**Enrolled Agent**

**PART I**

**Individual Taxation**





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**Table of Contents**

**[PART I](#_Toc103791504)** [1](#_Toc103791504)

**[Individual Taxation](#_Toc103791505)** [1](#_Toc103791505)

[What Is an EA Designation? 5](#_Toc103791506)

[CHAPTER 1 Preliminary Work and Taxpayer Data 9](#_Toc103791507)

[Module: Preliminary Work to Prepare Tax Returns 11](#_Toc103791508)

[Use of Prior Year Returns for Comparison, Accuracy, and Carryovers for Current Year's Return 11](#_Toc103791509)

[Taxpayer’s Personal Information 11](#_Toc103791510)

[Residency Status and/or Citizenship 12](#_Toc103791511)

[Filing Requirements and Due Dates 23](#_Toc103791512)

[Taxpayer’s Filing Status 34](#_Toc103791513)

[Sources of All Worldwide Taxable and Non-taxable Income 45](#_Toc103791514)

[Sources of Applicable Exclusions and Adjustments to Gross Income 47](#_Toc103791515)

[Sources of Applicable Deductions 51](#_Toc103791516)

[Qualification for Dependency 51](#_Toc103791517)

[Sources of Applicable Credits 54](#_Toc103791518)

[Sources of Tax Payments and Refundable Credits 59](#_Toc103791519)

[Previous IRS Correspondence with the Taxpayer 65](#_Toc103791520)

[Additional Required Returns Filed, and Taxes Paid 65](#_Toc103791521)

[Special Filing Requirements 71](#_Toc103791522)

[Foreign Account and Asset Reporting 81](#_Toc103791523)

[Minor Children's Unearned Income (Kiddie Tax) 89](#_Toc103791524)

[Affordable Care Act (ACA) Requirements 89](#_Toc103791525)

[CHAPTER 2 Income and Assets 93](#_Toc103791526)

[Module: Income 95](#_Toc103791527)

[Taxability of Wages, Salaries and Other Earnings 95](#_Toc103791528)

[Interest Income 105](#_Toc103791529)

[Dividends and Other Distributions from Mutual Funds, Corporations and Other Entities 107](#_Toc103791530)

[Personal Property Rental 111](#_Toc103791531)

[Gambling Income and Allowable Deductions 115](#_Toc103791532)

[Tax Treatment of Cancellation of Debt 116](#_Toc103791533)

[Tax Treatment of a U.S. Citizen/Resident with Foreign Income 121](#_Toc103791534)

[Other Income 140](#_Toc103791535)

[Constructive Receipt of Income 143](#_Toc103791536)

[Constructive Dividends 144](#_Toc103791537)

[Passive Income and Loss 144](#_Toc103791538)

[Pass-through Income 145](#_Toc103791539)

[Royalties and Related Expenses 147](#_Toc103791540)

[State/Local Income Tax Refunds and Other Itemized Deduction Recoveries 151](#_Toc103791541)

[1099 MISC, 1099 NEC, 1099 K Reporting, Irregularities, and Corrections 152](#_Toc103791542)

[Module: Retirement Income 158](#_Toc103791543)

[Basis in a Traditional IRA 158](#_Toc103791544)

[Comparison of and Distributions from Traditional and Roth IRAs 160](#_Toc103791545)

[Distributions from Qualified and Non-Qualified Plans 161](#_Toc103791546)

[Excess Contributions and Tax Treatment 163](#_Toc103791547)

[Penalties and Exceptions on Premature Distributions from Qualified Retirement Plans and IRAs 165](#_Toc103791548)

[Prohibited Transactions and Tax Consequences 165](#_Toc103791549)

[IRA Conversions and Recharacterization 166](#_Toc103791550)

[Required Minimum Distributions 167](#_Toc103791551)

[Loans from Qualified Plans 168](#_Toc103791552)

[Taxability of Social Security and Railroad Retirement Benefits 169](#_Toc103791553)

[Inherited Retirement Accounts 170](#_Toc103791554)

[Foreign Pensions and Retirement Income 171](#_Toc103791555)

[Module: Property, Real and Personal 177](#_Toc103791556)

[Sale or Disposition of Property Including Depreciation Recapture Rules and 1099A 177](#_Toc103791557)

[Capital Gains and Losses 178](#_Toc103791558)

[Basis of Assets 186](#_Toc103791559)

[Basis of Stock After Stock Splits and/or Stock Dividends 189](#_Toc103791560)

[Publicly Traded Partnerships (PTP) 190](#_Toc103791561)

[Sale of a Personal Residence 194](#_Toc103791562)

[Installment Sales 194](#_Toc103791563)

[Options 196](#_Toc103791564)

[Like-Kind Exchange 197](#_Toc103791565)

[Non-Business Bad Debts 200](#_Toc103791566)

[Investor vs. Trader 200](#_Toc103791567)

[Module: Adjustments to Income 207](#_Toc103791568)

[Self-Employment Tax (SE Tax) 207](#_Toc103791569)

[Retirement Contribution Limits and Deductibility 207](#_Toc103791570)

[Health Savings Account 208](#_Toc103791571)

[Other Adjustment to Income 211](#_Toc103791572)

[Self-Employed Health Insurance 215](#_Toc103791573)

[CHAPTER 3 Deductions and Credits 218](#_Toc103791574)

[Module: Itemized Deductions and QBI 220](#_Toc103791575)

[Medical, Dental, Vision, Long-Term Care Expenses 221](#_Toc103791576)

[Various Taxes 225](#_Toc103791577)

[Interest Expense 226](#_Toc103791578)

[Charitable Contributions 229](#_Toc103791579)

[Nonbusiness Casualty and Theft Losses 235](#_Toc103791580)

[Other Itemized Deductions 237](#_Toc103791581)

[Itemized Deductions for Form 1040-NR 238](#_Toc103791582)

[Qualified Business Income (QBI) Deduction 242](#_Toc103791583)

[Module: Credits 245](#_Toc103791584)

[Child and Dependent Care Credit 245](#_Toc103791585)

[Child Tax Credit and Credit for Other Dependents 249](#_Toc103791586)

[Education Credits 255](#_Toc103791587)

[Foreign Tax Credit 263](#_Toc103791588)

[Earned Income Tax Credit (EITC) 264](#_Toc103791589)

[Adoption Credits 274](#_Toc103791590)

[ACA Premium Tax Credit 275](#_Toc103791591)

[Other Credits 278](#_Toc103791592)

[CHAPTER 4 Taxation and Advice 290](#_Toc103791593)

[Module: Taxation 292](#_Toc103791594)

[Alternative Minimum Tax and Credit for Prior Year 292](#_Toc103791595)

[Household Employees 293](#_Toc103791596)

[Underpayment Penalties and Interest 294](#_Toc103791597)

[Self-Employment Tax 295](#_Toc103791598)

[Excess Social Security Withholding 296](#_Toc103791599)

[Tax Provisions for Members of the Clergy 301](#_Toc103791600)

[Tax Provisions for Members of the Military 302](#_Toc103791601)

[Income in Respect of Decedent 303](#_Toc103791602)

[Net Investment Income Tax 304](#_Toc103791603)

[Additional Medicare Tax 307](#_Toc103791604)

[Uncollected Social Security and Medicare Tax 307](#_Toc103791605)

[Other Taxes 308](#_Toc103791606)

[CHAPTER 5 Advising the Individual Taxpayer 314](#_Toc103791607)

[Module: Advising the Individual Taxpayer 316](#_Toc103791608)

[Reporting Obligation for Individual Taxpayers 316](#_Toc103791609)

[Property Sales 318](#_Toc103791610)

[Education Planning 319](#_Toc103791611)

[Estate Planning 320](#_Toc103791612)

[Retirement Planning 322](#_Toc103791613)

[Marriage and Divorce 322](#_Toc103791614)

[Items That Will Affect Future/Past Returns 328](#_Toc103791615)

[Injured Spouse 329](#_Toc103791616)

[Innocent Spouse 329](#_Toc103791617)

[Estimated Tax and Penalty Avoidance 330](#_Toc103791618)

[Adjustments, Deductions and Credits for Tax Planning 331](#_Toc103791619)

[Character of Transaction 332](#_Toc103791620)

[Advantages and Disadvantages of MFJ/MFS/HOH Filing Status in Various Scenarios 332](#_Toc103791621)

[Conditions for Filing a Claim for Refund 334](#_Toc103791622)

[Penalty of Perjury 335](#_Toc103791623)

[CHAPTER 6 Specialized Returns for Individuals 338](#_Toc103791624)

[Module: Estate Tax 340](#_Toc103791625)

[Gross Estate, Taxable Estate (Calculations and Payments), Unified Credit, Life Insurance, and Filing Requirements 340](#_Toc103791626)

[Jointly-Held Property 346](#_Toc103791627)

[Marital Deduction and Other Marital Issues 346](#_Toc103791628)

[Life Insurance, IRAs and Retirement Plans 347](#_Toc103791629)

[Estate Filing Requirements and Due Dates 348](#_Toc103791630)

[Module: Gift Tax 354](#_Toc103791631)

[Gift-Splitting 354](#_Toc103791632)

[Annual Exclusion 355](#_Toc103791633)

[Unified Credit 355](#_Toc103791634)

[Effect on Estate Tax 356](#_Toc103791635)

[Filing Requirements 356](#_Toc103791636)

[Module: International Information Reporting 361](#_Toc103791637)

[Filing and Reporting Requirements and Due Dates 361](#_Toc103791638)

[Covered Accounts 362](#_Toc103791639)

[Potential Penalties 362](#_Toc103791640)

[Distinctions Between FBAR and Form 8938 Requirements 363](#_Toc103791641)

What Is an EA Designation?

1. An Enrolled Agent is a person who has earned the privilege of representing taxpayers before the Internal Revenue Service. To become an Enrolled Agent, the person must pass the Special Enrollment Examination (SEE), as well as a suitability check. The information contained in this course will explain the steps needed to take the SEE and to become an Enrolled Agent. We wish you well in preparing for your examination.

Follow these steps if you are interested in becoming an Enrolled Agent:

1. **Review this course thoroughly.**
2. **Schedule an Appointment:** The applicant can schedule an examination appointment at any time online at www.prometric.com/see, by calling (800)306-3926 between 8:00 a.m. and 9:00 p.m. (ET), Monday through Friday, or by completing Form 2587. The IRS has a new online registration process. It requires the applicant to create a user profile before he or she schedules and pays for the exam. The applicant has to refer to the job aid under “What’s New” on Prometric.com/see to create an account. After the appointment has been scheduled, the applicant will receive a number confirming the appointment. The applicant has to keep this confirmation number in his or her records. He or she will need it to reschedule, cancel, or change the appointment. The applicant may take each part of the examination at his or her convenience and in any order. Examination parts do not have to be taken on the same day or on consecutive days. The applicant may take examination parts up to four times each during each test window. The current test window is from May 2, 2022 to February 28, 2023. Testing is not available in the months of March and April each year while the examination is updated. The testing fee is $185 for each part of the examination.
3. **Prepare for your examination:** The examination topics treated in this course are the basis for the examination.
4. **Bring the required identification to the test center and take the scheduled examination:** The applicant must present a valid, non-expired form of identification before he or she can take the test. That identification document must:
   1. Be government-issued (e.g. driver’s license, passport, state-issued identification card or military identification card);
   2. Contain both a current photo and his/her signature (if it does not, the applicant must present two government-issued identification cards: one with his/her photo and one with his/her signature);
   3. Closely resemble his/her appearance on the date of testing; and
   4. Have a first and last name that exactly matches the first and last name used to register for the examination.
5. After passing all three parts of the examination, the candidate must apply for enrollment via Form 23, Application for Enrollment to Practice Before the Internal Revenue Service, within one year of the date the applicant passed the third examination part. The applicant may electronically file Form 23 and pay the application fee at pay.gov. Copies of the score report do not need to be submitted to the IRS when submitting his/her application for enrollment (Form 23). As part of the evaluation of his/her enrollment application, the Internal Revenue Service will conduct a suitability check that will include a review of his or her personal tax compliance.

Anyone who prepares or assists in preparing federal tax returns for compensation, including Enrolled Agents, must have a valid Preparer Tax Identification Number (PTIN) before preparing returns.

1. The IRS Tax Professional PTIN System is available at www.irs.gov/ptin. Once you enter the website, you will need to create your account and follow the steps to get your PTIN. This process takes about 15 minutes.
2. If you opt to use the paper application, Form W-12 IRS Paid Preparer Tax Identification Number Application, it will take 4-6 weeks to process.
3. PTINs must be renewed annually by December 31 for the following year. Renewal Open Season usually begins each year in mid-October.

**Extension of the Two-Year Carryover Period**

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 IRS extended the two-year period 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, 2020. Subsequently the candidate passed Part 2 on February 15, 2021. That candidate has until November 15, 2023 to pass the remaining part. Otherwise, the candidate loses credit for Part 1. The candidate has until February 15, 2024 to pass all other parts of the examination or will lose credit for Part 2.

**Candidate Information Bulletin**

Before you sign up to take the SEE, please review the Enrolled Agent Special Enrollment Examination Candidate Information Bulletin. This bulletin will provide you with important information about the examination and the process for becoming an Enrolled Agent.

**Important Changes to the Break Policy**

The Special Enrollment Exam (SEE) includes one scheduled 15-minute break. The exam clock stops after you have answered questions 1-50 and the first section of the test has been completed.

Once you have answered questions 1-50, completed your review of your answers, and acknowledged you have completed section one, the test timer will stop for up to 15 minutes. After acknowledging that you have completed the first section of the exam you will no longer be able to access the first section of the test content, including making changes to your answers. You may choose to decline the scheduled break and continue testing.

If you choose to take the scheduled break you will leave the testing room, adhering to all security protocols.

If you have not returned and started the second section (questions 51-100) of the exam prior to the expiration of the 15 minutes, the exam clock will restart.

You are allowed to take additional unscheduled breaks; however, the exam clock will continue to count down during any unscheduled break.

CHAPTER 1   
  
Preliminary Work and Taxpayer Data

## Module: Preliminary Work to Prepare Tax Returns

### Use of Prior Year Returns for Comparison, Accuracy, and Carryovers for Current Year's Return

Tax preparers must use the previous tax return to prevent errors and mathematical changes related to calculations, including the sources of income. All sources of income for the taxpayers, either individual or business, must be verified. All tax preparers are also expected to review prior year tax returns for compliance, accuracy, and completeness. A preparer is required to notify a taxpayer of an error or omission on a prior year tax return and the consequences of not correcting the error or omission.

Comparisons with previous years help to determine all changes occurring in that tax return. All tax preparers are also expected to perform due diligence in collecting, verifying, and gathering taxpayers’ data.

### Taxpayer’s Personal Information

This comprises the personal information about the taxpayers that is relevant for filing the tax return. The IRS requires preparers of tax returns to interview the taxpayers so that they can ascertain the information the taxpayers provide for tax filing. The personal information that is included in the tax return form includes the following information:

1. Legal name.
2. Date of birth.
3. Marital status.
4. Residency status and/or citizenship.
5. Dependents.
6. Taxpayer’s identification number.
7. State issued photo ID.

According to Form 1040, the name should be provided in the order of first name and the initial of the second, followed by the surname. For joint returns where the taxpayer is involving the spouse in their tax return, the spouse’s name is to be provided in that same order.

1. Identity Protection PIN (IP PIN)

An Identity Protection PIN (IP PIN) is a six-digit number that prevents someone else from filing a tax return using the taxpayer’s Social Security number or Individual Taxpayer Identification Number. The IP PIN is known only to the taxpayer and the IRS. It helps the IRS to verify the identity of the taxpayer when they file an electronic or paper tax return. Even though the taxpayer may not have a filing requirement, an IP PIN still protects their account.

If the taxpayer is a confirmed victim of tax-related identity theft and the IRS has resolved the taxpayer’s tax account issues, the IRS will mail the taxpayer a CP01A Notice with their new IP PIN each year.

If the taxpayer doesn't already have an IP PIN, they may get an IP PIN as a proactive step to protect themself from tax-related identity theft.

If the taxpayer wants to request an IP PIN, please note:

1. They must pass an identity verification process.
2. Spouses and dependents are eligible for an IP PIN if they can pass the identity verification process.

### Residency Status and/or Citizenship

All persons born in the United States are U.S. citizens. This is the case regardless of the tax or immigration status of a person’s parents.

A person born outside the United States may also be a U.S. citizen at birth if at least one parent is a U.S. citizen and has lived in the United States for a specified period. The United States Citizenship and Immigration (USCIS) web page on citizenship through parents contains more detailed information for persons born outside the United States to a U.S. citizen parent or parents.

All U.S. citizens are subject to U.S. income tax on their worldwide income, regardless of where they reside. U.S. citizens residing abroad are subject to the same income tax filing requirements that apply to U.S. citizens living in the United States. All U.S. citizens must file a U.S. federal individual income tax return each year (Form 1040, U.S. Individual Income Tax return) if their gross income from all sources meets the amounts in the filing requirement charts that can be found under *Filing Requirements and Due Dates*, later.

1. Non-Resident Dual-Status Aliens

Non-resident dual-status alien taxation applies for the individuals who are both residents in the U.S. and have foreign citizenship during the tax year. There are a number of rules that are applicable to the non-resident dual-status alien when filing tax returns during any given tax period. The first condition is when, for part of the year, the individual is a U.S. resident alien. In this case, the individual is taxed on all the income received from all the sources during the year.

The income that is earned from outside the U.S. is only taxable if it is received by the individual when he or she was a resident of the foreign country during the year. For example, if the taxpayer was a non-resident during the year, the income that is earned within the U.S. is taxed, not the other income earned from foreign country. For the income earned from U.S. sources, taxes are applied whether it is received when one is a resident or a non-resident alien during the tax period. The tax provision for this case is provided by the Internal Revenue Code (IRC). Furthermore, the exemptions are considered when filing tax returns under such conditions.

Certain rules exist for determining the starting and ending residency dates for aliens. In some cases, aliens are allowed to make elections that override the green card test and the substantial presence test, as follows:

1. Non-resident spouse treated as a resident.
2. Closer connection to a foreign country.
3. Tax treaties.

The taxpayer can be both a non-resident alien and a resident alien during the same tax year. This usually occurs in the year he or she arrives or departs from the United States. If so, the taxpayer may elect to be treated as a [d](https://www.irs.gov/Individuals/International-Taxpayers/Dual-Status-Aliens" \t "Dual Status Alien)ual-status alien for this taxable year and a resident alien for the next taxable year if he or she meets certain tests. For more information, see Pub. 519. A resident alien who is required to establish his or her U.S. residency for the purpose of claiming a tax treaty benefit with a foreign country should refer to [Certification of U.S. Residency for Tax Treaty Purposes](https://www.irs.gov/Individuals/International-Taxpayers/Certification-of-U.S.-Residency-for-Tax-Treaty-Purposes" \t "Certification of U.S. Residency for Tax Treaty Purposes).

A resident alien is an individual who is not a citizen or national of the U.S. and who meets either the green card test or the substantial presence test for the calendar year.

1. Green Card Test

The taxpayer is a U.S. resident if he or she was a lawful permanent resident of the U.S. at any time during the calendar year. This is known as the green card test, because resident aliens hold immigrant visas (also known as green cards).

1. Substantial Presence Test

A taxpayer is considered a U.S. resident 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 the current calendar year, and
2. A total of 183 days during the current year and the 2 preceding years, counting all the days of physical presence in the current year, but only 1/3 of the number of days of presence in the first preceding year, and only 1/6 the number of days in the second preceding year.
3. Dual-Status Aliens

If a person is a U.S. resident for the calendar year but is not a U.S. resident at any time during the preceding calendar year, he or she is a U.S. resident only for the part of the calendar year beginning on the residency starting date. The person is a non-resident alien for the part of the year before that date.

1. Non-resident Aliens

Non-resident aliens are required to file an income tax return (Form 1040-NR) if they are any of the following:

1. A non-resident alien individual engaged or considered to be engaged in a trade or business in the U.S. during the year. A nonresident alien individual must file even if:
2. The non-resident alien had no income from a trade or business conducted in the U.S.
3. The non-resident alien had no income from U.S. sources, or
4. The non-resident alien’s income is exempt from income tax.
5. A non-resident alien individual not engaged in a trade or business in the U.S with U.S. income on which the tax liability was not satisfied by the withholding of tax at the source.
6. The non-resident alien is a representative of a deceased person who would have had to file Form 1040NR.
7. The non-resident alien acts as a fiduciary for a non-resident alien estate or trust.

Generally, a foreign person is subject to U.S. tax on its U.S. source income. Most types of U.S. source income received by a foreign person are subject to U.S. tax of 30%. A reduced rate, including exemption, may apply if an Internal Revenue Code Section provides for a lower rate, or there is a tax treaty between the foreign person's country of residence and the United States. The tax is generally withheld (NRA withholding) from the payment made to the foreign person.

If the taxpayer did not receive wages as an employee subject to U.S. income tax withholding, file Form 1040-NR by the 15th day of the 6th month after their tax year ends. A return for the 2021 calendar year is due by June 15, 2022. If the taxpayer was an employee and received wages subject to U.S. income tax withholding, they must file Form 1040-NR by the 15th day of the 4th month after their tax year ends. A return for the 2021 calendar year is due by April 18, 2022.

1. Non-Resident Spouse

If, at the end of their tax year, the taxpayer is married and one spouse is a U.S. citizen or a U.S. resident and the other is not, the taxpayer can choose to treat the nonresident spouse as a U.S. resident for tax purposes. This includes situations in which one of the taxpayers was not a U.S. resident at the beginning of the tax year but was at the end of the year, and the other was not a U.S. resident at the end of the year.

If the taxpayer and their spouse do not choose to treat the nonresident spouse as a U.S. resident, they may be able to use head of household filing status. To use this status, the taxpayer must pay more than half the cost of maintaining a household for certain dependents or relatives other than the nonresident spouse.

If the taxpayer makes this choice, the following rules apply:

1. The taxpayer and their spouse are treated, for federal income tax purposes, as U.S residents for all tax years that the choice is in effect. However, for Social Security and Medicare tax withholding purposes, the nonresident spouse may still be treated as a nonresident.
2. The taxpayer must file a joint income tax return for the year they make the choice (but the taxpayer and their spouse can file joint or separate returns in later years).
3. Each spouse must report their entire worldwide income for the year they make the choice and for all later years unless the choice is ended or suspended.
4. Generally, neither the taxpayer nor their spouse can claim tax treaty benefits as a resident of a foreign country for a tax year for which the choice is in effect. However, the exception to the saving clause of a tax treaty might allow a tax treaty benefit on certain specified income.
5. Sandra has been a U.S. citizen for many years and is married to Luis, who is neither a U.S. citizen nor a U.S. resident. Sandra and Luis make the choice to treat Luis as a U.S. resident by attaching a statement to their joint return. Sandra and Luis must report their worldwide income for the year they make the choice and for all later years unless the choice is ended or suspended. Although Sandra and Luis must file a joint return for the year they make the choice, so long as one spouse is a U.S. citizen or a U.S. resident, they can file either joint or separate returns for later years.

The election is made by attaching a statement, signed by both spouses, to the joint return for the first tax year for which the choice applies. It should contain the following information:

1. A declaration that on the last day of the tax year one spouse was neither a U.S. citizen nor a U.S. resident and the other spouse was, and that the spouse chooses to be treated as U.S. resident for the entire tax year.
2. The name, address, and identification number of each spouse. (If one spouse died, include the name and address of the person making the choice for the deceased spouse.)

The choice to be treated as a U.S. resident does not apply to any later tax year if neither of the taxpayers or their spouse are a U.S. citizen or a U.S. resident at any time during the later tax year.

1. Daniela was a U.S. resident on December 31, 2020, and married Ernesto, who was neither a U.S. citizen nor a U.S. resident. They chose to treat Ernesto as a U.S. resident and filed a joint 2020 income tax return. Because Daniela left the United States on January 10, 2021, and did not return at all during the year, Daniela was not a U.S. resident for tax year 2021. Ernesto remained a nonresident for that year. Since neither Daniela nor Ernesto were a U.S. resident at any time during 2021, their choice to treat Ernesto as a U.S. resident is suspended for that year. For 2021, both are treated as nonresidents. If Daniela becomes a U.S. resident again in 2022, their choice to treat Ernesto as a U.S. resident is no longer suspended, and they must file either joint or separate income tax returns reporting their worldwide income for tax year 2022.

Once made, the choice to be treated as a U.S. resident for federal income tax and withholding purposes applies to all later years unless suspended (as explained above) or ended in one of the ways shown below:

1. Revocation by either spouse
2. Death of either spouse
3. Legal separation
4. Inadequate records

#### 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. A Social Security number (SSN) is issued by the SSA whereas all other TINs are issued by the IRS. Taxpayer identification numbers are:

1. Social Security Number "SSN".
2. Employer Identification Number "EIN".
3. Individual Taxpayer Identification Number "ITIN".
4. Taxpayer Identification Number for Pending U.S. Adoptions "ATIN".
5. Preparer Taxpayer Identification Number "PTIN".

An Employer Identification Number (EIN) is also known as a federal tax identification number and is used to identify a business entity. It is also used by estates and trusts which have income that is required to be reported on Form 1041, U.S. Income Tax Return for Estates and Trusts.

1. Individual Taxpayer Identification Number (ITIN)

An Individual Taxpayer Identification Number (ITIN) is a nine-digit number issued by the IRS to individuals who are required for federal tax purposes to have a U.S. taxpayer identification number but who don't have and aren't eligible to get a social security number (SSN).

An ITIN doesn't entitle the taxpayer to social security benefits, and doesn't change their immigration status or their right to work within the U.S.

Individuals filing tax returns using an ITIN aren't eligible for the earned income credit (EIC). Also, a child who has an ITIN can't be claimed as a qualifying child for purposes of the EIC, or Child Tax Credit, this latter for tax years 2018 through 2025. However, the taxpayer may be able to claim the credit for other dependents (ODC) for their child or other qualifying relatives (excluding spouses) who live in the United States if they obtain an ITIN by the due date of the taxpayer's U.S. federal tax return (including extensions) and meet certain other requirements. If an ITIN is applied for on or before the due date of a 2021 return (including extensions) and the IRS issues an ITIN as a result of the application, the IRS will consider the ITIN as issued on or before the due date of the return.

To obtain an ITIN, Form W-7 must be completed and submitted. Keep in mind that filing this form is not necessary for an individual who is already an SSN holder.

1. Eligibility to Obtain an ITIN

The following individuals are eligible to obtain an ITIN by completing Form W-7.

1. Any individual who isn’t eligible to get an SSN but who must furnish a taxpayer identification number for U.S. tax purposes or to file a U.S. federal tax return must apply for an ITIN on Form W-7. Examples include the following:
2. A nonresident alien individual claiming reduced withholding under an applicable income tax treaty for which an ITIN is required.
3. A nonresident alien individual not eligible for an SSN who is required to file a U.S. federal tax return or who is filing a U.S. federal tax return only to claim a refund.
4. A nonresident alien individual not eligible for an SSN who elects to file a joint U.S. federal tax return with a spouse who is a U.S. citizen or resident alien.
5. A U.S. resident alien (based on the number of days present in the United States, known as the “substantial presence” test) who files a U.S. federal tax return but who isn’t eligible for an SSN.
6. A nonresident alien student, professor, or researcher who is required to file a U.S. federal tax return but who isn’t eligible for an SSN, or who is claiming an exception to the tax return filing requirement.
7. An alien spouse claimed as an exemption on a U.S. federal tax return who isn’t eligible to get an SSN. A spouse can be claimed as an exemption only for tax years prior to 2018.
8. An alien individual eligible to be claimed as a dependent on a U.S. federal tax return but who isn’t eligible to get an SSN. Taxpayer’s spouse is never considered taxpayer’s dependent. Dependents can be claimed as exemptions only for tax years prior to 2018.
9. A dependent/spouse of a nonresident alien U.S. visa holder who isn’t eligible for an SSN. Dependents and spouses can be claimed as exemptions only for tax years prior to 2018.
10. Persons who must renew their ITIN to file a U.S. federal tax return.
11. Supporting Documentation Requirements

The taxpayer must provide certain documentation, all of which meet the following requirements:

1. The taxpayer submits documentation to establish their identity and connection to a foreign country ("foreign status"). Applicants claimed as dependents must also prove U.S. residency unless the applicant is from Canada or México or the applicant is a dependent of U.S. military personnel stationed overseas.
2. The taxpayer must submit original documents, or certified copies of these documents from the issuing agency, that support the information provided on Form W-7. A certified copy of a document is one that the original issuing agency provides and certifies as an exact copy of the original document and contains an official stamped seal from the agency. The taxpayer may be able to request a certified copy of documents at an embassy or consulate. However, services may vary between countries, so it's recommended for the taxpayer to contact the appropriate consulate or embassy for specific information. Original documents submitted by the taxpayer will be returned to them at the mailing address shown on their Form W-7.
3. The documentation the taxpayer provides must be current (that is, not expired).

There are 13 acceptable documents that can be used to establish either foreign status or identity. At least one document must contain taxpayer's photograph, unless they are a dependent under age 14 (18 if a student). The taxpayer may later be required by the IRS to provide a certified translation of foreign-language documents.

The 13 acceptable documents earlier mentioned are listed in the following chart:

|  |  |  |
| --- | --- | --- |
| **Supporting Documentation** | **Can be used to establish:** | |
| **Foreign status** | **Identity** |
| Passport (the only stand-alone document\*) |  |  |
| U.S. Citizen an Immigration Services (USCIS) photo identification |  |  |
| Visa issued by the U.S. Department of State |  |  |
| U.S. driver's license |  |  |
| U.S. military identification card |  |  |
| Foreign driver's license |  |  |
| Foreign military identification card |  |  |
| National identification card (must contain name, photograph, address, date of birth and expiration date) |  |  |
| U.S. state identification card |  |  |
| Foreign voter's registration card |  |  |
| Civil birth certificate | \*\* |  |
| Medical records (valid only for dependents under age 6) | \*\* |  |
| School records (valid only for a dependent under age 18, if a student) | \*\* |  |
| \* Applicants claimed as dependents who need to prove U.S. residency must provide additional original documentation if the passport doesn’t have a date of entry into the United States.  \*\* May be used to establish foreign status only if documents are foreign. | | |

If the taxpayer submits an original valid passport or a certified copy from the issuing agency, it is not needed to submit any other documents from the table, unless the passport is for a dependent and it doesn't include a date of entry into the United States.

**Proof of U.S. residency for applicants who are dependents:** A passport that doesn't have a date of entry won't be accepted as a stand-alone identification document for dependents, unless they are dependents of U.S military personnel stationed overseas. In these cases, applicants will be required to submit at least one of the following original documents in addition to the passport to prove U.S. residency.

1. If under 6 years of age: A U.S. medical record, school record, or U.S. state identification card that lists the applicant's name an U.S. address, or a U.S. visa.
2. If at least 6 years of age but under 18 years of age: A U.S. school record, U.S. state identification card, or driver's license that lists the applicant's name and U.S. address, or a U.S. visa.
3. If 18 years of age or older: A U.S. school record, rental statement from a U.S. property, utility bill for a U.S. property, or a bank statement, U.S. state identification card or driver's license that lists the applicant's name and U.S. address, or a U.S. visa.
4. Additional Documentation Requirements
5. **Civil birth certificate**: An original birth certificate is required if the applicant is under age 18 and hasn't provided a valid passport.
6. **Passports and national identification cards:** These documents will be considered current only if their expiration date hasn't passed prior to the date the Form W-7 submitted.
7. **Medical records:** Medical records will be accepted for dependents under 6 years of age. A medical record consists only of a shot/immunization record that documents the patient's name and chronological dates of the patient's medical history and care. The medical record must contain the child's name, date of birth, and verifiable address.
8. **School records:** School records will be accepted only if they are for a school term ending no more than 12 months from the date of the Form W-7 application. The school record must consist of an official report card or transcript issued by the school or the equivalent of a Ministry of Education. The school record must also be signed by a school official or ministry official. The record must be dated and contain the student's name, coursework with grades (unless under age 6), date of grading period(s) (unless under age 6) for a term ending no more than 12 months from the date of the Form W-7 application, and school name and address.

Review Questions

1. Regarding non-resident dual status aliens, which of the following applies?
2. The taxpayer can be both a non-resident alien and a resident alien in the same tax year.
3. A resident alien cannot be a non-resident alien.
4. A and B are correct.
5. None of the above.

|  |
| --- |
| **Answer: A** |
| The taxpayer can be both a non-resident alien and a resident alien during the same tax year. This usually occurs in the year he or she arrives or departs from the United States. If so, the taxpayer 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. |

1. Gabriel was physically present in the U.S on 120 days in each of the years 2019, 2020 and 2021. Does he meet the substantial presence test?
2. Yes, because he has been physically present for 360 days counting the current year and the prior two.
3. No, because he has been physically present for 180 days for the 3-year-period.
4. Yes, because he has been physically present for 31 days during the current year.
5. No, because he has been physically present for 120 days in the current year, below 150.

|  |
| --- |
| **Answer: B** |
| To meet this test, the taxpayer must be physically present in the United States on at least:   * 31 days during the current calendar year. * A total of 183 days during the current year and the 2 preceding years, counting all the days of physical presence in the current year, 1/3 of the first preceding year and 1/6 of the second preceding year.   For Gabriel, this computing is as follows: 120 + 40(1/3x120) + 20(1/6x120) = 180, which is below the 183-days-threshold. |

1. The Employer Identification Number (EIN) is applied in the following ways, with the exception of:
2. It is used to identify a business entity.
3. It is used by estates and trusts that must file Form 1041.
4. It is used for the purpose of identifying victims of identity theft.
5. A and B are correct.

|  |
| --- |
| **Answer: D** |
| An Employer Identification Number (EIN) is also known as a federal tax identification number and is used to identify a business entity. It is also used by estates and trusts which have income that is required to be reported on Form 1041, U.S. Income Tax Return for Estates and Trusts. |

1. Regarding the Green Card Test, which of the following is not true?
2. Resident aliens will hold an immigrant visa.
3. The taxpayer does not have to be present in U.S in any time during the year.
4. A and B are correct.
5. All of the above is not true.

|  |
| --- |
| **Answer: B** |
| The taxpayer is a U.S. resident if he or she was a lawful permanent resident of the U.S. at any time during the calendar year. This is known as the green card test, because resident aliens hold immigrant visas (also known as green cards). |

### Filing Requirements and Due Dates

#### 2021 Filing Requirements Thresholds Amounts

The income requirements to determine if a taxpayer should file a tax return are:

|  |  |  |
| --- | --- | --- |
| **Filing Status** | **Age** | **If gross income was at least:** |
| Single | Under 65 | $12,550 |
| 65 or older | $14,250 |
| Head of Household | Under 65 | $18,800 |
| 65 or older | $20,500 |
| Married Filing Jointly | Both under 65 | $25,100 |
| One is 65 or older | $26,450 |
| Both are 65 or older | $27,800 |
| Married Filing Separate | Any age | $5 |
| Qualifying Widower | Under 65 | $25,100 |
| 65 or older | $26,450 |

#### New Standard Deduction and Personal Exemption Amounts

For 2021 tax year the standard deduction amounts are as follows:

|  |  |
| --- | --- |
| **Filing Status** | **Standard Deduction** |
| Married Filing Jointly and Qualifying widow(er) | $25,100 |
| Head of household | $18,800 |
| Single | $12,550 |
| Married filing separately | $12,550 |

In 2021, the standard deduction amount for an individual who may be claimed as a dependent by another taxpayer cannot exceed the greater of:

1. $1,100, or
2. The sum of $350 and the individual's earned income.

For 2021 tax year the additional standard deduction amount for the aged or the blind is $1,350. The additional standard deduction amount is increased to $1,700 if the individual is also unmarried and not a surviving spouse.

**Personal Exemption:** For taxable years between 2018 and 2025, the personal exemption amount is reduced to $0.

#### Other Situations when the Taxpayer Must File

The taxpayer must file a return if any of the seven conditions below apply for 2021:

1. The taxpayer’s owe any special taxes, including any of the following:
   1. Alternative minimum tax.
   2. Additional tax on a qualified plan, including an individual retirement arrangement (IRA), or other tax-favored account.
   3. Household employment taxes.
   4. Social security and Medicare tax on tips the taxpayer didn't report to his or her employer.
   5. Write-in taxes, including uncollected social security and Medicare or RRTA tax on tips the taxpayer reported to his or her employer or on group-term life insurance and additional taxes on health savings accounts.
   6. Recapture taxes.
2. The taxpayer (or their spouse, if filing jointly) received health savings account, Archer MSA, or Medicare Advantage MSA distributions.
3. The taxpayer had net earnings from self-employment of at least $400.
4. The taxpayer had wages of $108.28 or more from a church or qualified church-controlled organization that is exempt from employer social security and Medicare taxes.
5. Advance payments of the premium tax credit were made for the taxpayer, their spouse, or a dependent who enrolled in coverage through the Marketplace.
6. Advance payments of the health coverage tax credit were made for the taxpayer, their spouse, or a dependent.
7. The taxpayer is required to include amounts in income under section 965 or he or she has a net tax liability under section 965 that he or she is paying in installments under section 965(h) or deferred by making an election under section 965(i).
8. Due Dates

The annual income tax return for individuals is due by the 15th day of the fourth month after the close of the tax year, usually April 15. 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 17. By law, Washington, D.C., holidays impact tax deadlines for everyone in the same way federal holidays do. For 2021, the due date is April 18, instead of April 15, because of the Emancipation Day holiday in the District of Columbia for everyone except taxpayers who live in Maine or Massachusetts. Taxpayers in Maine or Massachusetts has until April 19, 2022, to file their returns due to the Patriots' Day holiday in those states.

If the return is mailed, it must be placed in the mail and postmarked on or before the due date. The IRS encourages early filing. Generally, the earliest possible date is January 1, although few, if any, taxpayers are in a position to file that soon. Employees, for example, must wait for Form W-2 to be issued by the employer. The tax law allows the employer to prepare and issue the necessary Forms 1099 or W-2 for the previous year until January 31.

For taxpayers sending their 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 USPO.

1. Extensions

If the taxpayer is not able to file his or her Federal individual income tax return by the due date, he or she may be able to get an automatic 6-month extension of time to file. To do so, file Form 4868, Application for Automatic Extension of Time to File U.S. Individual Income Tax Return, by the due date for filing his or her calendar year return (usually April 15) or fiscal year return. The extension of time to file does not grant the taxpayer any extension to pay their taxes. Taxpayers requesting an extension will have until Monday, October 17, 2022, to file.

If the taxpayer is a U.S. citizen or resident alien residing overseas, or is in the military on duty outside the U.S., on the regular due date of his or her return, the taxpayer is allowed an automatic 2-month extension to file his or her return and pay any amount due without requesting an extension. For a calendar year return, the automatic 2-month extension is to June 15. If the taxpayer is unable to file the return by the automatic two-month extension date, he or she can request an additional extension to October 15 by filing Form 4868 before the automatic two-month extension date. However, any tax due payments made after June 15 will be subject to both interest charges and failure to pay penalties.

#### Payments

The IRS offers several payment options. The taxpayer can pay online, by phone, mobile device, cash (maximum $1,000 per day and per transaction), check, or money order. For payments by mail, the taxpayer must attach Form 1040-V and send it to the address shown on the form that applies to the taxpayer.

**Online Payment Agreement:** If the taxpayer can’t pay in full by the due date of their tax return, they can apply for an online monthly installment agreement at IRS.gov/Payments. Once the taxpayer completes the online process, he or she will receive immediate notification of whether their agreement has been approved. For payments through Direct Debit, also known as a Direct Debit Installment Agreement (DDIA), the fee is $31 (apply online) or $107 (apply by phone, mail or in-person). The user fee for a regular pay by check installment agreement is $225 or $149 if requested through the online tool.

1. Refunds

The IRS will send the taxpayer a refund if their pay more taxes than they owe. If the taxpayer wants the IRS to directly deposit the amount shown on line 35a of Form 1040 to their checking or savings account, including an IRA, at a bank or other financial institution (such as a mutual fund, brokerage firm, or credit union) in the United States, he or she must:

1. Complete lines 35b through 35d (if he or she wants their refund deposited to only one account), or
2. Check the box on line 35a and attach Form 8888 if he or she wants to split the direct deposit of their refund into more than one account or use all or part of their refund to buy paper series I savings bonds.

