and relinquish all rights in the security and receive no consideration in exchange for it. All the facts and circumstances determine whether the transaction is properly characterized as an abandonment or other type of transaction, such as an actual sale or exchange, contribution to capital, dividend, or gift. If the taxpayer is a cash basis taxpayer and makes payments on a negotiable promissory note that he or she issued for stock that became worthless, the taxpayer can deduct these payments as losses in the years he or she actually makes the payments. Do not deduct them in the year the stock became worthless.

If the taxpayer did not claim a loss for a worthless security on his or her original return for the year it becomes worthless, he or she can file a claim for a credit or refund due to the loss. Use Form 1040X - Amended U.S. Individual Income Tax Return to amend the return for the year the security became worthless. The taxpayer must file it within 7 years from the date the original return for that year had to be filed, or 2 years from the date he or she paid the tax, whichever is later. (Claims not due to worthless securities or bad debts generally must be filed within 3 years from the date a return is filed, or 2 years from the date the tax is paid, whichever is later).

Nonbusiness Bad Debt

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

There are two kinds of bad debts: business and nonbusiness. Generally, a business bad debt is one that comes from operating a trade or business. The following are examples of business bad debts (if previously included in income):

- Loans to clients and suppliers.
- Credit sales to customer.
- Business loan guarantees.

A business deducts its bad debts from gross income when figuring its taxable income. Business bad debts may be deducted in part or in full. The taxpayer can claim a business bad debt using either the specific charge-off method or the nonaccrual-experience method. All other bad debts are nonbusiness. Nonbusiness bad debts must be totally worthless to be deductible. An individual cannot deduct a partially worthless nonbusiness bad debt.

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

A nonbusiness bad debt is reported as a short-term capital loss on Form 8949 - Sales and Other Dispositions of Capital Assets, Part 1, line 1. Enter the name of the debtor and “bad debt statement attached” in column (a). Enter the basis in the bad debt in column (f) and enter zero in column (e). Use a separate line for each bad debt. It is subject to the capital loss limitations. A nonbusiness bad debt deduction requires a separate detailed statement attached to the return. [(119)]

Bartering

Bartering is the trading of one product or service for another. Usually there is no exchange of cash. However, the fair market value of the goods and services exchanged must be reported as income by both parties. Income from bartering is taxable in the year it is performed. Barter dollars or trade dollars are identical to real dollars for tax reporting purposes. If the taxpayer conducts any direct barter, a barter for another’s products or services, he or she must report the fair market value of the products or services he or she received on his or her tax return.

Bartering may result in liabilities for income tax, self-employment tax, employment tax or excise tax. The taxpayer’s barter activities may result in ordinary business income, capital gains or capital losses, or he or she may have a nondeductible personal loss.

Virtual Currency

In some environments, virtual currency (such as Bitcoin) operates like "real" currency (i.e., the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance) but it does not have legal tender status in any jurisdiction. For Federal tax purposes, virtual currency is treated as property. General tax principles applicable to property transactions apply to transactions using virtual currency. A taxpayer who receives virtual currency as payment for goods or services must, in computing gross income, include the fair market value of the virtual currency, measured in U.S. dollars, as of the date that the virtual currency was received.

This also means that:

- Wages paid to employees using virtual currency are taxable to the employee, must be reported by an employer on a Form W-2, and are subject to federal income tax withholding and payroll taxes.
- Payments using virtual currency made to independent contractors and other service providers are taxable and self-employment tax rules generally apply. Normally, payers must issue Form 1099.
- The character of gain or loss from the sale or exchange of virtual currency depends on whether the virtual currency is a capital asset in the hands of the taxpayer.
- A payment made using virtual currency is subject to information reporting to the same extent as any other payment made in property.

If the fair market value of property received in exchange for virtual currency exceeds the taxpayer's adjusted basis of the virtual currency, the taxpayer has a taxable gain. The taxpayer has a loss if the fair market value of the property received is less than the adjusted basis of the virtual currency.

If the taxpayer's employer gives him or her virtual currency (such as Bitcoin) as payment for his or her services, the taxpayer must include the fair market value of the currency in his or her income. The fair market value of virtual currency paid as wages is subject to Federal income tax withholding, Federal Insurance Contribution Act (FICA) tax, and Federal Unemployment Tax Act (FUTA) tax and must be reported on Form W-2.

A payment made using virtual currency is subject to information reporting to the same extent as any other payment made in property. For example, a person who in the course of a trade or business makes a payment of fixed and determinable income using virtual currency with a value of $600 or more to a U.S. non-exempt recipient in a taxable year is required to report the payment to the IRS and to the payee. Examples of payments of fixed and determinable income include rent, salaries, wages, premiums, annuities, and compensation.

The IRS issued additional detailed guidance to help taxpayers better understand their reporting obligations for specific transactions involving virtual currency. The guidance included Revenue Ruling 2019-24 established the following rules that cryptocurrency is a type of virtual currency that utilizes cryptography to secure transactions that are digitally recorded on a distributed ledger, such as a blockchain. Units of cryptocurrency are generally referred to as coins or tokens. Distributed ledger technology uses independent digital systems to record, share, and synchronize transactions, the details of which are recorded in multiple places at the same time with no central data store or administration functionality.

A hard fork is unique to distributed ledger technology and occurs when a cryptocurrency on a distributed ledger undergoes a protocol change resulting in a permanent diversion from the legacy or existing distributed ledger. A hard fork may result in the creation of a new cryptocurrency on a new distributed ledger in addition to the legacy cryptocurrency on the legacy distributed ledger. Following a hard fork, transactions involving the new cryptocurrency are recorded on the new distributed ledger and transactions involving the legacy cryptocurrency continue to be recorded on the legacy distributed ledger.

An airdrop is a means of distributing units of a cryptocurrency to the distributed ledger addresses of multiple taxpayers. A hard fork followed by an airdrop results in the distribution of units of the new cryptocurrency to addresses containing the legacy cryptocurrency. However, a hard fork is not always followed by an airdrop.

Cryptocurrency from an airdrop generally is received on the date and at the time it is recorded on the distributed ledger. However, a taxpayer may constructively receive cryptocurrency prior to the airdrop being recorded on the distributed ledger. A taxpayer does not have receipt of cryptocurrency when the airdrop is recorded on the distributed ledger if the taxpayer is not able to exercise dominion and control over the cryptocurrency. For example, a taxpayer does not have dominion and control if the address to which the cryptocurrency is airdropped is contained in a wallet managed through a cryptocurrency exchange and the cryptocurrency exchange does not support the newly created cryptocurrency such that the airdropped cryptocurrency is not immediately credited to the taxpayer's account at the cryptocurrency exchange. If the taxpayer later acquires the ability to transfer, sell, exchange, or otherwise dispose of the cryptocurrency, the taxpayer is treated as receiving the cryptocurrency at that time.

For example, the taxpayer owns 100 units of Crypto A. Crypto A experiences a hard fork and Crypto B is created. 50 units of Crypto B are airdropped to the taxpayer. The taxpayer must report ordinary income equal to the fair market value of Crypto B. (120)

Sale of Personal Residences

Since 2013, the Affordable Care Act imposed a new 3.8% tax on investment income of taxpayers whose total income exceeds $200,000 ($250,000 if filing a joint return). All or part of the gain (not the entire proceeds) on the sale of a home is subject to the 3.8% tax if the taxpayer's total income (including the gain on the home sale) exceeds $200,000 (or $250,000 if a joint return is filed). However, if the taxpayer meets the other requirements for exclusion, the gain on sale is reduced by $250,000 (or $500,000 if the taxpayer files a joint return).

The exclusion applies in determining the amount of net investment income for purposes of the 3.8% tax. To exclude gain, the taxpayer, in most cases, must have owned and lived in the property as his or her main home for at least 2 years during the 5-year period ending on the date of sale. If he or she sells the land on which the main home is located, but not the house itself, the taxpayer cannot exclude any gain he or she realizes from the sale of the land.

Figuring Gain or Loss

To figure the gain or loss on the sale of the main home, the taxpayer must know the selling price, the amount realized, and the adjusted basis. Subtract the adjusted basis from the amount realized to get the gain or loss.

Selling price
−Selling expenses
Amount realized
−Adjusted basis
Gain or loss

The amount the taxpayer realizes from a sale or trade of property is everything he or she receives for the property minus his or her expenses of sale (such as redemption fees, sales commissions, sales charges, or exit fees). Amount realized includes the money the taxpayer receives plus the fair market value of any property or services he or she receives. If the taxpayer finances the buyer's purchase of his or her property and the debt instrument does not provide for adequate stated interest, the unstated interest that the taxpayer must report as ordinary income will reduce the amount realized from the sale.

A taxpayer may exclude from income up to $250,000 of gain ($500,000 on a joint return in most situations) realized on the sale or exchange of a principal residence if all of the following are true: (121)

- Meets the ownership test.
- Meets the use test.
- During the 2-year period ending on the date of the sale, taxpayer did not exclude gain from the sale of another home.

Ownership and Use

As a general rule, gain may only be excluded if, during the five-year period that ends on the date of the sale or exchange, the individual owned and used the property as a principal residence for periods aggregating two years or more (i.e., a total of 730 days (365 x 2)). Short temporary absences for vacations or seasonal absences are counted as periods of use, even if the individual rents out the property during these periods of absence.

However, an absence of an entire year is not considered a short temporary absence. The ownership and use test may be met during non-concurrent periods, provided that both tests are met during the five-year period that ends on the date of sale. Additionally, if the taxpayer owned and lived in the property as the main home for less than 2 years, he or she can still claim an exclusion in some cases. However, the maximum amount the taxpayer may be able to exclude will be reduced. (121)

If a taxpayer has more than one home, he or she can exclude gain only from the sale of the main home. The taxpayer must include in income the gain from the sale of any other home. If he or she has two homes and live in each of them, the main home is ordinarily the one he or she lives in most of the time during the year. In addition to the amount of time the taxpayer lives in each home, other factors are relevant in determining which home is the main home.

Those factors include the following: (122)

- The taxpayer's place of employment.
- The location of the taxpayer's family members' main home.
- The taxpayer's mailing address for bills and correspondence.
- The address listed on the taxpayer's:
    - Federal and state tax returns.
    - Driver's license.
    - Car registration.
    - Voter registration card.
- The location of the banks the taxpayer uses.
- The location of recreational clubs and religious organizations of which the taxpayer is a member.

Married Individuals

The amount of excludable gain is $500,000 for married individuals filing jointly if: (121)

- The taxpayer is married and files a joint return for the year.
- Either the taxpayer or his or her spouse meets the ownership test.
- Both the taxpayer and his or her spouse meet the use test.
- During the 2-year period ending on the date of the sale, neither the taxpayer nor his or her spouse excluded gain from the sale of another home.

The exclusion is determined on an individual basis. Thus, if a single individual who is otherwise eligible for an exclusion marries someone who has used the exclusion within the two years prior to the sale, the newly married individual is entitled to a maximum exclusion of $250,000. Once both spouses satisfy the eligibility rules and two years have passed since the exclusion was allowed to either of them, they may exclude up to $500,000 of gain on their joint return.

Deceased Spouse

When a spouse dies before the date of sale, the surviving spouse is considered as owning and living in the home for the same period as the deceased spouse. A widow(er) may qualify to exclude up to $500,000 of any gain from the sale or exchange of his or her main home if all of the following requirements are met: (121)

1. The sale or exchange took place after 2008.
2. The sale or exchange took place no more than 2 years after the date of death of the spouse.
3. The taxpayer has not remarried.
4. The taxpayer and his or her spouse met the use test at the time of the spouse's death.
5. The taxpayer or his or her spouse met the ownership test at the time of the spouse's death.
6. Neither the taxpayer nor his or her spouse excluded gain from the sale of another home during the last 2 years before the date of death.

Divorced Individuals

When a residence is transferred to an individual incident to a divorce, the time during which the individual's spouse or former spouse owned the residence is added to the individual's period of ownership. An individual who owns a residence is deemed to use it as a principal residence during the time the individual's spouse or former spouse had use of the home under a divorce or separation agreement.

Hardship Relief: Safe Harbors

A taxpayer who fails to meet the ownership and use requirements, or the minimum two-year time period for claiming the full exclusion (e.g., $250,000), may still be eligible for a partial exclusion when the sale of the home is due to: [(121)]

- A change in place of employment.
- Health reasons.
- Unforeseen circumstances.

According to the IRS, in order for an individual to be eligible for the partial exclusion, the individual's *primary reason* for the sale must be related to one of these three reasons. If the individual is able to satisfy one of the safe harbor tests discussed below, then the primary reason for the sale will be treated as having been due to employment, health, or unforeseen circumstances.

Change of Employment

The primary reason test will be satisfied if the individual's new place of employment is at least 50 miles farther from the residence sold or exchanged than was the former place of employment. If there was no former place of employment, the distance between the individual's new place of employment and the residence sold or exchanged must be at least 50 miles.

Health Reasons

The primary reason test will be satisfied if the reason for the sale is to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of disease, illness, or injury. Obtaining or providing medical or personal care for a qualified individual suffering from a disease, illness, or injury, will also qualify. The term qualified individual is very broad and includes the owner's spouse, as well as children, siblings, parents, and others. A physician's recommendation for a change of homes for health reasons also qualifies.

Unforeseen Circumstances

Examples of situations that will be recognized by the IRS as unforeseen circumstances include: [(121)]

- Involuntary conversion of the home.
- Natural or man-made disasters or acts of terrorism.
- Death.
- A period of unemployment that permits the individual to be eligible for unemployment compensation.
- Change of employment resulting in the inability to pay the costs of housing and basic living expenses.
- Divorce or legal separation.
- Multiple births resulting from the same pregnancy.
- An event the IRS determines unforeseen (For example, the IRS determined the September 11, 2001 terrorist attacks to be unforeseen circumstances).

Note

A sale of a residence due to the individual's change in preference or improvement in financial position is *not* due to an unforeseen circumstance.

Other Tests

If the individual does not satisfy one of the safe harbor tests listed previously, then the IRS will consider all the facts and circumstances when determining the principal reason for the sale. Factors that will be considered include:

- The circumstances giving rise to the sale.
- The individual's financial ability to maintain the property.
- Material changes that would impact the suitability of the property as the individual's residence.

Computing the Reduced Exclusion

When an individual qualifies for hardship relief, the individual may be entitled to a reduced exclusion. The reduced exclusion is computed by multiplying the maximum allowable exclusion (i.e., $250,000 or $500,000) by a fraction.

The numerator of the fraction is the shortest of:

- The period of time that the individual owned the property as a principal residence during the five-year period ending on the date of sale exchange.
- The period of time that individual used the property as a principal residence during the five-year period ending on the date of sale or exchange.
- The period between the date of the most recent prior sale or exchange to which the exclusion applied and the date of the current sale or exchange.

The numerator may be expressed in days or months. The denominator of the fraction is either 730 days or 24 months (depending on the measure of time used in the numerator).

Installment Sales

An installment sale is a sale of property where at least one payment is to be received after the tax year in which the sale occurs. The taxpayer is required to report gain on an installment sale under the installment method unless he or she elects out on or before the due date for filing the tax return (including extensions) for the year of the sale. Use Form 6252 - Installment Sale Income to report the sale on the installment method. Also use Form 6252 to report any payment received in 2020 from a sale made in an earlier year that was reported on the installment method.

To elect out of the installment method, report the full amount of the gain on Form 8949 on a timely filed return (including extensions) for the year of the sale. If the original return was filed on time, a taxpayer can make the election on an amended return filed no later than 6 months after the due date of the return (excluding extensions). Write “Filed pursuant to Section 301.9100-2” at the top of the amended return.

Installment method rules do not apply to sales that result in a loss. A taxpayer cannot use the installment method to report gain from the sale of inventory or stocks and securities traded on an established securities market. Any portion of the gain from the sale of depreciable assets that must be reported as ordinary income under the depreciation recapture rules must be reported in the year of the sale.

The total gain on an installment method is generally the amount by which the selling price of the property sold exceeds adjusted basis in that property. The selling price includes the money and the fair market value of property received for the sale of the property, any selling expenses, and existing debt encumbering the property that the buyer assumes. The taxpayer does not include stated interest, unstated interest, any amount refigured or recharacterized as interest, or OID.

Under the installment method, a taxpayer includes in income each year only part of the gain he or she receives or is considered to have received. Use Form 6252 - Installment Sale Income to report an installment sale in the year the sale occurs and for each year he or she receives an installment payment. [123]

Depreciation Recapture

Depreciation recapture is the portion of the gain attributable to the depreciation deductions previously allowed during the period the taxpayer owned the property. The deprecation recapture rate on this portion of the gain is 25%. The reasoning behind the depreciation recapture rules is since the taxpayer received the benefit of a depreciation deduction that offset ordinary income tax rates (a potential Federal tax savings of up to 37%), the government is not going to grant the most favorable capital gains rates on the portion of the gain relating to these prior depreciation deductions. Depreciation recapture is limited to the lesser of the gain or, the depreciation previously taken. In the event a property is sold at a loss the depreciation recapture rules do not apply.

Gifts and Inheritances

To determine if the sale of inherited property is taxable, the taxpayer must first determine his or her basis in the property. The basis of property inherited from a decedent is generally one of the following:

- The fair market value (FMV) of the property on the date of the decedent's death.
- The FMV of the property on the alternate valuation date if the executor of the estate chooses to use alternate valuation.

Report the sale on Schedule D (Form 1040) - Capital Gains and Losses, and on Form 8949 - Sales and other Dispositions of Capital Assets if the taxpayer sells the property for more than his or her basis, he or she has a taxable gain. In general, capital gains or losses from sale of inherited property are treated as long-term. For information on how to report the sale on Schedule D, see Publication 550, Investment Income and Expenses.

Proceeds From Real Estate Transactions

Generally, an individual is required to report a transaction that consists in whole or in part of the sale or exchange for money, indebtedness, property, or services of any present or future ownership interest in any of the following (File Form 1099-S - Proceeds From Real Estate Transactions to report the sale or exchange of real estate): (124)

- Improved or unimproved land, including air space.
- Inherently permanent structures, including any residential, commercial, or industrial building.
- A condominium unit and its appurtenant fixtures and common elements, including land.
- Stock in a cooperative housing corporation.
- Any non-contingent interest in standing lumber.

Adjustments to Income

Self-Employment Tax

All individuals engaged in a trade or business in any capacity, other than as employees, are subject to the self-employment tax. Generally, this includes a sole proprietor, a member of a partnership, and one who renders service as an independent contractor. For 2020, the SE tax rate on net earnings is 15.3% (12.4% Social Security tax plus 2.9% Medicare tax).

Tip

Self-employment (SE) tax is a Social Security and Medicare tax primarily for individuals who work for themselves. It is similar to the Social Security and Medicare taxes withheld from the pay of most wage earners and is usually calculated on the net profit from Schedule C. If a husband and wife both have separate Schedule C, each spouse must figure their SE tax separately on individual Schedule SE. If a taxpayer has more than one business and therefore more than one Schedule C, all business income or loss is determined before calculating SE tax. If any of the income from a trade or business, other than a partnership, is community property income under state law, it is included in the earnings subject to SE tax of the spouse carrying on the trade or business.

A taxpayer must pay SE tax and file Schedule SE if either of the following applies:

- Their net earnings from self-employment (excluding church employee income) were $400 or more.
- They had church employee income of $108.28 or more except for ministers and members of religious orders.

For a sole proprietor, net income (as reported on Schedule C) must be counted as self-employment income. If net income is less than $400, the self-employment tax does not apply. (125)

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 2020, 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 $137,700 of wages, for a maximum of $8,537.40 for employees and for employers, and $17,074.80 for self-employed people. The current rate for Medicare is 1.45% for the employer, 1.45% for the employee and 2.9% for self-employed individuals. There is not a wage base limit for Medicare tax. All covered wages are subject to Medicare tax.

Federal income tax is a pay-as-you-go tax. The taxpayer must pay it as he or she earns or receives income during the year. An employee usually has income tax withheld from his or her pay. If the taxpayer does not pay his or her tax through withholding, or does not pay enough tax that way, they might have to pay estimated tax. All taxpayers generally have to make estimated tax payments if they expect to owe taxes, including self-employment tax, of $1,000 or more when they file their return.

The self-employment tax is determined by completing Schedule SE Self-Employment. Business Net Profit on Schedule C is transferred to Form 1040 and to Schedule SE. If the taxpayer has to pay SE tax, he or she must file Form 1040 (with Schedule SE attached) even if the taxpayer does not otherwise have to file a Federal income tax return.

Figuring Earnings Subject to SE Tax

Utilize the flowchart on page 1 of Schedule SE to determine whether the taxpayer can use Section A - Short Schedule SE, or if they must use Section B - Long Schedule SE. For either section, the taxpayer will need to know what their net earnings from self-employment are. Generally, net earnings are simply the net profit from a farm or nonfarm business. There are three methods used to calculate the taxpayer's net earnings from self-employment:

1. *The regular method* - To figure net earnings using the regular method, multiply the taxpayer's self-employment earnings by 92.35% (0.9235).
2. *The nonfarm optional method* - Use the nonfarm optional method only for earnings that do not come from farming. The taxpayer may use this method if he or she meets all the following tests:
    a. He or she is self-employed on a regular basis. This means that his or her actual net earnings from self-employment were $400 or more in at least 2 of the 3 tax years before the one for which he or she uses this method. The net earnings can be from either farm or nonfarm earnings or both.
    b. He or she has used this method less than 5 years. (There is a 5-year lifetime limit.) The years do not have to be one after another.
    c. In 2020, his or her net nonfarm profits within annual limits:
        i. Less than $6,107, and
        ii. Less than 72.189% of his or her gross nonfarm income.
3. *The farm optional method* - Use the farm optional method only for self-employment earnings from a farming business.

The taxpayer may want to use the optional methods when he or she has a loss or a small net profit and any one of the following applies:

- He or she wants to receive credit for Social Security benefit coverage.
- He or she incurred child or dependent care expenses for which he or she could claim a credit. (An optional method may increase his or her earned income, which could increase his or her credit.)
- He or she is entitled to the Earned Income Tax Credit. (An optional method may increase his or her earned income, which could increase his or her credit.)
- He or she entitled to the Additional Child Tax Credit. (An optional method may increase his or her earned income, which could increase his or her credit.)

If the taxpayer uses both optional methods, he or she must add the net earnings figured under each method to arrive at his or her total net earnings from self-employment. The taxpayer can report less than his or her total actual farm and nonfarm net earnings but not less than actual nonfarm net earnings. If he or she uses both optional methods, he or she can report no more than $5,640 as his or her combined net earnings from self-employment in 2020. The taxpayer must use the regular method unless they are eligible to use one or both of the optional methods. Use Publication 334 - Tax Guide for Small Business for general information about the Federal tax laws that apply to small business owners who are sole proprietors and to statutory employees. Publication 334 also has information on business income, expenses, and tax credits.

Health Savings Accounts

Health Savings Accounts

Individuals and employees, through an employer's cafeteria plan, can establish Health Savings Accounts (HSA) to reimburse them for qualified medical expenses paid during the year. For 2020, these accounts allow taxpayers with high deductible health insurance to make pre-tax contributions for self-coverage of up to $3,550 each year ($7,100 for family coverage) to cover health care costs. Amounts are excluded from gross income if paid or distributed from an HSA that is used exclusively to pay the qualified medical expenses of the account beneficiary or dependent. Other distributions are included in income and subject to an additional 20% tax unless made after the participant reaches age 65, dies or becomes disabled. Qualified medical expenses are the same expenses that qualify for the medical expenses deduction. An exception is that premiums for long-term care and coverage during periods of unemployment, whether through COBRA or not, also qualify. (126)

In order for an individual to be eligible for an HSA, on the first day of each month, the individual must be covered by a high deductible health plan and not covered by any other health plan that is not a high deductible health plan. Individual eligibility for an HSA is determined on a monthly basis. For 2020, a high deductible health plan is defined as a plan that has at least a $1,400 annual deductible for self-only coverage and a $2,800 deductible for family coverage. In addition, annual out-of-pocket expenses paid under the plan must be limited to $6,900 for individuals and $13,800 for families. Out-of-pocket expenses include deductibles, co-payments and other amounts (does not include premiums) that must be paid for plan benefits.

Contributions to HSAs are deductible in determining adjusted gross income. The maximum annual aggregate contribution to an HSA is the lesser of the amount of the annual deductible for the high deductible health plan or the maximum deductible permitted under an Archer Medical Savings Account (MSA). Excess contributions are subject to a 6% excise tax and are includible in gross income. Additionally, contributions by an employer that exceed the annual HSA limits are taxable as income to the employee. Taxpayers use Form 8889 - Health Saving Accounts (HSAs) to calculate their HSA deductions and any taxable distributions. (127)

Individuals who reach age 55 by the end of the tax year can increase their annual contributions by $1,000. Contributions, however, cannot be made after the participant attains age 65 and is eligible for Medicare. However, distributions for qualified medical expenses continue to be excludable from gross income and premiums for health insurance other than for a Medicare supplemental policy are considered qualified medical expenses. (126)

HSAs vs. MSAs

HSAs differ from MSAs in several ways. MSAs are limited to individuals working for small employers (generally 50 employees or fewer), or who are self-employed, while there is no such limitation for HSAs. Archer MSA's generally cannot be established after 2007, although eligible individuals can still make MSA contributions, and receive distributions. HSAs are available for a wider range of high deductible plans than are MSAs. In addition, contributions for MSAs must be made by the self-employed individual or the taxpayer's employer, while contributions to HSAs may be made by the taxpayer, their family or their employer. Contributions to HSAs may be made even if the individual on whose behalf it is made has no compensation, or if the contribution exceeds the individual's compensation. (128)

Credits and Deductions for Higher Education Tuition and Related Expenses

A taxpayer may be able to deduct qualified tuition and related expenses even if the taxpayer does not itemize deductions on Schedule A (Form 1040). This deduction may be beneficial to him or her if he or she cannot take either the American Opportunity Tax Credit or Lifetime Learning Credit because income is too high.

Student Loan Interest Deduction

Interest paid during the tax year on any qualified education loan is deductible from gross income in arriving at adjusted gross income on Form 1040. The debt must be incurred by the taxpayer solely to pay qualified higher education expenses. The original loan and all refinancing of the loan are treated as one loan for this purpose. The maximum deductible amount of interest for tax year 2020 is $2,500.

For 2020, the amount of the student loan interest deduction is phased out (gradually reduced) if the taxpayer's filing status is married filing jointly and modified adjusted gross income (MAGI) is between $140,000 and $170,000. The taxpayer cannot take the deduction if modified AGI is $170,000 or more. If the taxpayer's filing status is married filing separately, he or she does not qualify for the deduction. For all other filing statuses, the student loan interest deduction is phased out if modified AGI is between $70,000 and $85,000. The taxpayer cannot take a deduction if modified AGI is $85,000 or more. The IRS provides a Student Loan Interest Deduction worksheet. For more information, see Publication 970 -Tax Benefits for Education.

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

- Tuition and fees.
- Room and board.
- Books, supplies, and equipment.
- Other necessary expenses (such as transportation).

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

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

Loan Origination Fee

In general, a loan origination fee is a one-time fee charged by the lender when a loan is made. To be deductible as interest, a loan origination fee must be for the use of money rather than for property or services (such as commitment fees or processing costs) provided by the lender. A loan origination fee is treated as interest accrues over the term of the loan. Loan origination fees were not required to be reported on Form 1098-E - Student Loan Interest Statement for loans made before September 1, 2004. If loan origination fees are not included in the amount reported on the taxpayer's Form 1098-E, he or she can use any reasonable method to allocate the loan origination fees over the term of the loan. One acceptable method allocates equal portions of the loan origination fee to each payment required under the terms of the loan. A method that results in the double deduction of the same portion of a loan origination fee would not be reasonable.

Voluntary Interest Payments

These are payments made on a qualified student loan during a period when interest payments are not required, such as when the borrower has been granted a deferment or the loan has not yet entered repayment status.

Capitalized Interest

This is unpaid interest on a student loan that is added by the lender to the outstanding principal balance of the loan. Capitalized interest is treated as interest for tax purposes and is deductible as payments of principal are made on the loan. No deduction for capitalized interest is allowed in a year in which no loan payments were made.

Student Loan Cancellations and Repayment Assistance

Generally, if the taxpayer is responsible for making loan payments, and the loan is canceled (forgiven), he or she must include the amount that was forgiven in his or her gross income for tax purposes. However, if the taxpayer fulfills certain requirements, student loan cancellation and student loan repayment assistance may be tax free. If the taxpayer's student loan is canceled, he or she may not have to include any amount in income.

To qualify for tax-free treatment, for the cancellation of the taxpayer's loan, the loan must have been made by a qualified lender to assist him of her in attending an eligible educational institution and contain a provision that all or part of the debt will be canceled if the taxpayer works: [129]

1. For a certain period of time.
2. In certain professions.
3. For any of a broad class of employers.

The cancellation of the taxpayer's loan will not qualify for tax-free treatment if it is cancelled because of services he or she performed for the educational institution that made the loan or other organization that provided the funds.

If the taxpayer refinanced a student loan with another loan from an eligible educational institution or a tax-exempt organization, that loan may also be considered as made by a qualified lender. The refinanced loan is considered made by a qualified lender if it is made under a program of the refinancing organization that is designed to encourage students to serve in occupations with unmet needs or in areas with unmet needs where the services required of the students are for or under the direction of a governmental unit or a tax-exempt Section 501(c)(3) organization.

Student loan repayments made to the taxpayer are tax free if he or she received them for any of the following: [129]

- The National Health Service Corps (NHSC) Loan Repayment Program (NHSC Loan Repayment Program).
- A state education loan repayment program eligible for funds under the Public Health Service Act.
- Any other state loan repayment or loan forgiveness program that is intended to provide for the increased availability of health services in underserved or health professional shortage areas (as determined by such state).

The taxpayer cannot deduct the interest he or she paid on a student loan to the extent payments were made through his or her participation in the above programs.

Tuition and Fees Deduction

The Bipartisan Budget Act of 2018 extended through 2017 the above-the-line deduction for qualified tuition and related expenses for higher education. The deduction is capped at $4,000 for an individual whose adjusted gross income (AGI) does not exceed $65,000 ($130,000 for joint filers) or $2,000 for an individual whose AGI does not exceed $80,000 ($160,000 for joint filers). The Further Consolidated Appropriations Act extended the deduction through 2020.

The Consolidated Appropriations Act, 2021, repeals the Tuition and Fees Deduction, effective with tax years that begin in 2021. This is a permanent repeal, so the Tuition and Fees Deduction will not return in the next tax extenders bill. Instead, the phase-out limits on the Lifetime Learning Credit are increased to $80,000 ($160,000 for married filing jointly).

Moving Expenses

Moving Expense Deduction Suspended Except in Limited Situations

For 2018 through 2025, employers must include moving expense reimbursements in employees' wages. The Tax Cuts and Jobs Act (TCJA) suspends the exclusion for qualified moving expense reimbursements. However, members of the U.S. Armed Forces can still exclude qualified moving expense reimbursements from their income if:

- They are on active duty.
- They move pursuant to a military order and incident to a permanent change of station.
- The move expenses would qualify as a deduction if the employee did not get a reimbursement.

Also, employers may exclude from wages any 2018 reimbursements to or payments on behalf of employees for moving expenses incurred for a move that took place prior to January 1, 2018, and which would have been deductible had they been paid prior to that date.

Other Deductions

One Half Self-Employment Tax Deduction

The taxpayer can deduct the employer-equivalent portion of self-employment tax in figuring adjusted gross income. This deduction only affects the income tax. It does not affect either net earnings from self-employment or self-employment tax. A taxpayer can claim 50% of what he or she paid in self-employment tax as an income tax deduction. See the Form 1040 and Schedule SE instructions for calculating and claiming the deduction. [93]

Self-Employed Health Insurance Deduction

Self-employed persons may deduct from gross income 100% of amounts paid during the year for health insurance for themselves, spouses, and dependents. The deduction is limited to the taxpayer's net earned income derived from the trade or business for which the insurance plan was established, minus the deductions for 50% of the self-employment tax and/or the deduction for contributions to Keogh, self-employed SEP or SIMPLE plans. Amounts eligible for the deduction do not include amounts paid during any month, or part of a month, that the self-employed individuals were able to participate in a subsidized health plan maintained by a previous employer or their spouses' employers. [130]

Penalty on Early Withdrawal of Savings

Interest that was previously earned on a time savings account or deposit with a savings institution and that is later forfeited because of premature withdrawals is deductible from gross income in the year when the interest is forfeited. The taxpayer can deduct the entire penalty even if it is more than the interest income. The deduction for this penalty is taken on line 17 of Schedule 1 (Form 1040). [56]

Employee Educational Assistance Plans

If a taxpayer receives educational assistance benefits from his or her employer under an educational assistance program, he or she can exclude up to $5,250 of those benefits each year. This means the taxpayer's employer should not include the benefits with his or her wages, tips, and other compensation shown in box 1 of his or her Form W-2. If the taxpayer's employer pays more than $5,250 for educational benefits for him or her during the year, the taxpayer must generally pay tax on the amount over $5,250. His or her employer should include in his or her wages (Form W-2, box 1) the amount that the taxpayer must include in income.

Tax-free educational assistance benefits include payments for tuition, fees and similar expenses, textbooks, supplies, and equipment. The payments may be for either undergraduate or graduate-level courses. The payments do not have to be for work-related courses.

Educational assistance benefits do not include payments for the following items: [131]

- Meals, lodging, or transportation.
- Tools or supplies (other than textbooks) that the taxpayer can keep after completing the course of instruction.
- Courses involving sports, games, or hobbies unless they:
  - Have a reasonable relationship to the business of the taxpayer's employer, or
  - Are required as part of a degree program.

If the benefits over $5,250 also qualify as a working condition fringe benefit, the taxpayer's employer does not have to include them in his or her wages. A working condition fringe benefit is a benefit which, had the taxpayer paid for it, he or she could deduct as an employee business expense. The taxpayer cannot use any of the tax-free education expenses paid for by his or her employer as the basis for any other deduction or credit, including the American Opportunity Tax Credit and Lifetime Learning Credit. [132]

Deductions and Credits

Deductions

There are certain personal expenses which Congress has allowed as deductions. These are called itemized expenses, or often called Schedule A deductions, as this is the form that is attached to the return to claim the itemized deductions.

Schedule A Categories	
Category	**Line(s)**
Medical and Dental Expenses	1-4
Taxes Paid	5-7
Interest Paid	8-10
Gifts to Charity	11-14
Casualty and Theft Losses (only for those losses attributable to a Federal disaster as declared by the President)	15
Other Miscellaneous Deductions	16

Table 3-1 - Schedule A (Form 1040) (2020)

Changes to Itemized Deductions

Under the Tax Cuts and Jobs Act (TCJA), the medical expense deduction remained in place with a lower floor of 7.5% for tax years 2017 (retroactively) and 2018 for all taxpayers regardless of age. Under the Further Consolidated Appropriations Act the 7.5% floor has returned (it was previously changed to 10%) for 2019 and 2020. The Consolidated Appropriations Act, 2021 makes permanent the lower threshold of 7.5% for all taxpayers.

The deduction for state and local income, property, and sales taxes (SALT) is capped at $10,000. The SALT deduction is a substantial reduction from the former rule allowing all property taxes, plus all state and local income or sales taxes, to be claimed as an itemized deduction.

The Coronavirus Aid, Relief, and Economic Security Act (CARES) allows an individual to make a cash contribution of up to $300 made to certain qualifying charities and deduct the contribution "above-the-line" in computing adjusted gross income. Thus, the taxpayer receives the deduction in addition to the standard deduction. This above-the-line deduction is here for 2020 and beyond but is available only to a taxpayer who does not itemize their deductions.

For taxpayers that do itemize their deductions, the new law temporarily lifts the limits on charitable giving for 2020. After passage of the TCJA, cash contributions to public charities are generally limited to 60% of a taxpayer's adjusted gross income (AGI). The CARES Act allows such contributions to be deducted up to 100% of adjusted gross income (AGI) for 2020, with any excess contributions available to be carried over to the next five years.

The casualty loss deduction is repealed, except for losses in Federally declared disasters. Miscellaneous itemized deductions subject to the 2% of adjusted gross income (AGI) floor, such as unreimbursed employee business expenses and tax preparation fees, are repealed.

Limit on Itemized Deductions

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.

Making the Election Between Using the Standard Deduction or Itemized Deductions

Each year the taxpayer must decide whether the standard deduction amount or the total of allowed itemized deductions provides him or her with the lowest tax liability. This election is made each year and does not depend on what was done in past years. The taxpayer is entitled to select the most favorable alternative each year.

If the taxpayer elects to itemize deductions even though the total is less than the amount of the Standard Deduction to which the taxpayer is entitled, the taxpayer must check the box on line 18, Schedule A, Form 1040.

Also, some taxpayers are not eligible for the standard deduction. A taxpayer's standard deduction is zero and he or she should itemize any deductions he or she has if:

- His or her filing status is married filing separately, and his or her spouse itemizes deductions on their return.
- He or she is filing a tax return for a short tax year because of a change in his or her annual accounting period.
- He or she is a nonresident or dual-status alien during the year. He or she is considered a dual-status alien if he or she was both a nonresident and resident alien during the year.

If the taxpayer was a nonresident alien who is married to a U.S. citizen or resident alien at the end of the year, he or she can choose to be treated as a U.S. resident. If he or she makes this choice, he or she can take the standard deduction.

Nonresident Alien

If the taxpayer is a nonresident alien, he or she cannot claim the standard deduction. However, students and business apprentices from India may be eligible to claim the standard deduction under Article 21 of the U.S.A.-India Income Tax Treaty. The taxpayer can claim deductions only to the extent they are connected with his or her effectively connected income. For example, nonresident aliens generally cannot deduct gambling losses on Schedule A (Form 1040-NR).

If the taxpayer is a nonresident alien for any part of the year, he or she generally cannot claim the Earned Income Tax Credit, the American Opportunity Tax Credit, or the Lifetime Learning Credit. However, he or she may claim an adjustment for the student loan interest deduction.

Nondeductible Expenses

Some expenses that the taxpayer incurs as an investor are not deductible. Some examples are: (55)

- Transportation and other expenses the taxpayer pays to attend stockholders' meetings of companies in which he or she has no interest other than owning stock.
- Interest on money the taxpayer borrows to buy or carry a single-premium life insurance, endowment, or annuity contract.
- Interest on money the taxpayer borrows to buy or carry a life insurance, endowment, or annuity contract if he or she plans to systematically borrow part or all of the increases in the cash value of the contract.
- Expenses the taxpayer incurs to produce tax-exempt income.
- Interest on money the taxpayer borrows to buy tax-exempt securities or shares in a mutual fund or other regulated investment company that distributes only exempt-interest dividends.

The taxpayer may have expenses that are for both tax-exempt and taxable income. If he or she cannot specifically identify what part of the expenses is for each type of income, he or she can divide the expenses, using reasonable proportions based on facts and circumstances. The taxpayer must attach a statement to the return showing how he or she divided the expenses and stating that each deduction claimed is not based on tax-exempt income.

One accepted method for dividing expenses is to do it in the same proportion that each type of income is to the total income. If the expenses relate in part to capital gains and losses, include the gains, but not the losses, in figuring this proportion. To find the part of the expenses that is for the tax-exempt income, divide the tax-exempt income by the total income and multiply the expenses by the result.

In addition to the miscellaneous itemized deductions discussed earlier, the taxpayer cannot deduct the following expenses: [133]

- Adoption expenses.
- Broker's commissions.
- Burial or funeral expenses, including the cost of a cemetery lot.
- Campaign expenses.
- Capital expenses.
- Check-writing fees.
- Club dues.
- Commuting expenses.
- Fees and licenses, such as car licenses, marriage licenses, and dog tags.
- Fines and penalties, such as parking tickets.
- Health spa expenses.
- Hobby losses.
- Home repairs, insurance, and rent.
- Home security system.
- Illegal bribes and kickbacks.
- Investment-related seminars.
- Life insurance premiums.
- Lobbying expenses.
- Losses from the sale of a home, furniture, personal car, etc.
- Lost or misplaced cash or property.
- Lunches with co-workers.
- Meals while working late.
- Medical expenses as business expenses other than medical examinations required by the employer.
- Personal disability insurance premiums.
- Personal legal expenses.
- Personal, living, or family expenses.
- Political contributions.
- Professional accreditation fees.
- Professional reputation, expenses to improve.
- Relief fund contributions.
- Residential telephone line.
- Stockholders' meeting, expenses of attending.
- Tax-exempt income, expenses of earning or collecting.
- The value of wages never received or lost vacation time.
- Travel expenses for another individual.
- Voluntary unemployment benefits fund contributions.
- Wristwatches.

Lost or Mislaid Cash or Property

The taxpayer cannot deduct a loss based on the mere disappearance of money or property. However, an accidental loss or disappearance of property can qualify as a casualty if it results from an identifiable event that is sudden, unexpected, or unusual.

Gift Expenses

The taxpayer can deduct no more than $25 for business gifts he or she gives directly or indirectly to each person during the tax year. A gift to a company that is intended for the eventual personal use or benefit of a particular person or a limited class of people will be considered an indirect gift to that particular person or to the individuals within that class of people who receive the gift. The IRS provides detailed guidance on these types of expenses in IRS Publication 463 - Travel, Entertainment, Gift, and Car Expenses. [134]

Medical Expenses

If the taxpayer paid for medical or dental expenses in 2020, he or she may be able to get a tax deduction for costs not covered by insurance. Here are seven facts from the IRS about claiming the medical and dental expense deduction: (135)

1. The taxpayer can only claim medical and dental expenses for costs not covered by insurance if he or she itemizes deductions on the tax return. The taxpayer cannot claim medical and dental expenses if he or she takes the standard deduction.
2. The taxpayer can deduct medical and dental expenses that are more than 7.5% of adjusted gross income.
3. The taxpayer can include medical and dental costs paid in 2020, even if he or she received the services in a previous year. Keep good records to show the amount paid.
4. The taxpayer may include most medical or dental costs paid for him or herself, his or her spouse and his or her dependents. Some exceptions and special rules apply.
5. The taxpayer can normally claim the costs of diagnosing, treating, easing, or preventing disease. The costs of prescription drugs and insulin qualify. The cost of medical, dental and some long-term care insurance also qualify.
6. The taxpayer may be able to claim the cost of travel to obtain medical care. That includes the cost of public transportation or an ambulance as well as tolls and parking fees. If he or she uses his or her car for medical travel, the taxpayer can deduct the actual costs, including gas and oil. Instead of deducting the actual costs, the taxpayer can deduct the standard mileage rate for medical travel, which is 17 cents per mile for 2020.
7. Funds from Health Savings Accounts or Flexible Spending Arrangements used to pay for medical or dental costs are usually tax-free. Therefore, the taxpayer cannot deduct expenses paid with funds from those plans.

Medical expenses are defined as expenditures to prevent, cure, or improve a physical or mental defect or illness.

These expenses include but are not limited to the following items: (34)

- Amount paid to physicians, surgeons, dentists, optometrists, chiropractors, chiropodists, podiatrists, osteopaths, psychiatrists, psychologists, and Christian Science practitioners.
- Hospital and clinic charges for in-patient board and lodging, X-rays, therapy treatments, laboratory, nursing care, surgery, obstetrics, treatment for alcoholism, etc.
- Cost and maintenance of certain appliances and medical aids such as false teeth, hearing aids, seeing eye dogs, orthopedic braces, artificial limbs, arch supports, eyeglasses, crutches, wheelchairs, truss belts, etc.
- Prescription medicines and insulin.
- Certain transportation costs incurred for the purpose of securing medical treatment. Personal use of automobile for medical transportation can be deducted at a standard rate per mile. The rate for tax year 2020 is 17 cents per mile.
- Premiums paid for hospitalization insurance.
- Certain capital expenditures made to a taxpayer's home for medical reasons.
- Cost of special training for the handicapped (such as for the blind to learn the Braille system or the deaf to learn lip-reading).
- Expenses incurred to remove structural barriers in the home of a physically handicapped person.
- Lodging costs essential to medical care provided by a physician in a licensed hospital.

Tip

A taxpayer cannot include in medical expenses the cost of dancing lessons, swimming lessons, etc., even if they are recommended by a doctor, if they are only for the improvement of general health. For a complete list of medical expenses that are includible and are not includible see Publication 502 - Medical and Dental Expenses.

Expenses that fall into any of these categories are said to be deductible. In some cases, however, certain percentage limitations may apply to reduce the amount of the deduction. Medical expenses for elective cosmetic surgery are not deductible. The relationship between deductions and limitations is expressed in the following formula: Medical expenses that qualify as deductions less applicable limitations equal medical expenses that result in an itemized deduction.

Rules for Deduction of Medical Expenses

The Consolidated Appropriations Act, 2021 makes permanent the lower threshold of 7.5% for all taxpayers, originally restored for 2017 and 2018 and then extended for 2019 and 2020.

For 2020, A taxpayer can deduct only the part of his or her medical and dental expenses that exceed 7.5% of his or her adjusted gross income (AGI). However, the current cost of medical insurance is so high that many families can exceed this limitation. Not only is the entire amount of medical or health insurance added with other medical expenses, but all prescription drugs and insulin are included. (34)

Medical care expenses include the insurance premiums the taxpayer paid for policies that cover medical care or for a qualified long-term care insurance policy covering qualified long-term care services. The taxpayer can include in medical expenses the amount he or she pays for eye examinations. He or she can also include in medical expenses amounts he or she pays for eyeglasses and contact lenses needed for medical reasons. Additionally, the taxpayer can include in medical expenses the amount he or she pays for eye surgery to treat defective vision, such as laser eye surgery or radial keratotomy.

If the taxpayer is an employee, medical expenses do not include that portion of his or her premiums treated as paid by the employer under its sponsored group accident or health policy or qualified long-term care insurance policy. Further, medical expenses do not include the premiums that the taxpayer paid under his or her employer-sponsored policy under a premium conversion policy.

If the taxpayer is self-employed and has a net profit for the year, he or she may be able to deduct (as an adjustment to income) the premiums paid on a health insurance policy covering medical care including a qualified long-term care insurance policy for him or herself and their spouse and dependents. The taxpayer cannot take this deduction for any month in which he or she was eligible to participate in any subsidized health plan maintained by an employer, a former employer, his or her spouse's employer, or a former spouse's employer.

If the taxpayer does not claim 100% of the self-employed health insurance deduction, he or she can include the remaining premiums with other medical expenses as an itemized deduction on Schedule A (Form 1040). The taxpayer may not deduct insurance premiums paid by an employer-sponsored health insurance plan (cafeteria plan) unless the premiums are included in Box 1 of Form W-2. (35)

Qualified Long-Term Care Insurance Premiums

The definition of medical care was expanded to include the amounts paid for qualified long-term care services and eligible long-term premiums paid under approved long-term care insurance policies. Qualified long-term care services are necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, rehabilitative services, and maintenance and personal care services that are: (75)

1. Required by a chronically ill individual.
2. Provided pursuant to a plan of care prescribed by a licensed health care practitioner.

A qualified long-term care insurance contract is an insurance contract that provides only coverage of qualified long-term care services. The contract must: (75)

1. Be guaranteed renewable.
2. Not provide for a cash surrender value or other money that can be paid, assigned, pledged, or borrowed.
3. Provide that refunds, other than refunds on the death of the insured or complete surrender or cancellation of the contract, and dividends under the contract must be used only to reduce future premiums or increase future benefits.
4. Generally, not pay or reimburse expenses incurred for services or items that would be reimbursed under Medicare, except where Medicare is a secondary payer, or the contract makes per diem or other periodic payments without regard to expenses.

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) by age (at of the close of the tax year) of the taxpayer:

Age Group	2020 Eligible Premium Amount
Age 40 and under	$430
Ages 41 through 50	$810
Ages 51 through 60	$1,630
Ages 61 through 70	$4,350
Age 71 and over	$5,430
Note: The limit on premiums is for each person.	

Table 3-2 - Publication 502 - Medical and Dental Expenses (2020)

Transportation

Include in medical expenses amounts paid for transportation primarily for, and essential to, medical care. A taxpayer can include: (136)

- Bus, taxi, train, or plane fares, or ambulance service.
- Transportation expenses of a parent who must go with a child who needs medical care.
- Transportation expenses of a nurse or other person who can give injections, medications, or other treatment required by a patient who is traveling to get medical care and who is unable to travel alone.
- Transportation expenses for regular visits to see a mentally ill dependent, if these visits are recommended as a part of treatment.

The taxpayer can take into account out-of-pocket expenses, such as the cost of gas and oil, when he or she utilizes his or her car for medical reasons. The taxpayer cannot include depreciation, insurance, general repair, or maintenance expenses. If the taxpayer does not want to use his or her actual automobile expenses for 2020, he or she can use the standard medical mileage rate of 17 cents per mile. The taxpayer can also include parking fees and tolls. He or she can add these fees and tolls to his or her medical expenses whether he or she uses actual automobile expenses or use the standard mileage rate.

Taxes

The itemized deduction for taxes may vary from state to state and even from city to city. Much depends upon the nature of the tax imposed, and there is little uniformity in state and local taxation. Any general rules, therefore, may be subject to qualifications that depend on state and local circumstances. But general rules are a good place to start, since they provide a basis for further investigation of the taxpayer's own state and local taxes.

To deduct any tax the following two tests must be met: (137)

1. The tax must be imposed on the taxpayer.
2. The taxpayer must pay the tax during the tax year.

Tip

Another useful rule is that Federal taxes are never deductible, but some state and local taxes are allowed. The rule is only valid as to deductions claimed on the Federal income tax return. Many states permit the deductions of some Federal taxes against the state income tax.

State, Local and Foreign Income Taxes

Under the Tax Cuts and Jobs Act (TCJA), state, local and foreign property taxes, and state and local sales taxes, are fully deductible only paid or accrued in carrying on a trade or business or an activity relating to the expenses for the production of income. Therefore, taxpayers may only fully claim deductions for these taxes that are currently deductible when figuring income on Schedule C, Schedule E or Schedule F.

However, a taxpayer may claim an itemized deduction of up to $10,000 ($5,000 for a married, filing separately taxpayer) for the aggregate of state and local property taxes not paid or accrued in carrying on a trade or business activity and state and local income, war profits and excess profits taxes (or sales taxes rather than income taxes) paid or accrued during the year. Foreign real property taxes may not be deducted under this exception.

There are four types of deductible nonbusiness taxes:

- State, local, and foreign income taxes.
- State and local general sales taxes.
- State and local real estate taxes.
- State and local personal property taxes.

State and Local General Sales Taxes

State and local income taxes withheld from the taxpayer's wages during the year appear on his or her Form W-2 - Wage and Tax Statement. The taxpayer can elect to deduct state and local general sales taxes instead of state and local income taxes, but he or she cannot deduct both. If the taxpayer elects to deduct state and local general sales taxes, he or she can use either his or her actual expenses or the optional sales tax tables. The following amounts are also deductible:

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

Generally, the taxpayer can take either a deduction or a tax credit for foreign income taxes imposed on him or her by a foreign country or a United States possession.

State and Local Real Estate Taxes

Deductible real estate taxes are generally any state or local taxes on real property levied for the general public welfare. The charge must be uniform against all real property in the jurisdiction at a like rate.

There are popular loan programs that finance energy saving improvements through government-approved programs. The taxpayer signs up for a home energy system loan and use the proceeds to make energy improvements to his or her home. In some programs, the loan is secured by a lien on his or her home and appears as a special assessment or special tax on his or her real estate property tax bill over the period of the loan. The payments on these loans may appear to be deductible real estate taxes; however, they are not deductible real estate taxes. Assessments or taxes associated with a specific improvement benefitting one home are not deductible. However, the interest portion of the taxpayer's payment may be deductible as home mortgage interest.

Many states and counties also impose local benefit taxes for improvements to property, such as assessments for streets, sidewalks, and sewer lines. The taxpayer cannot deduct these taxes. However, he or she can increase the cost basis of his or her property by the amount of the assessment.

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

State and Local Personal Property Taxes

Under the Tax Cuts and Jobs Act (TCJA), state, local and foreign property taxes, and state and local sales taxes, are fully deductible only if paid or accrued in carrying on a trade or business or an activity relating to the expenses for the production of income. Therefore, taxpayers may only fully claim deductions for these taxes that are currently deductible when figuring income on Schedule C, Schedule E or Schedule F.

However, a taxpayer may claim an itemized deduction of up to $10,000 ($5,000 for a married, filing separately taxpayer) for the aggregate of state and local property taxes not paid or accrued in carrying on a trade or business activity and state and local income, war profits and excess profits taxes (or sales taxes rather than income taxes) paid or accrued during the year. Foreign real property taxes may not be deducted under this exception.

Deductible personal property taxes are those based only on the value of personal property such as a boat or car. Personal property tax is deductible if it is a state or local tax that is: [32]

- Charged on personal property.

- Based only on the value of the personal property.
- Charged on a yearly basis, even if it is collected more or less than once a year.

Some taxes and fees the taxpayer cannot deduct on Schedule A include Federal income taxes, Social Security taxes, transfer taxes (or stamp taxes) on the sale of property, homeowner's association fees, estate and inheritance taxes, and service charges for water, sewer, or trash collection.

Under the TCJA, a taxpayer who makes payments or transfers property to an entity eligible to receive tax deductible contributions must reduce their charitable deduction by the amount of any state or local tax credit the taxpayer receives or expects to receive.

For example, if a state grants a 70% state tax credit and the taxpayer pays $1,000 to an eligible entity, the taxpayer receives a $700 state tax credit. The taxpayer must reduce the $1,000 contribution by the $700 state tax credit, leaving an allowable contribution deduction of $300 on the taxpayer's Federal income tax return. The regulations also apply to payments made by trusts or decedents' estates in determining the amount of their contribution deduction.

Nondeductible Taxes

The following taxes are not deductible for Federal income tax purposes: [137]

- Federal and state gift taxes.
- Federal and state death taxes.
- Federal income taxes.
- Federal excise taxes on telephone calls, airline tickets, gasoline, tobacco, wine, whiskey, etc.
- Federal stamp taxes on the sale of securities or real estate and the issuance of bonds and stock.
- Employment taxes including Medicare, Federal Social Security and railroad retirement taxes (other than one-half self-employment tax paid by a self-employed taxpayer).
- State excise taxes.
- State sales taxes.
- State occupational taxes.
- Per capita taxes.
- State license fees, including dog license, auto tags, hunting and fishing licenses, marriage license, and safety inspection charges for automobiles.
- State and local gasoline taxes.
- Fines and penalties.
- Estate, inheritance, legacy or succession taxes (except when the estate tax is a miscellaneous deduction that is not subject to the 2%-of-adjusted-gross-income limit).

Excise Taxes

Excise taxes are taxes paid when purchases are made on a specific good, such as gasoline. Excise taxes are often included in the price of the product. There are also excise taxes on activities, such as on wagering or on highway usage by trucks. Excise Tax has several general excise tax programs. One of the major components of the excise program is motor fuel. [138]

Recently, the Supreme Court ruled that the Professional and Amateur Sports Protection Act was unconstitutional. As a result, each state may decide whether to allow sports wagering. Sports wagering, like wagering in general, is subject to Federal excise taxes, regardless of whether the activity is allowed by the state. Also, as of July 1, 2010, indoor tanning services will be subject to a 10% excise tax under the Affordable Care Act.

Under the Tax Cut and Jobs Act (TCJA), certain payments made by an aircraft owner (or, in certain cases, a lessee) related to the management of private aircraft are exempt from the excise taxes imposed on taxable transportation by air.

Deduction for Qualified Business Income

For tax years beginning after 2017, the taxpayer may be entitled to a deduction of up to 20% of his or her qualified business income from his or her qualified trade or businesses plus 20% of the aggregate amount of qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership income. The deduction is subject to various limitations, such as limitations based on the type of the taxpayer's trade or business, his or her taxable income, the amount of W-2 wages paid with respect to the qualified trade or business, and the unadjusted basis of qualified property held by his or her trade or business. The taxpayer will claim this deduction on Form 1040, not on Schedule C. Unlike other deductions, this deduction can be taken in addition to the standard or itemized deductions.

The provision is actually comprised of three separate deductions. The first deduction is the "20% pass-through deduction." In its most simple terms, Section 199A grants an individual business owner (as well as some trusts and estates) a deduction equal to 20% of the taxpayer's qualified business income. In 2020, for business owners with taxable income in excess of $213,300 ($426,600 in the case of taxpayers married filing jointly), however, no deduction is allowed against income earned in a "specified service trade or business." In addition, at these same income levels, the deduction against income earned in an eligible business is limited to the greater of:

- 50% of the taxpayer's share of the W-2 wages with respect to the qualified trade or business, or
- The sum of 25% of the taxpayer's share of the W-2 wages with respect to the qualified trade or business, plus 2.5% of the taxpayer's share of the unadjusted basis immediately after acquisition of all qualified property.

Once this deduction is computed and limited, as appropriate, it is added to the second deduction for 20% of the taxpayer's qualified REIT dividends and publicly traded partnership (PTP) income for the year.

These two deductions are truly separate and distinct. For example, if a taxpayer has a net loss from his or her flow-through businesses, it does not preclude the taxpayer's ability to claim a deduction of 20% of REIT dividends and PTP income. Likewise, if a taxpayer's sum of REIT dividends and PTP income is a loss, it does not reduce the taxpayer's pass-through deduction. After each separate deduction is computed, they are added together and then subjected to an overall limitation, equal to 20% of the excess of:

- The taxpayer's taxable income for the year (before considering the Section 199A deduction), over
- The sum of net capital gain (as defined in Section 1(h)). This includes qualified dividend income taxed at capital gains rates, as well as any unrecaptured Section 1250 gain taxed at 25% and any collectibles gain taxed at 28%.

The third deduction applies only to specified agricultural and horticultural cooperatives.

Specified Service Trades or Businesses (SSTB)

A taxpayer must be engaged in a "qualified trade or business" in order to claim the Section 199A deduction. Section 199A defines a qualified trade or business by exclusion; every trade or business is a qualified business other than:

- The trade or business of performing services as an employee, and
- A specified service trade or business.

The first prohibition prevents an employee from claiming a 20% deduction against his or her wage income.

Qualified Business Income

Once a taxpayer has established that he or she is engaged in a Section 162 trade or business, the taxpayer must determine the "qualified business income (QBI)" for each separate qualified trade or business. QBI is defined as the net amount of qualified items of income, gain, deduction and loss with respect to a qualified trade or business that is effectively connected with the conduct of a business within the United States. As a result, QBI does not include certain investment-related income, including the following:

- Any item of short-term capital gain, short-term capital loss, long-term capital gain, long-term capital loss, or any item treated as capital gain or loss.
- Dividend income, income equivalent to a dividend, or payment in lieu of a dividend described in Section 954(c)(1)(G).
- Any interest income other than interest income properly allocable to a trade or business.
- Net gain from foreign currency transactions and commodities transactions.
- Income from notional principal contracts.
- Any amount received from an annuity which is not received in connection with the trade or business.
- Any deduction or loss properly allocable to the items described above.

Additionally, the Section 199A deduction does not reduce a partner or shareholder's basis in the partnership interest or stock. The deduction does not reduce net earnings from self-employment or net investment income tax. The same Section 199A deduction for regular tax purposes is allowed for AMT purposes. The threshold for the accuracy related penalty under Section 6662 for anyone claiming the Section 199A deduction is reduced so that it applies to any understatement that exceeds the greater of $5,000 or 5% of the tax required to be shown on the return (it is normally 10%).

Figuring the Deduction

The taxpayer should use Form 8995 - Qualified Business Income Deduction Simplified Computation to figure his or her qualified business income (QBI) deduction. Individual taxpayers and some trusts and estates may be entitled to a deduction up to 20% of their net QBI from a trade or business, including income from a pass-through entity, but not from a C corporation, plus 20% of qualified real estate investment trust (REIT) dividends and qualified publicly trade partnership (PTP) income. However, the taxpayer's total QBI deduction is limited to 20% of his or her taxable income, calculated before the QBI deduction, minus net capital gain. Also, total taxable income in 2020 must be under $163,300 for single filers or $326,600 for joint filers to qualify. If the taxpayer is over that limit, complex IRS rules determine whether his or her business income qualifies for a full or partial deduction.

The taxpayer should use Form 8995-A - Qualified Business Income Deduction to figure his or her qualified business income (QBI) deduction. He or she includes the following schedules as appropriate:

- Schedule A (Form 8995-A), Specified Service Trades or Businesses (SSTB).
- Schedule B (Form 8995-A), Aggregation of Business Operations.
- Schedule C (Form 8995-A), Loss Netting and Carryforward.
- Schedule D (Form 8995-A), Special Rules for Patrons of Agricultural or Horticultural Cooperatives.

Depending on the taxpayer's taxable income, his or her QBI component may also be limited based on the type of trade or business, W-2 wages paid by that business, and unadjusted basis immediately after acquisition (UBIA) of qualified property held by the business.

Carryover of Negative QBI Amounts

If the taxpayer's total qualified business income (QBI) amount is less than zero, the negative amount is treated as negative QBI from a separate business in the individual's following tax year. This carryover rule does not affect the deductibility of losses under any other tax code provisions.

Tip

W-2 wages and the unadjusted basis immediately after acquisition (UBIA) of qualified property from a business that produces negative QBI for the current tax year are not taken into account for purposes of the W-2 wage and UBIA of qualified property limitations. In addition, those W-2 wages and the UBIA of qualified property aren't carried over to the following tax year.

Disclosure Requirements

A pass-through entity is required to allocate and disclose QBI, W-2 wages, and UBIA of property. If any one item is not allocated, that item is presumed to be zero. There is no exception for pass-through entities that know that all of its owners have taxable income below the thresholds. In addition, a pass-through entity is required to disclose whether it has multiple trades or businesses, and if any of those businesses are a specified service trade or business (SSTB).

Interest

Interest expense probably leads all other personal deductions from adjusted gross income in placing taxpayers in a position to itemize. Interest on home mortgages is the largest single deduction for most taxpayers. As mortgages run for longer and longer periods of time and as down payments on the purchase of homes decrease, interest charges increase. Mortgage points are also generally deductible as interest, but only if paid on loans used to purchase a *principal residence* of the taxpayer.

To be deductible, interest must actually be owed by the taxpayer claiming the expense. The purpose for which the interest is paid is very important. In addition to excluding interest on funds borrowed to purchase tax-free securities, consumer interest was removed from the list of deductible expenses. Since 1991, no personal consumer interest deduction is allowed. Excluded is interest on credit cards, auto loans and insurance policies. Interest on indebtedness incurred in a trade or business is deductible, as is mortgage interest on the taxpayer's first and second residence, subject to certain limitations.

Investment interest is interest paid on money a person borrowed that is allocable to property held for investment. It does not include any interest allocable to passive activities or to securities that generate tax-exempt income. Complete and attach Form 4952 - Investment Interest Expense Deduction to figure the deduction.

Deductible Home Mortgage Interest

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 decrease 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.

Mortgage interest is any interest that a person pays on a loan that is secured by his or her principal residence. Secured debt, for purposes of the mortgage interest deduction, means that there is a signed written document:

1. That makes ownership in a qualified home security, or collateral for the mortgage debt.
2. That, in case of default on the loan, the home could be taken by the creditor to satisfy the debt.
3. That is recorded or otherwise protected under state or local law.