The taxpayer must enter on line 36 the amount, if any, of the overpayment on line 34 he or she wants applied to their 2022 estimated tax.

1. Interest and Penalties
2. Late payment penalty

This is usually ½% of any tax (other than estimated tax) not paid by de due date. It is charged for each month or part of a month the tax is unpaid. The maximum penalty is 25%. The tax will increase to 1% if the tax is not paid 10 days after a notice of intent to levy property. The late payment penalty will not be charged if the taxpayer can show reasonable cause for not paying on time; attach a statement to the return fully explaining the reason. Do not attach the statement to Form 4868. The taxpayer is considered to have reasonable cause for the period covered by this automatic extension if at least 90% of the previous tax liability is paid before the regular due date of the return through withholding, estimated tax payments, or payments made with Form 4868.

1. Late filing penalty

It is usually charged if the taxpayer’s return is filed after the due date (including extensions). The penalty is usually 5% of the amount due for each month or part of a month the return is late. The maximum penalty is 25%. If the taxpayer’s return is more than 60 days late, the minimum penalty is $435 or the balance of the tax due on the return, whichever is smaller. The taxpayer might not owe the penalty if he or she has a reasonable explanation for filing late; attach a statement fully explaining the reason, and do not attach it to Form 4868.

The IRS will charge the taxpayer interest on taxes not paid by the 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). Generally, interest charges are not abated; they continue to accrue until all assessed tax, penalties, and interest are paid in full.

A taxpayer that does not pay the additional tax due 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 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 credit or on which accuracy-related or fraud penalties are charged.

1. Frivolous return

In addition to any other penalties, the law imposes a penalty of $5,000 ($10,000 if MFJ) for filing a frivolous return, meaning 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. This penalty is added to any other penalty provided by law.

If there is any underpayment of tax on the return due to fraud, a penalty of 75% of the underpayment due to fraud will be added to the tax.

#### Form 1040 and Schedules

Most individuals only need to file Form 1040, but if an individual’s return is more complex, they will need to file one or more of the numbered schedules. Individuals who e-file their returns will not notice much of a difference, as the software to use will determine the schedules needed. For 2021, the taxpayer will use Form 1040 or, if he or she were born before January 2, 1957, she or she has the option to use Form 1040-SR.

1. **REMINDER:** Since 2019, Form 1040 was resized being now referred as “3/4-sized”. Schedules 4 and 5 were merged into Schedules 2 and 3 respectively. Schedule 6 has been discontinued; thus, this section was moved to page 2, Form 1040.

Below is a table determining which schedules the taxpayers need to complete and file, based on their circumstances.

|  |  |
| --- | --- |
| **If the taxpayer…** | **Use** |
| Has additional income such as capital gains, unemployment compensation or award winnings. | Schedule 1, Part I |
| Has deductions to claim, self-employment tax, or educator expenses. | Schedule 1, Part II |
| Owes AMT or needs to make excess advance premium tax credit repayments. | Schedule 2, Part I |
| Owes other taxes, for example the household employment taxes, the self-employment tax, additional tax on IRAs or other retirement plans that qualify and accounts that are tax-favored. | Schedule 2, Part II |
| Is able to claim a non-refundable credit that is not the child tax credit or credit for other dependents, for example the foreign tax credit, education credits or general business credit. | Schedule 3, Part I |
| Is able to claim a refundable credit that is not the earned income credit, American opportunity credit, or additional child tax credit, such as the net premium tax credit or health coverage tax credit. | Schedule 3, Part II |

1. Amended Returns

A taxpayer could file an amended return if they figured out an error in the originally filed return. A taxpayer should amend their return if, after the original return is filed, it is figured that:

1. The taxpayer did not report some income,
2. The taxpayer claimed deductions or credits that should not have been claimed,
3. The taxpayer did not claim deductions or credits that could have been claimed, or

The taxpayer should have claimed a different filing status. (Once a joint return is filed, a taxpayer cannot choose to file separate returns for that year after the due date of the return. However, an executor may be able to make this change for a deceased spouse).

Review Questions

1. In which of the following situations is it unnecessary to file a return?
2. A single taxpayer under age 65 with a gross income of $12,600.
3. Married taxpayers filing jointly, both under age 65, with a gross income of $25,200.
4. A single taxpayer that is age 70 with a gross income of $14,100.
5. A married taxpayer filing separately, 65 years old, with a gross income of $5,000.

|  |
| --- |
| **Answer: C** |
| If a single taxpayer is age 70, and has a gross income of $14,100, he does not need to file a return, since gross income needs to be at least $14,250 for that taxpayer to file a return. All other taxpayers must file a tax return, since they all surpass the gross income limit.   * Single taxpayers under age 65 with at least $12,550 in gross income must file a return. * Married taxpayers filing jointly, both under age 65, with a gross income of at least $25,100 must file a return. * A married taxpayer filing separately, of any age, with a gross income of over $5 must file a return. |

1. Which is the standard deduction amount for heads of households under the age of 65 for 2021?
2. $18,800.
3. $18,650.
4. $18,350.
5. $24,200.

|  |
| --- |
| **Answer: A** |
| For 2021, the standard deduction amount for taxpayers under 65 with the head of household filing status is of $18,800. |

1. Which of the following statements regarding extensions of time to file is correct?
2. An automatic 5-month extension can be obtained without submitting any forms.
3. The taxpayer must file Form 4868, prior to the expiration date of the original return, if he or she wants a 6-month extension to file.
4. The extension of time to file grant the Taxpayer an extension to pay their taxes.
5. All of the above statements are correct.

|  |
| --- |
| **Answer: B** |
| If the taxpayer is unable to file the federal individual income tax return before the due date, he or she can get an automatic 6-month extension of time by filing Form 4868 before the due date for filing the calendar year return (usually April 15). |

1. All of the following concerning extension of time to file are correct, except:
2. The taxpayer is allowed an automatic 2-month extension to file his or her return and pay any amount due without requesting an extension if he or she is an U.S. citizen or a resident alien living overseas.
3. For a calendar year return, the automatic 2-month extension is to June 15.
4. Any tax due payments made after June 15 will not be subject to neither of interest charges nor failure to pay penalties.
5. The taxpayer must file Form 4868 by the due date.

|  |
| --- |
| **Answer: C** |
| If the taxpayer is a U.S. citizen or resident alien residing overseas or is in the military on duty outside the U.S., on the regular due date of his or her return, the taxpayer is allowed an automatic 2-month extension to file his or her return and pay any amount due without requesting an extension. For a calendar year return, the automatic 2-month extension is to June 15. If the taxpayer is unable to file the return by the automatic two-month extension date, he or she can request an additional extension to October 15 by filing Form 4868 before the automatic two-month extension date. However, any tax due payments made after June 15 will be subject to both interest charges and failure-to-pay penalties. |

1. Under which circumstance would a self-employed taxpayer filing single and under age 65 have to file a tax return?
2. The taxpayer had gross income from self-employment of $300.
3. The taxpayer had gross income from self-employment of $420.
4. The taxpayer is a church employee and had gross income from self-employment of $100.
5. Both B and C.

|  |
| --- |
| **Answer: B** |
| Any self-employed individual whose net earnings exceed $400 is subject to SE tax, as well as church employees whose net earnings subject to SE tax are $108.28 and above. |

1. Regarding interest and penalties, the maximum late payment penalty is of:
2. 50%.
3. 30%.
4. 25%.
5. 40%.

|  |
| --- |
| **Answer: C** |
| The late payment penalty is usually ½ of 1% of any tax (other than estimated tax) not paid by April 15, 2022. It is charged for each month or part of a month the tax is unpaid. The maximum penalty is 25%. |

1. Which is the penalty for filing a frivolous return?
2. $1,000.
3. $545.
4. $250.
5. $5,000.

|  |
| --- |
| **Answer: D** |
| 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. |

### Taxpayer’s 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. The five filing statuses are:

#### Single (S)

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.

#### Married Filing Jointly (MFJ)

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 tax year, the determination will be made as of the time of death. An individual legally separated from his or her spouse under a decree of divorce or of separate maintenance is not considered as married.

The IRS gives joint filers one of the largest standard deductions each year. Additionally, married couples filing jointly qualify for multiple tax credits such as the Earned Income Tax Credit, the American Opportunity and Lifetime Learning Credits, the 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:

1. If the individuals are married as of the last day of the taxable year. A couple could be married at 11:59 p.m. on December 31 of the taxable year and still file a joint return for the entire year.
2. 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.
3. If the individuals are not divorced or legally separated before the end of the taxable year under a final decree.
4. If both spouses agree to file a joint return.
5. 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.
6. If the tax years of both spouses begin on the same date.

**Joint Responsibility:** Many married taxpayers choose to file a joint tax return because of certain benefits this filing status allows. Both taxpayers are jointly and individually responsible for the tax and any interest or penalty due on the joint return, even if they divorce at a later time. This is true even if a divorce decree states that a former spouse will be responsible for any amounts due on previously filed joint returns. One spouse may be held responsible for all the tax due.

In some cases, no matter how small the liability, 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.

There are three types of relief available:

1. Innocent spouse relief.
2. Separation of liability relief.
3. Equitable relief.

The taxpayer must file Form 8857, Request for Innocent Spouse Relief, to request relief from joint responsibility. There is more information available on this topic later in this book.

#### Married Taxpayers Filing Separately (MFS)

Married taxpayers have the option to choose this filing status, which might be beneficial if taxpayers want to be responsible only for their own tax or if it results in less tax than filing a joint return. One consideration that might lead a married person to file separately 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.

For taxpayers choosing the married filing separately filing status, the following special rules apply. Because of these, the taxpayer usually pays more tax on a separate return than if they use another filing status for which he or she qualifies:

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 they 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.
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 Credit and Lifetime Learning Credit), the deduction for student loan interest, or the tuition and fees deduction.
7. The taxpayer cannot exclude any interest income from qualified U.S. savings bonds they used for higher education expenses.
8. If the taxpayer lived with their spouse at any time during the tax year:
9. The taxpayer cannot claim the Credit for the Elderly or the Disabled.
10. 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.
11. The following credits are reduced in half of the income levels of a joint return:
12. The Child Tax Credit.
13. The Retirement Savings Contributions Credit.
14. The taxpayer’s capital loss deduction limit is $1,500 (instead of $3,000 on a joint return).
15. If the taxpayer’s spouse itemizes deductions, the taxpayer cannot claim the standard deduction. If the taxpayer can claim the standard deduction, taxpayer’s basic standard deduction is half the amount allowed on a joint return.

#### Head of Household (HOH)

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. **NOTE:** 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. But 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.
4. The taxpayer is unmarried. His or her mother, lived in a 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 dependent, the taxpayer can file as a head of household.

The taxpayer is considered unmarried on the last day of the tax year if he or she meets all the following tests:

1. The taxpayer files a separate return.
2. The taxpayer’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.

A taxpayer should include in the cost of keeping-up-a-home expenses such as rent, mortgage interest, real estate taxes, and 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.

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 Widow(er) With Dependent Child (QW)

Taxpayers with this filing status use the same tax tables and tax rate schedules as used by joint filers (up to 2 years after year of spouse’s death). Qualifying widow(er)s are those 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 may file as qualifying widow. For 2023 and later years, she is not a qualifying widow because her husband died earlier than the second preceding taxable year.

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

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 either the two years preceding the current tax year and the taxpayer did not remarry before the end of the current tax year.
3. The taxpayer has a child or stepchild for whom he or she can claim an exemption.
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.
6. Enrique's wife died in 2020. Enrique has not remarried. He has continued, during 2021 and 2022, to keep up a home for himself and his child, who lives with him. For 2020, he was entitled to file a joint return for himself and his deceased wife. For 2021 and 2022, he can file as a qualifying widower with a dependent child. After 2022, he can file as head of household if he qualifies.

#### Same Gender Marriage Filing Status

For federal tax purposes, the IRS has a general rule recognizing a marriage of same-sex individuals that was validly entered into in a domestic or foreign jurisdiction whose laws authorize the marriage of two individuals of the same sex even if the married couple resides in a domestic or foreign jurisdiction that does not recognize the validity of same-sex marriages.

A taxpayer’s same-sex spouse cannot be a dependent of the taxpayer. A same-sex spouse cannot file using head of household filing status. The Defense of Marriage Act (DOMA) is a United States federal lawthat allows states to refuse to recognizesame-sex marriagesgranted under the laws of other states.

#### Tax Rate Tables

For 2021 tax year the tax rate tables according to the filing status are:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Single** | | | | |
| **If the taxable income is** | | **Tax is** | **PLUS** | **Of the amount over** |
| **Over** | **But not over** |
| $0 | $9,950 | $0.00 | 10% | $0 |
| $9,950 | $40,525 | $995 | 12% | $9,950 |
| $40,525 | $86,375 | $4,664 | 22% | $40,525 |
| $86,375 | $164,925 | $14,751 | 24% | $86,375 |
| $164,925 | $209,425 | $33,603 | 32% | $164,925 |
| $209,425 | $523,600 | $47,843 | 35% | $209,425 |
| $523,600 | **AND OVER** | $157,804.25 | 37% | $523,600 |

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Married Filing Jointly and Qualified Widow(er)s** | | | | |
| **If the taxable income is** | | **Tax is** | **PLUS** | **Of the amount over** |
| **Over** | **But not over** |
| $0 | $19,900 | $0.00 | 10% | $0 |
| $19,900 | $81,050 | $1,990 | 12% | $19,900 |
| $81,050 | $172,750 | $9,328 | 22% | $81,050 |
| $172,750 | $329,850 | $29,502 | 24% | $172,750 |
| $329,850 | $418,850 | $67,206 | 32% | $329,850 |
| $418,850 | $628,300 | $95,686 | 35% | $418,850 |
| $628,300 | **AND OVER** | $168,993.50 | 37% | $628,300 |

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Married Filing Separately** | | | | |
| **If the taxable income is** | | **Tax is** | **PLUS** | **Of the amount over** |
| **Over** | **But not over** |
| $0 | $9,950 | $0.00 | 10% | $0 |
| $9,950 | $40,525 | $995 | 12% | $9,950 |
| $40,525 | $86,375 | $4,664 | 22% | $40,525 |
| $86,375 | $164,925 | $14,751 | 24% | $86,375 |
| $164,925 | $209,425 | $33,603 | 32% | $164,925 |
| $209,425 | $314,150 | $47,843 | 35% | $209,425 |
| $314,150 | **AND OVER** | $84,496.75 | 37% | $314,150 |

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Head of Household** | | | | |
| **If the taxable income is** | | **Tax is** | **PLUS** | **Of the amount over** |
| **Over** | **But not over** |
| $0 | $14,200 | $0.00 | 10% | $0 |
| $14,200 | $54,200 | $1,420 | 12% | $14,200 |
| $54,200 | $86,350 | $6,220 | 22% | $54,200 |
| $86,350 | $164,900 | $13,293 | 24% | $86,350 |
| $164,900 | $209,400 | $32,145 | 32% | $164,900 |
| $209,400 | $523,600 | $46,385 | 35% | $209,400 |
| $523,600 | **AND OVER** | $156,355 | 37% | $523,600 |

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Estates and Trusts** | | | | |
| **If the taxable income is** | | **Tax is** | **PLUS** | **Of the amount over** |
| **Over** | **But not over** |
| $0 | $2,650 | $0.00 | 10% | $0 |
| $2,650 | $9,550 | $265 | 24% | $2,650 |
| $9,550 | $13,050 | $1,921 | 35% | $9,550 |
| $13,050 | **AND OVER** | $3,146 | 37% | $13,050 |

Review Questions

1. Regarding the married filing jointly status, which of the following is a joint responsibility relief?
2. Equitable relief.
3. Innocent spouse relief.
4. Separation of liability relief.
5. All of the above.

|  |
| --- |
| **Answer: D** |
| There are three types of relief available:   * Innocent spouse relief. * Separation of liability relief. * Equitable relief. |

1. A married couple with no children lived apart for all of the year. On December 31, they were legally separated under a decree of separate maintenance. Based on the facts, which of the following is the only filing status choice available to them?
2. Married filing jointly.
3. Married filing separately.
4. Head of Household.
5. Single.

|  |
| --- |
| **Answer: D** |
| 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. |

1. Which of the following is the maximum tax rate for individuals in 2021?
2. 39%.
3. 42%.
4. 37%.
5. 32%.

|  |
| --- |
| **Answer: C** |
| For 2021, the maximum tax rate is of 37%. |

1. Which of the following is not a requirement a taxpayer must meet to claim the head of household filing status?
2. The taxpayer's spouse did not live in the same home with his or her spouse during the last 6 months of the tax year.
3. The taxpayer paid more than half of the cost of keeping up the home for the entire year.
4. The taxpayer's home was the main home of the taxpayer's dependent parent.
5. The taxpayer is unmarried or considered unmarried on the last day of the year.

|  |
| --- |
| **Answer: C** |
| To qualify as a head of household, a taxpayer must meet the following conditions:   * The taxpayer is unmarried or considered unmarried on the last day of the year. * The taxpayer paid more than half the cost of keeping up a home for the year. * 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. |

1. Which of the following is allowed for a taxpayer with the married filing separately status?
2. B and C are correct.
3. The taxpayer may take the EIC.
4. The taxpayer may exclude interest income from qualified U.S. saving bonds used for higher education expenses.
5. None of the above.

|  |
| --- |
| **Answer: D** |
| If the taxpayer chooses married filing separately as his or her filing status, the following rules apply, including, but not limited to:   * The taxpayer cannot take the Credit for Child and Dependent Care Expenses in most cases. * The taxpayer cannot take the Earned Income Credit. * The taxpayer cannot exclude any interest income from qualified U.S. savings bonds he or she used for higher education expenses. |

1. Which of the following is not a requirement that must be met in determining whether a taxpayer is considered unmarried for head of household filing status purposes?
2. An individual must file a separate return.
3. An individual must pay more than one-half the cost of keeping up a house for the tax year.
4. An individual's home must be, for the entire year, the main home of his child.
5. An individual spouse must not have lived in their home for the last six months of the tax year.

|  |
| --- |
| **Answer: C** |
| A taxpayer is considered unmarried on the last day of the tax year if he or she meets all the following tests:   * The taxpayer files a separate return. * The taxpayer paid more than half the cost of keeping up his or her home for the tax 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. * 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. * The taxpayer’s home was the main home of his or her child, stepchild, or foster child for more than half the year. |

1. A taxpayer is divorced from his wife since March 1st of the tax year. They have two minor children. One child lives with the taxpayer and the other child lives with the mother. The children have been with their respective parents from March through December of the tax year. The taxpayer provides all of the support for the minor child living with him. The filing status with the lowest rate that the taxpayer qualifies for is:
2. Married filing separately.
3. Single.
4. Head of Household.
5. Married filing jointly.

|  |
| --- |
| **Answer: C** |
| To qualify as a head of household, a taxpayer must meet the following conditions:   * The taxpayer is unmarried or considered unmarried on the last day of the year. * The taxpayer paid more than half the cost of keeping up a home for the year. * 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. |

1. A taxpayer was married with two dependent children. Her husband died in April and she did not remarry before the end of the year. Which filing status should the taxpayer use for her tax return?
2. Single.
3. Married filing jointly.
4. Head of Household.
5. Qualifying widow(er) with dependent child.

|  |
| --- |
| **Answer: B** |
| 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). |

1. A married couple lived apart beginning June 1. Their one minor child lived with her mother all year. The wife worked all year and provided more than half the cost of keeping up the home for herself and her minor child. The wife signed Form 8332, Release of Claim to Exemption for Child of Divorced or Separated Parents, allowing her husband to claim their child as a dependent on his separately filed return. The wife's proper filing status is:
2. Single.
3. Married filing jointly.
4. Married filing separately.
5. Head of household.

|  |
| --- |
| **Answer: D** |
| A custodial parent may be able to claim head of household filing status even if he or she released a claim to exemption for the child. |

1. Regarding same gender marriage, which of the following is allowed for a same-sex spouse?
2. To be a dependent of the taxpayer.
3. To file using the head of household status.
4. A and B.
5. None of the above.

|  |
| --- |
| **Answer: D** |
| A taxpayer’s same-sex spouse cannot be a dependent of the taxpayer. A same-sex spouse cannot file using head of household filing status. |

### Sources of All Worldwide Taxable and Non-taxable Income

Taxable Income Sources:

1. Wages, salaries, commissions, tips.
2. Interest, dividends, pensions, capital gains.
3. Business income (Schedule C), hobby income.
4. Rents, royalties, partnership income.
5. S-Corporation, estate or trust income.
6. Unemployment benefits, jury duty pay, gambling/lottery winnings.
7. Alimony (if under a divorce decree entered into before 2019).
8. Other items of income unless they are designated as non-taxable (e.g. certain Social Security benefits and retirement plan distributions/withdrawals).

Non-taxable Income Sources:

1. Alimony (if under a divorce decree entered into in 2019 and later years).
2. Child support.
3. Federal income tax refunds.
4. Gifts and inheritances.
5. Municipal bond interest.
6. Public assistance.
7. Workers' Compensation benefits.
8. Veteran's disability benefits.
9. Other non-taxable items (e.g. certain Social Security benefits and retirement plan distributions/withdrawals).

Example

Mr. and Mrs. Gomez received the following income during the current tax year:

1. $30,000 in W-2 wages income for Mrs. Gomez.
2. $2,000 in alimony for Mrs. Gomez, under a divorce decree entered into on January 6, 2020.
3. $5,000 in unemployment benefits received from a state sponsored plan paid to Mr. Gomez.
4. $7,000 in child support payments paid to Mrs. Gomez from her former spouse.

**How much income should be reported on their joint return?**

The amount of income to be reported on their joint return is $35,000 ($30,000 wages + $5,000 from Unemployment Benefits).

Unemployment compensation benefits were excluded from income up to $10,200 for each spouse for 2020 tax year only; that is to say, for unemployment benefits collected in 2021 tax year, no exemption amount is available. Neither alimony nor child support are taxable income to the recipient.

The IRS has a table on the source of income, depending on each type of income and indicates the factors that determine the sources:

|  |  |
| --- | --- |
| **Item of Income** | **Factor Determining Source** |
| Salaries, wages, other compensation | Where services performed |
| Business income: Personal services | Where services performed |
| Business income: Sale of inventory -purchased | Where sold |
| Business income: Sale of inventory -produced | Where produced (Allocation may be necessary) |
| Interest | Residence of payer |
| Dividends | Whether a U.S. or foreign corporation\* |
| Location of property | Location of property |
| Royalties: Natural resources | Location of property |
| Royalties: Patents, copyrights, etc. | Where property is used |
| Sale of real property | Location of property |
| Sale of personal property | Seller's tax home |
| Pensions | Where services were performed that earned the pension |
| Generally, the residence of the payer | Generally, the residence of the payer |
| Sale of natural resources | Allocation based on fair market value of product at export terminal. |

\*Exceptions include:

Part of a dividend paid by a foreign corporation is U.S. source if at least 25% of the corporation's gross income is effectively connected with a U.S. trade or business for the 3 tax years before the year in which the dividends are declared.

### Sources of Applicable Exclusions and Adjustments to Gross 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 non-cash income (such as a home or car) and allowances or reimbursements.

Foreign earned income doesn't include amounts that are actually a distribution of corporate earnings or profits rather than a reasonable allowance as compensation for the taxpayer’s personal services.

Foreign earned income also doesn't include the following types of income:

1. Pension and annuity income (including social security benefits and railroad retirement benefits treated as social security).
2. Interest, ordinary dividends, capital gains, alimony, etc.
3. Amounts paid to the taxpayer by the U.S. Government or any of its agencies if the taxpayer was an employee of the U.S. Government or any of its agencies.
4. Amounts received after the end of the tax year following the tax year in which the taxpayer performed the services.
5. Amounts the taxpayer must include in gross income because of their employer’s contributions to a nonexempt employees’ trust or to a nonqualified annuity contract

Example

Gabriela is a U.S. citizen, a bona fide resident of Canada, and working as a data scientist. 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. Her total income is $88,800. She works a 5-day week, Monday through Friday. After subtracting her vacation, she has a total of 240 workdays in the year. She worked in the United States during the year for 6 weeks (30 workdays). The following shows how Gabriela must figure the part of her income that is for work done in Canada during the year:

|  |  |
| --- | --- |
| Number of days worked in Canada during the year (210) | x Total Income ($88,800) = $77,700 |
| Number of days of work during the year for which the payment was made (240) |

Thus, Gabriela’s foreign source earned income is $77,700.

#### 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:

1. 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.
2. 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.
3. 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 IRC Section 911 is indexed to inflation. The exclusion amount is $108,700 for 2021. 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.

1. Other Exclusions and Adjustments to Gross Income

There is some other exclusions or adjustments to gross income such as retirement plans, HSAs, alimony paid, health insurance and self-employment tax. These topics will be detailed in later chapters.

Review Questions

1. For 2021, which is the maximum amount of the foreign earned income exclusion under Section 911 of the IRC?
2. $118,400.
3. $105,900.
4. $108,700.
5. $107,600.

|  |
| --- |
| **Answer: C** |
| The maximum amount of the Foreign Earned Income Exclusion under Internal Revenue Code (IRC) section 911 is $108,700 for 2021. |

1. Which of the following items is an adjustment to income for Luisa in 2021?
2. Expenses of her business.
3. Her federal taxes paid in 2020.
4. A and B are correct.
5. Contribution to an IRA Account.

|  |
| --- |
| **Answer: D** |
| There is some other exclusions or adjustments to gross income such as retirement plans, HSAs, alimony paid, health insurance and self-employment tax. These topics will be detailed in later chapters. |

1. Which of the following qualify as taxable income sources for an individual taxpayer?
2. Veteran's disability benefits.
3. Public assistance.
4. Royalties.
5. Municipal bond interest.

|  |
| --- |
| **Answer: C** |
| Rents, royalties and partnership income all count as taxable income sources. Some of non-taxable income sources include child support, gift and inheritances, public assistance, veteran’s disability benefits, municipal bond interest, among others. |

1. Rebeca worked for 6 months in Germany and earned foreign income. She is a U.S. citizen and lives in Miami. She did not receive any support for her income of Germany. Which of the following is true?
2. Rebeca can exclude that income because she does not have any support that prove it.
3. Rebeca has to report that income in her tax return.
4. Rebeca can exclude that income because it was not for the entire year.
5. All of the above are false.

|  |
| --- |
| **Answer: B** |
| 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 non-cash income (such as a home or car) and allowances or reimbursements. |

### Sources of Applicable Deductions

A deduction is another tax benefit that can reduce the amount of income returns significantly. The term simply is a short form of itemized deductions. There are different types of deductions, but itemized deductions and standard deduction are the main ones. Itemized deductions are only taken when the total deductions are greater than the standard deduction. The only taxpayer that is allowed to itemize is the one that can meet this requirement.

The most commonly itemized deduction is interest on a home mortgage loan. All other individuals can claim a standard deduction that is available to all. After total deduction that includes interest expenses, charitable contributions, medical expenses and local taxes are subtracted from the adjusted gross income, the taxable income is arrived at. This simply means that amount of income tax that will be paid will smaller.

### Qualification for Dependency

1. Qualifying Child

Five tests must be met for a child to be the taxpayer’s qualifying child, as follows:

**Relationship Test:** To meet the relationship test, a child must be:

1. Son or daughter of the taxpayer, stepson or stepdaughter, or a descendant of any of these (example: grandchild), or
2. The taxpayer’s brother, sister, half-brother, half-sister, stepbrother, stepsister, or a descendant (example: 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.

**Age Test:** To meet the age test, a child must be:

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

**Residency Test:** 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. 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.

**Support Test:** 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.

**Joint Return Test:** 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. In certain circumstances, the taxpayer does not have to claim the child as a dependent to qualify for head of household filing status. For example, a custodial parent may be able to claim head of household filing status even if he or she released a claim to exemption for the child.

A qualifying child must also meet these tests:

1. Nationality: Be a U.S. citizen or national, or a resident of the U.S., Canada or Mexico. There is an exception for certain adopted children.
2. Marital status: If married, did not file a joint return for that year, unless the return is filed only as a claim for refund and no tax liability would exist for either spouse if they had filed separate returns.
3. Qualifying Relative

Unlike a qualifying child, a qualifying relative can be any age. There is no age test for a qualifying relative. Four tests must be met for a person to be the taxpayer’s qualifying relative:

**Not a Qualifying Child Test:** 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.

**Member of Household or Relationship Test:** To meet the member of household or relationship test, a person must either:

1. Live with the taxpayer all year as a member of his or her household.
2. 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.

**Gross Income Test:** To meet the gross income test, a person's gross income for the year must be less than $4,300 for 2021 tax year.

**Support Test:** 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.

1. Relatives Who Do Not Live with the Taxpayer

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:

1. 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).
2. The taxpayer’s brother, sister, half-brother, half-sister, stepbrother, or stepsister.
3. The taxpayer’s father, mother, grandparent, or other direct ancestor, but not foster parent.
4. The taxpayer’s stepfather or stepmother.
5. A son or daughter of the taxpayer’s brother or sister.
6. A son or daughter of the taxpayer’s half-brother or half-sister.
7. A brother or sister of the taxpayer’s father or mother.
8. The taxpayer’s son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law.

Any of these relationships that were established by marriage aren't ended by death or divorce. For more information see the Publication 501.

1. Multiple Support Agreements

The rules for multiple support agreements apply to claiming an exemption for a qualifying relative and don't apply to claiming an exemption for a qualifying child.

Taxpayers use Form 2120 when they want to claim a relative as a dependent on their tax return, but they don’t pay enough of the cost of supporting that relative to do so under normal tax rules. If other people who contribute to the cost of caring for that relative agree, the taxpayer may be able to claim the dependent.

To claim someone as a dependent the taxpayer must have paid at least 10% of the costs of support. Further, no single person listed on the form can have paid more than 50% of the cost of support. Everyone who contributes at least 10% of the cost of care for the dependent must give the taxpayer a signed statement giving up any right to claim the person as a dependent. On the form 2120, the taxpayer must identify all of these people by name, address and Social Security number.

The taxpayer must attach Form 2120 to their return, but they do not have to include the signed statements.

For the 2021 tax year, a dependent must file a return if any of the following apply:

1. Single Dependent:
2. Unearned income was more than $1,100 ($2,800 if age 65 or older OR blind; $4,500 if age 65 or older AND blind).
3. Earned income was more than $12,550 ($14,250 if age 65 or older OR blind; $15,950 if age 65 or older AND blind).
4. Gross income was more than the larger of:
5. $1,100 ($2,800 if age 65 or older OR blind; $4,500 if age 65 or older AND blind), or
6. Earned income (up to $12,200) plus $350 ($2,050 if age 65 or older OR blind; $3,750 if age 65 or older AND blind).
7. Married dependents:
8. Unearned income was $1,100 ($2,450 if age 65 or older OR blind; $3,800 if age 65 or older AND blind).
9. Earned income was more than $12,550 ($13,900 if age 65 or older OR blind; $15,250 if age 65 or older AND blind).
10. Gross income was at least $5.
11. One of the spouses files separately and itemizes deductions.
12. Gross income was more than the larger of:
13. $1,100 ($2,450 if age 65 or older OR blind; $3,800 if age 65 or older AND blind) or,
14. Earned income (up to $12,200) plus $350 ($1,700 if age 65 or older OR blind; $3,050 if age 65 or older AND blind).

### Sources of Applicable Credits

The following are all sources of applicable credit:

1. Child and dependent care.
2. Child tax credit and other dependents credit.
3. Education.
4. Foreign tax.
5. Earned income tax.
6. Retirement contributions.
7. Adoption.
8. ACA Net Premium tax.
9. Health coverage.
10. General business.

Detailed information on each topic is discussed in Chapter 3, Module: *Credits*.

Review Questions

1. Which of the following is a source of applicable credit?
2. Personal residence sale.
3. Education.
4. A and B are correct.
5. None of the above.

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| **Answer: B** |
| The following are all sources of applicable credit: Child and dependent care, Child tax credit and other dependents, Education, Foreign tax, Earned income tax, Retirement contributions, Adoption, ACA Net Premium tax, Health coverage and General business. |

1. There are five tests which must be met for a child to be a qualifying child. Which of the following is not one of them?
2. Residency Test.
3. Relationship Test.
4. Gross Income Test.
5. Support Test.

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| **Answer: C** |
| Five tests must be met for a child to be the taxpayer’s qualifying child, as follows:   * Relationship Test. * Age Test. * Residency Test * Support Test. * Joint Return Test. |

1. In order to pass the gross income test for an individual to qualify as a relative, which is the limit that must not be exceeded?
2. $4,200.
3. $6,500.
4. $4,300.
5. $6,600.

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| **Answer: C** |
| To meet the gross income test, a person's gross income for the 2021 tax year must be less than $4,300. |

1. A taxpayer, under age 65, who can be claimed as a dependent on another person's tax return must file a tax return if he or she has unearned income of more than:
2. $950.
3. $1,100.
4. $4,150.
5. $12,000.

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| **Answer: B** |
| For the 2021 tax year, a dependent must file a return if any of the following apply:  Single Dependent:   * Unearned income was more than $1,100 ($2,800 if age 65 or older OR blind).   Married dependents:   * Unearned income was $1,100 ($2,450 if age 65 or older OR blind). |

1. Which of the following taxpayers, that are able to be claimed as a dependent, is required to file a tax return?
2. A dependent taxpayer, blind and age 25, filing status single, unearned income of $2,400.
3. A dependent taxpayer, age 66, filing status single, unearned income of $1,800.
4. A dependent taxpayer, age 69 and blind, filing status married, earned income of $13,000.
5. A dependent taxpayer, age 20, filing status single, earned income of $12,600.

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| **Answer: D** |
| For the 2021 tax year, a dependent must file a return if any of the following apply:  Single Dependent:   * Unearned income was more than $1,100 ($2,800 if age 65 or older OR blind). * Earned income was more than $12,550 ($14,250 if age 65 or older OR blind; $15,950 if age 65 or older AND blind).   Married dependents:   * Unearned income was $1,100 ($2,450 if age 65 or older OR blind). * Earned income was more than $12,550 ($13,900 if age 65 or older OR blind). |

1. Maria is a single dependent; she earns $3,800 in wages, has $200 in dividends, and has no income tax withheld. Which of the following statements is correct with respect to her being required to file a tax return for 2021?
2. Maria is not required to file a tax return.
3. Maria has to file a tax return because her unearned income is above the threshold.
4. Maria has to file a tax return because her earned income is above the threshold.
5. None of the above are correct.

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| **Answer: A** |
| For the 2021 tax year, a dependent must file a return if any of the following apply:  Single Dependent:   * Unearned income was more than $1,100 ($2,800 if age 65 or older OR blind). * Earned income was more than $12,550 ($14,250 if age 65 or older OR blind; $15,950 if age 65 or older AND blind). |

1. Which of the following sources can be used to establish the amount of itemized deductions of Gabriela?
2. Financial account statements.
3. Cash receipts.
4. Medical bills.
5. All of the above can be used.

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| **Answer: A** |
| The most commonly itemized deduction is interest on a home mortgage loan. All other individuals can claim a standard deduction that is available to all. After total deduction that includes interest expenses, charitable contributions, medical expenses and local taxes are subtracted from the adjusted gross income, the taxable income is arrived at. |

### Sources of Tax Payments and Refundable Credits

#### Tax Withholding for Individuals

If the taxpayer is an employee, his or her employer will probably withhold income tax from taxpayer’s paycheck and pay it to the IRS on behalf of the taxpayer.

If the taxpayer doesn’t pay his or her taxes through withholding, or doesn’t pay enough tax that way, he or she has to pay estimated tax (discussed later). People who are self-employed generally pay their tax this way.

#### When to Check Withholding

1. Early in the year.
2. When the tax law changes.
3. When the taxpayer has life changes:
4. Lifestyle - Marriage, divorce, birth or adoption of a child, home purchase, retirement, filing chapter 11 bankruptcy.
5. Wage income – The taxpayer and spouse start or stop working or start or stop a second job.
6. Taxable income not subject to withholding - Interest income, dividends, capital gains, self-employment income, IRA (including certain Roth IRA) distributions.
7. Adjustments to income - IRA deduction, student loan interest deduction, alimony expense.
8. Itemized deductions or tax credits - Medical expenses, taxes, interest expense, gifts to charity, dependent care expenses, education credit, child tax credit, earned income credit.

#### Payments subject to withholding

General payments subject to withholding are:

1. Taxpayer’s regular pay, commissions and vacation pay.
2. Reimbursements and other expense allowances paid under a non-accountable plan.
3. Pensions, bonuses, commissions, gambling winnings and certain other income.

For individuals, the following types of income are then subject to withholding:

1. Salaries and wages
2. Tips
3. Taxable fringe benefits
4. Sick pay
5. Pensions and annuities
6. Gambling winnings
7. Unemployment compensation
8. Certain federal payments

#### Estimated Tax

Estimated tax is the method used to pay tax on income that isn’t subject to withholding. This includes income from self-employment, interest, dividends, rent, gains from the sale of assets, prizes, and awards. The taxpayer also may have to pay estimated tax if the amount of income tax being withheld from his or her salary, pension, or other income isn’t enough.

Estimated tax is used to pay both income tax and self-employment tax, as well as other taxes and amounts reported on the taxpayer’s tax return. If the taxpayer does not pay enough tax, either through withholding or estimated tax, or a combination of both, he or she may have to pay a penalty. If the taxpayer does not pay enough by the due date of each payment period, he or she may be charged a penalty even if he or she is due a refund when he or she files his or her tax return.

1. Who Must Pay Estimated Tax?

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

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 and refundable credits to be less than the smaller of:
3. 90% of the tax to be shown on the taxpayer’s 2021 tax return.
4. 100% of the tax shown on the taxpayer’s 2020 tax return. The 2020 tax return must cover all 12 months.

**NOTE:** The percentages just listed above may be different if the taxpayer is a farmer, fisherman or higher income taxpayer. If all taxpayer’s income will be subject to income tax withholding, he or she probably won’t need to pay estimated tax.

**Farmers and Fishermen:** If at least two-thirds of the taxpayer’s gross income for 2020 or 2021 is from farming or fishing, 66⅔% is applied instead of 90% in the first point above.

**Higher Income Taxpayers:** If the taxpayer’s AGI for 2020 was more than $150,000 ($75,000 if filing status for 2020 is married filing a separate return), 110% is applied instead of 100% in the second point above.

1. When to Pay Estimated Tax

For estimated tax purposes, the year is divided into four payment periods. Each period has a specific payment due date. If the taxpayer doesn’t 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 filing income tax return.

If a payment is mailed, the date of the U.S. postmark is considered the date of payment. The general payment periods and due dates for estimated tax payments are shown next.

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| 1. **For the period:** | 1. **Due date:** |
| 1. January 1 – March 31 | 1. April 15 |
| 1. April 1 – May 31 | 1. June 15 |
| 1. June 1 – August 31 | 1. September 15 |
| 1. September 1 – December 31 | 1. January 15, next year |

If the due date for an estimated tax payment falls on a Saturday, Sunday, or legal holiday, the payment will be on time if the taxpayer makes it on the next day that isn’t a Saturday, Sunday, or a holiday.

If a taxpayer filed their 2021 Form 1040 by January 31, 2022, and paid the rest of the tax owed, then there is no need to make the payment due on January 18, 2022.

#### Earned Income Tax Credit (EITC)

The Earned Income Tax Credit, EITC or EIC, 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 are not required to file. EITC reduces the amount of tax the taxpayer owes and may be given a refund. Detailed information on this topic is available in Chapter 3, Module: *Credits*.

Review Questions

1. Christopher is a single individual. Which of the following circumstances would require him to verify his withholding?
2. He is self-employed, doing very well.
3. He bought a house in Los Angeles a month ago.
4. He broke up with his girlfriend.
5. All of the above.

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| **Answer: B** |
| The IRS recommends everyone to check withholding. However, the following circumstances are mandatory for everyone to check withholding:   * Early in the year. * When the tax law changes. * When the taxpayer has life changes as Marriage, divorce, birth or adoption of a child, home purchase, retirement, filing chapter 11 bankruptcy. |

1. Regarding estimated tax, which of the following is not true?
2. If the taxpayer does not pay enough tax, he may have to pay a penalty.
3. Estimated tax are used only to pay income tax.
4. A and B are correct.
5. None of the above are true.

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| **Answer: B** |
| Estimated tax is used to pay both income tax and self-employment tax, as well as other taxes and amounts reported on the taxpayer’s tax return. If the taxpayer does not pay enough tax, either through withholding or estimated tax, or a combination of both, he or she may have to pay a penalty. If the taxpayer does not pay enough by the due date of each payment period, he or she may be charged a penalty even if he or she is due a refund when he or she files his or her tax return. |

1. Julia had a $2,000 tax liability for 2020. In 2021, she expects to owe at least $1,500 in taxes and she has not withheld income tax for the year. What Julia should do?
2. She does not have to make estimated payments.
3. She has to make estimated taxes in 2021 because her withholding is less than 90% of her tax in 2020.
4. She has to write a letter to the IRS to be able to make estimated tax.
5. Julia should do C and B.

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| **Answer: B** |
| In most cases, the taxpayer must pay estimated tax for 2021 if both of the following apply:   * The taxpayer expects to owe at least $1,000 in tax for 2021, after subtracting his or her withholding and refundable credits. * The taxpayer expects his or her withholding and refundable credits to be less than the smaller of:   + 90% of the tax to be shown on the taxpayer’s 2020 tax return.   + 100% of the tax shown on the taxpayer’s 2020 tax return. The 2020 tax return must cover all 12 months. |

1. On which of the following dates must an individual taxpayer pay estimated taxes?
2. April 15, June 15, September 15 and March 15 of the following year.
3. April 15, June 15, September 15 and January 15 of the following year.
4. January 15, February15, March 15 and April 15.
5. None of the above.

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| **Answer: B** |
| The general payment periods and due dates for estimated tax payments for individual taxpayers are April 15, June 15, September 15 and January 15 of the following year. |

### Previous IRS Correspondence with the Taxpayer

The notice or letter from the IRS will explain why the taxpayer was contacted and will provide him or her instructions to proceed. In case of the taxpayer agreeing with the information given by the IRS, he or she has no need to contact the IRS. The IRS sends notices and letter for the reasons that follow:

1. The taxpayer has a balance due.
2. The taxpayer is due a larger or smaller refund.
3. The IRS has a question about the taxpayer’s tax return.
4. The IRS needs to verify the taxpayer’s identity.
5. The IRS requests additional information.
6. The IRS changed the taxpayer’s return.
7. The IRS needs to notify the taxpayer of delays in processing his or her return.

Afterwards, the taxpayer needs to read each notice or letter thoroughly and carefully. If the IRS changed his or her return, it is important that the taxpayer compares the information given in the notice or letter with the information in the tax return.

If the notice or letter requires a response by a specific date, it is recommended that the taxpayer complies with such in order to minimize additional interest and penalty charges, or to preserve his or her appeal rights if the taxpayer disagrees with the information given.

If the IRS requires that the taxpayer pays an amount of money, it is better that he or she does. Lastly, along with the tax records, the taxpayer should keep a copy of all notices or letters.

### Additional Required Returns Filed, and Taxes Paid

#### Employment

Employers must deposit and report employment taxes. Forms used for this purpose are as follows:

1. Form 940, Employer’s Annual Federal Unemployment (FUTA) Tax Return.
2. Form 943, Employer's Annual Federal Tax Return for Agricultural Employees.
3. Form 944, Employer’s Annual Federal Tax Return.
4. Form 945, Annual Return of Withheld Federal Income Tax.
5. Copy A of all paper Forms W-2, Wage and Tax Statement, with Form W-3, Transmittal of Wage and Tax Statements. Electronic Forms W-2 filing is permitted.
6. Copy A of paper, Form 1099, Miscellaneous Income, with Form 1096, Annual Summary and Transmittal of U.S. Information Returns. Electronic forms 1099, Miscellaneous Income is permitted.

Form W-2, Wage and Tax Statement to report wages, tips and other compensation paid to an employee, must be prepared by the end of the year. The taxpayer may use Form W-3, Transmittal of Wage and Tax Statements to transmit Forms W-2 to the Social Security Administration.

**Federal Income Tax:** Employers generally must withhold federal income tax from employees' wages. To figure out how much tax to withhold, the employee’s Form W-4 (submitted by the employee) and withholding tables described in Publication 15, Employer's Tax Guide, must be used.

1. The taxpayer must deposit his or her withholdings. The requirements for depositing, as explained in Publication 15, vary based on the taxpayer’s business and the amount he or she withholds.

**Social Security and Medicare Taxes:** Employers generally must withhold part of social security and Medicare taxes from employees' wages and the taxpayer pays a matching amount himself. To figure out how much tax to withhold, Form W-4 and the methods described in Publication 15, Employer's Tax Guide and Publication 15-A, Employer's Supplemental Tax Guide, are used. The taxpayer must deposit the wages he or she withholds.

**Additional Medicare Tax:** Employers are responsible for withholding the 0.9% Additional Medicare Tax on an employee's wages and compensation that exceeds a threshold amount based on the employee’s filing status. The taxpayer is required to begin withholding Additional Medicare Tax in the pay period in which it pays wages and compensation in excess of the threshold amount to an employee. There is no employer match for the Additional Medicare Tax. More detailed information is available in topic “Additional Medicare Tax”, of Chapter 4, Module: Taxation.

**Federal Unemployment (FUTA) Tax:** Employers report and pay FUTA tax separately from Federal Income tax, and social security and Medicare taxes. The taxpayer pays FUTA tax only from his/her own funds. Employees do not pay this tax or have it withheld from their pay.

**Self-Employment Tax:** Self-Employment Tax (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 employees. More detailed information is available in topic “Self-Employment Tax” of Chapter 4, Module: Taxation.

1. Deposit Due Dates

Generally, the employer must deposit federal income tax withheld and both the employer and employee social security and Medicare taxes.

There are two deposit schedules, monthly and semi-weekly. Before the beginning of each calendar year, the employer must determine which of the two deposit schedules he or she is required to use. The deposit schedule the employer must use is based on the total tax liability he or she reported on Form 941 during a “special rules” for Forms 944 and 945. Schedules for depositing and reporting taxes are not the same.

The employer must use electronic funds transfer (EFTPS) to make all federal tax deposits.

**Monthly Depositor:** Under the monthly deposit schedule, the employer must deposit employment taxes on payments made during a month by the 15th day of the following month. Employers who deposit monthly should only report their deposits quarterly or annually by filing Form 941 or Form 944.

**Semi-weekly Depositor**: Under the semiweekly deposit schedule, the employer must deposit employment taxes for payments made on Wednesday, Thursday, and/or Friday by the following Wednesday. Taxes for payments made on Saturday, Sunday, Monday, and/or Tuesday must be deposited by the following Friday. The employer reports his or her deposits quarterly or annually only by filing Form 941 or Form 944.

**FUTA Deposits:** The employer must deposit FUTA tax by the last day of the first month that follows the end of the quarter. If the due date for making the deposit falls on a Saturday, Sunday, or legal holiday, the employer may deposit on the next business day.

If employer’s liability for the fourth quarter (plus any undeposited amount from any earlier quarter) is over $500, he or she must deposit the entire amount by the due date of Form 940 (January 31). If it is $500 or less, the employer can make a deposit, pay the tax with a credit or debit card, or pay the tax with his or her Form 940 by January 31.

#### Gifts

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. If the taxpayer sells something at less than its full value or if the taxpayer makes an interest-free or reduced-interest loan, he or she may be making a gift.

More detailed information on this topic is available under the Module: “Gift Tax” from Chapter 5.

#### Information Returns

Any person engaged in a trade or business, including a corporation, partnership, individual, estate, and trust, who makes reportable transactions during the calendar year must file information returns to report those transactions to the IRS. Persons required to file information returns to the IRS must also furnish statements to the other party to the transaction, such as recipients of income. Filers who have 250 or more returns must file them electronically. The requirement to file information returns is mandated by the Internal Revenue Code and associated regulations.

The most common forms are 1097, 1098, 1099, 3921, 3922, 5498, and W-2G. However, it is not a complete list of all reportable payments and the absence of a payment from these forms does not mean that the payment is not reportable.

Review Questions

1. In which of the following situations will the IRS send a notice?
2. The taxpayer has a balance due.
3. The IRS changed the taxpayer's return.
4. The IRS requests additional information.
5. All of the above.

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| **Answer: D** |
| The IRS sends notices and letter for the following reasons:   * The taxpayer has a balance due. * The taxpayer is due a larger or smaller refund. * The IRS has a question about the taxpayer's tax return. * The IRS needs to verify the taxpayer's identity. * The IRS requests additional information. * The IRS changed the taxpayer's return. |

1. Bernardo works as a civil engineer for "C.T. Solutions", an enterprise whose owner is Ricardo. Which of the following is true?
2. Bernardo has to file Form W-2 to report wages and compensation paid to him, and Ricardo must file Form W-4 to report withholding.
3. Bernardo has to file Form W-2 to report wages and compensations paid to him, and send Form W-4 to Ricardo in order for him to figure out Bernardo's withholding.
4. Ricardo has to file Form W-2 to report wages and compensation paid to Bernardo, and Bernardo must send Form W-4 to Ricardo in order for him to figure out Bernardo's withholding.
5. A and C are correct.

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| **Answer: C** |
| Employers must deposit and report employment taxes. Form W-2, Wage and Tax Statement is required to report wages, tips and other compensation paid to an employee, must be prepared by the end of the year. Employers generally must withhold federal income tax from employees' wages. To figure out how much tax to withhold, employee’s Form W-4 must be submitted by the employee. |

### Special Filing Requirements

#### Form 1040NR

An alien is any individual who is not a U.S. citizen or U.S. national. A non-resident alien is an alien who has not passed the green card test or the substantial presence test. A non-resident alien individual engaged or considered to be engaged in a trade or business in the United States during the year is to file Form 1040NR. However, if his or her only U.S. source income is in wages in an amount less than the personal exemption, the taxpayer is not required to file.

#### Presidentially Declared Disaster Areas

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.

1. 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.

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 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.

1. Casualty Losses

Generally, the taxpayer may deduct casualty and theft losses relating to their home, household items, and vehicles on their federal income tax return if the loss is caused by a federally declared disaster. The taxpayer may not deduct casualty and theft losses covered by insurance, unless they file a timely claim for reimbursement and they reduce the loss by the amount of any reimbursement or expected reimbursement.

A casualty loss can result from the damage, destruction, or loss of the taxpayer’s property from any sudden, unexpected, or unusual event such as a flood, hurricane, tornado, fire, earthquake, or volcanic eruption. A casualty doesn't include normal wear and tear or progressive deterioration.

There are three types of casualty losses, federal casualty losses, disaster losses and qualified disaster losses. All three types of losses are referred to as federally declared disasters, but the requirements for each loss vary.

If the taxpayer’s property is personal-use property or isn't completely destroyed, the amount of their casualty loss is the lesser of:

1. The adjusted basis of your property, or
2. The decrease in fair market value of your property as a result of the casualty.

If the taxpayer’s property is business or income-producing property, such as rental property, and is completely destroyed, then the amount of the taxpayer’s loss is their adjusted basis.

When the amount the taxpayer receives from the insurance or other reimbursements is more than the cost or adjusted basis of the property the taxpayer will typically, subject to a few exceptions for items like inventory, have a capital gain. The taxpayer must ordinarily include the gain in their income, unless they are eligible to exclude or postpone reporting the capital gain. If the taxpayer has a personal casualty capital gain for the tax year, they may be able to deduct the portion of the personal casualty loss not attributed to a federally declared disaster area to the extent the loss doesn't exceed the personal capital gain. For more information, refer to Publication 547.

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.

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.

Individuals may claim their casualty and theft losses as an itemized deduction on Schedule A (Form 1040), Itemized Deductions (or Schedule A (Form 1040-NR), if they are a nonresident alien). For property held by the taxpayer for personal use, they must subtract $100 from each casualty or theft event that occurred during the year after they have subtracted any salvage value and any insurance or other reimbursement. Then add up all those amounts and subtract 10% of their adjusted gross income from that total to calculate their allowable casualty and theft losses for the year.

If the taxpayer has a qualified disaster loss, they may elect to deduct the loss without itemizing their deductions. The taxpayer’s net casualty loss doesn't need to exceed 10% of their adjusted gross income to qualify for the deduction, but the taxpayer would reduce each casualty loss by $500 after any salvage value and any other reimbursement. For more information, see the Instructions for Schedule A (Form 1040) or Instructions for Form 1040-NR.

Report casualty and theft losses on Form 4684, Casualties and Thefts. Use Section A for personal-use property and Section B for business or income-producing property.

Casualty losses are deductible in the year the taxpayer sustain the loss, which is generally in the year the casualty occurred. The taxpayer has not sustained a loss if they have a reasonable prospect of recovery through a claim for reimbursement. If the taxpayer has a casualty loss from a federally declared disaster that occurred in an area warranting public or individual assistance (or both), they can choose to treat the casualty loss as having occurred in the year immediately preceding the tax year in which the taxpayer sustained the disaster loss, and they can deduct the loss on their return or amended return for that preceding tax year.

Theft losses are generally deductible in the year the taxpayer discovers the property was stolen unless they have a reasonable prospect of recovery through a claim for reimbursement. In that case, no deduction is available until the taxable year in which the taxpayer can determine with reasonable certainty whether or not they will receive such reimbursement.

#### Injured Spouse

When spouses file joint income tax returns, each spouse has a separate interest in the jointly reported income and in any overpayment. If both spouses are liable for a debt described in IRC 6402, the entire overpayment may be offset, however, offset issues arise where spouses file joint returns and only one spouse owes an IRC 6402 debt. The general practice of the Service is to offset the entire debt. The spouse who is not liable for the debt (referred to as the “injured spouse”) may file a claim for his or her portion of the refund (referred to as an “injured spouse claim”). In this circumstance, an allocation must be made to determine the liable spouse's interest in the overpayment, the amount that can be offset for the liable spouse's debt, and the amount to be refunded to the injured spouse. However, due to different property rights in income tax and withholding and other credits, there is a difference in the allocation process for community property states as opposed to the other states.

If spouses file a joint income tax return and an obligation described in IRC 6402 is owed by one of the spouses, the Service will generally offset the entire overpayment. If the injured spouse files a claim for his or her share of the overpayment, the Service is required to refund the portion of the overpayment to which the injured spouse is legally entitled. An injured spouse obtains his or her portion of the overpayment by filing a Form 8379, *Injured Spouse Allocation*. An injured spouse claim can also be filed with an original return. As will be discussed below, in some circumstances the Service may have the right under IRC 6402 to offset all or part of the community property portion of the overpayment. The interest a liable spouse has in the community property portion of the overpayment varies from state to state.

1. Amount Retained and Amount Refunded

If an injured spouse files a claim with the joint return and the claim is allowed, the Service will refund the injured spouse’s share of the overpayment. The amount of the overpayment the Service keeps after an injured spouse claim is filed in either situation is referred to as the "amount retained". The injured spouse’s portion of the overpayment that is refunded after the injured spouse claim is filed is referred to as the "amount refunded".

1. Injured Spouse vs. Innocent Spouse

Injured spouse status and innocent spouse status are frequently confused with each other. Innocent spouse status relieves a spouse of the responsibility for paying taxes that are owed jointly and severally with the other spouse. Injured spouse status involves obtaining a refund of a spouse's interest in an overpayment that has been offset under IRC 6402.

1. Service Procedures After an Injured Spouse's Claim is Filed

**Offsets for Debts Other Than Federal Taxes:** If an injured spouse claim is filed by a spouse in a community property state, the Service needs to determine how much will be refunded. If the debt to which the offset was applied is not a federal tax liability, the Service determines what portion of the overpayment represents the injured spouse's share of the overpayment and refunds it.

**Offsets for Federal Tax Debts:** If the debt involved is a federal tax liability, the Service goes through a two-part procedure to determine how much will be refunded to the injured spouse. In the first part, the Service determines each spouse's community property share of the overpayment. The Service will also determine if any portion of the overpayment represents the liable spouse's separate property. The liable spouse's community property and separate property share of the overpayment is the minimum amount the Service will retain if an injured spouse claim is filed, and the claim is allowed.

The second part of the two-part process is to look to state law to determine if there is a right to retain more than 50% of the community property portion of the overpayment. In a state where a creditor under state law can reach more than 50% of community property to satisfy the separate liability of one of the spouses, the portion above 50% belongs to the liable spouse because state law gives him/her a property interest in that additional portion of the community property.

The Service may apply his/her greater than 50% share of community property portion of the overpayment to the separate tax liability. If an injured spouse claim is filed, no portion of the injured spouse's share of the community property portion of the overpayment can be retained for an IRC 6402 debt not relating to federal taxes, such as child support, state income taxes or unemployment compensation. The second part of the procedure only applies to claims for federal taxes.

**Injured Spouse’s Share of the Overpayment:** The injured spouse’s share of the overpayment is computed by subtracting that spouse's share of the joint liability, determined in accordance with the separate tax formula, from that spouse's contribution of credits toward the joint liability. The amount credited cannot exceed the amount of the joint overpayment.

Separate Tax Formula: Under the separate tax formula, a spouse's share of the joint liability is computed as follows:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Injured Spouse’s Separate Tax Liability / Total of Spouse’s Separate Tax Liabilities | x | Joint Tax Liability Shown on Return | **=** | Injured Spouse’s Share of Liability |

**Injured Spouse's Separate Tax Liability:** To determine the injured spouse's separate tax liability for purposes of the separate tax formula, each spouse's tax liability must be determined as if they filed separate returns. This requires an allocation of income and deductions between the spouses.

**Allocating Credits:** After determining each spouse's share of the tax under the separate tax formula, it is necessary to allocate and apply the credits (e.g., withholding, estimated tax, and earned income credits) to each spouse's tax liability to determine his or her share of the overpayment. Under no circumstances can an injured spouse be refunded more than the joint overpayment. Thus, for example, it is possible under this formula for the liable spouse to not have sufficient credits to cover his or her share of the tax liability, and for the injured spouse's share of the credits (when applied to his or her liability) to exceed the joint refund. In this circumstance, the injured spouse is entitled to a refund only to the extent of the overpayment on the joint return.

**State Community Property Law Presumptions:** State community property laws create a presumption that property received by spouses is community property. Therefore, in allocating income the Service will assume that the items on the return are community property unless the taxpayers prove otherwise or the law provides that particular items of income, deductions or credits are the separate property of one of the spouses.

1. Allocating Items in Community Property States

**Allocating Income:** As previously discussed, state community property laws presume that property acquired by spouses is community property. However, the Service will not treat an item as community property if it is clear from the face of the return that federal or other law requires that the item be treated as separate property. If items are community property income, each spouse is considered to be the recipient of half of the item. In an injured spouse allocation, items of community property income should be allocated 50% to each spouse.

**Deductions:** Deductions associated with income are generally characterized in the same manner as the income. Therefore, for example, if Schedule C income is treated as community property and allocated to both spouses, any Schedule C deductions are also treated as community property and split. Deductions that are not related to income (e.g., medical, charitable contributions, property taxes, state taxes) are split, unless it is established that they were paid with separate property, in which case they would be deductible by the spouse whose separate property was used to pay them. These rules apply to allocations of deductions for injured spouse calculations.

**Effect When All Items Are Community Property:** When all items on the return are community property, each spouse will be entitled to half of the overpayment. This happens frequently where all of the income on the return is from wages.

1. Items of Separate Property

In spite of the state community property law presumption, some items of income, deduction or tax may be separate property. This usually occurs because the spouses have provided proof that the items are separate property or because federal law dictates that the items are separate property. When this happens, the affected items should be allocated to the spouse who owns them. Common circumstances where items are separate property include the following:

**Marital Agreements:** The spouses may have entered into an agreement under state law characterizing all or part of their income as separate property. This would require proof by the spouses of the agreement and compliance with state laws governing such agreements.

**Income from Separate Property:** In some states, dividends, interest or rents from separate property are separate property. These states include Arizona, California, New Mexico, Nevada and Washington. This requires proof by the spouses that the source of the income was separate property. This is not true in the other community property states.

**Capital Gains from Separate Property:** Generally, market appreciation in the value of separate property is also separate property. Accordingly, capital gain income may be separate property. This would require proof by the spouses that the property sold was separate property.

**Distributions Deemed Separate Property Under Federal Law:** Federal law deems some items separate property, including IRA withdrawals, railroad retirement benefits, U.S. savings bonds and ERISA funds. If these items appear on the return, they must be allocated to the spouse who owns them. This does not require any proof by the spouses, since these items are deemed separate property as a matter of law.

1. Allocating Withholding and Estimated Tax Payments

**Wage Withholding:** Withholding credits from community property income are community property and are allocated 50% to each spouse. If it is established that the underlying wages are not community property, the withholding should be characterized consistently with the wages.

**Estimated Tax Payments:** Where spouses make estimated tax payments and subsequently file a joint return with an overpayment subject to an IRC 6402 offset, the estimated tax payments should be allocated in proportion to the spouses' separate tax liabilities. The formula for this is as follows:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Spouse's Separate Tax Liability | x | Joint Tax Liability Shown on Return | **=** | Injured Spouse’s Share of Liability |
| Total of Spouse's Separate Tax Liabilities |

Therefore, if the spouses establish that the source of the payment was community property, the payment should be split evenly. If they establish that it is the separate property of one of the spouses, it should be allocated to that spouse.

Review Questions

1. Gabriel is a nonresident alien with income from sources within the United States. What form should he use to report this income?
2. Form 1040
3. Form 1040-NR
4. Form 1041
5. Form 1065

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| **Answer: B** |
| Nonresident aliens are required to file an income tax return (Form 1040-NR) if they received U.S. income on which the tax liability was not satisfied by the withholding of tax at the source. |

1. Which of the following taxpayers is not required to file Form 1040-NR?
2. Teresa, who is engaged in a trade or business in the U.S during the tax year.
3. A and B are correct.
4. Gabriel, who is representing a deceased taxpayer who would have to file Form 1040-NR.
5. Francisco, who is married to a U.S citizen and the end of the tax year.

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| **Answer: D** |
| An alien is any individual who is not a U.S. citizen or U.S. national. A non-resident alien is an alien who has not passed the green card test or the substantial presence test. A non-resident alien individual engaged or considered to be engaged in a trade or business in the United States during the year is to file Form 1040NR. However, if his or her only U.S. source income is in wages in an amount less than the personal exemption, the taxpayer is not required to file. |

1. Which of the following is not true regarding injured spouse?
2. An allocation must be made to determine the liable spouse's interest in the overpayment.
3. The spouse who is not liable for the debt (referred to as the “injured spouse”) may file a claim for his or her portion of the refund.
4. When spouses file joint income tax returns, each spouse has a separate interest in the jointly reported income and in any overpayment.
5. All of the above is true.

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| **Answer: D** |
| When spouses file joint income tax returns, each spouse has a separate interest in the jointly reported income and in any overpayment. The general practice of the Service is to offset the entire debt. The spouse who is not liable for the debt may file a claim for his or her portion of the refund. In this circumstance, an allocation must be made to determine the liable spouse's interest in the overpayment, the amount that can be offset for the liable spouse's debt, and the amount to be refunded to the injured spouse. |

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### Foreign Account and Asset Reporting

#### Form 8938: Statement of Specified Foreign Financial Assets

1. Who must file?

Specified individuals and specified domestic entities that have an interest in specified foreign financial assets and meet the reporting threshold:

1. Specified individuals include U.S citizens, resident aliens, and certain non-resident aliens.
2. Specified domestic entities include certain domestic corporations, partnerships, and trusts.
3. **IMPORTANT:** Under this topic, United States does not include U.S territories.
4. Reporting Threshold (Total Value of Assets)

Specified individuals living in the US:

1. **Unmarried individual (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 individual 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:

1. **Unmarried individual (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 individual 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.

Specified domestic entities:

1. 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.

**Having interest in an account or asset:** The taxpayer has 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.

**What must be reported:** The taxpayer must report the maximum value of specified foreign financial assets, which include financial accounts with foreign financial institutions and certain other foreign non-account investment assets.

1. Specified Foreign Financial Assets

Specified foreign financial assets include the following assets:

1. Financial accounts maintained by a foreign financial institution.
2. The following foreign financial assets if they are held for investment and not held in an account maintained by a financial institution.
3. Stock or securities issued by someone that is not a U.S. person (including stock or securities issued by a person organized under the laws of a U.S. possession).
4. Any interest in a foreign entity.
5. Any financial instrument or contract that has an issuer or counterparty that is not a U.S. person (including a financial contract issued by, or with a counterparty that is, a person organized under the laws of a U.S. possession).
6. Reporting Period

Unless an exception applies, the reporting period for Form 8938 is the taxpayer’s tax year. Exception for partial tax years of specified individuals. If the taxpayer is a specified individual for less than the entire tax year, the reporting period is the part of the year that he or she is a specified individual.

1. Reporting Maximum Value

**Foreign currency conversion:** If taxpayer’s specified foreign financial asset is denominated in a foreign currency during the tax year, the maximum value of the asset must be determined in the foreign currency and then converted to U.S. dollars. In most cases, the taxpayer must use the U.S. Treasury Bureau of the Fiscal Service foreign currency exchange rate for purchasing U.S. dollars.

1. Assets Not Required to Be Reported

The taxpayer is not required to report the following assets.

**Certain financial accounts:** The following financial accounts and the assets held in such accounts are not specified foreign financial assets and do not have to be reported on Form 8938.

A financial account that is maintained by a U.S. payer, such as a domestic financial institution. In general, a U.S. payer also includes a domestic branch of a foreign bank or foreign insurance company and a foreign branch or foreign subsidiary of a U.S. financial institution. Examples of financial accounts maintained by U.S. financial institutions include:

1. U.S. mutual funds accounts.
2. IRAs (traditional or Roth).
3. Section 401(k) retirement accounts.
4. Qualified U.S. retirement plans.
5. Brokerage accounts maintained by U.S. financial institutions.

A financial account that is maintained by a dealer or trader in securities or commodities if all of the holdings in the account are subject to the mark-to-market accounting rules for dealers in securities or an election under section 475(e) or (f) is made for all of the holdings in the account.

**Certain financial assets:** The taxpayer does not have to report any asset that is not held in a financial account if the asset is subject to the mark-to-market accounting rules for dealers in securities or commodities or an election under section 475(e) or (f) is made for the asset.

#### Penalties

If the taxpayer is required to file Form 8938 but does not file a complete and correct Form 8938 by the due date (including extensions), he or she may be subject to a penalty 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 $50,000 for 2021. Criminal penalties may also apply.

**Reasonable cause exception:** No penalty will be imposed if the taxpayer fails to file Form 8938 or to disclose one or more specified foreign financial assets on Form 8938 and the failure is due to reasonable cause and not to willful neglect. The taxpayer must affirmatively show the facts that support a reasonable cause claim. The determination of whether a failure to disclose a specified foreign financial asset on Form 8938 was due to reasonable cause and not due to willful neglect will be determined on a case-by-case basis, taking into account all pertinent facts and circumstances.

#### FinCEN form 114, Report of Foreign Bank and Financial Accounts (FBAR)

1. Who must file?

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 must file on FinCEN Form 114 to report:

1. A financial interest in or signature or other authority over at least one financial account located outside the United States.
2. If the aggregate value of those foreign financial accounts exceeded $10,000 at any time during the calendar year reported.

Generally, an account at a financial institution located outside the United States is a foreign financial account. Whether the account produced taxable income has no effect on whether the account is a “foreign financial account” for FBAR purposes.

There is no need to report foreign financial accounts that are:

1. Correspondent/Nostro accounts,
2. Owned by a governmental entity,
3. Owned by an international financial institution,
4. Maintained on a United States military banking facility,
5. Held in an individual retirement account (IRA) the taxpayer’s own or are beneficiary of,
6. Held in a retirement plan of which the taxpayer is a participant or beneficiary, or
7. Part of a trust of which the taxpayer is a beneficiary, if a U.S. person (trust, trustee of the trust or agent of the trust) files an FBAR reporting these accounts.

A taxpayer doesn’t need to file an FBAR for the calendar year if:

1. All taxpayer’s foreign financial accounts are reported on a consolidated FBAR.
2. All taxpayer’s foreign financial accounts are jointly-owned with their spouse and,
3. The taxpayer completed and signed FinCEN Form 114a authorizing his or her spouse to file on taxpayer’s behalf, and his or her spouse reports the jointly-owned accounts on a timely-filed, signed FBAR.
4. How to File

The taxpayer must file the FBAR electronically through the Financial Crimes Enforcement Network’s BSA E-Filing System. The taxpayer must not file the FBAR with his or her federal tax return.

If the taxpayer wants to paper-file their FBAR, he or she must call FinCEN’s Regulatory Helpline to request an exemption from e-filing. If FinCEN approves the taxpayer’s request, FinCEN will send the paper FBAR form to complete and mail to the IRS at the address in the form’s instructions. IRS will not accept paper-filings on TD F 90-22.1 (obsolete) or a printed FinCEN Form 114 (for e-filing only).

1. Reporting Threshold (Total Value of Assets)

The taxpayer must file an FBAR if he or she has a financial interest in or signature authority over any financial account(s) outside of the United States and the 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.

1. Maximum Account Value

The maximum value of an account is a reasonable approximation of the greatest value of currency or non-monetary assets in the account during the calendar year. Periodic account statements may be relied upon to determine the maximum value of the account, provided that the statements fairly reflect the maximum account value during the calendar year.

**How to determine the maximum value of a foreign financial account:** The taxpayer must determine the maximum account value in the currency of the account. After the maximum value of the account is determined, the maximum account value for each account must be converted into United States dollars using the exchange rate on the last day of the calendar year.

1. A foreign financial account that is located in Japan would typically be valued in Yen. The taxpayer should then, determine the maximum value of the account in Yen. Next, and convert the maximum value of the account into United States dollars.

When converting between a foreign currency and United States dollars, the taxpayer must use the Treasury Reporting Rates of Exchange for the last day of the calendar year. If no Treasury Financial Management Service rate is available, the taxpayer may use another verifiable exchange rate and provide the source of that rate. In valuing currency of a country that uses multiple exchange rates, the taxpayer must use the rate that would apply if the currency in the account were converted into United States dollars on the last day of the calendar year.

1. Miguel, a United States person, owns foreign financial accounts X, Y, and Z with maximum account values of $300, $13,000, and $3,500, respectively. Miguel is required to file an FBAR because the aggregate value of the accounts is $16,800. Miguel 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.
2. Reporting Period

The FBAR is a calendar year report and must be received by the Department of Treasury on or before April 15 of the year following the calendar year being reported. There is a 6-month automatic extension to October 15 each year.

1. Penalties

The taxpayer may be subject to civil monetary penalties and/or criminal penalties for FBAR reporting and/or recordkeeping violations. Assertion of penalties depends on facts and circumstances. Civil penalty maximums must be adjusted annually for inflation. Current maximums are as follows:

|  |  |  |
| --- | --- | --- |
| **U.S. Code citation** | **Civil Monetary Penalty Description** | **Current Maximum** |
| 31 U.S.C. 5321(a)(5)(B)(i) | Foreign Financial Agency Transaction - Non-Willful Violation of Transaction | $10,000 |
| 31 U.S.C. 5321(a)(5)(C) | Foreign Financial Agency Transaction - Willful Violation of Transaction | Greater of $100,000, or 50% of the amount per 31 U.S.C.5321(a)(5)(D) |
| 31 U.S.C. 5321(a)(6)(A) | Negligent Violation by Financial Institution or Non-Financial Trade or Business | $500 |
| 31 U.S.C. 5321(a)(6)(B) | Pattern of Negligent Activity by Financial Institution or Non-Financial Trade or Business | $50,000 |

Review Questions

1. Carmen traveled to Germany 6 months ago, and while staying there, she deposited $12,000 in a German bank account. For her 2021 tax return, which of the following apply?
2. She has to file form 8938: Statement of Specified Foreign Financial Assets.
3. She has to file FinCEN Form 114, report of Foreign Bank and Financial Accounts.
4. A and B are correct.
5. None of the above is correct.

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| **Answer: B** |
| 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 must file on FinCEN Form 114 to report:   * A financial interest in or signature or other authority over at least one financial account located outside the United States. * Foreign financial accounts, if the aggregate value of those foreign financial accounts exceeded $10,000 at any time during the calendar year reported.   Generally, an account at a financial institution located outside the United States is a foreign financial account. Whether the account produced taxable income has no effect on whether the account is a “foreign financial account” for FBAR purposes. |

1. Jose is to file Form 8938, but he doesn't. ¿Up to which amount could he be set a penalty for not filing?
2. $10,000.
3. $5,000.
4. $50,000
5. $100,000

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| **Answer: A** |
| If the taxpayer is required to file Form 8938 but does not file a complete and correct Form 8938 by the due date, they may be subject to a penalty up to $10,000 for failure to disclose. |

1. Brenda and Dorian are married. They both live in L.A and have a filing status of Married Filing Jointly. When they traveled to Brazil for vacation in 2021, they opened a bank account and deposited $15,400. For their 2021 tax return, which of the following apply?
2. They have to file Form 8938, Statement of Specified Foreign Financial Assets.
3. They have to file FinCEN Form 114, report of Foreign Bank and Financial Accounts.
4. A and B are correct.
5. None of the above is correct.

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| **Answer: B** |
| 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 must file on FinCEN Form 114 to report:   * A financial interest in or signature or other authority over at least one financial account located outside the United States. * If the aggregate value of those foreign financial accounts exceeded $10,000 at any time during the calendar year reported.   Generally, an account at a financial institution located outside the United States is a foreign financial account. Whether the account produced taxable income has no effect on whether the account is a “foreign financial account” for FBAR purposes. |

1. Which of the following is not true regarding the FBAR?
2. The taxpayer must not file the FBAR with his or her federal tax return.
3. The taxpayer must file an FBAR if he has a financial interest in any financial account outside of the United States and the aggregate value exceeds $10,000 at any time during the calendar year.
4. The FBAR is file only by paper.
5. None of the above is true.

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| --- |
| **Answer: C** |
| The taxpayer must file the FBAR electronically through the Financial Crimes Enforcement Network’s BSA E-Filing System. The taxpayer must not file the FBAR with his or her federal tax return.  The taxpayer must file an FBAR if he or she has a financial interest in or signature authority over any financial account(s) outside of the United States and the aggregate value of financial accounts exceeds $10,000 at any time during the calendar year. |

### Minor Children's Unearned Income (Kiddie Tax)

Under the changes established by the TCJA, if a child’s interest, dividends and other unearned income are of $2,200 or more, the child could be subject to tax. The child’s income can be reported on the parent’s return if the child’s gross income was more than $1,100, and less than $11,000.

Because the TCJA led to an unintentional tax rate increase based on certain income of children, the SECURE Act modified the changes done by the TCJA. This means that a parent may now choose for the child’s unearned income (dividends, interest, and capital gains) over $2,200 to be taxed at the parent’s tax rate. This also applies retroactively for 2021.

Parents must use this Form 8814 to report their child’s income on their return, so their child will not have to file a return.

For 2021 tax year, a taxpayer who chooses to modify the tax on their child’s unearned income using the tentative tax based on the parent’s tax rate will need to use the 2021 Instructions for Form 8615 and file an amended return, Form 1040-X. If this election is made, include a statement or an attachment with the taxpayer’s amended return specifying “election to modify tax of unearned income”.

Additionally, the special exemption limit that would have applied in 2021 to certain children under age 24 was suspended. A taxpayer who is under age 24 is now required to figure his or her exemption amount in the same manner as any other taxpayer.

Form 8615 must be used if the child’s unearned income is more than $2,200.

### Affordable Care Act (ACA) Requirements

The comprehensive health care reform law enacted in March 2010 (sometimes known as ACA, PPACA, or “Obamacare”).

The law has 3 primary goals:

1. Make affordable health insurance available to more people. The law provides consumers with subsidies (“premium tax credits”) that lower costs for households with incomes between 100% and 400% of the federal poverty level (FPL).
2. If your income is above 400% FPL, you may still qualify for the premium tax credit in 2021 and 2022.
3. If your income is at or below 150% FPL, you may qualify to enroll in or change Marketplace coverage through a Special Enrollment Period.
4. Expand the Medicaid program to cover all adults with income below 138% of the FPL. (Not all states have expanded their Medicaid programs.)
5. Support innovative medical care delivery methods designed to lower the costs of health care generally.

#### Premium Tax Credit

If a taxpayer received the benefit of advance credit payments, they are required to file a tax return to reconcile the amount of advance credit payments made on his or her behalf with the amount of their actual premium tax credit. For this purpose, the taxpayer must file an income tax return even if he or she is otherwise not required to file a return. For more information about the Premium Tax Credit, see *ACA Premium Tax Credit* in Chapter 3.

1. Household Size

For most people, a household consists of the tax filer, their spouse if they have one, and their tax dependents, including those who don’t need coverage.

Review Questions

1. If Juan received a benefit from premium credit upfront, he must:
2. File a return in order to balance amounts received with the actual credit amount.
3. Not file a return.
4. Report expenses made with the credit amount.
5. A and C are correct.

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| **Answer: A** |
| If the taxpayer received the benefit of advance credit payments, they are required to file a tax return to reconcile the amount of advance credit payments made on their behalf with the amount of their actual premium tax credit. For this purpose, the taxpayer must file an income tax return, even if they are not otherwise required to file a return. |

1. Which of the following is a change in circumstances that may affect the amount of the taxpayer’s actual premium tax credit?
2. Marriage.
3. Birth or adoption of a child.
4. Moving to a different address
5. All of the above.

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| **Answer: D** |
| Changes in circumstances that can affect the amount of the taxpayer’s actual premium tax credit include:   * Increases or decreases in the taxpayer’s household income, including lump sum payments, such as a lump sum payment of Social Security benefits. * Marriage. * Divorce. * Birth or adoption of a child. * Other changes affecting the composition of the taxpayer’s tax family. * Gaining or losing eligibility for government sponsored or employer sponsored health care coverage. * Moving to a different address. |

1. Which of the following is not true regarding household size?
2. A friend who lives in another house can be include in the household size.
3. The household size includes dependents who does not need coverage.
4. Household include the tax filer and their spouse.
5. All of the above are true.

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| **Answer: A** |
| For most people, a household consists of the tax filer, their spouse if they have one, and their tax dependents, including those who don’t need coverage. |

1. In 2021, for purposes of the kiddie tax, the child’s income may be reported on the parent’s tax return if the child’s gross income is more than:
2. $1,100.
3. $1,050.
4. $1,200.
5. $500.

|  |
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| **Answer: A** |
| The child’s income can be reported on the parent’s return if the child’s gross income is more than $1,100, and less than $11,000. |

1. What form must be used to report the child’s income if the unearned income is $3,500?
2. Form 8614.
3. Form 8995.
4. Form 706.
5. Form 8615.

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| **Answer: D** |
| Form 8615 must be used if the child’s unearned income is more than $2,200. |

CHAPTER 2   
  
Income and Assets

## Module: Income

### Taxability of Wages, Salaries and Other Earnings

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.