This includes a mortgage, a second mortgage, a line of credit loan, or a home equity loan. In most cases, the entire amount of interest paid on a mortgage is deductible as an itemized deduction on Schedule A. However, there are some limitations. We will consider only those rules for mortgages taken out after October 13, 1987. First, the home mortgage must be on a qualified home. The qualified home is where the taxpayer lives most of the time. It can be a house, cooperative apartment, condominium, mobile home, house trailer, or houseboat that has sleeping, cooking, and toilet facilities. [33]

A second home can include any other residence the taxpayer owns and treats as a second home. The taxpayer does not have to use the home during the year. However, if he or she rents it to others, the taxpayer must also use it as a home during the year for more than the greater of 14 days or 10% of the number of days it is rented, for the interest to qualify as qualified residence interest. Qualified residence interest and points are generally reported on Form 1098 - Mortgage Interest Statement by the financial institution to which the taxpayer made the payments.

The following mortgages yield qualified residence interest and the taxpayer can deduct all of the interest on these mortgages: [33]

- A mortgage taken out on or before October 13, 1987 (grandfathered debt).
- A mortgage taken out after October 13, 1987, to buy, build, or improve a home (called home acquisition debt) up to a total of $1 million for this debt plus any grandfathered debt. The limit is $500,000 if the taxpayer is married filing separately.
- Home equity debt other than home acquisition debt taken out after October 13, 1987, up to a total of $100,000. The limit is $50,000 if married filing separately. Home equity debt other than home acquisition debt is further limited to the home's fair market value reduced by the grandfathered debt and home acquisition debt.

The taxpayer may be able to take a credit against Federal income tax if he or she was issued a mortgage credit certificate by a state or local government for low-income housing. Use Form 8396 - Mortgage Interest Credit to figure the amount. However, the taxpayer may be subject to a limit (phase-out) on some of the itemized deductions including mortgage interest.

Home Equity Loans

Under the Tax Cuts and Jobs Act (TCJA), 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.

If qualified, the general limitation is that a home equity loan cannot be more than the fair market value of the home minus the amount of acquisition debt remaining on the home at the time of the home equity loan. Further, the maximum dollar limitation on a home equity debt is $100,000 or less, $50,000 if married filing separately, and totaling no more than the fair market value of the home. The taxpayer reports the amount of mortgage interest paid on either line 8a of Schedule A (Form 1040). (139)

If the mortgage interest was paid to a financial institution, it is reported on line 8a, and if to a private person, on line 8b of Schedule A. If the taxpayer paid more than $600 in mortgage interest during the year, the taxpayer should receive a Form 1098 - Mortgage Interest Statement telling the taxpayer exactly how much mortgage interest the taxpayer had paid during the year. If the taxpayer paid mortgage interest and did not receive a Form 1098, report the amount of interest on Line 8b of Schedule A. (140)

Points

The term "points" is used to describe certain charges paid to obtain a home mortgage. Points are prepaid interest and may be deductible as home mortgage interest, if the taxpayer itemizes deductions on Form 1040, Schedule A. If the taxpayer can deduct all of the interest on the mortgage, he or she may be able to deduct all of the points paid on the mortgage. If the acquisition debt exceeds $1,000,000 ($500,000 if married filing separately) or the home equity debt exceeds $100,000 ($50,000 if married filing separately), the taxpayer cannot deduct all the interest on his or her mortgage and he or she cannot deduct all the points.

The taxpayer can deduct the points in full in the year they are paid, if **all** the following requirements are met: (141)

1. The loan is secured by the taxpayer's main home (the main home is the one he or she lives in most of the time).
2. Paying points is an established business practice in the taxpayer's area.
3. The points paid were not more than the amount generally charged in that area.
4. The taxpayer uses the cash method of accounting. This means the taxpayer reports income in the year received and deducts expenses in the year paid.
5. The points were not paid for items that usually are separately stated on the settlement sheet such as appraisal fees, inspection fees, title fees, attorney fees, or property taxes.
6. The funds the taxpayer provided at or before closing, plus any points the seller paid, were at least as much as the points charged. The taxpayer cannot have borrowed the funds from a lender or mortgage broker in order to pay the points.
7. The taxpayer uses the loan to buy or build a main home.
8. The points were computed as a percentage of the principal amount of the mortgage.
9. The amount is clearly shown as points on the settlement statement.

The taxpayer can also fully deduct (in the year paid) points paid on a loan to improve the main home if the above tests one through six are met. Points that do not meet these requirements may be deductible over the life of the loan. Points paid for refinancing generally can only be deducted over the life of the new mortgage. However, if the taxpayer uses part of the refinanced mortgage proceeds to improve the main home, and he or she meets the first six requirements stated above, the taxpayer can fully deduct the part of the points related to the improvement in the year paid with their own funds. The taxpayer can deduct the rest of the points over the life of the loan.

Points charged for specific services, such as preparation costs for a mortgage note, appraisal fees, or notary fees are not interest and cannot be deducted. Points paid by the seller of a home cannot be deducted as interest on the seller's return, but they are a selling expense which will reduce the amount of gain realized. Points paid by the seller may be deducted by the buyer, provided the buyer subtracts the amount from the basis or cost of the residence. Points the taxpayer pays on loans secured by a second home can be deducted only over the life of the loan. (141)

Mortgage Insurance Premiums Deduction

The Bipartisan Budget Act extended through 2017 the treatment of qualified mortgage insurance premiums as interest for purposes of the mortgage interest deduction. This deduction phases out ratably for taxpayers with adjusted gross income of $100,000 to $110,000. The Consolidated Appropriations Act, 2021 extended the deduction for mortgage insurance premiums through 2021. [142]

Cancelled Home Mortgage Debt

The Consolidated Appropriations Act, 2021 includes an extension of the qualified principal residence indebtedness exclusion through 2025. Typically, when debt is forgiven, the discharged amount is included in a taxpayer's gross income. The provision reduces the maximum amount that may be excluded from $2,000,000 to $750,000. Generally, indebtedness must be the result of acquisition, construction, or substantial improvement of primary residence. Many short sales and mortgage modifications include debt forgiveness that falls under the qualified principal residence indebtedness exclusion.

Charitable Contributions

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.

Under the Tax Cuts and Jobs Act no charitable deduction is allowed for any payment to an institution of higher education in exchange for which the payor receives the right to purchase tickets or seating at an athletic event. The law also repeals the donee-reporting exemption from the contemporaneous written acknowledgment requirement for tax years beginning after December 31, 2017.

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 2020. This is true even if he or she does not pay the credit card bill until 2021. Also, a check will count for 2020 as long as the taxpayer mails it in 2020. Use the following lists for a quick check of whether the taxpayer can deduct a contribution.

<table>
<tr><th colspan="2">Examples of Charitable Contributions</th></tr>
<tr><th>Deductible As
Charitable Contributions</th><th>Not Deductible As
Charitable Contributions</th></tr>
<tr><td>Money or property the taxpayer gives to:
• Churches, synagogues, temples, mosques, and other religious organizations.
• 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).
• Nonprofit schools and hospitals.
• The Salvation Army, American Red Cross,</td><td>Money or property the taxpayer gives to:
• Civic leagues, social and sports clubs, labor unions, and chambers of commerce.
• Foreign organizations (except certain Canadian, Israeli, and Mexican charities).
• Groups that are run for personal profit.
• Groups whose purpose is to lobby for law changes.
• Homeowners' associations.</td></tr>
</table>

CARE, Goodwill Industries, United Way, Boy Scouts of America, Girl Scouts of America, Boys and Girls Clubs of America, etc. • War veterans' groups.	• Individuals. • Political groups or candidates for public office.
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 3-3 - Publication 526 - Table 1 - Examples of Charitable Contributions - A Quick Check (2020)

Donations to qualified organizations by a taxpayer are deductible only if the taxpayer itemizes. To be qualified, an organization must be set up and operated exclusively for charitable, religious, educational, scientific, or literary purposes, or for the prevention of cruelty to children or animals. Typical organizations that meet these tests are nonprofit schools and hospitals, churches, the Salvation Army, the Y.M.C.A. and Y.W.C.A., the American Red Cross, the Boy Scouts and Girl Scouts of America, the Disabled American Veterans, CARE, the American Heart Association, the American Cancer Society, the United Cerebral Palsy Association, the Multiple Sclerosis National Society, Lincoln College, The Civil War Preservation Trust, The Abraham Lincoln Association, and The Civil War Round Table.

To be deductible, charitable contributions must be made to qualified organizations. Payments to individuals, a political organization or a political candidate are never deductible. To determine if the organization that the taxpayer contributed to qualifies as a charitable organization for income tax deductions, review Exempt Organizations Select Check on the IRS.gov website.

Qualified organizations generally include nonprofit groups whose purpose is:

- Religious.
- Charitable.
- Educational.
- Scientific.
- Literary.
- Preventing cruelty to children or animals.

If the contribution entitles an individual to merchandise, goods, or services, including admission to a charity ball, banquet, theatrical performance, or sporting event, he or she can deduct only the amount that exceeds the fair market value of the benefit received.

Contribution Percentage Limitations

The Coronavirus Aid, Relief, and Economic Security Act (CARES) allows an individual to make a cash contribution of up to $300 made to certain qualifying charities and deduct the contribution "above-the-line" in computing adjusted gross income. Thus, the taxpayer receives the deduction in addition to the standard deduction. This above-the-line deduction is here for 2020 and beyond but is available only to a taxpayer who does not itemize their deductions.

For taxpayers that do itemize their deductions, the CARES Act temporarily lifts the limits on charitable giving for 2020. After passage of the TCJA, cash contributions to public charities are generally limited to 60% of a taxpayer's adjusted gross income (AGI). The CARES Act allows such contributions to be deducted up to 100% of adjusted gross income (AGI) for 2020, with any excess contributions available to be carried over to the next five years.

Under the TCJA no charitable deduction is allowed for any payment to an institution of higher education in exchange for which the payor receives the right to purchase tickets or seating at an athletic event. The TCJA also repeals the donee-reporting exemption from the contemporaneous written acknowledgment requirement for tax years beginning after December 31, 2017. (143)

Written Substantiation Required

Charitable contributions of $250 or more must be substantiated by a written acknowledgment from the donee or receiving organization. Generally, the acknowledgment must include the amount of cash and a description of non-cash contributions, together with a description and good faith estimate of the value of any goods or services received for the contributions. Contributions made by payroll deduction may be substantiated with an employer-provided document, such as a paystub or Form W-2. Appraisal fees incurred by a taxpayer in determining the fair market value of donated property are not to be treated as part of the charitable contribution.

If the taxpayer made the contribution by phone or text message, a telephone bill showing the name of the donee organization, the date of the contribution, and the amount of the contribution will satisfy the recordkeeping requirement. Therefore, for example, if the taxpayer made a $10 charitable contribution by text message that was charged to his or her telephone or wireless account, a bill from the taxpayer's telecommunications company containing this information satisfies the recordkeeping requirement. (143)

Noncash Deductions Over $500

A taxpayer is required to attach Form 8283 – Noncash Charitable Contributions if the taxpayer claims a deduction over $500 for all non-cash charitable contributions. Generally, the taxpayer cannot take a deduction for clothing or household items donated unless the clothing or household items are in good used condition or better. However, he or she can take a deduction for $500 or more for a contribution of an item of clothing or household item (such as an appliance or furniture) that is not in good used condition or better if he or she includes a qualified appraisal of it with the return.

Noncash contributions over $5,000 must be substantiated with a contemporaneous written acknowledgement, with a qualified appraisal prepared by a qualified appraiser, and a completed Form 8283, Section B, that is filed with the return claiming the deduction. However, the taxpayer does not need a written appraisal for a qualified vehicle - such as a car, boat, or airplane- if his or her deduction for the qualified vehicle is limited to the gross proceeds from its sale and he or she obtained a contemporaneous written acknowledgment. (143)

Charitable Donation of Vehicles

Effective since tax year 2005, a taxpayer contributing a qualified vehicle valued at over $500 to a charity must meet new more stringent substantiation requirements. The taxpayer must obtain from the charity a Form 1098-C Contributions of Motor Vehicles, Boats, and Airplanes or a contemporaneous written statement that names the taxpayer, contains the taxpayer's Social Security number and the vehicle's identification number.

This statement must be attached to the donor's tax return. If the vehicle is sold, the gross proceeds are the taxpayer's charitable contribution for the vehicle. If the charity retains the vehicle for their use or to make a substantial improvement, the statement must state this fact with the estimated amount of time the charity will use the vehicle. The taxpayer will then be allowed to claim the fair market value of the qualified vehicle as a charitable donation. Qualified vehicles are defined as motor vehicles manufactured for use on public roads and highways, boats, and aircraft.

Contributions From Which the Taxpayer Benefits

If the taxpayer receives a benefit as a result of making a contribution to a qualified organization, he or she can deduct only the amount of his or her contribution that is more than the value of the benefit he or she receives. If the taxpayer pays more than fair market value to a qualified organization for goods or services, the excess may be a charitable contribution. For the excess amount to qualify, he or she must pay it with the intent to make a charitable contribution. Additionally, If the taxpayer receives or expect to receive a financial or economic benefit as a result of making a contribution to a qualified organization, he or she cannot deduct the part of the contribution that represents the value of the benefit he or she receives. Under the Tax Cuts and Jobs Act, no deduction is allowed for amounts paid in exchange for college or university athletic event seating rights. Also, if the taxpayer receives or expect to receive a state or local tax credit as a result of his or her contribution, the amount the taxpayer can deduct may be reduced or not allowed.

Value of Services

A taxpayer may deduct certain out of pocket costs that a taxpayer incurs in the giving of services to a qualified charity. For example, in tax year 2020, a taxpayer can deduct the cost of special uniforms, telephone expenses, car expenses, either using the actual mileage method or the standard mileage rate of 14 cents per mile, and other travel expenses as long as there is no significant element of personal recreation or pleasure involved in the travel. Gifts to Charity are claimed on Lines 11-14, Schedule A, Form 1040. However, the taxpayer cannot deduct the value of his or her time or services that includes blood donations to the American Red Cross or to blood banks and the value of income lost while he or she works as an unpaid volunteer for a qualified organization. (143)

Qualified Charitable Distributions (QCD)

The Protecting Americans from Tax Hikes Act of 2015 made permanent the tax exemption of distributions from individual retirement accounts for charitable purposes. A qualified charitable distribution (QCD) is a distribution made directly by the trustee of the taxpayer's individual retirement arrangement (IRA), other than a SEP or SIMPLE IRA, to certain qualified organizations. The taxpayer must have been at least age 70½ when the distribution was made. The taxpayer's total QCDs for the year cannot be more than $100,000 but it can count as a required minimum distribution (RMD). If all the requirements are met, a QCD is nontaxable, but the taxpayer cannot claim a charitable contribution deduction for a QCD. Also, the distribution does not apply to a Roth IRA, which has tax-free withdrawals and no required distributions.

Casualty and Theft Losses

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.

Personal casualty and theft losses of an individual, sustained in a tax year beginning after 2017, are deductible only to the extent that the losses are attributable to a Federally declared disaster. Personal casualty and theft losses attributable to a Federally declared disaster are subject to the $100 per casualty and 10% of the taxpayer's adjusted gross income (AGI) limitations. An exception to the rule, limiting the personal casualty and theft loss deduction to losses attributable to a Federally declared disaster, applies if the taxpayer has personal casualty gains for the tax year. In this case, he or she will reduce his or her personal casualty gains by any casualty losses not attributable to a Federally declared disaster. Any excess gain is used to reduce losses from a Federally declared disaster.

Also, under the TCJA, for tax years 2018 through 2025, if the taxpayer is an individual, casualty losses of personal-use property are deductible only if the loss is attributable to a Federally declared disaster (Federal casualty loss). If the event causing the taxpayer to suffer a personal casualty loss (not attributed to a Federally declared disaster) occurred before January 1, 2018, but the casualty loss was not sustained until January 1, 2018, or later, the casualty loss is not deductible.

Other Miscellaneous Deductions

Miscellaneous Itemized Deductions

Under the Tax Cuts and Jobs Act (TCJA) the provisions (which took 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:

- Business bad debt of an employee.
- Business liability insurance premiums.
- Damages paid to a former employer for breach of an employment contract.
- Depreciation on a computer the taxpayer's employer requires him or her to use in his or her work.
- Dues to a chamber of commerce if membership helps the taxpayer do his or her job.
- Dues to professional societies.
- Educator expenses.
- Home office or part of the taxpayer's home used regularly and exclusively in his or her work.
- Job search expenses in the taxpayer's present occupation.
- Laboratory breakage fees.
- Legal fees related to the taxpayer's job.
- Licenses and regulatory fees.
- Malpractice insurance premiums.
- Medical examinations required by an employer.
- Occupational taxes.
- Passport for a business trip.
- Repayment of an income aid payment received under an employer's plan.
- Research expenses of a college professor.
- Rural mail carriers' vehicle expenses.
- Subscriptions to professional journals and trade magazines related to the taxpayer's work.
- Tools and supplies used in the taxpayer's work.
- Travel, transportation, meals, entertainment, gifts, and local lodging related to the taxpayer's work.
- Union dues and expenses.
- Work clothes and uniforms if required and not suitable for everyday use.
- Work-related education.

Note

Also qualifying as miscellaneous expenses are the expenses that taxpayers incur for tax preparation and other tax-related services such as tax counsel fees and appraisal fees.

Other suspended miscellaneous deductions subject to the 2% include: [78]

- Appraisal fees for a casualty loss or charitable contribution.
- Casualty and theft losses from property used in performing services as an employee.
- Clerical help and office rent in caring for investments.
- Depreciation on home computers used for investments.
- Excess deductions (including administrative expenses) allowed a beneficiary on termination of an estate or trust.
- Fees to collect interest and dividends.
- Hobby expenses, but generally not more than hobby income.
- Indirect miscellaneous deductions from pass-through entities.
- Investment fees and expenses.
- Legal fees related to producing or collecting taxable income or getting tax advice.
- Loss on deposits in an insolvent or bankrupt financial institution.
- Loss on traditional IRAs or Roth IRAs when all amounts have been distributed to the taxpayer.
- Repayments of income.
- Repayments of social security benefits.
- Safe deposit box rental, except for storing jewelry and other personal effects.
- Service charges on dividend reinvestment plans.
- Tax advice fees.
- Trustee's fees for the taxpayer's IRA, if separately billed and paid.

Other miscellaneous itemized deductions subject to the 2% floor include:

- Repayments of income received under a claim of right (only subject to the 2% floor if less than $3,000).
- Repayments of Social Security benefits.
- The share of deductible investment expenses from pass-through entities.

Moving Expense Deduction Suspended Except in Limited Situations

For 2018 through 2025, employers must include moving expense reimbursements in employees' wages. The Tax Cuts and Jobs Act (TCJA) suspends the exclusion for qualified moving expense reimbursements. However, members of the U.S. Armed Forces can still exclude qualified moving expense reimbursements from their income if:

- They are on active duty.
- They move pursuant to a military order and incident to a permanent change of station.
- The move expenses would qualify as a deduction if the employee did not get a reimbursement.

Deductions Not Subject to the 2% Limit

The taxpayer can deduct the items listed below as miscellaneous itemized deductions. They are not subject to the 2% limit. The taxpayer reports these items on Schedule A (Form 1040) or Schedule A (Form 1040-NR).

- 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.
- An ordinary loss attributable to a contingent payment debt instrument or an inflation-indexed debt instrument (for example, a Treasury Inflation-Protected Security).
- Repayments of more than $3,000 under a claim of right.
- Unrecovered investment in an annuity.

Gambling Losses Up to the Amount of Gambling Winnings

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 (TCJA) 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." The taxpayer must report the full amount of gambling winnings for the year on Schedule 1 (Form 1040), line 8. He or she deducts gambling losses for the year on Schedule A (Form 1040), line 16. The taxpayer cannot deduct gambling losses that are more than winnings. Generally, nonresident aliens cannot deduct gambling losses on Schedule A (Form 1040-NR).

Note: The taxpayer cannot reduce gambling winnings by gambling losses and report the difference. He or she must report the full amount of winnings as income and claim losses (up to the amount of winnings) as an itemized deduction. Therefore, the taxpayer's records should show winnings separately from losses. The taxpayer must keep an accurate diary or similar record of losses and winnings. [78]

The diary should contain at least the following information: [78]

- The date and type of the specific wager or wagering activity.
- The name and address or location of the gambling establishment.

- The names of other persons present with the taxpayer at the gambling establishment.
- The amount(s) the taxpayer won or lost.

In addition to the diary, the taxpayer should also have other documentation. He or she can generally prove winnings and losses through Form W-2G - Certain Gambling Winnings, Form 5754 - Statement by Person(s) Receiving Gambling Winnings, wagering tickets, canceled checks, substitute checks, credit records, bank withdrawals, and statements of actual winnings or payment slips provided to the taxpayer by the gambling establishment.

Casualty and Theft Losses of Income-Producing Property

The taxpayer can deduct a casualty or theft loss as a miscellaneous itemized deduction not subject to the 2% limit if the damaged or stolen property was income-producing property (property held for investment, such as stocks, notes, bonds, gold, silver, vacant lots, and works of art). First report the loss in Section B of Form 4684 - Casualties and Thefts. The taxpayer may also have to include the loss on Form 4797 - Sales of Business Property if he or she is otherwise required to file that form. To figure the deduction, add all casualty or theft losses from this type of property included on Form 4684, lines 32 and 38b, or Form 4797, line 18a. (78)

Loss From Other Activities From Schedule K-1

If the amount reported in Schedule K-1- Beneficiary's Share of Income, Deductions, Credits (Form 1065-B), box 2, is a loss, report it on Schedule A (Form 1040), line 16, or Schedule A (Form 1040-NR), line 14 (only if effectively connected with a U.S. trade or business). It is not subject to the passive activity limitations. (78)

Federal Estate Tax on Income in Respect of a Decedent

The taxpayer can deduct the Federal estate tax attributable to income in respect of a decedent that he or she as a beneficiary include in his or her gross income. Income in respect of the decedent is gross income that the decedent would have received had death not occurred and that was not properly includible in the decedent's final income tax return. (78)

Amortizable Premium on Taxable Bonds

In general, if the amount the taxpayer pays for a bond is greater than its stated principal amount, the excess is bond premium. The taxpayer can elect to amortize the premium on taxable bonds. The amortization of the premium is generally an offset to interest income on the bond rather than a separate deduction item. (78)

- *Pre-1998 election to amortize bond premium* - Generally, if the taxpayer first elected to amortize bond premium before 1998, the above treatment of the premium does not apply to bonds acquired before 1988.
- *Bonds acquired after October 22, 1986, and before 1988* - The amortization of the premium on these bonds is investment interest expense subject to the investment interest limit, unless the taxpayer choses to treat it as an offset to interest income on the bond.
- *Bonds acquired before October 23, 1986* - The amortization of the premium on these bonds is a miscellaneous itemized deduction not subject to the 2% limit.

On certain bonds (such as bonds that pay a variable rate of interest or that provide for an interest-free period), the amount of bond premium allocable to a period may exceed the amount of stated interest allocable to the period. If this occurs, treat the excess as a miscellaneous itemized deduction that is not subject to the 2% limit. However, the amount deductible is limited to the amount by which the total interest inclusions on the bond in prior periods exceed the total amount the taxpayer treated as a bond premium deduction on the bond in prior periods. If any of the excess bond premium cannot be deducted because of the limit, this amount is carried forward to the next period and is treated as bond premium allocable to that period. (78)

Repayments Under Claim of Right

Under the Tax Cuts and Jobs Act (TCJA), for tax years beginning after December 31, 2017 until January 1, 2026, the deduction for miscellaneous itemized deductions that are subject to the 2% floor is suspended. Therefore, no miscellaneous itemized deductions may be claimed by an individual on Schedule A of Form 1040 for tax years 2018 through 2025. Consequently, if the amount the taxpayer repaid was $3,000 or less, the taxpayer will no longer deduct it as a miscellaneous itemized deduction on Schedule A (Form 1040) as repayments of income received under a claim of right as repayments are subject to the 2% floor if less than $3,000. If the taxpayer had to repay more than $3,000 that he or she included in his or her income in an earlier year because at the time he or she thought they had an unrestricted right to it, the taxpayer may be able to deduct the amount he or she repaid or take a credit against the tax in the year that they repaid it. When a repayment occurs, the taxpayer may:

- Reduce his or her income in the current year.
- Deduct the amount repaid as a miscellaneous deduction on Schedule A, Form 1040 in the year in which it is repaid.
- Take a refundable credit against tax on Form 1040 for the year that repayment occurs.

The prior year return cannot be amended. The taxpayer can use the method (deduction or credit) that results in less tax. The taxpayer generally deducts the repayment on the same form or schedule on which he or she previously reported it as income.

Whether the repayment is deemed a reduction in income, a miscellaneous itemized deduction, or a tax credit depends upon the amount of the repayment and the type of income that was included in the previous year. If the amount repaid was $3,000 or less, a Claim of Right under IRC Section 1341 does not apply.

Note

When determining whether the amount the taxpayer repaid was more or less than $3,000, consider the total amount being repaid on the return. Each instance of repayment is not considered separately. [78]

Unrecovered Investment in Annuity

A retiree who contributed to the cost of an annuity can exclude from income a part of each payment received as a tax-free return of the retiree's investment. If the retiree dies before the entire investment is recovered tax free, any unrecovered investment can be deducted on the retiree's final income tax return.

If the taxpayer receives annuity payments from a nonqualified retirement plan, he or she must use the General Rule. Under the General Rule, the taxpayer figures the taxable and tax-free parts of his or her annuity payments using life expectancy tables that the IRS issues. [78]

Impairment-Related Work Expenses

If the taxpayer has a physical or mental disability that limits him or her being employed, or substantially limits one or more of his or her major life activities, such as performing manual tasks, walking, speaking, breathing, learning, and working, the taxpayer can deduct the impairment-related work expenses. Impairment-related work expenses are ordinary and necessary business expenses for attendant care services at the taxpayer’s place of work and other expenses in connection with the taxpayer’s place of work that are necessary for him or her to be able to work. If the taxpayer is self-employed, he or she should enter his or her impairment-related work expenses on the appropriate form (Schedule C, E, or F) that he or she used to report his or her business income and expenses. [78]

Total Itemized Deductions

After completing all of the sections that apply to a given taxpayer, enter the total on line 17 of Schedule A (Form 1040). This is the total of all itemized deductions. If the taxpayer elects to itemize for state tax or other purposes even though the itemized deductions are less than the standard deduction, check the box on line 18.

Credits

A tax credit reduces the amount of tax for which a taxpayer is liable. Unlike a deduction, which reduces the amount of income subject to tax, a tax credit directly reduces tax liability. This means that a $500 tax credit actually takes $500 off the taxpayer’s tax balance due. A tax deduction, on the other hand, reduces his or her taxable income and is equal to the percentage of his or her marginal tax bracket.

Nonrefundable Tax Credits

Most of the tax credits are referred to as nonrefundable credits. A nonrefundable credit is subtracted from the taxpayer’s income tax liability, up to the total amount he or she owes. But unlike a refundable tax credit, a nonrefundable credit cannot reduce his or her tax balance beyond zero. Any unused portion of a nonrefundable tax credit will expire in the year the credit is claimed and cannot be carried over.

Examples of nonrefundable tax credits include:

- Adoption Credit.
- Child and Dependent Care Credit.
- Education credits.
- Credit for the Elderly or Disabled.
- Foreign Income Tax Credit.
- Residential Energy Efficient Property Credit (The credit for solar electric property and solar water heating property is extended for property placed in service through December 31, 2021).
- Credit to Holders of Tax Credit Bonds.
- Mortgage Interest Credit.
- Retirement Savings Contributions Credit (Saver's Credit).

Refundable Tax Credits

A refundable tax credit is a tax credit that can reduce tax liability below zero. It is possible to receive a tax refund from this type of credit. Refundable tax credits include:

- Earned Income Tax Credit (EITC).
- Excess Social Security Credit.
- Child Tax Credit (up to $1,400 is refundable).
- Premium Tax Credit.
- American Opportunity Tax Credit (up to $1,000 is refundable).
- Credit for Tax on Undistributed Capital Gain.

Eight Tax Benefits for Parents

Taxpayer's children may help qualify the taxpayer for valuable tax benefits, such as certain credits and deductions. If the taxpayer is a parent, here are eight benefits he or she can use when filing taxes this year.

1. *Dependents* - In most cases, a taxpayer can claim a child as a dependent even if the child was born anytime in 2020. For more information, see IRS Publication 501 - Dependents, Standard Deduction and Filing Information.
2. *Child Tax Credit* – The taxpayer may be able to claim the Child Tax Credit for each of his or her children that were under age 17 at the end of 2020. If the taxpayer does not benefit from the full amount of the Child Tax Credit, he or she may be eligible for the Credit for Other Dependents (ODC). For more information, see the instructions for Schedule 8812 - Child Tax Credit and Publication 972 - Child Tax Credit.
3. *Child and Dependent Care Credit* – The taxpayer may be able to claim this credit if he or she paid someone to care for his or her child or children under age 13, so that he or she could work or look for work. See IRS Publication 503 - Child and Dependent Care Expenses.
4. *Earned Income Tax Credit* - If the taxpayer worked but earned less than $56,844 in 2020, he or she may qualify for EITC. If the taxpayer has qualifying children, he or she may get up to $6,660 in 2020 back when he or she files a return and claims it. See Publication 596 - Earned Income Tax Credit.
5. *Adoption Credit* – The taxpayer may be able to take a tax credit for certain expenses he or she incurred to adopt a child. For details about this credit, see the instructions for IRS Form 8839 - Qualified Adoption Expenses.
6. *Higher education credits* - If the taxpayer paid higher education costs for him or herself or another student who is an immediate family member, he or she may qualify for either the American Opportunity Tax Credit or the Lifetime Learning Credit. Both credits may reduce the amount of tax owed. See IRS Publication 970 - Tax Benefits for Education.
7. *Student loan interest* – The taxpayer may be able to deduct interest he or she paid on a qualified student loan, even if the taxpayer does not itemize his or her deductions. For more information, see IRS Publication 970 - Tax Benefits for Education.
8. *Self-employed health insurance deduction* - If the taxpayer was self-employed and paid for health insurance, he or she may be able to deduct premiums paid to cover a child. It applies to children under age 27 at the end of the year, even if not the taxpayer's dependent.

Here are five credits the IRS wants the taxpayer to consider before filing the Federal income tax return: (144)

1. The **Earned Income Tax Credit (EITC)** is a refundable credit for people who work and do not earn a lot of money. The maximum credit for 2020 returns is $6,660 for workers with three or more children. Eligibility is determined based on earnings, filing status and eligible children. Workers without children may be eligible for a smaller credit. If the taxpayer worked and earned less than $56,844 in 2020, use the EITC Assistant tool on IRS.gov to see if he or she qualifies. For more information, see Publication 596 - Earned Income Tax Credit.
2. The **Child and Dependent Care Credit** is for expenses the taxpayer paid for the care of qualifying children under age 13, or for a disabled spouse or dependent. The care must enable the taxpayer to work or look for work. For more information, see Publication 503 - Child and Dependent Care Expenses.
3. The **Child Tax Credit** may apply to the taxpayer if he or she has a qualifying child under age 17. The credit may help reduce the Federal income tax by up to $2,000 for each qualifying child claimed on the return. The taxpayer may be required to file the new Schedule 8812 - Child Tax Credit with the tax return to claim the credit. See Publication 972 - Child Tax Credit for more information.
4. The **Retirement Savings Contributions Credit (Saver's Credit)** helps low-to-moderate income workers save for retirement. The taxpayer may qualify if his or her income is below a certain limit and he or she contributes to an IRA or a retirement plan at work. The credit is in addition to any other tax savings that apply to retirement plans. For more information, see Publication 590-A - Contributions to Individual Retirement Arrangements (IRAs).
5. The **American Opportunity Tax Credit (AOTC)** helps offset some of the costs that the taxpayer pays for higher education. The AOTC applies to the first four years of post-secondary education. The maximum credit is $2,500 per eligible student. 40% of the credit, up to $1,000, is refundable. The taxpayer must file Form 8863 - Education Credits to claim it if he or she qualifies. For more information, see Publication 970 - Tax Benefits for Education.

Earned Income Tax Credit

The Earned Income Tax Credit (EITC) is a benefit for working people with low to moderate income. To qualify, the taxpayer must meet certain requirements and file a tax return, even if he or she does not owe any tax or is not required to file. EITC reduces the amount of tax the taxpayer owes and may give him or her a refund.

Due Diligence Requirements

The due diligence requirement was originally designed to reduce errors on returns claiming the Earned Income Tax Credit (EITC). Legislation in 2015 expanded the due diligence requirements to include the Child Tax Credit (CTC), Additional Child Tax Credit (ACTC), and American Opportunity Tax Credit (AOTC). Under the Tax Cuts and Jobs Act (TCJA), the due diligence requirement now also applies to individual income tax returns claiming the head of household (HOH) filing status and Credit for Other Dependents (ODC). 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.

The IRS created Form 8867 to help preparers meet the requirement by obtaining eligibility information from their clients. Preparers have been required to keep copies of the form, or comparable documentation, which is subject to review by the IRS. To help ensure compliance with the law and that eligible taxpayers receive the right credit amount, the new regulations require preparers, effective January 1, 2012, to file the Form 8867 with each return claiming the EITC. Further details can be found in Treasury Decision 9570, published in the Federal Register. (145)

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 2020 is $540 per credit per return.

To meet the due diligence requirements a paid tax return preparer must complete the four following steps:

1. **Completion of Eligibility Checklist** - Prepare form 8867, the paid preparer Earned Income Tax Credit Checklist. The paid tax return preparer must ask and explain to his or her clients all the questions in Part I and all the questions that apply in Part II and III. He or she must personally answer the due diligence questions in Part IV.

2. **Computation of the Credit** - Complete the EITC worksheet, which is available in most tax preparation software programs.
3. **Knowledge** - For the knowledge requirement, the paid tax return preparer must not know or have reason to know that the information used to compute the EITC is incorrect. If there is any doubt, he or she must ask his or her client additional questions. A knowledgeable tax return preparer should be able to conclude if the information given seems incorrect, inconsistent or incomplete.
4. **Record Retention** - The paid tax return preparer must keep the 8867, the EITC worksheet and a record of how he or she received the information used to prepare the return for three years from June 30 following the date he or she presented the return to his or her client to sign. The paid tax return preparer can keep these records in either paper or electronic format. It is a good idea to keep a back-up of these records at an off-site, secure location.

Completing the Form 8867

Form 8867 covers the HOH filing status, EITC, the AOTC, and the CTC/ACTC/ODC. 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 four topics and has questions that are specifically related to HOH filing status only, EITC only, CTC/ACTC/ODC only, and the AOTC only.

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, 9b and 9c only ask three 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, 9b and 9c.

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/ODC could result in a $540 penalty for each failure in 2020. For example, if a paid tax return preparer prepares a return claiming the EITC, the AOTC and the CTC/ACTC/ODC 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 $1,620.

Document Retention

To meet the due diligence requirements for the HOH filing status, EITC, the AOTC, and the CTC/ACTC/ODC, you must keep all of the following records: (146)

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: (146)

- 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). [146]

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 ETIC 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: [147]

- 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 ETIC 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.

In 2020, if the IRS examines the EITC claims you prepared and finds you did not meet all four due diligence requirements, you can get: [147]

- A $540 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: [148]

- 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.

Earned Income Tax Credit (EITC)

For 2009 through 2017, the EITC amount had been temporarily increased for those with three (or more) children and the EITC marriage penalty had been reduced by increasing the income phase-out range by $5,000 (indexed for inflation) for those who are married and filing jointly. The Protecting Americans from Tax Hikes Act of 2015 made these provisions permanent. The provision also provided additional time for the IRS to review refund claims based on the EITC in order to reduce fraud and improper payments.

Under the Tax Cuts and Jobs Act (TCJA), to reduce waste, fraud, and abuse, a taxpayer is required to provide a work-eligible Social Security Number (SSN) in order to claim the refundable Earned Income Tax Credit. In addition, with respect to the Earned Income Tax Credit, taxpayers are required to properly reflect any net earnings from self-employment in their claims for the credit and employers would be required to provide additional information on their payroll tax returns. The IRS also is granted additional authority with respect to the substantiation of earned income amounts. Use Publication 596 - Earned Income Tax Credit (EITC) to determine eligibility.

To qualify for the credit adjusted gross income (AGI) must be below a certain amount and the taxpayer must: [149]

- Have a valid Social Security Number (if the taxpayer is filing a joint return, his or her spouse also must have a valid Social Security Number).

- Have earned income from employment or from self-employment.
- Have a filing status other than married filing separately.
- Be a U.S. citizen or resident alien all year, or a nonresident alien married to a U.S. citizen or resident alien and filing a joint return.
- Not be a qualifying child of another person (if the taxpayer is filing a joint return, his or her spouse also cannot be a qualifying child of another person).
- Not have investment income over a certain amount.
- Not file Form 2555 - Foreign Earned Income (related to foreign earned income).
- Have a qualifying child who meets four tests (the Age, Relationship, Residency and Joint Return tests) OR:
    - Be age 25 but under 65 at the end of the year.
    - Live in the United States for more than half the year.
    - Not qualify as a dependent of another person.

Tip

If the taxpayer qualifies, the amount of EITC will depend on filing status, whether the taxpayer has children, the number of children, and the amount of wages and income for the tax year. When EITC exceeds the amount of taxes owed, it results in a tax refund to those who claim and qualify for the credit.

Earned Income Tax Credit (EITC) Limitations

Previous legislation increased the Earned Income Tax Credit for families with three or more qualifying children and allowed married joint-filing couples to earn more without having their credits reduced. The Protecting Americans from Tax Hikes Act of 2015 made these provisions permanent. Credit percentages and phase-out percentages are provided for taxpayers who have one qualifying child, two or more qualifying children, and no children.

2020 Earned Income Tax Credit Limitations				
	No Children	One Child	Two Children	3 or more children
Maximum Amount of Credit	$538	$3,584	$5,920	$6,660
Earned Income and Adjusted Gross Income (AGI) must be less than for Single, Surviving Spouse or Head of Household	$15,820	$41,756	$47,440	$50,954
Earned Income and Adjusted Gross Income (AGI) must be less for Married Filing Jointly	$21,710	$47,646	$53,330	$56,844

Table 3-4 - Various Tax Benefits Increase Due to Inflation Adjustments (2020)

Disqualified Income

Tip

The Earned Income Tax Credit may not be claimed by taxpayers whose investment income is in excess of $3,650 in 2020. Disqualified income includes an individual's capital gain net income and net passive income in addition to interest, dividends, tax-exempt interest and non-business rents or royalties. (65)

Qualifying Child

The Earned Income Tax Credit adopts the uniform definition of a qualifying child as enacted by the Working Families Tax Relief Act of 2004. For purposes of claiming the Earned Income Tax Credit, a qualifying child is defined without regard to the support test. A qualifying child must meet a relationship, residency, and age test. Additionally, the taxpayer claiming the qualifying child must satisfy an identification requirement. The qualifying child must have one of the following relationships with the taxpayer to satisfy the relationship test: (150)

- A son, daughter, stepchild, or a descendent of such child.
- A brother or sister (including by half-blood), a stepsibling or a descendant of such individual.
- An adopted child.
- An eligible foster child that has been placed by an authorized agency.

A qualifying child does not include a child who is married unless the taxpayer is entitled to claim them as a dependent.

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.

Finally, to satisfy the identification test, the taxpayer must specify the name and age of each qualifying child as well as the taxpayer identification number of a qualifying child on their return. The rules for determining among several taxpayers who may claim a child as a qualifying child for purposes of the Earned Income Tax Credit have been simplified. In the event that two or more taxpayers claim the same child(ren) in the same calendar year, the child(ren) will be the qualifying child(ren) for the parents first and then for a taxpayer, other than the parents, with highest adjusted gross income.

If both qualifying child's parents seek to claim the credit, but do not file jointly, then the parent who is claiming the child as a dependent may claim the child as an eligible child for Earned Income Tax Credit determination. For more information on whether a child qualifies for the EITC, see Publication 596 - Chapter 2, Rules If You Have a Qualifying Child.

No Qualifying Child

An individual who does not have a qualifying child may be eligible for this credit if:

1. The principal residence of such individual is in the United States for more than one-half of the tax year.
2. The individual (or the spouse of the individual) is at least age 25 and under age 65 before the close of the tax year.
3. The individual is not claimed as a dependent by another.
4. The individual is not a qualifying child of another taxpayer.

Restrictions on Claiming the Credit

The credit is denied to taxpayers who are not eligible to work in the United States. A nonresident alien (unless married to a U.S. citizen and filing a joint return) usually cannot claim an Earned Income Tax Credit.

Filing Requirements

Married persons must file a joint return in order to claim this credit. However, a married person living apart from a spouse under certain circumstances need not file a joint return to claim the credit. Also, the credit may be claimed only for a full 12-month tax year, except in the case of death.

Earned Income

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: [151]

- 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.

How To Claim the Credit

Taxpayers should use Form 1040, Schedule EITC, to determine whether they are eligible for the credit. The IRS publishes the Earned Income Tax Credit (EITC) Table at the beginning of each year's tax season. Claim the Earned Income Tax Credit on line 27 of Form 1040.

As a reminder, 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 $540 penalty for each failure in 2020.

Child and Dependent Care Credit

The taxpayer may be able to claim the Child and Dependent Care Credit if he or she paid work-related expenses for the care of a qualifying individual. The credit is generally a percentage of the amount of work-related expenses he or she paid to a care provider for the care of a qualifying individual. The percentage depends on the taxpayer's adjusted gross income. Work-related expenses qualifying for the credit are those paid for the care of a qualifying individual to enable the taxpayer to work or actively look for work.

Expenses are considered work-related only if both of the following are true: [152]

1. They allow the taxpayer (and his or her spouse if filing jointly) to work or look for work.
2. They are for a qualifying person's care.

The cost of sending a child to an overnight camp is not considered a work-related expense. However, the cost of sending a child to a day camp may be a work-related expense, even if the camp specializes in a particular activity, such as computers or soccer.

Tip

A nonrefundable credit is allowed for a portion of qualifying child or dependent care expenses paid for the purpose of allowing the taxpayer to be gainfully employed. If a taxpayer paid someone to care for a child, spouse, or dependent in 2020, he or she may be able to claim the Child and Dependent Care Credit on the Federal income tax return.

Below are 10 things the IRS wants taxpayers to know about claiming a credit for child and dependent care expenses: [152]

1. The care must have been provided for one or more qualifying persons. A qualifying person is the taxpayer's dependent under the age of 13 when the care was provided. Additionally, the taxpayer's spouse and certain other individuals who are physically or mentally incapable of self-care may also be qualifying persons. The taxpayer must identify each qualifying person on the tax return.
2. The care must have been provided so the taxpayer – and his or her spouse if married filing jointly – could work or look for work.
3. If the taxpayer and his or her spouse file jointly, they must have earned income from wages, salaries, tips, other taxable employee compensation or net earnings from self-employment. One spouse may be considered as having earned income if they were a full-time student or were physically or mentally unable to care for themselves.
4. The payments for care cannot be paid to the taxpayer's spouse, to the parent of the qualifying person, to someone the taxpayer can claim as a dependent on the return, or to a child who will not be age 19 or older by the end of the year even if he or she is not a dependent. The taxpayer must identify the care provider(s) on the tax return.
5. The taxpayer's filing status must be single, married filing jointly, head of household or qualifying widow(er) with a dependent child.
6. The qualifying person must have lived with the taxpayer for more than half of 2020. There are exceptions for the birth or death of a qualifying person, or a child of divorced or separated parents. See Publication 503 - Child and Dependent Care Expenses.
7. The credit can be up to 35% of qualifying expenses, depending upon adjusted gross income.

8. The taxpayer may use up to $3,000 of expenses paid in a year for one qualifying individual or $6,000 for two or more qualifying individuals to figure the credit.
9. The qualifying expenses must be reduced by the amount of any dependent care benefits provided by the taxpayer's employer that he or she deducts or excludes from income.
10. If the taxpayer pays someone to come to the home and care for the dependent or spouse, he or she may be a household employer and may have to withhold and pay Social Security and Medicare tax and pay Federal unemployment tax. See Publication 926 - Household Employer's Tax Guide.

The custodial parent is the parent with whom the child lived for the greater number of nights in 2020. If the child was with each parent for an equal number of nights, the custodial parent is the parent with the higher adjusted gross income. The noncustodial parent cannot treat the child as a qualifying person even if that parent is entitled to claim the child as a dependent under the special rules for a child of divorced or separated parents.

In the case of a child of divorced or separated parents living apart, only the custodial parent may claim the credit. The qualifying person must reside with the taxpayer for more than half the year to qualify for the child and dependent care credit and must be unable to care for themselves for more than half of the year. In determining whether a person is a qualifying person, treat someone who was born or who died during the tax year as having lived with the taxpayer for the entire tax year only if the taxpayer's home was the person's home the entire time he or she was alive.

A spouse is never a dependent of the other spouse; but can qualify for the Child and Dependent Care Credit provided the conditions are met. One requirement for a spouse that is incapable of self-care is that the spouse must have the same principal place of abode as the taxpayer for more than half of the year. For more information on the Child and Dependent Care Credit, see Publication 503 - Child and Dependent Care Expenses.

Qualifying Individual

A qualifying individual for the Child and Dependent Care Credit is: (153)

- The taxpayer's dependent qualifying child who is under age 13 when the care is provided.
- The taxpayer's spouse who is physically or mentally incapable of self-care and lived with the taxpayer for more than half the year.
- A person who is physically or mentally incapable of self-care, lived with the taxpayer for more than half the year and either:
    - Is his or her dependent, or
    - Could have been his or her dependent except that:
        - He or she received gross income of $4,300 or more,
        - He or she filed a joint return, or
        - The taxpayer, or his or her spouse if filing jointly, could be claimed as a dependent on someone else's 2020 return.

An individual is physically or mentally incapable of self-care if, as a result of a physical or mental defect, the individual is incapable of caring for his or her hygiene or nutritional needs or requires the full-time attention of another person for the individual's own safety or the safety of others.

Amount of Credit

The credit amount is equal to the applicable percentage, as determined by the taxpayer's adjusted gross income (AGI), times the qualified employment expenses paid. In tax year 2020**,** taxpayers with an AGI of $15,000 or less use the highest applicable percentage of 35%. For taxpayers with adjusted gross income over $15,000, the credit is reduced by one percentage point for each $2,000 of adjusted gross income (or fraction thereof) over $15,000. The minimum applicable percentage of 20% is used by taxpayers with AGIs greater than $43,000. Thus, the maximum dependent care credit amount for one qualifying dependent is $1,050 and $2,100 for two or more qualifying dependents in 2020.

Note

If the taxpayer received dependent care benefits that he or she exclude or deduct from his or her income, the taxpayer must subtract that amount from the dollar limit that applies to him or her.

To determine the amount of the taxpayer's credit, multiply his or her work-related expenses (after applying the earned income and dollar limits) by a percentage. This percentage depends on the taxpayer's adjusted gross income shown on

Form 1040, Form 1040-SR, or Form 1040-NR, line 11. The following Child and Dependent Credit adjusted gross income (AGI) limits table is shown as a reference to determine the correct percentage rate for tax year 2020. (153)

2020 Adjusted Gross Income (AGI) PERCENTAGE					
OVER	BUT NOT OVER	PERCENTAGE	OVER	BUT NOT OVER	PERCENTAGE
$0	$15,000	35%	$29,000	$31,000	27%
$15,000	$17,000	34%	$31,000	$33,000	26%
$17,000	$19,000	33%	$33,000	$35,000	25%
$19,000	$21,000	32%	$35,000	$37,000	24%
$21,000	$23,000	31%	$37,000	$39,000	23%
$23,000	$25,000	30%	$39,000	$41,000	22%
$25,000	$27,000	29%	$41,000	$43,000	21%
$27,000	$29,000	28%	$43,000	---	20%

Table 3-5 - Publication 503 – Amount of Credit (2020)

Dependent care benefits include: (153)

1. Amounts the taxpayer's employer paid directly to either him or her or the care provider for the care of the taxpayer's qualifying person while he or she works.
2. The fair market value of care in a daycare facility provided or sponsored by the taxpayer's employer.
3. Pre-tax contributions the taxpayer made under a dependent care flexible spending arrangement.

Qualifying employment-related expenses are considered in determining the credit only to the extent of earned income: wages, salary, remuneration for personal services, net self-employment income, etc. For married taxpayers, expenses are limited to the earned income of the lower-earning spouse. Generally, if one spouse is not working, no credit is allowed. However, if the non-working spouse is physically or mentally incapable of caring for him or herself or is a full-time student at an educational institution for at least five calendar months during the year, the law assumes an earned income, for each month of disability or school attendance, of $250 if there is one qualifying child or dependent or of $500 if there are two or more.

Generally, a married taxpayer *must* file a joint return to claim the credit. However, a married person living apart from his or her spouse under certain circumstances is considered unmarried for this purpose, except that the spouse must not have been a member of the household during the last six months of the tax year. Also, a divorced or legally separated taxpayer having custody of a disabled or under the age-of-13 child is entitled to the credit even though he or she has released the right to claim the child as a dependent.

Taxpayers must provide each dependent's taxpayer identification number and the identifying number of the service provider in order to claim the credit. The Child and Dependent Care Expenses are computed on Form 2441 - Child and Dependent Care Expenses.

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). Here are some important facts from the IRS about this credit: (154)

1. *Amount* - With the Child Tax Credit, the taxpayer may be able to reduce the taxpayer's 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 2020.

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 the taxpayer's own child. An adopted child includes a child lawfully placed with the taxpayer 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 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.
8. *Residence Test* - The child must have lived with the taxpayer for more than half of 2020. There are some exceptions to the residence test, which can be found in IRS Publication 972 - Child Tax Credit.
9. *Limitations* - The credit phases out $50 for each $1,000 of modified AGI (rounded up to the next $1,000 increment) over certain amounts. The amount at which this phase-out begins varies depending on filing status. For married taxpayers filing a joint return, the phase-out begins at $400,000. For single taxpayers, head of household taxpayers, and married taxpayers filing a separate return, it begins at $200,000.

To claim the Child Tax Credit, the taxpayer must file Form 1040. Each child must have a Social Security number before the due date of his or her 2020 return (including extensions) to be claimed as a qualifying child for the Child Tax Credit or Additional Child Tax Credit.

Qualifying Child

A qualifying child for purposes of the child tax credit is a child who: [154]

- Is a son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, or a descendant of any of them (for example, a grandchild, niece, or nephew).
- Was under age 17 at the end of 2020.
- Did not provide over half of his or her own support for 2020.
- Lived with the taxpayer for more than half of 2020.
- Is claimed as a dependent on the return.
- Does not file a joint return for the year (or files it only as a claim for refund).
- Was a U.S. citizen, a U.S. national, or a U.S. resident alien.

The taxpayer's child must have a Social Security Number issued by the Social Security Administration (SSA) before the due date of the taxpayer's tax return (including extensions) to be claimed as a qualifying child for the Child Tax Credit or Additional Child Tax Credit. Children with an Individual Taxpayer Identification Number (ITIN) cannot be claimed for either credit.

If the taxpayer's child's immigration status has changed so that his or her child is now a U.S. citizen or permanent resident, but the child's Social Security card still has the words "Not valid for employment" on it, the taxpayer should ask the SSA for a new Social Security card without those words.

If the taxpayer's child does not have a valid SSN, his or her child may still qualify him or her for the Credit for Other Dependents (ODC). This is a non-refundable credit of up to $500 per qualifying person. If the taxpayer's dependent child lived with him or her in the United States and has an Individual Taxpayer Identification Number (ITIN), but not an SSN, issued by the due date of his or her 2020 tax return (including extensions), he or she may be able to claim the new Credit for Other Dependents for that child. Spouses and dependents residing outside the United States who use ITINs, a tax processing number issued by the IRS, should review the information on IRS.gov/ITIN to determine whether they need to renew an ITIN before filing a tax return next year.

Limitation of 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.

2020 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 3-6 - Tax Cuts and Jobs Act (2020)

Credit for Other Dependents (ODC)

The Tax Cuts and Jobs Act provides a $500 Credit for Other Dependents (such as 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 ODC can be claimed for eligible dependents for 2020. 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).

Additional Child Tax Credit

Under the Tax Cuts and Jobs Act, 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. The Additional Child Tax Credit is a refundable tax credit for people who have a qualifying child and did not receive the full amount of the Child Tax Credit.

The Additional Child Tax Credit is equal to the lesser of: [155]

- The unclaimed portion of the nonrefundable Child Tax Credit amount.
- 15% of the person’s earned income over $2,500.
- For taxpayers with three or more qualifying children, the excess of the taxpayer’s Social Security taxes for the tax year over his or her Earned Income Tax Credit for the year.

Any refund the taxpayer receives as a result of taking the Additional Child Tax Credit cannot be counted as income when determining if the taxpayer or anyone else is eligible for benefits or assistance, or how much the taxpayer or anyone else can receive, under any Federal program or under any state or local program financed in whole or in part with Federal funds. These programs include Temporary Assistance for Needy Families (TANF), Medicaid, Supplemental Security Income (SSI), and Supplemental Nutrition Assistance Program (food stamps).

In addition, when determining eligibility, the refund cannot be counted as a resource for at least 12 months after the taxpayer receives it. An individual should check with his or her local benefits coordinator to find out if his or her refund will affect his or her benefits. For more information on the Additional Child Tax Credit, see Schedule 8812 - Child Tax Credit.

Tax Liability Limitation

The total amount of child tax credit claimed by the taxpayer cannot exceed the sum of their regular income tax liability and their alternative minimum tax liability, over the sum of the nonrefundable personal credits allowed to the taxpayer (other than the adoption credit, the retirement savings contribution credit, child tax credit, the residential energy efficient property credit, and beginning with year 2009 the foreign tax credit). **No further carryover of the credit is allowed if the credit exceeds these limits**.

Credits and Deductions for Higher Education Tuition and Related Expenses

Student Loan Interest Deduction

A taxpayer may be able to deduct student loan interest even if he or she does not itemize deductions on Schedule A (Form 1040). Student loan interest is interest the taxpayer paid during the year on a qualified student loan. It includes both required and voluntarily pre-paid interest payments.

Interest paid during the tax year on any qualified education loan is deductible from gross income in arriving at adjusted gross income on Form 1040. The debt must be incurred by the taxpayer solely to pay qualified higher education expenses. The original loan and all refinancing of the loan are treated as one loan for this purpose. The maximum deductible amount of interest for tax year 2020 is $2,500.

For 2020, the amount of the student loan interest deduction is phased out (gradually reduced) if the taxpayer's filing status is married filing jointly and modified adjusted gross income (MAGI) is between $140,000 and $170,000. The taxpayer cannot take the deduction if modified AGI is $170,000 or more. If the taxpayer's filing status is married filing separately, he or she does not qualify for the deduction. For all other filing statuses, the student loan interest deduction is phased out if modified AGI is between $70,000 and $85,000. The taxpayer cannot take a deduction if modified AGI is $85,000 or more. The IRS provides a Student Loan Interest Deduction worksheet. For more information, see Publication 970 -Tax Benefits for Education.

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

- Tuition and fees.
- Room and board.
- Books, supplies, and equipment.
- Other necessary expenses (such as transportation).

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

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

Loan Origination Fee

In general, a loan origination fee is a one-time fee charged by the lender when a loan is made. To be deductible as interest, a loan origination fee must be for the use of money rather than for property or services (such as commitment fees or processing costs) provided by the lender. A loan origination fee is treated as interest accrues over the term of the loan. Loan origination fees were not required to be reported on Form 1098-E - Student Loan Interest Statement for loans made before September 1, 2004. If loan origination fees are not included in the amount reported on the taxpayer's Form 1098-E, he or she can use any reasonable method to allocate the loan origination fees over the term of the loan. One acceptable method allocates equal portions of the loan origination fee to each payment required under the terms of the loan. A method that results in the double deduction of the same portion of a loan origination fee would not be reasonable.

Voluntary Interest Payments

These are payments made on a qualified student loan during a period when interest payments are not required, such as when the borrower has been granted a deferment or the loan has not yet entered repayment status.

Capitalized Interest

This is unpaid interest on a student loan that is added by the lender to the outstanding principal balance of the loan. Capitalized interest is treated as interest for tax purposes and is deductible as payments of principal are made on the loan. No deduction for capitalized interest is allowed in a year in which no loan payments were made.

Student Loan Cancellations and Repayment Assistance

Generally, if the taxpayer is responsible for making loan payments, and the loan is canceled (forgiven), he or she must include the amount that was forgiven in his or her gross income for tax purposes. However, if the taxpayer fulfills certain requirements, student loan cancellation and student loan repayment assistance may be tax free. If the taxpayer's student loan is canceled, he or she may not have to include any amount in income.

To qualify for tax-free treatment, for the cancellation of the taxpayer's loan, the loan must have been made by a qualified lender to assist him of her in attending an eligible educational institution and contain a provision that all or part of the debt will be canceled if the taxpayer works: [129]

1. For a certain period of time.
2. In certain professions.
3. For any of a broad class of employers.

The cancellation of the taxpayer's loan will not qualify for tax-free treatment if it is cancelled because of services he or she performed for the educational institution that made the loan or other organization that provided the funds.

If the taxpayer refinanced a student loan with another loan from an eligible educational institution or a tax-exempt organization, that loan may also be considered as made by a qualified lender. The refinanced loan is considered made by a qualified lender if it is made under a program of the refinancing organization that is designed to encourage students to serve in occupations with unmet needs or in areas with unmet needs where the services required of the students are for or under the direction of a governmental unit or a tax-exempt Section 501(c)(3) organization.

Student loan repayments made to the taxpayer are tax free if he or she received them for any of the following: [129]

- The National Health Service Corps (NHSC) Loan Repayment Program (NHSC Loan Repayment Program).
- A state education loan repayment program eligible for funds under the Public Health Service Act.
- Any other state loan repayment or loan forgiveness program that is intended to provide for the increased availability of health services in underserved or health professional shortage areas (as determined by such state).

The taxpayer cannot deduct the interest he or she paid on a student loan to the extent payments were made through his or her participation in the above programs.

Tuition and Fees Deduction

The Bipartisan Budget Act of 2018 extended through 2017 the above-the-line deduction for qualified tuition and related expenses for higher education. The deduction is capped at $4,000 for an individual whose adjusted gross income (AGI) does not exceed $65,000 ($130,000 for joint filers) or $2,000 for an individual whose AGI does not exceed $80,000 ($160,000 for joint filers). The Further Consolidated Appropriations Act extended the deduction through 2020.

The Consolidated Appropriations Act, 2021, repeals the Tuition and Fees Deduction, effective with tax years that begin in 2021. This is a permanent repeal, so the Tuition and Fees Deduction will not return in the next tax extenders bill. Instead, the phase-out limits on the Lifetime Learning Credit are increased to $80,000 ($160,000 for married filing jointly).

American Opportunity Tax Credit (AOTC)

Due Diligence Requirements

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 (AOTC), 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.

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 of Form 8867 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.

Tip

The American Opportunity Tax Credit expanded and renamed the already-existing Hope Scholarship Credit. The maximum amount of the American Opportunity Tax Credit (AOTC) is $2,500 per student $2,500 of the cost of tuition, fees and course materials paid during the taxable year. Also, 40% of the credit (up to $1,000) is refundable. This means the taxpayer can get the credit even if he or she owes no tax. The credit can be claimed for claimed for expenses for the first four years of post-secondary education. The Protecting Americans from Tax Hikes Act of 2015 made the AOTC provisions permanent.

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.

Generally, 40% of the AOTC is now a refundable credit for most taxpayers, which means that the taxpayer can receive up to $1,000 even if he or she owes no taxes. The term qualified tuition and related expenses has been expanded to include expenditures for course materials. For this purpose, the term "course materials" means books, supplies, and equipment needed for a course of study whether or not the materials must be purchased from the educational institution as a condition of enrollment or attendance. For more information, see Chapter 2 of Publication 970 – Tax Benefits for Education.

Generally, the taxpayer can claim the American Opportunity Tax Credit if all three of the following requirements are met: [131]

1. He or she pays qualified education expenses of higher education.
2. He or she pays the education expenses for an eligible student.
3. The eligible student is either him or herself, his or her spouse, or a dependent for whom he or she claims as a dependent on his or her tax return.

Qualified Education Expenses

For purposes of the American Opportunity Tax Credit, qualified education expenses are tuition and certain related expenses required for enrollment or attendance at an eligible educational institution. Student-activity fees are included in qualified education expenses only if the fees must be paid to the institution as a condition of enrollment or attendance. However, expenses for books, supplies, and equipment needed for a course of study are included in qualified education expenses whether or not the materials are purchased from the educational institution.

Qualified education expenses do not include amounts paid for:

- Insurance.

- Medical expenses (including student health fees).
- Room and board.
- Transportation.
- Similar personal, living, or family expenses.

This is true even if the amount must be paid to the institution as a condition of enrollment or attendance.

Limitations for the American Opportunity Tax Credit

The taxpayer cannot claim the American Opportunity Tax Credit for 2020 if any of the following apply:

- His or her filing status is married filing separately.
- He or she is claimed as a dependent on another person's tax return, such as his or her parent's return.
- His or her modified adjusted gross income (MAGI) is $90,000 or more ($180,000 or more if married filing jointly).
- He or she (or his or her spouse) was a nonresident alien for any part of 2020 and the nonresident alien did not elect to be treated as a resident alien for tax purposes.
- He or she was not issued a SSN (or ITIN) by the due date of his or her 2020 return (including extensions).

Generally, a taxpayer whose modified adjusted gross income is $80,000 or less ($160,000 or less for joint filers) can claim the credit for the qualified expenses of an eligible student. The credit is reduced if a taxpayer's modified adjusted gross income exceeds those amounts. A taxpayer whose modified adjusted gross income is greater than $90,000 ($180,000 for joint filers) cannot claim the credit.

Lifetime Learning Credit

The Lifetime Learning Credit is a tax credit for any person who takes college classes. It provides a tax credit of 20% of tuition expenses, with a maximum of $2,000 in tax credits on the first $10,000 of college tuition expenses. The taxpayer can claim the Lifetime Learning Credit on the tax return if the taxpayer, his or her spouse, or his or her dependents are enrolled at an eligible educational institution and the taxpayer was responsible for paying college expenses. Unlike the American Opportunity Tax Credit, the student need not be in the first four years of undergraduate classes. Even if the student took only one class, he or she may take advantage of the Lifetime Learning Credit. [156]

Income Limitations on Lifetime Learning Credit

The amount of the Lifetime Learning Credit is limited over a phase-out range. If adjusted gross income is below the phase-out, the credit is not reduced. If income is in the middle of the phase-out range, the credit will be reduced. If income exceeds the phase-out range, the taxpayer is not eligible to claim the Lifetime Learning Credit.

The income phase-out range for 2020 is:

- $59,000 to $69,000 - Single, Head of Household, or Qualifying Widow(er).
- $118,000 to $138,000 - Married Filing Jointly.

If a taxpayer is eligible to claim the Lifetime Learning Credit and the American Opportunity Tax Credit for the same student in the same year, he or she can choose to claim either credit, but not both.

Under the Consolidated Appropriations Act, 2021, the phase-out limits on the Lifetime Learning Credit are increased to $80,000 ($160,000 for married filing jointly), effective with tax years that begin in 2021.