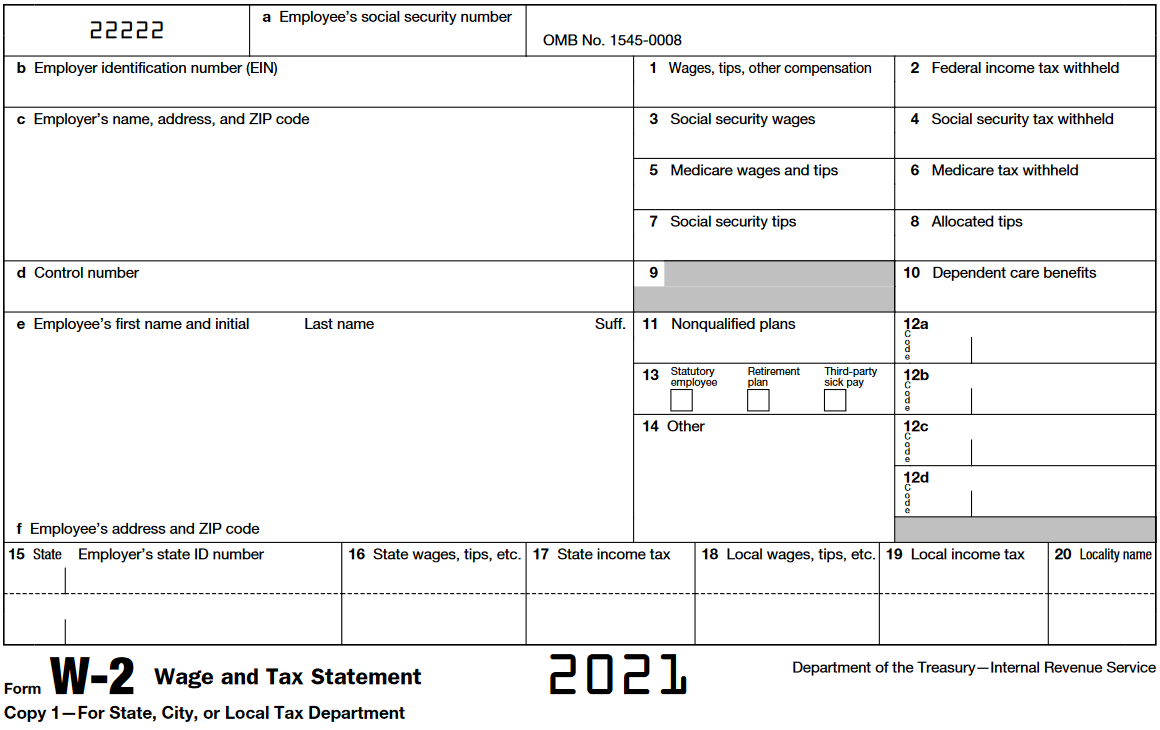
#### Compensation and Wages

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. The employer is required to provide or send Form W-2 to the taxpayer no later than January 31 of the year following the fiscal year. The taxpayer should receive a separate Form W-2 from each employer he or she worked for.

If the taxpayer stopped working before the end of the fiscal year, the employer could have given the taxpayer his or her Form W-2 at any time after the taxpayer stopped working. However, the employer must provide or send it to the taxpayer by January 31 of the year following the fiscal year. If the taxpayer asks for the form, the employer must send it to him or her within 30 days after receiving the written request or within 30 days after the taxpayer’s final wage payment, whichever is later. If the taxpayer has not received his or her Form W-2 by January 31, the taxpayer should ask his or her employer for it. If it is not received by February 15, it is recommended that the taxpayer call the IRS.

Form W-2 shows the taxpayer’s total pay and other compensation and the income tax, social security tax, and Medicare tax that was withheld during the year. In addition, Form W-2 is used to report any taxable sick pay the taxpayer received and any income tax withheld from the taxpayer’s sick pay.

When taxable income is not subject to withholdings, the taxpayer must report the amount on Form 1040, Schedule 1, Line 8, unless it fits into one of the categories shown on Lines 1 through 7, or Lines 10 through 19 from the same schedule. 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.



(Form W-2 Wage and Tax Statement)

1. Compensation Subject to 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.

1. Miscellaneous Compensation

**Advance commissions and other earnings:** A cash-method taxpayer that receives advance commissions or other amounts for services to be performed in the future must include these amounts in his or her income in the year he or she received them.

**Allowances and reimbursements****:** Employees may be able to get reimbursed when paying or incurring expenses on behalf of their employer. If employees received an advance, allowance, or reimbursement for expenses, how to report this amount and expenses depends on whether their employer reimbursed them under an accountable plan or a non-accountable plan.

**Accountable plans:** To be an accountable plan, the employer’s reimbursement or allowance arrangement must include all of the following rules:

1. Employees’ expenses must have a business connection. This means that employees must have paid or incurred deductible expenses while performing services as an employee of their employer.
2. Employees must adequately account to their employer for these expenses within a reasonable period of time.
3. Employees must return any excess reimbursement or allowance within a reasonable period of time.

**Non-accountable plans:** A non-accountable plan is a reimbursement or expense allowance arrangement that does not meet one or more of the three rules listed above for accountable plans.

**Back pay awards****:** The taxpayer must include in income amounts he or she was awarded in a settlement or judgment for back pay. These include payments made for damages, unpaid life insurance premiums, and unpaid health insurance premiums. They should be reported by the employer on Form W-2.

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

**Employee achievement award****:** 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, the taxpayer generally can exclude its value from his or her income. However, the amount that can be excluded is limited to the taxpayer’s 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 received during the year. The taxpayer’s employer can tell him or her 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:

1. 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.
2. 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.
3. Benito received three employee achievement awards during the year: a non-qualified 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, Benito must include $150 ($1,750 − $1,600) in his income.

**Differential wage payments****:** This is any payment made by an employer to an individual for any period during which the individual is, for a period of more than 30 days, an active duty member of the uniformed services and represents all or a portion of the wages the individual would have received from the employer for that period. These payments are treated as wages and are subject to income tax withholding, but not FICA or FUTA taxes. The payments are reported as wages on Form W-2.

**Government cost-of-living allowances****:** Most payments received by U.S. Government civilian employees for working abroad are taxable. However, certain cost-of-living allowances are tax-free. Pub. 516, further explains the tax treatment of allowances, differentials, and other special pay the taxpayers receive for employment abroad.

**Non-qualified deferred compensation plans****:** The taxpayer’s employer will report the total amount of deferrals for the year under a non-qualified deferred compensation plan. This amount is shown on Form W-2, box 12, using code Y. This amount is not included in the taxpayer’s income. However, if at any time during the tax year, the plan fails to meet certain requirements, or is not operated under those requirements, all amounts deferred under the plan for the tax year and all preceding tax years are included in the taxpayer’s income for the current year. This amount is included in the taxpayer’s wages shown on Form W-2, box 1. It is also shown on Form W-2, box 12, using code Z.

**Note received for services****:** If a taxpayer’s employer gives him or her a secured note as payment for services, the taxpayer must include the fair market value, or FMV (usually the discount value), of the note in income for the year the taxpayer receives it. When the taxpayer later receives payments on the note, a proportionate part of each payment is the recovery of the fair market value that the taxpayer previously included in his or her income. Do not include that part again in the taxpayer’s income. Include the rest of the payment in the taxpayer’s income in the year of payment.

If the employer gives the taxpayer a non-negotiable unsecured note as payment for services, payments on the note that are credited toward the principal amount of the note are compensation income when the taxpayer receives them.

**Severance pa****y:** Amounts received as severance pay and any payment for the cancellation of employment contract must be included as income.

**Sick pay****:** The pay a taxpayer receives from their employer while being sick or injured is part of the taxpayer’s salary or wages. In addition, it must be included in taxpayer’s income sick pay benefits received from any of the following payers:

1. A welfare fund.
2. A state sickness or disability fund.
3. An association of employers or employees.
4. An insurance company, if the taxpayer’s employer paid for the plan.

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

**Social Security and Medicare taxes paid by employer:** If the taxpayer and his or her employer have an agreement that the employer is to pay the taxpayer’s Social Security and Medicare taxes without deducting them from the taxpayer’s gross wages, the latter must report the amount of tax paid for him or her as taxable wages on his or her tax return. The payment is also treated as wages for figuring the taxpayer’s Social Security and Medicare taxes and benefits. However, if the taxpayer is a household worker or a farm worker, these payments are not treated as Social security and Medicare wages.

**Stock appreciation rights****:** Do not include a stock appreciation right granted by the taxpayer’s employer in income until the taxpayer uses the right. When he or she does, the taxpayer is entitled to a cash payment equal to the FMV of the corporation's stock on the date of use, minus the FMV on the date the right was granted. The taxpayer must include the cash payment in income in the year he or she uses the right.

#### Tips

All tips the taxpayer received in the fiscal year are income and are subject to federal income tax. Include in gross income all tips received directly, charged tips paid to the taxpayer by his or her employer, and the taxpayer’s share of any tips received under a tip-splitting or tip-pooling arrangement. The value of non-cash tips, such as tickets, passes, or other items of value, is also income and therefore subject to tax.

Reporting tip income correctly is not difficult. The taxpayer must do three things:

1. Keep a daily tip record.
2. Report tips to the taxpayer’s employer.
3. Report all the tips on the taxpayer’s income tax return.

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 IRC, because these amounts are not tips.

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

1. Large Party Charge (restaurant).
2. Bottle Service Charge (restaurant and night-club).
3. Room Service Charge (hotel and resort).
4. Contracted Luggage Assistance Charge (hotel and resort).
5. Mandated Delivery Charge (pizza or other retail deliveries).
6. The Restaurant “The Good Food” adds a charge of 18% to the check of groups of 6 or more customers. Juanita is part of a group of 8 people. In addition to the cost of food and beverages that are served to everyone in her group, the check includes an amount equal to 18% of said costs, which is shown on the line for tips. This amount is included in the total of the account. The charge of 18% is considered a charge for services. Do not record the charge of 18% in its record of tips. Charges for services that are paid are considered wages and not tips.

Employers are responsible for withholding the 0.9% Additional Medicare Tax on a tipped individual’s wages paid in excess of $200,000 in a calendar year. An employer is required to begin withholding Additional Medicare Tax in the pay period in which it pays wages in excess of $200,000 to an employee. There is no employer match for Additional Medicare Tax. If an individual received tips as a self-employed person, he or she should report these tips as income on Schedule C.

For 2021, the amounts are:

1. $200,000 for the single, head of household and qualifying widow(er) filing statuses.
2. $250,000 for the married filing jointly filing status.
3. $125,000 for the married filing separately filing status.

A taxpayer must report all tips he or she received in the fiscal year on his or her tax return, including both cash tips and non-cash tips. Any tips the taxpayer reported to his or her employer for 2021 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.

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:

1. Cash and charge tips received that totaled less than $20 for any month.
2. The value of non-cash 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 (or 1040-SR), Form 1040NR, Form 1040-SS, or 1040-PR (as appropriate) for this purpose. 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.

1. Allocated Tips

These 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:

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.
3. 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.

Review Questions

1. Regarding the compensation subject to tax, the following statements are correct, except:
2. Every payment made by an employer to an employee or by a customer for personal services is compensation.
3. All compensation for personal services is subject to the income tax.
4. Compensation does not include tips, commissions, fees for personal services, overtime pay, vacation pay or every other payment for personal services.
5. Bonuses and performance awards are usually taxable as compensation.

|  |
| --- |
| **Answer: C** |
| 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. Bonuses and performance awards are usually taxable as compensation. |

1. During an all-employee-awards ceremony, a company made a gift to Rosa (an employee). She received a new bicycle for her outstanding safety record. This award was presented to the employee for her services to the company and in accordance with the company's qualified employee achievement awards program. The bicycle costed the company $1,200. What amount must Rosa include in her income?
2. $1,200.
3. $0.
4. $1,700.
5. $500.

|  |
| --- |
| **Answer: B** |
| If the taxpayer receives tangible personal property as an award for length of service or safety achievement, the taxpayer generally can exclude its value from his or her income. However, the amount that can be excluded is limited to the taxpayer’s employer's cost and cannot be more than $1,600 for all such awards the taxpayer received during the year. |

1. Marina broke her leg this past year and was unable to work for three months. During this time, she received $2,500 in sick pay from her employer. She also received $1,000 from her personally purchased accident policy. How much of these benefits is taxable income?
2. $0.
3. $2,500.
4. $1,000.
5. $3,500.

|  |
| --- |
| **Answer: B** |
| The pay taxpayers receive from their employer while the taxpayer is sick or injured is part of the taxpayer’s salary or wages. In addition, taxpayers must include in their income sick pay benefits received from any of the following payers:   * A welfare fund. * A state sickness or disability fund. * An association of employers or employees. * An insurance company, if the taxpayer’s employer paid for the plan. |

1. A taxpayer is a waitress and earned $15,000 in wages, not including any tips. She received tips of $17 in March, which she did not report to her employer. Because she became ill in February and did not return to work until late March, she also forgot to report the $58 for tips that she received in February. She did report the $7,000 she received as tips for the rest of the year. How much income must she report as wages, tips and other compensation?
2. $22,185.
3. $22,075.
4. $15,260.
5. $15,183.

|  |
| --- |
| **Answer: B** |
| All tips the taxpayer received in the fiscal year are income and are subject to federal income tax. The taxpayer must include in gross income all tips received directly, charged tips paid to him/her by employer, and the taxpayer’s share of any tips received under a tip-splitting or tip-pooling arrangement. |

### Interest Income

In general, any interest received or that is credited to the taxpayer’s account and can be withdrawn is taxable income. The taxpayer should receive Copy B of Form 1099-INT reporting payments of interest and/or tax-exempt interest of $10 or more.

1. Taxable Interest

Taxable interest includes interest received from bank accounts, loans made to others, and other sources. Whether to report interest income or not depends on whether the taxpayers use the cash method or an accrual method to report income.

Certain distributions commonly called dividends are actually interest. They must be reported as interest so-called “dividends” on deposits or on share accounts in:

1. Cooperative banks,
2. Credit unions,
3. Domestic building and loan associations,
4. Domestic savings and loan associations,
5. Federal savings and loan associations, and
6. Mutual savings banks.

The “dividends” will be shown as interest income on Form 1099-INT.

1. Non-Taxable Interest

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.

#### Certificates of Deposit and Other Deferred Interest Accounts

If the taxpayer opens any of these accounts, 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 the taxpayer 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 paid 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 earned on the certificate are two separate items. The taxpayer must report the total interest that he or she earns on the certificate in his or her income. If the taxpayer itemizes deductions, he or she can deduct the interest paid as investment interest, up to the amount of the taxpayer’s net investment income.

#### Original Issue Discount (OID)

The original issue discount (OID) is a form of interest. Taxpayers generally include OID in their income as it accrues over the term of the debt instrument, whether they receive any payments from the issuer or not.

A debt instrument generally has OID when the instrument is issued for a price that is less than its stated redemption price at maturity. OID is the difference between the stated redemption price at maturity and the issue price.

All debt instruments that pay no interest before maturity are presumed to be issued at a discount. Zero coupon bonds are one example of these instruments.

#### Nominee Recipient

There are times when the taxpayer may receive a Form 1099 for interest in his or her name that actually belongs to someone else. In this case, the IRS considers the taxpayer a nominee recipient.

If the taxpayer received Form 1099-INT as a nominee, he or she should include this income in his or her tax return. The taxpayer must then prepare a Form 1099-INT for the interest that's not his or her unless that interest belongs to his or her spouse. The taxpayer must send Copy A of the 1099-INT and a completed Form 1096, Annual Summary and Transmittal of U.S. Information Returns to the Internal Revenue Service and give Copy B to the actual owner.

### Dividends and Other Distributions from Mutual Funds, Corporations and Other Entities

Dividends are distributions of money, shares or other kinds of goods that are paid to the taxpayer by a corporation or mutual fund. Many taxpayers may also receive dividends through a partnership, an estate, a trust or an association, which are taxed as a corporation.

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 they depend upon the decision of the corporate directors to make a distribution.

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 non-taxable 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 non-taxable return of capital.

1. Maria bought 100 shares of stock of GOMI Corporation in 2003 for $10 a share. In January 2004, she bought another 200 shares for $11 a share. In July 2005, she gave her son 50 shares. In December 2005, she bought 100 shares for $9 a share. In April 2021, he sold 130 shares. Maria cannot identify the shares she disposed of, so she must use the stock she acquired first to figure the basis. The shares of stock she gave her son had a basis of $500 (50 × $10). Maria figures the basis of the 130 shares of stock she sold in 2021 as follows:   
     
   - 50 shares (50 × $10) balance of stock bought in the year 2003: $500.   
   - 80 shares (80 × $11) stock bought in January of the year 2004: $880.  
   - Total basis of stock sold in 2021: $1,380.

#### Dividends Subject to Tax

For tax purposes, a dividend is any distribution of property made by a corporation to its stockholders, provided it is paid out of its accumulated earnings and profits. 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 the one given ordinary dividends. In addition, some distributions from certain corporations are taxed as capital gains. The usual example is the investments company, which distributes the ordinary dividends, received by it and the capital gains realized during the period.

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 FMV of the property at the time of the distribution is the measure of the dividend. Small, closely held corporations frequently make non-cash distributions 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.

The most common kinds of distributions are:

1. Ordinary dividends.
2. Capital gain distributions.
3. Non-dividend distributions.

Dividends have been split into ordinary dividends and qualified dividends.

#### Ordinary Dividends

These dividends (subject to tax) are the most common distribution by a corporation or a mutual fund. They are paid using revenues and earnings and are considered to be ordinary income to the taxpayer; therefore, they are not capital gains. Ordinary dividends received by a taxpayer are included in gross income and continue to be taxable as ordinary income. A taxpayer can assume that all dividends received of shares common or preferred is an ordinary dividend unless the corporation or mutual fund paying it tells him or her otherwise. Ordinary dividends are shown in box 1a of Form 1099-DIV, Dividends and Distributions.

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.

#### 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 the current fiscal year, this means that qualified dividends are subject to the same 0%, 15%, or 20% maximum tax rate that applies to net capital gain.

In 2021, the following capital gains tax rules are applicable:

1. The 0% tax rate applies to adjusted net capital gain up to $80,800 for joint filers and surviving spouses, $54,100 for heads of household, $40,400 for single filers and married taxpayers filing separately and $2,700 for an estate or trust.
2. The 15% tax rate applies to adjusted net capital gain over the amount subject to the 0% rate, and up to $501,600 for joint filers and surviving spouses, $473,750 for heads of household, $445,850 for single filers, $250,800 for married taxpayers filing separately and $13,250 in the case of an estate or trust.
3. The 20% tax rate applies to adjusted net capital gain over $501,601 for joint filers and surviving spouses, $473,751 for heads of household, $445,851 for single filers, $250,801 for married taxpayers filing separately and $13,250 for an estate or trust.

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.
4. 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 will not receive the next dividend payment. Instead, the seller will get the dividend. When counting the number of days the taxpayer held the stock, include the day the taxpayer disposed of the stock, but not the day the taxpayer 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.

1. Dividends that are not Qualified Dividends

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

1. 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.

1. Dividends from a corporation that is a tax-exempt organization or a 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.

1. 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.

Paymyents in lieu of dividends.

1. Payments shown in Form 1099-DIV, box 1b, from a foreign corporation to the extent the taxpayer knows or have reason to know the payments are not qualified dividends.
2. How to Report Dividend Income

Generally, the taxpayer can use Form 1040 to report dividend income. Report the total of the ordinary dividends on Line 3b of Form 1040, and report qualified dividends on line 3a of Form 1040. If the taxpayer received capital gain distributions, he or she uses 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.

1. 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 stock. It is not taxed until the basis in the stock is fully recovered. This non-taxable portion is also called a return of capital; it is a return of the 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.

1. Money Market Funds

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

### Personal Property Rental

A taxpayer generally must include in gross income all amounts received as rent. Rental income is any payment received for the use or occupation of property. In addition to amounts received as normal rent payments, there are other amounts that may be rental income.

1. Advance rent

Advance rent is included in rental income in the year received regardless of the period covered or the method of accounting used. Advance rent is any amount received early for the period that it covers.

1. Esteban signed a 10-year lease to rent his property. In the first year, he receives $5,000 as rent for the first year of the lease and $5,000 as rent for the last year of lease. Esteban must include $10,000 in his income in the first year.
2. Security deposits

A security deposit is not included in income when it is received if it is to be returned to the tenant at the end of the lease. But if the taxpayer keeps part or all of the security deposit during the year because the tenant did not live up to the terms of the lease, that amount is included in income.

1. Payment for canceling a lease

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

1. Expenses paid by tenant

If a tenant pays any of the expenses and deducts them from their rent paid to the lessor, the expense payments are rental income to the lessor. The expenses may be deducted by the lessor if they are deductible rental expenses.

1. Ms. Rojas owns an apartment complex. She received $5,000 in December of the current tax year to cover the January rents for tenants who will be on vacation January 15, of the next tax year, when the rent is due. Although she is a cash basis taxpayer for purposes of filing her return, she uses the accrual method of accounting to maintain her books on the rental property.

#### Rental Expenses

The costs of repairs to the rental property may be deducted. However, the cost of improvements cannot be deducted.

**The cost of improvements is recovered by taking depreciation:** Section 179 deductions cannot be claimed for property held to produce rental income.

**Depreciation of residential rental property:** Residential rental property is any building or structure, such as a rental home (including a mobile home), if 80% or more of its gross rental income for the tax year is from dwelling units. The MACRS recovery period for residential rental property (buildings) is 27.5 years.

1. The mid-month convention is used for residential rental property under which all property placed in service or disposed of during a month is considered to be placed in service or disposed of at the midpoint of the month.

**Home office depreciation:** A part of the home used for business may be depreciated over 39 years as non-residential real property.

**Repairs vs. Improvements:** A repair keeps the property in good operating condition. It does not materially add to the value of the property or substantially prolong its life. Repainting the property inside or out, fixing gutters or floors, fixing leaks, plastering, and replacing broken windows are examples of repairs.

1. **NOTE:** If the repairs are made as part of an extensive remodeling or restoration of the property, the whole job is an improvement and must be capitalized.

**Other expenses:** Other expenses that can be deducted from rental income include advertising, cleaning and maintenance services, fire and liability insurance, taxes, interest, commissions for the collection of rent, ordinary and necessary travel and transportation.

**Vacant rental property:** If a taxpayer holds property for rental purposes, the taxpayer may be able to deduct the ordinary and necessary expenses (including depreciation) for managing, conserving, or maintaining the property while the property is vacant.

1. Reporting Rental Activity

How rental income and deductions are figured depends on whether the dwelling unit was used as a home and, if used as a home, how many days the property was rented. If the dwelling unit is not used as the owner's home, all the rental income is reported, and all the rental expenses are deducted. Rental expenses can be more than gross rental income.

Property is placed in service when it is ready and available for a specific use, whether in a business activity, an income-producing activity, a tax-exempt activity, or a personal activity.

15-day rule for rental of property also used as a home: If property that the taxpayer uses as a home is also rented for less than 15 days during the tax year, the rent received is not included in gross income and the rental expenses are not deducted.

However, the interest, taxes, and casualty and theft losses that are allowed for non-rental property can be deducted on Schedule A of Form 1040, Line 15.

**Deductible expenses limited if property is not rented for profit:** If the property is not rented to make a profit, the rental expenses can be deducted only up to the amount of rental income.

**Property or services received as rent:** If property or services are received as rent, instead of money, the FMV of the property or services is included in rental income.

1. **NOTE:** If the taxpayer provides significant services that are primarily for the tenant's convenience, such as regular cleaning, changing linen, or maid service, report the rental income and expenses on Schedule C as a business as opposed to reporting the income and expenses on Schedule E.
2. Schedule E (Form 1040)

Use Schedule E (Form 1040) to report income or loss from rental real estate, royalties, partnerships, limited liability companies reporting as partnerships, S-Corporations, estates, trusts, and residual interests in REMICs.

Part 1 of Schedule E is used to report income and expenses from rental property and royalties. Rental and royalty income reported on Schedule E is not taxable for self-employment tax purposes.

1. Personal Use of Vacation Home (Dwelling Unit)
2. If the taxpayer has personal use of a vacation home or other dwelling unit that is rented out, the expenses are divided between the rental use and personal use.
3. If the dwelling unit is the taxpayer's home and is rented for 15 or more days, the rent is included in income and, if there is a net loss, all of the loss may not be deductible. The dwelling unit is used as a home during the tax year if the owner uses it for personal purposes more than the greater of 14 days, or 10% of the total days it is rented to others at a fair rental price.

**Dual use days:** If a dwelling unit is used for personal purposes on a day it is rented at a fair rental price, do not count that day as a day of rental in applying (2) above. Instead, count it as a personal day in applying (1) and (2) above. This rule does not apply when dividing expenses between rental and personal use.

**How to figure days of personal use:** A day of personal use of a dwelling unit is any day that it is used by:

1. The owner or any other person who has an interest in it, unless an owner rents it to another owner as his main home under a shared equity financing agreement.

A member of the family or a member of the family of any other person who has a financial interest in it, unless the family member uses the dwelling unit as his main home and pays a fair rental price. Family includes only brothers and sisters, half-brothers and half-sisters, spouses, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.).

1. Anyone under an arrangement that lets the owner use some other dwelling unit.

Anyone who pays at less than a fair rental price.

1. Any day the taxpayer spends working substantially full time repairing and maintaining the property is not considered a day of personal use, even if the taxpayer's family uses the property for recreational purposes on that day.

### Gambling Income and Allowable Deductions

According to the IRS, taxpayers engaging in gambling use Form W-2G to report their gambling winnings as well as any withholding income tax that is levied at source.

#### 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:

1. Any sweepstakes; wagering pool, including payments made to winners of poker tournaments; or lottery.
2. 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.

1. Exemption

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.

1. Form W-2G - Certain Gambling Winnings

If a payer withholds income tax from a taxpayer’s gambling winnings, the latter 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 the taxpayer’s Form 1040.

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.

Gambling losses can be deducted to the extent of taxpayer’s winnings. Gambling winnings are reported on Form 1040, Schedule 1, line 8.

For tax year 2021, gambling losses are deducted as an Itemized Deduction on Line 16 of Form 1040, Schedule A. Only taxpayers that itemize can claim gambling losses.

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

1. Allowable Deductions

According to the IRS, a taxpayer is allowed to deduct gambling losses in Schedule A up to his or her gambling winnings within any particular tax year. In this case, an individual is allowed to report his other winnings separately and claim gambling losses as separate deductions.

### Tax Treatment of Cancellation of Debt

As a general rule, any debt that is canceled or forgiven, other than as a gift or bequest, must be reported as income.

A debt includes any indebtedness for which a taxpayer is liable, or which attaches to the taxpayer's property.

Debt cancellation issues frequently involve auto loans, credit card debt, debt for medical care, professional services, installment purchases of furniture or other personal property, mortgages, and home equity loans.

1. Form 1099-C reports debt cancellation over $600

Lenders or creditors are required to issue Form 1099-C if they cancel a debt owed to them of $600 or more. Generally, an individual taxpayer must include all canceled amounts (even if less than $600) on the "Other Income" line of Form 1040, Schedule 1.

#### Debt Cancellation Income Exceptions and Exclusions

Some canceled or forgiven debts may be eliminated from income by applying exceptions, or reduced by applying exclusions to the general rule.

1. **NOTE:** Exceptions are applied before exclusions.

Exceptions may allow the taxpayer to eliminate these types of canceled debt from income:

1. Amounts otherwise excluded from income (e.g., gifts and bequests).
2. Certain student loans (e.g., doctors, nurses, and teachers serving in rural or low-income areas).
3. Deductible debt (e.g., home mortgage interest that would have been deductible on Schedule A).
4. Price reduced after purchase (e.g., debt on solvent taxpayer's property is reduced by the seller; basis of property must be reduced).

Exclusions from the general rule for reporting canceled debt as income include:

1. Discharge of debt through bankruptcy.
2. Discharge of debt of insolvent taxpayer (up to the level of insolvency).
3. Discharge of qualified farm indebtedness.
4. Discharge of qualified real property business indebtedness.
5. Discharge of qualified principal residence indebtedness.

**Cancellation of residential acquisition debt extended through December 31, 2020:** The Mortgage Forgiveness Debt Relief Act of 2007 retroactively added a new Section 108 exclusion to cancellation of residential acquisition debt income through 2014. The Protecting Americans from Tax Hikes Act of 2015 retroactively extended this exclusion through 2016. The Bipartisan Budget Act of 2018 extended this provision through 2017, and finally, the Further Consolidated Appropriations Act of December 2019 extended it through December 31, 2020.

1. Discharge in whole or in part of "qualified principal residence indebtedness" may be excluded from a taxpayer's gross income effective for discharges of indebtedness on or after January 1, 2007 and through December 31, 2020.
2. The amount excluded due to the "discharge of qualified principal residence indebtedness" is reported on Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment).
3. Form 982 must be filed with the taxpayer's return to report the excluded amount of discharge indebtedness and the reduction of certain tax attributes (certain credits, losses, and basis of assets).
4. Taxpayers excluding only discharged debt from "qualified principal residence indebtedness" must complete a few lines on Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment). Check box 1e and include the amount from Form 1099-C, box 2, on Form 982, Line 2.
5. If the taxpayer kept ownership of the home, complete line 10b to reflect the basis adjustment to the principal residence for the excluded canceled debt.

#### Foreclosure and Abandonment

If a property was taken by the lender (foreclosure) or given up by the borrower (abandonment), the lender usually sends the taxpayer Form 1099-A, Acquisition or Abandonment of Secured Property. Form 1099-A will have information needed to determine the gain or loss due to the foreclosure or abandonment.

1. If the debt is canceled, the taxpayer will receive Form 1099-C, Cancellation of Debt.
2. If foreclosure and cancellation occur in the same calendar year, the lender may issue only Form 1099-C, including the information otherwise reported on Form 1099-A.
3. Qualified principal residence debt. Qualified principal residence debt means acquisition debt except that the dollar limit is $2,000,000 ($1,000,000 in the case of a separate return) with respect to the taxpayer's principal residence.
4. No exclusion for cancellation of debt on vacation home.

For these purposes, the term "principal residence" has the same meaning as under Section 121. It does not include the taxpayer's vacation home, rental, or investment property.

#### Basis Reduction

The basis of the taxpayer's principal residence is reduced by the amount of debt forgiveness excluded from income.

1. **IMPORTANT:** Homeowners who refinanced their principal residence mortgage to pay off personal credit card debts, car loans, or for other personal uses are not entitled to this exclusion and will have cancellation of debt income.

#### Insolvency

A taxpayer is insolvent when his or her total liabilities exceed his or her total assets. The forgiven debt may be excluded as income under the "insolvency" exclusion. Normally, a taxpayer is not required to include forgiven debts in income to the extent that the taxpayer is insolvent. The forgiven debt may also qualify for exclusion if the debt was discharged in a Title 11 bankruptcy proceeding or if the debt is qualified farm indebtedness or qualified real property business indebtedness.

Review Questions

1. At which rate are qualified dividends taxed?
2. 0%.
3. 0%, 15% and 20%.
4. 15%.
5. 20% and 37%.

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| **Answer: B** |
| For the current fiscal year, qualified dividends are subject to the same 0%, 15%, or 20% maximum tax rate that applies to net capital gain. |

1. Elena has a taxable interest income of $2,000. ¿Which form must she use to report this income?
2. Form 1041, Schedule A
3. Form 8995
4. Form 1040, Schedule B.
5. Elena is not required to report this income.

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| **Answer: C** |
| Schedule B, Interest and Ordinary Dividends, must be used if the taxpayer had over $1,500 of taxable interest or ordinary dividends. |

1. Which of the following is not rental income in the year received?
2. Security deposit, equal to one month's rent, to be refunded at the end of the lease.
3. Payment to cancel the remaining lease.
4. Repairs paid by the tenant in lieu of rent.
5. January rent received in December.

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| **Answer: A** |
| The following are considered rental income in the year received:   * Advance rent (rent received before the period it covers). * Payment for canceling a lease. * Expenses paid by the tenant.   A security deposit is not included in income when it is received if it is to be returned to the tenant at the end of the lease. But if the taxpayer keeps part or all of the security deposit during the year because the tenant did not live up to the terms of the lease, that amount is included in income. |

1. A taxpayer rented his house for 10 days to a stranger and he used it for the rest of the year. He had rental income of $1,000 and he paid $600 for repairs. How should he report these activities on his tax return?
2. $1,000 income, $600 expense.
3. $333 income, $200 expense.
4. $0 income, $0 expense.
5. $667 income, $400 expense.

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| **Answer: C** |
| 15-day rule for rental of property also used as a home: If property that the taxpayer uses as a home is also rented for less than 15 days during the tax year, the rent received is not included in gross income and the rental expenses are not deducted. |

1. A taxpayer signed a 5-year lease to rent office space to a tenant. The tenant paid $24,000 for the first year's rent and $24,000 for the second year's rent. The taxpayer reports his income using the accrual method of accounting. How much of the $48,000 is included in the taxpayer’s tax income?
2. $24,000.
3. $120,000.
4. $48,000.
5. $0.

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| **Answer: C** |
| Advance rent is included in rental income in the year received regardless of the period covered or the method of accounting used. Advance rent is any amount received early for the period that it covers.  This taxpayer’s rental income is: $24,000 + $24,000, for a total of $48,000. |

1. A taxpayer purchased a heating, ventilating and air conditioning (HVAC) unit for his rental property on December 15th. It was delivered on December 28th and was installed and ready for use on January 2nd. When should the HVAC unit be considered placed in service?
2. December 15th.
3. December 28th.
4. December 31st.
5. January 2nd.

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| **Answer: D** |
| Property is placed in service when it is ready and available for a specific use, whether in a business activity, an income-producing activity, a tax-exempt activity, or a personal activity. |

### Tax Treatment of a U.S. Citizen/Resident with Foreign Income

If the taxpayer is a U.S. citizen or resident alien, his or her worldwide income generally is subject to U.S. income tax, regardless of where the taxpayer is living. Also, the taxpayer is subject to the same income tax filing requirements that apply to U.S. citizens or resident aliens living in the United States. Expatriation tax provisions apply to U.S. citizens who have renounced their citizenship and long-term residents who have ended their residency.

#### Resident Alien

A resident alien is an individual who is not a citizen or national of the United States and who meets either the green card test or the substantial presence test for the calendar year.

1. **Green card test:** The taxpayer is a U.S. resident if he or she was a lawful permanent resident of the United States at any time during the calendar year. This is known as the green card test because resident aliens hold immigrant visas (also known as green cards).
2. **Substantial presence test:** The taxpayer is considered a U.S. resident 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:
3. 31 days during the current calendar year; and
4. A total of 183 days during the current year and the 2 preceding years, counting all the days of physical presence in the current year, but only 1/3 the number of days of presence in the first preceding year, and only 1/6 the number of days in the second preceding year.
5. Bona Fide Residence Test

To meet this test, the taxpayer must meet the following conditions:

1. The taxpayer is 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 (January 1–December 31, if filing a calendar year return).
2. The taxpayer is 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 (January 1–December 31, if filing a calendar year return).

Whether the taxpayer is a bona fide resident of a foreign country depends on the intention about the length and nature of his or her stay. Evidence of intention may be words and acts. If these are conflicting, acts carry more weight than words. Generally, if the taxpayer goes to a foreign country for a definite, temporary purpose and return to the United States after he or she accomplishes it, the taxpayer isn't a bona fide resident of the foreign country. If accomplishing the purpose requires an extended, indefinite stay, and the taxpayer makes his or her home in the foreign country, the taxpayer may be a bona fide resident.

1. Physical Presence Test

To meet this test, the taxpayer must be a U.S. citizen or resident alien who is physically present in a foreign country, or countries, for at least 330 full days during any period of 12 months in a row. A full day means the 24-hour period that starts at midnight.

To figure 330 full days, the taxpayer shall add all separate periods he or she was present in a foreign country during the 12-month period, on which the physical presence test is based must include 365 days, part of which must be in 2021; the dates may begin or end in a calendar year other than 2021. The 330 full days can be interrupted by periods when the taxpayer is traveling over international waters or are otherwise not in a foreign country.

1. **NOTE:** A non-resident alien who, with a U.S. citizen or U.S. resident alien spouse, chooses to be taxed as a resident of the United States can qualify under this test if the time requirements are met.

#### Foreign Earned Income

Foreign earned income is income the taxpayer receives for working in a foreign country, as discussed in the previous chapter.

#### Form 2555

Form 2555 is needed to claim either the foreign earned income exclusion or the foreign housing exclusion.

If the taxpayer claims exclusion under the bona fide residence test, he or she should fill out Parts I, II, IV, and V of Form 2555. In filling out Part II, the taxpayer must be sure to give his or her visa type and the period of his/her bona fide residence. Frequently, these items are overlooked.

If claiming exclusion under the physical presence test, the taxpayer should fill out Parts I, III, IV, and V of Form 2555. When filling out Part III, the taxpayer must be sure to insert the beginning and ending dates of his/her 12-month period and the dates of his/her arrivals and departures, as requested in the travel schedule.

The taxpayer must fill out Part VI if he or she is claiming a foreign housing exclusion or deduction, Part IX if claiming the foreign housing deduction, Part VII If claiming the foreign earned income exclusion and Part VIII if claiming the foreign earned income exclusion, the foreign housing exclusion, or both.

1. **IMPORTANT:** If the taxpayer and his or her spouse both qualify to claim the foreign earned income exclusion, the foreign housing exclusion, or the foreign housing deduction, the taxpayer and the spouse must file separate Forms 2555 to claim these benefits.

A 2021 calendar year Form 1040 or 1040-SR is generally due April 15, 2022. Therefore, Form 2555 must be attached to taxpayer’s return following this due date.

However, the taxpayer is automatically granted a 2-month extension of time to file (to June 15, 2022, for a 2021 calendar year return) if, on the return’s due date, the taxpayer lives outside the United States and Puerto Rico and his/her tax home is outside the United States and Puerto Rico. If the taxpayer takes this extension, he or she must attach a statement to his/her return explaining that these two conditions are met.

The automatic 2-month extension also applies to paying the tax. However, the taxpayer will owe interest on any tax not paid by the regular due date of his or her return.

**When to claim the exclusion(s):** The first year the taxpayer plans to take the foreign earned income exclusion and/or the housing exclusion or deduction, he or she may not yet have met either the physical presence test or the bona fide residence test by the return’s due date (including the automatic 2-month extension, discussed earlier). If this occurs, the taxpayer can either:

1. Apply for a special extension to a date after the taxpayer expect to qualify.
2. File his or her return timely without claiming the exclusion and then file an amended return after qualifying.
3. Foreign Earned Income Exclusion

If the taxpayer’s tax home is in a foreign country and he or she meets the bona fide residence test or the physical presence test, he or she can choose to exclude from his/her income a limited amount of foreign earned income.

The taxpayer can also choose to exclude from his or her income a foreign housing amount. This is explained later under Foreign Housing Exclusion. If the taxpayer chooses to exclude a foreign housing amount, he or she must figure the foreign housing exclusion before figuring the foreign earned income exclusion. Taxpayer’s foreign earned income exclusion is limited to his or her foreign earned income minus foreign housing exclusion.

If the taxpayer chooses to exclude foreign earned income, it is not possible to deduct, exclude, or claim a credit for any item that can be allocated to or charged against the excluded amounts. This includes any expenses, losses, and other normally deductible items allocable to the excluded income.

1. Foreign Housing Exclusion

If the taxpayer does not have self-employment income, all of his or her earnings are employer-provided amounts and his or her entire housing amount is considered paid for with those employer-provided amounts. This means that the taxpayer can exclude (up to the limits) his or her entire housing amount.

Employer-provided amounts: These include any amounts paid to the taxpayer or paid or incurred on taxpayer’s behalf by his or her employer that are taxable foreign earned income (without regard to the foreign earned income exclusion) to the taxpayer himself for the year. Employer-provided amounts include:

1. The taxpayer salary.
2. Any reimbursement for housing expenses.
3. Amounts the taxpayer employer pays to a third party on his or her behalf.
4. The fair rental value of company-owned housing furnished to the taxpayer unless that value is excluded under the rules of Exclusion of Meals and Lodging.
5. Amounts paid to the taxpayer by his or her employer as part of a tax equalization plan.
6. Amounts paid to the taxpayer or a third party by his or her employer for the education of his or her dependents.
7. Choosing the exclusion

The taxpayer can choose the housing exclusion by completing the part IX of Form 2555. Rules about choosing the exclusion under Foreign Earned Income Exclusion, earlier, also apply to the foreign housing exclusion.

The taxpayer’s housing exclusion is the lesser of:

1. That part of the taxpayer’s housing amount paid for with employer-provided amounts.
2. Taxpayer’s foreign earned income.

If the taxpayer chooses the housing exclusion, he or she must figure it before figuring his or her foreign earned income exclusion. The taxpayer cannot claim less than the full amount of the housing exclusion to which he or she is entitled.

1. Foreign tax credit or deduction

Once the taxpayer chooses to exclude foreign housing amounts, he or she can’t take a foreign tax credit or deduction for excludable taxes on income. If the taxpayer does take a credit or deduction for any of those taxes, his or her choice to exclude housing amounts may be considered revoked.

1. Additional child tax credit

The taxpayer can’t take the additional child tax credit if claiming the foreign housing exclusion.

1. Earned income credit

If the taxpayer claims the foreign housing exclusion, he or she does not qualify for the earned income credit for the year.

#### Form 1116

A taxpayer may be able to claim the foreign tax credit without filing Form 1116. By making this election, the foreign tax credit limitation (lines 15 through 21 of the form) won't apply to the taxpayer. This election is available only if a taxpayer meets all of the following conditions.

1. All of taxpayer’s foreign source gross income was "passive category income" (which includes most interest and dividends). For this purpose, passive income also includes the following:
2. Income subject to the special rule for High-taxed income.
3. Certain export financing interest.
4. All the income and any foreign taxes paid on it were reported to the taxpayer on a qualified payee statement. Qualified payee statements include Form 1099-DIV, Form 1099-INT, Schedule K-1 (Form 1041), Schedule K-1 (Form 1065), Schedule K-1 (Form 1120-S), or similar substitute statements.
5. Taxpayer’s total creditable foreign taxes aren't more than $300 ($600 if married filing a joint return).
6. **NOTE:** This election isn't available to estates or trusts, or if the taxpayer paid or accrued certain foreign taxes to a foreign country or U.S. possession.

If the taxpayer makes this election, the following rules apply:

1. The taxpayer can't carry over to or from any other year any foreign taxes paid or accrued in a tax year to which the election applies (but carryovers to and from other years are unaffected).
2. The taxpayer is still required to take into account the general rules for determining whether a tax is creditable.
3. The taxpayer is still required to reduce the taxes available for credit by any amount that would have been entered on line 12 of Form 1116.

To make the election, it is just to be entered on the foreign tax credit line of taxpayer’s tax return (for example, Schedule 3 (Form 1040), Part I, line 1) the smaller of either:

1. Taxpayer’s total foreign tax
2. Taxpayer’s regular tax (for example, the total of Form 1040 or 1040-SR, line 16, and Schedule 2 (Form 1040), Part I, line 2).

**Nonresident aliens:** If the taxpayer is a nonresident alien, he or she generally can't take the credit. However, the taxpayer may be able to take the credit if:

1. The taxpayer was a resident of Puerto Rico during his/her entire tax year.
2. The taxpayer pays or accrues tax to a foreign country or U.S. possession on income from foreign sources that is effectively connected with a trade or business in the United States. But if the taxpayer must pay tax to a foreign country or U.S. possession on income from U.S. sources only because he or she is a citizen or a resident of that country or U.S. possession, don't use that tax in figuring the amount of the credit.

See section 906 for more information on the foreign tax credit allowed to a nonresident alien individual.

1. Credit or Deduction

Instead of claiming a credit for eligible foreign taxes, a taxpayer can choose to deduct foreign income taxes. Form 1040 or 1040-SR filers choosing to do so would deduct foreign income taxes on Schedule A (Form 1040), *Itemized Deductions*. Generally, if the taxpayer takes the credit for any eligible foreign taxes, he or she can't take any part of that year's foreign taxes as a deduction. However, even if the taxpayer takes the credit for eligible foreign taxes for the year, the taxpayer can take a deduction for the following.

1. Foreign taxes not allowed as a credit because of boycott provisions.
2. Taxes paid to certain foreign countries for which a credit has been denied, as described in item 2 under Foreign Taxes Not Eligible for a Credit, later.
3. Taxes on income or gain that aren't creditable because the taxpayer doesn't meet the holding period requirement, as described in item 3 or 5 under Foreign Taxes Not Eligible for a Credit, later.
4. Taxes on income or gain that aren't creditable because the taxpayer has to make related payments, as described in item 4 or 6 under Foreign Taxes Not Eligible for a Credit, later.
5. Certain taxes paid or accrued to a foreign country in connection with the purchase or sale of oil or gas extracted in that country, as described in item 8 under Foreign Taxes Not Eligible for a Credit, later.
6. Taxes on income or gain that aren't creditable because they were paid or accrued in connection with a covered asset acquisition, as described in item 10 under Foreign Taxes Not Eligible for a Credit, later.

If the taxpayer wants to change his o her election to take a deduction instead of a credit, or a credit instead of a deduction, it must be done within a special 10-year limitation period. Although the limitations period for refund claims relating to a foreign tax credit generally runs parallel with the election period, the limitations period for refund claims relating to a deduction of foreign tax doesn't, and may expire before the end of the election period. See Pub. 514 for more information.

1. Foreign Taxes Eligible for a Credit

A taxpayer can take a credit for income, war profits, and excess profits taxes paid or accrued during their tax year to any foreign country or U.S. possession, or any political subdivision (for example, city, state, or province) of the country or possession. This includes taxes paid or accrued in lieu of a foreign or possession income, war profits, or excess profits tax that is otherwise generally imposed. For purposes of the credit, U.S. possessions include Puerto Rico and American Samoa.

U.S. citizens living in certain treaty countries may be able to take an additional foreign tax credit for foreign tax imposed on certain items of income from the United States. See Tax Treaties in Pub. 514 for details.

If the taxpayer makes the election under section 962 to be taxed at corporate rates on the amount to be included in gross income under sections 951(a) and 951A(a) from taxpayer’s controlled foreign corporations, the taxpayer can claim the credit based on their share of foreign taxes paid or accrued by the controlled foreign corporation. If a taxpayer makes this election, they must claim the credit by filing Form 1118. The taxpayer must also still file Form 1116 to claim the credit for other foreign taxes paid or accrued.

1. Foreign Taxes Not Eligible for a Credit

A taxpayer can't take a credit for the following foreign taxes.

1. Taxes paid to a foreign country that they don't legally owe, including amounts eligible for refund by the foreign country. If the taxpayer don't exercise their available remedies to reduce the amount of foreign tax to what they legally owe, a credit for the excess amount isn't allowed. The amount of tax actually withheld by a foreign country isn't necessarily 100% creditable.

**Example:** Country X withholds $25 of tax from a payment made to the taxpayer. Under the income tax treaty between the United States and Country X, the taxpayer owes only $15 and can claim a refund from Country X for the other $10. Only $15 is eligible for the foreign tax credit (whether or not the taxpayer applies for a refund).

1. Taxes imposed by and paid to certain foreign countries. These countries are those designated by the Secretary of State as countries that repeatedly provide support for acts of international terrorism, countries with which the United States doesn't have or doesn't conduct diplomatic relations, or countries whose governments aren't recognized by the United States and aren't otherwise eligible to purchase defense articles or services under the Arms Export Control Act. Pub. 514 contains a list of these countries.
2. Foreign taxes withheld on a dividend from a corporation, if the taxpayer hasn't held the stock for at least 16 days within the 31-day period that begins 15 days before the ex-dividend date. This required holding period is greater for preferred-stock dividends attributable to periods totaling more than 366 days. See section 901(k)(3) or Pub. 514.
3. Foreign taxes withheld on a dividend to the extent that the taxpayer has to make related payments on positions in substantially similar or related property.

**Example:** A taxpayer receives a dividend subject to foreign withholding tax. They are obligated to pay someone else an amount equal to all these dividends they receive. The taxpayer can't claim a foreign tax credit for the withholding tax on these dividends.

1. Foreign taxes withheld on income or gain (other than dividends) from property if the taxpayer hasn't held the property for at least 16 days within the 31-day period that begins 15 days before the date on which the right to receive the payment arises.
2. Foreign taxes withheld on income or gain (other than dividends) from property to the extent the taxpayer has to make related payments on positions in substantially similar or related property.
3. Payments of foreign tax that are returned to the taxpayer in the form of a subsidy.
4. Taxes paid or accrued to a foreign country in connection with the purchase or sale of oil or gas extracted in that country if the taxpayer doesn't have an economic interest in the oil or gas, and the purchase price or sales price is different from the fair market value of the oil or gas at the time of the purchase or sale.
5. Foreign taxes paid or accrued on income for which the taxpayer is claiming an exclusion on Form 8873, Extraterritorial Income Exclusion. However, see section 943(d) for an exception for certain withholding taxes.
6. The disqualified portion of any foreign tax paid or accrued in connection with a covered asset acquisition. Covered asset acquisitions include certain acquisitions that result in a stepped-up basis for U.S. tax purposes.
7. Foreign taxes disallowed under section 965(g).

The taxpayer can't take a credit for any interest or penalties they must pay.

#### Form 5471

Form 5471 is used by certain U.S. persons 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, as well as to report amounts related to section 965.

**Who Must File:** Generally, all U.S. persons described in Categories of Filers (from 1 to 5, detailed here *https://www.irs.gov/instructions/i5471#idm140511182610944*) must complete the schedules, statements, and/or other information requested in the chart, Filing Requirements for Categories of Filers.

1. If the filer is described in more than one filing category, duplicating information is not valid. However, the taxpayer must complete all items that apply. For example, if the taxpayer is the sole owner of a CFC (i.e., He or she is described in Categories 4 and 5), the taxpayer must complete all six pages of Form 5471 and separate Schedules E, H, I-1, J, M, and P.
2. **NOTE:** The taxpayer must complete a separate Form 5471 and all applicable schedules for each applicable foreign corporation.

**When and Where to File:** Form 5471 must be attached to the taxpayer’s income tax return (or, if applicable, partnership or exempt organization return) and file both by the due date (including extensions) for that return.

1. Exceptions from Filing

**Multiple filers of same information:** One person may file Form 5471 and the applicable schedules for other persons who have the same filing requirements. If the taxpayer and one or more other persons are required to furnish information for the same foreign corporation for the same period, a joint information return that contains the required information may be filed with taxpayer’s tax return or with the tax return of any one of the other persons. For example, a U.S. person described in Category 5 may file a joint Form 5471 with a Category 4 or another Category 5 filer. However, for Category 3 filers, the required information may only be filed by another person having an equal or greater interest (measured in terms of value or voting power of the stock of the foreign corporation).

1. Penalties
2. Failure to file information required by section 6038(a) (Form 5471 and Schedule M):
3. A $10,000 penalty is imposed for each annual accounting period of each foreign corporation for failure to furnish the information required by section 6038(a) within the time prescribed. If the information is not filed within 90 days after the IRS has mailed a notice of the failure to the U.S. person, an additional $10,000 penalty (per foreign corporation) is charged for each 30-day period, or fraction thereof, during which the failure continues after the 90-day period has expired. The additional penalty is limited to a maximum of $50,000 for each failure.
4. Any person who fails to file or report all of the information required within the time prescribed will be subject to a reduction of 10% of the foreign taxes available for credit under sections 901, 902 (with respect to foreign corporate tax years beginning before January 1, 2018), and 960. If the failure continues 90 days or more after the date the IRS mails notice of the failure to the U.S. person, an additional 5% reduction is made for each 3-month period, or fraction thereof, during which the failure continues after the 90-day period has expired. See section 6038(c)(2) for limits on the amount of this penalty.
5. Failure to file information required by section 6046 and the related regulations (Form 5471 and Schedule O)

Any taxpayer who fails to file or report all of the information requested by section 6046 is subject to a $10,000 penalty for each such failure for each reportable transaction. If the failure continues for more than 90 days after the date the IRS mails notice of the failure, an additional $10,000 penalty will apply for each 30-day period or fraction thereof during which the failure continues after the 90-day period has expired. The additional penalty is limited to a maximum of $50,000.

1. Criminal penalties

Criminal penalties under sections 7203, 7206, and 7207 may apply for failure to file the information required by sections 6038 and 6046.

**NOTE:** Any taxpayer required to file Form 5471 and Schedule J, M, or O who agrees to have another person file the form and schedules for him or her may be subject to the above penalties if the other person does not file a correct and proper form and schedule.

**Section 6662(j):** Penalties may be imposed for undisclosed foreign financial asset understatements. No penalty will be imposed with respect to any portion of an underpayment if the taxpayer can demonstrate that the failure to comply was due to reasonable cause with respect to such portion of the underpayment and the taxpayer acted in good faith with respect to such portion of the underpayment.

#### Form 3520

U.S. persons (and executors of estates of U.S. decedents) file Form 3520 to report:

1. Certain transactions with foreign trusts,
2. Ownership of foreign trusts under the rules of sections 671 through 679, and
3. Receipt of certain large gifts or bequests from certain foreign persons.

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

1. Who Must File?

Form 3520 filing is mandatory if any one or more of the following applies:

1. The taxpayer is either the responsible party for reporting a reportable event that occurred during the current tax year, or a U.S. person who transferred property (including cash) to a related foreign trust (or a person related to the trust) in exchange for an obligation or holds a qualified obligation from that trust that is currently outstanding.
2. The taxpayer is a U.S. person who, during the current tax year, is treated as the owner of any part of the assets of a foreign trust under the rules of sections 671 through 679.

The identifying information must be completed on page 1 of the form and Part II. If the taxpayer receives distributions from the foreign trust, he or she may also need to complete lines 15 through 18 of Part I if the answer was "No" to line 3, and Part III.

**Note:** The taxpayer is required to complete Part II even if there have been no transactions involving the trust during the tax year. He or she may also be required to complete a substitute Form 3520-A and attach it to his/her Form 3520.

1. The taxpayer is either a U.S. person (including a U.S. owner) or an executor of the estate of a U.S. person who received (directly or indirectly) a distribution (defined later) from a foreign trust during the current tax year, or a U.S. person who is a U.S. owner or beneficiary of a foreign trust and in the current tax year, the taxpayer or a U.S. person related to him/her received:
2. A loan of cash or marketable securities (including an extension of credit) directly or indirectly from such foreign trust.
3. The uncompensated use of trust property; or the taxpayer is a U.S. person who is a U.S. owner or beneficiary of a foreign trust and in the current tax year such foreign trust holds an outstanding qualified obligation of the taxpayer’ or a U.S. person related to him/her. U.S. person, owner, beneficiary, and related person are defined later.

The identifying information must be completed on page 1 of the form and Part III. In the case of a U.S. person that is an estate, “Executor” on line B on page 1 must be checked. If the taxpayer received an amount from a portion of a foreign trust of which he or she is treated as the owner, lines 24 and 27 in Part III must be completed.

1. The taxpayer is a U.S. person who, during the current tax year, received either:
2. More than $100,000 from a non-resident alien individual or a foreign estate (including foreign persons related to that non-resident alien individual or foreign estate) that were treated as gifts or bequests by the taxpayer himself.
3. More than $16,388 from foreign corporations or foreign partnerships (including foreign persons related to such foreign corporations or foreign partnerships) that the taxpayer treated as gifts.

The identifying information must be completed on page 1 of the form and Part IV.

1. **NOTE:** The taxpayer may be required to file FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR). In addition, the taxpayer may be required to file Form 8938, Statement of Specified Foreign Financial Assets.
2. Exceptions to Filing

Form 3520 does not have to be filed to report the following transactions:

1. Transfers to foreign trusts described in section 402(b), 404(a)(4), or 404A.
2. Most fair market value (FMV) transfers by a U.S. person to a foreign trust. However, some FMV transfers must nevertheless be reported on Form 3520 (for example, transfers in exchange for obligations that are treated as qualified obligations, transfers of appreciated property to a foreign trust for which the U.S. transferor does not immediately recognize all of the gain on the property transferred, transfers involving a U.S. transferor that is related to the foreign trust).
3. Transfers to foreign trusts that have a current determination letter from the IRS recognizing their status as exempt from income taxation under section 501(c)(3).
4. Transfers to, ownership of, and distributions from a Canadian registered retirement savings plan (RRSP), a Canadian registered retirement income fund (RRIF), or any other Canadian retirement plan that is within the meaning of section 3 of Rev. Proc. 2014-55. See Rev. Proc. 2014-55, 2014-44 I.R.B. 753, available at IRS.gov/irb/2014-44\_IRB/ar10.html.
5. Deemed transfers from domestic trusts that become foreign trusts to the extent the trust is treated as owned by a foreign person, after application of section 672(f).
6. Distributions from foreign trusts that are taxable as compensation for services rendered (within the meaning of section 672(f)(2)(B) and its regulations), so long as the recipient reports the distribution as compensation income on its applicable federal income tax return.
7. Distributions from foreign trusts to domestic trusts that have a current determination letter from the IRS recognizing their status as exempt from income taxation under section 501(c)(3).
8. Joint Returns

If the taxpayer and their spouse are filing a joint income tax return for tax year 2021, and they are both transferors, grantors, or beneficiaries of the same foreign trust, then a joint Form 3520 may be filed. If the taxpayer and their spouse are filing a joint Form 3520, the box on line 1i on page 1 must be checked.

1. When and Where to File

In general, a U.S. person's Form 3520 is due on the 15th day of the 4th month following the end of such person's tax year for income tax purposes, which, for individuals, is April 15. If, however, on the due date of the taxpayer’s income tax return, he or she is a U.S. citizen or resident who qualifies for one of the following conditions, then his/her Form 3520 is due on the 15th day of the 6th month (June 15) following the end of taxpayer’s tax year for income tax purposes. The taxpayer must include a statement on the Form 3520 showing that he or she is a U.S. citizen or resident who meets one of these conditions:

1. The taxpayer lives outside of the United States and Puerto Rico and his or her place of business or post of duty is outside the United States and Puerto Rico.
2. He or she is in the military or naval service on duty outside the United States and Puerto Rico.

In the case of a Form 3520 filed with respect to a U.S. decedent, the due date to file a Form 3520 is the 15th day of the 4th month following the end of the decedent's last tax year for income tax purposes (April 15). If the U.S. person's estate is also required to file a Form 3520, the estate will have to file by the 15th day of the 4th month following the end of the estate's tax year for income tax purposes, just like any other U.S. person.

If the due date falls on a Saturday, Sunday, or legal holiday, the taxpayer shall file by the next day that is not a Saturday, Sunday, or legal holiday.

1. **CAUTION:** If a U.S. person is granted an extension of time to file an income tax return, the due date for filing Form 3520 is the 15th day of the 10th month (October 15) following the end of the U.S. person’s tax year.

Form 3520 must have all required attachments to be considered complete. If a complete Form 3520 is not filed by the due date, including extensions, the time for assessment of any tax imposed with respect to any event or period to which the information required to be reported in Parts I through III of such Form 3520 relates will not expire before the date that is 3 years after the date on which the required information is reported.

1. Who Must Sign?

If the return is filed by:

1. An individual or a fiduciary, it must be signed and dated by that individual or fiduciary.
2. A partnership, it must be signed and dated by a general partner or limited liability company member.
3. A corporation, it must be signed and dated by the president, vice president, treasurer, assistant treasurer, chief accounting officer, or any other corporate officer (such as a tax officer) who is authorized to sign.

The paid preparer must complete the required preparer information at the bottom of page 6 of Form 3520 and must be sure to:

1. Sign the return in the space provided for the preparer's signature.
2. Give a copy of the return to the filer.
3. Penalties

**Section 6677:** A penalty applies if Form 3520 is not timely filed or if the information is incomplete or incorrect (see below for an exception if there is reasonable cause). Generally, the initial penalty is equal to the greater of $10,000 or the following (as applicable).

1. 35% of the gross value of any property transferred to a foreign trust for failure by a U.S. transferor to report the creation of or transfer to a foreign trust in Part I.
2. 35% of the gross value of the distributions received from a foreign trust for failure by a U.S. person to report receipt of the distribution in Part III.
3. 5% of the gross value of the portion of the foreign trust's assets treated as owned by a U.S. person under the grantor trust rules (sections 671 through 679) for failure by the U.S. person to report the U.S. owner information in Part II. Such U.S. person is subject to an additional separate 5% penalty (or $10,000 if greater), if such person:
4. Fails to ensure that the foreign trust files a timely Form 3520-A and furnishes the required annual statements to its U.S. owners and U.S. beneficiaries.
5. Does not furnish all of the information required by section 6048(b) or includes incorrect information.

If a foreign trust fails to file Form 3520-A, the U.S. owner must complete and attach a substitute Form 3520-A to the U.S. owner’s Form 3520 by the due date of the U.S. owner’s Form 3520 (and not the due date for the Form 3520-A, which is otherwise due by the 15th day of the 3rd month after the end of the trust’s tax year in order to avoid being subject to the additional separate penalty for the foreign trust’s failure to file Form 3520-A. For example, a substitute Form 3520-A that, to the best of the U.S. owner’s ability, is completed and attached to the U.S. owner’s Form 3520 by the due date for the Form 3520 (such as, April 15 for U.S. owners who are individuals), is considered to be timely filed.

Additional penalties will be imposed if the non-compliance continues for more than 90 days after the IRS mails a notice of failure to comply with the required reporting. If the IRS can determine the gross value (defined later) of the portion of the trust’s assets treated as owned by the U.S. person at the close of the tax year, then the additional penalties will be reduced as necessary to assure that the aggregate amount of such penalties do not exceed the gross value of the trust.

**Reasonable cause:** No penalties will be imposed if the taxpayer can demonstrate that the failure to comply was due to reasonable cause and not willful neglect.

**NOTE:** The fact that a foreign country would impose penalties for disclosing the required information is not reasonable cause. Similarly, reluctance on the part of a foreign fiduciary or provisions in the trust instrument that prevent the disclosure of required information is not reasonable cause.

**Section 6039F:** In the case of a failure to timely report foreign gifts described in section 6039F, the IRS will determine the income tax consequences of the receipt of such gift, and a penalty equal to 5% of the amount of such foreign gifts applies for each month for which the failure to report continues (not to exceed a total of 25%). No penalty will be imposed if the taxpayer can demonstrate that the failure to comply was due to reasonable cause and not willful neglect.

**Section 6662(j):** If a U.S. owner of a foreign trust is subject to a penalty imposed under section 6662 for an underpayment of tax required to be shown on a return, then such penalty may be increased under section 6662(j) for any portion of an underpayment which is attributable to any transaction involving any asset with respect to which information was required to be provided on Form 3520-A. No penalty will be imposed with respect to any portion of an underpayment if the taxpayer can demonstrate that the failure to comply was due to reasonable cause with respect to such portion of the underpayment and the taxpayer acted in good faith with respect to such portion of the underpayment.

1. Tax Treaties

The United States has bilateral income tax treaties, also known as conventions, with many countries. See Table 3 under the list of tax treaty tables at IRS.gov/Individuals/International-Taxpayers/Tax-Treaty-Tables for a list of countries with which the United States has an income tax treaty in effect.

Under these treaties, citizens and residents of the United States who are subject to taxes imposed by the foreign countries are entitled to certain credits, deductions, exemptions, and reductions in the rate of taxes of those foreign countries. If a foreign country with which the United States has a treaty imposes a tax on the taxpayer, he or she may be entitled to benefits under the treaty.

Treaty benefits generally are available to residents of the United States. They generally are not available to U.S. citizens who do not reside in the United States. However, certain treaty benefits and safeguards, such as the nondiscrimination provisions, are available to U.S. citizens residing in the treaty countries. U.S. citizens residing in a foreign country may also be entitled to benefits under that country's tax treaties with third countries.

1. Certification of U.S. residency

Form 8802 is used to request certification of U.S. residency for purposes of claiming benefits under a tax treaty. Certification can be requested for the current and any prior calendar years.

The taxpayer should examine the specific treaty articles to find if he or she is entitled to a tax credit, tax exemption, reduced rate of tax, or other treaty benefit or safeguard.

More information on tax treaties is available at: IRS.gov/Individuals/International-Taxpayers/Tax-Treaties.

1. Common Benefits

Some common tax treaty benefits are explained below. The credits, deductions, exemptions, reductions in rate, and other benefits provided by tax treaties are subject to conditions and various restrictions. Benefits provided by certain treaties are not necessarily provided by others.

1. Personal service income

If the taxpayer is a U.S. resident who is in a treaty country for a limited number of days in the tax year and meets certain other requirements, the payment received for personal services performed in that country may be exempt from that country's income tax.

1. Professors and teachers

If the taxpayer is a U.S. resident, the payment received for the first 2 or 3 years that he or she is teaching or doing research in a treaty country may be exempt from that country's income tax.

1. Students, trainees, and apprentices

If the taxpayer is a U.S. resident, amounts received from the United States for study, research, or business, professional, and technical training may be exempt from a treaty country's income tax.

Some treaties exempt grants, allowances, and awards received from governmental and certain nonprofit organizations. Also, under certain circumstances, a limited amount of pay received by students, trainees, and apprentices may be exempt from the income tax of many treaty countries.

1. Pensions and annuities

If the taxpayer is a U.S. resident, non-government pensions and annuities received may be exempt from the income tax of treaty countries.

Most treaties contain separate provisions for exempting government pensions and annuities from treaty country income tax, and some treaties provide exemption from the treaty country's income tax for social security payments.

1. Investment income

If the taxpayer is a U.S. resident, investment income, such as interest and dividends, that the taxpayer received from sources in a treaty country may be exempt from that country's income tax or taxed at a reduced rate.

Several treaties provide exemption for capital gains (other than from sales of real property in most cases) if specified requirements are met.

1. Tax Credit Provisions

If the taxpayer is a U.S. resident who receives income from or owns capital in a foreign country, he or she may be taxed on that income or capital by both the United States and the treaty country.

Most treaties allow the taxpayer to take a credit against or deduction from the treaty country's taxes based on the U.S. tax on the income.

1. Non-discrimination provisions

Most U.S. tax treaties provide that the treaty country cannot discriminate by imposing more burdensome taxes on U.S. citizens who are residents of the treaty country than it imposes on its own citizens in the same circumstances.

1. Saving clauses

U.S. treaties contain saving clauses that provide that the treaties do not affect the U.S. taxation of its own citizens and residents. As a result, U.S. citizens and residents generally cannot use the treaty to reduce their U.S. tax liability.

However, most treaties provide exceptions to saving clauses that allow certain provisions of the treaty to be claimed by U.S. citizens or residents. It is important for the taxpayer to examine the applicable saving clause to determine if an exception applies.

Review Questions

1. Pedro is a single taxpayer, and he had a gambling loss of $5,000, if he takes the standard deduction, can he claim this loss?
2. Yes, he can claim the standard deduction and the gambling loss.
3. No, he can only claim the loss if he itemizes the deductions.
4. Pedro must file as married and take the standard deduction in order to deduct the loss.
5. None of the above.

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| **Answer: B** |
| For tax year 2021, gambling losses are deducted as an Itemized Deduction on Line 16 of Form 1040, Schedule A. Only taxpayers that itemize can claim gambling losses. |

1. Which Form is used to report the cancellation of a debt over $600?
2. Form 1099-MISC.
3. Form 1099-DIV.
4. A y B.
5. Form 1099-C.

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| **Answer: D** |
| Lenders or creditors are required to issue Form 1099-C if they cancel a debt owed to them of $600 or more. |

1. Rebecca is an American citizen, working in France for an American employer. Her earned income of $35,000 is treated as:
2. Foreign Earned Income.
3. U.S. Earned Income.
4. Unearned income as it occurred outside the country.
5. None of the above.

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| **Answer: A** |
| Foreign earned income is income the taxpayer receives for working in a foreign country. Where or how the taxpayer 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 the taxpayer's bank account in the United States and their employer is located in New York City. |

1. Daniel claims the exclusion of foreign housing, due to this election, what credits will he not be able to claim?
2. Additional credit for children.
3. Credit for earned income.
4. He may claim any credit.
5. A and B are correct.

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| **Answer: D** |
| If the taxpayer claims the foreign housing exclusion, he or she cannot take the additional child tax credit or the earned income credit. |

### Other Income

#### Scholarship Income

The IRS mandates that any amount of money received as scholarship would generally be treated as non-taxable if the stated funds are used to finance higher education degree and are actually used to cater for the individual’s tuition and fees. However, amounts used as part of incidental expenses for example room allocation and equipment would generally be treated as taxable. In general, scholarship, fellowships, and grants that originate from sources outside the United States are not taxable to nonresident aliens who receive such grants. Nor are they reportable to Internal Revenue Service.

#### Barter Income

Bartering is the exchange of goods or services. A barter exchange is an organization whose members contract with each other (or with the barter exchange) to exchange property or services. The term doesn't include arrangements that provide solely for the informal exchange of similar services on a noncommercial basis (for example, a babysitting cooperative run by neighborhood parents). Usually there's no exchange of cash. An example of bartering is a plumber exchanging plumbing services for the dental services of a dentist.

#### Hobby Income

According to the IRS, an individual must report any income that is earned from hobby activities and must be able to differentiate between business income and hobby income. Hobby income is generally taxable as other income on Line 8 of Schedule 1, Form 1040 (or 1040-SR). However, losses from hobby activities cannot be used to reduce income from other business activities.

1. For example, the breeding of racehorses is an activity which might not be considered a trade or business when carried on by a full-time dentist. The IRS might contend that the activity was for personal enjoyment and disallow any loss for tax purposes.

#### 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. Alimony is a payment made to, or for, a spouse or former spouse under a divorce or legal separation document (instrument). It excludes voluntary payments which are not made under a divorce or separation document.

Alimony does not include:

1. Child support.
2. Non-cash property settlements.
3. Payments that are the taxpayer’s spouse's part of community income.
4. Payments to keep up the payer's property.
5. Use of the payer's property.
6. Voluntary payments. For example, if the decree has the taxpayer to pay $1,000 a month, and they pay $1,200, the additional $200 payment is considered a voluntary payment.

**REMINDER:** Since 2019 alimony is no longer be taxable to the recipient nor deductible by the payer, if the payments are done under a divorce or separation decree entered into after December 31, 2018, or if an agreement made before that date is changed to state that the alimony received is not included in the recipient’s income.

1. 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 divorce, for this purpose, includes the ending of a marriage by annulment or due to violations of state laws.

A property transfer is incident to a taxpayer’s divorce if the transfer:

1. Occurs within 1 year after the date the marriage ends.
2. Is related to the ending of the marriage.

A property transfer is related to the ending of a marriage if both of these conditions apply:

1. The transfer is made under an original or modified divorce or separation instrument.
2. 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.

The following items are not considered taxable income:

1. Adoption expense reimbursements for qualifying expenses.
2. Child support payments.
3. Gifts, bequests and inheritances (subject to limits).
4. Workers' compensation benefits (some exceptions may apply).
5. Meals and lodging for the convenience of the taxpayer’s employer.
6. Compensatory damages awarded for physical injury or physical sickness.
7. Welfare benefits.
8. Cash rebates from a dealer or manufacturer.
9. Child Support

Child support is defined as court ordered payments, generally made by the divorced parent who does not have custody of the child. The purpose of these payments is to help provide for the child or children. These payments are non-taxable to the recipient and non-deductible by the taxpayer making the payments.

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.

#### Non-Taxable Combat Pay

1. According to the IRS, a taxpayer may elect to include his or her non-taxable combat pay in his or her earned income, which may either increase or decrease the taxpayer’s EITC. This can be done in Form W-2.

#### Unearned Income

Unearned income includes taxable interest, ordinary dividends, capital gains (including capital gain distributions), rents, royalties, etc. It also includes taxable social security benefits, pension and annuity income, taxable scholarship and fellowship grants not reported on Form W-2, unemployment compensation, alimony, and income (other than earned income) received as the beneficiary of a trust.

1. Taxable Recoveries

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 may also have recoveries of nonitemized 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 their income in the year they receive it up to the amount by which the deduction or credit they took for the recovered amount reduced their 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 tax in the earlier year.

1. Illegal Income

Taxation of illegal income in the United States arises from the provisions of the Internal Revenue Code (IRC), enacted by the U.S. Congress in part for the purpose of taxing net income. As such, a person's taxable income will generally be subject to the same Federal income tax rules, regardless of whether the income was obtained legally or illegally.

### Constructive Receipt of Income

Constructive receipt is an accounting term that requires an individual or business to pay taxes on income despite the fact that the money has not yet been received in actuality. What matters instead is that the recipient of the income is able to control or utilize that money even when it is not in hand, for instance being able to spend funds deposited from a check before it has cleared.

Constructive receipt matters for reporting taxable income, especially under the cash-basis method of accounting.

Taxpayers must include any income on their taxes based on the year that income was constructively received, even if they don’t have possession of the funds.

### Constructive Dividends

In the case of constructive dividends, a taxpayer may be involved in a situation where he or she uses business income to pay for personal expenses. The IRS states that business income or cash receipts that are used to pay for the taxpayer’s personal expenses should be reported along with his or her other business income as taxable income for the year. The implication is that such business income would still be considered taxable income despite the fact that it has been used to settle personal expenses for the stated individuals.

In addition, the fact that these expenses are not considered as part of the business expenses necessary to support the business operations implies that the individual would not be allowed to include such expenses as deductible expenses for tax purposes. Therefore, such personal expenses should not be written off against the taxable income for the business.

Regarding constructive dividends, it is recommended that individual taxpayers to separate business income and expenses from their personal accounts in order to avoid such conflicts.

### Passive Income and Loss

#### Passive Income

The IRS defines this type of income as the one a taxpayer earns from passive activities, meaning, incidental income that does not relate in any way to the taxpayer’s primary means of income. For instance, in this case, for a taxpayer working in a corporation, rental income earned from his or her properties is considered passive income. Therefore, examples of passive income within federal tax law include income from rental properties as well as income earned by the individual from the activities in which the stated individual has no primary active role.

Income from lottery winnings, dividends, royalties, gains on stock and bonds as well as wages and salaries may not be considered as passive income. In addition, any identified passive income should be reported on Form 4797 or on Schedule D.

#### Passive Losses

Passive losses relate to the losses a taxpayer incurs from passive activity he or she does not materially participate in. The general rule, as stated by the IRS, is that an individual cannot use losses from passive activity to offset income from other non-passive activities.

For instance, in this case, any losses that are incurred by a taxpayer from his or her rental property should not be used to reduce the taxable income from his or her business activities.

Example

Maria Martinez invests in three business activities: A, B, and C. She does not materially participate in any of the activities during the year but participates in Activity A for 105 hours, in Activity B for 160 hours, and in Activity C for 125 hours. Her net passive income or loss from the three activities is:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | **A** | **B** | **C** | **Total** |
| Passive activity gross income | $600 | $700 | $900 | $2,200 |
| Passive activity deductions | ($200) | ($1,000) | ($300) | ($1,500) |
| Net passive activity income | $400 | ($300) | $600 | $700 |

Maria's passive activity gross income from significant participation passive activities of $2,200 exceeds her passive activity deductions of $1,500. A ratable portion of her gross income from significant participation activities with net passive income for the tax year.

Activities A and C are treated as gross income that is not from a passive activity. The ratable portion is figured by dividing:

1. The excess of her passive activity gross income from significant participation over passive activity deductions from such activities (here $700) by
2. The net passive income of only the significant participation passive activities having net passive income (here $1,000). The ratable portion is 70%.

Thus, $280 of gross income from Activity A ($400 x 70%) and $420 of gross income from Activity C ($600 x 70%) are treated as non-passive gross income. This adjustment prevents $700 from being offset by passive losses from another activity.

### Pass-through Income

Pass-through income is sent from a pass-through entity to its owners. Pass-through entities, also known as flow-through entities, generally relate to foreign partnership entities, as well as foreign grantor trust entities that are considered as payee of foreign payments, which is different from income that is generated by a U.S. entity. Pass-through entities are generally used to avoid double taxation. Investors or proprietors pay taxes only on their passed-through income from the entity, instead of the entity itself.

Essentially, income generated by pass-through entities are directly transferred to the proprietors or the entity and get taxed as personal income. This lets business owners to pay taxes on individual income instead of corporate or dividends taxes. When time for filing is come, the share of each partner on business profits is reported on a Schedule K-1.

Pass-through entities comprehend sole proprietorships, partnerships, LLCs and S-Corporations.

Example

Company Luna is a pass-through entity. It files a [tax return](http://www.investinganswers.com/node/4224) that looks like this:

|  |  |
| --- | --- |
| Revenues | $1,000,000 |
| Expenses | $500,000 |
| Earnings Before Interest and Taxes (EBIT) | $100,000 |
| Interest Paid | $100,000 |
| Earnings Before Taxes (EBT) | $400,000 |
| Taxes | --------------- |
| Net Income Available to Owners | $400,000 |

Luna has two owners, Luisa and Marco, who each own 50% of the company. Luna sends both Luisa and Marco a [Schedule K-1](http://www.investinganswers.com/node/76) that reports their portions of Luna's [pass-through income](http://www.investinganswers.com/node/1118). Luisa and Marco each file their own tax return with $200,000 reported as [income](http://www.investinganswers.com/node/5798). It is important to [note](http://www.investinganswers.com/node/5082) that Company Luna allocates the income to Luisa and Marco, regardless of whether the $400,000 in Net Income is actually distributed.

For example, assume that Luisa's tax burden ends up being 20% of $200,000 for [tax year](http://www.investinganswers.com/node/4582) 2021. She owes the IRS $40,000, but Luna did not make a distribution in 2021, and it may not make a distribution in 2022, either. Therefore, Luisa is responsible for taxes owed on income that she did not actually receive.

Losses are also passed-through to owners, but the total [deductible](http://www.investinganswers.com/node/5249) amount available is limited to the original [investment](http://www.investinganswers.com/node/4904) amount.

#### Qualified Business Income (QBI) Items

QBI is the net amount of qualified items of income, gain, deduction and loss from any qualified trade or business, including income from partnerships, S corporations, sole proprietorships, and certain trusts. Generally, this includes, but is not limited to, the deductible part of self-employment tax, self-employed health insurance, and deductions for contributions to qualified retirement plans (e.g. SEP, SIMPLE and qualified plan deductions).

QBI does not include items such as:

1. Items that are not properly includable in taxable income.
2. Investment items such as capital gains or losses or dividends.
3. Interest income not properly allocable to a trade or business.
4. Wage income.
5. Income that is not effectively connected with the conduct of business within the U.S.
6. Commodities transactions or foreign currency gains or losses.
7. Certain dividends and payments in lieu of dividends.
8. Income, loss, or deductions from notional principal contracts.
9. Annuities, unless received in connection with the trade or business.
10. Amounts received as reasonable compensation from an S corporation.
11. Amounts received as guaranteed payments from a partnership.
12. Payments received by a partner for services other than in a capacity as a partner.
13. Qualified REIT dividends.
14. PTP income.

More detailed information is available under section *Qualified Business Income (QBI)*, Chapter 7 - Module: *Business Expenses, Deductions and Credits* of this book, and in general, under such module.

### Royalties and Related Expenses

Royalties are payment for use of patents or copyrights or for the use and exhaustion of mineral properties. Royalties are taxable as ordinary income and are reported on Schedule E (Form 1040 or 1040-SR). Depletion deductions relating to the royalties are also reported on Schedule E. If the taxpayer owns an operating oil, gas, or mineral interest, or is a self-employed writer, investor, or artist, report royalty income, expenses, and depletion on Schedule C.

Examples of royalty income are:

1. License fees received for use, manufacture, or sale of a patented article.
2. Renting fees received from patents, copyrights, and depletable assets (such as oil wells).
3. Authors' royalties including advance royalties if not a loan.
4. Royalties for musical compositions, works of art, etc.
5. Proceeds of sale of part of his or her rights in an artistic composition or book, for example, sale of motion picture or television rights.

#### Related Expenses with Respect to Royalties Income

According to the IRS, taxpayers with an interest in any mineral property that generates royalty income may claim a depletion allowance, which will mainly be treated as a deduction against the taxable royalty income. However, individuals with royalty income must decide between using the cost depletion or the percentage depletion when claiming the depletion allowance on mineral property. It is allowed for these taxpayers to use the method that benefits them with the greatest amount of depletion allowance.

Other additional royalty expenses that are allowable deductions against taxable royalty income consist of overhead expenses, legal and administrative expenses, utilities, travel expenses that are mainly incurred in travelling to the mine locations.