Eligible Educational Institutions

All accredited colleges and universities are eligible educational institutions. Additionally, vocational schools and other post-secondary institutions are also eligible. Basically, if the institution is eligible to participate in Federal student aid programs through the U.S. Department of Education, then the taxpayer may use tuition paid to the school for claiming the Lifetime Learning Credit.

Qualifying Expenses

Qualifying expenses include amounts paid for tuition and any required fees such as registration and student body fees. Student-activity fees and expenses for course-related books, supplies, and equipment are included in qualified education expenses only if the fees and expenses must be paid to the institution for enrollment or attendance.

Qualified education expenses do not include amounts paid for: (156)

- Insurance.
- Medical expenses (including student health fees).
- Room and board.
- Transportation
- Similar personal, living, or family expenses.

This is true even if the amount must be paid to the institution as a condition of enrollment or attendance. Also, qualified education expenses generally do not include expenses that relate to any course of instruction or other education that involves sports, games or hobbies, or any noncredit course. However, if the course of instruction or other education is part of the student's degree program, these expenses can qualify.

The taxpayer must be responsible for paying the college tuition and fees. The taxpayer also needs to reduce qualifying expenses when figuring the tax credit by the amount of financial assistance received from grants, scholarships, or reimbursements from an employer. The taxpayer does not need to reduce qualifying expenses, however, if he or she paid for college tuition using borrowed funds, including student loans, or by using gifts from family members.

Who Can Claim the Education Credits?

If the taxpayer's son or daughter is going to college and the taxpayer claims him or her as a dependent, then the taxpayer can claim the education credits on the tax return. If the taxpayer's son or daughter is no longer a dependent, then he or she should claim any education credits on his or her own tax return. If the taxpayer pays the college expenses for someone who is not a dependent, he or she cannot claim the tax credit.

Coordination with Other Provisions

Taxpayers may now elect *not* to claim a tax credit should the taxpayer desire to take full advantage of the exclusion available for distributions from Coverdell educational saving accounts and/or qualified tuition plans. Thus, eligible educational expenses are first reduced by excludable scholarships or fellowships, veterans' educational assistance allowance, employer-provided educational assistance that is excludable from income, and any other educational assistance other than gifts, bequests, devises, or inheritances that is excludable from gross income.

Taxpayers are then permitted to elect to claim either the AOTC or the Lifetime Learning Credit for a student in any tax year. The expenses used to claim an educational credit reduce the amount of eligible expenses available to exclude distributions from educational savings accounts or qualified tuition plans. Since any excess distributions from an educational savings account or a qualified tuition plan over the eligible educational expenses is includible in gross income and subject to a 10% additional tax, waiving the claiming of an educational credit may result in a lower tax liability.

However, taxpayers should be aware that the 10% additional tax for excess distributions from educational savings accounts or qualified tuition plans is waived if the excess is caused by the claiming of an educational credit. Taxpayers who receive distributions in excess of eligible expense from both an educational savings account and a qualified tuition plan in the same year must allocate the expenses between the two distributions. Finally, only after eligible expenses are reduced by an educational credit and distributions from educational savings accounts or qualified tuition plans, may the remaining expenses be used to determine the exclusion amount for Series EE United States Savings Bonds.

The 10% additional tax does not apply to distributions: (157)

- Paid to a beneficiary (or to the estate of the designated beneficiary) on or after the death of the designated beneficiary.

- Made because the designated beneficiary is disabled. A person is considered to be disabled if he or she shows proof that he or she cannot do any substantial gainful activity because of his or her physical or mental condition. A physician must determine that his or her condition can be expected to result in death or to be of long-continued and indefinite duration.
- Included in income because the designated beneficiary received:
  - A tax-free scholarship or fellowship.
  - Veterans' educational assistance.
  - Employer-provided educational assistance.
  - Any other nontaxable (tax-free) payments (other than gifts or inheritances) received as educational assistance.
- Made on account of the attendance of the designated beneficiary at a U.S. military academy (such as the USNA at Annapolis). This exception applies only to the extent that the amount of the distribution does not exceed the costs of advanced education (as defined in Section 2005(d)(3) of title 10 of the U.S. Code) attributable to such attendance.
- Included in income only because the qualified education expenses were taken into account in determining the American Opportunity or Lifetime Learning Credit.

Both the AOTC and the Lifetime Learning Credit (Education Credits) are supported by attaching Form 8863 – Education Credits, and entered on line 3 of Schedule 3 (Form 1040).

Credit Recapture

If any tax-free educational assistance for the qualified education expenses paid in 2020, or any refund of a taxpayer's qualified education expenses paid in 2020, is received after he or she files the 2020 income tax return, the taxpayer must recapture (repay) any excess credit. The taxpayer does this by refiguring the amount of the adjusted qualified education expenses for 2020 by reducing the expenses by the amount of the refund or tax-free educational assistance. He or she then refigures the education credit(s) for 2020 and figure the amount by which the 2020 tax liability would have increased if he or she had claimed the refigured credit(s). The taxpayer should include that amount as an additional tax for the year the refund or tax-free assistance was received.

Affordable Care Act Tax Credits

The Tax Cuts and Jobs Act (TCJA) made significant changes to the Federal tax code. The bill does not impact the majority of the Affordable Care Act (ACA) tax provisions. However, it did reduce the ACA's individual shared responsibility (or individual mandate) penalty to zero, as of 2019. This action effectively eliminated the individual mandate penalty for the 2019 tax year and beyond.

Also, despite the repeal of the individual mandate penalty, employers and individuals must continue to comply with all other ACA provisions. The tax reform bill does not impact any other ACA provisions, including the Patient-Centered Outcomes Research Institute (PCORI) fees and the health insurance provider's fee. In addition, the employer shared responsibility (pay or play) rules and related Section 6055 and Section 6056 reporting requirements are still in place.

The taxpayer may be eligible to claim the Premium Tax Credit if he or she, his or her spouse (if filing jointly), and his or her dependents enrolled in health insurance through the Health Insurance Marketplace. Advance payments of the Premium Tax Credit may have been made to a health insurer to help pay for the insurance coverage of the taxpayer, his or her spouse (if filing jointly), or his or her dependents. If advance payments of the Premium Tax Credit were made, the taxpayer must file a 2020 income tax return and Form 8962 - Premium Tax Credit (PTC).

If the taxpayer, his or her spouse (if filing jointly), or his or her dependents enrolled in health insurance through the Health Insurance Marketplace, the taxpayer should have received Form 1095-A - Health Insurance Marketplace Statement. If the taxpayer receives Form(s) 1095-A, he or she should save it. Form(s) 1095-A will help the taxpayer figure his or her Premium Tax Credit. If the taxpayer did not receive a Form 1095-A, he or she should contact the Marketplace.

Premium Tax Credit

Individuals and families may be eligible for the refundable Premium Tax Credit (PTC) to help them afford health insurance coverage purchased through an Affordable Insurance Exchange. Exchanges will operate in every state and the District of Columbia. This tax credit can help make the cost of purchasing health insurance coverage more affordable for individuals and families with low to moderate incomes. Additionally, the Premium Tax Credit is refundable so taxpayers who have little or no income tax liability can still benefit. The credit also can be paid in advance to a taxpayer's insurance company to help cover the cost of premiums.

In general, the taxpayer may be eligible for the credit if he or she meets all of the following: (46)

1. Purchases coverage through the Marketplace.
2. Has household income that falls within a certain range.
3. Is not able to get affordable coverage through an eligible employer plan that provides minimum value.
4. Is not eligible for coverage through a government program, like Medicaid, Medicare, CHIP or TRICARE.
5. Does not file a Married Filing Separately tax return (unless he or she meet the criteria in Section 1.36B-2T(b)(2) of the Temporary Income Tax Regulations, which allows certain victims of domestic abuse and spousal abandonment to claim the Premium Tax Credit using the Married Filing Separately filing status).
6. Cannot be claimed as a dependent by another person.

The Premium Tax Credit has both minimum and maximum income limits. In general, individuals and families whose household income for the year is between 100% and 400% of the Federal poverty line for their family size may be eligible for the Premium Tax Credit. An individual who meets these income requirements must also meet the other eligibility criteria described above. Thus, if the taxpayer has household income between 100% and 400% of the Federal poverty line but is eligible for coverage through his or her state's Medicaid program (for example, because his or her state provides Medicaid to individuals with household income up to 133% of the Federal poverty line), the taxpayer is not eligible for the Premium Tax Credit.

Tip

The taxpayer should use the 2019 Federal Poverty Guidelines (FPL) to determine 2020 Premium Tax Credit eligibility.

Federal Poverty Level (FPL) Guidelines 2019 - Continental U.S.					
Persons in Household	1	2	3	4	5
100%	$12,490	$16,910	$21,330	$25,750	$30,170
400%	$49,960	$67,640	$85,320	$103,000	$120,680
Federal Poverty Guidelines are different in Hawaii and Alaska.					

Table 3-7 - Federal Poverty Level (FPL) Guidelines (2020)

For purposes of the Premium Tax Credit, the taxpayer's household income is his or her modified adjusted gross income plus that of every other individual in his or her family for whom he or she can properly claim a as a dependent and who is required to file a Federal income tax return. Modified adjusted gross income is the adjusted gross income on the taxpayer's Federal income tax return plus any excluded foreign income, nontaxable Social Security benefits (including tier 1 railroad retirement benefits), and tax-exempt interest received or accrued during the taxable year. It does not include Supplemental Security Income (SSI).

If the taxpayer is eligible for the credit, he or she can choose to either:

- **Claim It Now** - have all or some of the credit paid in advance directly to his or her insurance company to lower what he or she pays out-of-pocket for his or her monthly premiums during 2020. Then when the taxpayer files his or her tax return, he or she will subtract the total advance credit payments he or she received during the year from the amount of the Premium Tax Credit calculated on his or her tax return. If the Premium Tax Credit computed on the return is more than the advance payments made on the taxpayer's behalf during the year, the difference will increase his or her refund or lower the amount of tax he or she owes. If the advance credit payments are more than the premium tax credit, the difference will increase the amount the taxpayer owes and result in either a smaller refund or a balance due.
- **Claim It Later** - wait to claim the full amount of the Premium Tax Credit when he or she files his or her 2020 tax return in 2021. This will either increase the taxpayer's refund or lower his or her balance due.

Whether the taxpayer chooses to claim the Premium Tax Credit now at the Marketplace or claim it later, he or she must file a Federal income tax return.

To claim the credit, the taxpayer must get insurance through the Marketplace. During enrollment through the Marketplace, using information the taxpayer provides about his or her projected income and family composition for 2020, the Marketplace will estimate the amount of the Premium Tax Credit he or she will be able to claim for the 2020 tax year that he or she will file in 2021. The taxpayer will then decide whether he or she wants to have all, some or none of the estimated credit paid in advance directly to his or her insurance company.

Note

The taxpayer should report income and family size changes to the Marketplace throughout the year. Reporting changes, increases or decreases, will help the taxpayer get the proper type and amount of financial assistance and will help him or her avoid getting too much or too little in advance.

For example, if the taxpayer does not report income or family size changes to the Marketplace when they happen in 2020, the advance payments may not match his or her actual qualified credit amount on his or her Federal tax return that he or she will file in 2021. This might result in a smaller refund or balance due.

If the taxpayer or a family member enrolled in health insurance through the Marketplace and advance payments of the Premium Tax Credit were made to his or her insurance company to reduce his or her monthly premium payment, the taxpayer must attach Form 8962 - Premium Tax Credit (PTC) to his or her income tax return to reconcile (compare) the advance payments with his or her Premium Tax Credit for the year. The Marketplace is required to send Form 1095-A by January 31, 2020, listing the advance payments and other information the taxpayer needs to complete Form 8962. The taxpayer will need Form 1095-A from the Marketplace in order to complete Form 8962 and to claim the credit and to reconcile his or her advance credit payments. The taxpayer should include Form 8962 with his or her Form 1040 or 1040-NR. (Do not include Form 1095-A).

If the taxpayer chooses to claim the Premium Tax Credit now, when he or she files his or her 2020 tax return in 2021, he or she will subtract the total advance payments he or she received during the year from the amount of the Premium Tax Credit calculated on his or her tax return. If the Premium Tax Credit computed on the return is more than the advance credit paid on the taxpayer's behalf during the year, the difference will increase his or her refund or lower the amount of tax he or she owes. If the advance credit payments are more than the Premium Tax Credit, the difference will increase the amount the taxpayer owes and result in either a smaller refund or a balance due.

If the taxpayer chooses to claim the Premium Tax Credit later, he or she will claim the full amount of the Premium Tax Credit when he or she files his or her 2020 tax return in 2021. This will either increase his or her refund or lower his or her balance due. The taxpayer should use Form 8962 - Premium Tax Credit (PTC) to figure the amount of his or her Premium Tax credit and to reconcile any advance payments of the Premium Tax Credit. (46)

Health Coverage Tax Credit (HCTC)

The Health Coverage Tax Credit (HCTC) was extended one year as part of the Consolidated Appropriations Act, 2021 and will expire on December 31, 2021. This means that all advanced payments of the HCTC end on December 31, 2021. The taxpayer should use Form 8885 - Health Coverage Tax Credit to elect and figure the amount, if any, of his or her HCTC. The Health Coverage Tax Credit (HCTC) is a tax credit that pays 72.5% of qualified health insurance premiums for eligible individuals and their families. A taxpayer may only elect to take the HCTC if he or she is one of the following:

- An eligible trade adjustment assistance (TAA) recipient, alternative (ATAA) recipient, reemployment (RTAA) recipient.
- An eligible Pension Benefit Guaranty Corporation (PBGC) pension payee.
- The family member of a TAA, ATAA, or RTAA recipient or PBGC pension payee who is deceased or who finalized a divorce with him or her.

The taxpayer is not eligible if he or she could have been claimed as a dependent on another person's Federal income tax return.

All plans that were previously qualified for the HCTC qualify for the HCTC through 2021. This includes individual (private and non-group) health insurance that the taxpayer purchases for him or herself or his or her family from an insurance company, agent, or broker. There are several types of health insurance that qualify for the HCTC. However, contributions by the taxpayer's employer or his or her spouse's employer may limit qualification.

Types of health insurance that qualify for the HCTC include:

1. Coverage under a COBRA continuation provision.
2. Coverage under a group health plan available through the employment of the taxpayer's spouse.
3. Coverage under an employee benefit plan funded by a voluntary employees' beneficiary association (VEBA) that was established through the bankruptcy of the taxpayer's former employer.
4. Coverage obtained in the non-group (individual) health insurance market other than coverage offered through the Health Insurance Marketplace.
5. Coverage under certain state-qualified health plans established prior to January 1, 2014.

A qualified health insurance plan does not include a flexible spending or similar arrangement and any insurance if substantially all of its coverage is of excepted benefits described in Section 9832(c) of the Internal Revenue Code. For example, dental or vision benefits purchased separately are not part of a qualified health insurance plan for the HCTC. But premiums paid for a comprehensive package that includes dental or vision benefits may be eligible for the HCTC if the dental or vision benefits do not represent substantially all of its coverage.

The taxpayer cannot claim the HCTC for any month that, on the first day of the month, he or she was covered under an employer-sponsored health insurance plan (including any employer-sponsored health insurance plan of a spouse) and the employer paid 50% or more of the cost of coverage. Also, if the taxpayer is an Alternative Trade Adjustment Assistance (ATAA) or Reemployment Trade Adjustment Assistance (RTAA) recipient, he or she cannot claim the HCTC for any month that, on the first day of the month, he or she was eligible for certain kinds of coverage (including any employer-sponsored health insurance plan of the taxpayers spouse) where the employer would have paid 50% or more of the cost of the coverage or he or she was covered under certain kinds of coverage (including any employer-sponsored health insurance plan of the taxpayer's spouse) where the employer paid any part of the cost of coverage.

Small Business Health Care Tax Credit

The Small Business Health Care Tax Credit helps small businesses and small tax-exempt organizations afford the cost of covering their employees and is specifically targeted for those with low- and moderate-income workers. The credit is designed to encourage small employers to provide health insurance coverage for the first time or maintain coverage they already have. In general, the credit is available to small employers that pay at least half the cost of single coverage for their employees.

In 2020, the Small Business Health Care Tax Credit benefits employers that: [158]

- Have fewer than 25 full-time equivalent employees.
- Pay average annual wages of less than $56,000 a year.
- Pay at least half of employee health insurance premiums.

To be eligible for this credit, the taxpayer must have purchased coverage through the Small Business Health Options Program, also known as the SHOP marketplace.

For tax years beginning in 2014 or later, there are changes to the credit: [158]

- The maximum credit increases to 50% of premiums paid for small business employers and 35% of premiums paid for small tax-exempt employers.
- To be eligible for the credit, a small employer must pay premiums on behalf of employees enrolled in a qualified health plan offered through a Small Business Health Options Program (SHOP) Marketplace or qualify for an exception to this requirement.
- The credit is available to eligible employers for two consecutive taxable years.

Even if the taxpayer is a small business employer who did not owe tax during the year, he or she can carry the credit back or forward to other tax years. Also, since the amount of the health insurance premium payments is more than the total credit, eligible small businesses can still claim a business expense deduction for the premiums in excess of the credit.

The credit is refundable, so even if the taxpayer has no taxable income, he or she may be eligible to receive the credit as a refund so long as it does not exceed his or her income tax withholding and Medicare tax liability. Refund payments issued to small tax-exempt employers claiming the refundable portion of credit are subject to sequestration. The taxpayer must use Form 8941 - Credit for Small Employer Health Insurance Premiums to calculate the credit.

Under the Small Business Health Care Tax Credit, if the taxpayer had more than 10 full-time equivalent employees (FTE) and average annual wages of more than $27,000, the FTE and average annual wage limitations will separately reduce the taxpayer's credit. This may reduce the taxpayer's credit to zero even if they had fewer than 25 FTEs and average annual wages of less than $56,000 in 2020.

Adoption Credit

The maximum credit and the exclusion for employer-provided benefits are both $14,300 per eligible child in 2020. This amount begins to phase out if the taxpayer has modified adjusted gross income (MAGI) in excess of $214,520 and is completely phased out for modified adjusted gross income (MAGI) of $254,520 or more. Qualified adoption expenses are reasonable and necessary expenses directly related to, and whose principal purpose is for, the legal adoption of an eligible child.

These expenses include:

- Adoption fees.
- Court costs.
- Attorney fees.
- Travel expenses (including meals and lodging) while away from home.
- Re-adoption expenses to adopt a foreign child.

Qualified adoption expenses do not include expenses:

- For which the taxpayer received funds under any state, local, or Federal program.
- That violate state or Federal law.
- For carrying out a surrogate parenting arrangement.
- For the adoption of the taxpayer's spouse's child.
- Reimbursed by the taxpayer's employer or otherwise.
- Allowed as a credit or deduction under any other provision of Federal income tax law.

An eligible child is an individual who has not attained the age of 18 at the time of the adoption or who is physically or mentally incapable of caring for him or herself.

Generally, the credit and exclusion are allowable whether the adoption is domestic or foreign. A domestic adoption is the adoption of a U.S. child (an eligible child who is a citizen or resident of the U.S. or its possessions before the adoption effort began). A foreign adoption is the adoption of an eligible child who was not a citizen or resident of the U.S. or its possessions before the adoption effort began.

The tax years for which the taxpayer can claim the credit depend on when the expenses are paid, whether the adoption is domestic or foreign, and whether the adoption has been finalized. In domestic adoptions, qualified adoption expenses paid before the year the adoption becomes final are allowable for the tax year following the year of payment (and the credit is allowable even if the adoption is never finalized). For a foreign adoption, however, the credit and exclusion are allowable only if the adoption is finalized. Qualified adoption expenses paid before and during the year of finality of a foreign adoption are allowable for the year of finality. Once an adoption becomes final, expenses paid during or after the year of finality are allowable for the year of payment, whether the adoption is foreign or domestic. [159]

Special Needs Child

In the case of an adoption of a U.S. child that a state has determined has special needs, the taxpayer may be eligible for the maximum amount of credit or exclusion for the year of finality, even if he or she paid no qualified adoption expenses.

A child is considered special needs for purposes of the adoption credit if all of the following conditions are met: [159]

1. The child was a U.S. citizen or resident when the adoption effort began.
2. A state determines that the child cannot or should not be returned to his or her parent's home.
3. A state determines that the child probably will not be adopted unless assistance is provided to the adoptive family.

The adoption credit's definition of children with special needs is narrower than the definitions of special needs for other purposes. For purposes of the adoption credit, foreign children are not considered special needs. Additionally, many U.S. children who have disabilities are not considered special needs for the purposes of the adoption credit. Generally, special needs adoptions are the adoptions of children whom the state's child welfare agency considers difficult to place for adoption, and most foster care adoptions are special needs adoptions, but few other adoptions are special needs adoptions.

The taxpayer should use Form 8839 - Qualified Adoption Expenses to figure his or her Adoption Credit and any employer-provided adoption benefits he or she can exclude from his or her income on Form 1040, 1040-SR, or 1040-NR. (160)

Credit for the Elderly or the Permanently and Totally Disabled

The Elderly and Disabled Tax Credit is a nonrefundable credit for low-income taxpayers over age 65 or those who are retired on permanent and total disability and received taxable disability income during the tax year. To qualify for the elderly and disabled tax credit, individual taxpayers must have income less than $17,500 ($25,000 for married filing jointly) and nontaxable income (nontaxable Social Security, pension, annuities, or disability income) of less than $5,000 ($7,500 for married filing jointly). The tax credit can be as high as $500.

The tax credit for the elderly or the permanently and totally disabled applies to citizens or residents who are a U.S. citizen or resident alien, and either of the following applies: (161)

- The taxpayer was age 65 or older at the end of 2020, or
- The taxpayer was under age 65 at the end of 2020 and he or she meets all of the following:
  1. He or she was permanently and totally disabled on the date he or she retired.
  2. He or she received taxable disability income for 2020.
  3. On January 1, 2020, he or she had not reached mandatory retirement age (the age when his or her employer's retirement program would have required him or her to retire).

Married taxpayers must file a joint return to claim the credit unless the spouses live apart throughout the tax year. The credit is computed on Schedule R - Credit for the Elderly or the Disabled Form 1040. The credit for the elderly or the disabled is entered on line 6 of Schedule 3 (Form 1040). The 2020 initial credits amounts are shown below. For individuals age 65 or older, the initial amount of allowable credit varies with filing status, as follows:

2020 Initial Credit Amounts	
IF the taxpayer's filing status is…	**THEN enter on line 10 of Schedule R…**
Single, Head of Household, or Qualifying Widow(er) and by the end of 2020	
the taxpayer was:	
• 65 or older	$5,000
• under 65 and retired on permanent and total disability[1]	$5,000
Married filing a joint return and by the end of 2020:	
• both of taxpayers were 65 or older	$7,500
• both of the taxpayers were under 65 and one of them retired on permanent and total disability[1]	$5,000
• both of the taxpayers were under 65 and both of them retired on permanent and total disability[2]	$7,500
• one of the taxpayers was 65 or older, and the other was under 65 and retired on permanent and total disability[3]	$7,500

• one of the taxpayers was 65 or older, and the other was under 65 and not retired on permanent and total disability	$5,000
Married filing a separate return and the taxpayer did not live with his or her spouse at any time during the year and, by the end of 2020, he or she was:	
• 65 or older	$3,750
• under 65 and retired on permanent and total disability[1]	$3,750
[1] Amount cannot be more than the taxable disability income.	
[2] Amount cannot be more than the taxpayer's combined taxable disability income.	
[3] Amount is $5,000 plus the taxable disability income of the spouse under age 65, but not more than $7,500.	

Table 3-8 - Publication 524 – Table 2 – Initial Amount (2020)

This initial amount is then reduced by amounts received as pension, annuity or disability benefits that are excludable from gross income and are payable under the Social Security Act, the Railroad Retirement Act of 1974, or a Veterans Administration program. No reduction is made for pension, annuity or disability benefits for personal injuries or sickness. The maximum amount determined above is further reduced by one-half of the excess of the adjusted gross income over the following levels, based on filing status. The 2020 adjusted gross income (AGI) limits are shown below.

2020 Adjusted Gross Income (AGI) Limits		
If the taxpayer's filing status is…	THEN, even if he or she qualifies, he or she cannot take the credit if...	
	His or her adjusted gross income (AGI)* is equal to or more than…	OR the total of his or her nontaxable social security and other nontaxable pension(s), annuities, or disability income is equal to or more than...
Single, head of household, or qualifying widow(er)	$17,500	$5,000
Individuals, joint return one spouse is a qualified individual	$20,000	$5,000
Married Individuals, joint return, both spouses are qualified individuals	$25,000	$7,500
Married filing separately and the taxpayer lived apart from his or her spouse for all of 2020	$12,500	$3,750
* AGI is the amount on Form 1040.		

Table 3-9 - Publication 524 – Table 1 – Income Limits (2020)

For permanently and totally disabled individuals under age 65, the applicable initial amount noted may not exceed the amount of disability income. A person is permanently and totally disabled if he or she cannot engage in any substantial gainful activity because of a physical or mental condition and a physician determines that the disability has lasted or can be expected to last continuously for at least a year or can lead to death. Substantial gainful activity is the performance of significant duties over a reasonable period of time while working for pay or profit, or in work generally done for pay or profit. Full-time work (or part-time work done at the employer's convenience) in a competitive work situation for at least the minimum wage conclusively shows that the taxpayer is able to engage in substantial gainful activity.

Substantial gainful activity is not work a taxpayer does to take care of him or herself or his or her home. It is not unpaid work on hobbies, institutional therapy or training, school attendance, clubs, social programs, and similar activities. However, doing this kind of work may show that the taxpayer is able to engage in substantial gainful activity. The fact that the taxpayer has not worked for some time is not, of itself, conclusive evidence that he or she cannot engage in substantial gainful activity.

Retirement Savings Contribution Credit (Saver's Credit)

For 2020, taxpayers with a low to moderate income may be able to claim a nonrefundable Saver's Credit if he or she, or his or her spouse if filing jointly, made: [162]

- Contributions (other than rollover contributions) to a traditional or Roth IRA.
- Elective deferrals to a 401(k), 403(b), governmental 457, SEP, or SIMPLE plan.
- Voluntary employee contributions to a qualified retirement plan as defined in Section 4974(c) (including the Federal Thrift Savings Plan).
- Contributions to a Section 501(c)(18)(D) plan.

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 2020, the maximum applicable percentage is 50%, which is completely phased out when AGI exceeds $65,000 for joint filers, $48,750 for head of household filers, and $32,500 for single and married filing separately filers. The applicable percentage is the percentage as determined in accordance with the following table: [163]

2020 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	$39,000	$0	$29,250	$0	$19,500	50%
$39,000	$42,500	$29,250	$31,875	$19,500	$21,250	20%
$42,500	$65,000	$31,875	$48,750	$21,250	$32,500	10%
$65,000	-----	$48,750	------	$32,500	----	0%

Table 3-10 - Retirement Savings Contributions Credit (Saver's Credit) (2020)

To be eligible for the credit, the individual making the contribution to a qualified retirement savings plan must be at least 18 years of age as of the close of the tax year, must *not* be claimed as a dependent on someone else's tax return, and must *not* be a full-time student. A person enrolled as a full-time student during any part of 5 calendar months during the year is considered a student.

The Saver's Credit can be taken for the taxpayer's contributions to a traditional or Roth IRA; his or her 401(k), SIMPLE IRA, SARSEP, 403(b), 501(c)(18) or governmental 457(b) plan; and his or her voluntary after-tax employee contributions to his or her qualified retirement and 403(b) plans. Rollover contributions (money that the taxpayer moved from another retirement plan or IRA) are not eligible for the Saver's Credit. Also, the taxpayer's eligible contributions may be reduced by any recent distributions he or she received from a retirement plan or IRA. Form 8880 – Credit for Qualified Retirement Savings Contributions is used to figure the dollar amount of this credit, which is claimed on line 4 of Schedule 3 (Form 1040).

Other Tax Credits

Foreign Tax Credit (FTC)

The Foreign Tax Credit is intended to relieve the taxpayer of a double tax burden when his or her foreign source income is taxed by both the United States and the foreign country. In most cases, if the foreign tax rate is higher than the U.S. rate, there will be no U.S. tax on the foreign income. If the foreign tax rate is lower than the U.S. rate, U.S. tax on the foreign income will be limited to the difference between the rates. The foreign tax credit can only reduce U.S. taxes on foreign source income; it cannot reduce U.S. taxes on U.S. source income. Although no one rule covers all situations, in most cases it is better to take a credit for qualified foreign taxes than to deduct them as an itemized deduction. This is because:

1. A credit reduces the taxpayer's actual U.S. income tax on a dollar-for-dollar basis, while a deduction reduces only his or her income subject to tax.
2. The taxpayer can choose to take the foreign tax credit even if he or she does not itemize his or her deductions. The taxpayer then is allowed the standard deduction in addition to the credit.
3. If the taxpayer chooses to take the Foreign Tax Credit, and the taxes paid or accrued exceed the credit limit for the tax year, he or she may be able to carry over or carry back the excess to another tax year.

A taxpayer may either deduct foreign income taxes paid or accrued as an itemized deduction on Schedule A of Form 1040 or may apply them as a credit against his or her U.S. income tax liability. The Foreign Tax Credit (FTC) is claimed on Form 1116 - Foreign Tax Credit unless the total foreign taxes paid are less than $300 for single filers ($600 for married filing jointly). The credit may be claimed directly on Form 1040 if all filing requirements are satisfied. [164]

Generally, the following four tests must be met for any foreign tax to qualify for the credit: [165]

- The tax must be imposed on the taxpayer.
- The taxpayer must have paid or accrued the tax.
- The tax must be the legal and actual foreign tax liability.
- The tax must be an income tax (or a tax in lieu of an income tax).

The taxpayer can claim a foreign tax credit only for foreign taxes on income, war profits, excess profits or certain other taxes. In addition, there is a limit on the amount of the credit that the taxpayer can claim. The taxpayer figures this limit and the credit on Form 1116 - Foreign Tax Credit. The credit is the amount of foreign tax he or she paid or accrued or, if smaller, the limit.

The limitation is the proportion of the taxpayer's tentative U.S. income tax (before the Foreign Tax Credit) that taxpayer's foreign source taxable income bears to his or her worldwide taxable income for the year. The maximum amount of tax that may be credited is computed using the following formula:

$$\text{FTC} = \text{U.S. income tax} \ \mathbf{X} \ \frac{\text{Foreign source taxable income}}{\text{Worldwide taxable income}}$$

The limit must be applied separately to nonbusiness interest income and all other income. Also, the amount used for taxable income in the numerator and the denominator is regular taxable income with adjustments.

Note: If the taxpayer has foreign taxes available for credit but cannot use them because of the limit, he or she may be able to carry them back 1 tax year and forward to the next 10 tax years.

The taxpayer will not be subject to the above limit and will be able to claim the credit without using Form 1116 if the following requirements are met:

- Only foreign source gross income for the tax year is passive category income. For purposes of this rule, high taxed income and export financing interest are also passive category income.
- Qualified foreign taxes for the tax year are not more than $300 ($600 if married filing a joint return).
- All of gross foreign income and the foreign taxes are reported to the taxpayer on a payee statement (such as a Form 1099-DIV or 1099-INT).
- The taxpayer elects the exemption from foreign tax credit limit for the tax year.

If the taxpayer makes this election, he or she cannot carry back or carry over any unused foreign tax to or from the current tax year.

Mortgage Interest Credit

The taxpayer can claim the Mortgage Interest Credit only if he or she was issued a qualified Mortgage Credit Certificate (MCC) by a state or local governmental unit or agency under a qualified mortgage credit certificate program. The home to which the certificate relates must be the taxpayer's main home and also must be located in the jurisdiction of the governmental unit that issued the certificate. If the interest on the mortgage was paid to a related person, the taxpayer cannot claim the credit. Also, if two or more persons (other than a married couple filing a joint return) hold an interest in the home to which the MCC relates, the credit must be divided based on the interest held by each person.

The taxpayer may have an unused credit to carry forward to the next 3 tax years or until used, whichever comes first. The current year credit is used first and then the prior year credits, beginning with the earliest prior year. If the taxpayer is subject to the $2,000 credit limit because the certificate credit rate is more than 20%, no amount over the $2,000 limit (or his or her prorated share of the $2,000 if he or she must allocate the credit) may be carried forward for use in a later year. For more information, see Form 8396 - Mortgage Interest Credit.

Credit for Excess Social Security Tax or Railroad Retirement Tax Withheld

Most employers must withhold Social Security tax from a taxpayer's wages. If he or she works for a railroad employer, that employer must withhold tier 1 railroad retirement (RRTA) tax and tier 2 RRTA tax. If a taxpayer worked for more than one employer during 2020 and had more than $8,537.40 in Social Security and Tier 1 RRTA tax withheld, he or she should claim the excess on the appropriate line of Form 1040 or Form 1040-NR. If an employee had total wages and compensation over the wage base limit in Tier 2 RRTA tax withheld from more than one employer, the employee should claim a refund on Form 843 - Claim for Refund and Request for Abatement.

If the taxpayer overpaid the tax, he or she may claim a credit for the overpayment on line 11 of Schedule 3 (Form 1040). The IRS will issue a full reimbursement of the overpayment, as long as the taxpayer does not owe any income tax. If the taxpayer does owe current year or previous year taxes, the IRS applies the overpayment to that amount first, then issues any balance to the taxpayer. If only one employer withheld too much Social Security or RRTA tax, the taxpayer cannot claim the excess as a credit against his or her income tax. The taxpayer's employer should make an adjustment of the excess. If the employer does not make an adjustment, the taxpayer can use Form 843 - Claim for Refund and Request for Abatement, to claim a refund.

Residential Energy Credits

Residential Energy Efficient Property Credit (Part I) - The taxpayer may be able to take the Residential Energy Efficient Property Credit if he or she made energy saving improvements to his or her home located in the United States. The credit currently applies to solar electric property, solar water heating property, geothermal systems and windmills and is available for property placed in service through December 31, 2021, based on an applicable percentage.

The applicable percentages are:

- In the case of property placed in service after December 31, 2016, and before January 1, 2020, 30%.
- In the case of property placed in service after December 31, 2019, and before January 1, 2021, 26%.
- In the case of property placed in service after December 31, 2020, and before January 1, 2022, 22%.

Nonbusiness Energy Property Credit (Part II) - The Nonbusiness Energy Property Credit for installing insulation, storm windows, etc., is extended through 2021 as part of the Consolidated Appropriations Act, 2021.

In 2020, an individual may claim a credit for (1) 10% of the cost of qualified energy efficiency improvements and (2) the amount of the residential energy property expenditures paid or incurred by the taxpayer during the taxable year (subject to the overall credit limit of $500).

Qualified energy efficiency improvements include the following qualifying products:

- Energy-efficient exterior windows, doors, and skylights.
- Roofs (metal and asphalt) and roof products.
- Insulation.

Residential energy property expenditures include the following qualifying products:

- Energy-efficient heating and air conditioning systems.
- Water heaters (natural gas, propane, or oil).
- Biomass stoves.

Please note that qualifying property must meet the applicable standards in the law.

Work Opportunity Tax Credit

The Work Opportunity Tax Credit (WOTC) is a Federal tax credit available to employers for hiring individuals from certain targeted groups who have consistently faced significant barriers to employment. The Consolidated Appropriations Act, 2021 extends, through 2025, the credit to employers hiring individuals who are members of one or more of ten targeted groups under the Work Opportunity Tax Credit program. [166]

An employer must obtain certification that an individual is a member of the targeted group, before the employer may claim the credit. An eligible employer must file Form 8850 - Pre-Screening Notice and Certification Request for the Work Opportunity Credit with their respective state workforce agency within 28 days after the eligible worker begins work.

The credit is limited to the amount of the business income tax liability or social security tax owed. A taxable business may apply the credit against its business income tax liability, and the normal carry-back and carry-forward rules apply. See the instructions for Form 3800 - General Business Credit for more details.

Note

For qualified tax-exempt organizations, the credit is limited to the amount of employer Social Security tax owed on wages paid to all employees for the period the credit is claimed.

Qualified tax-exempt organizations will claim the credit on Form 5884-C - Work Opportunity Credit for Qualified Tax-Exempt Organizations Hiring Qualified Veterans as a credit against the employer's share of Social Security tax. The credit will not affect the employer's Social Security tax liability reported on the organization's employment tax return.

Recovery Rebate Credit

The Recovery Rebate Credit is authorized by the Coronavirus Aid, Relief, and Economic Security (CARES) Act and the COVID-related Tax Relief Act. Eligible taxpayers who did not receive the full amounts of both Economic Impact Payments may claim the Recovery Rebate Credit on their 2020 Form 1040 or 1040-SR. To determine whether the taxpayer is an eligible individual or the amount of his or her Recovery Rebate Credit, he or she should complete the Recovery Rebate Credit Worksheet in the Instructions for Form 1040 and Form 1040-SR.

Generally, the taxpayer is eligible to claim the Recovery Rebate Credit if he or she was a U.S. citizen or U.S. resident alien in 2020, cannot be claimed as a dependent of another taxpayer for tax year 2020, and has a Social Security number valid for employment that is issued before the due date of his or her 2020 tax return (including extensions).

Taxpayers who received the correct amount for their Economic Impact Payment do not need to fill out any information about the Recovery Rebate Credit on their Form 1040. The money he or she received is not taxable.

The taxpayer received the full amounts of both Economic Impact Payments if:

1. His or her first Economic Impact Payment was $1,200 ($2,400 if married filing jointly for 2020) plus $500 for each qualifying child he or she had in 2020; and
2. His or her second Economic Impact Payment was $600 ($1,200 if married filing jointly for 2020) plus $600 for each qualifying child he or she had in 2020.

If eligible, the taxpayer can claim the Recovery Rebate Credit when he or she files his or her 2020 tax return (Form 1040 or Form 1040-SR) electronically using tax software or on paper. The 2020 tax return instructions include a worksheet the taxpayer can use to figure the amount of any Recovery Rebate Credit for which he or she is eligible. The worksheet requires the taxpayer to know the amounts of his or her Economic Impact Payments.

The Recovery Rebate Credit amount will be phased out if the taxpayer's adjusted gross income for 2020 exceeds $150,000 if he or she is married filing a joint return or filing as a qualifying widow or widower, $112,500 if he or she is using the head of household filing status, or $75,000 if he or she is using any other filing status.

Credit to Holders of Tax Credit Bonds

Tax credit bonds are bonds in which the holder receives a tax credit in lieu of some or all of the interest on the bond. The taxpayer may be able to take a credit if he or she is a holder of one of the following bonds: [167]

- Clean renewable energy bonds (issued before 2010).
- New clean renewable energy bonds.
- Qualified energy conservation bonds.
- Qualified school construction bonds.
- Qualified zone academy bonds.
- Build America bonds.

In some instances, an issuer may elect to receive a credit for interest paid on the bond. If the issuer makes this election, the taxpayer cannot also claim a credit.

Credit for Tax on Undistributed Capital Gain

A taxpayer must include in income any amounts that regulated investment companies (commonly called mutual funds) or real estate investment trusts (REITs) allocated to him or her as capital gain distributions, even if the taxpayer did not actually receive them. If the mutual fund or REIT paid a tax on the capital gain, the taxpayer is allowed a credit for the tax since it is considered paid by him or her. The mutual fund or REIT will send a Form 2439 - Notice to Shareholder of Undistributed Long-Term Capital Gains showing the taxpayer's share of the undistributed capital gains and the tax paid, if any. To take the credit, attach Copy B of Form 2439 to the taxpayer's Form 1040 or 1040-SR. Include the amount from box 2 of his or her Form 2439 in the total for Schedule 3 (Form 1040 or 1040-SR), line 13, and check box A.

Taxation

Alternative Minimum Tax

Alternative Minimum Tax (AMT) rules have been devised to ensure that at least a minimum amount of income tax is paid by higher-income taxpayers who reap large tax savings by making generous use of certain tax deductions, losses and credits. Without AMT some of these taxpayers might be able to escape income taxation entirely. In essence, the AMT functions as a recapture mechanism, reclaiming some of the tax breaks primarily available to higher-income taxpayers, and represents an attempt to maintain tax equity.

The Tax Cuts and Jobs Act (TCJA), enacted in December 2017, substantially changed the AMT. About 5 million taxpayers were expected to pay the AMT under the old law, but only 200,000 are expected to pay the AMT in 2020. So few taxpayers will owe the AMT that the IRS says it will remove its online AMT Assistant tax tool. Three key changes in the TCJA returned the AMT to being primarily a millionaire's tax.

First, the AMT exemption was increased substantially. For taxpayers who are married filing jointly, the exemption is $113,400 in 2020. It is $72,900 for singles and heads of household, and the exemption is $56,700 for married taxpayers filing separately.

Second, the income levels at which the exemptions phase out are much higher. They are $1,036,800 for married couples filing jointly and $518,400 for other taxpayers.

Third, many of the tax breaks that triggered the AMT for middle class taxpayers have been changed. Middle income taxpayers frequently were subject to the AMT when they had high levels of personal and dependent exemptions, deductions for miscellaneous itemized expenses, home equity mortgage interest, and state and local tax deductions. The personal exemptions are eliminated (though dependent exemptions remain), as are miscellaneous itemized expenses and the home equity interest deduction. The state and local tax deduction is limited to $10,000 per tax return. Collectively, they are replaced by a much higher standard deduction.

The taxpayer should use Form 6251 - Alternative Minimum Tax to figure the amount, if any, of his or her alternative minimum tax (AMT). The AMT is a separate tax that is imposed in addition to the taxpayer's regular tax. It applies to taxpayers who have certain types of income that receive favorable treatment, or who qualify for certain deductions, under the tax law. These tax benefits can significantly reduce the regular tax of some taxpayers with higher economic incomes. The AMT sets a limit on the amount these benefits can be used to reduce total tax. The taxpayer also uses Form 6251 to figure his or her tentative minimum tax (Form 6251, line 9).

New Starting Point for AMTI Calculation

Instead of starting with the amount of the taxpayer's regular tax adjusted gross income (AGI) reduced by any itemized deductions, the taxpayer will start his or her alternative minimum taxable income (AMTI) calculation with his or her taxable income for regular tax unless it is zero. In that case, the taxpayer will start from regular tax AGI reduced by his or her itemized deductions (or standard deduction) and qualified business income deduction. If the taxpayer is not itemizing his or her deductions, his or her standard deduction amount will be added back to AMTI on a later line (because the taxpayer cannot reduce AMTI by the standard deduction).

Amount Excluded from Minimum Taxation

A specified amount of AMTI, Alternative Minimum Taxable Income, 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.

For 2020 returns, the AMT exemption amounts are: [168]

- $113,400 for married individuals filing a joint return and surviving spouses.
- $72,900 for a single individual (who is not a surviving spouse) and head of household.
- $56,700 for married individuals filing separate returns.

AMT Exemption for Certain Children

For children under age 24 the AMT exemption amount is limited to the amount of earned income plus $7,900 in 2020 if any of the following conditions apply: (169)

- The taxpayer was under age 18 at the end of 2020.
- The taxpayer was age 18 at the end of 2020 and did not have earned income that was more than half of his or her support.
- The taxpayer was a full-time student over age 18 and under age 24 at the end of 2020 and did not have earned income that was more than half of his or her support.

Ordinarily, single individuals can subtract a $72,900 exemption amount from their AMT taxable income. However, a child who files Form 8615 - Tax for Certain Children Who Have Unearned Income has a limited exemption amount. The child's exemption amount for 2020 is limited to the child's earned income plus $7,900.

AMT Exemption Phase-out

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 AMTI exemption phase-out thresholds for 2020 begin at: (168)

- $1,036,800, for married individuals filing a joint return, and surviving spouses.
- $518,400, for unmarried individuals (other than surviving spouses).

AMT is computed at rates of 26% and 28%. In 2020, the 26% rate applies to the first $197,900 ($98,950, in the case of married individuals filing separately) of AMT income in excess of the applicable exemption amount. The 28% rate applies to any additional AMT income. However, special rates apply to net long-term capital gain and qualified dividends.

After subtracting the exemption amount from the taxpayer's AMTI, multiply the remainder by the applicable AMT rate of 26% or 28%. Generally, the resulting figure is his or her tentative minimum tax (TMT). Compare the taxpayer's TMT with his or her regular income tax. If the regular tax is higher, the taxpayer does not owe any AMT. But if the regular tax is lower, the difference between the two taxes is the amount of AMT he or she must pay in addition to his or her regular tax (if any).

Credit for Prior Year Alternative Minimum Tax

If a 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.

The AMT is caused by two types of adjustments and preferences - deferral items and exclusion items. Deferral items (for example, depreciation) generally do not cause a permanent difference in taxable income over time. Exclusion items (for example, the standard deduction), on the other hand, do cause a permanent difference. The minimum tax credit is allowed only for the AMT caused by deferral items.

The taxpayer should use Form 8801 - Credit for Prior Year Minimum Tax - Individuals, Estates, and Trusts if he or she is an individual, estate, or trust to figure the current year nonrefundable credit, if any, for alternative minimum tax (AMT) he or she incurred in prior tax years and to figure any credit carryforward to 2021.

Complete Form 8801 if the taxpayer is an individual, estate, or trust that for 2019 had:

- An AMT liability and adjustments or preferences other than exclusion items.
- A credit carryforward to 2020 (on 2019 Form 8801, line 26).
- An unallowed qualified electric vehicle credit.

Preferences and Adjustments

Positive and negative AMT adjustments are added or subtracted from regular taxable income to determine the "taxable income after AMT adjustments". Tax preference items are then added to get the taxpayer's AMTI. The following is a list of AMT adjustments:

- Standard deduction.
- Certain itemized deductions.
- Mortgage interest.
- Taxes.
- Medical expenses.
- Miscellaneous deductions.
- Investment interest.
- MACRS depreciation.
- Basis adjustment affects AMT gain or loss.
- Incentive stock options (ISO).
- Mining exploration and development costs.
- Circulation costs.
- Long-term contracts.
- Research and experimental procedures.
- Passive tax-shelter farm losses.
- Passive losses from non-farming activities.

Certain tax preference items must be added back into taxable income after AMT adjustments to determine the AMTI. These primary items include the following AMT preference items:

- Tax-exempt interest on private-activity municipal bonds.
- Percentage Depletion / Excess intangible drilling costs (IDC).
- Depreciation (ACRS/MACRS).
- Exercise of an Incentive Stock Option (Bargain Element).

Exclusion Items versus Deferral Items

Tax preference and adjustments to AMT are broken down into two categories; exclusion items and deferral items. Exclusion items are adjustments that cause a permanent difference in income for regular tax versus AMT purposes. They include the following AMT adjustments/preferences that are exclusion items:

- Standard deduction.
- Itemized deduction.
- Percentage depletion.
- Tax-exempt interest.
- Exclusion of gain from qualified small business stock.

Deferral items do not cause a permanent difference in taxable income over time. AMT adjustments/preference that are deferral items are any adjustment/preference item that is not an exclusion item from the list above.

Alternative Minimum Taxable Income (AMTI)

The AMT is calculated based on the alternative minimum taxable income (AMTI) that includes all of the income under the regular tax system plus some income that is tax exempt under the regular tax system. The following common items are not deductible under the AMT system:

- State and local taxes.
- Miscellaneous itemized deductions.

The only way to determine AMT liability is to calculate taxable income using standard procedures and then using the AMT procedures on Form 6251 - Alternative Minimum Tax for Individuals. The end result of the AMT calculation is a tentative AMT tax from which the regular tax is subtracted. If the result is positive, then this AMT tax is added to the regular tax on Form 1040; if the result is negative, then there is no AMT.

Example
Don's regular income tax is $50,000. When he calculates his tax using the AMT rules, he comes up with $62,000. Therefore, Don must pay $12,000 of AMT in addition to the $50,000 of regular income tax.

Household Employees

A taxpayer has a household employee if he or she hired someone to do household work and that worker is the taxpayer's employee. The worker is the taxpayer's employee if he or she can control not only what work is done, but how it is done. If the worker is the taxpayer's employee, it does not matter whether the work is full-time or part-time or that he or she hired the worker through an agency or from a list provided by an agency or association. It also does not matter whether the taxpayer pays the worker on an hourly, daily, or weekly basis, or by the job. Some examples of workers who do household work are: (170)

- Babysitters.
- Caretakers.
- House cleaning workers.
- Domestic workers.
- Drivers.
- Health aides.
- Housekeepers.
- Maids.
- Nannies.
- Private nurses.
- Yard workers.

The household employment taxes that the taxpayer may have to account for on Schedule H cover the same three taxes that are withheld from all employment wages: the 12.4% Social Security tax, a 2.9% Medicare tax and the 6% Federal unemployment tax, or FUTA. If the taxpayer also pays state unemployment insurance taxes, Schedule H gives him or her credit for the taxes by reducing the FUTA rate.

The taxpayer is responsible for paying all of FUTA – employees do not make contributions through withholding. The taxpayer also must pay half of each household employee's Social Security and Medicare tax liability; the employee pays the other half through amounts he or she withholds from her wages. If the taxpayer has to pay these taxes to the Internal Revenue Service, Schedule H calculates the precise amount that he or she should have withheld, as well as the portion he or she owes. (171)

Employment Tax Requirements	
If the taxpayer:	**Then he or she needs to:**
Pays cash wages of $2,200 or more in 2020 to any one household employee. The taxpayer does not count wages he or she pays to: • His or her spouse. • His or her child under the age of 21. • His or her parent (exceptions apply). • Any employee under the age of 18 at any time in 2020 (exceptions apply).	Withhold and pay Social Security and Medicare taxes. • The taxes are 15.3%[1] of cash wages. • The employee's share is 7.65%[1]. (The taxpayer can choose to pay it him or herself and not withhold it.) • The taxpayer's share is 7.65%
Pays total cash wages of $1,000 or more in any calendar quarter of 2019 or 2020 to household employees.	Pay Federal unemployment tax. • The tax is 6% of cash wages. • Wages over $7,000 a year per employee are not taxed. • The taxpayer may also owe state unemployment tax.

[1]In addition to withholding Medicare tax at 1.45%, an employer must withhold a 0.9% Additional Medicare Tax from wages he or she pays to an employee in excess of $200,000 in a calendar year. The employer is required to begin withholding Additional Medicare Tax in the pay period in which he or she pays wages in excess of $200,000 to an employee and continue to withhold it each pay period until the end of the calendar year. Additional Medicare Tax is only imposed on the employee. There is no employer share of Additional Medicare Tax. All wages that are subject to Medicare tax are subject to Additional Medicare Tax withholding if paid in excess of the $200,000 withholding threshold.

Table 4-1 - Publication 926 - Table 1-Do You Need To Pay Employment Taxes? (2020)

Social Security and Medicare Taxes (Federal Insurance Contributions Act – FICA)

If your client pays a household employee cash wages of more than the amount specified by law in a tax year ($2,200 for 2020), he or she generally must withhold Social Security and Medicare taxes from all cash wages paid to that employee. (Cash wages include wages paid by check, money order, etc.) Unless the taxpayer prefers to pay the employee's share of Social Security and Medicare taxes from his or her own funds, the taxpayer should withhold 7.65% from each payment of cash wages made. In addition, Additional Medicare Tax applies to an individual's Medicare wages that exceed a threshold amount based on the taxpayer's filing status. Employers are responsible for withholding the 0.9% Additional Medicare Tax on an 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.

The specified dollar amounts and percentages can be found Publication 926 - Household Employer's Tax Guide. The taxpayer should pay the amount he or she withholds to the IRS with an additional 7.65% for his or her share of the taxes. If the taxpayer pays the employee's share of Social Security and Medicare taxes from his or her own funds, the amounts the taxpayer pays for the employee counts as wages for purposes of the employees' income tax. However, they are not counted as Social Security and Medicare wages or as wages for Federal unemployment tax.

Do not withhold or pay Social Security and Medicare taxes from wages the taxpayer pays to: [(172)]

- His or her spouse.
- His or her child who is under age 21.
- His or her parent, unless an exception is met.
- An employee who is under age 18 at any time during the year, unless performing household work is the employee's principal occupation. If the employee is a student, providing household work is not considered to be his or her principal occupation.

Federal Income Tax Withholding

The taxpayer is not required to withhold Federal income tax from wages he or she pays to a household employee. However, if the employee asks the taxpayer to withhold Federal income tax and he or she agrees, the taxpayer will need a completed Form W-4 - Employee's Withholding Certificate from the employee. See Publication 15 - (Circular E) - Employer's Tax Guide, which has tax withholding tables that are updated each year. [(172)]

Form W-2 - Wage and Tax Statement

If the taxpayer must withhold and pay Social Security and Medicare taxes, or if the taxpayer withholds Federal income tax, he or she will need to complete Form W-2 - Wage and Tax Statement for each employee. The taxpayer will also need a Form W-3 - Transmittal of Wage and Tax Statement. To complete Form W-2 the taxpayer will need an employer identification number (EIN) and the employees' Social Security numbers. If the taxpayer does not already have an (EIN), he or she can apply for one using the online EIN application on the IRS website. [(172)]

Federal Unemployment Tax Act (FUTA)

If the taxpayer paid cash wages to household employees totaling more than $1,000 in any calendar quarter during the calendar year or the prior year, he or she generally must pay Federal unemployment tax (FUTA) tax on the first $7,000 of cash wages paid to each household employee. However, do not count wages paid to his or her spouse, his or her child who is under the age of 21, or his or her parent. The amounts the taxpayer pays to these individuals are also not considered wages subject to FUTA tax. Generally, the taxpayer can take a credit against the FUTA tax liability for amounts paid into state unemployment funds. A state that has not repaid money it borrowed from the Federal government to pay unemployment benefits is a "credit reduction state." If the taxpayer paid wages that are subject to the unemployment compensation laws of a credit reduction state, the FUTA tax credit may be reduced. See the instructions for Form 1040, Schedule H - Household Employment Taxes, or the IRS.gov website for more information. [172]

The FUTA tax is 6.0% of an employee's FUTA wages. However, the taxpayer may be able to take a credit of up to 5.4% against the FUTA tax, resulting in a net tax rate of 0.6%. The taxpayer's credit for 2020 is limited unless he or she pays all the required contributions for 2020 to his or her state unemployment fund by April 15, 2021. The credit the taxpayer can take for any contributions for 2020 that he or she pays after April 15, 2021, is limited to 90% of the credit that would have been allowable if the contributions were paid by April 15, 2021.

Schedule H - Household Employment Taxes

If the taxpayer pays wages subject to FICA tax, FUTA tax, or if he or she withholds Federal income tax from and employee's wages, he or she will need to file a Form 1040, Schedule H - Household Employment Taxes. Attach Schedule H to the individual income tax return. If the taxpayer is not required to file a return, he or she must still file Schedule H to report household employment taxes.

However, a sole proprietor who must file Form 940 - Employer's Annual Federal Unemployment (FUTA) and Form 941 - Employer's QUARTERLY Federal Tax Return or Form 944 - Employer's ANNUAL Federal Tax Return, for business employees, or Form 943 - Employer's Annual Federal Tax Return for Agricultural Employees, for farm employees, may report household employee tax information on these forms instead of on Schedule H. If the taxpayer chooses to report the wages for a household employee on the forms shown above, be sure to pay any taxes due by the date required based on the form, making Federal tax deposits if required. Additional information is available in the instructions for the form.

Estimated Tax Payments

If your client files Form 1040, Schedule H, he or she can avoid owing taxes with the return if he or she pays enough tax before filing the return to cover both the employment taxes for the household employee and the income tax. If the taxpayer is employed, he or she can ask the employer to withhold more Federal income tax from wages during the year. The taxpayer can also make estimated tax payments to the IRS during the year using Form 1040-ES - Estimated Tax for Individuals.

Notices and Bills, Penalties, and Interest Charges

Generally, April 15 is the deadline for most people to file their individual income tax returns and pay any tax owed. During its processing, the IRS checks the taxpayer's tax return for mathematical accuracy. When processing is complete, if the taxpayer owes any tax, penalty, or interest, he or she will receive a bill.

Generally, interest accrues on any unpaid tax from the due date of the return until the date of payment in full. The interest rate is determined quarterly and is the federal short-term rate plus 3%. Interest compounds daily.

In addition, if the taxpayer files a return but does not pay all tax owed on time, he or she will generally have to pay a late payment penalty. The failure-to-pay penalty is one-half of one percent for each month, or part of a month, up to a maximum of 25%, of the amount of tax that remains unpaid from the due date of the return until the tax is paid in full. The one-half of one percent rate increases to one percent if the tax remains unpaid 10 days after the IRS issues a notice of intent to levy property. If the taxpayer files his or her return by its due date and request an installment agreement, the one-half of one percent rate decreases to one-quarter of one percent for any month in which an installment agreement is in effect. Be aware that the IRS applies payments to the tax first, then any penalty, then to interest. Any penalty amount that appears on his or her bill is generally the total amount of the penalty up to the date of the notice, not the penalty amount charged each month.

If the taxpayer owes tax and does not file on time, there is also a penalty for not filing on time. The failure-to-file penalty is usually 5% of the tax owed for each month, or part of a month that his or her return is late, up to a maximum of 25%. If the taxpayer's return is over 60 days late, there is also a minimum penalty for late filing; it is the lesser of $435 (for tax returns required to be filed in 2021) or 100% of the tax owed. [173]

Self-Employment Tax

All individuals engaged in a trade or business in any capacity, other than as employees, are subject to the self-employment tax. Generally, this includes a sole proprietor, a member of a partnership, and one who renders service as an independent contractor. For 2020, the SE tax rate on net earnings is 15.3% (12.4% Social Security tax plus 2.9% Medicare tax).

Tip

Self-employment (SE) tax is a Social Security and Medicare tax primarily for individuals who work for themselves. It is similar to the Social Security and Medicare taxes withheld from the pay of most wage earners and is usually calculated on the net profit from Schedule C. If a husband and wife both have separate Schedule C, each spouse must figure their SE tax separately on individual Schedule SE. If a taxpayer has more than one business and therefore more than one Schedule C, all business income or loss is determined before calculating SE tax. If any of the income from a trade or business, other than a partnership, is community property income under state law, it is included in the earnings subject to SE tax of the spouse carrying on the trade or business. A taxpayer must pay SE tax and file Schedule SE if either of the following applies:

- Their net earnings from self-employment (excluding church employee income) were $400 or more.
- They had church employee income of $108.28 or more except for ministers and members of religious orders.

For a sole proprietor, net income (as reported on Schedule C) must be counted as self-employment income. If net income is less than $400, the self-employment tax does not apply.

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 2020, 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 $137,700 of wages, for a maximum of $8,537.40 for employees and for employers, and $17,074.80 for self-employed people. The current rate for Medicare is 1.45% for the employer, 1.45% for the employee and 2.9% for self-employed individuals. There is not a wage base limit for Medicare tax. All covered wages are subject to Medicare tax.

Federal income tax is a pay-as-you-go tax. The taxpayer must pay it as he or she earns or receives income during the year. An employee usually has income tax withheld from his or her pay. If the taxpayer does not pay his or her tax through withholding, or does not pay enough tax that way, they might have to pay estimated tax. All taxpayers generally have to make estimated tax payments if they expect to owe taxes, including self-employment tax, of $1,000 or more when they file their return.

Note

The self-employment tax is determined by completing Schedule SE Self-Employment. Business Net Profit on Schedule C is transferred to Form 1040 and to Schedule SE. If the taxpayer has to pay SE tax, he or she must file Form 1040 (with Schedule SE attached) even if the taxpayer does not otherwise have to file a Federal income tax return. [125]

Excess Social Security and RRTA Tax Withheld

Most employers must withhold Social Security tax from your wages. Certain government employers (some Federal, state and local governments) do not have to withhold Social Security tax. If the taxpayer works for a railroad employer, his or her employer must withhold Tier 1 Railroad Retirement Tax Act (RRTA) tax and Tier 2 RRTA tax. Tier 1 RRTA provides Social Security and Medicare equivalent benefits, and Tier 2 RRTA provides a private pension benefit.

If any one employer withheld too much Social Security, Tier 1 RRTA tax, or Tier 2 RRTA tax, the taxpayer cannot claim the excess as a credit against his or her income tax. The taxpayer's employer should adjust the excess for him or her. If the employer does not adjust the overcollection, the taxpayer can use Form 843 - Claim for Refund and Request for Abatement to claim a refund.

If the taxpayer had more than one employer during the taxable year and his or her total wages and compensation were over the wage base limit for the year, the total Social Security tax or Social Security equivalent Tier 1 RRTA tax withheld may have exceeded the maximum amount due for the tax year. In 2020, the maximum earnings subject to the Social Security payroll tax is $137,700. Therefore, the maximum withholding amount is $8,537.40 ($137,700 x

6.2%). If the taxpayer had more than one railroad employer, and his or her total compensation was over the maximum amount of wages subject to Tier 2 RRTA, the total Tier 2 RRTA tax withheld may have exceeded the maximum due for the tax year.

If the taxpayer had more than one employer and too much Social Security tax or Tier 1 RRTA tax withheld, he or she may be able to claim the excess as a credit against his or her income tax on his or her income tax return. If the taxpayer had more than one employer and too much Tier 2 RRTA tax withheld, he or she may request a refund of the excess Tier 2 RRTA tax using Form 843. The taxpayer should attach copies of his or her Forms W-2 - Wage and Tax Statement for the year to Form 843.

Military

For Federal tax purposes, the U.S. Armed Forces includes officers and enlisted personnel in all regular and reserve units controlled by the Secretaries of Defense, the Army, Marines, Navy and Air Force. The Coast Guard is also included, but not the U.S. Merchant Marine or the American Red Cross. However, these and other support personnel may qualify for certain tax deadline extensions because of their service in a combat zone. [174]

Members of the Armed Forces receive many different types of pay and allowances. Some are included in gross income while others are excluded from gross income. Included items are subject to tax and must be reported on the taxpayer's tax return. Excluded items are not subject to tax but may have to be shown on his or her tax return.

These items are included in gross income unless the pay is for service in a combat zone.

Basic pay:

- Active duty.
- Attendance at a designated service school.
- Back wages.
- Cadet/midshipman pay.
- Drills.
- Reserve training.
- Training duty.

Special pay:

- Aviation career incentives.
- Career sea.
- Diving duty.
- Foreign duty (outside the 48 contiguous states and the District of Columbia).
- Foreign language proficiency.
- Hardship duty.
- Hostile fire or imminent danger.
- Medical and dental officers.
- Nuclear-qualified officers.
- Optometry.
- Other Health Professional Special Pays (for example, nurse, physician assistant, social work, etc.).
- Pharmacy.
- Special compensation for assistance with activities of daily living (SCAADL).
- Special duty assignment pay.
- Veterinarian.
- Voluntary Separation Incentive.

Bonus pay:

- Career status.
- Continuation pay.
- Enlistment.
- Officer.
- Overseas extension.
- Reenlistment.

Incentive pay:

- Submarine.
- Flight.
- Hazardous duty.
- High altitude/Low Opening (HALO).

Other pay:

- Accrued leave.
- CONUS COLA.
- High deployment per diem.
- Personal money allowances paid to high-ranking officers.
- Student loan repayment from programs such as the Department of Defense Educational Loan Repayment Program when year's service (requirement) is not attributable to a combat zone.

In-kind military benefits:

- Personal use of a government-provided vehicle.