Review Questions

1. A college student working on a degree in accounting received a $4,000 scholarship used for tuition at State University, a $1,000 scholarship used for fees and books and a $8,000 fellowship used for room and board. Compute the amount to be included in his income.
2. $8,000.
3. $5,000.
4. $13,000.
5. $9,000.

|  |
| --- |
| **Answer: A** |
| The IRS mandates that any amount of money received as scholarship would generally be treated as non-taxable if the stated funds are used to finance higher education degree and are actually used to cater for the individual’s tuition and fees. However, amounts used as part of incidental expenses for example room allocation and equipment would generally be treated as taxable. |

1. Which of the following is a payment considered as alimony?
2. Non-cash property settlements.
3. Voluntary payments.
4. Payments to a former spouse made under a separation instrument.
5. Payments for child support required by the divorce decree.

|  |
| --- |
| **Answer: C** |
| Alimony is a payment made to, or for, a spouse or former spouse under a divorce or legal separation document (instrument). Alimony does not include Child support, Non-cash property settlements, Payments that are the taxpayer’s spouse's part of community income, Payments to keep up the payer's property, Use of the payer's property and Voluntary payments. |

1. Which of the following income is considered passive income?
2. Rental income
3. Royalty income
4. Lottery winnings
5. Salaries

|  |
| --- |
| **Answer: A** |
| Examples of passive income within federal tax law include income from rental properties. Income from lottery winnings, dividends, royalties, gains on stock and bonds as well as wages and salaries may not be considered as passive income. |

1. Which of the following is royalty income?
2. Authors' royalties including advance royalties if not a loan.
3. Royalties for musical compositions, works of art, etc.
4. License fees received for use, manufacture, or sale of a patented article.
5. All of the above are royalty income.

|  |
| --- |
| **Answer: D** |
| Examples of royalty income are:   * License fees received for use, manufacture, or sale of a patented article. * Renting fees received from patents, copyrights, and depletable assets. * Authors' royalties including advance royalties if not a loan. * Royalties for musical compositions, works of art, etc. * Proceeds of sale of part of taxpayer rights in an artistic composition or book, for example, sale of motion picture or television rights. |

### State/Local Income Tax Refunds and Other Itemized Deduction Recoveries

#### Taxable State/Local Income Tax Refunds

Any state or local income tax that is refunded to individuals would be considered as taxable income for the year in all of the following occurred:

1. The refund was provided.
2. The taxpayer included the refund as part of the itemized deductions during the previous year.
3. The refund actually lowered the taxpayer’s total taxable income during the previous year.

#### Non-Taxable State or Local Income Tax Refunds

If a taxpayer has state or local income tax refunds for the previous year, if the stated tax refund was reported as a standard deduction for the previous year, he or she does not have to report the stated tax refunds as taxable income for the year.

Similarly, if a taxpayer itemized his or her deductions regarding the sales tax instead of using the state or local income tax to reduce his taxable income, he or she cannot report the stated tax refund as taxable income. Finally, individuals with state or local income tax refunds cannot be allowed to report the stated tax refund as taxable income if the previous year’s income returns were subject to the AMT and the previous year’s tax refunds were less than the stated AMT.

#### Other Itemized Deduction Recoveries

Taxpayers may include itemized deduction recoveries in their taxable income for the year in which the recovery is received. In the first place, this will only be applicable if in the previous year, the individual’s itemized deductions were more than the relevant standard deductions by the amount of the stated recovery. In addition, the taxpayer must have taxable income and the stated itemized deductions must not have been subject to the limit that is usually placed on itemized deductions.

### 1099 MISC, 1099 NEC, 1099 K Reporting, Irregularities, and Corrections

#### Form 1099-MISC

Form 1099-MISC, *Miscellaneous Income*, must be filed for each person in the course of taxpayer’s business to whom the taxpayer has paid the following during the year:

1. At least $10 in royalties (see the instructions for box 2) or broker payments in lieu of dividends or tax-exempt interest (see the instructions for box 8).
2. At least $600 in:
3. Rents.
4. Prizes and awards.
5. Other income payments.
6. Generally, the cash paid from a notional principal contract to an individual, partnership, or estate.
7. Any fishing boat proceeds.
8. Medical and health care payments.
9. Crop insurance proceeds.
10. Payments to an attorney.
11. Section 409A deferrals.
12. Nonqualified deferred compensation.

Form 1099-MISC must also be filed for each person from whom the taxpayer has withheld any federal income tax (report in box 4) under the backup withholding rules regardless of the amount of the payment.

#### Form 1099-NEC

The PATH Act, P.L. 114-113, Div. Q, sec. 201, accelerated the due date for filing Form 1099 that includes nonemployee compensation (NEC) from February 28 to January 31 and eliminated the automatic 30-day extension for forms that include NEC. Beginning with tax year 2020, Form 1099-NEC must be used to report nonemployee compensation.

1. **CAUTION:** Due to the creation of Form 1099-NEC, Form 1099-MISC was redesigned and certain box numbers, for reporting certain income, rearranged.

Form 1099-NEC, *Nonemployee Compensation* (NEC), must be filed for each person in the course of taxpayer’s business to whom the taxpayer has paid the following during the year:

At least $600 in:

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

Form 1099-NEC must also be filed for each person from whom the taxpayer has withheld any federal income tax (report in box 4) under the backup withholding rules regardless of the amount of the payment.

1. **NOTE:** Be sure to report each payment in the proper box because the IRS uses this information to determine whether the recipient has properly reported the payment.

#### Form 1099-K

Payments made with a credit card or payment card and certain other types of payments, including third-party network transactions, must be reported on Form 1099-K by the payment settlement entity under section 6050W and are not subject to reporting on Form 1099-MISC or Form 1099-NEC.

#### Corrections to Form 1099-MISC and 1099-NEC

If the taxpayer needs to correct a Form 1099-MISC or Form 1099-NEC that have been already sent to the IRS:

1. The form must be corrected as soon as possible, and the taxpayer is to file Copy A and Form 1096.
2. Furnish statements to recipients showing the correction.
3. Forms that are two or three to a page must not be cut or separated. The taxpayer is to submit the entire page even if only one of the forms on the page is completed.
4. The forms must not be stapled to Form 1096.
5. The taxpayer must not send corrected returns to the IRS if he or she is correcting state or local information only.

If the taxpayer is filing a correction on a paper form, do not check the VOID box on the form. A checked VOID box alerts IRS scanning equipment to ignore the form and proceed to the next one. The correction will not be entered into IRS records if the taxpayer checks the VOID box.

1. Filing Requirement Applies Separately to Originals and Corrections

The electronic filing requirements apply separately to original returns and corrected returns. Originals and corrections are not aggregated to determine whether the taxpayer is required to file electronically. For example, if a taxpayer files 400 Forms 1098 electronically and he or she is making 75 corrections, taxpayer’s corrections can be filed on paper because the number of corrections for Form 1098 is less than the 100-filing requirement. However, if the taxpayer is filing 100 or more Form 1098 corrections, they have to be filed electronically.

**How to report incorrect payer name and/or TIN:** If a payer discovers an error in reporting the payer (not recipient) name and/or TIN, it must be written a letter containing the following information.

1. Name and address of the payer.
2. Type of error (including the incorrect payer name/TIN that was reported).
3. Tax year.
4. Payer TIN.
5. Transmitter Control Code (TCC).
6. Type of return.
7. Number of payees.
8. Filing method (paper or electronic).
9. Was federal income tax withheld?

#### Considerations to Form 1099-MISC and 1099-NEC

A taxpayer is to report on Form 1099-MISC and Form 1099-NEC only when payments are made in the course of taxpayer’s trade or business. Personal payments are not reportable. A taxpayer is considered to be engaged in a trade or business if they operate for gain or profit. However, nonprofit organizations are considered to be engaged in a trade or business and are subject to these reporting requirements. Other organizations subject to these reporting requirements include trusts of qualified pension or profit-sharing plans of employers, certain organizations exempt from tax under section 501(c) or (d), farmers' cooperatives that are exempt from tax under section 521, and widely held fixed investment trusts. Payments by federal, state, or local government agencies are also reportable.

Review Questions

1. Teresa has state income tax refund to her in 2020. This refund was reported as a standard deduction in that year. What Teresa should do?
2. She has to report the tax refund as a taxable income in 2020.
3. She does not have to report the tax refund as a taxable income in 2021.
4. She can include that tax refund for 2019 liability.
5. None of the above are correct.

|  |
| --- |
| **Answer: B** |
| If a taxpayer has state or local income tax refunds for the previous year, if the stated tax refund was reported as a standard deduction for the previous year, he or she does not have to report the stated tax refunds as taxable income for the year. |

1. Luis has paid $750 in rents to Manuel. What Form should Luis send to Manuel?
2. Form 1099-NEC.
3. Form 1099-K.
4. Form 1099-MISC.
5. Form 1099-DIV.

|  |
| --- |
| **Answer: C** |
| Form 1099-MISC, Miscellaneous Income, must be filed for each person in the course of taxpayer’s business to whom the taxpayer has paid the following during the year:   * At least $10 in royalties (see the instructions for box 2) or broker payments in lieu of dividends or tax-exempt interest (see the instructions for box 8). * At least $600 in:   + Rents.   + Prizes and awards. |

1. Elena has paid $1,250 to Gabriel, because he did a repair in her office. What Form should Elena send to Gabriel?
2. Form 1099-NEC.
3. Form 1099-K.
4. Form 1099-MISC.
5. Form 1099-DIV.

|  |
| --- |
| **Answer: C** |
| Form 1099-NEC, Nonemployee Compensation (NEC), must be filed for each person in the course of taxpayer’s business to whom the taxpayer has paid the following during the year:  At least $600 in:   * Services performed by someone who is not taxpayer’s employee. |

## Module: Retirement Income

An individual retirement arrangement (IRA) is a tax-favored personal savings account, which allows the taxpayer to set aside money for retirement. There are several different types of IRAs, which the taxpayer can set up with a bank, insurance company, or other financial institution.

### Basis in a Traditional IRA

The taxpayer may be able to deduct some or all of his or her contributions to this type of IRA. The taxpayer may also be eligible for a tax credit equal to a percentage of his or her contribution. Amounts in the taxpayer’s traditional IRA, including earnings, generally are not taxed until distributed to the taxpayer. IRAs cannot be owned jointly. However, any amounts remaining in the taxpayer’s IRA upon his or her death will be paid to the taxpayer beneficiary or beneficiaries.

Since 2019, to contribute to a traditional IRA a taxpayer has no longer an age limitation. The taxpayer, and/or their spouse if they file a joint return, must also have taxable compensation, such as wages, salaries, commissions, tips, bonuses, or net income from self-employment. Taxable alimony and separate maintenance payments received by an individual are treated as compensation for IRA purposes.

Compensation does not include earnings and profits from property, such as rental income, interest and dividend income, or any amount received as pension or annuity income, or as deferred compensation.Distributions from a traditional IRA are fully or partially taxable in the year of distribution. If the taxpayer made only deductible contributions, distributions are fully taxable. Use Form 8606 to figure the taxable portion of withdrawals.

A Roth IRA is a tax-favored account or annuity set up in the United States solely for the benefit of the taxpayer or his or her beneficiaries. The taxpayer can contribute to a Roth IRA if he or she has taxable compensation and the taxpayer’s modified AGI is within certain limitations. Regardless of the amount of the taxpayer’s AGI, he or she may be able to convert amounts from either a traditional, SEP, or SIMPLE IRA into a Roth IRA. The taxpayer also may be able to roll over amounts from a qualified retirement plan to a Roth IRA. A Roth IRA differs from a traditional IRA in that contributions are not deductible and qualified distributions are not included in income.

A Roth IRA differs from a traditional IRA in several aspects. Contributions to a Roth IRA are not deductible (and the taxpayer does not report the contributions on his or her tax return), but the taxpayer also is not taxed on qualified distributions or distributions that are a return of contributions. In addition, the taxpayer does not have age limitation to contribute to a Roth IRA. To be a Roth IRA, the account or annuity must be designated as a Roth IRA when it is set up.

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

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

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

Distributions that a taxpayer rolls over or transfer to another IRA or qualified retirement plan are not subject to this 10% additional tax.

For 2021, the maximum a taxpayer can contribute to all of his or her traditional and Roth IRAs is the smaller of:

1. $6,000 ($7,000 if taxpayer is of age 50 or older), or
2. His or her taxable compensation for the year.

The IRA contribution limit does not apply to:

1. Rollover contributions.
2. Qualified reservist repayments.
3. Non-deductible Contributions

Although a deduction for IRA contributions may be reduced or eliminated, contributions can be made to an IRA of up to the general limit or, if it applies, the spousal IRA limit. The difference between the total permitted contributions and the IRA deduction is the non-deductible contribution.

To designate contributions as non-deductible, Form 8606 must be filed, even if the taxpayer does not have to file a tax return for the year.

1. Failure to Report Non-deductible Contributions

If a taxpayer does not report non-deductible contributions, all of the contributions to the taxpayer's traditional IRA will be treated like deductible contributions when withdrawn. All distributions from the IRA will be taxed unless the taxpayer can show, with satisfactory evidence, that non-deductible contributions were made.

1. Penalty for Failure to File Form 8606

A taxpayer will have to pay a $50 penalty if he or she does not file a required Form 8606, unless it can be proved that the failure was due to reasonable cause.

#### Cost Basis

Taxpayers would have a cost basis in their traditional IRA if they made any non-deductible contributions. The cost basis is the sum of the non-deductible contributions to the IRA minus any withdrawals or distributions of non-deductible contributions.

### Comparison of and Distributions from Traditional and Roth IRAs

#### Comparisons

The first point of comparison between traditional IRAs and the Roth IRAs is the income limits. Any person is allowed to make contributions to the traditional IRA. On the other hand, Roth IRAs normally have income eligibility restrictions. The following chart shows how contributions to a Roth IRA are affected by the taxpayer’s MAGI, namely the phaseout amounts for a Roth IRA for 2021 tax year:

|  |  |  |
| --- | --- | --- |
| 1. **Filing Status** | 1. **MAGI** | 1. **Contribution amount** |
| 1. Married filing jointly and qualifying widower | 1. $198,000 or less | 1. Up to the limit |
| 1. $198,000 - $208,000 | 1. Reduced amount |
| 1. $208,000 or more | 1. $0 |
| 1. Married filing separately and the taxpayer lived with his spouse during the tax year | 1. $10,000 or less | 1. A reduced amount |
| 1. $10,000 or more | 1. $0 |
| 1. Single, head of household, or married filing separately who did not live with his or her spouse during tax year | 1. $125,000 or less | 1. Up to the limit |
| 1. $125,000 - $140,000 | 1. Reduced amount |
| 1. $140,000 or more | 1. $0 |

When it comes to the issue of tax incentives, both the traditional and Roth IRAs offer fair tax breaks. The difference lies in the matter of timing to claim for this tax breaks. Moreover, traditional IRAs contributions are normally tax deductible on both the state and the federal tax returns for the year in which the contribution is made, whereas withdrawals in retirement are normally taxed at the ordinary income tax rates. In the case of Roth IRAs, they do not provide tax breaks on contributions, but the withdrawals, as well as income, are tax-free in general.

### Distributions from Qualified and Non-Qualified Plans

In general terms, distributions from a traditional IRA are normally regarded as ordinary income, meaning they are subject to income taxation. Moreover, the distributed amount could be subjected to early distribution sanctions if the amount is withdrawn when the account holder is still under age 59½. For Roth IRAs, the qualified distributions are normally tax- and penalty-free.

Qualified and non-qualified retirement plans are normally offered by the employers with the objective of benefiting an employee. The qualified plans are meant to give individuals extra tax incentives. This is normally in addition to their normal retirement plans. In this case, the employers normally deduct an allowable amount from the pre-tax income of the employee and make the necessary contributions. These incomes increase, tax-deferred, up to the time of withdrawal. Regarding non-qualified plans, they are not eligible for tax-deferral incentives; hence, the contributions that are deducted are subjected to tax upon realization of the income.

There is no unique reporting for the qualified charitable distributions. However, the distributions from commercial annuities have to be reported. Moreover, the taxpayer must also report distributions to plans under Section 409A, Non-Qualified Deferred Compensation Plans, as well as plans under Section 457(b), Eligible Non-Governmental Plans, on Form W-2, but not on Form 1099-R.

1. Rollovers

A rollover moves retirement funds from one custodian to another, typically without paying taxes on the money transferred.

1. Direct rollovers are identified on Form 1099-R by using either the G or H distribution codes in box 7.
2. Indirect rollovers occur when the owner of the account takes possession of the retirement funds and re-deposits them into another qualified retirement account.

In order to avoid the funds being taxed as income and possible early distribution penalties, typically the funds must be rolled over into a qualified account within 60 days of distribution. Generally, the taxpayer is only allowed to do one indirect rollover in a 12-month period.

Funds distributed directly to the taxpayer are generally subject to a 20% federal income tax withholding. This means that the taxpayer must contribute additional funds in order to make up for the 20% that was withheld so that the rollover amount is equal to the total distribution. When a rollover meets all of the Internal Revenue Service guidelines, the distribution is not taxed; however, the amount still must be reported on the taxpayer’s tax return.

1. Form 1099-R

This form is used to report distributions from annuities, profit-sharing plans, retirement plans, IRAs, insurance contracts, or pensions. It deals specifically with passive income and retirement plans.

The taxpayer should receive a copy of Form 1099-R, or some variation, if he or she received a distribution of $10 or more from his or her retirement plan.

#### Qualified Charitable Distributions (QCD)

Generally, a qualified charitable distribution is an otherwise taxable distribution from an IRA (other than an ongoing SEP or SIMPLE IRA) owned by an individual who is age 72 or over that is paid directly from the IRA to a qualified charity. Qualified charitable distributions can satisfy all or part the amount of taxpayer’s required minimum distribution from taxpayer’s IRA.

The maximum annual exclusion for QCDs is $100,000. Any QCD in excess of the $100,000 exclusion limit is included in income as any other distribution. If the taxpayer files a joint return, their spouse can also have a QCD and exclude up to $100,000. The amount of the QCD is limited to the amount of the distribution that would otherwise be included in income. If taxpayer’s IRA includes nondeductible contributions, the distribution is first considered to be paid out of otherwise taxable income.

1. Annuities

If the taxpayer receives retirement benefits in the form of pension or annuity payments from a qualified employer retirement plan, all or some portion of the amounts the taxpayer receives may be taxable.

The pension or annuity payments that the taxpayer receives are fully taxable if he or she has no investment in the contract (sometimes referred to as "cost" or "basis") due to any of the following situations:

1. The taxpayer didn't contribute anything or is not considered to have contributed anything for the taxpayer’s pension or annuity.
2. The taxpayer’s employer didn't withhold contributions from the taxpayer’s salary, or
3. The taxpayer received all of his or her contributions tax-free in prior years.

### Excess Contributions and Tax Treatment

A taxpayer whose actual contributions, excluding the catch-up ones, exceed the maximum amount contributable (MAC), has excess contributions. These may lead to an income tax charge, additional taxes and penalties. The consequences of an excess contribution depend on the type of extra contribution made. If, at any time in the course of the year, a taxpayer’s employment status or compensation changes, they must refigure their MAC by using a revised estimate of the income in order to avoid having excess contributions.

At the beginning of each year, taxpayers should figure their MAC based on their actual compensation and contributions. If the income changes during the year, the taxpayer should refigure the MAC based on a revised estimate of compensation, in order to determine if the contributions to the 403(b) account should be increased or decreased for the year.

A taxpayer may correct certain excess contributions in a 403(b) account; the effect of an excess 403(b) contribution depends on its type:

1. **Excess annual addition:** A contribution exceeding the taxpayer’s limit on annual additions. In this case, the excess amount is included in his or her income. If a taxpayer’s 403(b) is investing in mutual funds and the limit on annual additions is surpassed, a penalty of 6% of excise tax will be issued.
2. **Excess elective deferral:** A contribution exceeding the taxpayer’s limit on elective deferrals. Excess deferrals may be corrected, but only the taxpayer complies with both of the following:
3. The plan and either the taxpayer or his or her employer designate the distribution as an excess deferral to the extent he or she has excess deferrals for the year.
4. The correcting distribution is made after the date on which the excess deferral was made.

A taxpayer with excess deferrals for a year may receive a correcting distribution by April 15 of the following year.

1. **NOTE:** In the case of Roth contributions, the excess deferral is included in income in the year contributed and the earnings on the excess deferral are taxed in the year of distribution.
2. Form 5329

Use Form 5329 to report additional taxes on:

1. IRAs,
2. Other qualified retirement plans,
3. Modified endowment contracts,
4. Coverdell ESAs,
5. QTPs,
6. Archer MSAs,
7. HSAs, or
8. ABLE accounts.

The taxpayer must file Form 5329 if any of the following apply:

1. The taxpayer received a distribution from a Roth IRA and either the amount on line 25c of Form 8606, Nondeductible IRAs, is more than zero, or the distribution includes a recapture amount subject to the 10% additional tax, or it’s a qualified first-time homebuyer distribution.
2. The taxpayer received a distribution subject to the tax on early distributions from a qualified retirement plan (other than a Roth IRA). However, if distribution code 1 is correctly shown in box 7 of all the taxpayer’s Forms 1099-R and he or she owes the additional tax on the full amount shown on each Form 1099-R, the taxpayer doesn’t have to file Form 5329.
3. The taxpayer received a distribution subject to the tax on early distributions from a qualified retirement plan (other than a Roth IRA) and the taxpayer meets an exception to the tax on early distributions, but box 7 of their Form 1099-R doesn’t indicate an exception or the exception doesn’t apply to the entire distribution.
4. The taxpayer received taxable distributions from Coverdell ESAs, QTPs, or ABLE accounts.
5. The contributions for 2022 to the taxpayer’s traditional IRAs, Roth IRAs, Coverdell ESAs, Archer MSAs, HSAs, or ABLE accounts exceed their maximum contribution limit, or the taxpayer had a tax due from an excess contribution on line 17, 25, 33, 41, or 49 of his or her 2021 Form 5329.
6. The taxpayer didn’t receive the minimum required distribution from their qualified retirement plan. This also includes trusts and estates that didn’t receive this amount.

### **Penalties and Exceptions on Premature Distributions from Qualified Retirement Plans and** IRAs

Taxpayers who make early withdrawals from their retirement plans are subject to a 10% penalty on their returns. This applies to all individuals with retirement plans, annuities and IRAs. However, the penalties have some exceptions. Essentially, the penalty does not apply to non-qualified plans funded by trusts or distribution from a non-tax-exempt organization. In actual fact, early distribution plans are applicable only to the amount that is inclusive of gross income. Some of the common exceptions inherent to these provisions include:

1. **Death and age exemptions:** The 10% penalty does not apply to an individual with at least age 59½. Additionally, the provision does not apply to the distribution of a deceased estate after the death of the taxpayer.
2. **Exception on disability basis:** Congress has approved that the 10% penalty does not apply in the situation the taxpayer is disabled. Categorically, disability of spouse does not guarantee taxpayer exemption. Notably, the law stipulates that a disabled person is an individual who cannot perform substantial work that can enable him to pay for tax.

Moreover, the law states that a beneficiary or a taxpayer is liable for the 10% tax even if he/she had not reported an early distribution to the IRS.

### Prohibited Transactions and Tax Consequences

These are certain transactions made between a retirement plan and a disqualified individual. If said individual engages in prohibited transactions, he or she must pay tax. Prohibited transactions in a qualified plan include:

1. A fiduciary’s act, through which he or she deals with plan income or assets for his or her interest.
2. A fiduciary’s receipt of consideration for his or her own account in a transaction involving plan income or assets from any party dealing with the plan in a transaction.
3. A disqualified individual’s transfer of plan income, assets, or their use for the individual’s advantage.
4. Sale, exchange or lease of property between a plan and a disqualified individual.
5. The lending of money or extending of credit between a plan and a disqualified individual.
6. The furnishing of goods, services or facilities between a plan and a disqualified individual.

Disqualified individuals in this context include the IRA owner’s fiduciary, as well as the members of his or her family. Some of the prohibited transactions under an IRA account include:

1. Selling property to the IRA.
2. Borrowing money from the IRA.
3. Using the IRA as a collateral in order to secure a loan.
4. Buying property for personal use with funds (present or future) from the IRA account.
5. Fiduciary

A person that does any of the following is considered an IRA fiduciary:

1. A person providing investment advice to the IRA for a fee, or who has any authority or responsibility to do so.
2. A person who exercises any discretionary authority or control in managing the IRA, or in managing or disposing of its assets.
3. A person with any discretionary authority or responsibility in administering the IRA.

An owner or beneficiary of an IRA account who engages in a prohibited transaction will result in that account ceasing to be an IRA as from the first day of the same year. The account is then treated as if it distributed all of its assets to the IRA owner at their FMV on the first day of the year. In the event where the sum of those values totals more that the basis in the IRA, the account owner will have a taxable gain, includible in their income.

### IRA Conversions and Recharacterization

When a person requests a Roth IRA conversion, assets are normally distributed from the non-Roth IRA before being rolled over into a person’s Roth IRA. The conversions are then reported on Form 1099-R.

A person may also recharacterize their IRA contribution, Roth IRA conversion or the Roth IRA rollover from a qualified retirement plan through the arrangement of a trustee-to-trustee transfer from a one IRA to another type of IRA. It must be known that the trustee-to-trustee transfers are normally carried out directly between financial institutions or just within the same financial organization. According to the latest instructions of Form 8606 regarding this issue, one must make the intended transfer by the due date of their return and ensure it appears on the individual’s return. This includes the extensions provided.

If an individual makes a contribution to an individual retirement account (IRA) (traditional or Roth) for a tax year, the individual is allowed to re-characterize the contribution as a contribution to the other type of IRA (traditional or Roth) by making a trustee-to-trustee transfer to the other type of IRA before the due date for the individual's income tax return for that year. In the case of a recharacterization, the contribution will be treated as having been made to the transferee IRA (and not the original, transferor IRA) as of the date of the original contribution. Both regular contributions and conversion contributions to a Roth IRA can be recharacterized as having been made to a traditional IRA.

For 2021, IRA contributions from one type are not recharacterized as a contribution to the other type of IRA. For example, a conversion contribution establishing a Roth IRA during a tax year is no longer recharacterized as a contribution to a traditional IRA.

**Recharacterization is still permitted in other situations:** For example, an individual can still make a contribution for a year to a Roth IRA and before the due date for the individual's income tax return for that year, recharacterize it as a contribution to a traditional IRA. In short, recharacterization provisions can no longer be used to unwind a Roth conversion.

### Required Minimum Distributions

A Required Minimum Distributions (RMD) is defined as the smallest amount that a taxpayer can withdraw from their retirement accounts every year. The IRS demands that an individual start taking their distributions when they reach age 72 for 2021 tax year. The RMDs are normally required for different retirement accounts, including the traditional IRAs. However, the Roth IRAs are not part of the RMDs arrangement. Note that the RMD payments have to start at the time a person attains 72 years of age.

Normally, the RMDs are calculated for every single IRA owned by the taxpayer, though he or she may be expected to add together the amounts to take the figure from a single account. Moreover, a taxpayer is allowed to withdraw more than the required figure within a year, but the extra amount cannot be credited for future distributions.

Regarding tax rates, the distributions from IRAs are normally included in the individual’s gross income and are subjected to a normal tax rate. A taxpayer is allowed to have the taxes withheld from their distribution as a prepayment for any IRS tax liability that they owe to the institution. For taxpayers that do not take their RMDs there is an excess accumulation penalty of 50% on the figure that is not distributed.

### Loans from Qualified Plans

If a taxpayer’s Section 401(k) plan allows him or her to take loans, the maximum amount that he or she can borrow is the lesser of:

1. The greater of:
2. $10,000.
3. 50% of the taxpayer’s vested account balance.
4. $50,000.

A vested account balance is the amount belonging to the taxpayer. This means, for example, that if a participant has an account balance of $40,000, the maximum amount that he or she is allowed to borrow is $20,000. It is important to note, however, that a Section 401(k) plan is not required to provide for loans.

The loan is normally settled within a period of five years, unless it is for purposes of purchasing a residential home; if this is the case, the loan may be repaid during a period of more than 5 years. Additionally, the loans are paid in quarterly installments.

If a taxpayer already has an outstanding loan, he or she must reduce the maximum amount of $50,000 by the difference between the highest outstanding balance of the participant’s loans during the 12-month period ending the day before the new loan, and the outstanding balance of all of the participant’s loan from the plan on the date the new loan comes in effect. It is recommended that the taxpayer needs to be careful, as the loan may adversely affect the earnings that he or she gets from their account and lower the amount of money that they finally receive from the plan on retirement.

### Taxability of Social Security and Railroad Retirement Benefits

Taxpayers receiving Social Security benefits may have to pay federal income tax on a portion of those benefits. Social Security benefits include monthly retirement, survivor and disability benefits. They don't include supplemental security income payments, which aren't taxable.

The portion of benefits that are taxable depends on the taxpayer's income and filing status.

To find out if their benefits are taxable, taxpayers should:

* Take one half of the Social Security money they collected during the year and add it to their other income. Other income includes pensions, wages, interest, dividends and capital gains.
* If they are single and that total comes to more than $25,000, then part of their Social Security benefits may be taxable.
* If they are married filing jointly, they should take half of their Social Security, plus half of their spouse's Social Security, and add that to all their combined income. If that total is more than $32,000, then part of their Social Security may be taxable.

Fifty percent of a taxpayer's benefits may be taxable if they are:

* Filing single, head of household or qualifying widow or widower with $25,000 to $34,000 income.
* Married filing separately and lived apart from their spouse for all of 2021 with $25,000 to $34,000 income.
* Married filing jointly with $32,000 to $44,000 income.

Up to 85% of a taxpayer's benefits may be taxable if they are:

* Filing single, head of household or qualifying widow or widower with more than $34,000 income.
* Married filing jointly with more than $44,000 income.
* Married filing separately and lived apart from their spouse for all year with more than $34,000 income.
* Married filing separately and lived with their spouse at any time during the year.

### Inherited Retirement Accounts

An inherited IRA is an account that is opened when an individual inherits an IRA or employer-sponsored retirement plan after the original owner dies. The individual inheriting the Individual Retirement Account (IRA) (the beneficiary) may be anyone [a spouse, relative, or unrelated party or entity (estate or trust)]. Rules on how to handle an inherited IRA differ for spouses and non-spouses, however.

#### Spouses

Spouses have more flexibility in how to handle an inherited IRA. For one, they can roll over the IRA, or a part of the IRA, into their own existing individual retirement accounts; the big advantage of this is the ability to defer required minimum distributions (RMDs) of the funds until they reach the age of 72. They have 60 days from receiving a distribution to roll it over into their own IRAs as long as the distribution is not a required minimum distribution.

If the original owner had already begun receiving RMDs at the time of death, the spousal beneficiary must continue to receive the distributions as calculated or submit a new schedule based on their own life expectancy. If the owner had not yet committed to an RMD schedule or reached their required beginning date (RBD), the beneficiary of the IRA has a five-year window to withdraw the funds, which would then be subject to income taxes.

1. Non-Spouses

Non-spouse beneficiaries may not treat an inherited IRA as their own. That is, they may not make additional contributions to the account, nor can they transfer funds into an existing IRA account they have in their own names. Non-spouses may not leave assets in the original IRA. They must set up a new inherited IRA account unless they want to distribute the assets immediately via a lump-sum payment.

The SECURE Act dictates that, for accounts inherited after Dec. 31, 2019, non-spouse beneficiaries typically must cash out the account within 10 years of the original owner's death. Some heirs are exempted: those whose age is within a decade of the deceased's, disabled or chronically ill individuals, or minor children. However, these minors must be direct descendants (no grandchildren, in other words), and, once they reach majority age, the 10-year rule applies for them too. There's no particular timetable for the withdrawals; they can be taken annually or all at once. For beneficiaries in these categories and those already in possession of inherited IRAs, the old distribution rules and schedules remain in effect.

### Foreign Pensions and Retirement Income

A foreign pension or annuity distribution is normally a retirement plan received from a source that is outside the United States of America. Just like in the case of the domestic pensions or annuities, the taxable amount for the foreign case is normally the gross distribution amount minus the cost. The income received from the foreign pensions may be partly or fully taxable even if the individual does not get the Form 1099 report regarding the amount of income. The foreign pensions are normally taxed under the domestic tax laws of the United States of America.

If both spouses have taxable income, each can set up an IRA. An IRA cannot be set up for spouses to use jointly. If filing a joint return, only one spouse needs to have income.

Review Questions

1. Generally, which of the following rules applies to both traditional IRAs and Roth IRAs?
2. Both traditional and Roth IRAs offer tax breaks.
3. Contributions are always nondeductible.
4. Contributions may not be made for the tax year in which the taxpayer reaches age 70½, or for years thereafter.
5. Contributions phaseout limits are the same for both traditional IRAs and Roth IRAs.

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| **Answer: A** |
| When it comes to the issue of tax incentives, both the traditional and Roth IRAs offer fair tax breaks. The difference lies in the matter of timing to claim for these tax breaks. Moreover, traditional IRAs contributions are normally tax deductible on both the state and the federal tax returns for that year in which the contribution is made, whereas withdrawals in retirement are normally taxed at the ordinary income tax rates. For the case of the Roth IRAs, they do not provide tax breaks on contributions, but the withdrawals as well as incomes are tax-free in general. |

1. All of the following are examples of prohibited transactions with a traditional IRA, except for:
2. Selling property to it.
3. Using it as security for a loan.
4. Buying property for personal use with IRA funds.
5. Taking a distribution before after age 59½.

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| **Answer: D** |
| Some of the prohibited transactions under an IRA account include:   * Borrowing money from the IRA. * Selling property to the IRA. * Using the IRA as a collateral in order to secure a loan. * Buying property for personal use with funds (present or future) from the IRA account. |

1. Which of the following amounts may be converted directly to a Roth IRA, provided all requirements are met?
2. Amounts in a SIMPLE, SEP or traditional IRA.
3. Amounts in a traditional IRA inherited from a person other than a spouse.
4. Hardship distributions from a 401 (k) plan.
5. Required minimum distributions from a traditional IRA.

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| **Answer: A** |
| Regardless of the amount of the taxpayer AGI, he or she may be able to convert amounts from either a traditional, SEP, or SIMPLE IRA into a Roth IRA. The taxpayer also may be able to roll over amounts from a qualified retirement plan to a Roth IRA. A Roth IRA differs from a traditional IRA in that contributions are not deductible and qualified distributions are not included in income. |

1. The use of IRA funds in prohibited transactions can result in additional taxes and penalties. Which of the following is not a prohibited transaction in a traditional IRA?
2. Selling property to an IRA.
3. Borrowing money from the IRA.
4. Inheriting a spouse's IRA.
5. Using an IRA as security for a loan.

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| **Answer: C** |
| Some of the prohibited transactions under an IRA account include:   * Borrowing money from the IRA. * Selling property to the IRA. * Using the IRA as a collateral in order to secure a loan. * Buying property for personal use with funds (present or future) from the IRA account. |

1. Maite's modified adjusted gross income was $141,000. She made a $4,000 contribution to her previously established Roth IRA. What is the penalty for excess contributions if she doesn't withdraw the contribution?
2. $0.
3. $240.
4. $300.
5. $400.

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| **Answer: B** |
| Excess IRA contributions are subject to a tax of 6% per year as long as they remain in the IRA. Excess contributions occur when an individual contributes more than their contribution limit.  In this case, Maite has a MAGI of $141,000 exceeding the limit of $140,000, so she cannot contribute anything to her Roth IRA. The penalty is $4,000 x 6% = $240. |

1. The basis in property inherited from a decedent is generally one of the following, except:
2. The FMV of the property at the date of the individual's death.
3. The FMV on the alternate valuation date if the personal representative for the estate chooses to use alternate valuation.
4. The FMV of the property at the date it was sold by the decedent.
5. None of the above

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| **Answer: C** |
| The basis of property inherited from a decedent is generally one of the following:   * The FMV of the property at the date of the individual's death. * The FMV on the alternate valuation date if the personal representative for the estate chooses to use alternate valuation. * The value under the special use valuation method for real property used in farming or a closely held business if chosen for estate tax purposes. |

1. Raul is single and 52 years old, in 2021 he wants to contribute $8,000 to his IRA, which of the following is true??
2. Raul can contribute up to $10,000.
3. Raul cannot make contributions because of his age.
4. Raul may contribute up to a maximum of $6,000.
5. Raul may contribute up to a maximum of $7,000.

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| **Answer: D** |
| There are limits on how much a person can contribute to an IRA each year. By 2021, an individual's total contribution cannot exceed $6,000 (or $7,000 for individuals over 50). |

1. A taxpayer received the following from his employer during the year: $25,000 in regular wages, $5,000 in cash bonus, a trip valued at $1,000, and parking valued at $100 per month at a lot adjacent to the office building. His employer contributed $200 per month to a 401(k) plan for him. The taxpayer chose not to set aside any of his pay for the retirement plan. What amount of income must be reported?
2. $34,600.
3. $33,400.
4. $31,000.
5. $32,200.

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| **Answer: C** |
| Bonuses or awards that taxpayers receive for outstanding work are included in their income and should be shown on their Form W-2. These include prizes such as vacation trips for meeting sales goals. If the prize or award received is goods or services, taxpayers must include the fair market value of the goods or services in their income. Employees may exclude from gross earnings employer payments of up to $270 per month in 2021 to cover the cost of public transportation or parking for work.  The taxpayer’s gross income is: $25,000 in wages + $5,000 for the bonus + $1,000 in the trip, for a total of $31,000. |

## Module: Property, Real and Personal

Property refers to any asset owned. There are two main types of property; real property and personal property. Personal property is defined as any asset that is movable and not fixed permanently to one location, such as cars, tools and office equipment. Real property, on the other hand, refers to any asset that is immovable, such as land and houses.

### Sale or Disposition of Property Including Depreciation Recapture Rules and 1099A

Disposal of a property occurs when a taxpayer:

1. Sells property.
2. Exchanges the property for other property.
3. The property is condemned or disposed of under a threat to condemnation.
4. The property is repossessed.
5. The property is abandoned.
6. The property is given away.

A sale occurs when the property is transferred for money or a mortgage, note, or any other promise to pay money.

Gains or losses earned from property disposal are reported in Form 1040. In some cases, however, the gains are not taxable, or the losses incurred are not deductible. When a depreciable or amortizable property is disposed of at a gain, all or part of the gain, even if non-taxable, is to be treated as ordinary income. In order to determine gains that have to be reported as ordinary income, permanent records of allowed or allowable depreciation or amortization amounts must be kept, including the date and manner of acquisition, property costs or other basis, the depreciation or amortization, and all other adjustments that may affect basis.

File Form 1099-A, Acquisition or Abandonment of Secured Property, for every borrower, if the taxpayer lends money in connection with his or her business, and, in full or partial satisfaction of the debt, he or she obtains interest in property that is security for the debt, or the taxpayer has reason to know that the property was abandoned.

No reporting is required for tangible personal property if it is held for personal use, unless it is totally or partially held for business or investment. Additionally, if a property securing a loan is held outside the United States, there is no reporting required.

1. Depreciation Recapture Rules

Depreciation divides the cost associated with the use of an asset over a number of years. The IRS publishes specific depreciation schedules for different classes of assets. The schedules tell a taxpayer what percentage of an asset’s value may be deducted each year and the number of years for which the deductions may be taken.

For tax purposes, annual depreciation expense lowers the ordinary income that a company or individual pays each year and reduces the adjusted cost basis of the asset. If the depreciated asset is disposed of or sold for a gain, the ordinary income tax rate will be applied to the amount of the depreciation expense previously taken on the asset.

Depreciation recapture is a tax provision that allows the IRS to collect taxes on any profitable sale of an asset that the taxpayer had used to previously offset his or her taxable income. Since depreciation of an asset can be used to deduct ordinary income, any gain from the disposal of the asset must be reported and taxed as ordinary income, rather than the more favorable capital gains tax rate.

Depreciable capital assets held by a business for over a year are considered to be Section 1231 property, as defined in section 1231 of the IRS Code. Section 1231 is an umbrella for both Section 1245 property and Section 1250 property. Section 1245 refers to capital property that is not a building or structural component. Section 1250 refers to real estate property, such as buildings and land. The tax rate for the depreciation recapture will depend on whether an asset is a section 1245 or 1250 asset.

### Capital Gains and Losses

A capital gain, or loss, is the difference between the amount realized from the sale of a capital asset and the adjusted basis. A capital asset is everything a person owns and uses, either for personal or investment purpose. This may include a taxpayer’s home, house furnishings, stocks and bonds which are held as investments. A capital gain is realized when the sale value of an asset is more than the adjusted basis, while a capital loss is realized when the amount realized is less than the adjusted basis.

The IRS classifies capital gains and losses as either long-term or short-term, depending on the time an asset was held before disposal. Items held for less than one year since the date of acquisition up to (and including) the date of disposal are considered short-term, while those that have been held for longer than one year are considered long-term.

A net capital gain is the amount by which a net long-term capital gain for the year is more than the net short-term capital loss for the same year. Net long-term capital gains are long-term capital gains less long-term capital losses, including any unused long-term capital losses carried over from previous years. When one has a net capital gain, lower tax rates are applied rather than the tax rates used ordinary income.