Nontaxable pay for service members is generally referred to as allowance or assistance and includes:

- Pay for active service in a combat zone or qualified Hazardous Duty Area.
- Living allowances, like BAH, BAS, and OHA.
- Disability and medical benefits.
- Educational assistance.
- Legal assistance.
- Family separation allowances.
- Temporary lodging.
- Uniform allowances.

It is worth noting some of the nontaxable items listed above might need to be used to calculate certain tax benefits – for example, excluded combat pay is included in the taxpayer's gross income amount when calculating the allowed IRA contributions, and for the Child Tax Credit, Additional Child Tax Credit, Earned Income Tax Credit, and the Credit for Child and Dependent Care expenses.

Note

The taxpayer can still deduct mortgage interest and real estate taxes on his or her home if he or she pays these expenses with his or her Basic Housing Allowance (BHA).

If a taxpayer serves in a combat zone as an enlisted person or as a warrant officer (including commissioned warrant officers) for any part of a month, all his or her military pay received for military service that month is excluded from gross income. For commissioned officers, the monthly exclusion is capped at the highest enlisted pay, plus any hostile fire or imminent danger pay received.

A combat zone is any area the President of the United States designates by Executive Order as an area in which the U.S. Armed Forces are engaging or have engaged in combat. An area usually becomes a combat zone and ceases to be a combat zone on the dates the President designates by Executive Order.

Combat Zone Service

The time for taking care of certain tax matters can be postponed. These postponements are referred to as extensions of deadlines. The deadline for IRS to take certain actions, such as collection and examination actions, may also be extended. The deadline for filing tax returns, paying taxes, filing claims for refund, and taking other actions with the IRS is automatically extended if either of the following statements is true: [175]

- The taxpayer serves in the Armed Forces in a combat zone or he or she has qualifying service outside of a combat zone.
- The taxpayer serves in the Armed Forces on deployment outside the United States away from his or her permanent duty station while participating in a contingency operation. A contingency operation is a military operation that is designated by the Secretary of Defense or results in calling members of the uniformed services to active duty (or retains them on active duty) during a war or a national emergency declared by the President or Congress.

The deadline for taking actions with the IRS is extended for 180 days after the later of: (175)

- The last day the taxpayer is in a combat zone, have qualifying service outside of the combat zone, or serve in a contingency operation (or the last day the area qualifies as a combat zone or the operation qualifies as a contingency operation).
- The last day of any continuous qualified hospitalization for injury from service in the combat zone or contingency operation or while performing qualifying service outside of the combat zone.

In addition to the 180 days, the deadline is extended by the number of days that were left for the taxpayer to take the action with the IRS when he or she entered a combat zone (or began performing qualifying service outside the combat zone) or began serving in a contingency operation. If the person entered the combat zone or began serving in the contingency operation before the period of time to take the action began, the deadline is extended by the entire period of time he or she has to take the action.

For example, the individual had 3½ months (January 1 - April 15, 2021) to file his or her 2020 tax return. Any days of this 3½ month period that were left when he or she entered the combat zone (or the entire 3½ months if he or she entered the combat zone by January 1, 2020) are added to the 180 days when determining the last day allowed for filing the 2020 tax return. (175)

Travel Expenses of Armed Forces Reservists

If the taxpayer is a member of a reserve component of the Armed Forces and he or she travels more than 100 miles away from home in connection with his or her performance of services as a member of the reserves, he or she can deduct his or her unreimbursed travel expenses on his or her tax return. Include all unreimbursed expenses from the time the taxpayer leaves home until the time he or she returns home.

If the taxpayer has reserve-related travel that takes him or her more than 100 miles from home, he or she should first complete Form 2106 - Employee Business Expenses. Then on Schedule 1 (Form 1040), line 11, enter the part of the taxpayer's expenses, up to the Federal rate, included on Form 2106, line 10, that is for reserve-related travel more than 100 miles from his or her home.

Note

The Schedule A (Form 1040) itemized deduction previously available for reserve-related travel that takes the taxpayer less than 100 miles from home has been suspended. It is not available for 2020.

Clergy

For income tax purposes, a licensed, commissioned, or ordained minister is generally treated as a common law employee of his or her church, denomination, or sect. If the taxpayer is a minister performing ministerial services, he or she is taxed on wages, offerings, and on any fees received for performing marriages, baptisms, funerals and masses. (176)

Special rules for housing apply to members of the clergy. Under these rules, the taxpayer does not include in income the rental value of a home (including utilities) or a designated housing allowance provided to him or her as part of pay. However, the exclusion cannot be more than the reasonable pay for the taxpayer's service. Facts and circumstances determine whether the taxpayer is considered an employee or a self-employed person under common-law rules. Generally, he or she is an employee if the church or organization he or she performs services for has the legal right to control both what he or she does and how he or she does it, even if he or she has considerable discretion and freedom of action.

If a congregation employs the taxpayer for a salary, he or she is generally a common-law employee of the congregation and his or her salary is considered wages for income tax purposes. However, amounts received directly from members of the congregation, such as fees for performing marriages, baptisms or other personal services, are generally earnings from self-employment for income tax purposes. Both the salary the taxpayer receives from the congregation and fees he or she receives from members of the congregation are subject to self-employment tax.

If the taxpayer is a member of a religious order who has taken a vow of poverty, how he or she treats earnings that he or she renounces and turn over to the order depends on whether the taxpayer's services are performed for the order. If the taxpayer is performing the services as an agent of the order in the exercise of duties required by the order, do not include in his or her income the amounts turned over to the order.

If the taxpayer's order directs him or her to perform services for another agency of the supervising church or an associated institution, the taxpayer is considered to be performing the services as an agent of the order. Any wages he or she earns as an agent of an order that he or she turns over to the order are not included in his or her income. (53)

Example
Harold is a member of a church order and has taken a vow of poverty. He renounces any claims to his earnings and turns over to the order any salaries or wages he earns. Harold is a registered nurse, so his order assigns him to work in a hospital that is an associated institution of the church. However, Harold remains under the general direction and control of the order. He is considered to be an agent of the order and any wages he earns at the hospital that he turns over to his order are not included in his income.

If the taxpayer is directed to work outside the order, his or her services are not an exercise of duties required by the order unless they meet both of the following requirements:

1. They are the kind of services that are ordinarily the duties of members of the order.
2. They are part of the duties that the taxpayer must exercise for, or on behalf of, the religious order as its agent.

If the taxpayer is an employee of a third party, the services he or she performs for the third party will not be considered directed or required of him or her by the order. Amounts the taxpayer receives for these services are included in his or her income, even if he or she has taken a vow of poverty.

Income in Respect of Decedent (IRD)

All income the decedent would have received had death not occurred that was not properly includible on the final return is income in respect of a decedent. Income in respect of a decedent must be included in the income of one of the following: (177)

- The decedent's estate, if the estate receives it.
- The beneficiary, if the right to income is passed directly to the beneficiary and the beneficiary receives it.
- Any person to whom the estate properly distributes the right to receive it.

If the taxpayer has to include income in respect of a decedent in his or her gross income and an estate tax return (Form 706) was filed for the decedent, he or she may be able to claim a deduction for the estate tax paid on that income.

Net Investment Income Tax

The Net Investment Income Tax (NIIT) is imposed by Section 1411 of the Internal Revenue Code (IRC) and took effect on January 1, 2013. The NIIT applies at a rate of 3.8% to certain net investment income of individuals, estates and trusts that have income above the statutory threshold amounts. In general, investment income includes, but is not limited to interest, dividends, capital gains, rental and royalty income, non-qualified annuities, income from businesses involved in trading of financial instruments or commodities, and businesses that are passive activities to the taxpayer.

Tip

The amount subject to the 3.8% tax is the lesser of the taxpayer's net investment income or the amount by which modified adjusted gross (MAGI) exceeds the applicable threshold. Individuals will owe the tax if they have Net Investment Income and also have modified adjusted gross income over the following thresholds: (178)

Filing Status	Threshold Amount*
Married filing jointly	$250,000
Married filing separately	$125,000

Single	$200,000
Head of household (with qualifying person)	$200,000
Qualifying widow(er) with dependent child	$250,000
*Taxpayers should be aware that these threshold amounts are not indexed for inflation. These amounts will stay the same from year to year, unless Congress specifically changes these amounts through new legislation.	

Table 4-2 - IRS.GOV Net Investment Income Tax FAQs (2020)

If an individual is exempt from Medicare taxes, he or she still may be subject to the Net Investment Income Tax if he or she has Net Investment Income and also has modified adjusted gross income over the applicable thresholds.

Nonresident Aliens (NRAs) are not subject to the Net Investment Income Tax. If an NRA is married to a U.S. citizen or resident and has made, or is planning to make, an election under IRC Section 6013(g) to be treated as a resident alien for purposes of filing as Married Filing Jointly, the proposed regulations provide these couples special rules and a corresponding IRC Section 6013(g) election for the NIIT.

Estates and Trusts will be subject to the Net Investment Income Tax if they have undistributed Net Investment Income and also have adjusted gross income over the dollar amount at which the highest tax bracket for an estate or trust begins for such taxable year. Generally, the threshold amount for the upcoming year is updated by the IRS each fall in a revenue procedure. For tax year 2020, the highest regular income tax bracket for trusts and estates (37%) begins with taxable income in excess of $12,950. The taxpayer should be aware that there are special computational rules for certain unique types of trusts, such as Charitable Remainder Trusts and Electing Small Business Trusts.

The following trusts are not subject to the Net Investment Income Tax:

1. Trusts that are exempt from income taxes imposed by Subtitle A of the Internal Revenue Code (e.g., charitable trusts and qualified retirement plan trusts exempt from tax under IRC Section 501, and Charitable Remainder Trusts exempt from tax under IRC Section 664).
2. A trust in which all of the unexpired interests are devoted to one or more of the purposes described in IRC Section 170(c)(2)(B).
3. Trusts that are classified as grantor trusts under IRC Sections 671-679.
4. Trusts that are not classified as trusts for Federal income tax purposes (e.g., Real Estate Investment Trusts and Common Trust Funds).

In general, investment income includes, but is not limited to: interest, dividends, capital gains, rental and royalty income, non-qualified annuities, income from businesses involved in trading of financial instruments or commodities, and businesses that are passive activities to the taxpayer (within the meaning of IRC Section 469).

To the extent that gains are not otherwise offset by capital losses, the following gains are common examples of items taken into account in computing Net Investment Income:

- Gains from the sale of stocks, bonds, and mutual funds.
- Capital gain distributions from mutual funds.
- Gain from the sale of investment real estate (including gain from the sale of a second home that is not a primary residence).
- Gains from the sale of interests in partnerships and S corporations (to the extent the taxpayer was a passive owner).

The Net Investment Income Tax will not be applicable to any amount of gain that is excluded from gross income for regular income tax purposes. The pre-existing statutory exclusion in IRC Section 121 exempts the first $250,000 ($500,000 in the case of a married couple) of gain recognized on the sale of a principal residence from gross income for regular income tax purposes and, therefore, from the NIIT. Wages, unemployment compensation; operating income from a non-passive business, Social Security Benefits, alimony, tax-exempt interest, self-employment income, Alaska Permanent Fund Dividends and distributions from certain Qualified Plans are some common types of income that are not investment income.

In order to arrive at Net Investment Income, Gross Investment Income is reduced by deductions that are properly allocable to items of Gross Investment Income. Examples of properly allocable deductions include investment interest expense, investment advisory and brokerage fees, expenses related to rental and royalty income, and state and local income taxes properly allocable to items included in Net Investment Income.

Taxpayers will determine any applicable Medicare tax on the new Form 8960 - Net Investment Income Tax - Individuals, Estates and Trusts, when they file their income tax return. Taxpayers whose AGI may exceed the threshold amounts and who have investment income may need to adjust their withholding or make estimated tax payments to ensure the new Medicare tax on investment income does not prompt a balance due when filing taxes next year.

Additional Medicare Tax

Effective January 2013, Additional Medicare Tax applies to an individual's Medicare wages that surpass a threshold amount based on the taxpayer's filing status. All wages that are currently subject to Medicare Tax are subject to Additional Medicare Tax if they are paid in excess of the applicable threshold for an individual's filing status. Employers are responsible for withholding the 0.9% Additional Medicare Tax on an individual's wages paid in excess of $200,000 in a calendar year. An employer is obligated 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. [(226)]

An individual is responsible for Additional Medicare Tax if the individual's wages, compensation, or self-employment income (together with that of his or her spouse if filing a joint return) surpass the threshold amount for the individual's filing status.

Filing Status	Threshold Amount
Married filing jointly	$250,000
Married filing separately	$125,000
Single	$200,000
Head of household (with qualifying person)	$200,000
Qualifying widow(er) with dependent child	$200,000

Table 4-3 - Questions and Answers for the Additional Medicare Tax (2020)

The Additional Medicare Tax statute mandates an employer to withhold Additional Medicare Tax on wages it pays to an employee in excess of $200,000 in a calendar year. An employer has this withholding obligation even though an employee may not be liable for Additional Medicare Tax because, for example, the employee's wages together with that of his or her spouse do not exceed the $250,000 threshold for joint return filers. Any withheld Additional Medicare Tax will be credited against the total tax liability shown on the individual's income tax return (Form 1040).

An employee who foresees liability for Additional Medicare Tax may ask that his or her employer withhold an additional amount of income tax withholding on Form W-4 - Employee's Withholding Allowance Certificate. This additional income tax withholding will be applied against all taxes shown on the individual's income tax return (Form 1040), including any Additional Medicare Tax liability.

Other Taxes

Excise Taxes

Excise taxes are taxes paid when purchases are made on a specific good, such as gasoline. Excise taxes are often included in the price of the product. There are also excise taxes on activities, such as on wagering or on highway usage by trucks. Excise Tax has several general excise tax programs. One of the major components of the excise program is motor fuel. [(138)]

Recently, the Supreme Court ruled that the Professional and Amateur Sports Protection Act was unconstitutional. As a result, each state may decide whether to allow sports wagering. Sports wagering, like wagering in general, is subject to Federal excise taxes, regardless of whether the activity is allowed by the state. Also, as of July 1, 2010, indoor tanning services will be subject to a 10% excise tax under the Affordable Care Act.

Under the Tax Cut and Jobs Act (TCJA), certain payments made by an aircraft owner (or, in certain cases, a lessee) related to the management of private aircraft are exempt from the excise taxes imposed on taxable transportation by air.

Foreign Income Taxes

U.S. citizens and residents who lived or worked abroad may need to file a Federal income tax return. If the taxpayer is living or working outside the United States, he or she generally must file and pay taxes in the same way as people living in the U.S. This includes people with dual citizenship. Here are seven tips taxpayers with foreign income should know:

1. *Report Worldwide Income* - The law requires U.S. citizens and resident aliens to report any worldwide income. This includes income from foreign trusts, and foreign bank and securities accounts.
2. *File Required Tax Forms* - In most cases, affected taxpayers need to file Schedule B - Interest and Ordinary Dividends with their tax returns. Some taxpayers may need to file additional forms. For example, some may need to file Form 8938 - Statement of Specified Foreign Financial Assets, while others may need to electronically file Financial Crimes Enforcement Network (FinCEN) Form 114 - Report of Foreign Bank and Financial Accounts (FBAR) to the Internal Revenue Service.
3. *Consider the Automatic Extension* **-** U.S. citizens and resident aliens living abroad on April 15, 2021, may qualify for an automatic two-month extension to file their 2020 Federal income tax returns. The extension of time to file until June 15, 2021 also applies to those serving in the military outside the U.S. Taxpayers must attach a statement to their returns explaining why they qualify for the extension.
4. *Review the Foreign Earned Income Exclusion* - Many Americans who live and work abroad qualify for the foreign earned income exclusion. This means taxpayers who qualify will not pay taxes on up to $107,600 of their wages and other foreign earned income they received in 2020.
5. *Do Not Overlook Credits and Deductions* - Taxpayers may be able to take either a credit or a deduction for income taxes paid to a foreign country. This benefit reduces the taxes these taxpayers pay in situations where both the U.S. and another country tax the same income.
6. *Use IRS Free File* - Taxpayers who live abroad can prepare and e-file their Federal tax return for free by using IRS Free File. In 2020, people who make $72,000 or less can use Free File's brand-name software. Free File is available exclusively through the IRS.gov website.
7. *Get Tax Help Outside the U.S.* - Taxpayers living abroad can get IRS help in four U.S. embassies and consulates. IRS staff at these offices can help with tax filing issues and answer questions about IRS notices and tax bills. The offices also have tax forms and publications. To find the nearest foreign IRS office, visit the IRS.gov website. At the bottom of the home page click on the link labeled 'Contact Your Local IRS Office.' Then click on 'International'.

Generally, a taxpayer can take either a deduction or a credit for income taxes imposed by a foreign country or a U.S. possession. Also, a taxpayer can change his or her choice for each year's taxes. However, a deduction or credit cannot be taken for foreign income taxes paid on income that is exempt from U.S. tax under the foreign earned income exclusion or the foreign housing exclusion. If a taxpayer claimed an itemized deduction for a given year for qualified foreign taxes, he or she can choose instead to claim a foreign tax credit that will result in a refund for that year by filing an amended return on Form 1040X within 10 years from the original due date of his or her return. The 10-year period also applies to calculation corrections of his or her previously claimed foreign tax credit. See Publication 54 - Tax Guide for U.S. Citizens and Resident Aliens Abroad for additional details. (179)

Foreign Earned Income Exclusion

If the taxpayer meets certain requirements, he or she may qualify for the foreign earned income exclusion, the foreign housing exclusion, and/or the foreign housing deduction. To claim these benefits, the taxpayer must have foreign earned income, his or her tax home must be in a foreign country, and he or she must be one of the following:

- 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,
- 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

- 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.

If the taxpayer is a U.S. citizen or a resident alien of the United States and he or she lives abroad, he or she is taxed on his or her worldwide income. However, the taxpayer may qualify to exclude his or her foreign earnings from income up to an amount that is adjusted annually for inflation ($107,600 for 2020. In addition, he or she can exclude or deduct certain foreign housing amounts.

Generally, the taxpayer is considered to have earned income in the year in which he or she does the work for which he or she receives the income, even if he or she works in one year but are not paid until the following year. If the taxpayer reports his or her income on a cash basis, he or she reports the income on his or her return for the year he or she receives it. If the taxpayer works one year but is not paid for that work until the next year, the amount he or she can exclude in the year he or she is paid is the amount he or she could have excluded in the year he or she did the work if he or she had been paid in that year.

Additional Taxes on Qualified Retirement Plans (including IRAs and MSAs)

In general, if a taxpayer takes a distribution from an IRA and/or MSA before they have reached age 59½ (including an involuntary cashout), not only is the distribution included in their income, but they are also subject to a special penalty tax for the early withdrawal from their qualified retirement plan. The amount of the penalty is equal to 10% of the amount of the early distribution, and is reported on Form 5329 - Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts. [180]

962 Election

The 962 election is an election by individuals to be subject to tax at corporate rates. Under prescribed regulations, in the case of a United States shareholder who is an individual and who elects to have the provisions of this section apply for the taxable year: [181]

1. The tax imposed under this chapter on amounts which are included in his gross income under Section 951 (a) shall (in lieu of the tax determined under Sections 1 and 55) be an amount equal to the tax which would be imposed under Sections 11 and 55 if such amounts were received by a domestic corporation.
2. For purposes of applying the provisions of Section 960 (relating to foreign tax credit) such amounts shall be treated as if they were received by a domestic corporation.

An election to have the provisions of this section apply for any taxable year shall be made by a United States shareholder at such time and in such manner as the Secretary shall prescribe by regulations. An election made for any taxable year may not be revoked except with the consent of the Secretary.

Unreported Social Security and Medicare Tax

Use Form 4137 - Social Security and Medicare Tax on Unreported Tip Income **only** to figure the Social Security and Medicare tax owed on tips the taxpayer did not report to an employer, including any allocated tips shown on the Form(s) W-2 that he or she must report as income.

Use Form 8919 - Uncollected Social Security and Medicare Tax on Wages to figure and report the taxpayer's share of the uncollected Social Security and Medicare taxes due on his or her compensation if the taxpayer was an employee but was treated as an independent contractor by his or her employer.

An Individual can file Form SS-8 - Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding if he or she wants the IRS to determine whether the taxpayer is an independent contractor or an employee. Complete a separate line for each firm. If the taxpayer worked as an employee for more than five firms in 2020, attach additional Form(s) 8919 with lines 1 through 5 completed. Complete lines 6 through 13 on only one Form 8919. The line 6 amount on that Form 8919 should be the combined totals of all lines 1 through 5 of all the Forms 8919. [182]

Business Taxes

Fees and charges that are expenses of a trade or business or of producing income can be deducted. [183]

- *Income taxes* - The taxpayer can deduct on Schedule C a state tax on gross income (as distinguished from net income) directly attributable to a business. The taxpayer can deduct other state and local income taxes on Schedule A (Form 1040) if he or she itemizes deductions. Do not deduct Federal income tax.
- *Employment taxes* - The taxpayer can deduct the Social Security, Medicare, and Federal unemployment (FUTA) taxes paid out of his or her own funds as an employer. The taxpayer can also deduct payments made as an employer to a state unemployment compensation fund or to a state disability benefit fund. Deduct these payments as taxes.
- *Self-employment tax* - The taxpayer can deduct the employer-equivalent portion of self-employment tax on line 14 of Schedule 1 (Form 1040).
- *Personal property tax* - The taxpayer can deduct on Schedule C any tax imposed by a state or local government on personal property used in a business. The taxpayer can also deduct registration fees for the right to use property within a state or local area.
- *Real estate taxes* - The taxpayer can deduct on Schedule C the real estate taxes he or she paid on a business property. Deductible real estate taxes are any state, local, or foreign taxes on real estate levied for the general public welfare. The taxing authority must base the taxes on the assessed value of the real estate and charge them uniformly against all property under its jurisdiction.
- *Excise taxes* - The taxpayer can deduct on Schedule C all excise taxes that are ordinary and necessary expenses of carrying on a business.

Note

Taxes on gasoline, diesel fuel, and other motor fuels the taxpayer uses in a business are usually included as part of the cost of the fuel. Do not deduct these taxes as a separate item. The taxpayer may be entitled to a credit or refund for Federal excise tax he or she paid on fuels used for certain purposes.

Federal Unemployment Tax Act (FUTA)

The Federal unemployment tax is part of the Federal and state program under the Federal Unemployment Tax Act (FUTA) that pays unemployment compensation to workers who lose their jobs. Most employers may owe both the Federal unemployment tax (the FUTA tax) and a state unemployment tax. Or the employer may owe only the FUTA tax or only the state unemployment tax. To find out whether the employer will owe state unemployment tax, contact the employer's state's unemployment tax agency. For a list of state unemployment tax agencies, visit the U.S. Department of Labor's website. The employer should also find out if he or she needs to pay or collect other state employment taxes or carry workers' compensation insurance.

The FUTA tax is 6.0% of the employee's FUTA wages. However, the employer may be able to take a credit of up to 5.4% against the FUTA tax, resulting in a net tax rate of 0.6%. The employer's credit for 2020 is limited unless he or she pays all the required contributions for 2020 to his or her state unemployment fund by April 15, 2021. The credit the employer can take for any contributions for 2020 that he or she pays after April 15, 2021, is limited to 90% of the credit that would have been allowable if the contributions were paid by April 15, 2021.

Note

The 5.4% credit is reduced for wages paid in a credit reduction state. Also, the employer does not withhold the FUTA tax from his or her employee's wages. The employer must pay it from his or her own funds.

The employer figures the FUTA tax on the FUTA wages he or she pays. If the employer pays cash wages to all of his or her household employees totaling $1,000 or more in any calendar quarter of 2019 or 2020, the first $7,000 of cash wages he or she pays to each household employee in 2020 is FUTA wages. (A calendar quarter is January through March, April through June, July through September, or October through December.) If his or her employee's cash wages reach $7,000 during the year, the employer does not figure the FUTA tax on any wages he or she pays that employee during the rest of the year.

The employer does not count wages he or she pays to any of the following individuals as FUTA wages: (170)

- His or her spouse.
- His or her child who is under the age of 21.
- His or her parent.

Federal Insurance Contributions Act (FICA)

The 2020 Combined (Employee and Corporate) FICA tax is 7.65% each for the employee and employer on the first

$137,700 plus 2.9% on earnings greater than $137,700. The result for most American wage earners is a total FICA tax of 15.3% (Social Security plus Medicare). Self-employed individuals are responsible for the entire FICA tax rate of 15.3% (12.4% Social Security plus 2.9% Medicare). The tax rate and the overall tax obligation have remained the same as 2019.

First-Time Homebuyer Credit Repayment

Taxpayers, who claimed the First-Time Homebuyer credit on their Federal income tax returns and purchased homes in 2008, should have begun repaying their credit (up to $7,500) in 15 equal installments starting in 2010.

For homes purchased after 2008, and people who claimed the first-time homebuyer credit on their Federal income tax returns, the credit does not have to be paid back, unless the home is sold within 36 months of buying the property or the home is no longer the taxpayer's primary residence. Form 5405 - Repayment of the First-Time Homebuyer Credit will be used to calculate the repayment of the first-time home buyer credit. The following are exceptions to the repayment rule: (184)

- If the taxpayer sells the home to someone who is not related to him or her, the repayment in the year of sale is limited to the amount of gain on the sale as determined in Part III of Form 5405. The amount of the credit in excess of the gain does not have to be repaid.
- If the home is destroyed or the taxpayer sells the home through condemnation or under threat of condemnation, he or she does not have to repay the credit if he or she purchases a new main home within 2 years of the event and he or she owns and use it as the main home during the remainder of the 36-month period.
- If the home is destroyed or the taxpayer sells the home through condemnation or under threat of condemnation to someone who is not related to him or her and he or she does not acquire a new home within the 2-year period, the repayment with the return for the year in which the 2-year period ends is limited to the gain on the disposition as determined in Part III of Form 5405. The amount of the credit in excess of the gain does not have to be repaid.
- If the home is transferred to a spouse (or ex-spouse as part of a divorce settlement), the spouse who receives the home is responsible for repaying the credit if, during the 36-month period beginning on the purchase date, he or she disposes of the home or it ceases to be his or her main home and none of the other exceptions apply.
- Members of the uniformed services or Foreign Service and employees of the intelligence community, and spouses of such individuals, do not have to repay the credit if, after 2008, they sell the home or the home ceases to be their main home because they received Government orders to serve on qualified official extended duty.
- If the taxpayer dies, repayment of the credit is not required. If he or she claimed the credit on a joint return and then he or she dies, his or her surviving spouse would be required to repay his or her half of the credit if, during the 36-month period beginning on the purchase date, he or she disposes of the home or it ceases to be his or her main home and none of the other exceptions apply.

Advising the Individual Taxpayer

All Americans pay taxes. Everyone who works pays Federal payroll taxes. Everyone who buys gasoline pays Federal and state gas taxes. Everyone who owns or rents a home directly or indirectly pays property taxes. Anyone who shops pays sales taxes in most states. Also, most individuals, but not all individuals need to file a Federal tax return.

The taxpayer 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:

1. 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.)
2. Dependents.
3. Certain children under age 19 or full-time students.
4. Self-employed persons.
5. Aliens.

A taxpayer should file 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. The taxpayer 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.

According to the IRS, many individuals who do not need to file tax returns still do, because they are not aware of the minimum requirements. To determine whether a taxpayer needs to file a Federal tax return, he or she must first look at his or her gross income. In general, the taxpayer need not file a Federal tax return if his or her tax filing status, age and gross income does not meet certain filing requirements. The amount varies depending on the taxpayer's filing status and, for tax year 2020, the minimum income requirements are:

Filing Status	Minimum Income Requirements
Single individual	$12,400
Single individual 65 or older	$14,050
Married couple, filing jointly	$24,800
Married couple, one spouse 65 or older	$26,100
Married couple, both 65 or older	$27,400
Head of household	$18,650
Head of household 65 or over	$20,300
Surviving spouse	$24,800
Surviving spouse 65 or older	$26,100

Table 5-1 - Publication 17 - Filing Requirements for Most Taxpayers (2020)

Reporting Obligations

For all other individuals who are U.S. citizens or residents and are required to file a tax return based on their gross income, filing status and age there are great number of tax laws to consider. These include, but are not limited to, the following tax planning matters.

Sale of a Home

If the taxpayer has a gain from the sale of his or her main home, he or she may qualify to exclude up to $250,000 of that gain from his or her income. The taxpayer may qualify to exclude up to $500,000 of that gain if he or she files a joint return with his or her spouse. Publication 523 - Selling Your Home provides rules and worksheets.

In general, to qualify for the exclusion, the taxpayer must meet both the ownership test and the use test. He or she is eligible for the exclusion if he or she has owned and used his or her home as his or her main home for a period aggregating at least two years out of the five years prior to its date of sale. The taxpayer can meet the ownership and use tests during different 2-year periods. However, he or she must meet both tests during the 5-year period ending on the date of the sale. Generally, the taxpayer is not eligible for the exclusion if he or she excluded the gain from the sale of another home during the two-year period prior to the sale of his or her home.

If the taxpayer receives an informational income-reporting document such as Form 1099-S - Proceeds From Real Estate Transactions, he or she must report the sale of the home even if the gain from the sale is excludable. Additionally, the taxpayer must report the sale of the home if he or she cannot exclude all of his or her capital gain from income. The taxpayer should use Form 1040, Schedule D - Capital Gains and Losses, and Form 8949 - Sales and Other Dispositions of Capital Assets, when required to report the home sale.

Capital Gains and Losses

When the taxpayer sells a capital asset the sale results in a capital gain or loss. A capital asset includes most property he or she owns for personal use or own as an investment. Here are 10 facts that the taxpayer should know about capital gains and losses:

1. **Capital Assets.** Capital assets include property such as the taxpayer's home or car, as well as investment property, such as stocks and bonds.
2. **Gains and Losses**. A capital gain or loss is the difference between the taxpayer's basis and the amount he or she gets when he or she sells an asset. The taxpayer's basis is usually what he or she paid for the asset.
3. **Net Investment Income Tax.** The taxpayer must include all capital gains in his or her income and he or she may be subject to the Net Investment Income Tax. This tax applies to certain net investment income of individuals, estates and trusts that have income above statutory threshold amounts. The rate of this tax is 3.8%.
4. **Deductible Losses.** The taxpayer can deduct capital losses on the sale of investment property. He or she cannot deduct losses on the sale of property that he or she hold for personal use.
5. **Long and Short Term.** Capital gains and losses are either long-term or short-term, depending on how long the taxpayer held the property. If he or she held the property for more than one year, his or her gain or loss is long-term. If he or she held it one year or less, the gain or loss is short-term.
6. **Net Capital Gain.** If the taxpayer's long-term gains are more than his or her long-term losses, the difference between the two is a net long-term capital gain. If his or her net long-term capital gain is more than his or her net short-term capital loss, the taxpayer has a net capital gain.
7. **Tax Rate.** The capital gains tax rate usually depends on the taxpayer's income. The maximum net capital gain tax rate is 20%. However, for most taxpayers a 0% or 15% rate will apply. A 25% or 28% tax rate can also apply to certain types of net capital gains.
8. **Limit on Losses.** If the taxpayer's capital losses are more than his or her capital gains, he or she can deduct the difference as a loss on his or her tax return. This loss is limited to $3,000 per year, or $1,500 if the taxpayer is married and files a separate return.
9. **Carryover Losses.** If the taxpayer's total net capital loss is more than the limit he or she 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 happened in that next year.
10. **Forms to File.** The taxpayer often will need to file Form 8949 - Sales and Other Dispositions of Capital Assets, with his or her Federal tax return to report his or her gains and losses. The taxpayer also needs to file Schedule D - Capital Gains and Losses with his or her tax return.

Collectibles

Collectibles are considered alternative investments by the IRS and include things like art, stamps & coins, cards and comics, rare items, and antiques. If collectibles are sold at a gain, the taxpayer will be subject to a long-term capital gains tax rate of 28%, if disposed of after more than one year of ownership. The taxpayer needs to know his or her cost basis to calculate his or her taxable gain. Basis is generally the price paid plus any costs, fees, and commissions involved with that purchase.

1099-MISC - Miscellaneous Income

Form 1099-MISC - Miscellaneous Income is an IRS form taxpayers use to report non-employee compensation. This is generally a business payment, not a personal payment. Independent contractors, freelancers, sole-proprietors, and self-employed individuals, for example, receive one from each client who paid them $600 or more in a calendar year. The form is also used to report miscellaneous compensation such as rents, prizes, awards, healthcare payments, and payments to an attorney.

The taxpayer should check the amount of compensation his or her clients say they paid him or her in each Form 1099 against his or her own records to make sure they are consistent. If there is a mistake, call the client immediately and request a corrected Form 1099. The client may not have filed the 1099 with the IRS yet, because they are not due until February 28th (March 31st if filed electronically). If the 1099 has been filed with the IRS, ask the client to send the IRS a corrected 1099. The taxpayer does not want the IRS to think he or she was paid more than he or she really was. The 1099-MISC form has a special box that should be checked to show that it is correcting a prior 1099 form.

Whether or not the taxpayer receives a Form 1099, it is his or her responsibility to report all the self-employment income he or she earns each year to the IRS.

Education Planning

Education Tax Credits

Did the taxpayer pay for college in 2020? If he or she did it can mean tax savings on his or her Federal tax return. There are two education credits that can help the taxpayer with the cost of higher education. The credits may reduce the amount of tax he or she owes on his or her tax return. Here are some important facts the taxpayer should know about education tax credits.

American Opportunity Tax Credit:

- The taxpayer may be able to claim up to $2,500 per eligible student.
- The credit applies to the first four years at an eligible college or vocational school.
- The credit reduces the amount of tax the taxpayer owes. If the credit reduces his or her tax to less than zero, the taxpayer may receive up to $1,000 as a refund.
- The credit is available for students earning a degree or other recognized credential.
- The credit applies to students going to school at least half-time for at least one academic period that started during the tax year.
- Costs that apply to the credit include the cost of tuition, books and required fees and supplies.

Lifetime Learning Credit:

- The credit is limited to $2,000 per tax return, per year.
- The credit applies to all years of higher education. This includes classes for learning or improving job skills.
- The credit is limited to the amount of the taxpayer’s taxes.
- Costs that apply to the credit include the cost of tuition, required fees, books, supplies and equipment that the taxpayer must buy from the school.

For both credits:

- The credits apply to an eligible student. Eligible students include the taxpayer, his or her spouse or a dependent that the taxpayer lists on his or her tax return.
- The taxpayer must file Form 1040 and complete Form 8863 - Education Credits, to claim these credits on his or her tax return.
- The taxpayer’s school should give him or her a Form 1098-T - Tuition Statement, showing expenses for the year. This form contains helpful information needed to complete Form 8863. The amounts shown in Boxes 1 and 2 of the form may be different than what the taxpayer actually paid. For example, the form may not include the cost of books that qualify for the credit.
- The taxpayer cannot claim either credit if someone else claims him or her as a dependent.
- The taxpayer cannot claim both credits for the same student or for the same expense, in the same year.

- The credits are subject to income limits that could reduce the amount the taxpayer can claim on his or her return.

The taxpayer cannot claim an education credit on a 2020 tax return if any of the following apply:

1. He or she is claimed as a dependent on another person's tax return, such as his or her parent's return.
2. His or her filing status is married filing separately.
3. He or she (or his or her spouse) was a nonresident alien for any part of 2020 and did not elect to be treated as a resident alien for tax purposes.
4. His or her modified adjusted gross income (MAGI) is the following:
    a. For the American Opportunity Tax Credit: $180,000 or more if married filing jointly; or $90,000 or more if single, head of household, or qualifying widow(er) with dependent child.
    b. For the Lifetime Learning Credit: $138,000 or more if married filing jointly; or $69,000 or more if single, head of household, or qualifying widow(er) with dependent child.

The taxpayer can visit IRS.gov and use the Interactive Tax Assistant tool to see if he or she is eligible to claim these credits.

Coverdell Education Savings Accounts (CESA)

The American Taxpayer Relief Act made permanent the $2,000 total contributions per year for the beneficiary of a Coverdell ESA. Low and middle-income taxpayers may open up a Coverdell Education Savings Account (CESA) for qualified higher education as well as elementary and secondary education expenses (i.e., grades kindergarten through 12). The school may be public, private or religious. Contributions to a Coverdell ESA are not deductible but amounts deposited in the account grow tax free until distributed. A Coverdell ESA is a tax-exempt trust.

The requirements to establish a CESA are: [185]

1. When the account is established, the designated beneficiary must be under the age of 18 or a special needs beneficiary.
2. Except in the case of rollover contributions, annual contributions may not exceed $2,000.
3. The account must be designated as a Coverdell ESA when it is created.
4. The document creating and governing the account must be in writing and must meet certain requirements.
5. Contributions must be in cash.
6. The trustee must be a bank or other qualified person.
7. No portion of the trust's assets may be invested in life insurance contracts.
8. Trust assets must not be commingled with other property, except in a common trust or investment fund.
9. Upon death of the beneficiary, any balance in the fund must be distributed to the beneficiary's estate within 30 days of death.

Qualified High Education Expenses are related to enrollment or attendance at an eligible post-secondary school. To be qualified some expenses must be required by the school and some must be incurred by students who are enrolled at least half time. [186]

- The following expenses must be required for enrollment or attendance of a designated beneficiary at an eligible postsecondary school:
    - Tuition and fees.
    - Books, supplies, and equipment.
- Expenses for special needs services needed by a special needs beneficiary must be incurred in connection with enrollment or attendance at an eligible postsecondary school.
- Expenses for room and board must be incurred by students who are enrolled at least half-time.
- The expense for room and board qualifies only to the extent that it is not more than the greater of the following two amounts:
    - The allowance for room and board, as determined by the school, that was included in the cost of attendance (for Federal financial aid purposes) for a particular academic period and living arrangement of the student.
    - The actual amount charged if the student is residing in housing owned or operated by the school.

Qualified Elementary and Secondary Education Expenses are expenses related to enrollment or attendance at an eligible elementary or secondary school. As shown in the following list, to be qualified, some of the expenses must be required or provided by the school. There are special rules for computer-related expenses. (186)

The following expenses must be incurred by a designated beneficiary in connection with enrollment or attendance at an eligible elementary or secondary school: (186)

- Tuition and fees.
- Books, supplies, and equipment.
- Academic tutoring.
- Special needs services for a special needs beneficiary.

The following expenses must be required or provided by an eligible elementary or secondary school in connection with attendance or enrollment at the school: (186)

- Room and board.
- Uniforms.
- Transportation.
- Supplementary items and services (including extended day programs).

The purchase of computer technology, equipment, or internet access and related services is a qualified elementary and secondary education expense if it is to be used by the beneficiary and the beneficiary's family during any of the years the beneficiary is in elementary or secondary school. (This does not include expenses for computer software designed for sports, games, or hobbies unless the software is predominantly educational in nature). The maximum annual contribution that could be made to a CESA is $2,000 per beneficiary; and the annual contribution is phased out for joint filers with modified adjusted gross income at or above $190,000 and less than $220,000 (at or above $95,000 and less than $110,000 for single filers). (186)

Contributions to a Coverdell ESA are not deductible but amounts deposited in the account grow tax free until distributed. The beneficiary will not owe tax on the distributions if they are less than a beneficiary’s qualified education expenses at an eligible institution.

CESA Distributions

Amounts remaining in the account must be distributed within 30 days after the beneficiary reaches age 30 or 30 days after the death of the beneficiary. One way of avoiding taking an unwanted distribution is to take advantage of the rollover provision for Coverdell ESAs.

Distributed amounts are not subject to Federal income taxes if they are rolled over to another ESA for the benefit of the same beneficiary or a member of the beneficiary's family that is under the age of 30 including: (186)

- Son, daughter, stepchild, foster child, adopted child, or a descendant of any of them.
- Brother, sister, stepbrother, or stepsister.
- Father or mother or ancestor of either.
- Stepfather or stepmother.
- Son or daughter of a brother or sister.
- Brother or sister of father or mother.
- Son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law.
- The spouse of any individual listed above.
- First cousin.

The age limit does not apply to beneficiaries with special needs.

CESA Coordination with Other Education Benefits

The American opportunity or Lifetime learning credit can be claimed in the same year the beneficiary takes a tax-free distribution from a Coverdell ESA, as long as the same expenses are not used for both benefits. Qualified expenses will first be reduced for tax-exempt scholarships or fellowship grants and any other tax-free educational benefits. Expenses will then be reduced for amounts taken into account in determining the American opportunity and Lifetime learning credits. Where a student receives distributions from both a CESA and a qualified tuition program that together exceed these remaining expenses, the expenses must be allocated between the distributions.

Generally, contributions to CESAs are treated as gifts to the beneficiaries. Distributions from CESAs are excludable from gross income to the extent that the distribution does not exceed the qualified higher education expenses incurred by the beneficiary during the year in which the distribution is made. Qualified distributions, with the exception of room and board, are tax exempt regardless of whether the beneficiary attends an eligible educational institution on a full-time, half-time, or less than half-time basis. Room and board expenses constitute qualified higher education expenses only if the student is enrolled at an eligible institution on at least a half-time basis.

Distributions are deemed paid from both contributions (which are always tax free) and earning (which may be excludable). The amount of contributions distributed is determined by multiplying the distribution by the ratio that the aggregate amount of contributions bears to the total balance of the account at the time the distribution is made.

If aggregate distributions exceed expenses during the tax year, qualified education expenses are deemed to be paid from a pro rata share of both principal and interest. To calculate, the portion of earnings excludable from income is based on the ratio that the qualified higher education expenses bear to the total amount of the distribution. The remaining portion of earnings is included in the income of the distributee. The tax imposed on any taxpayer who receives a payment or distribution from a CESA that is includible in gross income will be increased by an additional 10% penalty.

Qualified higher education expenses include tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution fall under the definition of qualified education expenses. The term also generally includes the room and board expenses. Also, for students residing in housing owned or operated by an eligible educational institution, the term will be expanded to cover, if greater, the actual room and board expenses charged by the institution.

Room and board expenses are considered qualified higher education costs only if the designated beneficiary is enrolled in a degree, certificate, or other program leading to a recognized educational credential at an eligible educational institution and the student carries at least one-half the normal full-time workload for the course of study pursued. Furthermore, funds from a CESA may be used to pay for elementary and secondary education expenses, including tutoring, computer equipment, room and board, uniforms, and extended day program costs.

An eligible educational institution is generally an accredited postsecondary educational institution providing credit towards a bachelor's degree, an associate's degree, a graduate-level or professional degree, or another recognized postsecondary credential. Generally, proprietary and postsecondary vocational institutions are eligible educational institutions. (186)

Section 529 Plan

A Qualified Tuition Program (QTP) is also called a Section 529 plan. If the program is established and maintained by a state, or agency or instrumentality of a state, the program may allow either prepaying or contributing to an account for paying a beneficiary's qualified higher education expenses at an eligible educational institution. Eligible educational institutions can also establish and maintain QTPs but only to allow prepaying a beneficiary's qualified higher education expenses. Contributions to a QTP on behalf of any beneficiary cannot be more than the amount necessary to provide for the qualified higher education expenses of the beneficiary. Contact the program's trustee or administrator to determine the program's contribution limit. Contributions made to a QTP are not deductible on the taxpayer's Federal tax return.

The benefits of establishing a QTP are that earnings accumulate tax free while in the account, and no tax is due on a distribution that is used to pay qualified higher education expenses. The beneficiary generally does not have to include in income any of the earnings from a QTP unless the amount distributed is greater than the beneficiary's qualified higher education expenses.

The important differences between a Coverdell ESA and a 529 plan include: (187)

- 529 plans do not have age limits on beneficiaries, while Coverdell ESAs must be used, or rolled over to another beneficiary, by age 30.

- Contribution limits for Coverdell ESAs are much lower than 529 plans. While the annual contributions are almost limitless for 529 plans, Coverdell contributions are limited to $2,000 per year.
- Coverdell ESAs can offer taxpayers a much broader range of investment options when compared to state run 529 plans.
- Coverdell ESAs offer greater flexibility when using the funds for qualified education expenses. For example, the account can be used to pay for expenses of qualified elementary and secondary schools.

The Setting Every Community Up for Retirement Enhancement (SECURE) Act expands Section 529 education savings accounts to cover costs associated with registered apprenticeships; homeschooling; up to $10,000 of qualified student loan repayments (including those for siblings); and private elementary, secondary, or religious schools beginning January 1, 2020.

Qualified Student Loan

Generally, personal interest the taxpayer pays, other than certain mortgage interest, is not deductible on his or her tax return. However, if the taxpayer's modified adjusted gross income (MAGI) is less than $85,000 ($170,000 if filing a joint return) there is a special deduction allowed for paying interest on a student loan (also known as an education loan) used for higher education. For most taxpayers, MAGI is the adjusted gross income as figured on their Federal income tax return before subtracting any deduction for student loan interest. This deduction can reduce the amount of the taxpayer's income subject to tax by up to $2,500.

A qualified student loan is any loan an individual took out to pay the qualified higher education expenses for his or herself, for his or her spouse, or any for any person who was the taxpayer's dependent when the student loan was taken out (usually for a son or daughter). The loan must be for an eligible student and pay for qualified higher education expenses. An eligible student is a person who:

1. Was enrolled in a degree, certificate, or other program (including a program of study abroad that was approved for credit by the institution at which the student was enrolled) leading to a recognized educational credential at an eligible educational institution, and
2. Carried at least half the normal full-time workload for the course of study he or she was pursuing.

For purposes of the student loan interest deduction, these expenses are the total costs of attending an eligible educational institution, including graduate school. They include amounts paid for the following items: [131]

- Tuition and fees.
- Room and board.
- Books, supplies and equipment.
- Other necessary expenses (such as transportation).

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

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

In addition to simple interest on the loan, if all other requirements are met, the items following types of interest can be student loan interest:

- **Loan origination fee** - In general, this is a one-time fee charged by the lender when a loan is made. To be deductible as interest, a loan origination fee must be for the use of money rather than for property or services (such as commitment fees or processing costs) provided by the lender. A loan origination fee treated as interest accrues over the life of the loan.
- **Capitalized interest** - This is unpaid interest on a student loan that is added by the lender to the outstanding principal balance of the loan. Capitalized interest is treated as interest for tax purposes and is deductible as payments of principal are made on the loan. No deduction for capitalized interest is allowed in a year in which no loan payments were made.

- **Interest on revolving lines of credit** - This interest, which includes interest on credit card debt, is student loan interest if the borrower uses the line of credit (credit card) only to pay qualified education expenses.
- **Interest on refinanced and consolidated student loans** - This includes interest on a loan used solely to refinance a qualified student loan of the same borrower. It also includes a single consolidation loan used solely to refinance two or more qualified student loans of the same borrower. (If the taxpayer refinances a qualified student loan for more than his or her original loan and he or she uses the additional amount for any purpose other than qualified education expenses, he or she deduct any interest paid on the refinanced loan.)

Qualified education expenses must be reduced by certain non-taxable benefits such as employer-provided educational assistance, excludable U.S. Series EE and I savings bond interest (from Form 8815 - Exclusion of Interest From Series EE and I U.S. Savings Bonds Issued After 1989), nontaxable qualified state tuition program earnings, nontaxable earnings from Coverdell education savings accounts, and any scholarship, educational assistance allowance, etc. Furthermore, a loan is not a qualified student loan if any of the proceeds were used for other purposes or the loan was from either a related person or a person who borrowed the proceeds under a qualified employer plan or a contract purchased under such a plan. [(188)]

Estate Planning

The Gross Estate of the decedent consists of an accounting of everything the taxpayer owns or has certain interests in at the date of death. The fair market value of these items is used, not necessarily what the taxpayer paid for them or what their values were when he or she acquired them. The total of all of these items is the taxpayer's "Gross Estate." The includible property may consist of cash and securities, real estate, insurance, trusts, annuities, business interests and other assets. Keep in mind that the Gross Estate will likely include non-probate as well as probate property.

Generally, the Gross Estate does not include property owned solely by the decedent's spouse or other individuals. Lifetime gifts that are complete (no powers or other control over the gifts are retained) are not included in the Gross Estate (but taxable gifts are used in the computation of the estate tax). Life estates given to the decedent by others in which the decedent has no further control or power at the date of death are not included.

Some deductions that are available to reduce the Estate Tax include:

- Marital Deduction: One of the primary deductions for married decedents is the Marital Deduction. All property that is included in the gross estate and passes to the surviving spouse is eligible for the marital deduction. The property must pass "outright." In some cases, certain life estates also qualify for the marital deduction.
- Charitable Deduction: If the decedent leaves property to a qualifying charity, it is deductible from the gross estate.
- Mortgages and Debt.
- Administration expenses of the estate.
- Losses during estate administration.

The sale of inherited property is usually considered the sale of a capital asset and may be subject to capital gains (or loss) treatment. However, IRC Section 1014 provides that the basis of property acquired from a decedent is its fair market value at the date of death, so there is usually little or no gain to account for if the sale occurs soon after the date of death. (Remember, the rules are different for determining the basis of property received as a lifetime gift).

Retirement Planning

Taking money out early from an individual's retirement plan may trigger an additional tax. Here are some key points from the IRS that the taxpayer should know about early withdrawals from retirement plans:

1. An early withdrawal normally means taking money from the taxpayer's plan before he or she reaches age 59½.
2. If the taxpayer made a withdrawal from a plan last year, he or she must report the amount he or she withdrew to the IRS. The taxpayer may have to pay income tax as well as an additional 10% tax on the amount he or she withdrew.

3. The additional 10% tax does not apply to nontaxable withdrawals. Nontaxable withdrawals include withdrawals of the taxpayer's cost to participate in the plan. The taxpayer's cost includes contributions that he or she paid tax on before he or she put them into the plan.
4. A rollover is a type of nontaxable withdrawal. Generally, a rollover is a distribution to the taxpayer of cash or other assets from one retirement plan that he or she contributes to another retirement plan. The taxpayer usually has 60 days to complete a rollover to make it tax-free.
5. There are many exceptions to the additional 10% tax. Some of the exceptions for retirement plans are different from the rules for IRAs.
6. If the taxpayer makes an early withdrawal, he or she may need to file Form 5329 - Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts, with his or her Federal tax return.

Future Tax Returns

A few tax credits or deductions can be applied to a different tax year. That means any excess tax credits are not lost, but instead can be carried back to a previous tax year or carried forward to a later tax year.

Net Operating Loss (NOL)

To have an NOL, the taxpayer's loss must generally be caused by deductions from his or her:

- Trade or business.
- Work as an employee (although not deductible for most taxpayers for 2018 through 2025).
- Casualty and theft losses resulting from a federally declared disaster.
- Moving expenses (although not deductible for most taxpayers for 2018 through 2025).
- Rental property.

A loss from operating a business is the most common reason for an NOL. Partnerships and S corporations generally cannot use an NOL. However, partners or shareholders can use their separate shares of the partnership's or S corporation's business income and business deductions to figure their individual NOLs.

Prior to 2018, net operating losses of a business or individual could be carried back two years and forward 20, and when carried forward, they could offset 100% of taxable income. The TCJA altered these rules, disallowing all carrybacks related to post-2017 losses, providing for an indefinite carryforward period, and limiting the use of post-2017 losses when carried forward to 80% of taxable income.

The CARES Act retroactively suspends the 80% income limitation on use of NOL carryovers for taxable years beginning before January 1, 2021 and allows 100% of any such taxable income of offset the amount of such NOL carryforward. This 80% income limitation is reinstated (with slight modifications) for tax years beginning after December 31, 2021. Also, losses from 2018, 2019 and 2020, will be permitted to be carried back for up to five years. As was previously the case, a taxpayer will be permitted to forgo the carryback, and instead carry the loss forward. The bill also eliminates loss limitation rules applicable to sole proprietors and pass-through entities to allow them to take advantage of the NOL carryback.

Foreign Tax Credit

If a taxpayer cannot claim a credit for the full amount of qualified foreign income taxes he or she paid or accrued in the year, the taxpayer is allowed a carryback and/or carryover of the unused foreign income tax. He or she can carryback for one year or carryover for 10 years the unused foreign tax. If the taxpayer claims the credit directly on Form 1040 or Form 1040-NR without filing Form 1116 - Foreign Tax Credit, he or she cannot carryback or carryover any unused foreign tax to or from this year.

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

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: (189)

- ➢ 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.

Tip

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.

Deduction for Qualified Business Income

For tax years beginning after 2017, the taxpayer may be entitled to a deduction of up to 20% of his or her qualified business income from his or her qualified trade or businesses plus 20% of the aggregate amount of qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership income. The deduction is subject to various limitations, such as limitations based on the type of the taxpayer's trade or business, his or her taxable income, the amount of W-2 wages paid with respect to the qualified trade or business, and the unadjusted basis of qualified property held by his or her trade or business. The taxpayer will claim this deduction on Form 1040, not on Schedule C. Unlike other deductions, this deduction can be taken in addition to the standard or itemized deductions.

Depreciation

Depreciation is 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. Most types of tangible property (except, land), such as buildings, machinery, vehicles, furniture, and equipment are depreciable. Likewise, certain intangible property, such as patents, copyrights, and computer software is depreciable. (190)

Depreciation begins when a taxpayer places property in service for use in a trade or business or for the production of income. The property ceases to be depreciable when the taxpayer has fully recovered the property's cost or other basis or when the taxpayer retires it from service, whichever happens first. (191)

Depreciation on Computers

If the taxpayer uses his or her home computer to produce income (for example, to manage his or her investments that produce taxable income), the depreciation of the computer for that part of the usage of the computer is a miscellaneous itemized deduction and is no longer deductible.

Extensions

Beginning with 2005, an individual is granted an automatic extension of six months for filing a return (but not for payment of tax), provided that Form 4868 - Application for Automatic Extension of Time To File U.S. Individual Income Tax Return is properly filed before the normal due date of the return. (Previously, the automatic filing extension was good for four months.) Also, filing extensions may be obtained via telephone or via internet on the IRS website.

If a taxpayer pays part of their tax liability by using a credit card using one of the prescribed IRS service providers, an automatic extension will be granted, and a confirmation of such extension will be provided at the end of the credit card transaction. To obtain more information please visit the www.PAY1040.com_ internet site. The late payment penalty is usually ½ of 1% of any tax (other than estimated tax) not paid by the filing due date. It is charged for each month or part of a month the tax is unpaid. The maximum penalty is 25%.

Filing extensions can be obtained without making tax payments if taxpayers properly estimate their tax liability on the form. If tax is not properly estimated, the extension request will be disallowed, and the late-filing penalty will be assessed. If the amount of tax included with the extension request is less than sufficient to cover the taxpayer's liability, the taxpayer will be charged interest on the overdue amount.

The taxpayer is considered to have reasonable cause for the period covered by this automatic extension if at least 90% of the actual tax liability is paid before the regular due date of the return through withholding, estimated tax payments, or payments made with Form 4868. (192)

Abandoned Spouse

When married persons file separate returns, several unfavorable tax consequences result. For example, the taxpayer must use the Tax Rate Schedule for married taxpayers filing separately. To mitigate such harsh treatment, Congress enacted provisions commonly referred to as the abandoned spouse rules. These rules allow a married taxpayer to file as a head of household if all of the following conditions are satisfied. Per IRC Section 7703(b), an individual who is married but meets the following requirements shall not be considered as married: (38)

- The abandoned individual pays more than half the cost of maintaining his or her household for the taxable year.
- The individual files a separate tax return.
- The individual's household is the principal home of a dependent child for more than six months of the tax year.
- The individual lives in a separate residence from his or her spouse for the last six months of the tax year.

Community Property

Generally, the laws of the state in which the taxpayer is domiciled govern whether he or she has community property and community income or separate property and separate income for Federal tax purposes. This information applies to married taxpayers who are domiciled in one of the following community property states:

- Arizona.
- California.
- Idaho.
- Louisiana.
- Nevada.
- New Mexico.
- Texas.
- Washington.
- Wisconsin.

If the taxpayer's domicile is in a community property state during any part of his or her tax year, he or she may have community income. The taxpayer's state law determines whether his or her income is separate or community income. If the taxpayer and his or her spouse file separate returns, the taxpayer must report half of any income described by state law as community income and all of his or her separate income, and the taxpayer's spouse must report the other half of any community income plus all of his or her separate income. Each taxpayer can claim credit for half the income tax withheld from community income.

Note

Payments that may otherwise qualify as alimony are not deductible by the payer if they are the recipient spouse's part of community income. They are deductible as alimony only to the extent they are more than that spouse's part of community income.

Generally, community property is property:

- That the taxpayer, his or her spouse (or his or her registered domestic partner), or both acquire during their marriage (or registered domestic partnership) while the taxpayer and his or her spouse (or his or her registered domestic partner) are domiciled in a community property state.
- That the taxpayer and his or her spouse (or his or her registered domestic partner) agreed to convert from separate to community property.
- That cannot be identified as separate property.

Generally, community income is income from:

- Community property.
- Salaries, wages, and other pay received for the services performed by the taxpayer, his or her spouse (or his or her registered domestic partner), or both during their marriage (or registered domestic partnership) while domiciled in a community property state.
- Real estate that is treated as community property under the laws of the state where the property is located.

For income tax purposes, community property laws apply to annuities payable under the Civil Service Retirement Act (CSRS) or Federal Employee Retirement System (FERS). Whether a civil service annuity is separate or community income depends on the taxpayer's marital status (or his or her status as a registered domestic partner) and domicile of the employee when the services were performed for which the annuity is paid. Even if the taxpayer now lives in a noncommunity property state and he or she receives a civil service annuity, it may be community income if it is based on services he or she performed while married (or during the registered domestic partnership) and domiciled in a community property state.

If a civil service annuity is a mixture of community income and separate income, it must be divided between the two kinds of income. The division is based on the employee's domicile and marital status (or registered domestic partnership) in community and noncommunity property states during his or her periods of service. Ordinarily, filing a joint return will give the taxpayer a greater tax advantage than filing a separate return. But in some cases, his or her combined income tax on separate returns may be less than it would be on a joint return.

If the taxpayer files a separate return, he or she and his or her spouse must each report half of their combined community income and deductions in addition to their separate income and deductions. Each of the taxpayers must complete and attach Form 8958 - Allocation of Tax Amounts Between Certain Individuals in Community Property States to the Form 1040 showing how he or she figured the amount he or she is reporting on the return. On the appropriate lines of the separate Form 1040, list only the taxpayer's share of the income and deductions on the appropriate lines of his or her separate tax returns (wages, interest, dividends, etc.). An extension of time for filing the separate return does not extend the time for filing the spouse's separate return. If the taxpayer and his or her spouse file a joint return, they cannot file separate returns after the due date for filing either separate return has passed.

Relief From Community Property

Married persons who live in community property states, but who did not file joint returns, may also qualify for relief from liability arising from community property law or for equitable relief. The taxpayer is not responsible for the tax on an item of community income if all five of the following conditions exist: (38)

1. The taxpayer did not file a joint return for the tax year.
2. The taxpayer did not include an item of community income in gross income on the separate return.
3. The item of community income the taxpayer did not include is one of the following:
    a. Wages, salaries, and other compensation the taxpayer's spouse (or former spouse) received for services he or she performed as an employee.
    b. Income the taxpayer's spouse (or former spouse) derived from a trade or business he or she operated as a sole proprietor.
    c. The taxpayer's spouse's (or former spouse's) distributive share of partnership income.

d. Income from the taxpayer's spouse's (or former spouse's) separate property (other than income described in (a), (b), or (c)). Use the appropriate community property law to determine what is separate property.
e. Any other income that belongs to the taxpayer's spouse (or former spouse) under community property law.

4. The taxpayer establishes that he or she did not know of, and had no reason to know of, that community income.
5. Under all facts and circumstances, it would not be fair to include the item of community income in the taxpayer's gross income.

In some states a husband and wife may enter into an agreement that affects the status of property or income as community or separate property. Check state law to determine how it affects the taxpayer.

Note

All other forms of income are taxed in accordance with normal community property laws. This includes dividend, interest, rents, royalties, capital gains, and earnings of unemancipated minor children.

Divorce and Separation

State law governs whether a taxpayer is married or legally separated under a divorce or separate maintenance decree. A taxpayer is unmarried for the whole year if either of the following applies: (38)

- The taxpayer has obtained a final decree of divorce or separate maintenance by the last day of the tax year. He or she must follow state law to determine if he or she is divorced or legally separated.
- The taxpayer has obtained a decree of annulment, which holds that no valid marriage ever existed. He or she must file amended returns for all tax years affected by the annulment that are not closed by the statute of limitations. The statute of limitations generally does not end until 3 years (including extensions) after the date the taxpayer files the original return or within 2 years after the date he or she pays the tax.

On the amended return the taxpayer will change his or her filing status to single, or if he or she meets certain requirements, head of household.

Tip

If the taxpayer and his or her spouse obtain a divorce in one year for the sole purpose of filing tax returns as unmarried individuals, and at the time of divorce the taxpayers intend to remarry each other and do so in the next tax year, the taxpayer and his or her spouse must file as married individuals.

If the taxpayer is divorced, he or she is jointly and individually responsible for any tax, interest, and penalties due on a joint return for a tax year ending before the divorce. This responsibility applies even if the divorce decree states that the former spouse will be responsible for any amounts due on previously filed joint returns. In some cases, a spouse may be relieved of the tax, interest, and penalties on a joint return. The taxpayer can ask for relief no matter how small the liability. There are three types of relief available: (38)

1. *Innocent Spouse Relief* provides a taxpayer relief from additional tax he or she owes if his or her spouse or former spouse failed to report income, reported income improperly or claimed improper deductions or credits.
2. *Separation of Liability Relief* provides for the allocation of additional tax owed between the taxpayer and his or her former spouse or his or her current spouse from whom the taxpayer is separated because an item was not reported properly on a joint return. The tax allocated to the taxpayer is the amount for which he or she is responsible.
3. *Equitable Relief* may apply when the taxpayer does not qualify for innocent spouse relief or separation of liability relief for something not reported properly on a joint return and generally attributable to the taxpayer's spouse. He or she may also qualify for equitable relief if the correct amount of tax was reported on the joint return, but the tax remains unpaid.

Note

A taxpayer must request innocent spouse relief or separation of liability relief no later than 2 years after the date the IRS first attempted to collect the tax from him or her. For equitable relief, the taxpayer must request relief during the time the IRS has to collect the tax from him or her. If the taxpayer is looking for a refund of tax he or she paid, then the request must be made within the time period for seeking a refund, which is generally three years after the date the return is filed or two years following the payment of the tax, whichever is later.

The taxpayer must meet all of the following conditions to qualify for innocent spouse relief: (193)

1. The taxpayer filed a joint return that has an understatement of tax (deficiency) that is solely attributable to his or her spouse's erroneous item. An erroneous item includes income received by his or her spouse, but which was omitted from the joint return. Deductions, credits, and property basis are also erroneous items if they are incorrectly reported on the joint return.
2. The taxpayer establishes that at the time he or she signed the joint return he or she did not know, and had no reason to know, that there was an understatement of tax.
3. Taking into account all the facts and circumstances, it would be unfair to hold the taxpayer liable for the understatement of tax.

To qualify for separation of liability relief the taxpayer must have filed a joint return and must meet one of the following requirements at the time he or she requests relief: (193)

- The taxpayer is divorced or legally separated from the spouse with whom he or she filed the joint return.
- The taxpayer is widowed.
- The taxpayer has not been a member of the same household as the spouse with whom he or she filed the joint return at any time during the 12-month period ending on the date he or she files Form 8857 - Request for Innocent Spouse Relief.

The separation of liability relief does not apply to any part of the understated tax due to the taxpayer's spouse's (or former spouse's) erroneous items of which he or she had actual knowledge. The taxpayer and his or her spouse (or former spouse) remain jointly and severally liable for this part of the understated tax.

If the taxpayer had actual knowledge of only a portion of an erroneous item, the IRS will not grant relief for that portion of the item. A taxpayer had actual knowledge of an erroneous item if:

- He or she knew that an item of unreported income was received. (This rule applies whether or not there was a receipt of cash.)
- He or she knew of the facts that made an incorrect deduction or credit unallowable.
- For a false or inflated deduction, he or she knew that the expense was not incurred, or not incurred to the extent shown on the tax return.

Knowledge of the source of an erroneous item is not sufficient to establish actual knowledge. Also, the taxpayer's actual knowledge may not be inferred when he or she merely had a reason to know of the erroneous item. Similarly, the IRS does not have to establish that the taxpayer knew of the source of an erroneous item in order to establish that he or she had actual knowledge of the item itself.

The taxpayer's actual knowledge of the proper tax treatment of an erroneous item is not relevant for purposes of demonstrating that he or she had actual knowledge of that item. Neither is the taxpayer's actual knowledge of how the erroneous item was treated on the tax return. For example, if the taxpayer knew that his or her spouse received dividend income, relief is not available for that income even if he or she did not know it was taxable.

To qualify for equitable relief the taxpayer must establish that, under all the facts and circumstances, it would be unfair to hold him or her liable for the understatement or underpayment of tax. In addition, the taxpayer must meet other requirements listed in Publication 971 - Innocent Spouse Relief.

Tax Treatment of Alimony and Separate Maintenance

Amounts paid to a spouse or a former spouse under a divorce or separation instrument (including a divorce decree, a separate maintenance decree, or a written separation agreement) may be alimony or separate maintenance payments for Federal tax purposes. Certain alimony or separate maintenance payments are deductible by the payer spouse, and the recipient spouse must include it in income (taxable alimony or separate maintenance).

The taxpayer cannot deduct alimony or separate maintenance payments made under a divorce or separation agreement (1) executed after 2018, or (2) executed before 2019 but later modified if the modification expressly states the repeal of the deduction for alimony payments applies to the modification. Alimony and separate maintenance payments he or she receives under such an agreement are not included in his or her gross income.

Decedent Issues

The personal representative must file the final income tax return (Form 1040) of the decedent for the year of death and any returns not filed for preceding years. A surviving spouse, under certain circumstances, may have to file the returns for the decedent.

The final income tax return is due at the same time the decedent's return would have been due had death not occurred. A final return for a decedent who was a calendar year taxpayer is generally due on April 15 following the year of death, regardless of when during that year death occurred. However, when the due date falls on a Saturday, Sunday, or legal holiday, the return is filed timely if filed by the next business day. If the taxpayer's spouse died during the year, he or she is considered married for the whole year for filing status purposes. If the taxpayer did not remarry before the end of the tax year, he or she can file a joint return for him or herself and his or her deceased spouse. For the next 2 years, the taxpayer may be entitled to the special qualifying widow(er) with dependent child benefits.

The Qualifying Widow(er) With Dependent Child benefits filing status entitles the taxpayer to use joint return tax rates and the highest standard deduction amount (if he or she does not itemize deductions). It does not entitle the taxpayer to file a joint return. If the taxpayer files as qualifying widow(er) with dependent child, he or she should use the Married filing jointly column of the Tax Table or Section B of the Tax Computation Worksheet to figure the tax.

As previously noted, a taxpayer is eligible to file the 2020 return as a qualifying widow(er) with dependent child if he or she meets all of the following tests: (194)

- The taxpayer was entitled to file a joint return with his or her spouse for the year his or her spouse died. It does not matter whether the taxpayer actually filed a joint return.
- The taxpayer's spouse died in 2018 or 2019 and the taxpayer did not remarry before the end of 2020.
- The taxpayer has a child or stepchild for whom he or she can claim as a dependent. This does not include a foster child.
- This child lived in the taxpayer's home all year, except for temporary absences.
- The taxpayer paid more than half the cost of keeping up a home for the year.

After the due date of the return, the taxpayer and his or her spouse cannot file separate returns if they previously filed a joint return. However, a personal representative for a decedent can change from a joint return elected by the surviving spouse to a separate return for the decedent. The personal representative has one year from the due date (including extensions) of the joint return to make the change.

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

Common Law Marriage

A common law marriage is a legally recognized marriage that can arise in some jurisdictions without a license or ceremony. Many states recognize a common law marriage when two people capable of getting married live together as spouses and hold themselves out as such for a specified amount of time. Common law marriages can be contracted in nine states (Alabama, Colorado, Iowa, Kansas, Montana, Rhode Island, South Carolina, Texas, and Utah) and the District of Columbia. New Hampshire recognizes common law marriage for purposes of probate only, and Utah recognizes common law marriages only if they have been validated by a court or administrative order.

For Federal tax purposes, a taxpayer and his or her spouse are considered married for the whole year if on the last day of the tax year they are living together in a common law marriage recognized in the state where they now live or in the state where the common law marriage began. (38)

Same-Sex Married Couples

Obergefell v. Hodges is a landmark United States Supreme Court case in which the Court held in a 5–4 decision that the fundamental right to marry is guaranteed to same-sex couples by both the Due Process Clause and the Equal Protection Clause of the Fourteenth Amendment to the United States Constitution. Decided on June 26, 2015, Obergefell requires all states to issue marriage licenses to same-sex couples and to recognize same-sex marriages validly performed in other jurisdictions. This legalized same-sex marriage throughout the United States, its possessions and territories.

The Supreme Court found that states have used marital status as the basis for other government rights, benefits and responsibilities including tax and inheritance and property rights. Tax, of course, was the driving factor in one of two same sex marriage cases United States v. Windsor and Hollingsworth v. Perry, decided at the Supreme Court just two years ago.

The Obergefell case does not change the analysis in Windsor. The case does advance the analysis by clarifying that states may not have differing standards of marriage by gender. In other words, individual states may not ban same sex marriages and they may not fail to recognize same sex marriages in other states. That makes a huge difference for same sex couples at tax time.

Under the ruling, same-sex couples will be treated as married for all Federal tax purposes, including income and gift and estate taxes. The ruling applies to all Federal tax provisions where marriage is a factor, including filing status, claiming dependents, taking the standard deduction, employee benefits, contributing to an IRA and claiming the earned income tax credit or child tax credit.

Any same-sex marriage legally entered into in one of the 50 states, the District of Columbia, a U.S. territory or a foreign country will be covered by the ruling. However, the ruling does not apply to registered domestic partnerships, civil unions or similar formal relationships recognized under state law.

For tax year 2013 and going forward, same-sex spouses generally must file using a married filing separately or jointly filing status. For tax year 2012 and all prior years, same-sex spouses who filed an original tax return on or after September 16, 2013 (the effective date of Revenue Ruling 2013-17), generally must have filed using a married filing separately or jointly filing status. For tax year 2012, same-sex spouses who filed their tax return before September 16, 2013, may have chosen (but are not required) to amend their Federal tax returns to file using married filing separately or jointly filing status. [195]

Character of Transaction

Income tax is paid on earnings from employment, interest, dividends, royalties, or self-employment, whether it is in the form of services, money, or property. Capital gains tax is paid on income that derives from the sale or exchange of an asset, such as a stock or property that is categorized as a capital asset.

The taxpayer's income tax percentage is variable based on his or her specific tax bracket, and this is dependent on how much income he or she makes throughout the entire calendar year. Tax brackets also vary depending upon whether the taxpayer files as an individual or jointly with a spouse. For 2020 federal income tax percentages range between 10% and 37% of a person's taxable yearly income after deductions.

Capital gains tax rates depend on how long the taxpayer owned or held the asset. Short-term capital gains for assets held for less than a year are taxed at ordinary income rates. However, if the taxpayer held an asset for more than a year, more preferential long-term capital gains apply. These rates are 0%,15%, or 20% - depending on the taxpayer's income level.

Estimated Taxes

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.

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.

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. The taxpayer does not have to pay estimated tax for the current year if he or she meets all three of the following conditions: (196)

1. The taxpayer had no tax liability for the prior year.
2. The taxpayer was a U.S. citizen or resident for the whole year.
3. The taxpayer's prior tax year covered a 12-month period.

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.

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: (196)

- 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 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 2020 estimated tax payments, the taxpayer may need to take account of any additional tax liability associated with the NIIT.

Penalty for Underpayment

In general, the taxpayer may owe a penalty for 2020 if the total of his or her withholding and timely estimated tax payments did not equal at least the smaller of:

- 90% of his or her 2020 tax.
- 100% of his or her 2019 tax. (The taxpayer's 2019 tax return must cover a 12-month period.)

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 2020 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: (197)

- 22.5% of his or her 2020 tax.
- 25% of his or her 2019 tax. (The taxpayer's 2019 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: (197)

- 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.

Short Method for Figuring the Penalty

The taxpayer may be able to use the short method in Part III of Form 2210 to figure his or her penalty for underpayment of estimated tax. If the taxpayer qualifies to use this method, it will result in the same penalty amount as the regular method. However, either the annualized income installment method or the actual withholding method may result in a smaller penalty.

The taxpayer can use the short method only if he or she meets one of the following requirements:

- The taxpayer made no estimated tax payments (or the taxpayer's only payments were withheld for Federal income tax).
- The taxpayer paid the same amount of estimated tax on each of the four payment due dates.

If the taxpayer does not meet either requirement, figure the penalty using the regular method in Part IV of Form 2210 and the Penalty Worksheet in the instructions.

Part III of Form 2210

Line 14 - Total underpayment for the 2020 tax year. Subtract line 13 from line 10. If zero or less, stop; the taxpayer does not owe a penalty. If the amount on line 14 was paid on or before 1/15/21, do not use the short method. Do not file Form 2210 unless the taxpayer checked box E in Part II.

Line 15 - Multiply line 14 by 0.01744.

Line 16 -
- If the amount on line 14 was paid on or after 4/15/21, enter -0-.
- If the amount on line 14 was paid after 1/15/21 and before 4/15/21, make the following computation to find the amount to enter on line 16.
  - Amount on line 14 × Number of days paid before 4/15/21 × .00008.

Line 17 - Penalty. Subtract line 16 from line 15. Enter the result here and on Form 1040, Form 1040-SR or 1040-NR, line 38; or Form 1041, line 27.

Exceptions

The taxpayer does not owe a penalty if the total tax shown on his or her return minus the amount he or she paid through withholding (including excess Social Security and tier 1 railroad retirement (RRTA) tax withholding) is less than $1,000. Also, the taxpayer does not owe a penalty if he or she had no tax liability last year and he or she was a U.S. citizen or resident for the whole year. For this rule to apply, the taxpayer's tax year must have included all 12 months of the year. The taxpayer had no tax liability for the last year if his or her total tax was zero or he or she was not required to file an income tax return.

Additionally, the penalty does not apply to either of the following: (198)

- A decedent's estate for any tax year ending before the date that is 2 years after the decedent's death.
- A trust that was treated as owned by the decedent if the trust will receive the residue of the decedent's estate under the will (or if no will is admitted to probate, the trust primarily responsible for paying debts, taxes, and expenses of administration) for any tax year ending before the date that is 2 years after the decedent's death.

Lastly, if the taxpayer meets both tests 1 and 2 below, he or she does not owe a penalty for underpaying estimated tax:

1. His or her gross income from farming or fishing is at least two-thirds of the taxpayer's annual gross income from all sources for 2019 or 2020.
2. He or she filed Form 1040 or 1041 and paid the entire tax due by March 1, 2021.

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. (199)

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. (200)

- 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.

The following table shows the tax form, payment type, tax year, and payment transaction limit, for which a taxpayer can make using a debit or credit card.

Individuals		
Tax Form	**Payment Type and Tax Year**	**Limit**
Form 1040 series	Current Tax Due Current Tax Notice Prior Tax Year Proposed Tax Assessment - CP 2000/2501/ CP 3219A Installment Agreement	2 per year 2 per year 2 per year 2 per year 2 per month
Form 1040-ES	Estimated Tax	2 per quarter
Form 1040-X	Amended	2 per year
Form 4868	Extension to File	2 per year
Form 5329	Current Tax Year	2 per year
Health Care - Form 1040	Balance Due Notice	2 per year
Health Care - Form 1040-X	Amended	2 per year
Trust Fund Recovery Penalty	2001-2020 Installment Agreement	2 per quarter 2 per month

Table 5-2 - Frequency Limit Table by Type of Tax Payment (2020)

When a taxpayer is using a debit or credit card for payment, keep in mind these additional considerations: (200)

- 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: [201]

- 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 is 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.

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

Installment Agreements

If the taxpayer cannot pay in full immediately, he or she may qualify for additional time --up to 120 days-- to pay in full. There is no fee for this full payment agreement; however, interest and any applicable penalties continue to accrue until the taxpayer's liability is paid in full. The taxpayer may be able to set up this agreement using the Online Payment Agreement (OPA) application.

If the taxpayer is not able to pay his or her balance in full immediately or within 120 days, he or she may qualify for a monthly installment agreement. The IRS 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: [202]

- 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 via check or money order.
- Payment with cash at a retail partner.

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 charges a user fee of $225 when a taxpayer enters into a standard installment agreement or a payroll deduction agreement. If he or she enters a standard installment agreement and chooses to pay via direct debit from his or her bank account, the user fee is $107. If taxpayer uses the OPA application to request an installment agreement, the user fee is $149. If the taxpayer uses the OPA application to request an installment agreement and choose to pay via direct debit, the user fee is $31 for all taxpayers regardless of income levels.

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 for entering into a new installment agreement or restructuring or reinstating an established installment agreement. [202]

The user fee for restructuring or reinstating an established installment agreement is $89 regardless of income levels or method of payment.

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.

Offer in Compromise

An offer in compromise allows the taxpayer to settle his or her tax debt for less than the full amount he or she owes. It may be a legitimate option if the taxpayer cannot pay his or her full tax liability or doing so creates a financial hardship. The IRS will consider each taxpayer's unique set of facts and circumstances based on: (203)

- Ability to pay.
- Income.
- Expenses.
- Asset equity.

Before the IRS can consider the taxpayer's offer, he or she must be current with all filing and payment requirements. The taxpayer is not eligible if he or she is in an open bankruptcy proceeding. The taxpayer can use the Offer in Compromise Pre-Qualifier on the IRS website to confirm his or her eligibility and prepare a preliminary proposal. The taxpayer's completed offer package that is submitted to the IRS will include: (203)

1. Form 433-A (OIC) -Collection Information Statement for Wage Earners and Self-Employed Individuals or Form 433-B (OIC) - Collection Information Statement for Businesses and all required documentation as specified on the forms.
2. Form 656 - Offer Income Compromise - individual and business tax debt (Corporation/ LLC/ Partnership) must be submitted on separate Form 656(s).
3. $186 application fee (non-refundable).
4. Initial payment (non-refundable) for each Form 656.

The taxpayer's initial payment will vary based on his or her offer and the payment option he or she chooses:

- *Lump Sum Cash* - The taxpayer submits an initial payment of 20% of the total offer amount with his or her application. He or she then waits for written acceptance, then pays the remaining balance of the offer in five or fewer payments.
- *Periodic Payment* - The taxpayer submits his or her initial payment with his or her application. He or she continues to pay the remaining balance in monthly installments while the IRS considers the offer. If accepted, the taxpayer continues to pay monthly until it is paid in full.

If the taxpayer meets the Low-Income Certification guidelines, he or she does not have to send the application fee or the initial payment and he or she will not need to make monthly installments during the evaluation of the offer.

While the taxpayer's offer is being evaluated:

- His or her non-refundable payments and fees will be applied to the tax liability (the taxpayer may designate payments to a specific tax year and tax debt).
- A Notice of Federal Tax Lien may be filed.
- Other collection activities are suspended.
- The legal assessment and collection period is extended.
- He or she should make all required payments associated with the offer.
- He or she is not required to make payments on an existing installment agreement.
- His or her offer is automatically accepted if the IRS does not make a determination within two years of the IRS receipt date.

If the taxpayer's offer is accepted:

1. He or she must meet all the Offer Terms listed in Section 8 of Form 656, including filing all required tax returns and making all payments.
2. Any refunds due within the calendar year in which the offer is accepted will be applied to the tax debt.
3. Federal tax liens are not released until the offer terms are satisfied.
4. Certain offer information is available for public review at designated IRS offices.

If the taxpayer's offer is rejected he or she may appeal a rejection within 30 days using Form 13711 - Request for Appeal of Offer in Compromise.

IRS Notices and Letters

Each year, the IRS sends millions of notices and letters to taxpayers for a variety of reasons. Here are ten things to know in case one shows up in the taxpayer's mailbox.

1. The taxpayer should not panic. He or she often only needs to respond to take care of a notice.
2. There are many reasons why the IRS may send a letter or notice. It typically is about a specific issue on the taxpayer's Federal tax return or tax account. A notice may tell him or her about changes to his or her account or ask the taxpayer for more information. It could also tell him or her that he or she must make a payment.
3. Each notice has specific instructions about what the taxpayer needs to do.
4. The taxpayer may get a notice that states the IRS has made a change or correction to his or her tax return. The taxpayer should review the information and compare it with his or her original return.
5. If the taxpayer agrees with the notice, he or she usually does not need to reply unless it gives him or her other instructions or he or she needs to make a payment.
6. If the taxpayer does not agree with the notice, it is important that he or she responds. The taxpayer should write a letter to explain why he or she disagrees. The taxpayer should include any information and documents he or she wants the IRS to consider. The taxpayer mails the reply with the bottom tear-off portion of the notice and sends it to the address shown in the upper left-hand corner of the notice. Allow at least 30 days for a response.
7. The taxpayer should not have to call or visit an IRS office for most notices. If he or she does have questions, call the phone number in the upper right-hand corner of the notice. The taxpayer should have a copy of the tax return and the notice when he or she calls.
8. The taxpayer should keep copies of any notices he or she receives with his or her other tax records.
9. The IRS sends letters and notices by mail. The IRS does not contact people by email or social media to ask for personal or financial information.
10. For more on this topic, the taxpayer can visit IRS.gov and click on the link 'Responding to a Notice' at the bottom left of the home page. He or she can also see Publication 594 - The IRS Collection Process.

Joint and Several Liability

Many married taxpayers choose to file a joint tax return because of certain benefits this filing status allows. In filing jointly, both taxpayers are jointly and severally liable for the tax and any additions to tax, interest, or penalties that arise as a result of the joint return even if they later divorce. Joint and several liability means that each taxpayer is legally responsible for the entire liability. Thus, both spouses are generally held responsible for all the tax due even if one spouse earned all the income or claimed improper deductions or credits. This is also true even if a divorce decree states that a former spouse will be responsible for any amounts due on previously filed joint returns. In some cases, however, a spouse can get relief from joint and several liability. There are three types of relief from joint and several liability for spouses who filed joint returns: [204]

1. **Innocent Spouse Relief** provides the taxpayer relief from additional tax he or she owes if his or her spouse or former spouse failed to report income, reported income improperly or claimed improper deductions or credits.
2. **Separation of Liability Relief** provides for the allocation of additional tax owed between the taxpayer and his or her former spouse or his or her current spouse from whom the taxpayer is separated because an item was not reported properly on a joint return. The tax allocated to the taxpayer is the amount for which he or she is responsible.

3. **Equitable Relief** may apply when the taxpayer does not qualify for innocent spouse relief or separation of liability relief for something not reported properly on a joint return and generally attributable to his or her spouse. The taxpayer may also qualify for equitable relief if the correct amount of tax was reported on the joint return but the tax remains unpaid.

A taxpayer must request innocent spouse relief or separation of liability relief no later than 2 years after the date the IRS first attempted to collect the tax from him or her. For equitable relief, the taxpayer must request relief during the time the IRS has to collect the tax from him or her. If the taxpayer is looking for a refund of tax he or she paid, then his or her request must be made within the time period for seeking a refund, which is generally three years after the date the return is filed or two years following the payment of the tax, whichever is later.

To seek innocent spouse relief, separation of liability relief, or equitable relief, the taxpayer should submit to the IRS a completed Form 8857 - Request for Innocent Spouse Relief or a written statement containing the same information required on Form 8857, which is signed under penalties of perjury.

Relief from joint and several liability should not be confused with an injured spouse claim. The taxpayer is an "injured spouse" if he or she files a joint return and all or part of his or her share of the refund was, or will be, applied against the separate past-due Federal tax, state tax, child support, or Federal non-tax debt (such as a student loan) of his or her spouse with whom the taxpayer filed the joint return. If your client is an injured spouse, he or she may be entitled to recoup his or her share of the refund.

Amended Returns

What should a taxpayer do if he or she already filed the Federal tax return and then discovers a mistake? The taxpayer has a chance to fix errors by filing an amended tax return. Here are 10 facts every taxpayer should know about filing an amended tax return:

1. Use Form 1040X - Amended U.S. Individual Income Tax Return to file an amended tax return. An amended return cannot be e-filed. The taxpayer must file it on paper.
2. The taxpayer should consider filing an amended tax return if there is a change in his or her filing status, income, deductions or credits.
3. The taxpayer normally does not need to file an amended return to correct math errors. The IRS will automatically make those changes. Also, do not file an amended return because the taxpayer forgot to attach tax forms, such as W-2s or schedules. The IRS normally will send a request asking for those.
4. Generally, the taxpayer must file Form 1040X within three years from the date he or she filed the original tax return or within two years of the date he or she paid the tax, whichever is later. Be sure to enter the year of the return the taxpayer is amending at the top of Form 1040X.
5. If the taxpayer is amending more than one tax return, prepare a 1040X for each return and mail them to the IRS in separate envelopes. The taxpayer will find the appropriate IRS address to mail the return to in the Form 1040X instructions.
6. If the taxpayer's changes involve the need for another schedule or form, he or she must attach that schedule or form to the amended return.
7. If the taxpayer is filing an amended tax return to claim an additional refund, wait until he or she have received the original tax refund before filing Form 1040X. Amended returns take up to 12 weeks to process. The taxpayer may cash the original refund check while waiting for the additional refund.
8. If the taxpayer owes additional taxes with Form 1040X, file it and pay the tax as soon as possible to minimize interest and penalties.
9. The taxpayer can track the status of the amended tax return three weeks after it is filed with the IRS's new tool called, 'Where's My Amended Return?' The automated tool is available on IRS.gov and by phone at 866-464-2050. The online and phone tools are available in English and Spanish. The taxpayer can track the status of the amended return for the current year and up to three prior years.
10. To use either 'Where's My Amended Return' tool, just enter the taxpayer identification number (usually a Social Security number), date of birth and zip code. If the taxpayer has filed amended returns for more than one year, he or she can select each year individually to check the status of each. If the taxpayer uses the tool by phone, he or she will not need to call a different IRS phone number unless the tool tells him or her to do so.

A taxpayer should correct his or her return if, after it was filed, it is determined that:

- The taxpayer did not report some income.
- The taxpayer claimed deductions or credits the taxpayer should not have claimed.
- The taxpayer did not claim deductions or credits that could have been claimed.
- The taxpayer should have claimed a different filing status.

A taxpayer cannot change his or her filing status from married filing jointly to married filing separately after the due date of the original return. An executor may be able to make this change for a deceased spouse.

Form 1040X

If an individual discovers an error after the return has been filed, he or she may need to amend the return. The IRS may correct errors in math on a return and may accept returns with certain forms or schedules left out. In these instances, do not amend the return. However, do file an amended return if there is a change in filing status, income, deductions, or credits.

File Form 1040X - Amended U.S. Individual Income Tax Return only after the taxpayer filed the original return. Use Form 1040X to correct the Form 1040 already filed. On Form 1040X write the taxpayer's income, deductions, and credits as originally reported on the return, the changes being made, and the corrected amounts. Then figure the tax on the corrected amount of taxable income and the amount the taxpayer owes or will be refunded.

Do not file more than one original return for the same year, even if the taxpayer has not received the refund or has not heard from the IRS since he or she filed. Filing more than one original return for the same year or sending in more than one copy of the same return (unless requested by the IRS), could delay the refund.

If the taxpayer owes tax, pay the full amount with Form 1040X. The tax owed will not be subtracted from any amount the taxpayer had credited to his or her estimated tax. If the taxpayer overpaid tax, he or she can have all or part of the overpayment refunded, or the taxpayer can apply all or part of it to his or her estimated tax. If the taxpayer chose to get a refund, it will be sent separately from any refund shown on his/her original return.

File a separate Form 1040X for each year the taxpayer is amending. Mail each form in a separate envelope. Be sure to enter the year of the return being amended at the top of Form 1040X. The form has three columns. Column A shows original or adjusted figures from the original return. Column C shows the corrected figures. The difference between Columns A and C is shown in Column B. There is an area on the back of the form to explain the specific changes being made and the reason for each change. Attach any forms or schedules that are affected by the change.

Attach copies of any forms or schedules that are being changed as a result of the amendment, including any Form(s) W-2 received after the original return was filed. An amended tax return cannot be filed electronically under the e-file system. Normal processing time for Form 1040X is 8 to 12 weeks from the IRS receipt date. [205]

Time for Filing a Claim for Refund

Generally, a taxpayer must file a claim for a credit or refund within 3 years after the date the taxpayer filed the original return or within 2 years after the date the taxpayer paid the tax, whichever is later. Returns filed before the due date (without regard to extensions) are considered filed on the due date (even if the due date was a Saturday, Sunday, or legal holiday). If a claim is not filed within this period, the taxpayer may not be entitled to a credit or a refund.

The state tax liability may be affected by a change made on the Federal return. For information on how to correct the state tax return, contact the state tax agency.

Interest and Penalties

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).

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.

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.

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. (206)

Form 1040X Line Instructions

If the taxpayer has questions such as “what income is taxable” or “what expenses are deductible”, the instructions for the form from the year being amended should help. Also use those instructions to find the method to figure the correct tax. Be sure to use tax laws from the year the original tax was filed. If the taxpayer is not changing any dollar amounts originally reported, but is sending in only additional information, do the following: (206)

1. Check the box for the calendar year or enter the other calendar or fiscal year being amended.
2. Complete name, address, and SSN.
3. Check a box in Part II, if applicable, for the Presidential Election Campaign Fund.
4. Complete Part III, Explanation of changes.

If the taxpayer and his or her spouse are changing from separate returns to a joint return, follow these steps: (206)

1. Enter in column A the amounts from the return as originally filed or as previously adjusted (either by the taxpayer or the IRS).
2. To determine the amounts to enter in column B, combine the amounts from the spouse’s return as originally filed or as previously adjusted with any other changes. If the spouse did not file an original return, include the spouse’s income, deductions, credits, other taxes, etc., in the amounts entered in column B.
3. Read the instructions for column C to figure the amounts to enter in that column.
4. Both must sign and date Form 1040X.

If the taxpayer is changing amounts on the original return or as previously adjusted by the IRS, follow the rules below:

1. Always complete the top of page 1 through Amended return filing status.
2. Complete the lines according to what the taxpayer is changing.
3. Check a box in Part II, if applicable, for the Presidential Election Campaign Fund.
4. Complete Part III, Explanation of changes.
5. Sign and date the form.

Columns A Through C

Column A. Enter the amounts from the original return. However, if the taxpayer previously amended that return or it was changed by the IRS, enter the adjusted amounts.

Column B. Enter the net increase or decrease for each line the taxpayer is changing. Explain each change in Part III. If more space is needed, attach a statement. Attach any schedule or form relating to the change. For example, attach Schedule A (Form 1040) if amending Form 1040 to itemize deductions. If the taxpayer is amending the return because he or she received another Form W-2, attach a copy of the new W-2. Do not attach items unless required to do so.

Column C. To figure the amounts to enter in this column, the taxpayer should:

- Add the increase in column B to the amount in column A.
- Subtract the decrease in column B from the amount in column A.

For any item not changed, enter the amount from column A in column C. Show any negative numbers (losses or decreases) in Columns A, B, or C in parentheses.

Line 1 - Adjusted Gross Income
The taxpayer enters adjusted gross income (AGI), which is the total of income minus certain deductions (adjustments). Any change to the income or adjustments on the return being amended will be reflected on this line.
A change made to AGI can cause other amounts to increase or decrease. For example, changing AGI can change:

- Miscellaneous itemized deductions, credit for child and dependent care expenses, child tax credit, education credits, retirement savings contributions credit, or making work pay credit.
- Allowable charitable contributions deduction or the taxable amount of Social Security benefits.

Line 2 - Itemized Deductions or Standard Deduction
If the taxpayer itemized deductions, enter in column A the total from the original Schedule A (Form 1040) or the deduction as previously adjusted by the IRS. If the taxpayer is now itemizing deductions instead of using the standard deduction, or has changed the amount of any deduction, attach a copy of the corrected Schedule A to this amended return.

If the taxpayer is using the standard deduction, enter the amount for the filing status for the year being amended. Remember that the standard deduction for all years can be increased for the age and/or blindness of the taxpayer(s). See the form instructions for the year being amended.

Line 4a - Exemptions
The taxpayer must complete the Exemptions section on page 2 of Form 1040X if:

- He or she is increasing or decreasing the number of dependents claimed.
- He or she is claiming a personal exemption for him or herself or his or her spouse that was not previously claimed.
- He or she is eliminating a personal exemption for him or herself or his or her spouse previously claimed but was not entitled to claim.
- If any of these situations apply to the taxpayer, complete Form 1040X, lines 24 through 30.

Line 4b - Qualified business income deduction

Line 5 - Taxable Income
If the taxable income on the return the taxpayer is amending is $0 and he or she has made changes on Form 1040X, line 1, 2, or 4, enter on line 5, column A, the actual taxable income instead of $0. Enclose a negative amount in parentheses.

Line 6 - Tax
Figure the tax on the taxable income shown on line 5, column C. Generally, the taxpayer will use the tax table or other method he or she used to figure the tax on the original return. However, the taxpayer may need to change to a different method if, for example, he or she amend the return to include or change the amount of certain types of income, such as capital gains or qualified dividends.

Line 7 - Credits
The taxpayer enters the total nonrefundable credits in column A. Nonrefundable credits are those that reduce the tax, but any excess is not refunded. If the taxpayer made any changes to Form 1040X, lines 1 through 6, be sure to refigure the original credits. Attach the appropriate forms for the credits he or she is adding or changing.

Line 9 - Health Care: Individual Responsibility
If the taxpayer made any changes to Form 1040X lines 1 through 5, he or she may need to refigure his or her individual shared responsibility payment.

Line 10 - Other Taxes
The taxpayer enters other taxes paid in column A.

Line 12 - Withholding
In column A, enter from the return the taxpayer is amending any Federal income tax withheld and any excess Social Security and tier 1 RRTA tax withheld (SS/RRTA). If he or she is changing the withholding or excess SS/RRTA, attach to the front of Form 1040X a copy of all additional or corrected Forms W-2 received after the original return was filed. Also attach additional or corrected Forms 1099-R that showed any Federal income tax withheld.

Line 13 - Estimated Tax Payments
In column A, enter the estimated tax payments claimed on the original return. If the taxpayer filed Form 1040-C - U.S. Departing Alien Income Tax Return, include on this line the amount paid as the balance due with that return. Also include any of prior year's overpayment that the taxpayer elected to apply to estimated tax payments for the year being amended.

Line 14 - Earned Income Tax Credit (EITC)
If the taxpayer is amending the return to claim the EITC and he or she has a qualifying child, attach Schedule EITC (Form 1040). If the taxpayer is amending the EITC based on a nontaxable combat pay election, enter “nontaxable combat pay” and the amount in Part III of Form 1040X.

Line 15 - Refundable Credits
A refundable credit can give the taxpayer a refund for any part of a credit that is more than the total tax. If the taxpayer is amending the return to claim or change a refundable credit, attach the appropriate schedule(s) or form(s). In addition, specify any credit not listed in the blank area after “other (specify):” and include this amount in the line 15 total.

Line 16 - Amount Paid With Extension or Tax Return
On this line, the taxpayer enters the total of the following amounts:

- Any amount paid with the taxpayer’s request for an extension on Form 4868 or 2350. Also include any amount paid with a credit or debit card or the Electronic Federal Tax Payment System (EFTPS) used to get an extension of time to file, but do not include the convenience fee charged. Also include any amount paid by electronic funds withdrawal.
- The amount of the check or money order the taxpayer sent with the original return, the amount paid with a credit or debit card or the EFTPS, or by electronic funds withdrawal. Also include any additional payments made after it was filed. However, do not include payments of interest or penalties, or the convenience fee charged for paying with a credit or debit card.

Line 17 - Total Payments
The taxpayer includes in the total on this line any payments shown on Form 8689 - Allocation of Individual Income Tax to the U.S. Virgin Islands, lines 40 and 45. Enter “USVI” and the amount on the dotted line to the left of line 17.

Line 18 - Overpayment
The taxpayer enters the overpayment from the original return. If the original return was changed by the IRS and the result was an additional overpayment of tax, also include that amount on line 18. Do not include interest received on any refund. Any additional refund the taxpayer is entitled to on Form 1040X will be sent separately from any refund not yet received from the original return.

Line 19 - Amount Available To Pay Additional Tax
If line 18 is larger than line 17, line 19 will be negative. The taxpayer will owe additional tax. To figure the amount owed, treat the amount on line 19 as positive and add it to the amount on line 11. Enter the result on line 20.

Line 20 - Amount Taxpayer Owes
The taxpayer can pay online or by phone, mobile device, cash (maximum $1,000 per day and per transaction), check, or money order.

Line 22 - Overpayment Received as Refund
If the IRS does not use the overpayment to pay past due Federal or state debts, the refund amount on line 22 will be sent separately from any refund claimed on the original return. The IRS will figure any interest and include it in the refund. The taxpayer will receive a check for any refund due. A refund on an amended return **cannot** be deposited directly to his or her bank account.

Line 23 - Overpayment Applied to Estimated Tax
Enter on line 23 the amount, if any, from line 21 the taxpayer wants applied to estimated tax for next year. Also, enter that tax year in the box indicated. No interest will be paid on this amount. The taxpayer will be notified if any of the overpayment was used to pay past due Federal or state debts so that he or she will know how much was applied to estimated tax.

Part I - Exemptions
If the taxpayer is changing the number of exemptions claimed on the return, he or she should complete lines 24 through 29, and line 30, if necessary. He or she enters the new exemption amount on line 29 and line 4, column C.

Line 29 - Exemption Amount
To figure the amount to enter on line 29, the taxpayer may need to use the Deduction for Exemptions Worksheet in the Form 1040 instructions for the year being amended.

Line 30 - Dependents
The taxpayer lists all dependents claimed on this amended return. This includes:

- Dependents claimed on the original return who are still being claimed on this return.
- Dependents not claimed on the original return who are being added to this return.

If the taxpayer is now claiming more than four dependents, attach a separate statement with the required information.

Part II - Presidential Election Campaign Fund
The taxpayer can use Form 1040X to have $3 go to the Presidential Election Campaign Fund if he or she (or his or her spouse on a joint return) did not do so on the original return. This must be done within 20½ months after the original due date for filing the return. For calendar year 2020, this period ends in January 2, 2023. A previous designation of $3 to the fund cannot be changed.

Part III - Explanation of Changes
The IRS needs to know why the taxpayer is filing Form 1040X. For example:

- Received another Form W-2 after the taxpayer filed the original return.
- Forgot to claim the child tax credit.
- Changed filing status from qualifying widow(er) to head of household.
- Are carrying an unused NOL or credit to an earlier year.

Assembling the Return

Assemble any schedules and forms behind Form 1040X in order of the "Attachment Sequence No." shown in the upper right corner of the schedule or form. If the taxpayer has supporting statements, arrange them in the same order as the schedules or forms they support and attach them last. Do not attach correspondence or other items unless required to do so, including a copy of the original return. Attach to the front of Form 1040X:

- A copy of any Forms W-2, W-2c (a corrected Form W-2), and 2439 that support changes made on this return.
- A copy of any Form W-2G and 1099-R that support changes made on this return, but only if tax was withheld.
- A copy of any Forms 1042S, SSA-1042S, RRB-1042S and 8288-A that support changes made on this return.

Attach to the back of Form 1040X any Form 8805 that supports changes made on this return. If the taxpayer owes tax, enclose (do not attach) the check or money order in the envelope with the amended return.

Reduced Refund

The Department of Treasury's Bureau of Fiscal Service (BFS), which issues IRS tax refunds, has been authorized by Congress to conduct the Treasury Offset Program. Through this program, a refund or overpayment may be reduced by BFS and offset to pay: [207]

- Past-due child support.
- Federal agency non-tax debts.
- State income tax obligations.

- Certain unemployment compensation debts owed to a state. (Generally, these are debts for compensation that was paid due to fraud or for contributions due to a state fund that were not paid due to fraud).

State Tax Liability

If a taxpayer's return is changed for any reason, it may affect his or her state income tax liability. This includes changes made as a result of an examination of the taxpayer's return by the IRS. [(205)]

Penalties of Perjury

Under the perjury and false statements statute, there are several different types of conduct which may form the basis for tax fraud penalties and prosecution. The statute makes it a felony for a person to do any of the following: [(208)]

- Make a false declaration under penalties of perjury.
- Willfully aid or assist in the preparation or presentation of any return or other document that is false as to a material matter.
- Simulate or fraudulently sign or execute any bond, permit any entry, or other document required by the internal revenue laws, or procure the same to be falsely or fraudulently executed, or advises, aids in, or connives at such execution thereof.
- Remove or conceal property with intent to evade or defeat assessment or collection of any tax.
- In connection with an offer in compromise and closing agreement, either conceal property or withhold, falsify, or destroy records or make any false statement relating to the financial condition of the taxpayer or other person liable for the tax.

Under IRC Section 7206(1), any person who "willfully makes and subscribes any return, statement or other document which contains or is verified by a written declaration that it is made under the penalties of perjury, and which he does not believe true and correct as to every material matter" is guilty of a felony. This crime is closely related to the crime of tax evasion, but in this case, the penalties may be less severe. The government also has an easier time proving the false tax return crime as opposed to the tax evasion charge because unlike tax evasion, the false tax return crime does not require a showing of "additional tax due and owing." For this reason, the government sometimes attempts to first prosecute taxpayers for tax evasion, and then follow up with a false tax return charge if the taxpayer can successfully defeat the "additional tax due and owing" requirement of the tax evasion charge.

Specialized Returns for Individuals

Estate Tax

If the taxpayer inherited property from a decedent, except those who died in 2010, the basis in property he or she inherits from a decedent is generally one of the following: [209]

- The Fair Market Value (FMV) of the property at the date of the decedent's death.
- The FMV on the alternate valuation date if the personal representative for the estate elects to use alternate valuation.
- The value under the special-use valuation method for real property used in farming or a closely held business if elected for estate tax purposes.
- The decedent's adjusted basis in land to the extent of the value excluded from the decedent's taxable estate as a qualified conservation easement.

If a Federal estate tax return does not have to be filed, the basis in the inherited property is its appraised value at the date of death for state inheritance or transmission taxes.

The Estate Tax is a tax on the right to transfer property at the time of a person's death. It consists of an accounting of everything he or she owns or has certain interests in on the date of death. The fair market value of these items is used, not necessarily what the taxpayer paid for them or what their values were when acquired. The total of all of these items is the gross estate. The gross estate includes the value of all property to the extent of the decedent's interest in the property at the time of death. Unpaid interest that has accrued on savings from the date of the last interest payment to the date of death is included in the gross estate. Outstanding dividends declared to shareholders of record on or before the date of death are included in the gross estate. The includible property may consist of cash and securities, real estate, insurance, trusts, annuities, business interests and other assets.

A taxpayer's gross estate also includes the following: [210]

- Life insurance proceeds payable to the estate or, if the taxpayer owned the policy, to his or her heirs.
- The value of certain annuities payable to the estate or the heirs.
- The value of certain property transferred within 3 years before the decedent's death.

Once the taxpayer has accounted for the Gross Estate, certain deductions (and in special circumstances, reductions to value) are allowed in arriving at the taxable estate. These deductions may include mortgages and other debts, estate administration expenses, property that passes to surviving spouses and qualified charities. The value of some operating business interests or farms may be reduced for estates that qualify. [211]

The allowable deductions used in determining the taxable estate include: [210]

- Funeral expenses paid out of the estate.
- Debts owed at the time of death.
- The marital deduction (generally, the value of the property that passes from the estate to the surviving spouse).
- The charitable deduction (generally, the value of the property that passes from the estate to the United States, any state, a political subdivision of a state, the District of Columbia, or to a qualifying charity for exclusively charitable purposes).
- The state death tax deduction (generally any estate, inheritance, legacy, or succession taxes paid as the result of the decedent's death to any state or the District of Columbia).

The generation-skipping transfer tax is imposed as a separate tax, in addition to the gift and estate taxes, on generation-skipping transfers that are taxable distributions or terminations with respect to a generation skipping trust or direct skips. See Form 709 - United States Gift (and Generation-Skipping Transfer) Tax Return.

After the net amount is computed, the value of lifetime taxable gifts (beginning with gifts made in 1977) is added to this number and the tax is computed. The tax is then reduced by the available unified credit.

The unified credit applies to both the gift tax and the estate tax and it equals the tax on the applicable exclusion amount. A taxpayer must subtract the unified credit from any gift or estate tax that he or she owes. Any unified credit the taxpayer uses against gift tax in one year reduces the amount of credit that he or she can use against gift or estate taxes in a later year. [210]

As of 2011, the amount of unified credit available to a person will equal the tax on the basic exclusion amount plus the tax on any deceased spousal unused exclusion (DSUE) amount. The DSUE is only available if an election was made on the deceased spouse's Form 706 - United States Estate (and Generation-Skipping Transfer) Tax Return.

For decedents who died in 2020, Form 706 must be filed by the executor of the estate of every U.S. citizen or resident:

- Whose gross estate, plus adjusted taxable gifts and specific exemption, is more than $11,580,000; or
- Whose executor elects to transfer the DSUE amount to the surviving spouse, regardless of the size of the decedent's gross estate.

The applicable exclusion amount consists of the basic exclusion amount ($11,580,000 in 2020) and, in the case of a surviving spouse, any unused exclusion amount of the last deceased spouse (who died after December 31, 2010). The executor of the predeceased spouse's estate must have elected on a timely and complete Form 706 - United States Estate (and Generation-Skipping Transfer) Tax Return to allow the donor to use the predeceased spouse's unused exclusion amount.

Estates of decedents who die during 2020 have a basic exclusion amount of $11,580,000, up from a total of $11,400,000 for estates of decedents who died in 2019.

Most relatively simple estates (cash, publicly traded securities, small amounts of other easily valued assets, and no special deductions or elections, or jointly held property) do not require the filing of an estate tax return. A filing is required for estates with combined gross assets and prior taxable gifts exceeding the following amounts:

Jointly Held Property

The general estate tax treatment for property interests held jointly by spouses, usually referred to as qualified joint interests, is that each spouse is treated as having owned a one-half interest in the assets at the time of the first spouse's death (that is, contributions between spouses are not traced for estate tax purposes). As a result, the estate of the first spouse to die will include one-half of these qualified joint interests and will report such holdings on Schedule E of the Federal estate tax return (assuming that a return is required to be filed). The inclusion of these assets for estate tax purposes will not increase the estate's potential estate tax liability because the qualified joint interests will qualify for the marital deduction as passing to the surviving spouse by operation of law.

The income tax treatment of the qualified joint interests in the hands of the surviving spouse is also fairly simple in most cases. At the death of the first spouse to die, the surviving spouse will not recognize income on receipt of these assets. In addition, the basis of the qualified joint interests will be adjusted to the fair market value of the property at the time of death to the extent that such interests are included in the estate of the deceased spouse for estate tax purposes. (Assume for these purposes that no elections are made regarding potential alternate valuations of assets.)

The basis adjustments under IRC Section 1014, often referred to as a step-up in basis, may be a disadvantage if the decedent's basis in the property exceeds the fair market value of the property at the time of death because then a step-down in basis would result.) This basis adjustment is mandated by the Code and is applicable even when no estate tax return is required to be filed.

Only the one-half portion of the qualified joint interest included in the gross estate under IRC Section 2040 will receive a basis adjustment under IRC Section 1014. There will be no adjustment to the basis of the other one-half of the qualified joint interest.

Portability Election

In order to elect portability of the decedent's unused exclusion amount (deceased spousal unused exclusion (DSUE) amount) for the benefit of the surviving spouse, the estate's representative must file an estate tax return (Form 706) and the return must be filed timely. The due date of the estate tax return is nine months after the decedent's date of death, however, the estate's representative may request an extension of time to file the return for up to six months. An automatic six-month extension of time to file the return is available to all estates, including those filing solely to elect portability, by filing Form 4768 on or before the due date of the estate tax return.

Estate Tax Deduction

Income that the decedent had a right to receive is included in the decedent's gross estate and is subject to estate tax. This income in respect of a decedent is also taxed when received by the recipient (estate or beneficiary). However, an income tax deduction is allowed to the recipient for the estate tax paid on the income.

The deduction for estate tax paid can only be claimed for the same tax year in which the income in respect of a decedent must be included in the recipient's income. (This also is true for income in respect of a prior decedent.) Individuals can claim this deduction only as an itemized deduction on line 16 of Schedule A (Form 1040). Estates can claim the deduction on line 19 of Form 1041.

If income in respect of a decedent is capital gain income, the taxpayer must reduce the gain, but not below zero, by any deduction for estate tax paid on such gain.

This applies in figuring the following:

- The maximum tax on net capital gain (including qualified dividends).
- The exclusion for gain on small business stock under Section 1202.
- The limitation on capital losses.

To figure a recipient's estate tax deduction, determine:

1. The estate tax that qualifies for the deduction.
2. The recipient's part of the deductible tax.

The estate tax is the tax on the taxable estate, reduced by any credits allowed. The estate tax qualifying for the deduction is the part of the net value of all the items in the estate that represent income in respect of a decedent. Net value is the excess of the items of income in respect of a decedent over the items of expenses in respect of a decedent. The deductible estate tax is the difference between the actual estate tax and the estate tax determined without including net value. (210)

Gift Tax

The gift tax is a tax on the transfer of property by one individual to another while receiving nothing, or less than full value, in return. The tax applies whether the donor intends the transfer to be a gift or not. The gift tax applies to the transfer by gift of any property. The taxpayer makes a gift if he or she gives property (including money), or the use of or income from property, without expecting to receive something of at least equal value in return. The basis of property received as a gift is the donor's carry-over basis (adjusted basis). If a taxpayer sells something at less than its full value or if he or she makes an interest-free or reduced-interest loan, it may be a gift. (212)

The annual gift exclusion for 2020 remains at $15,000. For gifts made to spouses who are not U.S. citizens, the annual exclusion has increased to $157,000 for 2020. The top rate for gifts and generation-skipping transfers remains at 40%. The general rule is that any gift is a taxable gift. However, there are many exceptions to this rule.

Generally, the following gifts are not taxable gifts:

- Gifts, excluding gifts of future interest, that are not more than the annual exclusion for the calendar year. For 2020, a taxpayer generally can give gifts valued up to $15,000 per person, to any number of people, and none of the gifts will be taxable.
- Tuition or medical expenses paid directly to an educational or medical institution for someone else.
- Gifts to the taxpayer's spouse.
- Gifts to a political organization for its use.
- Gifts to charities.

If the taxpayer or his or her spouse makes a gift to a third party, the gift can be considered as made one-half by the taxpayer and one-half by the spouse. This is known as gift splitting. Both the taxpayer and the spouse must agree to split the gift. For 2020, gift splitting allows married couples to give up to $30,000 to a person without making a taxable gift. (210)

Use Form 709 - United States Gift (and Generation-Skipping Transfer) Tax Return to report the following: (213)

1. Transfers subject to the Federal gift and certain generation-skipping transfer (GST) taxes and to figure the tax due, if any, on those transfers, and
2. Allocation of the lifetime GST exemption to property transferred during the transferor's lifetime. (For more details, Regulations Section 26.2632-1).

In general, if the taxpayer is a citizen or resident of the United States, he or she must file a gift tax return (whether or not any tax is ultimately due) in the following situations: (213)

- If he or she gave gifts to someone in 2020 totaling more than $15,000 (other than to his or he spouse), he or she probably must file Form 709.
- Certain gifts, called future interests, are not subject to the $15,000 annual exclusion and the taxpayer must file Form 709 even if the gift was under $15,000.
- A husband and wife may not file a joint gift tax return. Each individual is responsible for his or her own Form 709.
- The taxpayer must file a gift tax return to split gifts with his or her spouse (regardless of their amount).
- If a gift is of community property, it is considered made one-half by each spouse. For example, a gift of $100,000 of community property is considered a gift of $50,000 made by each spouse, and each spouse must file a gift tax return.
- Likewise, each spouse must file a gift tax return if they have made a gift of property held by them as joint tenants or tenants by the entirety.
- Only individuals are required to file gift tax returns. If a trust, estate, partnership, or corporation makes a gift, the individual beneficiaries, partners, or stockholders are considered donors and may be liable for the gift and GST taxes.
- The donor is responsible for paying the gift tax. However, if the donor does not pay the tax, the person receiving the gift may have to pay the tax.
- If a donor dies before filing a return, the donor's executor must file the return.

If the taxpayer meets all of the following requirements, he or she is not required to file Form 709: (213)

1. He or she made no gifts during the year to his or her spouse.
2. He or she did not give more than $15,000 to any one person.
3. All the gifts he or she made were of present interests.

If the only gifts a taxpayer made during the year are deductible as gifts to charities, he or she does not need to file a return as long as he or she transferred the entire interest in the property to qualifying charities. If the taxpayer transferred only a partial interest or transferred part of the interest to someone other than a charity, he or she must still file a return and report all of his or her gifts to charities.

International Information Reporting

Foreign Employer

A U.S. citizen who works in the United States for a foreign government, an international organization, a foreign embassy, or any foreign employer, must include his or her salary in his or her income. The taxpayer is exempt from Social Security and Medicare employee taxes if he or she is employed in the United States by an international organization or a foreign government. However, the taxpayer must pay self-employment tax on earnings from services performed in the United States, even though he or she is not self-employed. This rule also applies if the taxpayer is an employee of a qualifying wholly owned instrumentality of a foreign government. (53)

Report of Foreign Bank and Financial Accounts (FBAR)

The Financial Crimes Enforcement Network (FinCEN) distributed a rule that amends the Bank Secrecy Act (BSA) implementing regulations regarding the Report of Foreign Bank and Financial Accounts (FBAR). The FBAR form is utilized to report a financial interest in, or signature or other authority over, one or more financial accounts in foreign countries. A report is not mandatory if the aggregate value of the accounts does not exceed $10,000. Therefore, if a U.S. person who 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 that exceeds $10,000 at any time during the calendar year, the Bank Secrecy Act may require him or her to report the account yearly to the Internal Revenue Service by filing a Report of Foreign Bank and Financial Accounts (FBAR).

FBARs must be electronically filed through the Bank Secrecy Act (BSA) E-Filing System using the electronic FinCEN Form 114 - Report of Foreign Bank and Financial Accounts (FBAR), which supersedes the now-obsolete paper Treasury Department Form 90-22.1. Starting after December 31, 2015, the due date of FinCEN Report 114 (relating to Report of Foreign Bank and Financial Accounts) is April 15 with a maximum extension for a 6-month period ending on October 15 and with provision for an extension under rules similar to the rules in Treasury Regulation Section 1.6081–5. For any taxpayer required to file such Form for the first time, any penalty for failure to timely request for, or file, an extension, may be waived by the Secretary.

United States persons are required to file an FBAR if both of the following apply: (214)

1. The United States person had a financial interest in or signature authority over at least one financial account located outside of the United States.
2. The aggregate value of all foreign financial accounts exceeded $10,000 at any time during the calendar year to be reported.

United States person includes U.S. citizens; U.S. residents; entities, including but not limited to, corporations, partnerships, or limited liability companies, created or organized in the United States or under the laws of the United States; and trusts or estates formed under the laws of the United States.

The Federal tax treatment of an entity does not determine whether the entity has an FBAR filing requirement. For example, an entity that is disregarded for purposes of Title 26 of the United States Code must file an FBAR, if otherwise required to do so. Similarly, a trust for which the trust income, deductions, or credits are taken into account by another person for purposes of Title 26 of the United States Code must file an FBAR, if otherwise required to do so.

A financial account contains, but is not limited to, securities, brokerage, savings, demand, checking, deposit, time deposit, or other account maintained with a financial institution (or other person performing the services of a financial institution). A financial account also is comprised of commodity futures or options account, an insurance policy with a cash value (such as a whole life insurance policy), an annuity policy with a cash value, and shares in a mutual fund or similarly pooled fund (i.e., a fund that is available to the general public with a regular net asset value determination and regular redemptions).

A foreign financial account is a financial account located outside of the United States. For example, an account maintained with a branch of a United States bank that is physically located outside of the United States is a foreign financial account. An account maintained with a branch of a foreign bank that is physically located in the United States is not a foreign financial account. Exceptions to the FBAR reporting requirements are located in the FBAR instructions.

There are filing exceptions for the following United States persons or foreign financial accounts:

- Certain foreign financial accounts jointly owned by spouses.
- United States persons included in a consolidated FBAR.
- Correspondent/nostro accounts.
- Foreign financial accounts owned by a governmental entity.
- Foreign financial accounts owned by an international financial institution.
- IRA owners and beneficiaries.
- Participants in and beneficiaries of tax-qualified retirement plans.
- Certain individuals with signature authority over but no financial interest in a foreign financial account.
- Trust beneficiaries (but only if a U.S. person reports the account on an FBAR filed on behalf of the trust).
- Foreign financial accounts maintained on a United States military banking facility.

A U.S. person who has a foreign financial account may have a reporting obligation even though the account produces no taxable income. The reporting obligation is met by answering questions on a tax return about foreign accounts (for example, the questions about foreign accounts on Form 1040 Schedule B) and by filing an FBAR.

The FBAR is a calendar year report, which must be filed with the Department of Treasury on or before April 15 of the year following the calendar year reported. Generally, extensions of time to file an FBAR are allowed. The law affords an extension of up to six months to be available to all taxpayers, which coincides with the October 15 extension due date for individual income tax returns. While the due dates for the FBAR and individual income tax returns now coincide, the method of filing FBARs has not changed. FBARs must be filed electronically through the FinCEN BSA E-Filing System.

Those required to file an FBAR who fail to properly file a complete and correct FBAR may be subject to civil monetary penalties. For penalties that are assessed in 2020, the IRS may assess an inflation-adjusted civil penalty not to exceed $12,927 per violation for non-willful violations that are not due to reasonable cause. For willful violations, the inflation-adjusted penalty may be the greater of $129,210 or 50% of the balance in the account at the time of the violation, for each violation.

Taxpayers with specified foreign financial assets that exceed $50,000 on the last day of the tax year or $75,000 at any time during the tax year (higher threshold amounts apply to married individuals filing jointly and individuals living abroad) must report those assets to the IRS on Form 8938 - Statement of Specified Foreign Financial Assets, which is filed with an income tax return. The new Form 8938 filing requirement is in addition to the FBAR filing requirement.

Offshore Voluntary Disclosure Program (OVDP)

The Offshore Voluntary Disclosure Program (OVDP) was a voluntary disclosure program specifically designed for taxpayers with exposure to potential criminal liability and/or substantial civil penalties due to a willful failure to report foreign financial assets and pay all tax due in respect of those assets. OVDP was designed to provide to taxpayers with such exposure (1) protection from criminal liability and (2) terms for resolving their civil tax and penalty obligations.

The IRS closed the 2014 OVDP effective September 28, 2018. While the program had been successful in the past, there had been a significant decline in the number of taxpayers participating as well as an increase in awareness of offshore tax and reporting obligations. The IRS had previously stated publicly that the 2014 OVDP would close at some time. Taxpayers have had the opportunity to participate in OVDP since 2009. Complete offshore voluntary disclosures conforming to the requirements of 2014 OVDP must have been received or postmarked by September 28, 2018 and could not have been partial, incomplete, or placeholder submissions. Practitioners and taxpayers were required to ensure complete submissions by the deadline to request to participate in the 2014 OVDP.

Stopping offshore tax noncompliance and evasion remain top priorities of the IRS. The IRS enforces offshore compliance with tax and FBAR requirements using information received under the Foreign Account Tax Compliance Act (FATCA), the network of intergovernmental agreements between the U.S. and partner jurisdictions, automatic third-party account reporting, and other data-rich sources such as the Department of Justice's Swiss Bank Program and various John Doe Summonses. The IRS leverages information resources using enhanced data analytics to continue to make it more difficult to evade tax by hiding offshore.

Civil Resolution Framework

For all voluntary disclosures received after September 28, 2018, the Department of the Treasury will apply the civil resolution framework outlined below. At the Department's discretion, this civil resolution framework may extend to non-offshore voluntary disclosures that have not been resolved but were received on or before September 28, 2018.

Examiners are authorized to resolve tax and tax related noncompliance of taxpayers who make voluntary disclosures in the following manner:

1. In general, voluntary disclosures will include a six-year disclosure period. The disclosure period will require examinations of the most recent six tax years. Disclosure and examination periods may vary as described below:
    a. In voluntary disclosures not resolved by agreement, the examiner has discretion to expand the scope to include the full duration of the noncompliance and may assert maximum penalties under the law with the approval of management.
    b. In cases where noncompliance involves fewer than the most recent six tax years, the voluntary disclosure must correct noncompliance for all tax periods involved.
    c. With the IRS' review and consent, cooperative taxpayers may be allowed to expand the disclosure period. Taxpayers may wish to include additional tax years in the disclosure period for various reasons (e.g., correcting tax issues with other governments that require additional tax periods, correcting tax issues before a sale or acquisition of an entity, correcting tax issues relating to unreported taxable gifts in prior tax periods).
2. Taxpayers must submit all required returns and reports for the disclosure period.
3. Examiners will determine applicable taxes, interest, and penalties under existing law and procedures. Penalties will be asserted as follows:
    a. Except as set forth below, the civil penalty under I.R.C. Section 6663 for fraud or the civil penalty under I.R.C. Section 6651(f) for the fraudulent failure to file income tax returns will apply to the one tax year with the highest tax liability.
    b. In limited circumstances, examiners may apply the civil fraud penalty to more than one year in the six-year scope (up to all six years) based on the facts and circumstances of the case, for example, if there is no agreement as to the tax liability.
    c. Examiners may apply the civil fraud penalty beyond six years if the taxpayer fails to cooperate and resolve the examination by agreement.
    d. Willful FBAR penalties will be asserted in accordance with existing IRS penalty guidelines under IRM 4.26.16 and 4.26.17.
    e. A taxpayer is not precluded from requesting the imposition of accuracy related penalties under I.R.C. Section 6662 instead of civil fraud penalties or non-willful FBAR penalties instead of willful penalties. Given the objective of the voluntary disclosure practice, granting requests for the imposition of lesser penalties is expected to be exceptional. Where the facts and the law support the assertion of a civil fraud or willful FBAR penalty, a taxpayer must present convincing evidence to justify why the civil fraud penalty should not be imposed.
    f. Penalties for the failure to file information returns will not be automatically imposed. Examiner discretion will take into account the application of other penalties (such as civil fraud penalty and willful FBAR penalty) and resolve the examination by agreement.
    g. Penalties relating to excise taxes, employment taxes, estate and gift tax, etc. will be handled based upon the facts and circumstances with examiners coordinating with appropriate subject matter experts.
    h. Taxpayers retain the right to request an appeal with the Office of Appeals.
4. The Department will provide procedures for civil examiners to request revocation of preliminary acceptance when taxpayers fail to cooperate with civil disposition of cases.
5. All impacted IRM sections will be updated within two years of the date of this memorandum.

Streamlined Filing Compliance Procedures

The streamlined filing compliance procedures are available to taxpayers certifying that their failure to report foreign financial assets and pay all tax due in respect of those assets did not result from willful conduct on their part. The streamlined procedures are designed to provide to taxpayers in such situations with:

- A streamlined procedure for fling amended or delinquent returns,
- Terms for resolving their tax and penalty procedure for filing amended or delinquent returns, and
- Terms for resolving their tax and penalty obligations.

The streamlined filing procedures that were first offered on September 1, 2012 have been expanded and modified to accommodate a broader group of U.S. taxpayers. Major changes to the streamlined procedures include:

- Extension of eligibility to U.S. taxpayers residing in the United States,
- Elimination of the $1,500 tax threshold, and
- Elimination of the risk assessment process associated with the streamlined filing compliance procedure announced in 2012.

Taxpayers eligible to use the streamlined procedures who have previously filed delinquent or amended returns in an attempt to address U.S. tax and information reporting obligations with respect to foreign financial assets (so-called "quiet disclosures" made outside of the Offshore Voluntary Disclosure Program (OVDP) or its predecessor programs) may still use the streamlined procedures by following the instructions set forth below. However, any penalty assessments previously made with respect to those filing will not be abated.

Delinquent International Information Return Submission Procedures

Taxpayers who do not need to use the OVDP or the Streamlined Filing Compliance Procedures to file delinquent or amended tax returns to report and pay additional tax, but who:

1. Have not filed one or more required international information returns,
2. Have reasonable cause for not timely filing the information returns,
3. Are not under a civil examination or a criminal investigation by the IRS, and
4. Have not already been contacted by the IRS about the delinquent information returns…

…should file the delinquent information returns with a statement of all facts establishing reasonable cause for the failure to file.

As part of the reasonable cause statement, taxpayers must also certify that any entity for which the information returns are being filed was not engaged in tax evasion. If a reasonable cause statement is not attached to each delinquent information return filed, penalties may be assessed in accordance with existing procedures.

- All delinquent international information returns other than Forms 3520 and 3520-A should be attached to an amended return and filed according to the applicable instructions for the amended return.
- All delinquent Forms 3520 and 3520-A should be filed according to the applicable instructions for those forms.
- A reasonable cause statement must be attached to each delinquent information return filed for which reasonable cause is being requested.

Information returns filed with amended returns will not be automatically subject to audit but may be selected for audit through the existing audit selection processes that are in place for any tax or information returns.

Comparison of Form 8938 and FBAR Requirements

The Form 8938 - Statement of Specified Foreign Financial Assets filing requirement does not replace or otherwise affect a taxpayer’s obligation to file FinCEN Form 114 (Report of Foreign Bank and Financial Accounts). Unlike Form 8938, the FBAR (FinCEN Form 114) is not filed with the IRS. It must be filed directly with the office of Financial Crimes Enforcement Network (FinCEN), a bureau of the Department of the Treasury, separate from the IRS. Individuals and domestic entities must check the requirements and relevant reporting thresholds of each form and determine if they should file Form 8938 or FinCEN Form 114, or both.