When capital losses exceed the capital gains, the amount of losses one can claim in Form 1040 in order to lower income is the lesser of $3,000 ($1,500 if MFJ) or the total net loss. A taxpayer with big investment income may also be subject to net investment income tax.

1. Virtual Currencies

The IRS establishes that a taxpayer engaging in transactions involving virtual currency must report them on Schedule 1 of Form 1040 or 1040-SR. Said transactions include:

1. The receipt or transfer of virtual currency for free (without providing any consideration), including from an airdrop or following a hard fork.
2. An exchange of virtual currency for goods or services.
3. A sale of virtual currency.
4. An exchange of virtual currency for other property, including for another virtual currency.

If the taxpayer disposed of any virtual currency that was held as a capital asset, use Form 8949 to figure his or her capital gain or loss and report it on Schedule D (Form 1040 or 1040-SR).

Likewise, taxpayers that did any of the following actions must report the income as other income of the same type that they would report (for example, W-2 wages on Form 1040 or 1040-SR, line 1, or inventory or services from Schedule C on Schedule 1):

1. Received any virtual currency as compensation for services.
2. Disposed of any virtual currency that the taxpayer held for sale to customers in a trade or business.

#### Amount Recognized

The taxpayer’s gain or loss realized from a disposition of property is usually a recognized gain or loss for tax purposes. Recognized gains must be included in gross income, but recognized losses are deductible from gross income. Use Form 8949 to report the sale or exchange of a capital asset not reported on another form or schedule. Complete all necessary pages of Form 8949 before completing line 1b, 2, 3, 8b, 9, or 10 of Schedule D.

Use Form 4797 to report the following:

1. The sale or exchange of:
2. Real property used in the taxpayer’s trade or business;
3. Depreciable and amortizable tangible property used in the taxpayer’s trade or business (but see Form 4797 instructions);
4. Oil, gas, geothermal, or other mineral property; and
5. Section 126 property.
6. The involuntary conversion (other than from casualty or theft) of property used in a trade or business and capital assets held more than 1 year for business or profit.
7. The disposition of non-capital assets other than inventory or property held primarily for sale to customers in the ordinary course of the taxpayer’s trade or business.
8. Ordinary loss on the sale, exchange, or worthlessness of small business investment company (section 1242) stock.
9. Ordinary loss on the sale, exchange, or worthlessness of small business (section 1244) stock.
10. Ordinary gain or loss on securities or commodities held in connection with the taxpayer’s trading business, if he or she made a mark-to-market election.

Use Form 4684 to report involuntary conversions of property due to casualty or theft. Use Form 6781 to report gains and losses from Section 1256 contracts and straddles.

Form 8824 is used to report like-kind exchanges. A like-kind exchange occurs when a taxpayer exchanges business or investment property for property of a like-kind.

Form 8960 is used to figure any net investment income tax relating to gains and losses reported on Schedule D, including gains and losses from a securities trading activity.

#### Capital Asset

Most of the property owned by a taxpayer and used for personal purposes or investment is a capital asset. For example, the taxpayer’s house, furniture, car, stocks, and bonds are capital assets. A capital asset is any property owned by the taxpayer except the following:

1. Stock in trade or other property included in inventory or held mainly for sale to customers.
2. Accounts or notes receivable:
3. For services rendered in the ordinary course of the taxpayer’s trade or business,
4. For services rendered as an employee, or
5. From the sale of stock in trade or other property included in inventory or held mainly for sale to customers.
6. Depreciable property used in the taxpayer’s trade or business, even if it is fully depreciated.
7. Real estate used in the taxpayer’s trade or business.
8. A copyright; a literary, musical, or artistic composition; a letter or memorandum; or similar property that is:
9. Created by the taxpayer’s personal efforts,
10. Prepared or produced for the taxpayer (in the case of a letter, memorandum, or similar property), or
11. Received under circumstances (such as by gift) that entitle the taxpayer to the basis of the person who created the property or for whom the property was prepared or produced.
12. A U.S. Government publication, including the Congressional Record, received from the Government for less than the normal sales price, or received by the taxpayer under circumstances that entitle him or her to the basis of someone who received the publication for less than the normal sales price.
13. Certain commodities derivative financial instruments held by a dealer and connected to the dealer's activities as a dealer.
14. Certain hedging transactions entered into in the normal course of the taxpayer’s trade or business.
15. Supplies regularly used in the taxpayer’s trade or business.

#### Short- or Long-Term Gain or Loss

Short-term gains or losses are reported on Part I. Report long-term gains or losses in Part II. The holding period for short-term capital gains and losses is 1 year or less. The holding period for long-term capital gains and losses is more than 1 year.

#### Mark-To-Market Election for Traders

A trader may make an election under Section 475(f) to report all gains and losses from securities held in connection with a trading business as ordinary income (or loss), including those from securities held at the end of the year. Securities held at the end of the year are “marked-to-market” by treating them as if they were sold (and reacquired) for their FMV on the last business day of the year. Generally, the election must be made by the due date (not including extensions) of the tax return for the year prior to the year for which the election becomes effective. For this year, the election must have been made by April 15, 2020, in order to be effective for 2021.

Starting with the year the election becomes effective, a trader reports all gains and losses from securities held in connection with the trading business, including securities held at the end of the year, in Part II of Form 4797. For taxpayers who previously made the election, see the instructions for Form 4797.

A taxpayer holding securities for investment must identify them as such in his or her records on the day they were acquired (for example, by holding the securities in a separate brokerage account). Securities held by the taxpayer for investment are not marked-to-market.

#### Capital Gain Distributions

These are paid by a mutual fund or real estate investment trust from its net realized long-term capital gains. Do not treat said capital gain distributions as capital gains; include them on Form 1099-DIV as ordinary dividends. Enter on Schedule D, Line 13, the total capital gain distributions paid to the taxpayer, regardless of how long his or her investment was held. This amount is shown in box 2a of Form 1099-DIV.

If there is an amount in box 2b, include that amount on Line 11 of the Unrecaptured Section 1250 Gain Worksheet in the instructions for Schedule D if Line 19 of that schedule is completed.

If there is an amount in box 2c, see Exclusion of Gain on Qualified Small Business (QSB) Stock.

If there is an amount in box 2d, include that amount on Line 4 of the 28% Rate Gain Worksheet in the instructions if Line 18 of Schedule D is completed.

If the taxpayer received capital gain distributions as a nominee (that is, they were paid to him or her but actually belong to someone else), report on Schedule D, Line 13, only the amount that belongs to the taxpayer. Attach a statement showing the full amount received and the amount received as a nominee. See the Instructions for Schedule B to learn about the requirement for filing Forms 1099-DIV and 1096.

#### Capital Assets Held for Personal Use

Generally, gain from the sale or exchange of a capital asset held for personal use is a capital gain. Report it on Form 8949 with box C checked (if the transaction is short-term) or box F checked (if the transaction is long-term). However, if the taxpayer converted depreciable property to personal use, all or part of the gain on the sale or exchange of that property may have to be recaptured as ordinary income. Use Part III of Form 4797 to figure the amount of ordinary income recapture. The recapture amount is included on Line 31 (and Line 13) of Form 4797. Do not enter any gain from this property on line 32 of Form 4797.

Loss from the sale or exchange of a capital asset held for personal use is not deductible. But if the taxpayer had a loss from the sale or exchange of real estate held for personal use for which he or she received a Form 1099-S, the taxpayer must report the transaction on Form 8949 even though the loss is not deductible.

1. Cristina has a loss on the sale of a vacation home that is not her main home, and she received a Form 1099-S for the transaction. She has to report the transaction in Part I or Part II of Form 8949, depending on how long Cristina owned the home.

#### Capital Losses

The taxpayer can deduct capital losses up to the amount of capital gains plus $3,000 ($1,500 if married filing separately). He or she may be able to use capital losses exceeding this limit in future years. The taxpayer must make sure to report all of his or her capital gains and losses even if the taxpayer cannot use all of his or her losses in the fiscal year.

1. Non-deductible Losses

The taxpayer must not deduct a loss from a sale or exchange between certain related parties. This includes a direct or indirect sale or exchange of property between any of the following:

1. Members of a family.
2. A corporation and an individual who directly (or indirectly) owns more than 50% of the corporation's stock (unless the loss is from a distribution in complete liquidation of a corporation).
3. A grantor and a fiduciary of a trust.
4. A fiduciary and a beneficiary of the same trust.
5. A fiduciary of a trust and a fiduciary (or beneficiary) of another trust if both trusts were created by the same grantor.
6. An executor of an estate and a beneficiary of that estate, unless the sale or exchange was to satisfy a pecuniary bequest (that is, a bequest of a sum of money).
7. An individual and a tax-exempt organization controlled directly (or indirectly) by the individual or the individual's family.
8. A transaction resulting in a non-deductible loss is to be reported in Part I or Part II of Form 8949 (depending on how long the taxpayer held the property).

**At-risk rules:** If the taxpayer disposed of (a) an asset used in an activity to which the at-risk rules apply or (b) any part of his or her interest in an activity to which the at-risk rules apply, and the taxpayer has amounts in the activity for which he or she is not at risk, see the Instructions for Form 6198.

**Passive activity rules:** If the loss is allowable under the at-risk rules, it then may be subject to the passive activity rules. See Form 8582 and its instructions for details on reporting capital gains and losses from a passive activity.

#### Taxable Exchanges

This is defined as exchange in which the gain is taxable, or the loss is deductible. A taxable gain or deductible loss is also known as a recognized gain or loss. If the taxpayer receives property in exchange for other property in a taxable exchange, the basis of property received is usually its FMV at the time of the exchange. A taxable exchange occurs when a taxpayer receives cash or property not similar or related in use to the property exchanged.

1. Olivia trades a tract of farmland with an adjusted basis of $3,000 for a tractor that has an FMV of $6,000. Olivia must report a taxable gain of $3,000 for the land. The tractor has a basis of $6,000.
2. Involuntary Conversions

If a taxpayer receives property as a result of an involuntary conversion, such as a casualty, theft, or condemnation, he or she can figure the basis of the replacement property received using the basis of the converted property.

1. Similar or Related Property

If a taxpayer receives replacement property similar or related in service or use to the converted property, the replacement property's basis is the old property's basis on the date of the conversion. However, he or she must make the following adjustments:

1. Decrease the basis by the following:
2. Any loss the taxpayer recognizes on the conversion, and
3. Any money received by the taxpayer that he or she does not spend on similar property.
4. Increase the basis by the following:
5. Any gain the taxpayer recognizes on the conversion, and
6. Any cost of acquiring the replacement property.

**Money or property not similar or related:** If a taxpayer receives money or property not similar or related in service or use to the converted property, and he or she buys replacement property similar or related in service or use to the converted property, the basis of the new property is its cost decreased by the gain not recognized on the conversion.

Example

The state condemned Antonio’s property. The property had an adjusted basis of $26,000 and the state paid him $31,000 for it. Antonio realized a gain of $5,000 ($31,000 − $26,000), and he bought replacement property similar in use to the converted property for $29,000. Antonio recognizes a gain of $2,000 ($31,000 − $29,000), the unspent part of the payment from the state. Antonio’s gain that is not recognized is $3,000, the difference between the $5,000 realized gain and the $2,000 recognized gain.

The basis of the new property is figured as follows:

|  |  |
| --- | --- |
| Cost of replacement property | $29,000 |
| Minus: Gain not recognized | $3,000 |
| Basis of the replacement property | $26,000 |

#### Allocating the Basis

If a taxpayer buys more than one piece of replacement property, he or she is to allocate his or her basis among the properties based on their respective costs.

1. The state in the previous example condemned Antonio’s unimproved real property and the replacement property that he bought was improved real property with both land and buildings. Antonio must allocate the replacement property's $26,000 basis between land and buildings based on their respective costs.

#### Market Discount Bonds

In general, a capital gain from the disposition of a market discount bond is treated as interest income to the extent of accrued market discount as of the date of disposition. See the Instructions for Form 8949 for detailed information about how to report the disposition of a market discount bond.

#### Undistributed Capital Gains

Include on Schedule D, line 11, the amount from box 1a of Form 2439. This represents the taxpayer’s share of the undistributed long-term capital gains of the regulated investment company (including a mutual fund) or real estate investment trust. If there is an amount in box 1b, include that amount on Line 11 of the Unrecaptured Section 1250 Gain Worksheet if Line 19 of Schedule D is filled. If there is an amount in box 1d, include that amount on line 4 of the 28% Rate Gain Worksheet if Line 18 of Schedule D is filled.

Include on Form 1040, Schedule 3, Line 13, or Form 1040NR, line 69, the tax paid as shown in box 2 of Form 2439. Also check the box for Form 2439. Add to the basis of the taxpayer’s stock the excess of the amount included in income over the amount of the credit for the tax paid.

### Basis of Assets

The basis of an asset refers to its cost. This is the amount paid for its acquisition in cash, deposit, obligations, other property, or services. It also includes all other adjustments that affect the cost, such as freight, legal fees and all taxes attached to the asset.

The basis of personal property, such as stocks and bonds, is usually the purchase price plus any other cost of purchase such as commissions, transfer and recording fees. When an asset has not been purchased, its basis is determined by the FMV, or the previous owner’s adjusted basis of the asset. The FMV refers to the price at which a property would change hands between a seller and a buyer, with neither having to sell or buy, and with both having a reasonable knowledge of all facts. This can be determined by sales of the same property on or about the same date.

If a property has been received in exchange for a service, the property’s FMV should be included in the income, and therefore becomes the basis, unless in the case where the services were performed for an agreed price, then that price becomes the basis. For gifted property, the taxpayer must figure the adjusted basis to the donor before the gifting, plus all gift tax paid on the property. This becomes the new basis of that property.

#### Inherited Property

The basis of property inherited from a decedent is generally one of the following:

1. The FMV of the property at the date of the individual's death.
2. The FMV on the alternate valuation date if the personal representative for the estate chooses to use alternate valuation.
3. The value under the special­-use valuation method for real property used in farming or a closely held business if chosen for estate tax purposes.
4. 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.
5. Adjusted Basis

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

1. Increases to Basis

Increase the basis of any property by all items properly added to a capital account. These include the cost of any improvements having a useful life of more than 1 year. Rehabilitation expenses also increase basis, but the taxpayer has to subtract any rehabilitation credit allowed for these expenses before adding them to his or her basis.

If the taxpayer has to recapture any of the credit, he or she may increase his or her basis by the recaptured amount. If making additions or improvements to business property, the taxpayer must keep separate accounts for them. He or she must also depreciate the basis of each according to the depreciation rules that would apply to the underlying property if the taxpayer had placed it in service at the same time that he or she placed the addition or improvement in service.

The following items increase the basis of property:

1. The cost of extending utility service lines to the property.
2. Impact fees.
3. Legal fees, such as the cost of defending and perfecting title.
4. Zoning costs.
5. Legal fees for obtaining a decrease in an assessment levied against property to pay for local improvements.
6. The capitalized value of a redeemable ground rent.
7. Assessments for Local Improvements

Increase the basis of property by assessments for items such as paving roads and building ditches that increase the value of the property assessed. Do not deduct them as taxes. However, the taxpayer can deduct as taxes charges for maintenance, repairs, or interest charges related to the improvements.

1. Julia’s city changes the street in front of her store into an enclosed pedestrian mall and assesses her and other affected landowners for the cost of the conversion. Julia should add the assessment to her property's basis. In this example, the assessment is a depreciable asset.
2. Deducting vs. Capitalizing Costs

The taxpayer must not add to his or her basis costs than he or she can deduct as current expenses. For example, any amounts paid for incidental repairs or maintenance that are deductible as business expenses cannot be added to basis. Nevertheless, the taxpayer can choose either to deduct or capitalize certain other costs. If he or she makes the choice to deduct then, then the taxpayer cannot include them in his or her basis.

The costs that can be chosen to deduct or to capitalize include the following:

1. Carrying charges, such as interest and taxes, paid to own property, except carrying charges that must be capitalized under the uniform capitalization rules.
2. Research and experimentation costs.
3. Intangible drilling and development costs for oil, gas, and geothermal wells.
4. Exploration costs for new mineral deposits.
5. Mining development costs for a new mineral deposit.
6. Costs of establishing, maintaining, or increasing the circulation of a newspaper or other periodical.
7. Costs of removing architectural and transportation barriers to people with disabilities and the elderly. If the taxpayer claims the disabled access credit, he or she must reduce the amount deducted or capitalized by the amount of the credit.
8. Decreases to Basis

The following items reduce the basis of property:

1. Section 179 deduction.
2. Non-taxable corporate distributions.
3. Deductions previously allowed (or allowable) for amortization, depreciation, and depletion.
4. Exclusion of subsidies for energy conservation measures.
5. Certain vehicle credits.
6. Residential energy credits.
7. Postponed gain from sale of home.
8. Investment credit (part or all) taken.
9. Casualty and theft losses and insurance reimbursement.
10. Certain canceled debt excluded from income.
11. Rebates treated as adjustments to the sales price.
12. Easements.
13. Gas­-guzzler tax.
14. Adoption tax benefits.
15. Credit for employer ­provided child care.

Example

In January 2017, Alex paid $80,000 for real property to be used as a factory. He also paid commissions of $2,000 and title search and legal fees of $600. Alex allocated the total cost of $82,600 between the land and the building ($10,325 for the land and $72,275 for the building). Immediately, he spent $20,000 in remodeling the building before placing it in service. Alex was allowed depreciation of $14,526 for the years 2017 through 2020. In 2020, he had a $5,000 casualty loss from a storm that was not covered by insurance on the building. Alex claimed a deduction for this loss. He spent $5,500 to repair the damages and extend the useful life of the building.

The adjusted basis of the building on January 1, 2021, is figured as follows:

|  |  |
| --- | --- |
| 1. Original cost of building including fees and commissions | 1. $72,275 |
| 1. Adjustments to basis: |  |
| 1. Add: Improvements | 1. $20,000 |
| 1. Repair of damages | 1. $5,500 |
|  | 1. $97,775 |
| 1. Subtract: Depreciation | 1. $14,526 |
| 1. Deducted casualty loss | 1. $5,000 |
|  | 1. $19,526 |
| 1. **Adjusted basis on January 1, 2021** | 1. **$78,249** |

### Basis of Stock After Stock Splits and/or Stock Dividends

Usually, the basis of stocks bought is the total of the purchase price and any additional costs, including commissions and transfer or recording fees. Stocks received by any other means apart from purchase have their basis determined by the FMV or the previous owner’s adjusted basis.

The basis of shares of stocks or bonds sold is the cost or other basis of the particular stocks or bonds. If the stocks or bonds are sold at different times, in varying quantities, the basis of those securities is the basis of the securities that were acquired first.

The basis of securities must be adjusted for events that occur after their purchase. For example, if additional stocks are received from non-taxable dividends or stock splits, the basis of the original stock must be reduced. The basis of stocks must also be reduced when non-dividend distributions are received. Non-dividend distributions, up to the amount of the basis of stocks, are a non-taxable return of capital.

A stock split is a multiplying or dividing of a company's outstanding share count that doesn't change its overall market value or capitalization. For example, if a company doubles its share count by giving investors one additional share of stock for every share they own, each shareholder will own twice as many shares of stock, but the overall value of all outstanding shares won't change, as no additional capital will have been paid into the company.

Investors should always keep good records of their securities transactions, including copies of account statements, trade confirmations, and canceled checks. Federal securities laws require brokers to keep particular records for specified periods of time. Brokers must retain blotters (records containing details of all purchases and sales of securities) for at least six years. But they must keep copies of trade confirmations for only three years.

### Publicly Traded Partnerships (PTP)

A PTP is defined as any partnership with an interest that is regularly traded on a securities market. It does not include PTPs treated as corporations. Generally, an interest in a partnership is not considered property held for use in a business or trade, and, therefore, gains or losses from the sale or partnership interest should be considered as investment income.

A gain or loss incurred from the disposition of a partnership interest is treated as net investment income under Section 1411 and is subject to the net investment income tax. If the entire interest in a passive activity is disposed of to an unrelated person in a taxable transaction, the losses allocable to the activity for the tax year are not limited by the passive activity loss rules for income tax purposes. However, if the activity has always been a passive activity, the suspended passive losses from the activity are allowed in full as an allocable deduction.

Review Questions

1. A taxpayer bought investment property on March 9, 2020 and sold it on March 9, 2021. The property costed $100,000 and it was sold for $135,000. What is the character of the gain or loss?
2. Long term gain of $35,000.
3. Ordinary income of $135,000.
4. Short-term gain of $35,000.
5. Long-term gain of $135,000.

|  |
| --- |
| **Answer: C** |
| The holding period for short-term capital gains and losses is 1 year or less. The holding period for long-term capital gains and losses is more than 1 year. |

1. Maria has a capital loss of $4,500 for 2021, she is married and file as MFJ. How much of that loss can she claim in her Form 1040?
2. $4,500.
3. $1,500.
4. $3,000.
5. $0.

|  |
| --- |
| **Answer: C** |
| When capital losses exceed the capital gains, the amount of losses one can claim in Form 1040 in order to lower income is the lesser of $3,000 ($1,500 if MFJ) or the total net loss. A taxpayer with big investment income may also be subject to net investment income tax. |

1. What Form should be used to report involuntary conversions of property due to casualty?
2. Form 4684.
3. Form 8824.
4. Form 8995.
5. Form 1099-DIV.

|  |
| --- |
| **Answer: A** |
| Use Form 4684 to report involuntary conversions of property due to casualty or theft. Use Form 6781 to report gains and losses from Section 1256 contracts and straddles. |

1. In what Form is reported the capital gain?
2. Schedule C, Form 1040.
3. Schedule D, Form 1040.
4. Form 8995, Form 1040.
5. Form 1099-DIV.

|  |
| --- |
| **Answer: B** |
| Use Form 4684 to report involuntary conversions of property due to casualty or theft. Use Form 6781 to report gains and losses from Section 1256 contracts and straddles. |

1. Paola has a loss on the sale of a vacation home that is not her main home, and she received a Form 1099-S for the transaction. Where does she had to report that loss?
2. Schedule C.
3. Form 8949.
4. Form 8995.
5. Form 1099-DIV.

|  |
| --- |
| **Answer: B** |
| Loss from the sale or exchange of a capital asset held for personal use is not deductible. But if the taxpayer had a loss from the sale or exchange of real estate held for personal use for which he or she received a Form 1099-S, the taxpayer must report the transaction on Form 8949 even though the loss is not deductible. |

### Sale of a Personal Residence

The taxpayer may qualify to exclude up to $250,000 of gains from the sale of a personal residence from their income. For individuals filing joint returns, the exclusion is increased to $500,000.

To qualify for the primary residence exclusion, however, the taxpayer must meet the ownership and use test in Sec. 121 exclusions. If a taxpayer owned and used the home for at least two years out of the last five years prior to its sale, he or she is qualified. These can be different two-year periods, although both of them must be in one five-year period. A taxpayer is not eligible for Sec. 121 exclusions if they excluded gains from the sale of another house in the last two-year period prior to the sale of their residence. If one party in a marriage is on a qualified extended duty in the Uniformed Service or the intelligent community, they may opt to extend the five-year test to 10 years. A qualified extended duty is where for more than 90 days; one spouse is at a duty station more than 50 miles from the main home or residing under government orders in government housing.

A taxpayer reports the sale of a home if he or she receives an informational income reporting document such as Form 1099-S even if the gain from the sale is excludable. The taxpayer must also report the sale of the residence if he or she cannot exclude all the capital gain from the income.

In the case that the sales contract provides partial payment of the selling price to be made in a later year, the sale of the house must be reported under the installment method in Form 6252, Part II, Installment Sale Income.

### Installment Sales

This is a property sale where at least one payment is received after the tax year of the sale. Each payment of an installation shall include interest income, return of the adjusted basis of the property, and the gain on sale.

The interest from the installments must be reported as ordinary income. Property sales made using the installment method are reported in Form 6252. The sale is reported in the year it takes place and all consecutive years until the debt is paid off, even if he or she does not receive the payment in that year. Report only part of the gains received, or considered to have received as income. The return of the property basis is not included as income.

If depreciable property is sold to a related person using an installment method, the sale may not be reported using the installment method. If the related person disposes of the property before paying off the remaining installments, the original seller is required to file all the amounts realized by the related person from the sale as if received by the original seller.

Generally, interest on an installment sale is reported as ordinary income in the same manner as other interest income. When the sales contract does not provide enough interest, a part of the principal is characterized as stated interest or original issue discount for tax purposes, even if the sale resulted in a loss.

A taxpayer is required to report gain on an installment sale under the installment method unless he or she chooses to “elect out" of this requirement on or before the due date for filing the tax return (including extensions) in which the sale would be reported on. The taxpayer may elect out by reporting all the gain as income in the year of the sale on Form 4797, Sales of Business Property or on Form 1040, Schedule D and Form 8949.

An installment sale contract may provide that each deferred payment on the sale will include interest or that there will be an interest payment in addition to the principal payment. Interest provided in the contract is called stated interest.

If an installment sale contract doesn’t provide for adequate stated interest, part of the stated principal amount of the contract may be recharacterized as interest.

Example 1

Pablo sells property at a contract price of $6,000 and his gross profit is $1,500. Pablo’s gross profit percentage is 25% ($1,500 ÷ $6,000). After subtracting interest, Pablo reports 25% of each payment, including the down payment, as installment sale income from the sale for the tax year he receives the payment. The remainder (balance) of each payment is the tax-free return of Pablo’s adjusted basis.

Example 2

In 2017, Max sold land with a basis of $40,000 for $100,000. Max’s gross profit was $60,000. Max received a $20,000 down payment and the buyer's note for $80,000. The note provides for four annual payments of $20,000 each, plus 8% interest, beginning in 2017. Max’s gross profit percentage is 60%. Max reported a gain of $12,000 on each payment received in 2017 and 2018. In 2019, Max and the buyer agreed to reduce the purchase price to $85,000 and payments during 2019, 2020, and 2021 are reduced to $15,000 for each year.

The new gross profit percentage, 46.67%, is figured on the followingworksheet:

|  |  |  |
| --- | --- | --- |
| 1. | Enter the reduced selling price for the property. | $85,000 |
| 2. | Enter the taxpayer’s adjusted basis for the property. | $40,000 |
| 3. | Enter the taxpayer’s selling expenses. | -0- |
| 4. | Enter any depreciation recapture. | -0- |
| 5. | Add lines 2,3 and 4. | $40,000 |
| 6. | Subtract line 5 from line 1. This is the taxpayer’s adjusted gross profit. | $45,000 |
| 7. | Enter any installment sale income reported in prior years. | $24,000 |
| 8. | Subtract line 7 from line 6. | $21,000 |
| 9. | Future installments. | $45,000 |
| 10. | Divide line 8 by line 9. This is the new gross profit’s percentage | 46.67% |

Max will report a gain of $7,000 (46.67% of $15,000) on each of the $15,000 installments due in 2019, 2020, and 2021.

### Options

When receiving an option to buy stock as payment for services rendered, a taxpayer may have income when the option is received, when the option is exercised, or when the option is disposed of or stock received when the option is exercised.

When an employee receives a statutory stock option, they generally do not include any amount in their gross income when the stock option is received or exercised. However, they may be subject to the Alternative Minimum Tax (AMT) in the year they exercise an Incentive Stock Option (ISO). Gains realized after the sale of stock that was received when one exercised the option result in a taxable income or a deductible loss. These amounts are treated as capital gains or losses, but if they do not meet special holding period requirements, they are to be treated as ordinary income. These amounts are to be added to the basis of the stocks to determine the gain or loss in stock disposition.

After exercising an ISO, an employee should receive a Form 3921 for reporting important dates and values required to determine the correct amount of capital and ordinary income applicable. After the first transfer or sale of stock granted under an employee stock purchase plan (ESPP), a Form 3922 shall be used to record important dates and values for determining the correct amount of capital and ordinary gains applicable.

When granted non-statutory stock options, the amount if income to be included and the time to include it is dependent on whether the FMV of the stock can be readily determined. The FMV of actively traded stocks can be readily determined. For options whose FMV cannot be readily determined, there is no taxable event when the stocks are granted, although income in the FMV when the options are traded must be reported.

#### Gain or Loss from Options

Report on Form 8949 gain or loss from the closing or expiration of an option that is not a section 1256 contract but is a capital asset in the taxpayer’s hands. If an option the taxpayer purchased expired, enter the expiration date in column (c) and enter “EXPIRED” in column (d). If an option that was granted (written) expired, enter the expiration date in column (b) and enter “EXPIRED” in column (e). Fill in the other columns according to their instructions.

If a call option sold after 2013 was exercised, the option premium received will be reflected in the proceeds shown in box 1d of the Form 1099-B (or substitute statement) received by the taxpayer. If he or she sold the call option before 2014, the option premium received may not be reflected on Form 1099-B. If it is not, enter the premium as a positive number in column (g) of Form 8949. Enter “E” in column (f).

1. For $10 in 2021, María sold José an option to buy one share of COLOR stock for $80. José later exercised the option. The Form 1099-B María gets, shows the proceeds to be $80. It must be entered then $80 in column (d) of Form 8949. It must be entered “E” in column (f) and $10 in column (g). The other columns must be completed according to the instructions.

### Like-Kind Exchange

The gains that are received in a like-kind exchange, according to Section 1031, are tax-deferred, not tax-free. A like-kind exchange can include like-kind property, or include like-kind property along with cash, liabilities or property that are not like-kind.

A deferred exchange is different from a sale of one property and using the proceeds to buy another property, which is a taxable transaction. A deferred exchange constitutes mutually dependent parts of an integrated transaction involving exchange of property, usually by involving exchange facilitators.

Under Section 1031, real property and personal property can both qualify as exchange properties, but real property cannot be like kind to personal property. To qualify as exchange property, personal and real property must be held for investment purposes and not for personal use. In personal properties, rules that qualify exchange properties are stringent than in real property. For example, a car is not like-kind to a truck.

There are time limits to complete a like-kind exchange, otherwise the whole transaction may be taxable. A taxpayer is allowed a maximum of 45 days from disposition of relinquished property to identify qualifying replacement property, and a maximum of 180 days for the replacement property to be received.

The basis of properties acquired in a like-kind exchange is usually the basis of the property relinquished with some adjustments. This preserves the basis of the relinquished property for later recognition. The resulting depreciable basis is therefore lower than what would be available if the replacement property was acquired using taxable transactions.

1. In 2019, Jorge Reyes trades personal property with an installment sale basis of $400,000 for like-kind property having an FMV of $200,000. He also receives an installment note for $800,000 in the trade. Under the terms of the note, he is to receive $100,000 (plus interest) in 2020 and the balance of $700,000 (plus interest) in 2021. Jorge's selling price is $1,000,000 ($800,000 installment note + $200,000 FMV of like-kind property received). His gross profit is $600,000 ($1,000,000 − $400,000 installment sale basis).   
     
   The contract price is $800,000 ($1,000,000 − $200,000). The gross profit percentage is 75% ($600,000 ÷ $800,000). He reports no gain in 2019 because the like-kind property he receives is not treated as a payment for figuring gain. He reports $75,000 gain for 2020 (75% of $100,000 payment received) and $525,000 gain for 2021 (75% of $700,000 payment received).
2. Deferred Exchanges

A deferred exchange is one in which a taxpayer transfers property he or she used in business or held for investment and receives like-kind property later to be used in business or held for investment. Under this type of exchange, the person receiving the taxpayer’s property may be required to place funds in an escrow account or trust. If certain rules are met, these funds will not be considered a payment until the taxpayer has the right to receive the funds or, if earlier, the end of the exchange period.

1. Contingent Payment Sale

A contingent payment sale is one in which the total selling price cannot be determined by the end of the tax year of sale. This happens, for example, if the taxpayer sells his or her business and the selling price includes a percentage of its profits in future years.

If the selling price cannot be determined by the end of the tax year, he or she must use different rules to figure the contract price and the gross profit percentage than those used for an installment sale with a fixed selling price.

1. Single Sale of Several Assets

If a taxpayer sells different types of assets in a single sale, he or she needs to identify each asset so that they can determine whether he or she can use the installment method to report the sale of that asset. The taxpayer also has to allocate part of the selling price to each asset.

Unless an allocation of the selling price has been agreed to by both parties in an arm's-length transaction, the taxpayer has to allocate the selling price to an asset based on its FMV. If the buyer assumes a debt, or takes the property subject to a debt, the taxpayer is to reduce the FMV of the property by the debt. This becomes the net FMV.

A sale of separate and unrelated assets of the same type under a single contract is reported as one transaction for the installment method. However, if an asset is sold at a loss, its disposition cannot be reported on the installment method. It must be reported separately. The taxpayer reports together the remaining assets sold at a gain.

Example

Marco sold three separate and unrelated parcels of real property (A, B, and C) under a single contract calling for a total selling price of $130,000. The total selling price consisted of a cash payment of $20,000, the buyer's assumption of a $30,000 mortgage on parcel B, and an installment obligation of $80,000 payable in eight annual installments, plus interest at 8% a year.

Marco’s installment sale basis for each parcel was $15,000. Marco’s net gain was $85,000 ($130,000 − $45,000). Marco reports the gain on the installment method.

The sales contract did not allocate the selling price, or the cash payment received in the year of sale among the individual parcels. The FMV of parcels A, B, and C were $60,000, $60,000, and $10,000, respectively.

The installment sale basis for parcel C was more than its FMV, so it was sold at a loss and must be treated separately. Marco must allocate the total selling price and the amounts received in the year of sale between parcel C and the remaining parcels.

Of the total $130,000 selling price, Marco must allocate $120,000 to parcels A and B together and $10,000 to parcel C. Marco should allocate the cash payment of $20,000 received in the year of sale and the note receivable on the basis of their proportionate net FMV. The allocation is figured as follows:

|  |  |  |
| --- | --- | --- |
|  | **Parcels A and B** | **Parcel C** |
| FMV | $120,000 | $10,000 |
| Minus: Mortgage assumed | $30,000 | -0- |
| Net FMV | $90,000 | $10,000 |
| Proportionate net FMV |  |  |
| Percentage of total | 90% | 10% |
| Payments in year of sale |  |  |
| $20,000 x 90% | $18,000 |  |
| $20,000 x 10% |  | $2,000 |
| Excess of parcel B mortgage over installment sale basis | $15,000 | -0- |
| Allocation of payments received (or considered  received) in the year of sale | $33,000 | $2,000 |

Marco cannot report the sale of parcel C on the installment method because the sale results in a loss. Marco reports this loss of $5,000 ($10,000 selling price − $15,000 installment sale basis) in the year of sale. However, if parcel C was held for personal use, the loss is not deductible.

Marco allocates the installment obligation of $80,000 to the properties sold based on their proportionate net FMVs (90% to parcels A and B, 10% to parcel C).

### Non-Business Bad Debts

A bad debt is a debt that one is unable to collect. To qualify one as a bad debt, a taxpayer must prove that during the time of transaction, they intended to make a loan, and not a gift. A non-business bad debt must be totally worthless in order to be deductible. He or she cannot deduct a partially worthless bad debt.

For a debt to become worthless, the surrounding facts and circumstances must prove that reasonable expectations for payment do not exist. This includes proof that the creditor has taken reasonable steps to collect the debt. However, this does not mean that the taxpayer has to go to court, as long as he or she can prove that a judgement from the court would be uncollectible. A deduction may only be taken in the year the debt becomes worthless. A debt does not have to be due in ordered to be determined as worthless.

A non-business bad debt is required to be reported as a short-term capital loss in Line 1 of Form 8949. A bad debt is subject to short term capital loss limitations. A deduction of a bad debt requires a separate detailed statement to be attached to the returns.

### Investor vs. Trader

Typically, investors buy and sell securities expecting income from interest, dividends, or capital appreciation. Investors buy and sell the securities and hold them for personal investments for a period. Sales of these securities result in capital gains or losses, and should be reported in Form 1040, Schedule 1, and Form 8949, as appropriate. Investors are subject to capital loss limitations and wash sales rules.

An individual participating in the business of buying and selling of securities for their own account is considered a trader. Even if the individual does not maintain inventory and has no customers, the law considers them as a trader. Special rules apply for individuals considered as traders in securities.

The difference between a trader and an investor is the nature of their trading activities. If the nature of the activities qualifies as a business, an individual is considered a trader, and not as an investor. The rules applying for traders do not apply for the securities held as an investment. Therefore, a trader must distinguish the securities they hold for investment from those they trade on.

#### Contingent Payment Debt Instruments

Any gain recognized on the sale, exchange, or retirement of a contingent payment debt instrument subject to the non-contingent bond method is treated as interest income rather than as capital gain. In certain situations, all or a portion of a loss recognized on the sale, exchange, or retirement of a contingent payment debt instrument subject to the non-contingent bond method may be treated as an ordinary loss rather than as a capital loss.

#### Wash Sales

A wash sale occurs when the taxpayer sells or otherwise disposes of stock or securities (including a contract or option to acquire or sell stock or securities) at a loss and, within 30 days before or after the sale or disposition, he or she:

1. Buys substantially identical stock or securities.
2. Acquires substantially identical stock or securities in a fully taxable trade.
3. Enters a contract or option to acquire substantially identical stock or securities.
4. Acquires substantially identical stock or securities for the taxpayer’s individual retirement arrangement (IRA) or Roth IRA.

The losses from wash sales cannot be deducted unless the loss was incurred in the ordinary course of the taxpayer’s business as a dealer in stock or securities. The basis of the substantially identical property (or contract or option to acquire such property) is its cost increased by the disallowed loss (except in the case of (4) above). The rules of wash sale rules do not apply to a redemption of shares in a floating-NAV (net asset value) money market fund.

If the taxpayer received a Form 1099-B (or substitute statement), boxes 1f and 1g of that form generally will show whether there was any non-deductible wash sale loss and its amount if:

1. The stock or securities sold were covered securities (defined in the instructions for Form 8949, column (e)), and
2. The substantially identical stock or securities bought had the same CUSIP number as the stock or securities sold and were bought in the same account as the stock or securities sold by the taxpayer (CUSIP numbers are security identification numbers).

However, the taxpayer cannot deduct a loss from a wash sale even if it is not reported on Form 1099-B (or substitute statement).

Report a wash sale transaction in Part I or Part II (depending on how long the taxpayer owned the stock or securities) of Form 8949 with the appropriate box checked. Complete all columns. Enter "W" in column (f). Enter as a positive number in column (g) the amount of the loss not allowed. See the instructions for Form 8949, columns (f), (g), and (h).

#### Traders in Securities

A taxpayer is a trader in securities if he or she is engaged in the business of buying and selling securities for his or her own account. In order to be engaged in business as a trader in securities, the following statements must be true:

1. The taxpayer must seek to profit from daily market movements in the prices of securities and not from dividends, interest, or capital appreciation.
2. The taxpayer’s activity must be substantial.
3. The taxpayer 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 business.

1. Typical holding periods for securities bought and sold by the taxpayer.
2. The frequency and dollar amount of the taxpayer’s trades during the year.
3. The extent to which the taxpayer pursues the activity to produce income for a livelihood.
4. The amount of time devoted to the activity.

If the taxpayer’s activity does not meet the above definition of a business, then the taxpayer is considered an investor, and not a trader. It does not matter whether the taxpayer refers to himself or herself as a trader or a “day trader.”

Similar to an investor, a trader generally must report each sale of securities (taking into account commissions and any other costs of acquiring or disposing of the securities) on Form 8949 unless one of the exceptions described in the instructions to Form 8949 applies. However, if a trader previously made the mark-to-market election, each transaction is reported in Part II of Form 4797 instead of on Form 8949. Regardless of whether a trader reports his or her gains and losses on Form 8949 or Form 4797, the gain or loss from the disposition of securities is not taken into account when figuring net earnings from self-employment on Schedule SE.

The limitation on investment interest expense that applies to investors does not apply to interest paid or incurred in a trading business.

A trader reports interest expense and other expenses (excluding commissions and other costs of acquiring or disposing of securities) from a trading business on Schedule C (instead of Schedule A). A trader also may hold securities for investment. The rules for investors generally will apply to those securities. Allocate interest and other expenses between the taxpayer’s trading business and his or her investment securities.

1. Short Sales

A short sale is a contract to sell property the taxpayer borrowed for delivery to a buyer. At a later date, he or she either buys substantially identical property and delivers it to the lender, or delivers property held but the taxpayer did not want to transfer at the time of the sale.