Comparison of Form 8938 and FBAR Requirements		
	Form 8938 - Statement of Specified Foreign Financial Assets	**FinCEN Form 114 - Report of Foreign Bank and Financial Accounts (FBAR)**
Who Must File?	Specified individuals and specified domestic entities that have an interest in specified foreign financial assets and meet the reporting threshold: • Specified individuals include U.S citizens, resident aliens, and certain non-resident aliens. • Specified domestic entities include certain domestic corporations, partnerships, and trusts.	U.S. persons, which include U.S. citizens, resident aliens, trusts, estates, and domestic entities that have an interest in foreign financial accounts and meet the reporting threshold.
Does the United States include U.S. territories?	No.	Yes, resident aliens of U.S territories and U.S. territory entities are subject to FBAR reporting.
Reporting Threshold (Total Value of Assets)	Specified individuals living in the US: • Unmarried taxpayer (or married filing separately): Total value of assets was more than \$50,000 on the last day of the tax year, or more than \$75,000 at any time during the year. • Married taxpayer filing jointly: Total value of assets was more than \$100,000 on the last day of the tax year, or more than \$150,000 at any time during the year. Specified individuals living outside the US: • Unmarried taxpayer (or married filing separately): Total value of assets was more than \$200,000 on the last day of the tax year, or more than \$300,000 at any time during the year. • Married taxpayer filing jointly: Total value of assets was more than \$400,000 on the last day of the tax year, or more than \$600,000 at any time during the year.	Aggregate value of financial accounts exceeds \$10,000 at any time during the calendar year. This is a cumulative balance, meaning if the taxpayer has 2 accounts with a combined account balance greater than \$10,000 at any one time, both accounts would have to be reported.

	Specified domestic entities: Total value of assets was more than $50,000 on the last day of the tax year, or more than $50,000 at any time during the tax year.	
When does the taxpayer have an interest in an account or asset?	If any income, gains, losses, deductions, credits, gross proceeds, or distributions from holding or disposing of the account or asset are or would be required to be reported, included, or otherwise reflected on his or her income tax return.	Financial interest: the taxpayer is the owner of record or holder of legal title; the owner of record or holder of legal title is his or her agent or representative; he or she has a sufficient interest in the entity that is the owner of record or holder of legal title. Signature authority: the taxpayer has authority to control the disposition of the assets in the account by direct communication with the financial institution maintaining the account. See instructions for further details.
What is Reported?	Maximum value of specified foreign financial assets, which include financial accounts with foreign financial institutions and certain other foreign non-account investment assets.	Maximum value of financial accounts maintained by a financial institution physically located in a foreign country.
How are maximum account or asset values determined and reported?	Fair market value in U.S. dollars in accord with the Form 8938 instructions for each account and asset reported. Convert to U.S. dollars using the end of the taxable year exchange rate and report in U.S. dollars.	Use periodic account statements to determine the maximum value in the currency of the account. Convert to U.S. dollars using the end of the calendar year exchange rate and report in U.S. dollars.
When Due?	Form is attached to the taxpayer's annual return and due on the date of that return, including any applicable extensions.	Received by April 15 (6-month automatic extension to Oct 15).
Where to File?	File with income tax return pursuant to instructions for filing the return. Form 8938 and Instructions can be found at www.irs.gov/pub/irs-pdf/i8938.pdf.	File electronically through FinCENs BSA E-Filing System. The FBAR is not filed with a Federal tax return.

Penalties	Up to $10,000 for failure to disclose and an additional $10,000 for each 30 days of non-filing after IRS notice of a failure to disclose, for a potential maximum penalty of $60,000; criminal penalties may also apply.	Civil monetary penalties are adjusted annually for inflation. For civil penalty assessment prior to Aug 1, 2016, if non-willful, up to $10,000; if willful, up to the greater of $100,000 or 50% of account balances; criminal penalties may also apply.

Table 6-1 - Comparison of Form 8938 and FBAR Requirements (2020)

Global Intangible Low-taxed Income (GILTI)

The global intangible low-taxed income (GILTI) provision (Section 951A) added by The Tax Cuts and Jobs Act (TCJA) requires U.S. shareholders of controlled foreign corporations (CFCs) to include in their gross income their GILTI income for that tax year (the inclusion amount). The new provision applies to tax years of foreign corporations beginning after December 31, 2017, and to the U.S. shareholders' tax years within which the foreign corporations' tax years end.

This inclusion amount is intended to subject intangible income earned by a CFC to U.S. tax on a current basis and is determined using a formula. A 10% return is attributed to certain tangible assets called specified tangible property (qualified business asset investment, or QBAI), and each dollar of certain income above that is treated as intangible income. The IRS explains that the inclusion amount is treated similarly to a Subpart F income inclusion, but it is determined in a fundamentally different manner, aggregating the inclusion amounts for all CFCs the U.S. shareholder owns.

U.S. shareholders of controlled foreign corporations use Form 8992 - U.S. Shareholder Calculation of Global Intangible Low-Taxed Income (GILTI) and Schedule A to figure their global intangible low-taxed income inclusions under Section 951A and its related regulations. Also, if the taxpayer is eligible for a deduction under Section 250 for his or her GILTI inclusion, he or she should see Form 8993 - Section 250 Deduction for Foreign-Derived Intangible Income (FDII) and Global Intangible Low-Taxed Income (GILTI) and its instructions.

Section 965 Transition Tax

Section 965 requires United States shareholders (as defined under Section 951(b)) to pay a transition tax on the untaxed foreign earnings of certain specified foreign corporations as if those earnings had been repatriated to the United States. Very generally, a specified foreign corporation means either a controlled foreign corporation, as defined under Section 957 ("CFC"), or a foreign corporation (other than a passive foreign investment company, as defined under Section 1297, that is not also a CFC) that has a United States shareholder that is a domestic corporation. Section 965 allows U.S. shareholders to reduce the amount of the income inclusion based on deficits in earnings and profits with respect to other specified foreign corporations. The effective tax rates applicable to income inclusions are adjusted by way of a participation deduction set out in Section 965(c). A reduced foreign tax credit applies to the inclusion under Section 965(g). Taxpayers may elect to pay the transition tax in installments over an eight-year period.

It is important that all potentially impacted taxpayers are aware of the requirements under Section 965. U.S. shareholders of specified foreign corporations need to be aware that an income inclusion may be required for 2020 and certain elections, which may have a significant impact on a taxpayer's 2020 payment and filing obligations, must be made no later than the due date for a taxpayer's 2020 tax return. U.S. shareholders include domestic corporations, but could also include other U.S. persons, such as individuals, S corporations, partnerships, estate, trusts, cooperatives, REITS, RICs and tax-exempt organizations. Notably, all U.S. shareholders of a CFC previously filing a Form 5471 should determine if there is an obligation to file and pay the tax under Section 965 for 2020. Note, however, that even if a United States shareholder has not previously filed Form 5471, the United States shareholder may be subject to tax under Section 965.

Taxpayers should be aware of their income tax obligations under Section 965. The new tax applies to the last taxable year of specified foreign corporations beginning before January 1, 2018, and the tax is includible in the U.S. shareholder's tax year in which or with which the specified foreign corporation's year ends.

If the taxpayer was a U.S. shareholder of one or more CFCs or other specified foreign corporations, Section 965 requires him or her to take the following actions:

1. He or she must determine if he or she held an interest in one or more specified foreign corporations whose tax year ends with or within his or her 2020 taxable year.
2. He or she must determine the amount, if any, of previously untaxed earnings and profits to be included in income on his or her 2020 tax return.
3. A U.S. shareholder that is required to pay the tax with respect to a 2020 inclusion must do so either in one lump sum, or, pursuant to an election, in eight annual installments. See IRC Section 965(h).
4. Failure to properly comply with the reporting and payment obligations could result in the imposition of interest and/or the assertion of tax penalties.

Taxpayers must keep adequate records to support the calculation of tax pursuant to Section 965. The IRS plans to monitor compliance with the provisions of Section 965. Follow-up inquiries may occur if the IRS determines that the required filings and/or payments are not made.

Form 8865 - Return of U.S. Persons With Respect to Certain Foreign Partnerships

A partnership formed in a foreign country that is controlled by U.S. partners is required to file Form 8865 - Return of U.S. Persons With Respect to Certain Foreign Partnerships. Control means that five or fewer U.S. persons who each own a 10% or greater interest in the partnership also own (in the aggregate) more than 50% of the partnership interests.

A U.S. person who is a partner in a foreign partnership (or an entity electing to be taxed as a partnership) is required to file Form 8865 to report the income and financial position of the partnership and to report certain transactions between the partner and the partnership. The form is required to be filed with the partner's tax return.

A controlled foreign corporation (with multiple owners) that elects to be taxed as a disregarded entity, should file Form 8865 and should file a Form K-1 for each U.S. partner. The taxpayer should use Form 8865 to report the information required under Section 6038 (reporting with respect to controlled foreign partnerships), section 6038B (reporting of transfers to foreign partnerships), or Section 6046A (reporting of acquisitions, dispositions, and changes in foreign partnership interests).

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201. —. Pay by Check or Money Order. *irs.gov.* [Online] http://www.irs.gov/Individuals/Pay-by-Check-or-Money-Order.
202. —. Topic 202 - Tax Payment Options. *irs.gov.* [Online] http://www.irs.gov/taxtopics/tc202.html.
203. —. Offer in Compromise. *irs.gov.* [Online] http://www.irs.gov/Individuals/Offer-in-Compromise-1.
204. —. Topic 205 - Innocent Spouse Relief (Including Separation of Liability and Equitable Relief). *irs.gov.* [Online] http://www.irs.gov/taxtopics/tc205.html.
205. —. Topic 308 - Amended Returns. *irs.gov.* [Online] http://www.irs.gov/taxtopics/tc308.html.
206. —. Instructions for Form 1040X. *irs.gov.* [Online] http://www.irs.gov/pub/irs-pdf/i1040x.pdf.
207. —. Topic 203 - Refund Offsets: For Unpaid Child Support, and Certain Federal, State and Unemployment Compensation Debts. *irs.gov.* [Online] http://www.irs.gov/taxtopics/tc203.html.
208. **Cornell University Law School.** 26 U.S. Code § 7206 - Fraud and false statements. *law.cornell.edu.* [Online] https://www.law.cornell.edu/uscode/text/26/7206.
209. **IRS.** Publication 17 , Chapter 13 - Basis of Property. *irs.gov.* [Online] http://www.irs.gov/publications/p17/ch13.html.
210. —. Publication 559 - Survivors, Executors, and Administrators. *irs.gov.* [Online] https://www.irs.gov/pub/irs-pdf/p559.pdf.
211. —. Estate Tax. *irs.gov.* [Online] http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Estate-Tax.
212. —. Gift Tax. *irs.gov.* [Online] http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Gift-Tax.
213. —. Form 709 - United States Gift (and Generation-Skipping Transfer) Tax Return. *irs.gov.* [Online] http://www.irs.gov/instructions/i709/.
214. —. Understanding Your LTR4868CS Letter. *irs.gov.* [Online] http://www.irs.gov/Individuals/Understanding-Your-LTR4868CS-Letter.

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Practice Exam Instructions

The Special Enrollment Exam (SEE) is based on the results of a survey sent to over 10,000 enrolled agents and it represents the knowledge needed for the tasks performed by enrolled agents. For *Part 1 - Individuals* you will be tested on five subject areas:

Section 1: Preliminary Work and Taxpayer Data - 14 Questions
Section 2: Income and Assets - 17 Questions
Section 3: Deductions and Credits - 17 Questions
Section 4: Taxation - 15 Questions
Section 5: Advising the Individual Taxpayer - 11 Questions
Section 6: Specialized returns for individuals - 11 Questions

The *Part 1 - Individuals* exam contains 100 multiple-choice questions. There are 85 questions that are scored and 15 questions that are experimental and not scored.

IRSTaxTraining.com, Inc. has prepared two practice examinations that have the EXACT look, feel and functionality of the Special Enrollment Exam (SEE). You will see this exact screen on the day of your test. You have the ability to mark questions you would like to come back and answer later, as well as a review button that will give you an overview of what you have and have not answered. Also, a non-functioning calculator is provided for demonstration purposes. You will need to have a calculator on hand for the practice exams. Our practice tests also include the ability to ‘clear’ or ‘reset’ the tests so that you can take them more than once. We recommend you do this so that you become comfortable with the testing environment and time limitation.

When taking the exam remember to have patience. Always check and re-read the answers. Do not immediately select the answer that “looks right”. Slow down and choose the best possible answer. Most people have plenty of time. Also, remember the exams usually use 1-year-old rules. Make sure you check to see which year is being tested.

For exams taken between **May 1, 2021 – February 28, 2022,** all references on the examination are to the Internal Revenue Code, forms and publications, as amended through December 31, 2020. Also, unless otherwise stated, all questions relate to the calendar year 2020. Questions that contain the term ‘current tax year’ refer to the calendar year 2020. In answering questions, candidates should not take into account any legislation or court decisions after December 31, 2020.

When answering questions in this study guide, candidates should account for any changes to tax law as a result of the Tax Cuts and Jobs Act (TCJA).

For this study guide, all questions relate to **tax year 2020**.

We advise that you take these practice tests in one continuous sitting, with a time limit of 3½ hours. You should set aside a period of time that you know you will not be interrupted. If you finish in less time that is fine but try to ensure you complete it within this time frame. When you are finished, submit your answers and you will see the questions you missed. While you are given an answer key, we strongly recommend you repeat the practice tests until you score 90% or better within the time limitation.

These practice exams can be taken online at www.IRSTaxTraining.com. You simply login using your e-mail address and password and click on the examination you wish to take. Your results will be made immediately available to you after you press the complete and submit button and you also have access to the answer keys for both practice tests. You can clear the exams of your answers and re-take them as often as you like and in fact, we recommend you do so. We are here to help you pass the exam, so if you have questions or comments please e-mail us at Support@irstaxtraining.com.

All questions pertain to Tax Year 2020 unless noted.

1. For two taxpayers married on November 30. That same year, the husband enrolled in an accredited college to further his career and subsequently received a *Form 1098-T - Tuition Statement*. The wife was employed with an income of $45,000 and paid for the husband's education expenses. Based on their circumstances, which of the following is true regarding their eligibility for education credits?
   A. Based on the wife's adjusted gross income (AGI), they do not qualify to claim an education credit
   B. The husband is ineligible to claim an education credit because the wife paid his education expenses
   C. The wife should report nonqualified education expenses on Form 8863 - Education Credits (American Opportunity and Lifetime Learning Credits)
   D. The taxpayers must file a joint return to claim an education credit

2. Bill donated $100 to the American Red Cross, $200 to the Boy Scouts of America, and $300 to his neighbor's GoFundMe page whose home was destroyed by an earthquake. How much is Bill's deduction for charitable contributions?
   A. $300
   B. $400
   C. $500
   D. $600

3. Rick and Tina are married and filing a joint tax return for 2020. Their two children under age 18 and Tina's mother lived with them all year. During 2020, Rick and Tina provided all the support for their children and more than half of the support for Tina's mother. The children each had interest income of less than $400. Tina's mother received $4,500 from a taxable pension, $2,500 of dividends, and $2,000 of interest income. How many personal exemptions can Rick and Tina claim on their income tax return?
   A. 0
   B. 3
   C. 4
   D. 5

4. Which of the following statements about a sole proprietorship is correct?
   A. A sole proprietor may not use a business or trade name other than their legal name
   B. Sole proprietorships also have the same government rules and regulations affecting it as other types of corporations
   C. A sole proprietorship is a type of business entity that is owned and operated by one individual and in which there is no legal distinction between the owner and the business
   D. A sole proprietorship is owned and controlled by one person and there cannot be many employees working for him or her

5. Esmeralda received a scholarship of $2,500. The scholarship was not received under any exceptions mentioned in Publication 970 - Chapter 1 - Scholarships, Fellowship Grants, Grants, and Tuition Reductions. As a condition for receiving the scholarship, she must serve as a part-time teaching assistant. Of the $2,500 scholarship, $1,000 represents payment for teaching. The provider of her scholarship gives Esmeralda a Form W-2 showing $1,000 as income. Her qualified education expenses were $3,000. Assuming that all other conditions are met, the most Esmeralda can exclude from her gross income is what amount?
   A. $0
   B. $1,000
   C. $1,500
   D. $2,500

6. Craig, a United States citizen, owns foreign financial accounts X, Y, and Z with maximum account values of $100, $12,000 and $3,000, respectively. None of the accounts produce income. Which of the following is true regarding Craig's Report of Foreign Bank and Financial Accounts (FBAR) requirement?
    A. Craig is not required to file an FBAR because the aggregate value of the accounts is below $20,000
    B. Craig is not required to file an FBAR because the accounts do not produce income
    C. Craig must report foreign financial accounts X, Y, and Z on the FBAR even though accounts X and Z have maximum account values below $10,000
    D. Craig must only report foreign financial account Y on the FBAR because accounts X and Z have maximum account values below $10,000

7. 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 2020. All of the following are true regarding the simplified option except:
    A. The standard deduction is $5 per square foot of the home used for business
    B. The standard deduction is allowed on a maximum of 300 square feet
    C. Allowable home-related itemized deductions are claimed in full on Schedule A
    D. Home depreciation deduction or later recapture of depreciation for the years is allowable if the simplified option is used

8. Which of the following statements is correct regarding *Form 1095-A - Health Insurance Marketplace Statement*?
    A. Taxpayers do not need Form 1095-A to complete *Form 8962 - Premium Tax Credit*, to reconcile advance payments of the Premium Tax Credit or claim the Premium Tax Credit on their income tax return
    B. Taxpayers will receive Form 1095-A to complete *Form 8962 - Premium Tax Credit*, if they have been covered by an employer insurance plan for the entire year
    C. Taxpayers will use Form 1095-A to complete *Form 8962 - Premium Tax Credit*, to reconcile advance payments of the Premium Tax Credit or claim the Premium Tax Credit on their income tax return
    D. Taxpayers will attach a Form 1095-A with their return to reconcile advance payments of the Premium Tax Credit or claim the Premium Tax Credit on their income tax return

9. Mark Brown is a member of a religious order and has taken a vow of poverty. He renounces all claims to his earnings and turns over his earnings to the order. Mark is a schoolteacher. He was instructed by the superiors of the order to get a job with a private tax-exempt school. Mark became an employee of the school, and, at his request, the school made the salary payments $10,000 directly to the order. What amount of the $10,000 salary Mark earns working for the school is included in his income?
    A. $0
    B. $2,500
    C. $5,000
    D. $10,000

10. Mike is divorced. His dependent daughter, Sara, lived with him all year. Property taxes of $1,000 and mortgage interest of $4,000 on the home where he and Sara live are divided equally with his ex-wife. Mike paid the utilities of $100 per month. What portion of the yearly household expenses allows him to qualify for head of household filing status?
    A. $2,500
    B. $3,700
    C. $5,600
    D. $6,200

11. Carla will be considered a U.S. resident for tax purposes if she meets the substantial presence test for calendar year 2020. Carla was physically present in the United States on 120 days in each of the years 2018, 2019, and 2020. She counts how many days in this 3-year period to determine if she meets the substantial presence test for 2020?
    A. 20 days
    B. 120 days
    C. 180 days
    D. 360 days

12. Hugo is a single taxpayer with $175,000 in salary and $100,000 in capital gains. His modified adjusted gross income is $275,000 while his net investment income is $100,000. Hugo's modified adjusted gross income exceeds the net investment income tax threshold by $75,000. What amount does Hugo owe for the net investment income tax?
    A. $0
    B. $2,850
    C. $3,800
    D. $5,225

13. Barney and Betty are married, and they file a joint return. Barney earned $75,000 in Medicare wages and Betty earned $200,000 in Medicare wages, so their combined total wages are $275,000. Barney and Betty will owe what amount for the Additional Medicare Tax on their income tax return?
    A. $0
    B. $225
    C. $250
    D. $275

14. Which of the following statements is false regarding a taxpayer's eligibility to qualify for the Premium Tax Credit?
    A. If a taxpayer enrolls in an employer-sponsored plan, including retiree coverage, he or she is eligible for the Premium Tax Credit
    B. If a taxpayer is not eligible for coverage through a government program, like Medicaid, Medicare, CHIP or TRICARE he or she is eligible for the Premium Tax Credit
    C. A taxpayer is eligible for the Premium Tax Credit if he or she cannot be claimed as a dependent by another person
    D. A taxpayer is eligible for the Premium Tax Credit if he or she purchases coverage through the Marketplace

15. To the extent that gains are not otherwise offset by capital losses, all of the following gains are common examples of items taken into account in computing Net Investment Income except:
    A. Gains from the sale of stocks, bonds, and mutual funds
    B. Capital gain distributions from mutual funds
    C. Gains from the pre-existing statutory exclusion in Section 121 that exempts the first $250,000 ($500,000 in the case of a married couple) of gain recognized on the sale of a principal residence
    D. Gain from the sale of investment real estate (including gain from the sale of a second home that is not a primary residence)

16. A nonresident alien received a $40,000 scholarship from a U.S. corporation to go to a gymnastic camp in the individual's resident country, which has a 10% flat tax. How much U.S. tax must be paid on the scholarship?
    A. $0
    B. $4,000
    C. $8,000
    D. $12,000

17. Which of the following is a requirement that must be met in determining whether a taxpayer is eligible for head of household filing status purposes?
    A. An individual's spouse must not have lived in their home for the entire tax year
    B. The individual must be divorced or legally separated for over one year
    C. An individual must pay less than one-half the cost of keeping up a home for the tax year
    D. An individual's home must be, for at least 6 months, the main home of his or her child, stepchild, or adopted child whom he or she can properly claim as a dependent

18. A taxpayer must pay self-employment tax and file Schedule SE if net earnings from self-employment are what amount or more?
    A. $400
    B. $500
    C. $600
    D. $800

19. In meeting the gross income test for claiming his father as a dependent, James must consider the income received by his father. This income included gross rents of $3,000 (expenses were $2,000), municipal bond interest of $1,000, dividends of $1,500, and Social Security of $4,000. What is James' father's gross income for dependency test purposes?
    A. $3,000
    B. $4,500
    C. $5,500
    D. $9,600

20. Jane purchased 500 shares of stock five years ago for $144 a share. The directors voted a 3 for 1 stock split. After the split, Jane had 1500 shares. What is Jane's basis per share after the split?
    A. $48
    B. $144
    C. $288
    D. $432

21. Sandy is a sophomore at California Community College. She paid $2,000 in tuition, $300 for books, and $150 for student fees. She also paid room and board of $2,500. For the calculation of the American Opportunity Tax Credit, what is the total qualifying educational expense for Sandy?
    A. $2,000
    B. $2,450
    C. $4,500
    D. $4,950

22. A taxpayer qualifies for the tax benefits available to taxpayers who have foreign earned income if which of the following apply?
    A. The taxpayer meets the tax home test
    B. The taxpayer meets the bona fide residence test
    C. The taxpayer meets the physical presence test
    D. All of the above

23. Nikki is 13 years old. She received income in the current year from the following sources:
    - Dividends - $1,000
    - Wages - $2,100
    - Taxable interest - $1,200
    - Tax-exempt interest - $100
    - Capital gains - $300
    - Capital losses - ($200)

    If the dividends were qualified dividends on stock given to her by her grandparents, what is Nikki's unearned income for the year?
    A. $200
    B. $2,200
    C. $2,300
    D. $2,400

24. Jennifer Peterson, a single taxpayer, has wages and compensation that total $238,000 for the year. What is the amount of Additional Medicare Tax for which she is liable?
    A. $0
    B. $342
    C. $684
    D. $1,017

25. All of the following are types of relief from joint and several liability for spouses who filed joint returns except:
    A. Prenuptial Agreement
    B. Equitable Relief
    C. Separation of Liability Relief
    D. Innocent Spouse Relief

26. Soraya is a U.S. citizen, a bona fide resident of Canada, and is working as a mining engineer. Her salary is $76,800 per year. She also receives a $6,000 cost-of-living allowance, and a $6,000 education allowance. Her employment contract did not indicate that she was entitled to these allowances only while outside the United States. Soraya works a 5-day week, Monday through Friday. After subtracting her vacation, she has a total of 240 workdays in the year. She also worked in the United States during the year for 6 weeks (30 workdays). What amount is the part of Soraya's income that is foreign earned income for work done in Canada during the year?
    A. $76,800
    B. $77,700
    C. $82,800
    D. $88,800

27. The Gross Estate of the decedent consists of an accounting of everything he or she owns or has certain interests in at the date of death. The fair market value of these items is used, not necessarily what the taxpayer paid for them or what their values were when he or she acquired them. The total of all of these items is the taxpayer's "Gross Estate." The includible property may consist of which of the following?
    A. Cash and securities
    B. Real estate
    C. Insurance
    D. All of the above

28. Emelia is an employee of ABC, Inc. from January through April 2020, and earns $80,000 during that period. From May through the end of the year, she works for XYZ, Inc. and earns $65,000. ABC withholds $4,960 in Social Security taxes ($80,000 × 6.20%), and XYZ withholds $4,030 ($65,000 × 6.20%), for a total $8,990 withheld. On Emelia's 2020 individual tax return, she will be entitled to claim a credit for a payment of taxes for what amount?
    A. $0
    B. $452.60
    C. $524.90
    D. $561.60

29. A taxpayer has taxable income of $100 in 2020, a pre-TCJA net operating loss (NOL) of $60, and a 2019 NOL of $50. Under the CARES Act the taxpayer can offset what amount of 2020 taxable income on his or her tax return?
    A. $0
    B. $50
    C. $60
    D. $100

30. In 2020, in addition to the annual exclusion of $15,000, a taxpayer also can give which of the following without triggering the gift tax?
    A. Gifts to a political organization for its use
    B. Gifts to cover educational expenses
    C. Gifts used to pay for medical expenses
    D. All of the above

31. Under what condition is the taxpayer exempt from having to repay the first-time homebuyer's credit?
    A. Value of the home drops below purchase price
    B. Foreclosure
    C. Death
    D. None of the above

32. For purposes of the Earned Income Tax Credit (EITC), which of the following is a requirement for a qualifying child?
    A. Is over age 24 at the end of 2020 and not permanently and totally disabled
    B. Has lived with the taxpayer in the United States for at least 12 months
    C. Is filing a joint return
    D. Meets the relationship test

33. Isaac and Cynthia are married. Isaac transfers $30,000 to their daughter, Gretel. If Cynthia consents to split the gift, the gift will be treated as if each of them transferred what amount to Gretel for 2020?
    A. $5,000
    B. $7,500
    C. $10,000
    D. $15,000

34. Jack Sage used the cash method of accounting. At the time of his death, he was entitled to receive $12,000 from clients for his services and he had accrued bond interest of $8,000, for a total income in respect of a decedent of $20,000. He also owed $5,000 for business expenses for which his estate is liable. The income and expenses are reported on Jack's estate tax return. The tax on Jack's estate is $9,460, after credits. The net value of the items included as income in respect of the decedent is $15,000 ($20,000 − $5,000). The estate tax determined without including the $15,000 in the taxable estate is $4,840, after credits. The estate tax that qualifies for the deduction is what amount?
    A. $0
    B. $4,620
    C. $4,840
    D. $9,460

35. Carolina inherited an antique table in 2015. The fair market value at the time of inheritance was $5,000. She put $1,000 into it for restoration, which she hoped would help increase its value, upping her basis to $6,000. Fortunately, Carolina was correct, and she sold the table for $7,500 in 2020. She has a net capital gain of $1,500 and her capital gain obligation is what amount on her income tax return?
    A. $0
    B. $420
    C. $1,500
    D. $7,000

36. Glen pays $300 a year for membership in a university's athletic scholarship program. His $300 payment includes the purchase of one season ticket for the stated ticket price of $120. What amount can Glen deduct as a charitable contribution?
    A. $0
    B. $144
    C. $180
    D. $300

37. Steve is a self-employed roofer. He reported a profit of $30,000 on his Schedule C. He had other taxable income of $5,000. He paid $3,000 for hospitalization insurance. He contributed $4,000 to a Keogh Plan. His self-employment tax was $4,656. He paid his former wife $4,000 in court-ordered alimony for a divorce executed on March 18, 2017 and $4,000 in child support. What is the amount Steve can deduct in arriving at AGI?
    A. $9,328
    B. $13,328
    C. $15,656
    D. $19,656

38. Dan purchased 100 shares of common stock in a computer company for $72. Shortly after he purchased it, the corporation distributed two new shares of common stock for each share held. What is his basis for each of the three shares of common stock?
    A. $0
    B. $24
    C. $72
    D. $144

39. Kevin and Jennifer are married and filing a joint tax return. They have a combined taxable income of $80,000. They have four children, whom they claim as dependents. When they file their 2020 income tax return, Kevin and Jennifer's taxable income will be reduced by what amount for their personal exemption deduction?
    A. $0
    B. $12,150
    C. $18,225
    D. $24,900

40. 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. Foreign earned income for this purpose includes which of the following?
    A. Pay received as a military or civilian employee of the U.S. Government or any of its agencies
    B. Pay for professional fees
    C. Pay for services conducted in international waters (not a foreign country)
    D. Pension or annuity payments, including Social Security benefits

41. Frank Johnson owned and operated an apple orchard. He used the cash method of accounting. He sold and delivered 1,000 bushels of apples to a canning factory for $2,000 but did not receive payment before his death. The proceeds from the sale are income in respect of a decedent. When the estate was settled, payment had not been made and the estate transferred the right to the payment to his widow. When Frank's widow collects the $2,000, she must include what amount her income tax return?
    A. $0
    B. $1,000
    C. $1,500
    D. $2,000

42. Eduardo, who is 64 years of age and single, received wages of $15,000, interest income of $3,000, dividends of $2,000, municipal bond interest of $7,000 and state unemployment compensation of $3,000. What is Eduardo's gross income?
    A. $15,000
    B. $18,000
    C. $23,000
    D. $27,000

43. A taxpayer who receives a *Form 1099-MISC - Miscellaneous Income* with the wrong dollar amount in box 7 should do which of the following?
    A. Contact the payer for a corrected Form 1099-MISC
    B. Contact IRS for a corrected Form 1099-MISC
    C. Report the income as stated on the Form 1099-MISC
    D. Disregard the Form 1099-MISC since it is incorrect

44. Veronica is a 62-year-old, married taxpayer who files married filing separately, and who lives apart from her spouse for an entire taxable year. What is the Veronica's base amount for computing taxable Social Security benefits?
    A. $0
    B. $10,000
    C. $25,000
    D. $32,000

45. Henry and Wilma own their residence as tenants by the entirety. Their basis in the residence is $100,000. At the time of Henry's death, the fair market value of the residence was $400,000. Even if no estate tax return is required to be filed, Wilma's basis in the residence will be what amount?
    A. $100,000
    B. $250,000
    C. $300,000
    D. $400,000

46. Wayne was a bona fide resident of Brazil for all of 2019 and 2020. He reports his income on the cash basis. In 2019, he was paid $87,900 for work he did in Brazil during that year. He excluded all of the $87,900 from his income in 2019. In 2020, Wayne was paid $121,000 for his work in Brazil. $20,500 was for work he did in 2019 and $100,500 was for work he did in 2020. What amount of the 2019 income received in 2020 can Wayne exclude from his 2020 income tax return?
    A. $0
    B. $10,900
    C. $18,000
    D. $20,500

47. All gifts made to a taxpayer's spouse are exempt from the Federal gift tax provided that his or her spouse is a U.S. citizen. Additionally, the taxpayer is exempt from the Federal gift tax for transfers up to what amount to a spouse who is not a U.S. citizen in 2020?
    A. $0
    B. $125,000
    C. $157,000
    D. $225,000

48. In 2020, what is maximum amount of qualified long-term care insurance premiums a 35-year-old taxpayer is allowed to include as medical expenses on Schedule A (Form 1040)?
    A. $260
    B. $430
    C. $810
    D. $1,630

49. Camilo and Isa have three children all under the age of ten. The two youngest children, who are three and five years old, attended El Cuento Pre-School for a total cost of $3,500. Juan, who is nine, attended Little House Daycare after school at a cost of $1,000. Isa has earned income of $12,000 and Camilo earns $24,000. What amount of childcare expenses should be used to determine the Child and Dependent Care Credit?
    A. $3,500
    B. $4,500
    C. $12,000
    D. $36,000

50. For the purposes of deductible mortgage interest, if the taxpayer rents a second home to others, he or she must use the home during the year for more than the greater of how many days or 10% of the number of days it is rented, for the interest to qualify as qualified residence interest?
    A. 5 days
    B. 10 days
    C. 14 days
    D. 15 days

51. *Form 4868 - Application for Automatic Extension of Time to File U.S. Individual Income Tax Return*, will provide the taxpayer with the following:
    A. An automatic extension of 6 months to pay the taxes due
    B. An automatic extension of 6 months to file the return
    C. An automatic extension of 8 months to file the return
    D. An automatic extension of 2 months for taxpayers out of the country on April 15th

52. Jerry's jointly owned home (owned as joint tenants with right of survivorship) had an adjusted basis of $50,000 on the date of his spouse's death in 2020, and the fair market value on that date was $100,000. Jerry's new basis in the home is what amount?
    A. $50,000
    B. $67,500
    C. $75,000
    D. $100,000

53. Self-employment tax applies to which of the following?
    A. Individuals who report only interest and dividend income
    B. Corporations that report less than $50,000 in gross receipts
    C. Independent contractors reporting net earnings from self-employment of $100
    D. Independent contractors reporting net earnings from self-employment of $400 or more

54. Bob, a single filer, has $220,000 in self-employment income and $0 in wages. All of the following are true regarding Bob's Additional Medicare Tax liability except:
    A. Bob is liable to pay Additional Medicare Tax on $20,000
    B. Bob is liable to pay Additional Medicare Tax on $220,000
    C. Bob must file *Form 8959 - Additional Medicare Tax*
    D. The Additional Medicare Tax threshold for Bob's filing status is $200,000

55. Dawn is a single taxpayer with a modified adjusted gross income (MAGI) of $50,000. When her daughter, Soraya, was born in 2019, two separate Coverdell Education Savings Accounts (CESA) were set up for her, one by Dawn and one by her daughter's grandfather. In 2020, Dawn contributed $1,000 and the grandfather contributed $600 to Soraya's CESAs. Also, in 2020, Dawn establishes one CESA account for her son, Edgar. During 2020, she can contribute what amount to her son Edgar's CESA?
    A. $0
    B. $400
    C. $1,000
    D. $2,000

56. Sandy executes her divorce on January 18, 2020. She earns $120,000 and pays $30,000 alimony annually to her spouse who earns $25,000. Sandy will be required to pay taxes on what amount of her income?
    A. $0
    B. $30,000
    C. $90,000
    D. $120,000

57. Captain Harris, a member of the Army Reserve, traveled to a location 220 miles from his home to perform his work in the Reserves in April 2020. He incurred $1,553 of unreimbursed expenses consisting of $253 for mileage (440 miles × 57.5 cents a mile), $300 for meals, and $1,000 for lodging. Only 50% of his meal expenses are deductible. He shows his total deductible travel expenses of $1,403 on Form 2106, line 10. He enters what amount for travel over 100 miles from home on Schedule 1 (Form 1040), line 11?
    A. $0
    B. $253
    C. $1,403
    D. $1,553

58. In 2020, Paola files as a head of household and has an adjusted gross income (AGI) of $289,890. She made charitable contributions of $10,000 and paid $25,000 of mortgage interest. Her total itemized deductions are $35,000. Of Paola's $35,000 total itemized deductions, what amount can be listed on her Schedule A?
    A. $0
    B. $10,000
    C. $25,000
    D. $35,000

59. Miranda and Tony adopted a child, not determined to have special needs, in the current year. During the year their qualified adoption expenses were $17,000 and they had a modified adjusted gross income (MAGI) of $283,500. What is the amount of Miranda and Tony's Adoption Credit?
    A. $0
    B. $6,700
    C. $14,300
    D. $17,000

60. Which of the following statements regarding tip income is true?
    A. If the taxpayer is an indirectly tipped employee (for example, a busser or bartender) he or she is not required to report tips to an employer
    B. Any tips the taxpayer reported to an employer are to be included in the wages in box 1 (Wages, tips, other compensation) of his or her Form W-2
    C. If the only tips a taxpayer receives in a month are charged tips (for example, credit and debit card charges) distributed to him or her by an employer, he or she not required to report these tips to the employer
    D. The taxpayer must report the value of any noncash tips, such as tickets and passes, to the employer

61. An unmarried taxpayer provides all of the support necessary for an elderly parent to live independently in a separate home. The taxpayer is claiming the parent as a dependent. Which of the following filing statuses is the taxpayer allowed to use when filing and generally will be the most advantageous for the taxpayer to use?
    A. Single
    B. Head of household
    C. Qualifying widow
    D. Married filing separately

62. Which of the following is a refundable tax credit?
    A. Child and Dependent Care Credit
    B. Credit for the Elderly or Disabled
    C. Foreign Tax Credit
    D. Earned Income Tax Credit

63. Once the taxpayer has accounted for the gross estate, certain deductions (and in special circumstances, reductions to value) are allowed in arriving at the taxable estate. These deductions may include all of the following except:
    A. Mortgages
    B. Estate administration expenses
    C. Qualifying family-owned business
    D. Property that passes to surviving spouses and qualified charities

64. Generally, if a taxpayer owns stock in a small corporation that meets the requirements of Section 1244 (small business) stock and he or she sells that stock at a loss, the loss is reported as which of the following?
    A. Short-term loss on Schedule D limited to $3,000
    B. Long-term loss on Schedule D limited to $3,000
    C. Ordinary loss on Form 4797 limited to $25,000 for a single individual and limited to $50,000 for those filing a joint return
    D. Ordinary loss on Form 4797 limited to $50,000 for a single individual and limited to $100,000 for those filing a joint return

65. Captain Margaret Jones entered Afghanistan on December 1, 2018. She remained there through March 31, 2020, when she departed for the United States. She was not injured and did not return to the combat zone. What is the deadline for Captain Jones' income tax return that she files in 2021 for her 2020 tax year return?
    A. January 10, 2021
    B. April 15, 2021
    C. June 15, 2021
    D. October 15, 2021

66. All of the following are true regarding the Lifetime Learning Credit except:
    A. The credit is available for all years of postsecondary education and for courses to acquire or improve job skills
    B. The credit is available for an unlimited number of tax years
    C. The credit is available only if the student is pursuing a program leading to a degree or other recognized education credential
    D. The maximum credit is up to $2,000 credit per return

67. Sophia sold a painting that she held as an investment on an online auction website for $100. She bought the painting for $20 at a garage sale three years ago. Sophia should report what amount as a capital gain on her Schedule D (Form 1040)?
    A. $0
    B. $20
    C. $80
    D. $100

68. For single filing taxpayers, age 65 or older, the initial amount of allowable Credit for the Elderly or the Permanently and Totally Disabled is what amount?
    A. $3,000
    B. $3,750
    C. $4,000
    D. $5,000

69. If a taxpayer took a distribution from IRA-1 on January 1, 2020, and rolled it over into IRA-2 the same day, which of the following is true?
    A. The distributed amount is treated as an excess contribution
    B. The taxpayer must include the amounts in gross income
    C. The taxpayer is subject to the 10% early withdrawal tax
    D. The taxpayer could not roll over any other 2020 IRA distribution (unless it is a conversion)

70. Zella files as a head of household. She contributed $1,200 to her 403(b) plan this year. In 2020 her adjusted gross income was $30,800. Zella can claim what amount of her contribution for the Retirement Savings Contributions Credit (Saver's Credit) on her tax return?
    A. $0
    B. $240
    C. $600
    D. $1,200

71. When all conditions are met for certain children under age 24, the 2020 alternative minimum tax (AMT) exemption amount is limited to the amount of earned income plus what amount?
    A. $5,950
    B. $6,350
    C. $7,250
    D. $7,900

72. All of the following are true regarding Publicly Traded Partnerships except:
    A. A publicly traded partnership is any partnership an interest in which is regularly traded on an established securities market regardless of the number of its partners
    B. A publicly traded partnership can be treated as a corporation under Section 7704 of the Internal Revenue Code
    C. A publicly traded partnership that has effectively connected income, gain, or loss must pay withholding tax on any distributions of that income made to its foreign partners
    D. A publicly traded partnership rate of withholding is 35%

73. As a general rule, how long should account holders keep records of the accounts required to be reported on the Report of Foreign Bank and Financial Accounts (FBAR)?
    A. 3 years
    B. 5 years
    C. 7 years
    D. 10 years

74. Mike Jackson died in 2020 and left his daughter, Sophia, a commercial rental property in Georgia. He purchased the property for $150,000 and had taken $25,000 in depreciation. The fair market value (FMV) at the time of his death was $300,000. Four months after his death, the property was re-titled into Sophia's name by the estate's representative. There was no alternative valuation done on the transfer. The FMV on that day was $310,000. Sophia's basis in the property is what amount?
    A. $125,000
    B. $150,000
    C. $300,000
    D. $310,000

75. To find out if a taxpayer's Social Security benefits may be taxable, all of the following are taken into account except:
    A. Interest that is tax-exempt
    B. The exclusion for foreign earned income
    C. Notary fees received
    D. Unemployment benefits

76. The requirement to file the *FinCEN Form 114 - Report of Foreign Bank and Financial Accounts (FBAR)*, applies to U.S. Persons with a financial interest in or signature authority over any foreign financial account(s), if the aggregate value of these accounts, at any time during the calendar year, exceeds:
    A. $1,000
    B. $5,000
    C. $7,500
    D. $10,000

77. In 2020, Nancy's employer, JJ Handyman, contributes $5,000 to Nancy's SEP-IRA at ABC Investment Co. based on the terms of the JJ Handyman SEP plan. Nancy, age 45, is permitted to make traditional IRA contributions to her SEP-IRA account at ABC Investment Co., and she contributes $3,000 during the year. She also wants to contribute to her Roth IRA at XYZ Investment Co. What amount can Nancy contribute to her Roth IRA?
    A. $0
    B. $1,500
    C. $3,000
    D. $6,000

78. 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 all of the following except:
    A. Gambling expenses to the extent of gambling winnings
    B. Unreimbursed employee expenses
    C. Home office expenses
    D. Tax preparation expenses

79. Bob's annual salary is $50,000 and he starts contributing to his employer's SIMPLE IRA plan on September 1st. He contributes $1,536 through December 31. Bob's employer must match Bob's contributions up to what amount?
    A. $0
    B. $375
    C. $750
    D. $1,500

80. Darren has a certified statement from his optometrist on December 1, 2020, that confirms he can see no better than 20/250. For tax year 2020, which is correct?
    A. Darren is eligible for the higher standard deduction for blindness in 2020
    B. Darren is eligible for the higher standard deduction for blindness in 2021, the first full year of his blindness
    C. Darren is not eligible for the higher standard deduction for blindness as he is only partially blind
    D. Darren is not eligible for the higher standard deduction for blindness as he can see better than 20/300

81. For 2020, Leslie is unmarried and paid more than half the cost of keeping up her home. All of the following dependents would qualify Leslie to file as head of household except:
    A. Leslie's grandson, who lived with her but was absent from her home for 9 months in 2020 while attending boarding school
    B. Leslie's married son, who could properly be claimed as a dependent on his father's return only
    C. Leslie's father, whom she can claim as a dependent and whose main home for 2020 was a home for the elderly for which Leslie paid more than one-half the cost
    D. Leslie's sister, whom Leslie can claim as a dependent and who lived with Leslie until she died in May 2020

82. Evan, a U.S. citizen, and his wife, Ingrid, a nonresident alien, both make the proper election to file a joint return. As a corporate pilot, Evan has earned income from both domestic and foreign sources. Ingrid has earned income from both her part-time job in the U.S. and from a restaurant her family owns and operates in her native Norway. The couple also has foreign sourced interest income. On what income will the couple be taxed?
    A. Evan's income and Ingrid's part-time job
    B. Evan's domestic and foreign income
    C. All income except for the foreign sourced interest
    D. All of their worldwide income

83. All of the following are nondeductible expenses except:
    A. Payments for food
    B. Life insurance premiums paid by the insured
    C. Ordinary and necessary business expenses
    D. Rent and insurance premiums paid for the taxpayer's own dwelling

84. Joseph and Rachel are married and earn $220,800 a year, which includes $90,800 in wages from Joseph's job managing a theater, and $130,000 of net income from Rachel's clothing store (which is simply a sole proprietorship business reported on her Schedule C). In addition, the couple has a $150,000 portfolio, that produced $3,000 of qualified dividends and $2,000 of real estate investment trust (REIT) income in the past year. The couple's total income is $225,800, of which $132,000 (including Rachel's business income and the REIT income) is qualified business income (QBI). In 2020, the couple will be eligible for a $24,800 standard deduction, reducing their $225,800 of income down to only $201,000. In addition, they will receive a qualified business income (QBI) deduction for what amount?
    A. $0
    B. $13,200
    C. $26,400
    D. $52,800

85. Laura's spouse, Jim, died in September of the tax year. She has not remarried, and provides all the support for their dependent children, ages 8 and 10. Laura can file as Married Filing Jointly for this tax year. For the next two tax years, she can use which of the following, if any, filing statuses (if she does not remarry)?
    A. Married, filing jointly
    B. Qualifying Widow(er)
    C. A or B
    D. None of the above

86. If the taxpayer is the custodial parent, he or she can use *Form 8332 - Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent* to make the written declaration to release a claim to an exemption for a child to the noncustodial parent. Although the exemption amount is zero for tax year 2020, this release allows the noncustodial parent to claim all of the following tax credits except:
    A. American Opportunity Tax Credit
    B. Child Tax Credit
    C. Additional Child Tax Credit
    D. Credit for Other Dependents

87. All of the following changes in circumstances can affect the amount of the taxpayer's actual Premium Tax Credit except:
    A. Marriage
    B. Divorce
    C. Birth or adoption of a child
    D. Opting out of advance credit payments

88. All of the following income types are reported on *Form 1099-MISC - Miscellaneous Income* except:
    A. Canceled debt payments of $600 of more
    B. Non-employee compensation over $600
    C. Medical and health care payments of $600 or more made in the course of a trade or business
    D. Crop insurance proceeds of $600 or more

89. $100 of interest was credited on Emma Moore's frozen deposit during the year. She withdrew $80 but could not withdraw any more before the end of the year. Emma must include what amount in her income for the year?
    A. $0
    B. $20
    C. $80
    D. $100

90. Will purchases rental property for $150,000. He uses $20,000 cash and obtains a mortgage for $130,000. He pays closing costs of $10,000, which includes $5,000 in points on the mortgage and $5,000 for bank fees and title costs. His initial basis in the property is what amount?
    A. $30,000
    B. $150,000
    C. $155,000
    D. $160,000

91. In 2020, for which of the following reasons may a taxpayer claim a casualty loss deduction on his or her income tax return?
    A. The casualty loss is a partial destruction of property
    B. The casualty loss is related to a dwelling unit
    C. The casualty loss is attributable to a federally declared disaster
    D. The casualty loss is the result of an event beyond the taxpayer's reasonable control

92. When determining earned income, which of the following **does not qualify** for the Earned Income Tax Credit (EITC)?
    A. Wages
    B. Salaries
    C. Tips
    D. Interest and Dividends

93. Alfonso works 3 days a week. While he works, his 6-year-old child attends a dependent care center, which complies with all state and local regulations. Alfonso can pay the center $150 for any 3 days a week or $250 for 5 days a week. His child attends the center 5 days a week. What amount of Alfonso's weekly work-related expenses can he use when figuring the Child and Dependent Care Credit?
    A. $0
    B. $83
    C. $150
    D. $250

94. Which dependent relative does not have to live in the same household as the taxpayer claiming head of household filing status?
    - A. Uncle
    - B. Sister or brother
    - C. Mother
    - D. Daughter

95. Jean Blanc, a citizen and resident of Canada, is employed as a professional hockey player by a U.S. hockey club. Under Jean's contract, he received $150,000 for 242 days of play during the year. This includes days spent at pre-season training camp, days during the regular season, and playoff game days. Of the 242 days, 194 days were spent performing services in the United States and 48 days performing services in Canada. The amount of U.S. source income is what amount?
    - A. $0
    - B. $75,000
    - C. $120,248
    - D. $150,000

96. Most types of U.S. source Fixed, Determinable, Annual, Periodical (FDAP) Income received by a foreign person are subject to what tax rate?
    - A. No U.S. tax
    - B. U.S. tax at a 13% rate
    - C. U.S. tax at a 30% rate
    - D. U.S. tax equal to the rate applied by the taxpayer's country of residence

97. A taxpayer goes to a casino and wins $10,000. The casino withholds $500 for Federal income taxes. What is the proper tax treatment by the taxpayer?
    - A. The taxpayer must report the winnings and can claim the amount of Federal income tax withheld on Form 1040
    - B. The taxpayer does not have to report the winnings because the taxpayer did not receive a Form 1099-G from the casino
    - C. The taxpayer is not required to report the winnings on the taxpayer's Form 1040 unless the taxpayer wants to claim the withholding on the Form 1040
    - D. The taxpayer must report the winnings on the taxpayer's Form 1040, but the taxpayer may not claim the amount of Federal income tax withheld unless the taxpayer itemizes deductions

98. Brandt is a college student working on a degree in engineering. He received the following:
    - A $3,000 scholarship used for tuition at his community college
    - A $1,000 scholarship used for books
    - A $7,000 fellowship used for his room and board

    Compute the amount Brandt must include in income for the year.
    - A. $1,000
    - B. $3,000
    - C. $7,000
    - D. $11,000

99. Adam, a single filer, earns $210,000 in wages and sells his principal residence that he has owned and resided in for the last 10 years for $420,000. Adam's cost basis in the home is $200,000. Adam's realized gain on the sale is $220,000. Under IRC Section 121, Adam may exclude up to $250,000 of gain on the sale. What amount of this gain is included for purposes of determining Net Investment Income?
    - A. $0
    - B. $200,000
    - C. $210,000
    - D. $220,000

100. In general, all of the following are included in net investment income except:
   A. Interest
   B. Dividends
   C. Social Security Benefits
   D. Capital gains

All questions pertain to Tax Year 2020 unless noted.

1. When Lenore, age 25, graduated from college last year she had $5,000 left in her Coverdell ESA. She wanted to give this money to her younger sister, who was still in high school. Lenore took a $5,000 distribution and contributed the same amount to her sister's Coverdell ESA within 60 days of the distribution. What amount of the distribution is taxable?
   A. $0
   B. $2,000
   C. $2,500
   D. $5,000

2. Amanda and Steve Smith are married and file jointly. During 2020 they paid state property taxes of $15,000 and state income taxes of $2,000. If they decided to itemize their deductions what amount of combined property and state income taxes can Amanda and Steve claim on their *Schedule A - Itemized Deductions*?
   A. $2,000
   B. $10,000
   C. $15,000
   D. $17,000

3. During the current year, Tom Jackson, who is 50 years old and single, maintained his home in which he and his widowed father, age 75, resided. His father had $2,650 interest income from a savings account and also received $3,000 from Social Security during the current year. Tom provided 60% of his father's total support for the current year. What is Tom's filing status for the current year, and how many dependents should he claim on his tax return?
   A. Head of household and one dependent
   B. Head of household and no dependents
   C. Single and no dependents
   D. Single and one dependent

4. Which of the following statements regarding extensions of time to file is true?
   A. An automatic 2-month extension can be obtained by filing *Form 4868 - Application for Automatic Extension of Time To File U.S. Individual Income Tax Return*
   B. An additional automatic 6-month extension can be obtained by filing *Form 2688 -Application for Additional Extension of Time To File U.S. Individual Income Tax Return*
   C. A penalty for late payment may still be charged even if an extension is granted
   D. An extension request for a Year 1 individual income tax return must be filed by October 15, Year 2

5. Tanvir and Aurora Ahmed, who are married, received $10,000 in the current year as dividends from a taxable domestic corporation. In Tanvir and Aurora's current-year joint return, what amount of these dividends is included in their gross income?
   A. $7,000
   B. $9,800
   C. $9,900
   D. $10,000

6. Which of the following amounts paid may be claimed as a credit on the estate tax return?
   A. Charitable contributions
   B. Generation-skipping transfer tax
   C. State death taxes paid
   D. Amount paid as estimated tax

7. Jason and Monica have children ages three and nine. Monica has wages of $120,000 and Jason volunteers full-time at the Fire Department. Their youngest daughter, Olivia, went to Uptown Nursery School, Inc. at a total cost of $4,000 and their son, Davis, attended a qualified afterschool program that costs $2,000. What amount of childcare expenses can be used to determine the Child and Dependent Care Credit on their income tax return?
   A. $0
   B. $2,000
   C. $4,000
   D. $6,000

8. Depreciation is 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. Which of the following types of tangible property are **not** depreciable?
   A. Land
   B. Buildings
   C. Machinery
   D. Vehicles

9. For purposes of *Form 8880 - Credit for Qualified Retirement Savings Contributions*, a taxpayer must report the total amount of recent distributions from which of the following sources?
   A. Loans from a qualified employer plan
   B. Distributions from qualified retirement plans
   C. Tax-exempt distributions
   D. Distributions of excess contributions or deferrals

10. Kristin, a United States person, owns foreign financial accounts A, B and C with account balances of $3,000, $1,000 and $8,000, respectively. None of the accounts produce income. Which of the following is true regarding Kristin's Report of Foreign Bank and Financial Accounts (FBAR) requirement?
   A. Kristin is not required to file an FBAR because the aggregate value of the accounts is below $20,000
   B. Kristin is not required to file an FBAR because the accounts do not produce income
   C. Kristin must report foreign financial accounts A, B, and C on the FBAR even though no single account exceeded $10,000
   D. Kristin must only report foreign financial account C on the FBAR because account C has a maximum account value above $5,000

11. Mary and Matthew are the parents of four children, ages 5, 9, 13, and 22. Their 22-year-old child is a full-time student with income of $4,700. Mary and Matthew provided more than 50% of the support for all their children. If they file a joint return, how many dependents can they claim for the above family members?
   A. 1
   B. 2
   C. 3
   D. 4

12. Christina Brooks, a resident of the Netherlands, worked 240 days for a U.S. company during the tax year. She received $80,000 in compensation. None of it was for fringe benefits. Christina performed services in the United States for 60 days and performed services in the Netherlands for 180 days. If she uses the time basis to determine the source of compensation, what amount is her U.S. source income?
   A. $0
   B. $20,000
   C. $40,000
   D. $80,000

13. Steve Butler is employed on an offshore oil rig in the territorial waters of a foreign country and works a 28-day on/28-day off schedule. He returns to his family residence in the United States during his off periods. What amount of the Foreign Earned Income Exclusion can Steve claim on his income tax return?
   A. $0
   B. $27,200
   C. $54,400
   D. $105,900

14. Tanya is single and lives in an apartment for which she pays all the expenses. An unrelated 6-year-old child has been living with her since May. She is raising the child as her own and receives no financial assistance. The child was not placed by an authorized adoption agency, but Tanya has filed for adoption although it is not yet final. She has no other dependents. Which of the following statements is correct?
    A. Tanya can file as head of household
    B. Tanya can claim a credit for qualified adoption expenses in the current year, even if the adoption is not final
    C. Tanya can claim the child as her dependent on her return
    D. Tanya should file as a single taxpayer

15. Michael is 16 years old and single. His parents can claim for him as a dependent on their 2020 tax return. He has interest income of $780 and wages of $150. He has no itemized deductions. Michael uses the Standard Deduction Worksheet for Dependents to find his standard deduction. He enters $1,100 (the larger of $500 and $1,100) on line 5, and $12,400 on line 6. His standard deduction, on line 7a, is what amount?
    A. $0
    B. $350
    C. $1,100
    D. $12,400

16. Alejandro is a married taxpayer, and he files a joint return. His adjusted gross income after deductions in 2020 is $250,000. The deductions that he needs to add back in for AMT purposes are $6,000 in state and local taxes and $4,000 in personal property taxes. Based on Alejandro's alternative minimum taxable income (AMTI) of $260,000, he is entitled to subtract what amount of the AMT exemption to arrive at his final taxable amount?
    A. $0
    B. $55,850
    C. $82,050
    D. $113,400

17. All or the following are true regarding the taxation of foreign pension and annuity distributions except:
    A. A foreign pension or annuity distribution is a payment from a pension plan or retirement annuity received from a source outside the United States
    B. Income received from foreign pensions or annuities is not taxable if the taxpayer does not receive a Form 1099 or other similar document reporting the amount of the income
    C. Just as with domestic pensions or annuities, the taxable amount of a foreign pension distribution generally is the Gross Distribution minus the Cost (investment in the contract)
    D. As a general rule, the pension/annuity articles of most tax treaties allow the country of residence (as determined by the residency article) to tax the pension or annuity under its domestic laws

18. Under the Tax Cuts and Jobs Act "pass-through" entities will be taxed at their individual tax rates less a 20% deduction for qualified business income (QBI). However, above certain threshold amounts, the deduction would be disallowed for businesses offering "professional services", such as which of the following?
    A. Law firms
    B. Doctor's offices
    C. Investment offices
    D. All of the above

19. Cameron is a single taxpayer with $190,000 in wages. He also received $70,000 from a passive partnership interest, which is considered Net Investment Income. Cameron's modified adjusted gross income is $260,000. What amount does Cameron owe for the net investment income tax?
    A. $0
    B. $2,280
    C. $3,420
    D. $10,260

20. Gwen inherited 100 shares of SuperShoes stock when her mother died on October 21, 2017; the fair market value of the stock was $20 per share. Her mother paid $200 per share when she purchased the stock March 1, 2009. If Gwen sells all 100 shares for $50 per share on July 3, 2020, how should she report the sale on her current year's return?
    A. $3,000 long-term capital gain
    B. $3,000 short-term capital gain
    C. $15,000 short-term capital loss
    D. $15,000 long-term capital loss

21. In which of the following situations would Stephanie **not** be required to file *Schedule H - Household Employment Taxes*, for the year 2020?
    A. Paid $2,900 wages to Charlie for babysitting in Stephanie's home
    B. Withheld $100 Federal income tax from payments to her yard worker
    C. Paid household help, other than her mother, $1,700 for the period July, August, and September
    D. Paid $2,000 to her mother for housekeeping

22. All of the following are included in calculating the total support of a dependent except:
    A. Medical insurance benefits, including basic and supplementary Medicare benefits received
    B. Childcare even if the taxpayer is claiming the credit for the expense
    C. Amounts veterans receive under the GI bill for tuition and allowances while in school
    D. Tax-exempt income, savings, or borrowed money used to support a person

23. Ann, a single filer, has $130,000 in self-employment income and $0 in wages. What amount of Additional Medicare Tax is Ann liable to pay?
    A. $0
    B. $1,000
    C. $1,170
    D. $2,000

24. Dave is married to Stefanie and he works for E-Services Inc. Dave is paid $230,000, and he has no other earned income during the year. Stefanie is not employed. Regarding Dave and Stefanie's joint income tax return, all of the following are true about their Additional Medicare Tax except:
    A. Because Dave's salary exceeds $200,000, E-Services Inc. must withhold and remit an additional 0.9% Medicare tax on the excess
    B. The total Additional Medicare Tax withheld by E-Services Inc. is $270
    C. Because Dave and Stefanie file a joint income tax return and their total combined wages are less than the $250,000 threshold for married filing jointly, the additional 0.9% Medicare tax does not apply to them
    D. If Dave and Stefanie do not owe any other Federal income taxes, interest, or penalties to which the withholding could be applied, the excess withholding will be returned by E-Services Inc.

25. Wayne and Kim divorced on September 1, 2018. As part of the divorce decree, beginning in September, Wayne was to make payments to Kim of $1,000 a month for the balance of the year for recent medical expenses; child support payments of $1,000 per month, and $1,500 a month for the mortgage payment on a jointly owned home. Kim and the children will continue to live in the home. What is the amount that Wayne can deduct as alimony for 2020?
    A. $0
    B. $7,000
    C. $10,000
    D. $14,000

26. Tony Smith's father died June 15, 2020. Tony is the executor of his father's estate. Tony is required to file a final income tax return for his father. When is this return due if he does not file for an extension (ignoring weekends, holidays and automatic extensions)?
    A. December 15, 2020
    B. March 15, 2021
    C. April 15, 2021
    D. June 15, 2021

27. Which item from the prior-year return may **not** be needed to complete the current-year return?
    A. State income tax refund
    B. Alternative Minimum Tax (AMT) for credit
    C. Adjusted Gross Income (AGI)
    D. Gain/loss carryover

28. When does the holding period for a purchased property begin?
    A. On the first business day after the asset was acquired
    B. On the day before the asset was acquired
    C. On the day the asset was acquired
    D. On the first day after the asset was acquired

29. In the current year, Richard Sherman provided more than half the support for his wife, his uncle, and his cousin. Richard's wife was the only relative who was a member of Richard's household. None of the relatives had any income, nor did either the uncle or the cousin file an individual or a joint return. All of these relatives are U.S. citizens. Which of these relatives should be claimed as a dependent or dependents on Richard's current-year joint return?
    A. His wife, his uncle, and his cousin
    B. Only his uncle
    C. Only his cousin
    D. Only his wife

30. Samantha Anderson, age 21, is single, and cannot be claimed as a dependent by another taxpayer. For 2020, she must file a Federal income tax return if she had gross income of at least what amount?
    A. $1,100
    B. $2,100
    C. $4,300
    D. $12,400

31. Which of the following items is not tax deductible as a work-related education expense under an Employee Educational Assistance Plan?
    A. Tuition
    B. Meals
    C. Textbooks
    D. Lab fees

32. Which of the following is not a requirement for a qualifying child for purposes of the Child Tax Credit?
    A. The child is claimed as the taxpayer's dependent
    B. The child was under age 19 at the end of 2020 or under age 24 at the end of 2020 and was a full-time student
    C. The child is the taxpayer's son, daughter, adopted child, grandchild, stepchild, or foster child
    D. The child is a citizen or resident of the United States

33. What type of contribution is excluded from the Credit for Qualified Retirement Savings Contributions?
    A. Rollover contribution
    B. Traditional IRA contribution
    C. Roth IRA contribution
    D. 401(k) contribution

34. Which of the following is **not** an example of expenses that may be deducted from total rental income?
    A. Depreciation
    B. Repairs to keep property in good working condition
    C. Improvements to increase property value
    D. Operating Expenses

35. Brendan is a degree candidate at the University of Buffalo. During the fall semester of 2020 he received a $3,000 scholarship. He spent the entire amount plus another $1,500 from a student loan by paying $2,000 for tuition, $500 for books, and $2,000 for room and board. How much of the $3,000 scholarship does Brendan report as 2020 income?
    A. $0
    B. $500
    C. $1,500
    D. $3,000

36. Gabriel is 73 years of age and single. He received Social Security benefits of $12,000, wages of $5,000, interest and dividends of $5,500, which included $1,500 of tax-exempt interest. He also received unemployment compensation of $3,000. What amount is Gabriel's adjusted gross income?
    A. $9,600
    B. $12,000
    C. $22,200
    D. $25,500

37. During the course of 2020 Brooke and Eric, who are both U.S. citizens, give $5,000 to their son, Bob, in March and then another $5,000 in December. They also give $3,000 to their daughter, Betty, in March and then another $10,000 in December. Additionally, they give $2,000 to their niece, Susie, in June. All gifts came from a joint account titled in the names of Brooke and Eric. What amount of their gifts does not qualify for the annual exclusion for gifts?
    A. $2,000
    B. $9,000
    C. $10,000
    D. All of their gifts qualify for the annual exclusion

38. Which of the following is true regarding the Report of Foreign Bank and Financial Accounts (FBAR) requirements?
    A. The FinCEN Form 114 (FBAR) must be filed by anyone with any type of foreign bank accounts
    B. The due date for the FBAR filing is generally July 15 of the current tax year for individuals
    C. The FinCEN Form 114 (FBAR) is filed with the taxpayer's current tax year individual income tax return
    D. The FinCEN Form 114 (FBAR) is filed online with the Financial Crimes Enforcement Network

39. Patrick and Nathalie purchased a house to use as rental property. They paid the following amounts: $300,000 cash, assumption of an existing $35,000 mortgage, title search $700, recording fees of $300, points for their new loan of $2,000, and the seller's part of the property taxes of $5,500. The seller did not reimburse them for the property taxes. What is their cost basis in the house?
    A. $300,000
    B. $335,000
    C. $341,500
    D. $343,500

40. Once the taxpayer has accounted for the Gross Estate, certain deductions (and in special circumstances, reductions to value) are allowed in arriving at the "Taxable Estate". The allowable deductions used in determining the taxable estate include which of the following?
    A. Funeral expenses paid out of the estate
    B. Debts owed at the time of death
    C. Estate administration expenses
    D. All of the above

41. During 2020, Soraya was a nonresident alien engaged in a business in the United States. All of her income was from self-employment not subject to wage withholding. Soraya is a calendar-year taxpayer. When is Soraya's income tax return due if she does not apply for an extension of time to file (ignoring weekends, holidays and automatic extensions)?
    A. April 15, 2021
    B. June 15, 2021
    C. August 15, 2021
    D. October 15, 2021

42. Mark, who is 62 years of age and single, has wages of $10,000, interest income of $3,000, dividends of $2,000, municipal bond interest of $1,000, state unemployment compensation of $4,000 and Social Security benefits of $4,000. What is Mark's adjusted gross income?
    A. $16,000
    B. $19,000
    C. $20,000
    D. $24,000

43. Luka Jones dies in 2020. His gross estate is $4,000,000 and his allowable debts, expenses and deductions are $500,000. Luka's taxable estate is what amount?
    A. $0
    B. $500,000
    C. $3,500,000
    D. $4,000,000

44. A lump-sum distribution is the distribution or payment, within how many tax year(s), of a plan participant's entire balance from an employer's qualified pension?
    A. One year
    B. Two years
    C. Three years
    D. Four years

45. The taxable part of a gain from selling Section 1202 qualified small business stock is taxed at a maximum of what rate?
    A. 10%
    B. 15%
    C. 25%
    D. 28%

46. If a taxpayer bought an asset on November 7, 2020 all of the following are true except:
    A. The taxpayer should start counting the holding period on November 7, 2020
    B. The taxpayer should start counting the holding period on November 8, 2020
    C. If the taxpayer sold the asset on November 7, 2021, his or her holding period is not-longer-than 1 year
    D. If the taxpayer sold the asset on November 8, 2021, his or her holding period is longer than 1 year

47. During the year, Sandra, single filing taxpayer, has:
    - $2,000 in short-term capital gains
    - $3,500 in short-term capital losses
    - $3,000 in long-term capital gains
    - $5,000 in long-term capital losses

    For this capital loss, she can take a deduction of what amount against her other income on her income tax return?
    A. $500
    B. $3,000
    C. $3,500
    D. $8,000

48. For which of the following reasons may a taxpayer who fails to meet the ownership and use requirements or the minimum two-year time period for claiming the full exclusion, still be eligible for a partial exclusion on the sale of his or her home?
    A. Change in place of employment
    B. Health Reasons
    C. Unforeseen Circumstances
    D. All of the above

49. Brandt exchanged his collection of stamp albums for a tractor from Virgil in September 2020. The fair market value of the stamp albums is $3,000. The tractor has the same $3,000 fair market value. The collection of stamps cost Brandt $2,000 over the years to assemble. How should Brandt report this transaction on his income tax return?
    A. He reports it as a capital transaction with a $0 gain
    B. He is not required to report it because it is not taxable
    C. He attaches a statement to his return explaining that the exchange was for something of equal value
    D. He reports a $1,000 capital gain

50. In general, what additional tax would a taxpayer be subject to if he or she took an early distribution from a qualified retirement plan (such as an IRA)?
    A. 10% of the amount of the early distribution
    B. 15% of the amount of the early distribution
    C. 20% of the amount of the early distribution
    D. 25% of the amount of the early distribution

51. A taxpayer must pay SE tax and file Schedule SE if they had church employee income of what amount or more?
    A. $108.28
    B. $138.28
    C. $223.54
    D. $370.80

52. Which of the following statements about Self-Employment (SE) tax is not correct?
    A. It is a Social Security and Medicare tax primarily for individuals who work for themselves
    B. If a taxpayer has more than one business, all business income or loss is determined before calculating SE tax
    C. If any of the income from a business is community property income under state law, it is included in the earnings subject to SE tax of the spouse carrying on the business
    D. If the taxpayer is self-employed as a sole proprietor or independent contractor, he or she generally uses Form 1040-ES to figure his or her earnings subject to SE tax

53. As a result of a storm, a tree fell on Mariana's house in December 2018, and she suffered $5,000 in damage. The President did not declare the storm a Federally declared disaster. Mariana filed a claim with her insurance company and reasonably expected the entire amount of the claim to be covered by her insurance company. In January 2020, Mariana's insurance company paid her $3,000 and determined it did not owe her the remaining $2,000 from her claim. The $2,000 personal casualty loss is sustained in 2020 even though the storm occurred in 2018. Thus, what amount is deductible as a casualty loss under the Tax Cuts and Jobs Act (TCJA) limitations on Mariana's income tax return?
    A. $0
    B. $1,000
    C. $1,500
    D. $2,000

54. Nathan is 37 years old. His wife died during the tax year, and he has not remarried. His deceased wife had no income. He has two minor children living with him. Nathan paid all of the costs for keeping up his home for the tax year, and he has paid for all of the support of his wife and these children. Which filing status that Nathan qualifies for has the lowest tax rate?
    A. Married filing separately
    B. Head of household
    C. Qualifying widower with dependent child
    D. Married filing jointly

55. Harold and his wife, Helen, agree to split the gifts that they made during 2020. Harold gives his nephew, George, $21,000, and Helen gives her niece, Gina, $18,000. What amount of the gifts is taxable to Harold and Helen?
    A. $0
    B. $4,000
    C. $7,000
    D. $11,000

56. When e-filing his or her Federal return, a taxpayer who meets the requirements to file both *Form 8938 - Statement of Specified Foreign Financial Assets* and *Form 114 - Report of Foreign Bank and Financial Accounts* should complete which of the following?
    A. Attach both forms to their Federal return
    B. Attach only the Form 114 as it contains the 8938 information
    C. Send both forms in separately to the Internal Revenue Service
    D. Attach only the Form 8938 and file the Form 114 separately

57. Which of the following are points charged for specific services that are not interest and cannot be deducted?
    A. Preparation costs for a mortgage note
    B. Appraisal fees
    C. Notary fees
    D. All of the above

58. When Maria Luna was born in 2018, three separate Coverdell ESAs were set up for her, one by her parents, one by her grandfather, and one by her aunt. In 2020, if her parents contributed $1,000 and her aunt $600, her grandfather could contribute what amount to Maria Luna's Coverdell ESA?
    A. $400
    B. $600
    C. $1,000
    D. $2,000

59. Charitable contributions of what amount must be substantiated by a written acknowledgment from the donee organization?
    A. $100
    B. $250
    C. $500
    D. $1,000

60. Armando opens a savings account at his local bank and deposits $800. The account earns $20 interest. He also receives a $15 calculator. If no other interest is credited to his account during the year, the Form 1099-INT he receives will show $35 interest for the year. What amount of interest income must Armando report on his tax return?
    A. $0
    B. $15
    C. $20
    D. $35

61. Virgil, age 53, and Hillary, age 51, are married and file a joint return. In 2020, Virgil had compensation of $50,000 and Hillary had compensation of $175,000. Their adjusted gross income (AGI) was $200,000. Both are covered by a retirement plan at work, and they figure their modified gross adjusted income (MAGI) to be $172,000. What is the amount of the deductible contribution that can be made for Hillary to her traditional IRA for 2020?
    A. $0
    B. $2,500
    C. $3,000
    D. $6,000

62. A taxpayer may not claim the Retirement Savings Contribution Credit (Saver's Credit) if which of the following are true?
    A. His or her filing status is single
    B. Another taxpayer claims him or her as a dependent
    C. He or she is married and files separately
    D. His or her filing status is head of household

63. Lois and Clark are married, filing jointly taxpayers. Their adjusted gross income (AGI) for the year is $57,600. What is the total amount of Lois and Clark's personal exemptions for 2020?
    - A. $0
    - B. $4,300
    - C. $6,000
    - D. $7,000

64. Which of the following is an example of employee expenses that may be itemized?
    - A. Subscriptions to professional journals and trade magazines related to the taxpayer's work
    - B. Tools and supplies used in the taxpayer's work
    - C. Travel, transportation, meals, entertainment, gifts, and local lodging related to the taxpayer's work
    - D. None of the above

65. Which of the following events is a casualty loss that is deductible?
    - A. Decline in value of a home due to mudslides which damaged only neighboring homes
    - B. Loss of a seawall from the waves continually striking it
    - C. Damage to a house from wood rotting
    - D. None of the above

66. Among other items the Tax Cuts and Jobs Act (TCJA) contains all of the following provisions except:
    - A. Changes the seven existing tax brackets
    - B. Increases the standard deduction
    - C. Repeals the deduction for personal exemptions
    - D. Suspends the deduction for amortizable bond premiums

67. Cynthia is married. Her filing status is married filing jointly. She owns a manufacturing business that generates $100,000 of qualified business income (QBI) and is a qualified trade or business to claim the QBI deduction. Her taxable income is $315,000. The business paid $30,000 in wages and has $50,000 in qualified property. For 2020, Cynthia can claim a qualified business income (QBI) deduction for what amount?
    - A. $0
    - B. $20,000
    - C. $30,000
    - D. $50,000

68. Ms. Nelson, who is married, wants to file as a single person for the current year. Which of the following will prevent her from filing as a single person?
    - A. Her spouse lived in her home for the final 6 months of the current year
    - B. She and her husband did not commingle funds for support purposes
    - C. She paid more than half the cost of keeping up her home for the tax year
    - D. Her home was, for more than 6 months of the year, the principal home of her son, whom she can claim as a dependent

69. Sharon Rose is age 63 and retired. She received $7,000 in Social Security benefits during the year and $9,500 from a part-time job. She also received a taxable pension of $6,400. Sharon had no other income. Sharon is not married and lived alone in the United States for the entire year. She cannot be claimed as a dependent on anyone else's return. She does not have any investment income and does not have a qualifying child. What amount can Sharon claim for the Earned Income Tax Credit (EITC) on her tax return?
    - A. $0
    - B. $538
    - C. $3,584
    - D. $5,920

70. Nontaxable pay for service members is generally referred to as an allowance or assistance and includes all of the following except:
    - A. Pay for active service in a combat zone or qualified Hazardous Duty Area
    - B. Disability and medical benefits
    - C. Special Pay
    - D. Uniform allowances

71. For the purpose of the Child and Dependent Care Credit, taxpayers with an adjusted gross income (AGI) of what amount or less use the highest applicable percentage of 35%?
    A. $11,000
    B. $15,000
    C. $17,000
    D. $20,000

72. Carl, a single filer, has $145,000 in self-employment income and $130,000 in wages. Carl's employer did not withhold Additional Medicare Tax. Therefore, Carl is liable to pay Additional Medicare Tax on what amount of self-employment income?
    A. $0
    B. $75,000
    C. $130,000
    D. $145,000

73. For any child for whom an IRS Individual Taxpayer Identification Number (ITIN) was filed on Schedule 8812 to meet the substantial presence test, the child must have been physically present in the United States at least 183 days during which of the following periods?
    A. 3-year period
    B. 4-year period
    C. 5-year period
    D. 6-year period

74. Mike bought his principal residence for $250,000 on May 3, 2019. He sold it on May 3, 2020, for $400,000. What is the amount and character of his gain?
    A. Long-term, ordinary gain of $400,000
    B. Long-term, capital gain of $150,000
    C. Short-term, ordinary gain of $400,000
    D. Short-term, capital gain of $150,000

75. In 2020, a single taxpayer must reduce his or her Child Tax Credit if modified adjusted gross income (MAGI) is above what amount?
    A. $75,000
    B. $100,000
    C. $200,000
    D. $400,000

76. After Mary died on June 30 of the current year, her executor identified the following items belonging to her estate:
    - Personal residence with a fair market value of $400,000 and an existing mortgage of $100,000
    - Certificate of deposit in the amount of $150,000 of which $10,000 was accrued interest payable at maturity on August 1
    - Stock portfolio with a value at date of death of $2,000,000 and a basis of $500,000
    - Life insurance policy, with her daughter named as an irrevocable beneficiary, in the amount of $150,000

    Assuming that no alternate valuation date is elected, what is the gross value of Mary's estate?
    A. $2,090,000
    B. $2,450,000
    C. $2,550,000
    D. $2,700,000

77. If two or more persons join together to support the same individual, every group member who provides more than what percentage of the support must file the consent to a multiple-support agreement on *Form 2120 - Multiple Support Declaration*?
    A. 5%
    B. 10%
    C. 15%
    D. 20%

78. Kirk decides to use the simplified option for his home office deduction on his 2020 tax return. He figures he uses 200 square feet of his home for business. What is his allowable home office deduction?
    A. $0
    B. $600
    C. $1,000
    D. $2,000

79. John made the following transfers during tax year 2020:
    - To his neighbor in the amount of $17,000
    - To his nephew in the amount of $16,000
    - To his uncle in the amount $15,000

    All of the transfers are gifts that qualify for the annual exclusion. John files one *Form 709 - United States Gift (and Generation-Skipping Transfer) Tax Return* for tax year-end December 31, 2020. What is the total annual exclusion amount for gifts listed on John's Form 709 filing?
    A. $15,000
    B. $31,000
    C. $45,000
    D. $48,000

80. Dan, age 45, earned $35,000 in 2020. He pays 10% on the first $9,875 income and 12% on the income that comes after that. His total tax liability is $4,003. If Dan sells an asset that produced a short-term capital gain of $1,000, then his tax liability rises by what amount?
    A. $0
    B. $120
    C. $150
    D. $1,000

81. Scott received three acres of land valued at $12,000 as a gift. The donor's adjusted basis was $15,000. Scott sold the land for $20,000. For purposes of computing his gain, what is Scott's basis in the land?
    A. $3,000
    B. $12,000
    C. $15,000
    D. $20,000

82. In 2020, the following events occur: Reese pays $13,400 of qualified adoption expenses in connection with an adoption of an eligible child; her employer reimburses her for $3,400 of those expenses; and the adoption becomes final. Reese's modified adjusted gross income (MAGI) amount for 2020 is $155,750. Assuming Reese meets all other requirements, she can claim what amount of the allowable expenses for the Adoption Credit?
    A. $0
    B. $3,400
    C. $10,000
    D. $13,400

83. Jerry and Heather are married, both are employed, and they have three children all under the age of 9. The two youngest children are in preschool and the oldest child is in grade school. They claim their children as dependents and file a joint return. Their adjusted gross income (AGI) is $37,000. Heather earned $30,000 and Jerry earned $7,000. During the year, they paid $2,500 each for the two children to attend preschool. They also paid Jerry's mother $4,000 to watch the oldest child after school. How much of their childcare payments are eligible to calculate the Child and Dependent Care Credit on their return?
    A. $4,000
    B. $5,000
    C. $6,000
    D. $6,500

84. What is the maximum amount a married taxpayer filing jointly can claim for the Retirement Savings Contributions Credit (Savers Credit)?
    A. $2,000
    B. $2,700
    C. $2,800
    D. $2,900

85. Which statement pertaining to estimated tax payments is **not** correct?
    A. An individual, whose only income is from self-employment, may have to pay estimated payments
    B. If insufficient tax is paid through withholding, estimated payments may be necessary
    C. Estimated tax payments are required when the withholding taxes are greater than the overall tax liability
    D. Estimated tax is used to pay not only income tax, but self-employment tax and alternative minimum tax

86. Which of the following is **not** rental income in the year received?
    A. Security deposit, equal to one month's rent, to be refunded at the end of the lease if the building passes inspection
    B. Payment to cancel the remaining lease
    C. Repairs paid by the tenant in lieu of rent
    D. January 2021 rent received in December 2020

87. Jim Grand, who is single, owns a rental apartment building property. This is the only rental property that Jim owns. He “actively participates” in this rental activity as he collects the rents and performs ordinary and necessary repairs. In 2020, Jim had a loss of $30,000 on this rental activity and had no reportable passive income. His adjusted gross income, without regard to this rental loss, is $60,000. How much of the rental loss may Jim deduct on his income tax return?
    A. $0
    B. $6,000
    C. $25,000
    D. $30,000

88. Dave and his spouse Stephanie (both over 65) are filing a joint return and they both received Social Security benefits during the year. In January 2020, Dave receives a Form SSA-1099 showing net benefits of $7,500 in box 5. Stephanie receives a Form SSA-1099 showing net benefits of $3,500 in box 5. Dave also received a taxable pension of $22,800 and interest income of $500. The couple did not have any tax-exempt interest income. What amount of Dave and Stephanie’s Social Security benefits are taxable?
    A. $0
    B. $5,500
    C. $9,350
    D. $11,000

89. Generally, the Earned Income Tax Credit (EITC) is available for which of the following taxpayers?
    A. Resident aliens filing joint returns who have earned income and adjusted gross income (AGI) within certain limits
    B. Unmarried nonresident aliens using an Individual Taxpayer Identification Number (ITIN)
    C. Partnerships formed over the past year by a national organization
    D. All of the above

90. Mary must pay Michael $8,000 a year in alimony and $4,000 in child support according to their divorce statement dated February 2, 2020. She can claim what amount of the alimony as a deduction on her 2020 Tax Return?
    A. $0
    B. $4,000
    C. $8,000
    D. $12,000

91. Mrs. Adams made deductible contributions to traditional individual retirement accounts for several years. Mrs. Adams decides to withdraw $10,000 from one of her accounts in 2020. Mrs. Adams is 61 years old. How does this transaction affect Mrs. Adams' income tax return?
    A. Mrs. Adams must report the entire amount of $10,000
    B. Mrs. Adams does not have to report anything because she is older than 59½ years
    C. Mrs. Adams does not have to report any amount because this was not withdrawn from a Roth IRA
    D. Mrs. Adams must report all of the distribution received but can elect to use the 10-year option

92. Generally, the estate tax return is due how many months after the date of death?
    A. Three months
    B. Six months
    C. Eight months
    D. Nine months

93. Joe's annual salary is $70,000 and he contributed 1% of his compensation, or $700, to his employer's SIMPLE IRA plan. Joe's employer must make a matching contribution of what amount?
    A. $0
    B. $700
    C. $1,000
    D. $1,500

94. For decedents who died in 2020, Form 706 - United States Estate (and Generation-Skipping Transfer) Tax Return must be filed by the executor of the estate of every U.S. citizen or resident for which, if any, of the following reasons?
    A. The gross estate, plus adjusted taxable gifts and specific exemption, is more than $11,580,000
    B. The executor elects to transfer the Deceased Spousal Unused Exclusion (DSUE) amount to the surviving spouse, regardless of the size of the decedent's gross estate
    C. A or B
    D. None of the above

95. A decedent gave $25,000 to her 25-year-old daughter. What part of the gift is a taxable gift?
    A. $5,000
    B. $7,500
    C. $10,000
    D. $15,000

96. Alexandra made cash contributions to her local chapter of the Society for Prevention of Cruelty to Animals (SPCA) to care for stray dogs and cats. She donated several times a year, but she paid less than $250 for the entire year. These are the only charitable contributions Alexandra makes during the year. What documentation must Alexandra keep and provide to the Internal Revenue Service upon request in order to substantiate her tax return charitable contribution deduction?
    A. No documentation is necessary since the contribution is less than $250
    B. A receipt for each donation that shows the amount, date, and to whom paid
    C. An acknowledgement from the SPCA that she made contributions during the year
    D. A self-prepared statement or letter would be sufficient for contributions less than $250

97. Tom is an insurance agent and small business consultant during 2020. He takes one of his clients golfing to give guidance on a business transaction and sell an insurance policy. During the outing he spends $400. Tom can take a deduction for what amount on his income tax return for his entertainment expenses?
    A. $0
    B. $100
    C. $200
    D. $400

98. On February 1, George High, a cash method taxpayer, sold his tractor for $3,000, payable March 1 of the same year. His adjusted basis in the tractor was $2,000. George died on February 15, before receiving payment. The gain to be reported as income in respect of a decedent is what amount?
    A. $0
    B. $1,000
    C. $2,000
    D. $3,000

99. Which of the following statements is not true regarding tax benefits for education?
    A. The American Opportunity Tax Credit may be claimed for tuition expenses incurred in the first 4 years of post-secondary education
    B. The maximum annual American Opportunity Tax Credit is $2,500 per student
    C. The Lifetime Learning Credit is allowed for tuition paid for graduate program studies
    D. Room and board are qualifying expenses for the American Tax Opportunity Credit

100. Ben Smith began working at the Blue Ocean Restaurant (his only employer in 2020) on June 30 and received $10,000 in wages during the year. Ben kept a daily tip record showing that his tips for June were $18 and his tips for the rest of the year totaled $7,000. He was not required to report his June tips to his employer, but he reported all of the rest of his tips to his employer as required. Ben's Form W-2 from Blue Ocean Restaurant shows $17,000 ($10,000 wages + $7,000 reported tips) in box 1. What is the amount of wages Ben should report on his tax return?
    A. $7,000
    B. $10,000
    C. $17,000
    D. $17,018

Practice Exam #1 Answer Key

Question 1 - D. The taxpayers must file a joint return to claim an education credit
A taxpayer may be able to claim an education credit if he or she, his or her spouse, or a dependent he or she claim on his or her tax return was a student enrolled at or attending an eligible educational institution. For 2020, the credits are based on the amount of adjusted qualified education expenses paid for the student in 2020 for academic periods beginning in 2020 or beginning in the first 3 months of 2021.

The taxpayer cannot claim an education credit on a 2020 tax return if any of the following apply:

1. He or she is claimed as a dependent on another person's tax return, such as his or her parent's return.
2. His or her filing status is married filing separately.
3. He or she (or his or her spouse) was a nonresident alien for any part of 2020 and did not elect to be treated as a resident alien for tax purposes.
4. His or her modified adjusted gross income (MAGI) is the following:
    a. For the American Opportunity Tax Credit: $180,000 or more if married filing jointly; or $90,000 or more if single, head of household, or qualifying widow(er) with dependent child.
    b. For the Lifetime Learning Credit: $138,000 or more if married filing jointly; or $69,000 or more if single, head of household, or qualifying widow(er) with dependent child.

Lesson 5 - Education Tax Credits
Source - Instructions for Form 8863 - Who Can Claim an Education Credit

Question 2 - A. $300
To be deductible, charitable contributions must be made to qualified organizations. Payments to individuals, a political organization or a political candidate are never deductible. To determine if the organization that the taxpayer contributed to qualifies as a charitable organization for income tax deductions, review Exempt Organizations Select Check on the IRS.gov website.

In this question, the gift to the neighbor is not a charitable deduction, as the neighbor is not a qualifying charitable organization.

Lesson 3 - Contributions
Source - IRS.GOV - Topic 506 - Charitable Contributions

Question 3 - A. 0
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. Therefore, for 2020, the taxpayer cannot claim a personal exemption deduction for him or herself, his or her spouse, or his or her dependents.

Lesson 1 - Personal Exemptions
Source - Publication 501 - Dependents, Standard Deduction, and Filing Information

Question 4 - C. A sole proprietorship is a type of business entity that is owned and operated by one individual and in which there is no legal distinction between the owner and the business
Normally a business is organized as a sole proprietorship, partnership, or corporation. A sole proprietorship is an unincorporated business owned by an individual. A sole proprietorship has no existence apart from its owner. Business debts are personal debts of the owner. A limited liability company (LLC) with one individual owner generally is treated as a sole proprietorship for Federal income tax purposes, unless the owner elects to treat the LLC as a corporation.

Lesson 1 - Business Income
Source - IRS.GOV - Topic 407 - Business Income

Question 5 - C. $1,500
A taxpayer must include in gross income amounts used for incidental expenses, such as room and board, travel, and optional equipment, and generally amounts received as payments for teaching, research, or other services required as a condition for receiving the scholarship or fellowship grant. Generally, the taxpayer cannot exclude from his or her

gross income the part of any scholarship or fellowship that represents payment for teaching, research, or other services required as a condition for receiving the scholarship. This applies even if all candidates for a degree must perform the services to receive the degree. Also, when reporting scholarship income on the tax return, a taxpayer will include the amounts on the same line as "Wages, salaries, tips, etc."

However, the taxpayer does not have to treat as payment for services the part of any scholarship or fellowship that represents payment for teaching, research or other services if he or she receives the amount under:

- The National Health Service Corps Scholarship Program.
- The Armed Forces Health Professions Scholarship and Financial Assistance Program.
- A comprehensive student work-learning-service program (as defined in Section 448(e) of the Higher Education Act of 1965) operated by a work college (as defined in that section).

Whether the taxpayer must report his or her scholarship or fellowship depends on whether he or she must file a return and whether any part of his or her scholarship or fellowship is taxable.

In this question, assuming that all other conditions are met, the most Esmeralda can exclude from her gross income is $1,500. The $1,000 she received for
teaching must be included in her gross income.

Lesson 2 - Scholarships, Fellowships, and Grants
Source - Publication 970 - Chapter 1 - Scholarships, Fellowship Grants, Grants, and Tuition Reductions

Question 6 - C. Craig must report foreign financial accounts X, Y, and Z on the FBAR even though accounts X and Z have maximum account values below $10,000
A United States person must file an FBAR if that person has a financial interest in or signature authority over any financial account(s) outside of the United States and the aggregate maximum value of the account(s) exceeds $10,000 at any time during the calendar year.

Craig must report foreign financial accounts X, Y, and Z on the FBAR even though accounts X and Z have maximum account values below $10,000. Whether or not an account produces income does not affect the requirement to file an FBAR.

Lesson 6 - Report of Foreign Bank and Financial Accounts (FBAR)
Source - IRS FBAR Reference Guide

Question 7 - D. Home depreciation deduction or later recapture of depreciation for the years is allowable if the simplified option is used
Key points of the simplified option include:

- Standard deduction of $5 per square foot of the home used for business (maximum 300 square feet).
- 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.

Choices A and B are true because they state that the standard deduction is $5 per square foot of the home used for business (maximum 300 square feet). Choice C is true because allowable home-related itemized deductions are claimed in full on Schedule A. Thus, Choice D is false. It states home depreciation deduction or later recapture of depreciation for the years is allowable if the simplified option is used which is inaccurate.

Lesson 5 - Simplified Optionfor Home Office Deduction
Source - IRS.GOV - Simplified Option for Home Office Deduction

Question 8 - C. Taxpayers will use Form 1095-A to complete Form 8962 - Premium Tax Credit, to reconcile advance payments of the Premium Tax Credit or claim the Premium Tax Credit on their income tax return
If the taxpayer or a family member enrolled in health insurance through the Marketplace and advance payments of the Premium Tax Credit were made to his or her insurance company to reduce his or her monthly premium payment, the taxpayer must attach Form 8962 - Premium Tax Credit (PTC) to his or her income tax return to reconcile (compare) the advance payments with his or her Premium Tax Credit for the year. The Marketplace is required to send Form 1095-A by January 31, 2020, listing the advance payments and other information the taxpayer needs to complete Form 8962. The taxpayer will need Form 1095-A from the Marketplace in order to complete Form 8962 and to claim the credit and to reconcile his or her advance credit payments. The taxpayer should include Form 8962 with his or her 1040 or 1040-NR. (Do not include Form 1095-A).

Lesson 3 - Premium Tax Credit
Source - Instructions for Form 8962 - Premium Tax Credit (PTC)

Question 9 - D. $10,000
If the taxpayer is an employee of a third party, the services he or she performs for the third party will not be considered directed or required of him or her by the order. Amounts the taxpayer receives for these services are included in his or her income, even if he or she has taken a vow of poverty. Because Mark is an employee of the school, he is performing services for the school rather than as an agent of the order. The wages Mark earns working for the school are included in his income.

Lesson 4 - Clergy
Source - Publication 525 - Members of Religious Orders

Question 10 - B. $3,700
Half of the property taxes and mortgage interest (since they are shared with his ex-wife) plus the full cost of the utilities are used as costs of keeping up the home.

Lesson 1 - Head of Household
Source - Publication 17 - Chapter 2 - Filing Status

Question 11 - C. 180 days
The taxpayer will be considered a U.S. resident for tax purposes if he or she meets the substantial presence test for the calendar year. To meet this test, the taxpayer must be physically present in the United States on at least:

1. 31 days during 2020, **and**
2. 183 days during the 3-year period that includes the 2020, 2019 and 2018, counting:
    a. All the days he or she was present in 2020, and
    b. 1/3 of the days he or she was present in 2019, and
    c. 1/6 of the days he or she was present in 2018.

To determine if Carla meet the substantial presence test for 2020, count the full 120 days of presence in 2020, 40 days in 2019 (1/3 of 120), and 20 days in 2018 (1/6 of 120). Because the total for the 3-year period is 180 days, she is not considered a resident under the substantial presence test for 2020.

Lesson 1 - Nonresident and Dual Status Aliens
Source - Publication 519 - Chapter 1 - Substantial Presence Test

Question 12 - B. $2,850
The tax applies on the lesser of modified adjusted gross income (MAGI) over the threshold or net investment income, so it applies to the $75,000 of MAGI over the threshold amount of $200,000 for a single taxpayer. Hugo owes the IRS $2,850 ($75,000 X 3.8%) for the tax.

Lesson 4 - Net Investment Income Tax
Source - IRS.GOV - Questions and Answers on the Net Investment Income Tax

Question 13 - B. $225
Barney and Betty will owe the Additional Medicare Tax on the amount by which their combined wages exceed $250,000, the threshold amount for married couples filing jointly. Their excess amount is $275,000 less $250,000, or $25,000. Barney and Betty's Additional Medicare Tax is 0.9% of $25,000, or $225.

Lesson 4 - Additional Medicare Tax
Source - IRS.GOV - Questions and Answers for the Additional Medicare Tax

Question 14 - A. If a taxpayer enrolls in an employer-sponsored plan, including retiree coverage, he or she is eligible for the Premium Tax Credit
If a taxpayer enrolls in an employer-sponsored plan, including retiree coverage, he or she is not eligible for the premium tax credit even if the plan is unaffordable or fails to provide minimum value.

Lesson 3 - Premium Tax Credit
Source - IRS.GOV - Questions and Answers on the Premium Tax Credit

Question 15 - C. Gains from the pre-existing statutory exclusion in Section 121 that exempts the first $250,000 ($500,000 in the case of a married couple) of gain recognized on the sale of a principal residence
The Net Investment Income Tax does not apply to any amount of gain that is excluded from gross income for regular income tax purposes. The pre-existing statutory exclusion in Section 121 exempts the first $250,000 ($500,000 in the case of a married couple) of gain recognized on the sale of a principal residence from gross income for regular income tax purposes and, thus, from the NIIT.

Lesson 4 - Net Investment Income Tax
Source - IRS.GOV - Questions and Answers on the Net Investment Income Tax

Question 16 - A. $0
A scholarship, fellowship, grant, etc. received by a nonresident alien for activities conducted outside of the U.S. is treated as foreign source income (see Publication 515). Because the scholarship will not be treated as U.S. source income, there is no U.S. tax.

Lesson 1 - Nonresident and Dual Status Aliens
Source - IRS.GOV - Taxation of Dual-Status Aliens

Question 17 - D. An individual's home must be, for at least 6 months, the main home of his child, stepchild, or adopted child whom he or she can properly claim as a dependent.
The taxpayer may be able to file as head of household if he or she is unmarried or considered unmarried on the last day of the year, paid more than half the cost of keeping up a home for the year and a qualifying person lived with him or her in the home for more than half the year (except for temporary absences, such as school).

Lesson 1 - Head of Household
Source - Publication 501 - Dependents, Standard Deduction, and Filing Information

Question 18 - A. $400
Generally, the taxpayer must pay SE tax and file Schedule SE (Form 1040) if net earnings from self-employment were $400 or more. Use Schedule SE to figure net earnings from self-employment. Only Choice A has the correct dollar amount and is therefore the correct response.

Lesson 4 - Self-Employment Tax
Source - Publication 334 - Chapter 10 - Self-Employment (SE) Tax

Question 19 - B. $4,500
Social Security and municipal bond income are not taxable income to James' dad and are not included in the gross income figure. The rental income is included without allowing for expenses. He may deduct the rental expenses for tax purposes, but the question asks about gross income for dependency test purposes.

Lesson 1 - Tests to Be a Qualifying Relative
Source - Publication 17 - Chapter 3 - Qualifying Relative

Question 20 - A. $48
Jane had 500 shares purchased at $144 a share (or $72,000). She now has 1500 shares with the same total cost ($72,000). $72,000 / 1500 = $48.

Lesson 2 - Stock Split
Source - IRS.GOV - Stocks (Options, Splits, Traders)

Question 21 - B. $2,450
Tuition, books, and fees are qualifying education expenses for the calculation of the American Opportunity Tax Credit. Room and board expenses are not considered qualifying educational expenses.

Lesson 3 - American Opportunity Tax Credit (AOTC)
Source - IRS.GOV - Tax Benefits for Education: Information Center

Question 22 - D. All of the above
A taxpayer qualifies for the tax benefits available to taxpayers who have foreign earned income if he or she meets the tax home test, he or she meets either the bona fide residence test or the physical presence test.

Lesson 2 - Foreign Earned Income
Source - IRS.GOV - Foreign Earned Income Exclusion

Question 23 - C. $2,300
Unearned income is generally all income other than salaries, wages, and other amounts received as pay for work actually performed. It includes taxable interest, dividends, capital gains (including capital gain distributions), the taxable part of social security and pension payments, certain distributions from trusts, and unemployment compensation. Unearned income includes amounts produced by assets the taxpayer's child obtained with earned income (such as interest on a savings account into which the taxpayer deposited wages).

For this purpose, unearned income includes only amounts the taxpayer's child must include in gross income. Nontaxable unearned income, such as tax-exempt interest and the nontaxable part of Social Security and pension payments, is not included in gross income.

The taxpayer's child's capital losses are taken into account in figuring their unearned income. Capital losses are first applied against capital gains. If the capital losses are more than the capital gains, the difference (up to $3,000) is subtracted from the taxpayer's child's interest, dividends, and other unearned income. Any difference over $3,000 is carried to the next year.

Also, the taxpayer's child's unearned income includes all income produced by property belonging to the child. This is true even if the property was transferred to the child, regardless of when the property was transferred or purchased or who transferred it. Additionally, the child's unearned income includes income produced by property given as a gift to the taxpayer's child. This includes gifts to the child from grandparents or any other person and gifts made under the Uniform Gift to Minors Act.

In this question, Nikki's unearned income is $2,300. This is the total of the dividends ($1,000), taxable interest ($1,200), and capital gains reduced by capital losses ($300 − $200 = $100). Her wages are earned (not unearned) income because they are received for work actually performed. Her tax-exempt interest isn't included because it is nontaxable.

Lesson 1 - Tax for Certain Children Who Have Unearned Income (Kiddie Tax)
Source - Publication 929 - Unearned Income

Question 24 - B. $342
Calculating the Additional Medicare Tax is straightforward: Take the excess of the wages and other compensation (or self-employment income) over the applicable threshold (for a single taxpayer it is $200,000) and then multiply that amount by 0.9%. ($38,000 x .009 = $342).

Lesson 4 - Additional Medicare Tax
Source - IRS.GOV - Questions and Answers for the Additional Medicare Tax

Question 25 - A. Prenuptial Agreement
There are three types of relief from joint and several liability for spouses who filed joint returns; Innocent Spouse Relief (Choice D), Separation of Liability Relief (Choice C) and Equitable Relief (Choice B). Prenuptial Agreement (Choice A) is not a type of relief from joint and several liability for spouses who filed joint returns.

Lesson 5 - Joint and Several Liability
Source - IRS.GOV - Topic 205 - Innocent Spouse Relief (Including Separation of Liability and Equitable Relief)

Question 26 - B. $77,700
The source of the taxpayer's earned income is the place where he or she performs the services for which he or she received the income. Foreign earned income is income the taxpayer receives for working in a foreign country. Where or how he or she is paid has no effect on the source of the income. The following shows how to figure the part of Soraya's income that is for work done in Canada during the year.

$$\frac{\text{Number of days worked in Canada during the year (210)}}{\text{Number of days of work during the year for which payment was made (240)}} \textbf{ X } \text{Total income (\$88,800)} = \$77,700$$

Her foreign source earned income is $77,700.

Lesson 2 - Foreign Earned Income
Source - Publication 54 - Chapter 4 - Source of Earned Income

Question 27 - D. All of the above
The Gross Estate of the decedent consists of an accounting of everything he or she owns or has certain interests in at the date of death. The fair market value of these items is used, not necessarily what the taxpayer paid for them or what their values were when he or she acquired them. The total of all of these items is the taxpayer's "Gross Estate." The includible property may consist of cash and securities, real estate, insurance, trusts, annuities, business interests and other assets. Keep in mind that the Gross Estate will likely include non-probate as well as probate property.

Lesson 6 - Estate Tax
Source - IRS.GOV - Frequently Asked Questions on Estate Taxes

Question 28 - B. $452.60
If the taxpayer had more than one employer during the taxable year and his or her total wages and compensation were over the wage base limit for the year, the total Social Security tax or Social Security equivalent Tier 1 RRTA tax withheld may have exceeded the maximum amount due for the tax year. In 2020, the maximum earnings subject to the Social Security payroll tax is $137,700. Therefore, the maximum withholding amount is $8,537.40 ($137,700 x 6.2%).

In this question the withholding is $452.60 more than the $8,537.40 maximum amount for 2020. Therefore, on Emelia's 2020 individual tax return, she will be entitled to claim a credit for a payment of taxes of $452.60.

Lesson 4 - Excess Social Security and RRTA Tax Withheld
Source - IRS.GOV - Topic 608 Excess Social Security and RRTA Tax Withheld

Question 29 - D. $100
Under the Coronavirus Aid, Relief, and Economic Security Act (CARES) a net operating loss (NOL) arising in a tax year beginning in 2018, 2019 or 2020 can be carried back for five years. It also allows for NOLs arising before January 1, 2021 to fully offset income. Taxpayers may elect to irrevocably waive the entire 5-year carryback period with respect to an NOL. Such election must be made by the due date (including extensions) for filing the taxpayer's return (i) for the first tax year ending after the date the CARES Act is enacted, with respect to 2018 and 2019 NOLs, and (ii) for the tax year the loss is incurred, with respect to a 2020 NOL.

With the repeal of the 80% income limitation, the taxpayer in this question can fully offset the $100 of 2020 taxable income with the $60 pre-TCJA NOL and $40 of the 2019 NOL.

Lesson 5 - Net Operating Loss (NOL)
Source - Publication 536 - Net Operating Losses (NOLs) for Individuals, Estates, and Trusts

Question 30 - D. All of the above
In addition to the annual exclusion, a taxpayer also can give the following without triggering the gift tax:

- Charitable gifts.
- Gifts to a spouse.
- Gifts to a political organization for its use.
- Gifts of educational expenses. These are unlimited as long as the taxpayer makes a direct payment to the educational institution for tuition only.
- Gifts of medical expenses. These, too, are unlimited as long as they are paid directly to the medical facility.

Lesson 6 - Gift Tax
Source - Publication 559 - Gift Tax

Question 31 - C. Death
If the taxpayer dies, repayment of the First-time Homebuyer Credit is not required. If he or she claimed the credit on a joint return and then he or she dies, his or her surviving spouse would be required to repay his or her half of the credit if, during the 36-month period beginning on the purchase date, he or she disposes of the home or it ceases to be his or her main home and none of the other exceptions apply.

Lesson 4 - First-Time Homebuyer Credit Repayment
Source - Instructions for Form 5405 - Repayment of the First-Time Homebuyer Credit

Question 32 - D. Meets the relationship test
A qualifying child must meet a relationship, residency, and age test. Additionally, the taxpayer claiming the qualifying child must satisfy an identification requirement. The qualifying child must have one of the following relationships with the taxpayer to satisfy the relationship test:

- A son, daughter, stepchild, or a descendent of such child.
- A brother or sister (including by half-blood), a step-sibling or a descendant of such individual.
- An adopted child.
- An eligible foster child that has been placed by an authorized agency.

A qualifying child does not include a child who is married unless the taxpayer is entitled to claim him or her as a dependent.

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.

Lesson 3 - Qualifying Child
Source - IRS.GOV - EITC, Earned Income Tax Credit, Questions and Answers

Question 33 - D. $15,000
If the taxpayer or his or her spouse makes a gift to a third party, the gift can be considered as made one-half by the taxpayer and one-half by the spouse. This is known as gift splitting. Both the taxpayer and the spouse must agree to split the gift. For 2020, gift splitting allows married couples to give up to $30,000 to a person without making a taxable gift.

Lesson 6 - Gift Tax
Source - Publication 559 - Gift Splitting

Question 34 - B. $4,620
The estate tax is the tax on the taxable estate, reduced by any credits allowed. The estate tax qualifying for the deduction is the part of the net value of all the items in the estate that represent income in respect of a decedent. Net value is the excess of the items of income in respect of a decedent over the items of expenses in respect of a decedent. The deductible estate tax is the difference between the actual estate tax and the estate tax determined without including net value.

In this question, the tax on Jack's estate is $9,460, after credits. The net value of the items included as income in respect of the decedent is $15,000 ($20,000 − $5,000). The estate tax determined without including the $15,000 in the taxable estate is $4,840, after credits. The estate tax that qualifies for the deduction is $4,620 ($9,460 − $4,840).

Lesson 6 - Estate Tax Deduction
Source - Publication 559 - Survivors, Executors, and Administrators

Question 35 - B. $420
If collectibles are sold at a gain, the taxpayer will be subject to a long-term capital gains tax rate of 28%, if disposed of after more than one year of ownership. In this question, Carolina has a net capital gain of $1,500. Her capital gain obligation at 28% is $420.

Lesson 5 - Collectibles
Source - IRS.GOV - Topic 409 Capital Gains and Losses

Question 36 - A. $0
If the taxpayer receives or expect to receive a financial or economic benefit as a result of making a contribution to a qualified organization, he or she cannot deduct the part of the contribution that represents the value of the benefit he or she receives. Therefore, under the Tax Cuts and Jobs Act, no deduction is allowed for amounts paid in exchange for college or university athletic event seating rights.

Lesson 3 - Contributions From Which the Taxpayer Benefits
Source - Publication 526 - Contributions From Which You Benefit

Question 37 - B. $13,328
Keogh contributions, alimony paid for any divorce or separation agreement executed before December 31, 2018, 50% of self-employment tax, and 100% of self-employed health insurance premiums are adjustments to income to arrive at Adjusted Gross Income (AGI). Child support payments are not deducted in arriving at AGI.

Lesson 2 - Adjustments to Gross Income
Source - Publication 17 - Part Four - Adjustments to Income

Question 38 - B. $24
The basis of the new shares is determined by dividing the original basis by the stock split ratio. The $7,200 cost ($72 X 100) split over the 300 shares he now has results in an adjusted basis of $24 a share.

Lesson 2 - Dividends
Source - Publication 550 - Chapter 4 - Basis of Investment Property

Question 39 - A. $0
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 $4,300 in 2020, as adjusted by inflation. In 2026, taxpayers can claim personal and dependent exemptions again.

Lesson 1 - Personal Exemptions
Source - Publication 501 - Dependents, Standard Deduction, and Filing Information

Question 40 - B. Pay for professional fees
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. Foreign earned income for this purpose means wages, salaries, professional fees, and other compensation received for personal services the taxpayer performed in a foreign country during the period for which he or she met the tax home test and either the bona fide residence test or the physical presence test. It also includes noncash income (such as a home or car) and allowances or reimbursements.

Foreign earned income does not include the following amounts:

- Pay received as a military or civilian employee of the U.S. Government or any of its agencies.
- Pay for services conducted in international waters (not a foreign country).
- Pay in specific combat zones, as designated by an Executive Order from the President, that is excludable from income.
- Payments received after the end of the tax year following the year in which the services that earned the income were performed.
- The value of meals and lodging that are excluded from income because it was furnished for the convenience of the employer.
- Pension or annuity payments, including Social Security benefits.

Lesson 2 - Foreign Earned Income
Source - IRS.GOV - Foreign Earned Income Exclusion

Question 41 - D. $2,000
Income in respect of a decedent must be included in the income of one of the following:

- The decedent's estate, if the estate receives it.
- The beneficiary, if the right to income is passed directly to the beneficiary and the beneficiary receives it.
- Any person to whom the estate properly distributes the right to receive it.

In this case, the proceeds from the sale are income in respect of a decedent. When the estate was settled, payment had not been made and the estate transferred the right to the payment to his widow. When Frank's widow collects the $2,000, she must include that amount in her return. It is not reported on the final return of the decedent or on the return of the estate.

Lesson 4 - Income in Respect of Decedent (IRD)
Source - Publication 559 - Survivors, Executors, and Administrators

Question 42 - C. $23,000
Wages of $15,000, interest income of $3,000, dividends of $2,000 and state unemployment compensation of $3,000 are 100% taxable. Municipal bond interest of $7,000 is 100% nontaxable.

Lesson 2 - Adjustments to Gross Income
Source - 1040 Instructions - Adjusted Gross Income

Question 43 - A. Contact the payer for a corrected Form 1099-MISC
The taxpayer should check the amount of compensation his or her clients say they paid him or her in each Form 1099 against his or her own records to make sure they are consistent. If there is a mistake, call the client immediately and request a corrected Form 1099. The client may not have filed the 1099 with the IRS yet, because they are not due until February 28th (March 31st if filed electronically). If the 1099 has been filed with the IRS, ask the client to send the IRS a corrected 1099. The taxpayer does not want the IRS to think he or she was paid more than he or she really was. The 1099-MISC form has a special box that should be checked to show that it is correcting a prior 1099 form.

Lesson 5 - 1099-MISC - Miscellaneous Income
Source - Instructions for Form 1099-MISC

Question 44 - C. $25,000
The base amounts used to figure the tax on Social Security benefits are:

- $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.

Lesson 2 - Taxation of Social Security Benefits
Source - Publication 915 - Base Amount

Question 45 - B. $250,000
Only the one-half portion of the qualified joint interest included in the gross estate under IRC Section 2040 will receive a basis adjustment under IRC Section 1014. There will be no adjustment to the basis of the other one-half of the qualified joint interest.

In this question, Wilma's basis in the residence will be $250,000 (one-half at the original basis of $100,000 divided by 2 and one-half at the fair market value of $400,000 divided by 2).

Lesson 6 - Jointly Held Property
Source - IRS.GOV - Estate Tax

Question 46 - C. $18,000
If a taxpayer works one year but is not paid for that work until the next year, the amount he or she can exclude in the year he or she is paid is the amount he or she could have excluded in the year he or she did the work if he or she had been paid in that year. Wayne can exclude $18,000 of the $20,500 from his income in 2020. This is the $105,900 maximum exclusion in 2019 minus the $87,900 actually excluded that year. He must include the remaining $2,500 in income in 2020 because he could not have excluded that income in 2019 if he had received it that year. He can exclude all of the $100,500 you were paid for work he did in 2020 from his 2020 income.

His total foreign earned income exclusion for 2020 is $118,500 ($18,000 for work he did in 2019 and $100,500 for work he did in 2020). He would include in his 2020 income $2,500 for the work he did in 2019.

Lesson 4 - Foreign Earned Income Exclusion
Source - Pub 54 - Foreign Earned Income Exclusion

Question 47 - C. $157,000
If the taxpayer's spouse is not a U.S. citizen, the marital deduction for gifts that are not taxable is limited to an annual exclusion of $157,000 in 2020.

Lesson 6 - Gift Tax
Source - IRS.GOV - Frequently Asked Questions on Gift Taxes for Nonresidents not Citizens of the United States

Question 48 - B. $430
For 2020, 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) by age (at of the close of the tax year) of the taxpayer:

- Age 40 or under – $430.
- Age 41 to 50 – $810.
- Age 51 to 60 – $1,630.
- Age 61 to 70 – $4,350.
- Age 71 or over – $5,430.

Lesson 3 - Qualified Long-Term Care
Source - Publication 502 - Long-Term Care

Question 49 - B. $4,500
The Child and Dependent Care Credit is 20-35% of the smallest of:

1. $3,000 ($6,000 for 2 or more qualifying persons).
2. Qualified expenses incurred in 2020 ($3,500 + $1,000)
3. Taxpayer's earned income.
4. The spouse's earned income.

Lesson 3 - Child and Dependent Care Credit
Source - Publication 503 - Tests To Claim the Credit

Question 50 - C. 14 days
For the purposes of deductible mortgage interest, a second home can include any other residence the taxpayer owns and treats as a second home. The taxpayer does not have to use the home during the year. However, if he or she rents it to others, the taxpayer must also use it as a home during the year for more than the greater of 14 days or 10% of the number of days it is rented, for the interest to qualify as qualified residence interest.

Lesson 3 - Deductible Home Mortgage Interest
Source - IRS.GOV - Topic 505 - Interest Expense

Question 51 - B. An automatic extension of 6 months to file the return
Beginning with 2005, an individual is granted an automatic extension of six months for filing a return (but not for payment of tax), provided that *Form 4868 - Application for Automatic Extension of Time To File U.S. Individual Income Tax Return* is properly filed before the normal due date of the return. (Previously, the automatic filing extension was good for four months.) Also, filing extensions may be obtained via telephone or via internet on the IRS website.

Lesson 5 - Extensions
Source - Form 4868 - Application for Automatic Extension of Time To File U.S. Individual Income Tax Return

Question 52 - C. $75,000
If the taxpayer is a surviving spouse and he or she owned his or her home jointly, his or her basis in the home will change. The new basis for the interest the taxpayer's spouse owned will be its fair market value on the date of death (or alternate valuation date). The basis in his or her interest will remain the same. The taxpayer's new basis in the home is the total of these two amounts. If the taxpayer and his or her spouse owned the home either as tenants by the entirety or as joint tenants with right of survivorship, the taxpayer will each be considered to have owned one-half of the home.

In this case, Jerry's new basis in the home is $75,000 ($25,000 for one-half of the adjusted basis plus $50,000 for one-half of the fair market value).

Lesson 2 - Property Inherited Before 2010 and after 2010
Source - Publication 523 - Home Inherited

Question 53 - D. Independent Contractors reporting net earnings from self-employment of $400 or more
A taxpayer must pay SE tax and file Schedule SE if either of the following applies:

- Their net earnings from self-employment (excluding church employee income) were $400 or more.
- They had church employee income of $108.28 or more except for ministers and members of religious orders.

For a sole proprietor, net income (as reported on Schedule C) must be counted as self-employment income. If net income is less than $400, the self-employment tax does not apply.

Lesson 4 - Self-Employment Tax
Source - Publication 334 - Chapter 10 - Self-Employment (SE) Tax

Question 54 - B. Bob is liable to pay Additional Medicare Tax on $220,000
Bob is only liable to pay Additional Medicare Tax on $20,000 ($220,000 in self-employment income minus the threshold of $200,000 for his filing status). Also, Bob must file Form 8959 - Additional Medicare Tax. Therefore, Choice B is incorrect.

Lesson 4 - Additional Medicare Tax
Source - Instructions for Form 8959

Question 55 - D. $2,000
Generally, a taxpayer can contribute up to $2,000 for each designated beneficiary for 2020. This is the most he or she can contribute for the benefit of any one beneficiary for the year, regardless of the number of Coverdell ESAs set up for the beneficiary. In this question, if Dawn contributed $1,000 to Soraya's Coverdell ESA in 2020, she could also contribute $2,000 to Edgar's Coverdell ESA.

Lesson 5 - Coverdell Education Savings Account (CESA)
Source - Publication 970 - Coverdell Education Savings Account (ESA)

Question 56 - D. $120,000
The Tax Cuts and Jobs Act (TCJA) repeal of the 75-year-old law that allowed the payor of alimony to make tax deductions on their alimony payments is effective for any divorce or separation instruments executed after December 31, 2018. Because Sandy executed her divorce agreement after December 31, 2018, she is required to pay taxes on her entire $120,000 earnings regardless of her $30,000 alimony payment. Her ex-husband, in turn, would only need to pay taxes on his $25,000 earnings.

Lesson 5 - Tax Treatment of Alimony and Separate Maintenance
Source - IRS.GOV - Topic 452 - Alimony

Question 57 - C. $1,403
If the taxpayer is a member of a reserve component of the Armed Forces and he or she travels more than 100 miles away from home in connection with his or her performance of services as a member of the reserves, he or she can deduct his or her unreimbursed travel expenses on his or her tax return. Include all unreimbursed expenses from the time the taxpayer leaves home until the time he or she returns home.

If the taxpayer has reserve-related travel that takes him or her more than 100 miles from home, he or she should first complete Form 2106 - Employee Business Expenses. Then on Schedule 1 (Form 1040), line 11, enter the part of the taxpayer's expenses, up to the Federal rate, included on Form 2106, line 10, that is for reserve-related travel more than 100 miles from his or her home.

In this question, Captain Harris shows his total deductible travel expenses of $1,403.00 ($253.00 + $150 (50% of $300) + $1,000) on Form 2106, line 10. He enters the $1,403.00 ($253.00 + $150 + $1,000) for travel over 100 miles from home on Schedule 1 (Form 1040), line 11.

Lesson 4 - Travel Expenses of Armed Forces Reservists
Source - Publication 3 - Armed Forces' Tax Guide

Question 58 - D. $35,000
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. In this question, Paola can claim the entire $35,000 of total itemized deductions.

Lesson 1 - Limit on Itemized Deductions
Source - Publication 529 - Miscellaneous Deductions

Question 59 - A. $0
The maximum credit and the exclusion for employer-provided benefits are both $14,300 per eligible child in 2020. This amount begins to phase out if the taxpayer has modified adjusted gross income (MAGI) in excess of $214,520 and is completely phased out for modified adjusted gross income (MAGI) of $254,520 or more. Qualified adoption expenses include reasonable and necessary adoption fees, court costs, attorney fees and other expenses that are directly related to the legal adoption of an eligible child. An eligible child is an individual who has not attained the age of 18 at the time of the adoption or who is physically or mentally incapable of caring for him or herself.

Lesson 3 - Adoption Credit
Source - IRS.GOV - Topic 607 - Adoption Credit and Adoption Assistance Programs

Question 60 - B. Any tips the taxpayer reported to an employer are to be included in the wages in box 1 (Wages, tips, other compensation) of his or her Form W-2
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 cash and charge tips received that totaled less than $20 for any month and the value of noncash tips, such as tickets, passes, or other items of value to the amount in box 1 of the Form W-2.

Lesson 2 - Tips
Source - IRS.GOV - Topic 761 - Tips – Withholding and Reporting

Question 61 - B. Head of household
To qualify as a head of household, the taxpayer must provide over half the cost of keeping up a home that was the main home for the entire tax year for the taxpayer's parent(s) whom the taxpayer can claim as a dependent(s). The parent(s) did not have to reside in the taxpayer's home.

Lesson 1 - Head of Household
Source - Publication 501 - Dependents, Standard Deduction, and Filing Information

Question 62 - D. Earned Income Tax Credit
A refundable tax credit is a tax credit that can reduce tax liability below zero. It is possible to receive a tax refund from this type of credit. Refundable tax credits include:

- Earned Income Tax Credit.
- Excess Social Security Credit.
- Additional Child Tax Credit.
- Health Coverage Tax Credit.
- American Opportunity Tax Credit (up to $1,000 is refundable).

Lesson 3 - Refundable Tax Credits
Source - IRS.GOV - Five Tax Credits that Can Reduce Your Taxes

Question 63 - C. Qualifying family-owned business
Once the taxpayer has accounted for the Gross Estate, certain deductions (and in special circumstances, reductions to value) are allowed in arriving at his or her "Taxable Estate." These deductions may include mortgages and other debts, estate administration expenses, property that passes to surviving spouses and qualified charities. The value of some operating business interests or farms may be reduced for estates that qualify. However, the deduction for a qualifying family-owned business (IRC 2057) was repealed beginning in 2004.

Lesson 6 - Estate Tax
Source - IRS.GOV - Estate Tax

Question 64 - D. Ordinary loss on Form 4797 limited to $50,000 for a single individual and limited to $100,000 for those filing a joint return
The maximum amount that may be treated as an ordinary loss on *Form 4797- Sales of Business Property* is $50,000 ($100,000 if married filing jointly). Special rules may limit the amount of ordinary loss if the taxpayer received Section 1244 stock in exchange for property with a basis in excess of its Fair Market Value (FMV) or his or her stock basis increased because of contributions to capital or otherwise.

Lesson 2 - Sales and Other Dispositions of Capital Assets
Source - Form 4797 - Sales of Business Property

Question 65 - B. April 15, 2021
For members of the Armed Forces serving in a combat zone or qualified hazardous duty area, the deadline for filing tax returns, paying taxes, filing claims for refunds, and taking other actions with the IRS is automatically extended.

The deadline for taking action with the IRS is extended 180 days after the later of:

- The last day in a combat zone/qualified hazardous duty area.
- The last day of any continuous hospitalization for injury from service in a combat zone or qualified
- hazardous duty area.

In addition to the 180-day extension, the deadline is also extended by the number of days that were left to take the action with the IRS when the taxpayer entered a combat zone (or began performing qualifying service outside the combat zone). For example, the taxpayer has 3 1/2 months (Jan. 1 - April 15) to file the tax return. Any days left in this period when the taxpayer entered the combat zone (or the entire 3½ months if they entered it before the beginning of the year) are added to the 180 days.

In this question, the deadline is not extended for Captain Jones' 2020 tax return because the 180-day extension period after March 31, 2020, plus the number of days left in the filing period when she entered the combat zone ends on January 10, 2021, which is before the due date for her 2020 return (April 15, 2021).

Lesson 4 - Combat Zone Service
Source - Publication 3 - Length of Extension

Question 66 - C. The credit is available only if the student is pursuing a program leading to a degree or other recognized education credential
The Lifetime Learning Credit is a tax credit for any person who takes college classes. It provides a tax credit of 20% of tuition expenses, with a maximum of $2,000 in tax credits per return on the first $10,000 of college tuition expenses. In 2020, the limit on modified adjusted gross income (MAGI) for the credit is $59,000 - $69,000 ($118,000 - $138,000 filing a joint return).

The taxpayer can claim the Lifetime Learning Credit on the tax return if the taxpayer, his or her spouse, or his or her dependents are enrolled at an eligible educational institution and the taxpayer was responsible for paying college expenses. Unlike the American Opportunity Tax Credit, the student need not be in the first four years of undergraduate classes. Even if the student took only one class, he or she may take advantage of the Lifetime Learning Credit. The student does not need to be pursuing a program leading to a degree or other recognized education credential.

Lesson 3 - Lifetime Learning Credit
Source - Publication 970 - Chapter 3 - Overview of the Lifetime Learning Credit

Question 67 - C. $80
If the taxpayer sold an item he or she owned for personal use, such as a car, refrigerator, furniture, stereo, jewelry, or silverware, his or her gain is taxable as a capital gain. He or she should report it as explained in the Instructions for Schedule D (Form 1040). The taxpayer cannot deduct a loss. However, if the taxpayer sold an item he or she held for investment, such as gold or silver bullion, coins, or gems, any gain is taxable as a capital gain and any loss is deductible as a capital loss. In this case, Sophia should report her $80 gain as a capital gain as explained in the Instructions for Schedule D (Form 1040).

Lesson 5 - Collectibles
Source - Publication 525 - Sale of Personal Items

Question 68 - D. $5,000
For single filing taxpayers, age 65 or older, the initial amount of allowable Credit for the Elderly or the Permanently and Totally Disabled is $5,000. This initial amount is then reduced by amounts received as pension, annuity or disability benefits that are excludable from gross income and are payable under the Social Security Act, the Railroad Retirement Act of 1974, or a Veterans Administration program. No reduction is made for pension, annuity or disability benefits for personal injuries or sickness.

Lesson 3 - Credit for the Elderly or the Permanently and Totally Disabled
Source - Publication 524 - Table 2 Initial Amounts

Question 69 - D. The taxpayer could not roll over any other 2020 IRA distribution (unless it's a conversion)
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. In this question, if the taxpayer took a distribution from IRA-1 on January 1, 2020 and rolled it over into IRA-2 the same day, he or she could not roll over any other 2020 IRA distribution (unless it is a conversion).

Lesson 2 - IRA One-Rollover-Per-Year Rule
Source - IRS.GOV - IRA One-Rollover-Per-Year Rule

Question 70 - D. $240
Depending on the taxpayer's adjusted gross income and tax filing status, he or she can claim the credit for 50%, 20% or 10% of the first $2,000 he or she contributes during the year to a retirement account. Therefore, the maximum credit amounts that can be claimed are $1,000, $400 or $200. In this question, Zella can claim a 20% Savers Credit for her contribution, worth $240.

Lesson 3 - Retirement Savings Contribution Credit (Saver's Credit)
Source - Form 8880 - Credit for Qualified Retirement Savings Contributions

Question 71 - D. $7,900
For children under age 24 the AMT exemption amount is limited to the amount of earned income plus $7,900 if any of the following conditions apply:

- The child was under age 18 at the end of 2020.
- The child was age 18 at the end of 2020 and did not have earned income that was more than half of his or her support.
- The child was a full-time student over age 18 and under age 24 at the end of 2020 and did not have earned income that was more than half of his or her support.

Lesson 4 - AMT Exemption for Certain Children
Source - Publication 929 - Alternative Minimum Tax

Question 72 - B. A publicly traded partnership can be treated as a corporation under Section 7704 of the Internal Revenue Code
A publicly traded partnership is any partnership an interest in which is regularly traded on an established securities market regardless of the number of its partners. This does not include a publicly traded partnership treated as a corporation under Section 7704 of the Internal Revenue Code. A publicly traded partnership that has effectively connected income, gain, or loss must pay withholding tax on any distributions of that income made to its foreign partners. The rate of withholding is 35%. This rate is subject to future tax law changes.

Lesson 2 - Publicly Traded Partnerships (PTP)
Source - IRS.GOV - Publicly Traded Partnerships

Question 73 - B. 5 years
Generally, records of accounts required to be reported on the FBAR should be kept for five years from the due date of the report, which is June 30 of the year following the calendar year being reported. The records should contain the following:

- Name maintained on each account.
- Number or other designation of the account.
- Name and address of the foreign bank or other person with whom the account is maintained.
- Type of account.
- Maximum value of each account during the reporting period.

Retaining a copy of the filed FBAR can help to satisfy the record keeping requirements. An officer or employee, however, who files an FBAR to report signature authority over an employer's foreign financial account is not required to personally retain records regarding these foreign financial accounts.

Lesson 6 - Report of Foreign Bank and Financial Accounts (FBAR)
Source - IRS FBAR Reference Guide

Question 74 - C. $300,000
The basis of inherited property is the Fair Market Value (FMV) on the date of death unless the estate elects an alternate valuation date. The estate did not make this election, so basis is the FMV as of the date of death; or $300,000.

Lesson 6 - Estate Tax
Source - Publication 17 - Chapter 13 - Inherited Property

Question 75 - B. The exclusion for foreign earned income
To find out whether any of the taxpayer's Social Security benefits may be taxable, compare the base amount for his or her filing status with the total of:

1. One-half of his or her benefits; plus
2. All his or her other income (such as pensions, wages, ordinary dividends, and capital gain distributions) 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.

Lesson 2 - Taxation of Social Security Benefits
Source - Publication 17 - Are Any of Your Benefits Taxable?

Question 76 - D. $10,000
Any United States person who has a financial interest in or signature authority over any financial account(s) located outside of the United States is required to electronically file a *FinCEN Report 114 - Report of Foreign Bank and Financial Accounts (FBAR)*, if the aggregate value of these accounts exceeds $10,000 at any time during the calendar year.

Lesson 6 - Report of Foreign Bank and Financial Accounts (FBAR)
Source - Publication 4261 - Do You Have a Foreign Financial Account?

Question 77 - C. $3,000
Because a SEP-IRA is a traditional IRA, the taxpayer may be able to make regular, annual IRA contributions to this IRA, rather than opening a separate IRA account. However, any dollars he or she contributes to the SEP-IRA will reduce the amount he or she can contribute to other IRAs, including Roth IRAs, for the year.

Since Nancy also wants to contribute to her Roth IRA at XYZ Investment Co., she can contribute $3,000 ($6,000 maximum contribution less the $3,000 already contributed to her SEP-IRA).

Lesson 2 - SEP-IRA Deduction
Source - IRS.GOV - SEP Plan FAQs - Contributions

Question 78 - A. Gambling expenses to the extent of gambling winnings
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.

However, 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."

Lesson 3 - Other Miscellaneous Deductions
Source - Publication 529 - Miscellaneous Deductions

Question 79 - D. $1,500
If an employee starts or stops salary reduction contributions in the middle of the year the employer must base their SIMPLE IRA plan employer matching contribution on the employee's entire calendar-year compensation, regardless of when the employee starts or stops contributing during the year. The maximum matching contribution is always 3% of the employees' compensation for the entire calendar year. Matching contributions may be made on a per-pay-period basis, or by the due date of the employer's tax return (including extensions).

Bob's employer must match Bob's contributions up to 3% of Bob's calendar-year compensation, or $1,500 (3% of $50,000). It does not matter that Bob only contributed to the plan during the last 4 months of the calendar year.

Lesson 2 - SIMPLE IRA
Source - IRS.GOV - SIMPLE IRA Plan FAQs - Contributions

Question 80 - A. Darren is eligible for the higher standard deduction for blindness in 2020
A taxpayer who has vision of 20/200 is considered legally blind for Federal tax purposes. In 2020, married taxpayers who are legally blind are entitled to an additional standard deduction of $1,300 ($1,650 for those whose filing status is unmarried or head of household). Thus, Darren is entitled to the additional deduction.

Lesson 1 - Elderly and/or Blind Taxpayers
Source - Publication 501 - Dependents, Standard Deduction, and Filing Information

Question 81 - B. Leslie's married son, who could properly be claimed as a dependent on his father's return only
If the person is the taxpayer's qualifying child (such as a son, daughter, or grandchild who lived with him or her more than half the year and meets certain other tests) and he or she is married, and the taxpayer cannot claim him or her as a dependent because the person is a dependent of another taxpayer, then that person is not a qualifying person.

Lesson 1 - Head of Household
Source - Publication 17 - Table 2-1. Who Is a Qualifying Person Qualifying You To File as Head of Household?

Question 82 - D. All of their worldwide income
If a non-resident alien is married to a citizen of the United States and they make the proper election to file a joint return they will be taxed on their worldwide income.

Lesson 1 - Married Filing a Joint Return
Source - IRS.GOV - Nonresident Alien Spouse

Question 83 - C. Ordinary and necessary business expenses
Among other nondeductible expenses, a taxpayer cannot deduct payments for food, life insurance premiums paid by the insured or rent and insurance premiums paid for the taxpayer's own dwelling. Ordinary and necessary business expenses are deductible. An ordinary expense is one that is common and accepted in the taxpayer's trade or business. A necessary expense is one that is helpful and appropriate for the taxpayer's trade or business. An expense does not have to be indispensable to be considered necessary.

Lesson 3 - Nondeductible Expenses
Source - Publication 529 - List of Nondeductible Expenses

Question 84 - C. $26,400
Under the Tax Cuts and Jobs Act (TCJA), Section 199A allows eligible taxpayers to deduct up to 20% of their qualified business income (QBI), plus 20% of qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership (PTP) income. For business owners with taxable income in excess of $213,300 ($426,600 in the case of taxpayers married filing jointly), however, no deduction is allowed against income earned in a "specified service trade or business."

In 2020, the couple in this question will be eligible for a $24,800 standard deduction, reducing their $225,800 of income down to only $201,000. In addition, they will receive a $26,400 QBI deduction ($132,000 x 20%), further reducing their income to $174,600.

Lesson 3 - Deduction for Qualified Business Income
Source - IRS.GOV - Qualified Business Income Deduction

Question 85 - B. Qualifying Widow(er)
Taxpayers who do not remarry in the year their spouse dies can file jointly with the deceased spouse. For the two years following the year of death, the surviving spouse may be able to use the Qualifying Widow(er) filing status.

Lesson 5 - Decedent Issues
Source - Publication 501 - Dependents, Standard Deduction, and Filing Information

Question 86 - A. American Opportunity Tax Credit
If the taxpayer is the custodial parent, he or she can use Form 8332 - Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent to make the written declaration to release a claim to an exemption for a child to the noncustodial parent. Although the exemption amount is zero for tax year 2020, this release allows the noncustodial parent to claim the Child Tax Credit, Additional Child Tax Credit, and Credit for Other Dependents, if applicable, for the child. The noncustodial parent must attach a copy of the form or statement to his or her tax return. The release can be for 1 year, for a number of specified years (for example, alternate years), or for all future years, as specified in the declaration.

Lesson 1 - Children of Divorced or Separated Parents (or Parents Who Live Apart)
Source - Form 8332 - Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent

Question 87 - D. Opting out of advance credit payments
Notifying the Marketplace about changes in circumstances will allow the Marketplace to update the information used to determine the taxpayer's expected amount of the Premium Tax Credit and adjust his or her advance payment amount. This adjustment will decrease the likelihood of a significant difference between the taxpayer's advance credit payments and his or her actual Premium Tax Credit.

Changes in circumstances that can affect the amount of the taxpayer's actual Premium Tax Credit include:

- Increases or decreases in his or her household income.
- Marriage.
- Divorce.
- Birth or adoption of a child.
- Other changes to the taxpayer's household composition.
- Gaining or losing eligibility for government sponsored or employer sponsored health care coverage.

Lesson 3 - Premium Tax Credit
Source - IRS.GOV - Questions and Answers on the Premium Tax Credit

Question 88 - A. Canceled debt payments of $600 of more
If the total of all the payments the taxpayer receives from a client over the course of a year is $600 or more, the client must complete and file IRS Form 1099-MISC reporting the payments. The client should file Form 1099-MISC - Miscellaneous Income, for each person in the course of his or her business to whom he or she has paid during the year:

- At least $10 in royalties or broker payments in lieu of dividends or tax-exempt interest.
- At least $600 in:
    1. Rents.
    2. Services performed by someone who is not his or her employee (including parts and materials).
    3. Prizes and awards.
    4. Other income payments.
    5. Medical and health care payments.
    6. Crop insurance proceeds.
    7. Cash payments for fish (or other aquatic life) he or she purchases from anyone engaged in the trade or business of catching fish.
    8. Generally, the cash paid from a notional principal contract to an individual, partnership, or estate.
    9. Payments to an attorney.
    10. Any fishing boat proceeds.

In addition, the client uses Form 1099-MISC to report that he or she made direct sales of at least $5,000 of consumer products to a buyer for resale anywhere other than a permanent retail establishment.

The client must also file Form 1099-MISC for each person from whom he or she has withheld any Federal income tax under the backup withholding rules regardless of the amount of the payment.

Lesson 2 - Corrections to Form 1099-MISC
Source - Instructions for Form 1099-MISC - Specific Instructions

Question 89 - C. $80
The taxpayer should exclude from his or her gross income interest on frozen deposits. A deposit is frozen if, at the end of the year, the taxpayer cannot withdraw any part of the deposit because:

- The financial institution is bankrupt or insolvent.
- The state in which the institution is located has placed limits on withdrawals because other financial institutions in the state are bankrupt or insolvent.

The amount of interest the taxpayer must exclude is the interest that was credited on the frozen deposits minus the sum of:

1. The net amount he or she withdrew from these deposits during the year, and
2. The amount he or she could have withdrawn as of the end of the year (not reduced by any penalty for premature withdrawals of a time deposit).

Even if the taxpayer receives a Form 1099-INT for interest on deposits that he or she could not withdraw at the end of the year, he or she must exclude these amounts from his or her gross income. The taxpayer does not include this income on Form 1040. The interest the taxpayer excludes is treated as credited to his or her account in the following year. The taxpayer must include it in income in the year he or she can withdraw it. In this question, Emma must include $80 in her income and exclude $20 from her income for the year. Emma must include the $20 in her income for the year she can withdraw it.

Lesson 2 - Interest Income on Frozen Deposits
Source - Publication 550 - Chapter 1 - Taxable Interest - General

Question 90 - C. $155,000
The original basis in the property includes the original purchase price plus the bank fees and title costs. The points on the mortgage are not added to the basis but rather are amortized over the term of the loan.

Lesson 2 - Basis
Source - Publication 527 - Chapter 2 - Cost Basis

Question 91 - C. The casualty loss is attributable to a federally declared disaster
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.

Lesson 3 - Casualty and Theft Losses
Source - Publication 547 - Casualties, Disasters, and Thefts

Question 92 - D. Interest and Dividends
The Earned Income Tax 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:

- 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.

Lesson 3 - Earned Income
Source - Publication 596 - Rule 7 - Earned Income

Question 93 - C.$150
If the taxpayer works part-time, he or she generally must figure his or her expenses for each day. Because Alfonso can pay the center $150 for any 3 days a week his work-related expenses are limited to $150 a week.

Lesson 3 - Child and Dependent Care Credit
Source - Publication 503 - Work-Related Expense Test - Part-time Work

Question 94 - C. Mother
If the taxpayer's qualifying person is his or her father or mother, he or she may be eligible to file as head of household even if his or her father or mother does not live with him or her. However, the taxpayer must be able to claim his or her father or mother as a dependent. Also, he or she must pay more than half the cost of keeping up a home that was the main home for the entire year for his or her father or mother. The taxpayer is keeping up a main home for his or her father or mother if he or she pays more than half the cost of keeping his or her parent in a rest home or home for the elderly.

Lesson 1 - Head of Household
Source - Publication 17 - Chapter 2 - Special Rule for Parents

Question 95 - C. $120,248
Of the 242 days, 194 days were spent performing services in the United States and 48 days performing services in Canada. The amount of U.S. source income is $120,248 ((194 ÷ 242) × $150,000).

Lesson 1 - Allocation of Personal Service Income
Source - IRS.GOV - Source of Income - Personal Service Income

Question 96 - C. U.S. tax at a 30% rate
Fixed, Determinable, Annual, or Periodical (FDAP) income is taxed at a flat 30% (or lower treaty rate) and no deductions are allowed against such income. Effectively Connected Income should be reported on page one of Form 1040NR. FDAP income should be reported on page four of Form 1040NR.

Lesson 1 - Taxation of Nonresident Aliens
Source - IRS.GOV - Taxation of Nonresident Aliens

Question 97 - A. The taxpayer must report the winnings and can claim the amount of Federal income tax withheld on Form 1040
Winnings or gains arising from gambling, betting, and lotteries are includible in gross income. If a payer withholds income tax from the 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. Report the tax withheld on Form 1040, along with all other Federal income tax withheld, as shown on Forms W-2 and 1099.

Lesson 2 - Gambling Income
Source - Publication 505 - Chapter 1 - Gambling Winnings

Question 98 - C. $7,000
The two scholarship items are not taxable income as the full amount of the proceeds were used for qualified educational expenses. The fellowship income is fully taxable because it was not used for a qualified educational expense (room and board is not a qualified expense).

Lesson 2 - Scholarships, Fellowships, and Grants
Source - IRS.GOV - Topic 421 - Scholarship and Fellowship Grants

Question 99 - A. $0
Adam may exclude up to $250,000 of gain on the sale. Because this gain is excluded for regular income tax purposes, it is also excluded for purposes of determining Net Investment Income. In this example, the Net Investment Income Tax does not apply to the gain from the sale of Adam's home.

Lesson 4 - Net Investment Income Tax
Source - IRS.GOV - Questions and Answers on the Net Investment Income Tax

Question 100 - C. Social Security Benefits

Wages, unemployment compensation; operating income from a non-passive business, Social Security Benefits, alimony, tax-exempt interest, self-employment income, Alaska Permanent Fund Dividends and distributions from certain Qualified Plans are some common types of income that are not Net Investment Income.

Lesson 4 - Net Investment Income Tax
Source - IRS.GOV - Questions and Answers on the Net Investment Income Tax

Practice Exam #2 Answer Key

Question 1 - A. $0
Any amount distributed from a Coverdell ESA is not taxable if it is rolled over to another Coverdell ESA for the benefit of the same beneficiary or a member of the beneficiary's family (including the beneficiary's spouse) who is under age 30. This age limitation does not apply if the new beneficiary is a special needs beneficiary. An amount is rolled over if it is paid to another Coverdell ESA within 60 days after the date of the distribution. Therefore, choice A of $0 is the correct response. Any choice more than $0, including choices B, C and D is incorrect.

Lesson 5 - CESA Distributions
Source - Publication 970 - Rollovers and Other Transfers

Question 2 - B. $10,000
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.

State, local, and foreign property taxes, and sales taxes which are deductible on Schedule C, Schedule E, or Schedule F are not capped. This means that, for example, rental property - even if held individually and not in a separate entity - remains deductible and not subject to these limitations.

Lesson 3 - State, Local and Foreign Income Taxes
Source - IRS.GOV - Topic 503 - Deductible Taxes

Question 3 - A. Head of household and one dependent
If the taxpayer qualifies to file as head of household, his or her tax rate usually will be lower than the rates for single or married filing separately. The taxpayer will also receive a higher standard deduction than if he or she files as single or married filing separately. To qualify as a head of household, a taxpayer must meet the following conditions:

1. The taxpayer is unmarried or considered unmarried on the last day of the year.
2. The taxpayer paid more than half the cost of keeping up a home for the year.
3. A qualifying person lived with the taxpayer in the home for more than half the year (except for temporary absences, such as school). However, if the qualifying person is the taxpayer's dependent parent, he or she does not have to live with him or her.

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

Lesson 1 - Head of Household
Source - Publication 501 - Dependents, Standard Deduction, and Filing Information

Question 4 - C. A penalty for late payment may still be charged even if an extension is granted
The six-month extension generally does not relieve taxpayers of a late payment penalty or interest on unpaid taxes. The late payment penalty is usually ½ of 1% of any tax (other than estimated tax) not paid by filing due date. It is charged for each month or part of a month the tax is unpaid. The maximum penalty is 25%.

Lesson 5 - Extensions
Source - Form 4868 - Application for Automatic Extension of Time To File U.S. Individual Income Tax Return

Question 5 - D. $10,000
Section 61(a)(7) lists dividends as being included in gross income. They are included in their entirety unless there is a specific exclusion. There is no exclusion for dividends received by an individual from a taxable domestic corporation (provided the dividends are paid out of earnings and profits, which is the assumed case unless other information is provided in a question). Therefore, the entire $10,000 of dividends are included in their gross income.

Lesson 2 - Dividends Subject to the Tax
Source - Publication 17 - Chapter 8 - Dividends and Other Distributions

Question 6 - D. Amount paid as estimated tax
The income tax withheld from the decedent's salary, wages, pensions, or annuities, and the amount paid as estimated tax are credits (advance payments of tax) that must be claimed on the final return making Choice D correct.

Choice A is incorrect because charitable contributions are a deduction from the gross estate, not a credit against the estate tax liability. Choice B is incorrect the generation-skipping transfer tax is imposed as a separate tax, in addition to the gift and estate taxes, on generation-skipping transfers that are taxable distributions or terminations with respect to a generation skipping trust or direct skips. Choice C is incorrect is incorrect because the credit for state death taxes paid was repealed in 2005 and replaced with a deduction.

Lesson 6 - Estate Tax
Source - Publication 559 - Payments of Tax

Question 7 - A. $0
A taxpayer may consider up to $6,000 ($3,000 per child) of expenses paid for the care of two or more qualifying persons to figure the credit, provided the amount of expenses claimed does not exceed the gross earnings of the lower earning taxpayer. Since Jason is a volunteer and has no earned income they do not qualify for the Child and Dependent Care Credit.

Lesson 3 - Child and Dependent Care Credit
Source - Publication 503 - Child and Dependent Care Expenses

Question 8 - A. Land
Depreciation is 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. Most types of tangible property (except, land), such as buildings, machinery, vehicles, furniture, and equipment are depreciable. Likewise, certain intangible property, such as patents, copyrights, and computer software is depreciable.

Lesson 5 - Depreciation
Source - IRS.GOV - Brief Overview of Depreciation

Question 9 - B. Distributions from qualified retirement plans
The amount of retirement distributions from a qualified retirement plan as defined in Section 4974(c) must be reported by the taxpayer. Payments that are not reported include loans from a qualified employer plan, tax-exempt distributions, and military retirement plan.

Lesson 3 - Retirement Savings Contribution Credit (Saver's Credit)
Source - Form 8880 - Credit for Qualified Retirement Savings Contributions

Question 10 - C. Kristin must report foreign financial accounts A, B, and C on the FBAR even though no single account exceeded $10,000

A United States person must file an FBAR if that person has a financial interest in or signature authority over any financial account(s) outside of the United States and the aggregate maximum value of the account(s) exceeds $10,000 at any time during the calendar year.

Kristin is required to report accounts A, B and C because the aggregate value of the accounts is over $10,000. It does not matter that no single account exceeded $10,000. Whether or not an account produces income does not affect the requirement to file an FBAR.

Lesson 6 - Report of Foreign Bank and Financial Accounts (FBAR)
Source - IRS FBAR Reference Guide

Question 11 - D. 4

Since Mary and Matthew provided more than 50% of the support for all of their children and their 22-year-old child is a full-time student, each child qualifies as a dependent. Thus, Mary and Matthew can claim each of their four children as dependents.

Lesson 1 - Tests to Be a Qualifying Child
Source - Publication 501 - Dependents, Standard Deduction, and Filing Information

Question 12 - B. $20,000

The taxpayer uses a time basis to figure his or her U.S. source compensation (other than the fringe benefits). He or she does this by multiplying his or her total compensation (other than the fringe benefits) by the following fraction:

$$\frac{\text{Number of days he or she performed services in the United States during the year.}}{\text{Total number of days he or she performed services during the year.}}$$

In this question, using the time basis for determining the source of compensation, $20,000 ($80,000 × 60/240) is her U.S. source income.

Lesson 1 - Nonresident and Dual Status Aliens
Source - Publication 519 - Chapter 2 - Time Basis

Question 13 - A. $0

To claim the foreign earned income exclusion, the foreign housing exclusion, or the foreign housing deduction, the taxpayer must have his or her tax home must be in a foreign country. In this question, Steve is considered to have an abode in the United States and does not satisfy the tax home test in the foreign country. He cannot claim Foreign Earned Income Exclusion.

Lesson 2 - Foreign Earned Income
Source - Publication 54 - Chapter 4 - Tax Home

Question 14 - D. Tanya should file as a single taxpayer

A dependent must be a qualifying child or a qualifying relative. The child is not a qualifying child, as the adoption is not final. The child did not live with Tanya the entire year, and therefore is also not a qualifying relative (Choice C). Tanya cannot file as head of household without a dependent (Choice A). For expenses paid prior to the year the adoption becomes final, the credit generally is allowed for the year following the year of payment (Choice B). A taxpayer who paid qualifying expenses in the current year for an adoption which became final in the current year, may be eligible to claim the credit for the expenses on the current year return, in addition to credit for expenses paid in a prior year. For the current tax year, Tanya should file as a single taxpayer therefore Choice D is correct.

Lesson 3 - Adoption Credit
Source - Form 8839 - Qualified Adoption Expenses

Question 15 - C. $1,100
In 2020, the standard deduction for an individual who can be claimed as a dependent on another person's tax return is generally limited to the greater of:

- $1,100, or
- The individual's earned income for the year plus $350 (but not more than the regular standard deduction amount, generally $12,400).

In this question, Michael uses the Standard Deduction Worksheet for Dependents to find his standard deduction. He enters $1,100 (the larger of $500 and $1,100) on line 5, and $12,400 on line 6. His standard deduction, on line 7a, is $1,100 (the smaller of $1,100 and $12,400).

Lesson 1 - Dependents of Other Taxpayers
Source - Publication 501 - Dependents, Standard Deduction, and Filing Information

Question 16 - D. $113,400
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 $113,400 for joint filers, $56,700 for married filing separately, and $72,900 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 $1,036,800 for joint filers and $518,400 for individual filers.

In this question, Alejandro has an alternative minimum taxable income (AMTI) of $260,000. This is well under the $1,036,800 phase-out threshold, so he would be entitled to subtract the entire AMT exemption of $113,400 which results in a final taxable amount of $146,600.

Lesson 4 - Amount Excluded from Minimum Taxation
Source - Instructions for Form 6251 - Alternative Minimum Tax - Individuals

Question 17 - B. Income received from foreign pensions or annuities is not taxable if the taxpayer does not receive a Form 1099 or other similar document reporting the amount of the income
A foreign pension or annuity distribution is a payment from a pension plan or retirement annuity received from a source outside the United States. Just as with domestic pensions or annuities, the taxable amount generally is the Gross Distribution minus the Cost (investment in the contract). As a general rule, the pension/annuity articles of most tax treaties allow the country of residence (as determined by the residency article) to tax the pension or annuity under its domestic laws. However, income received from foreign pensions or annuities may be fully or partly taxable, even if the taxpayer does not receive a Form 1099 or other similar document reporting the amount of the income.

Lesson 2 - Foreign Pension and Annuity Distributions
Source - IRS.GOV - The Taxation of Foreign Pension and Annuity Distributions

Question 18 - D. All of the above
The deduction for qualified business income (QBI) would be disallowed for businesses offering "professional services", such as law firms, doctor's offices and investment offices, above certain threshold amounts. For 2020, the W-2 wage limit does not apply in the case of a taxpayer with taxable income not exceeding $326,600 for married individuals filing jointly ($163,300 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).

Lesson 3 - Specified Service Trades or Businesses (SSTB)
Source - Tax Cuts and Jobs Act, Provision 11011 Section 199A - Qualified Business Income Deduction FAQs

Question 19 - B. $2,280
Taxpayer's modified adjusted gross income exceeds the threshold of $200,000 for single taxpayers by $60,000. Taxpayer's Net Investment Income is $70,000. The Net Investment Income Tax is based on the lesser of $60,000 (the amount that Taxpayer's modified adjusted gross income exceeds the $200,000 threshold) or $70,000 (Taxpayer's Net Investment Income). Taxpayer owes NIIT of $2,280 ($60,000 x 3.8%).

Lesson 4 - Net Investment Income Tax
Source - IRS.GOV - Questions and Answers on the Net Investment Income Tax

Question 20 - A. $3,000 long-term capital gain
In general, capital gains or losses from sale of inherited property are treated as long term. Gwen's basis in the stock is the FMV of the stock on her mother's date of death (100 shares at $20 per share is $2,000). She sold the stock for $5,000 which means the gain was $3,000 and is a long term-capital gain. In this case, the opportunity to deduct a substantial loss on the stock was lost when her mother passed away.

Lesson 2 - Property Inherited Before 2010 and after 2010
Source - Publication 544 - Sales and Other Dispositions of Assets

Question 21 - D. Paid $2,000 to her mother for housekeeping
Spouses, minor children and parents (some exceptions) are not household employees for Federal tax purposes, even if the taxpayer pays them.

Lesson 4 - Household Employees
Source - Publication 926 - Do You Need To Pay Employment Taxes?

Question 22 - A. Medical insurance benefits, including basic and supplementary Medicare benefits received
A taxpayer must provide over one-half of the support for a person to be considered a dependent. The term "support" includes food, shelter, clothing, medical and dental care, education, and other items contributing to the individual's maintenance and livelihood. Although medical care is an item of support, medical insurance benefits are not included. Medical insurance premiums are included.

Lesson 1 - Tests to Be a Qualifying Child
Source - Publication 501 - Dependents, Standard Deduction, and Filing Information

Question 23 - A. $0
Ann is not liable to pay Additional Medicare Tax and does not need to file Form 8959 because her self-employment income is less than the $200,000 threshold for single filers.

Lesson 4 - Additional Medicare Tax
Source - Instructions for Form 8959

Question 24 - D. If Dave and Stefanie do not owe any other Federal income taxes, interest, or penalties to which the withholding could be applied, the excess withholding will be returned by E-Services Inc.
The employer must begin withholding the additional 0.9% Medicare tax in the pay period in which the employee's calendar-year wages subject to Medicare tax exceed $200,000, regardless of the employee's filing status or other income. Withholding is required even if the employee will not be subject to the tax because his or her wages, when combined with a spouse's wages, will not exceed the $250,000 married-filing-jointly threshold.

In this question, because Dave's salary exceeds $200,000, E-Services Inc. must withhold and remit an additional 0.9% Medicare tax on the excess (i.e., on $30,000). The total additional Medicare tax withheld is $270 ($30,000 × 0.009). But because Dave and Stefanie file a joint income tax return and their total combined wages are less than the $250,000 threshold for married filing jointly, the additional 0.9% Medicare tax does not apply to them. The $270 will be credited against the total tax liability shown on their income tax return. Therefore, assuming they do not owe any other federal income taxes, interest, or penalties to which the withholding could be applied, they will receive a $270 refund of the additional 0.9% Medicare tax withholding.

Lesson 4 - Additional Medicare Tax
Source - Instructions for Form 8959

Question 25 - B. $7,000
$1,000 for medical payments in September, October, November and December total $4,000 and are considered alimony. The $1,000 per month child support is not alimony. Wayne can also claim one-half of the $1,500 per month mortgage payment as alimony since the house is jointly owned. The total he can claim as alimony for 2020 is $7,000 ($4,000 + $3,000 = $7,000).

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.

Lesson 1 - Alimony
Source - Publication 504 - General Rules

Question 26 - C. April 15, 2021
The final income tax return is due at the same time the decedent's return would have been due had death not occurred. A final return for a decedent who was a calendar year taxpayer is generally due on April 15 following the year of death, regardless of when during that year death occurred. However, when the due date falls on a Saturday, Sunday, or legal holiday, the return is filed timely if filed by the next business day.

Lesson 5 - Decedent Issues
Source - Publication 559 - When and Where To File

Question 27 - C. Adjusted Gross Income (AGI)
Many tax preparers neglect to go over last year's return. But it is worth the time because very often he or she will find an applicable item that is not common for all individuals such as itemized deductions, sale of a residence, retirement pay, applicable taxes or some other important piece of information that might be beneficial to this year's return. Certain items from the prior year return may be needed to complete the current-year return (state income tax refund, AMT for credit, gain/loss carryover, charitable gift carryover, etc.).

Lesson 1 - Review of Prior Year’s Return for Accuracy, Comparison and Carryovers for Current Year Return

Question 28 - D. On the first day after the asset was acquired
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, 2019, the first day of the period is June 20. If the taxpayer sells the asset on June 19, 2020, 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, 2020, that is now more than one year, and the asset was held long-term.

Lesson 2 - Holding Period
Source - Instructions for Schedule D

Question 29 - B. Only his uncle
If the taxpayer files a joint return, the person can be related to either him or her or his or her spouse. Also, the person does not need to be related to the spouse who provides support. For example, the taxpayer’s spouse's uncle who receives more than half of his support from the taxpayer may be a qualifying relative, even though he does not live with the taxpayer. The taxpayer’s cousin meets this test only if he or she lives with taxpayer all year as a member of the household. A cousin is a descendant of a brother or sister of the taxpayer’s father or mother. If at any time during the year the person was the taxpayer’s spouse, that person cannot be a qualifying relative.

Lesson 1 - Tests to Be a Qualifying Relative
Source - Publication 17 - Chapter 3 - Qualifying Relative

Question 30 - D. $12,400
Generally, a taxpayer must file a return if his or her gross income equals or exceeds the standard deduction amount applicable to the taxpayer's filing status. For a single taxpayer, the standard deduction is $12,400 in 2020. Samantha must file a tax return if her gross income is at least $12,400.

Lesson 5 - Advising the Individual Taxpayer
Source - Publication 501 - Dependents, Standard Deduction, and Filing Information

Question 31 - B. Meals
A taxpayer may be able to deduct work-related educational expenses paid during the year as an itemized deduction on Form 1040, Schedule A. To be deductible, the expenses must be for education that maintains or improves the taxpayer's job skills or is required by an employer or by law to keep a salary, status or job. However, even if the education meets either of these tests, the education cannot be part of a program that will qualify the taxpayer for a new trade or business or needed to meet the minimal educational requirements of his or her trade or business. Expenses that can be deducted include:

- Tuition, books, supplies, lab fees, and similar items.
- Certain transportation and travel costs.
- Other educational expenses, such as the cost of research and typing.

Educational assistance benefits do not include payments for the following items:

- Meals, lodging, or transportation.
- Tools or supplies (other than textbooks) that the taxpayer can keep after completing the course of instruction.
- Courses involving sports, games, or hobbies unless they:
  - Have a reasonable relationship to the business of the taxpayer's employer, or
  - Are required as part of a degree program.

Lesson 2 - Employee Educational Assistance Plans
Source - Publication 15-B - Employer's Tax Guide to Fringe Benefits

Question 32 - B. The child was under age 19 at the end of 2020 or under age 24 at the end of 2020 and was a full-time student
With the Child Tax Credit, the taxpayer may be able to reduce his or her Federal income tax by up to $1,000 for each qualifying child under the age of 17.

Lesson 3 - Child Tax Credit
Source - Publication 972 - Child Tax Credit

Question 33 - A. Rollover contribution
For tax year 2020, taxpayers with a low to moderate income may be able to claim a nonrefundable Saver's Credit if he or she, or his or her spouse if filing jointly, made:

- Contributions (other than rollover contributions) to a traditional or Roth IRA.
- Elective deferrals to a 401(k), 403(b), governmental 457, SEP, or SIMPLE plan.
- Voluntary employee contributions to a qualified retirement plan as defined in Section 4974(c) (including the Federal Thrift Savings Plan).
- Contributions to a 501(c)(18)(D) plan.

Lesson 3 - Retirement Savings Contribution Credit
Source - Form 8880 - Credit for Qualified Retirement Savings Contributions

Question 34 - C. Improvements to increase property value
Some examples of expenses that may be deducted from total rental income are:

- *Depreciation* – the taxpayer begins to depreciate his or her rental property when it is placed in service. The taxpayer can recover some or all of his or her original acquisition cost and improvements by using *Form 4562 - Depreciation and Amortization* beginning in the year the rental property is first placed in service and beginning in any year the taxpayer makes improvements or adds furnishings.
- *Repairs* – repairs to keep the property in good working condition but do not add to the value of the property.
- *Operating Expense* - other expenses necessary for the operation of the rental property, such as the salaries of employees or fees charged by independent contractors (groundkeepers, bookkeepers, accountants, attorneys, etc.) for services provided.
- *Uncollected rents* – unless taxpayer is a cash basis taxpayer and cannot deduct uncollected rents as an expense because he or she has not included those rents in income.

Lesson 2 - Rental Expenses
Source - IRS.GOV - Topic 414 - Rental Income and Expenses

Question 35 - B. $500
The qualified educational expenses include $2,000 of tuition and $500 for books. Room and board are not qualified educational expenses. The $3,000 scholarship minus the $2,500 in qualified expenses leaves $500 of the scholarship as taxable income. The student loan is not taxable.

Lesson 2 - Scholarships, Fellowships, and Grants
Source - Publication 970 - Chapter 1 - Scholarships, Fellowships, Grants, and Tuition Reductions

Question 36 - B. $12,000
Social Security benefits are not taxed if provisional income is less than the lower base amount. For single taxpayers, this threshold is $25,000. Combined income is one-half of Social Security benefits, plus all other income, including tax-exempt interest, reduced by all deductions for adjusted gross income (AGI), except those for tuition and fees, student loan interest or domestic production activities. Gabriel's combined income is less than $25,000, so none of his Social Security benefits are included in income. His AGI does not include the municipal bond interest. $5,000 wages + $4,000 taxable interest and dividends (does not include the portion $1,500 that is tax-exempt) + $3,000 unemployment benefits = $12,000.

Lesson 2 - Maximum Taxable Part
Source - SSA.GOV - Benefits Planner: Income Taxes And Your Social Security Benefits

Question 37 - D. All of their gifts qualify for the annual exclusion
Brooke and Eric have made total gifts of $25,000 in 2020, and all of them qualify as annual exclusion gifts. A total of $10,000 to Bob, a total of $13,000 to Betty and a total of $2,000 to Susie all qualify as the gifts were less than the annual exclusion amount of $15,000.

Lesson 6 - Gift Tax
Source - Publication 559 - Estate and Gift Taxes

Question 38 - D. The FinCEN Form 114 (FBAR) is filed online with the Financial Crimes Enforcement Network
The taxpayer must file Form 114 - Report of Foreign Bank and Financial Accounts (FBAR), if he or she had any financial interest in, or signature or other authority over a bank, securities, or other financial account in a foreign country. The taxpayer does not need to file the report if the assets are with a U.S. military banking facility operated by a financial institution or if the combined assets in the account(s) are $10,000 or less during the entire year.

Form 114 is filed electronically with the Financial Crimes Enforcement Network (FinCEN). The due date for FBAR filings is April 15. FinCEN will grant an automatic extension to October 15 if the taxpayer is unable to meet the FBAR annual due date of April 15.

Lesson 4 - Report of Foreign Bank and Financial Accounts (FBAR)
Source - Publication 54 - Other Forms You May Have To File

Question 39 - C. $341,500
Cost basis in the house includes $335,000 purchase price (cash and mortgages assumed), $1,000 title search and recording fees, $5,500 payment for seller's portion of the property taxes. Points paid for business property are business expenses that must be amortized over the life of the loan. The value of the points is not added to the cost basis.

Lesson 2 - Basis
Source - Publication 572 - Chapter 2 - Cost Basis

Question 40 - D. All of the above
The allowable deductions used in determining the taxable estate include:

- Estate administration and funeral expenses paid out of the estate.
- Debts owed at the time of death.
- The marital deduction (generally, the value of the property that passes from the estate to the surviving spouse).
- The charitable deduction (generally, the value of the property that passes from the estate to the United States, any state, a political subdivision of a state, the District of Columbia, or to a qualifying charity for exclusively charitable purposes).
- The state death tax deduction (generally any estate, inheritance, legacy, or succession taxes paid as the result of the decedent's death to any state or the District of Columbia).

Lesson 6 - Estate Tax
Source - Publication 559 - Estate Tax - Gross Estate

Question 41 - B. June 15, 2021
A nonresident alien not subject to wage withholding generally may file a return as late as the 15th day of the sixth month after the close of the tax year.

Lesson 1 - Nonresident and Dual Status Aliens
Source - IRS.GOV - Taxation of Dual-Status Aliens

Question 42 - B. $19,000
Wages, interest income, dividend income, and state unemployment compensation are 100% taxable. Municipal bond interest is 100% nontaxable. Social Security benefits range between 0 - 85% taxable. For a single individual if the total of one-half of the taxpayer's benefits plus all other income is less than $25,000, Social Security benefits are nontaxable.

Lesson 2 - Adjusted Gross Income
Source - Form 1040 Instructions - Adjusted Gross Income

Question 43 - A. $0
If a taxpayer dies in 2020 and his or her gross estate is $4,000,000 and his or her allowable debts, expenses and deductions are $500,000, then his or her net estate is $3,500,000. The taxpayer then subtracts from his or her net estate the available estate tax exemption to arrive at his or her taxable estate.

In this case, since Luka's net estate is less than the 2020 estate tax exemption, his taxable estate will be $0 and so his tax liability will be $0: $3,500,000 net estate - $11,580,000 estate tax exemption = $0 taxable estate.

Lesson 6 - Estate Tax
Source - IRS.GOV - Estate Tax

Question 44 - A. One year
A lump-sum distribution is the distribution or payment, within one tax year, of a plan participant's entire balance from all of the employer's qualified pension, profit-sharing, or stock bonus plans. All of the participant's accounts under the employer's qualified pension, profit-sharing, or stock bonus plans must be distributed in order to be a lump-sum distribution. If a taxpayer received a lump-sum distribution from a qualified retirement plan or a qualified retirement annuity and he or she was born before January 2, 1936, he or she may be able to elect optional methods of figuring the tax on the distribution.

Lesson 2 - Lump-Sum Distribution
Source - IRS.GOV - Topic 412 - Lump-Sum Distributions

Question 45 - D. 28%
The taxable part of a gain from selling Section 1202 qualified small business stock is taxed at a maximum of 28%.

Lesson 2 - Tax on Capital Gains
Source - IRS.GOV - Topic 409 - Capital Gains and Losses

Question 46 - A. The taxpayer should start counting the holding period on November 7, 2020
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.

To figure if the taxpayer held property longer than 1 year, start counting on the day following the day he or she acquired the property. The day the taxpayer disposed of the property is part of his or her holding period.

Lesson 2 - Holding Period of Stock for Purposes of Claiming a Qualified Dividend
Source - Publication 544 - Chapter 4 - Reporting Gains and Losses

Question 47 - B. $3,000
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.

In this question, Sandra has a net short-term capital loss of $1,500 and a net long-term capital loss of $2,000. So her total capital loss is $3,500. For this capital loss, she can take a $3,000 deduction against her other income, and she can use the remaining $500 to offset her capital gains next year.

Lesson 2 - Capital Loss Deduction
Source - Publication 550 - Chapter 4 - Capital Losses

Question 48 - D. All of the above
A taxpayer who fails to meet the ownership and use requirements, or the minimum two-year time period for claiming the full exclusion (e.g.$250,000), may still be eligible for a partial exclusion when the sale of the home is due to:

- A change in place of employment.
- Health reasons.
- Unforeseen circumstances.

According to the IRS, in order for an individual to be eligible for the partial exclusion, the individual’s *primary reason* for the sale must be related to one of these three reasons. If the individual is able to satisfy one of the safe harbor tests discussed below, then the primary reason for the sale will be treated as having been due to employment, health, or unforeseen circumstances.

Lesson 2 - Hardship Relief: Safe Harbors
Source - Publication 523 - Reduced Maximum Exclusion

Question 49 - D. He reports a $1,000 capital gain
While an exchange was made, it is not of a like kind because the property is not similar or related in service or use. Bartering is an exchange of property or services. Bartering income includes income derived from the exchange of property for property. The taxpayer must report the fair market value of property or services received in bartering as income. Brandt's basis in the given property was $2,000 and the property he received in the exchange has a value of $3,000. He has a $1,000 gain to report ($3,000 - $2,000 = $1,000).

Lesson 2 - Bartering
Source - IRS.GOV - Topic 420 - Bartering Income

Question 50 - A. 10% of the amount of the early distribution
In general, if a taxpayer takes a distribution from an IRA and/or MSA before they have reached age 59½ (including an involuntary cashout), not only is the distribution included in their income, but they are also subject to a special penalty tax for the early withdrawal from their qualified retirement plan. The amount of the penalty is equal to 10% of the amount of the early distribution and is reported on *Form 5329 - Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*.

Lesson 4 - Qualified Retirement Plans (including IRAs and MSAs)
Source - Form 5329 - Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts

Question 51 - A. $108.28
A taxpayer must pay SE tax and file Schedule SE if either their net earnings from self-employment (excluding church employee income) were $400 or more or they had church employee income of $108.28 or more except for ministers and members of religious orders.

Lesson 4 - Self-Employment Tax
Source - Publication 334 - Self-Employment (SE) Tax

Question 52 - D. If the taxpayer is self-employed as a sole proprietor or independent contractor, he or she generally uses Form 1040-ES to figure his or her earnings subject to SE tax
Self-employment (SE) tax is a Social Security and Medicare tax primarily for individuals who work for themselves (Choice A). It is similar to the Social Security and Medicare taxes withheld from the pay of most wage earners, and is usually calculated on the net profit from Schedule C. If a husband and wife both have separate Schedule Cs, each spouse must figure their SE tax separately on individual Schedule SEs. If a taxpayer has more than one business and therefore more than one Schedule C, all business income or loss is determined before calculating SE tax (Choice B). If any of the income from a trade or business, other than a partnership, is community property income under state law, it is included in the earnings subject to SE tax of the spouse carrying on the trade or business (Choice C). If the taxpayer is self-employed as a sole proprietor or independent contractor, he or she generally use Schedule C (Form 1040) to figure his or her earnings subject to SE tax therefore Choice D is the correct answer.

Lesson 4 - Self-Employment Tax
Source - Publication 334 - Self-Employment (SE) Tax

Question 53 - A. $0
Under the TCJA, for tax years 2018 through 2025, if the taxpayer is an individual, casualty losses of personal-use property are deductible only if the loss is attributable to a Federally declared disaster (Federal casualty loss). If the event causing the taxpayer to suffer a personal casualty loss (not attributed to a Federally declared disaster) occurred before January 1, 2018, but the casualty loss was not sustained until January 1, 2018, or later, the casualty loss is not deductible.

Lesson 3 - Casualty and Theft Losses
Source - Publication 547 - Casualty

Question 54 - D. Married filing jointly
A joint return may be filed if one spouse dies during the taxable year, provided that the surviving spouse has not remarried during the year. If remarried, the taxpayer may file jointly with his/her new spouse.

Lesson 1 - Married Filing a Joint Return
Source - Publication 501 - Dependents, Standard Deduction, and Filing Information

Question 55 - A. $0
Harold's gift to George is treated as one-half ($10,500) from Harold and one-half ($10,500) from Helen. Helen's gift to Gina is also treated as one-half ($9,000) from Helen and one-half ($9,000) from Harold. In each case, because one-half of the split gift is not more than the 2020 annual exclusion of $15,000, it is not a taxable gift. However, each of them must file a gift tax return.

Lesson 6 - Gift Tax
Source - Instructions for Form 709

Question 56 - D. Attach only the Form 8938 and file the Form 114 separately
Taxpayers with specified foreign financial assets that exceed $50,000 on the last day of the tax year or $75,000 at any time during the tax year (higher threshold amounts apply to married individuals filing jointly and individuals living abroad) must report those assets to the IRS on Form 8938 - Statement of Specified Foreign Financial Assets, which is filed with an income tax return. The new Form 8938 filing requirement is in addition to the FBAR filing requirement. Attach Form 8938 to the taxpayer's annual income tax return and file by the due date (including extensions) for that return. FinCEN Report 114 is reported electronically.

Lesson 6 - Estate Tax
Source - Instructions for Form 8938 - When and How To File

Question 57 - D. All of the above
Points charged for specific services, such as preparation costs for a mortgage note, appraisal fees, or notary fees are not interest and cannot be deducted. Points paid by the seller of a home cannot be deducted as interest on the seller's return, but they are a selling expense which will reduce the amount of gain realized. Points paid by the seller may be deducted by the buyer, provided the buyer subtracts the amount from the basis or cost of the residence. Points the taxpayer pays on loans secured by a second home can be deducted only over the life of the loan.

Lesson 3 - Points
Source - IRS.GOV - Topic 504 - Home Mortgage Points

Question 58 - A. $400
For 2020, the total of all contributions to all Coverdell ESAs set up for the benefit of any one designated beneficiary cannot be more than $2,000. If Maria Luna's parents contributed $1,000 and her aunt $600, her grandfather or someone else could contribute no more than $400. These contributions could be put into any of Maria's Coverdell ESA accounts.

Lesson 5 - Coverdell Education Savings Accounts (CESA)
Source - Publication 970 - Chapter 7 - Contribution Limits

Question 59 - B. $250
Charitable contributions of $250 or more must be substantiated by a written acknowledgment from the donee organization. Generally, the acknowledgment must include the amount of cash and a description of non-cash contributions, together with a description and good faith estimate of the value of any goods or services received for the contributions. Contributions made by payroll deduction may be substantiated with an employer-provided document, such as a paystub or Form W-2.

Lesson 3 - Written Substantiation Required
Source - Publication 17 - Chapter 24 - Contributions

Question 60 - D. $35
If the taxpayer receives noncash gifts or services for making deposits or for opening an account in a savings institution, he or she may have to report the value as interest. For deposits of less than $5,000, gifts or services valued at more than $10 must be reported as interest. For deposits of $5,000 or more, gifts or services valued at more than $20 must be reported as interest. The value is determined by the cost to the financial institution.

Lesson 2 - Gift for Opening an Account
Source - Publication 17 - Chapter 7 - Taxable Interest

Question 61 - A. $0
If a taxpayer is covered by a retirement plan at work and the filing status is married, filing jointly and modified adjusted gross income (MAGI) is $124,000 or more in 2020 the taxpayer does not qualify for a deductible contribution.

Lesson 3 - Deductible Phase-Out Range
Source - IRS.GOV - IRA Contribution and Deduction Limits - Effect of Modified AGI on Deductible Contributions If You ARE Covered by a Retirement Plan at Work

Question 62 - B. Another taxpayer claims him or her as a dependent
To be eligible for the credit, the individual making the contribution to a qualified retirement savings plan must be at least 18 years of age as of the close of the tax year, must *not* be claimed as a dependent on someone else's tax return, and must *not* be a student. Form 8880 – Credit for Qualified Retirement Savings Contributions is used to figure the dollar amount of this credit, which is claimed line 4 of Schedule 3 (Form 1040).

Lesson 3 - Retirement Savings Contribution Credit (Saver's Credit)
Source - Form 8880 - Credit for Qualified Retirement Savings Contributions

Question 63 - A. $0
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 $4,300 in 2020, as adjusted by inflation.

Lesson 1 - Personal Exemptions
Source - Publication 501 - Dependents, Standard Deduction, and Filing Information

Question 64 - D. None of the above
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. Among other items, suspended miscellaneous deductions subject to the 2% floor include unreimbursed employee expenses for:

- Subscriptions to professional journals and trade magazines related to the taxpayer's work.
- Tools and supplies used in the taxpayer's work.
- Travel, transportation, meals, entertainment, gifts, and local lodging related to the taxpayer's work.
- Union dues and expenses.
- Work clothes and uniforms if required and not suitable for everyday use.
- Work-related education.

Lesson 3 - Deductions Subject to the 2% Limit
Source - Instructions for Schedule A (Form 1040)

Question 65 - D. None of the above
Under the Tax Cuts and Jobs Act the deduction for personal casualty and theft losses is suspended (unless incurred in Federally declared disaster area). 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.

Lesson 3 - Casualty and Theft Losses
Source - Publication 17 - Chapter 25 - Nonbuisness Casualty or Loss

Question 66 - D. Suspends the deduction for amortizable bond premiums
Line 16 of Schedule A (Form 1040) allows the taxpayer to list certain other deductions that are miscellaneous deductions.

Common deductions taken here include:

- Gambling losses up to the amount of gambling winnings.
- Casualty and theft losses from income-producing property.
- Loss from other activities from Schedule K-1 (Form 1065-B), Box 2.
- Federal estate tax on income in respect of a decedent.
- Amortizable premium on taxable bonds.
- An ordinary loss attributable to a contingent payment debt instrument or an inflation-indexed debt instrument (for example, a Treasury Inflation-Protected Security).
- Repayment of amounts under a claim of right if over $3,000.
- Unrecovered investment in an annuity.
- Impairment-related work expenses of persons with disabilities.

Lesson 3 - Deductions Not Subject to the 2% Limit
Source - Instructions for Schedule A (Form 1040)

Question 67 - B. $20,000
Generally, taxpayers can deduct 20% of QBI, qualified cooperative dividends, qualified REIT dividends, and qualified publicly traded partnership (PTP) income. In this question, because Cynthia's taxable income was less than $326,600, her QBI deduction is $20,000 (20% x $100,000).

Lesson 3 - Qualified Business Income
Source - IRS.GOV - Qualified Business Income Deduction

Question 68 - A. Her spouse lived in her home for the final 6 months of the current year
The determination of whether an individual is married is made as of the close of the taxable year. A taxpayer's filing status is single if the taxpayer is unmarried or is separated from his/her spouse by a divorce or separate maintenance decree and does not qualify for another filing status. As Ms. Nelson is married, the fact that her spouse lived in her home for the final 6 months of the tax year will prevent her from filing as a single person.

Lesson 1 - Married Filing a Joint Return
Source - Publication 17 - Chapter 2 - Filing a Joint Return

Question 69 - A. $0
To claim the Earned Income Tax Credit (EITC) the taxpayer's earned income and adjusted gross income (AGI) must each be less than $15,820 for a single filing taxpayer with no qualifying children in 2020. In this question, Sharon's AGI is $15,900 ($9,500 + $6,400). Because her AGI ($15,900) is not less than $15,820, she cannot take the EITC.

Lesson 3 - Earned Income Tax Credit (EITC) Limitations
Source - Publication 596 - Chapter 1 - Rules for Everyone

Question 70 - C. Special Pay
Nontaxable pay for service members is generally referred to as allowance or assistance and includes:

- Pay for active service in a combat zone or qualified.
- Hazardous Duty Area.
- Living allowances, like BAH, BAS, and OHA.
- Disability and medical benefits.
- Educational assistance.
- Legal assistance.
- Family separation allowances.
- Temporary lodging.
- Uniform allowances.

Special pay is included in gross income, unless the pay is for service in a combat zone.

Lesson 4 - Military
Source - Publication 3 - Armed Forces' Tax Guide

Question 71 - B. $15,000
For the Child and Dependent Care credit, the amount is equal to the applicable percentage, as determined by the taxpayer's adjusted gross income (AGI), times the qualified employment expenses paid. Taxpayers with an adjusted gross income (AGI) of $15,000 or less use the highest applicable percentage of 35%. For taxpayers with adjusted gross income over $15,000, the credit is reduced by one percentage point for each $2,000 of adjusted gross income (or fraction thereof) over $15,000. The minimum applicable percentage of 20% is used by taxpayers with AGIs greater than $43,000.

Lesson 3 - Amount of Credit
Source - Publication 503 - Amount of Credit

Question 72 - B. $75,000
The Additional Medicare Tax is an additional 0.9% in tax an individual or couple must pay on income thresholds above $200,000 for singles and $250,000 for couples.

In this question, Carl's employer did not withhold Additional Medicare Tax. However, the $130,000 of wages reduces the self-employment income threshold to $70,000 ($200,000 threshold minus the $130,000 of wages). Carl is liable for Additional Medicare Tax on $75,000 of self-employment income ($145,000 in self-employment income minus the reduced threshold of $70,000). Carl must file Form 8959.

Lesson 4 - Additional Medicare Tax
Source - Instructions for Form 8959

Question 73 - A. 3-year period
For any child for whom an IRS Individual Taxpayer Identification Number (ITIN) was filed on *Schedule 8812 – Child Tax Credit* to meet the substantial presence test, the child must have been physically present in the United States at least 183 days in the past 3-year period.

Lesson 3 - Qualifying Child
Source - Schedule 8812 - Child Tax Credit

Question 74 - D. Short-term, capital gain of $150,000
Separate a taxpayer's capital gains and losses according to how long he or she held or owned the property. The holding period for short-term capital gains and losses is 1 year or less. Report these transactions on Part I of Form 8949. The holding period for long-term capital gains and losses is more than 1 year. Report these transactions on Part II of Form 8949. To figure the holding period, begin counting on the day after the taxpayer received the property and include the day he or she disposed of it.

Lesson 1 - Sale of Personal Residence
Source - Instructions for Form 8949

Question 75 - C. $200,000
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.

Lesson 3 - Child Tax Credit
Source - Publication 972 - Limits on the Credit

Question 76 - C. $2,550,000
The gross value of Mary's estate includes items valued at their gross amount. The $100,000 mortgage is deducted after the gross valuation of the estate. Therefore, the gross value is $2,550,000 ($400,000 + $150,000 + $2,000,000). The life insurance is excluded under Section 2042 because there is no incidence of ownership of the decedent. The life insurance proceeds are excluded. The portfolio is valued at its FMV at the date of death, not her basis, and the CD's accrued interest is not deducted. The mortgage is not subtracted from the gross value of the estate.

Lesson 6 - Estate Tax
Source - IRS.GOV - Estate Tax

Question 77 - B. 10%
In many cases, two or more persons join together to support the same individual. For example, several children may share the cost of supporting a parent. In these situations, one of the groups can claim the individual as a dependent, even though no one provides over one-half the support. The group can enter into a multiple-support agreement if the following conditions are met:

- No one person contributes over 50% of the dependent's support.
- Every member of the group could claim the individual as a dependent, except for the support test.
- The group member who claims the individual as a dependent provides more than 10% of the support.
- Every group member who provides more than 10% of the support files the consent on *Form 2120 - Multiple Support Declaration*.

Lesson 1 - Multiple-Support Agreements
Source - Form 2120 - Multiple Support Declaration

Question 78 - C. $1,000
When using the simplified option for the home office deduction the taxpayer can use a standard deduction of $5 per square foot of the home used for business (maximum 300 square feet).

Lesson 5 - Simplified Option for Home Office Deduction
Source - IRS.GOV - Simplified Option for Home Office Deduction

Question 79 - C. $45,000
A separate $15,000 exclusion applies to each person to whom the taxpayer makes a gift. The taxpayer made 3 gifts to 3 different people, therefore the total annual exclusion amount for the gifts on his income tax return would be $45,000 (3 x $15,000) in 2020.

Lesson 6 - Gift Tax
Source - Instructions for Form 709

Question 80 - B. $120
Capital gains tax rates depend on how long the taxpayer owned or held the asset. Short-term capital gains for assets held for less than a year are taxed at ordinary income rates. However, if the taxpayer held an asset for more than a year, more preferential long-term capital gains apply. These rates are 0%,15%, or 20% - depending on the taxpayer's income level.

In this question, if Dan sells an asset that produced a short-term capital gain of $1,000, then his tax liability rises by another $120 (12% x $1,000). However, if Dan waits one year and a day to sell, then he pays 0% on the capital gain.

Lesson 5 - Character of Transaction
Source - IRS.GOV - Topic 409 Capital Gains and Losses

Question 81 - C. $15,000
The basis of property received as a gift is the donor's "carry-over" basis (adjusted basis). The fair market value at the date of the gift is irrelevant for property sold at a gain.

Lesson 6 - Gift Tax
Source - Publication 559 - Gift Tax

Question 82 - C. $10,000
The dollar limitation applies separately to both the credit and the exclusion, and a 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. Reese can exclude $3,400 from her gross income for 2020. However, the expenses allowable for the Adoption Credit are limited to $10,000 ($13,400 total expenses paid less $3,400 employer reimbursement).

Lesson 3 - Adoption Credit
Source - Form 8839 - Qualified Adoption Expenses

Question 83 - C. $6,000
A taxpayer may include up to $6,000 of expenses paid for the care of two or more qualifying persons to figure the child and dependent care credit, provided the amount of expenses claimed does not exceed the gross earnings of the lower earning taxpayer. A taxpayer should combine the total qualifying expenses for all qualifying persons. In this case combine the amounts paid for the two preschool children of $5,000 and the amount paid for after school care of $4,000. However, the total of $9,000 exceeds the maximum of $6,000 therefore they may only use $6,000 of the child care expenses to calculate the child and dependent care credit.

Lesson 3 - Child and Dependent Care Credit
Source - Publication 503 - Child and Dependent Care Expenses

Question 84 - A. $2,000
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.

Lesson 3 - Retirement Savings Contribution Credit (Saver's Credit)
Source - IRS.GOV - Retirement Savings Contributions Credit (Saver's Credit)

Question 85 - C. Estimated tax payments are required when the withholding taxes are greater than the overall tax liability
Estimated tax liability exists when:

1. Individuals will owe at least $1,000 in tax, after subtracting withholding and credits.
2. Withholding and credits will be less than the smaller of:
    a. 90% of the tax to be shown on this year's tax return.
    b. 100% of the tax shown on last year's return (110% if AGI over $150,000).

Estimated tax payments are not required when the withholding taxes are greater than the overall tax liability therefore Choice C is not correct.

Lesson 5 - Estimated Taxes
Source - IRS.GOV - Estimated Taxes

Question 86 - A. Security deposit, equal to one month's rent, to be refunded at the end of the lease if the building passes inspection
Generally, cash or the fair market value of property a taxpayer receives for the use of real estate or personal property is taxable to him or her as rental income. Most individuals operate on a cash basis, which means they count their rental income as income when it is actually or constructively received and deduct their expenses as they are paid.

Some specific types of income are:

- Amounts paid to cancel a lease – If a tenant pays a taxpayer to cancel a lease, this money is also rental income and is reported in the year received.
- Advance rent – Generally the taxpayer includes any advance rent paid in income in the year he or she receives it regardless of the period covered or the method of accounting used.

- Expenses paid by a tenant – If the tenant pays any of the taxpayer's expenses, those payments are rental income. The taxpayer may be allowed to deduct the expenses if they are considered deductible expenses.
- Security deposits – Do not include a security deposit in taxpayer's income if he or she may be required to return it to the tenant at the end of the lease. But if the taxpayer keeps part or all of the security deposit because the tenant did not live up to the terms of the lease, this money is taxable income in the year the determination is made. If the taxpayer keeps the security deposit because the tenant damaged the property, the security deposit is not taxable. If the security deposit is to be used as the tenant's final month's rent, include the money as income when received, rather than when it is applied to the last month's rent.

Lesson 1 - Rental Income
Source - IRS.GOV - Topic 414 - Rental Income and Expenses

Question 87 - C. $25,000
If the taxpayer or his or her spouse actively participated in a passive rental real estate activity, he or she can deduct up to $25,000 of loss from the activity from a non-passive income. This special allowance is an exception to the general rule disallowing losses in excess of income from passive activities. Similarly, a taxpayer can offset credits from the activity against the tax on up to $25,000 of non-passive income after taking into account any losses allowed under this exception.

Lesson 2 - Passive Income
Source - Publication 527 - Chapter 3 - Limits on Rental Losses

Question 88 - A. $0
Their benefits are not taxable for 2020 because their income, (one-half of total benefits plus taxable pensions, wages, interest, dividends, and other taxable income) is not more than their base amount for married filing jointly.

Lesson 2 - Maximum Taxable Part
Source - Publication 17 - Chapter 11 - Are Any of Your Benefits Taxable?

Question 89 - A. Resident aliens filing joint returns who have earned income and adjusted gross income (AGI) within certain limits
The Earned Income Tax Credit (EITC) is a tax credit for certain people who work and have low wages. It reduces the amount of taxes owed and may entitle the taxpayer to a refund. Certain eligibility requirements must be met in order to claim this credit. Generally, the taxpayer must have taxable income must be below a specified amount and must be a U.S. citizen or resident alien all year with a valid Social Security number.

Lesson 3 - Earned Income Tax Credit
Source - IRS.GOV - Do I Qualify for EITC?

Question 90 - A. $0
Under the Tax Cuts and Jobs Act (TCJA), alimony payments are no longer tax-deductible for the payer, and they are not considered taxable income for the person receiving them. The changes affect divorce agreements signed after December 31, 2018. In this question, Mary cannot claim the alimony as a deduction on her 2020 Tax Return and Michael does not need to report the alimony as income on his 2020 Tax Return.

Lesson 5 - Tax Treatment of Alimony and Separate Maintenance
Source - IRS.GOV - Topic 452 Alimony and Separate Maintenance

Question 91 - A. Mrs. Adams must report the entire amount of $10,000
Generally, IRA distributions from a Traditional IRA are taxable in the year withdrawn. Additionally, distributions from Traditional IRAs that are included in income are taxed as ordinary income subject to regular income tax rates. Distributions may also be fully or partially taxable depending on whether the IRA includes any nondeductible contributions.

Lesson 2 - Traditional IRA Distributions
Source - Publication 590-B - Distributions from Individual Retirement Arrangements (IRAs)

Question 92 - D. Nine months
Generally, the estate tax return is due nine months after the date of death. A six-month extension is available if requested prior to the due date and the estimated correct amount of tax is paid before the due date.

Lesson 6 - Portability Election
Source - IRS.GOV - Filing Estate and Gift Tax Returns

Question 93 - B. $700
The maximum matching contribution is always 3% of the employees' compensation for the entire calendar year. Matching contributions may be made on a per-pay-period basis, or by the due date of the employer's tax return (including extensions). Joe's employer must make a matching contribution of $700 because the employer is only required to match the amount Joe actually contributes during the year up to a maximum of 3% of his calendar-year compensation.

Lesson 2 - SIMPLE IRA
Source - IRS.GOV - SIMPLE IRA Plan FAQs - Contributions

Question 94 - C. A or B
For decedents who died in 2020, Form 706 must be filed by the executor of the estate of every U.S. citizen or resident:

- Whose gross estate, plus adjusted taxable gifts and specific exemption, is more than $11,580,000; or
- Whose executor elects to transfer the Deceased Spousal Unused Exclusion (DSUE) amount to the surviving spouse, regardless of the size of the decedent's gross estate.

Lesson 6 - Estate Tax
Source - Instructions for Form 706

Question 95 - C. $10,000
In 2020, generally, gifts valued up to $15,000 per person could have been given to any number of people, and none of the gifts will be taxable. In this question, the first $15,000 of the gift is not subject to the gift tax because of the annual exclusion. The remaining $10,000 is a taxable gift.

Lesson 6 - Gift Tax
Source - Publication 559 - Gift Tax

Question 96 - B. A receipt for each donation that shows the amount, date, and to whom paid
For a contribution of cash, check, or other monetary gift (regardless of amount), the taxpayer must maintain as a record of the contribution a bank record or a written communication from the qualified organization containing the name of the organization, the date of the contribution, and the amount of the contribution. In addition to deducting cash contributions, the taxpayer generally can deduct the fair market value of any other property he or she donates to qualified organizations.

Lesson 3 - Contributions
Source - IRS.GOV - Topic 506 - Charitable Contributions

Question 97 - A. $0
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.

Lesson 3 - Entertainment Expenses
Source - IRS.GOV - Topic 512 - Business Entertainment Expenses

Question 98 - B. $1,000
Income in respect of a decedent must be included in the income of one of the following:

- The decedent's estate, if the estate receives it.
- The beneficiary, if the right to income is passed directly to the beneficiary and the beneficiary receives it.
- Any person to whom the estate properly distributes the right to receive it.

In this case, the gain to be reported as income in respect of a decedent is the $1,000 difference between the decedent's basis in the property and the sale proceeds. In other words, the income in respect of a decedent is the gain the decedent would have realized had he lived.

Lesson 4 - Income in Respect of Decedent (IRD)
Source - Publication 559 - Survivors, Executors, and Administrators

Question 99 - D. Room and board are qualifying expenses for the American Opportunity Tax Credit
The term "qualified tuition and related expenses" has been expanded to include expenditures for "course materials." For this purpose, the term "course materials" means books, supplies, and equipment needed for a course of study whether or not the materials must be purchased from the educational institution as a condition of enrollment or attendance. Room and board expenses are not considered qualifying educational expenses.

Lesson 3 - American Opportunity Tax Credit
Source - IRS.GOV - Tax Benefits for Education: Information Center

Question 100 - D. $17,018
If a taxpayer kept a daily tip record and reported tips to his or her employer as required, he or she should add the cash and charge tips the taxpayer received that totaled less than $20 for any month to the amount in box 1 of his or her Form W-2.

Lesson 2 - Tips
Source - IRS.GOV - Tips - Withholding and Reporting