1. Lena thinks the value of COLOR stock will drop, so she borrows 10 shares from her broker and sells them for $100. This is a short sale. Later, she buys 10 shares for $80 and delivers them to her broker to close the short sale. Her gain is $20 ($100 − $80).
2. Holding Period

Usually, a holding period is the amount of time in which the taxpayer actually held the property eventually delivered to the broker or lender to close the short sale. However, the earned gain when closing a short sale is short term if the taxpayer:

1. Held substantially identical property for 1 year or less on the date of the short sale, or
2. Acquired property substantially identical to the property sold short after the short sale but on or before the date the taxpayer closes the short sale.

If substantially identical property is held for more than 1 year on the date of a short sale, any loss realized on the short sale is a long-term capital loss, even if the property used to close the short sale was held 1 year or less.

Report any short sale on Form 8949 in the year it closes. If a short sale closed in 2021 but the taxpayer did not get a 2021 Form 1099-B (or substitute statement) for it because he or she entered into it before 2021, report it on Form 8949 in Part I with box C checked or Part II with box F checked (whichever applies). In column (a), enter (for example) “100 sh. COLOR Co.–2010 short sale closed”. Fill in the other columns according to their instructions. Report the short sale the same way if the taxpayer received a 2021 Form 1099-B (or substitute statement) that does not show proceeds (sales price).

1. Floating-NAV Money Market Funds

If a taxpayer has a capital gain or loss determined under the net asset value (NAV) method with respect to shares in a floating-NAV money market fund, report the capital gain or loss on Form 8949, Part I, with box C checked. Enter the name of each fund followed by “(NAV)” in column (a). Enter the net gain or loss in column (h). Leave all other columns blank. See the Instructions for Form 8949.

Review Questions

1. Married taxpayers sold their principal residence in 2021 for $1,000,000. They purchased the home in 2013 for $250,000. They incurred improvement costs of $100,000, real estate commissions of $60,000 and other settlement costs of $10,000. They lived in this home until the date of sale. They file a joint return and have not previously excluded a gain on another home. What is their taxable gain?
2. $750,000.
3. $140,000.
4. $80,000.
5. $150,000.

|  |
| --- |
| **Answer: C** |
| A taxpayer may qualify to exclude up to $500,000 (MFJ) of gains from the sale of a personal residence from their income. In this case the married couple qualifies because they lived in the house for more than 2 years, and they don’t exclude gains from the sale of another house.  The selling price was $1,000,000. Subtract the expenses of real estate commissions ($60,000), the settlement costs ($10,000), the purchase price ($250,000) and the improvements ($100,000). The gain was of $580,000. Minus the exclusion ($500,000 for MFJ), the taxable gain is of $80,000. |

1. Non-business bad debts must be deducted as:
2. Ordinary loss on Form 4797.
3. Long-term capital loss on Schedule D.
4. Short-term capital loss on Form 8949.
5. Investment expense as an itemized deduction.

|  |
| --- |
| **Answer: C** |
| A non-business bad debt is required to be reported as a short-term capital loss in Form 8949. |

1. Where a taxpayer must report the sale of a property that is made using the installment method?
2. Form 8995.
3. Form 4562.
4. Form 6557.
5. Form 6252.

|  |
| --- |
| **Answer: D** |
| The interest from the installments must be reported as ordinary income. Property sales made using the installment method are reported in Form 6252. |

## Module: Adjustments to Income

When figuring the taxable net income, some adjustments are made to the gross income, reducing the amount. This adjusted amount is known as the adjusted gross income.

### Self-Employment Tax (SE Tax)

This tax refers to Social Security and Medicare taxes specifically for individuals that work for themselves and is similar to the Social Security and Medicare taxes that are withheld from the wages of other employees. It does not include other taxes that self-employed people may be required to file.

A self-employed individual is one who carries on a trade as a sole proprietor or independent contractor, is a member of a partnership business or is otherwise in any business for themselves, including a part-time business. An individual is required to figure the self-employment tax (SE tax) by themselves using Form 1040 (Schedule SE), in addition to figuring Social Security and Medicare taxes for their employees.

50% of SE tax is deducted "above-the-line". A taxpayer can deduct one-half of his self-employment tax as a business expense in figuring adjusted gross income. This deduction only affects income tax. It does not affect net earnings from self-employment or self-employment tax. The amount of the total SE tax is figured using Schedule SE. The SE deduction (½ of the SE tax) is taken on Form 1040, Schedule 1.

More detailed information is available under section *Self-Employment Tax*, Chapter 4 - Module: *Taxation*.

### Retirement Contribution Limits and Deductibility

Retirement contributions are the amounts paid into a reserve for a retirement plan. There are limits to how much an individual can contribute to an IRA each year. For 2021, an individual’s total contribution cannot exceed $6,000 (or $7,000 for individuals over 50 years) or the taxable income for the year in cases where the income is less than this amount. This contribution limit applies to both traditional and Roth IRAs, although Roth contributions are sometimes limited based on an individual’s filing status and income.

The contribution limit for employees who participate in 401(k), 403(b), most 457 plans, and the federal government's Thrift Savings Plan keeps on $19,500 for 2021.

The limitation regarding SIMPLE retirement accounts for 2021 keeps on $13,500.

The income ranges for determining eligibility to make deductible contributions to traditional Individual Retirement Arrangements (IRAs), to contribute to Roth IRAs and to claim the Saver's Credit all increased for 2021.

Taxpayers can deduct contributions to a traditional IRA if they meet certain conditions. If during the year either the taxpayer or his or her spouse was covered by a retirement plan at work, the deduction may be reduced, or phased out, until it is eliminated, depending on filing status and income. Here are the phase-out ranges for 2021:

* For single taxpayers covered by a workplace retirement plan, the phase-out range is $66,000 to $76,000, up from $65,000 to $75,000.
* For married couples filing jointly, where the spouse making the IRA contribution is covered by a workplace retirement plan, the phase-out range is $105,000 to $125,000, up from $104,000 to $124,000.
* For an IRA contributor who is not covered by a workplace retirement plan and is married to someone who is covered, the deduction is phased out if the couple's income is between $198,000 and $208,000, up from $196,000 and $206,000.
* For a married individual filing a separate return who is covered by a workplace retirement plan, the phase-out range is not subject to an annual cost-of-living adjustment and remains $0 to $10,000.

Excess IRA contributions are subject to a tax of 6% per year as long as they remain in the IRA. Excess contributions occur when an individual contributes more than their contribution limit, makes a regular IRA contribution to a traditional IRA after reaching age 70½, or makes an irregular rollover to an IRA.

### Health Savings Account

A health savings account (HSA) is defined as the tax-exempted custodial account of trust set up by an individual, along with a qualified HSA trustee who pays or reimburses the individual for the medical expenses they incur. A qualified HSA trustee can be an insurance company, a bank or other entity that has been approved by the IRS to be a trustee for IRAs. A health savings account can be established through a trustee that is different from an individual’s health provider. Any eligible individual can contribute to an HSA. If an HSA is established by a self-employed or unemployed individual, the individual can contribute. The IRS dictates that contribution to an HSA must always be made in cash, and that property or stock contributions are not allowed.

The amount an individual can contribute to an HSA will depend on the type of High Deductible Health Plan (HDHP) they have, their age, the time they became eligible for the plan, and the date they shall cease to be eligible for the plan. For a self-only HDHP coverage, the individual can contribute up to $3,600, and in the case of family HDHP coverage, the maximum contribution is $7,200 for 2021 tax year.

**Distributions from an HSA:** These are amounts received from a health savings account. An individual is required to pay their medical expenses without any reimbursements until they get to the annual deductible amount for the plan. Tax-free distributions are then received as reimbursements for any qualified medical expense, but if the expense is not qualified, the amount received is subject to income tax and an additional 20% tax.

The following table shows the minimum annual deductible and maximum annual deductible and other out-of-pocket expenses for HDHPs for 2021 tax year.

|  |  |  |
| --- | --- | --- |
|  | **Self-only coverage** | **Family coverage** |
| Minimum annual deductible | $1,400 | $2,800 |
| Maximum annual deductible and other out-of-pocket expenses | $7,000 | $14,000 |

The amount of catch-up contribution for participants of age 55 and older remains at $1,000 for 2021, as this amount is fixed by statute. For example, if a taxpayer has self-only coverage, they can contribute up to $4,600 [the contribution limit for self-only coverage ($3,600) plus the additional contribution of $1,000].

This limit does not apply to deductibles and expenses for out-of-network services if the plan uses a network of providers. Instead, only deductibles and out-of-pocket expenses for services within the network should be used to figure whether the limit applies.

1. An eligible individual and his dependent child are covered under an “employee plus one” HDHP offered by the individual's employer. This is family HDHP coverage.
2. Family Plans that Do Not Meet the High Deductible Rules

There are some family plans that have deductibles for both the family as a whole and for individual family members. Under these plans, if he or she meets the individual deductible for one family member, he or she does not have to meet the higher annual deductible amount for the family. If either the deductible for the family as a whole or the deductible for an individual family member is less than the minimum annual deductible for family coverage, the plan does not qualify as an HDHP.

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Type of plan** | **Last date for contribution** | **Maximum contribution** | **Maximum deduction** | **When to set up plan** |
| **SEP** | Due date of employer's return (including extensions). | Smaller of $58,000 or 25% of participant's compensation (290,000 for 2021). | 25% of all participants' compensation. | Any time up to the due date of employer's return (including extensions). |
| **SIMPLE IRA and SIMPLE 401(k)** | Salary reduction contributions: 30 days after the end of the month for which the contributions are to be made.  Matching or non-elective contributions: Due date of employer's return (including extensions). | Employee contribution: Salary reduction contribution up to $13,500 for 2021 ($16,500 if age 50 or over).  Employer contribution:  Either dollar-for-dollar matching contributions, up to 3% of employee's compensation, or fixed non-elective contributions of 2% of compensation. | Same as maximum contribution. | Any time between January 1 and October 1 of the calendar year.  For a new employer coming into existence after October 1, as soon as administratively feasible. |
| **Qualified Plan: Defined Contribution Plan** | Elective deferral: Due date of employer's return (including extensions).  Employer contribution: Money Purchase Pension Plan or Profit-Sharing: Due date of employer's return (including extensions). | Employee contribution: Elective deferral up to $19,500, $26,000 if age 50 or over for 2021.  Employer contribution: Money Purchase Pension Plan: Smaller of $58,000 or 100% of participant's compensation for 2021.  Profit-Sharing: Smaller of $58,000 or 100% of participant's compensation. | 25% of all participants' compensation, plus the amount of elective deferrals made. | By the end of the tax year. |
| **Qualified Plan: Defined Benefit Plan** | Contributions generally must be paid in quarterly installments, due 15 days after the end of each quarter. | Amount needed to provide an annual benefit no larger than the smaller of $230,000 or 100% of the participant's average compensation for their highest 3 consecutive calendar years. | Based on actuarial assumptions and computations. | By the end of the tax year. |

1. Juan has family health insurance coverage in 2021. The annual deductible for the family plan is $3,600 for 2021 tax year. This plan also has an individual deductible of $1,500 for each family member. The plan does not qualify as an HDHP because the deductible for an individual family member is less than the minimum annual deductible ($2,800) for family coverage.

### Other Adjustment to Income

#### Student Loan Interest Deduction

Student loan interest is interest paid during the year on a qualified student loan. It includes both required and voluntarily pre-paid interest payments. A taxpayer may deduct the lesser of $2,500, for 2021 tax year, or the amount of interest they actually paid during the year. The deduction is gradually reduced and eventually eliminated by phaseout when his or her modified adjusted gross income (MAGI) amount reaches the annual limit for the taxpayer’s filing status.

The amount of the taxpayer’s student loan interest deduction is phased out (gradually reduced) if his or her MAGI is between $80,000 and $90,000 ($160,000 and $180,000 if the taxpayer files a joint return). The taxpayer can't claim a student loan interest deduction if his or her MAGI is $90,000 or more ($180,000 or more if the taxpayer files a joint return).

The taxpayer may claim this deduction as an adjustment to income, so they do not need to itemize their deductions onForm 1040, Schedule A**,** *Itemized Deductions*.

A taxpayer is allowed to claim the deduction if all of the following apply:

1. They paid interest on a qualified student loan in tax year.
2. They are legally obligated to pay interest on a qualified student loan.
3. Their filing status is not married filing separately.
4. Their MAGI is less than a specified amount which is set annually; and
5. The taxpayer or their spouse, if filing jointly, cannot be claimed as dependents on someone else's return.

A qualified student loan is a loan taken out solely to pay qualified higher education expenses that were:

1. For the taxpayer, their spouse, or a person who was the taxpayer’s dependent when the taxpayer took out the loan.
2. For education provided during an academic period for an eligible student; and
3. Paid or incurred within a reasonable period before or after the taxpayer took out the loan.
4. Educator Expense Deduction

If the taxpayer is an eligible educator, he or she can deduct up to $250 ($500 if married filing jointly and both spouses are eligible educators, but not more than $250 each) of unreimbursed trade or business expenses. Qualified expenses are amounts paid or incurred for participation in professional development courses, books, supplies, computer equipment (including related software and services), other equipment, and supplementary materials used by the taxpayer in the classroom. For courses in health or physical education, the expenses for supplies must be for athletic supplies. This deduction is for expenses paid or incurred during the tax year.

The taxpayer is an eligible educator if, for the tax year, he or she is a kindergarten through grade 12 teacher, instructor, counselor, principal or aide for at least 900 hours a school year in a school that provides elementary or secondary education as determined under state law.

Qualified expenses are deductible only to the extent the amount of such expenses exceed the following amounts for the tax year:

1. The interest on Series EE and I U.S. Savings Bonds that the taxpayer excludes from income because he or she paid qualified higher education expenses,
2. Any distribution from a qualified state tuition program excluded from income,
3. Any tax-free withdrawals from the taxpayer’s Coverdell education savings accounts,
4. Any reimbursements received for expenses that are not reported to the taxpayer in box 1 of his or her Form W-2.

#### Alimony

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 for federal tax purposes. Alimony is deductible by the payer spouse, and the recipient spouse must include it in income. Keep in mind that for 2019 and later tax years, only alimony received under a divorce or separation agreement entered into before December 31, 2018 may be deducted by the payer and included in income by the recipient. Otherwise, it is no longer deductible.

1. Alimony Requirements

A payment is alimony only if all the following requirements are met:

1. The spouses do not file a joint return with each other.
2. The payment is in cash (including checks or money orders).
3. The payment is to or for a spouse or a former spouse made under a divorce or separation instrument.
4. The divorce or separation instrument does not designate the payment as not alimony.
5. The spouses are not members of the same household when the payment is made (This requirement applies only if the spouses are legally separated under a decree of divorce or of separate maintenance).
6. There is no liability to make the payment (in cash or property) after the death of the recipient spouse.
7. The payment is not treated as child support or a property settlement.

Child support is never deductible and is not considered income. Additionally, if a divorce or separation instrument provides for alimony and child support, and the payer spouse pays less than the total required, the payments apply to child support first. Only the remaining amount is considered alimony.

1. Reporting Alimony

If the taxpayer paid amounts that are considered taxable alimony, he or she may deduct from income the amount of alimony paid whether he or she itemizes his or her deductions. Alimony payments are only deductible on Form 1040, Schedule 1. He or she is to enter the social security number (SSN) or individual taxpayer identification number (ITIN) of the spouse or former spouse receiving the payments or his or her deduction may be disallowed, and the taxpayer may have to pay a $50 penalty.

#### Moving Expenses for Active Military

The taxpayer can claim the moving expense deduction since tax year 2018 if he or she are on active duty and are subject to a permanent change of station. This can include a move from the taxpayer’s home to their first post, from one post to another, or from their final post to their home or to a nearer point in the U.S.

The taxpayer cannot claim expenses that are reimbursed by the government, and he or she has only one year to claim them if they are moving due to ending their duty. Expenses associated with members of the taxpayer’s household are covered, and his or her spouse and dependents can claim the moving expense deduction if they must relocate without the taxpayer because he or she has died, are imprisoned, or deserted his or her post.

Deductible moving expenses include the costs of moving the contents of the home, as well as lodging in route, but not meals. And the expenses must be reasonable.

Military members will claim the deduction on line 13 of the 2021 Schedule 1, Form 1040.

#### Write-in Adjustments

The write-in adjustments are different adjustments that has to be write in line 22 of the Schedule 1, Form 1040. To find out if the taxpayer can take the deduction, see the form or publication indicated. The write-in adjustments are:

* Archer MSA deduction (see Form 8853). Identify as “MSA”.
* Jury duty pay if the taxpayer gave the pay to their employer because their employer paid their salary while they served on the jury. Identify as “Jury Pay”.
* Deductible expenses related to income reported on line 8 from the rental of personal property engaged in for profit. Identify as “PPR”.
* Nontaxable amount of the value of Olympic and Paralympic medals and USOC prize money reported on line 8. Identify as “USOC”.
* Reforestation amortization and expenses (see Pub. 535). Identify as “RFST”.
* Repayment of supplemental unemployment benefits under the Trade Act of 1974 (see Pub. 525). Identify as “Sub-Pay TRA”.
* Contributions to section 501(c)(18)(D) pension plans (see Pub. 525). Identify as “501(c)(18)(D)”.
* Contributions by certain chaplains to section 403(b) plans (see Pub. 517). Identify as “403(b)”.
* Attorney fees and court costs for actions involving certain unlawful discrimination claims, but only to the extent of gross income from such actions (see Pub. 525). Identify as “UDC”.
* Attorney fees and court costs the taxpayer paid in connection with an award from the IRS for information they provided that helped the IRS detect tax law violations, up to the amount of the award includible in the taxpayer’s gross income. Identify as “WBF”.
* Excess deductions of section 67(e) expenses from Schedule K-1 (Form 1041), box 11, code A. See the Instructions for Schedule K-1 (Form 1041). Identify as “ED67(e)”.

### Self-Employed Health Insurance

Deductions for amounts paid for medical expenses, dental insurance and any other qualified long-term care insurance for an individual and their dependents are allowed. For one to claim the deductions:

1. They must be self-employed, have had a net profit for the year reported on Schedule C of Form 1040, or profit or loss from farming (Schedule F Form 1040).
2. They must have been a partner with net earnings from self-employment for the year, reported on Schedule K-1 (Form 1065).
3. They have used one of the optional methods on Schedule SE to figure their net earnings from self-employment.
4. They have received wages from an S-Corporation in which they are more than 2% shareholders.

Where the individual is a sole proprietor of independent contractor, an insurance policy can be set up in the name of the business or the individual, and this also applies for a partnership. When a partnership pays the contribution on the behalf of the partner, they have to report it on Schedule K-1 as guaranteed payments, which are included in the partner’s gross income, and if paid by an S corporation, the corporation reports it on Form W-2 as wages included in the individual’s gross income.

The IRS does not allow deductions for certain types of insurance.

1. Premium amounts that have been credited to a reserve that is set up for self-insurance.
2. Premiums paid to any policy that pays for lost earnings caused by sickness or disability.
3. Any life insurance or annuity contract that states the policy holder as the beneficiary.
4. Any insurance taken for the business owner or any other individual who has financial interests in the business.

Review Questions

1. Juan has family coverage from Health Savings Account, with a High Deductible Health Plan, for 2021, how much is the maximum he can contribute?
2. $3,600
3. $7,200
4. $3,550
5. $7,100

|  |
| --- |
| **Answer: B** |
| The amount an individual can contribute to an HSA will depend on the type of High Deductible Health Plan (HDHP) they have, their age, the time they became eligible for the plan, and the date they shall cease to be eligible for the plan. For a self-only HDHP coverage, the individual can contribute up to $3,600, and in the case of family HDHP coverage, the maximum contribution is $7,200 for tax year 2021. |

1. Marco paid a student loan interest of $2,700 during the year on a qualified student loan. Marco’s filing status is single. How much can Marco deduct if he takes the student loan interest deduction?
2. $2,700.
3. $2,500.
4. $2,000.
5. $0.

|  |
| --- |
| **Answer: B** |
| Regarding student loan interest deduction, a taxpayer may deduct the lesser of $2,500, for 2021 tax year, or the amount of interest they actually paid during the year. |

1. Pablo works as self-employment. Which of the following is true?
2. He does not have to pay taxes from self-employment income.
3. He has to pay 21% of his taxable income from the business.
4. He can deduct one-half of his self-employment tax.
5. None of the above is true.

|  |
| --- |
| **Answer: C** |
| 50% of SE tax is deducted "above-the-line". A taxpayer can deduct one-half of his self-employment tax as a business expense in figuring adjusted gross income. |

1. Sara is a high school math teacher; she purchases $600 worth of supplies related to her teaching. Her spouse is a high school math teacher and spends $500 in education supplies for his classes. They are filing as married filing jointly, and have total income of $54,380, what is the amount of their adjusted gross income?
2. $0.
3. $54,380.
4. $53,880.
5. $28,780.

|  |
| --- |
| **Answer: C** |
| If the taxpayer is an eligible educator, he or she can deduct up to $250 ($500 if married filing jointly and both spouses are eligible educators, but not more than $250 each) of unreimbursed trade or business expenses.  In this case the total income of $54,380 minus $500 gives an adjusted gross income of $53,380. |

1. Where is the penalty for not include the SSN of the former spouse that is receiving alimony?
2. $0.
3. $50.
4. $150.
5. $200.

|  |
| --- |
| **Answer: C** |
| If the taxpayer paid amounts that are considered taxable alimony, he or she may deduct from income the amount of alimony paid whether he or she itemizes his or her deductions. Alimony payments are only deductible on Form 1040, Schedule 1. He or she is to enter the social security number (SSN) or individual taxpayer identification number (ITIN) of the spouse or former spouse receiving the payments or his or her deduction may be disallowed, and the taxpayer may have to pay a $50 penalty. |

CHAPTER 3   
  
Deductions and Credits

## Module: Itemized Deductions and QBI

An itemized deduction is an expense that that a taxpayer may report on their federal income tax returns to decrease the value of their taxable income. The tax laws allow the standard deduction and the itemized deductions, also known as itemized expenses, or often called Schedule A deductions, as this is the form that is attached to the return to claim the itemized deductions. First figure the itemized deductions and compare that amount to the standard deduction to make sure that the method that gives the greater benefit is being used.

#### When to Itemize the Deductions

The taxpayer must decide whether to itemize deductions or to use the standard deduction. The standard deduction is a dollar amount that reduces the amount of income on which he or she is taxed. The taxpayer should itemize deductions if his or her allowable itemized deductions are greater than his or her standard deduction. Some taxpayers must itemize deductions because they cannot use the standard deduction. Taxpayers may benefit from itemizing deductions on Schedule A (Form 1040) if they:

1. Do not qualify for the standard deduction, or the amount they can claim is limited.
2. Had large uninsured medical and dental expenses during the year.
3. Paid interest and taxes on their home.
4. Had large unreimbursed employee business expenses or other miscellaneous deductions.
5. Had large uninsured casualty or theft losses.
6. Made large contributions to qualified charities.
7. Have total itemized deductions that are more than the standard deduction to which the taxpayers otherwise are entitled.

#### Limit on Itemized Deductions

Due to the TCJA, the AGI limit for itemized deductions no longer applies for tax year 2018 and onwards. However, there may be other limitations that impact the amount of itemized deductions the taxpayer may claim on Schedule A.

1. Making the Election between Using the Standard Deduction or Itemized Deductions

Each year, a taxpayer has to decide which type of deduction will make a bigger difference in lowering his or her tax liability. Said decision does not depend on what was done in past years, so the taxpayer may choose the most favorable option 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.

### Medical, Dental, Vision, Long-Term Care Expenses

Medical expenses are the costs of diagnosis, cure, mitigation, treatment, or prevention of disease, and the costs for treatments affecting any part or function of the body. These expenses include payments for legal medical services rendered by physicians, surgeons, dentists, and other medical practitioners. They include the costs of equipment, supplies, and diagnostic devices needed for these purposes.

Medical care expenses must be primarily to alleviate or prevent a physical or mental defect or illness. They do not include expenses that are merely beneficial to general health, such as vitamins or a vacation. Medical expenses include the premiums paid by the taxpayer for insurance that covers the expenses of medical care, and the amounts paid for transportation to get medical care. Medical expenses also include amounts paid for qualified long-term care services and limited amounts paid for any qualified long-term care insurance contract.

A taxpayer can include only the medical and dental expenses he or she incurred during the year, regardless of when the services were provided. If medical expenses are paid by check, the day the taxpayer mails or delivers the check generally is the date of payment. If using a “pay-by-phone” or “online” account to pay medical expenses, the date reported on the statement of the financial institution showing when payment was made is the date of payment. If using a credit card, the taxpayer must include any medical expenses charged to his or her credit card in the year the charge is made, not when he or she pays the amount charged.

The taxpayer can also deduct payments for transportation primarily for and essential to medical care that qualify as medical expenses, such as payments of the actual fare for a taxi, bus, train, ambulance, or for transportation by personal car; the amount of the taxpayer’s actual out-of-pocket expenses such as for gas and oil; or the amount of the standard mileage rate for medical expenses (16 cents per mile for 2021 tax year), plus the cost of tolls and parking.

Individuals who are self-employed and possess an annual profit might be eligible for the deduction of the self-employed health insurance. This is entered as an adjustment to income instead of an itemized deduction. This income covers any insurance premiums that were paid for to cover long term medical care for the individual, their dependents and their spouse. According to the IRS, the expenses can only be deducted only once on the return and only for the year concerned.

1. What Medical Expenses Are Includible?

Following is a list of items that the taxpayer can include in figuring their medical expense deduction:

1. Abortion, Acupuncture, Alcoholism, Ambulance, Annual Physical Examination, Artificial Limb, Artificial Teeth, Bandages, Birth Control Pills, Body Scan, Braille Books and Magazines, Breast Pumps and Supplies, Breast Reconstruction Surgery, Capital Expenses, Car, Chiropractor, Christian Science Practitioner, Contact Lenses, Crutches, Dental Treatment, Diagnostic Devices, Disabled Dependent Care Expenses, Drug Addiction, Drugs, Eye Exam, Eyeglasses, Eye Surgery, Fertility Enhancement, Guide Dog or Other Service Animal, Health Institute, Health Maintenance Organization (HMO), Hearing Aids, Home Care, Home Improvements, Hospital Services, Insurance Premiums, Laboratory Fees, Lactation Expenses, Lead-Based Paint Removal, Learning Disability, Legal Fees, Lifetime Care—Advance Payments, Lodging, Long-Term Care, Meals, Medical Conferences, Medical Information Plan, Medicines, Nursing Home, Nursing Services, Operations, Optometrist, Organ Donors, Osteopath, Oxygen, Physical Examination, Pregnancy Test Kit, Prosthesis, Psychiatric Care, Psychoanalysis, Psychologist, Special Education, Sterilization, Stop-Smoking Programs, Surgery, Telephone, Television, Therapy, Transplants, Transportation, Trips, Tuition, Vasectomy, Vision Correction Surgery, Weight-Loss Program, Wheelchair, Wig and X-rays.

This list doesn't include all possible medical expenses. For more information see Publication 502, Medical and Dental Expenses.

1. Capital Expenses

The taxpayer can include in medical expenses amounts they pay for special equipment installed in a home, or for improvements, if their main purpose is medical care for the taxpayer, their spouse, or their dependent. The cost of permanent improvements that increase the value of their property may be partly included as a medical expense. The cost of the improvement is reduced by the increase in the value of their property. The difference is a medical expense. If the value of the taxpayer’s property isn't increased by the improvement, the entire cost is included as a medical expense.

Certain improvements made to accommodate a home to the taxpayer’s disabled condition, or that of their spouse or their dependents who live with the taxpayer, don't usually increase the value of the home and the cost can be included in full as medical expenses. These improvements include, but aren't limited to, the following items:

1. Constructing entrance or exit ramps for the home.
2. Widening doorways at entrances or exits to the home.
3. Widening or otherwise modifying hallways and interior doorways.
4. Installing railings, support bars, or other modifications to bathrooms.
5. Lowering or modifying kitchen cabinets and equipment.
6. Moving or modifying electrical outlets and fixtures.
7. Installing porch lifts and other forms of lifts (but elevators generally add value to the house).
8. Modifying fire alarms, smoke detectors, and other warning systems.
9. Modifying stairways.
10. Adding handrails or grab bars anywhere (whether or not in bathrooms).
11. Modifying hardware on doors.
12. Modifying areas in front of entrance and exit doorways.
13. Grading the ground to provide access to the residence.

Only reasonable costs to accommodate a home to the taxpayer’s disabled condition are considered medical care. Additional costs for personal motives, such as for architectural or aesthetic reasons, aren't medical expenses.

Use this worksheet to figure the amount, if any, of the taxpayer’s medical expenses due to a home improvement.

|  |  |  |  |
| --- | --- | --- | --- |
| 1. | Enter the amount the taxpayer paid for the home improvement |  |  |
| 2. | Enter the value of the taxpayer’s home immediately after the improvement |  |  |
| 3. | Enter the value of the taxpayer’s home immediately before the improvement |  |  |
| 4. | Subtract line 3 from line 2. This is the increase in the value of the taxpayer’s home due to the improvement |  |  |
|  | * If line 4 is more than or equal to line 1, the taxpayer has no medical expenses due to the home improvement; stop here. |  |  |
|  | * If line 4 is less than line 1, go to line 5. |  |  |
| 5. | Subtract line 4 from line 1. These are the taxpayer’s medical expenses due to the home improvement. |  |  |

**Improvements to property rented by a person with a disability**

Amounts paid to buy and install special plumbing fixtures for a person with a disability, mainly for medical reasons, in a rented house are medical expenses.

1. John has arthritis and a heart condition. He can't climb stairs or get into a bathtub. On his doctor's advice, he installs a bathroom with a shower stall on the first floor of his two-story rented house. The landlord didn't pay any of the cost of buying and installing the special plumbing and didn't lower the rent. John can include in medical expenses the entire amount he paid.

#### Vision

Along with the allowed medical expenses detailed in Pub 202, there is available a deduction for vision-related expenses. The taxpayer can include in medical expenses amounts paid for:

1. Eye examinations.
2. Eyeglasses and contact lenses needed for medical reasons. It can also be included the cost of equipment and materials required for using contact lenses, such as saline solution and enzyme cleaner.
3. Eye surgery to treat defective vision, such as laser eye surgery or radial keratotomy.

#### Long Term Care Expenses

It can be included in medical expenses amounts paid for qualified long-term care services and certain amounts of premiums paid for qualified long-term care insurance contracts.

1. Qualified Long-Term Care Services

Qualified long-term care services are necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, rehabilitative services, and maintenance and personal care services (defined later) that are:

1. Required by a chronically ill individual.
2. Provided pursuant to a plan of care prescribed by a licensed health care practitioner.

**Chronically ill individual:** An individual is chronically ill if, within the previous 12 months, a licensed health care practitioner has certified that the individual meets either of the following descriptions.

1. He or she is unable to perform at least two activities of daily living without substantial assistance from another individual for at least 90 days, due to a loss of functional capacity. Activities of daily living are eating, toileting, transferring, bathing, dressing, and continence.
2. He or she requires substantial supervision to be protected from threats to health and safety due to severe cognitive impairment.

**Maintenance and personal care services:** Maintenance or personal care services is care which has as its primary purpose the providing of a chronically ill individual with needed assistance with his or her disabilities (including protection from threats to health and safety due to severe cognitive impairment).

### Various Taxes

There exist four types of deductions in the category of deductible non-business taxes:

1. State, foreign and local real estate taxes.
2. State, foreign and local foreign income taxes.
3. Local and state general sales tax.
4. Local and state personal property taxes.

For a tax to be deductible, it must be imposed on an individual and the individual must have paid for it during their annual tax year. The claims must be done only as itemized deductions on Form 1040. The local and state withheld income taxes must from one’s wages and appear on Form W-2.

One can only choose to deduct the local and state general sales tax or the local income tax but not both. If one chooses to deduct the local and state general sales tax, they can use either the tables of optional sales tax or their actual expenses. The following taxes are also deductible:

1. Any previous annual local or state income tax paid for in the period.
2. Any estimation of taxes that were paid for either to the local or state governments.

Deductible taxes of the real estate are defined as any local, state, or foreign taxes imposed in real estate and are levied for welfare of the general public. The charges must be similar across the jurisdiction. There are some states that also impose taxes on improvements done in their state and they cannot be deducted. However, one can increase the cost based on the cost of their property depending on the value of the assessments. Deductible personal taxes are defined as those taxes that are based on the value of the property held by an individual, e.g. a car or a boat. There are some fees and taxes that cannot be deducted, such as transfer taxes, social security taxes, taxes on sale of a property, estate and inheritance fees, homeowner’s association fees and service charges for sewer, water or trash collection.

A taxpayer may claim an itemized deduction of property taxes and state and local taxes up to $10,000 ($5,000 for a married taxpayer filing a separate return).

### Interest Expense

The IRS defines interest as an amount one pays to use money that is borrowed. Some interests can be treated as a credit or as a deduction. When one pays interest, they must allocate the interest expense over the annual tax periods to which the tax applies. One may deduct each year only if the tax expense applies for that year. There is however an exemption that applies to points that are paid on a principal residence. The types of deductible interest that is itemized include:

1. Mortgage interests that are qualified and include points if one is the buyer.
2. Investment interest but it is not limited to one’s net investment income.

Other types of interest that are deductible include:

1. Interest on student loans treated as an adjustment income.
2. Interests from non-farm business interest.
3. Interest from farm business.
4. Interest that is incurred in producing royalties or rents.

Interests that are not deductible include:

1. Interest that one pays on a loan to buy a car that is for personal use.
2. Credit card as well as installment interest that is incurred in personal expenses.
3. Points, if one is a seller, credit investigation fees, service charge and interest that relates to tax-exempt income e.g. interest to buy or possess securities that are tax-exempt.

#### Mortgage Interest Deduction

Qualified interest for this deduction is defined as interest and points that one pays on a loan that is secured by one’s main home or the second home. The financial institution to which the taxpayer makes their payments must report his or her qualified mortgage interest, as well as points, in Form 1098. The following mortgages can be deducted:

1. A mortgage taken out or on before October 13, 1987 (grandfathered debt).
2. A mortgage that was taken out after October 13, 1987 and before December 15, 2017, either to build, buy, or even improve one’s home- home acquisition debt, but only if throughout the year these mortgages plus any grandfathered debt totaled $1,000,000 or less ($500,000 if married filing separately).
3. Mortgages taken out after December 15, 2017, to buy, build, or improve the taxpayer's home (home acquisition debt), but only if throughout 2021 these mortgages plus any grandfathered debt totaled $750,000 or less ($375,000 if married filing separately).

The dollar limits in the last two categories apply to the combined mortgages on the main home and second home. Additionally, there is an exception for certain loans taken out after December 15, 2017, but before April 1, 2018. If the exception applies to the taxpayer, their loan may be treated in the same manner as a loan taken out on or before December 15, 2017.

1. Mortgage Insurance Premiums

Use Form 1098, Mortgage Interest Statement, to report MIP aggregating $600 or more, that the taxpayer received during the calendar year in the course of his or her trade or business from an individual, including a sole proprietor. For tax year 2021, report MIP in box 5 and file and furnish Forms 1098 according to the specifications in the Instructions for Form 1098 and the General Instructions for Certain Information Returns.

The mortgage insurance premiums are required when the taxpayer gives a down payment of less than 20% for a home, the taxpayer’s lender will likely require him or her to purchase private mortgage insurance as a condition of his or her mortgage loan. The mortgage insurance premium deduction applies only to loans taken out on or after January 1, 2007.

The itemized deduction for mortgage insurance premiums (MIP) is applicable for 2021 tax year. However, its applicability is to be checked every year by checking 1098 Form.

This deduction phases out and becomes unavailable at higher income levels. If the taxpayer files as head of household, or married and filing jointly, the deduction begins phasing out by 10% for each $1,000 by which his or her adjusted gross income exceeds $100,000, meaning the deductions it is not allowed when the taxpayer’s AGI is $109,000. For married filing separately, the phase-out begins at $50,000 and increases for each $500 by which the taxpayer’s AGI exceed this limit, meaning the deductions it is not allowed when the taxpayer’s AGI is $54,500.

To qualify for this deduction the taxpayer must itemize deductions. If the taxpayer does not take itemize deductions and take the standard tax deduction, he or she will not be eligible.

1. Investment Interest

Investment interest is any interest that is paid or accrued on debt allocable to property held for investment. Thus, if a taxpayer borrows money to buy investments (e.g., stocks and bonds), the interest on the loan is investment interest. Investment interest is deductible from AGI as an itemized deduction to the extent of net investment income, which is calculated as follows:

Gross investment income - Investment expenses = Net investment income.

1. Points

Lenders sometimes charge points in addition to the stated interest rate. Each point represents 1% of the loan.

Points are treated as a service fee or prepaid interest, depending on what they cover. If points cover services (e.g., appraisal, document preparation, notary services, and recording services), the points are a nondeductible service fee. If points represent the borrower's buying down the interest rate, the points are prepaid interest. For every point the borrower pays, the interest rate is reduced about 0.25%.

In general, points that represent prepaid interest are deductible over the term of the loan. However, if those points are paid in connection with the purchase of a principal residence, and if certain conditions are satisfied, points are deductible as qualified residence interest in the year paid.

1. Indebtedness Limitation

The taxpayer can deduct home mortgage interest on the first $750,000 ($375,000 if married filing separately) of indebtedness. However, higher limitations [$1 million ($500,000 if married filing separately)] apply if the taxpayer is deducting mortgage interest from indebtedness incurred before December 16, 2017.

### Charitable Contributions

Generally, the taxpayer can only deduct charitable contributions if he or she itemize deductions on Schedule A (Form 1040), Itemized Deductions. However, for 2021, individuals who do not itemize their deductions may deduct up to $300 ($600 for MFJ) from gross income for their qualified cash charitable contributions to public charities, private operating foundations, and federal, state, and local governments.

For a contribution to be considered a charitable contribution, it must be made to a qualified organization; contributions made to individuals are never considered. The IRS provides a form with a list of all the organizations considered by them for charitable contributions.

A taxpayer making the donation cannot claim a deduction for any contribution of cash, check or other monetary contribution unless the donor keeps a record of said contribution, either as a bank record or as a written communication from the organization they donated to, as long as the donated amount exceeds $250.

This acknowledgement must show the name of the organization, the date of the contribution and the amount of the contribution. This written communication may be in the form of a receipt or letter, and the donor taxpayer is responsible for requesting it.

The charitable organization must also provide a written disclosure to a donor receiving goods or services in exchange for a single payment over $75.

#### Qualified Organizations

1. The United States or any state, the District of Columbia, a U.S. possession (including Puerto Rico), a political subdivision of a state or U.S. possession, or an Indian tribal government (Contributions made to this type of organizations are deductible only if they are to be used for public purposes).
2. A community chest, corporation, trust, fund, or foundation organized or created in or under the laws of the United States, any state, the District of Columbia, or any possession of the U.S. It must be organized and operated only for charitable, religious, educational, scientific, or literary purposes, or for the prevention of cruelty to children or animals.
3. War veterans’ organizations.
4. Certain non-profit cemetery companies or corporations.
5. Domestic fraternal societies, orders, and associations operating under a lodge system that use contributions solely for charitable, religious, etc. purposes.
6. Under income tax treaties with Canada, Israel, and Mexico, contributions to certain Canadian, Israeli, or Mexican charitable organizations are deductible, if the taxpayer has income from that country.
7. Types of Qualified Organizations

For the purpose of applying the deduction limits to the taxpayer's charitable contributions, qualified organizations can be divided into two categories:

1. First category of qualified organizations (50% limit organizations)

The first category includes only the following types of qualified organizations.

1. Churches and conventions or associations of churches.
2. Educational organizations with a regular faculty and curriculum that normally have a regularly enrolled student body attending classes on site.
3. Hospitals and certain medical research organizations associated with these hospitals.
4. Organizations that are operated only to receive, hold, invest and administer property, and to make expenditures to or for the benefit of state and municipal colleges and universities and that normally receive substantial support from the United States or any state or their political subdivisions, or from the general public.
5. The United States or any state, the District of Columbia, a U.S. possession (including Puerto Rico), a political subdivision of a state or U.S. possession, or an Indian tribal government or any of its subdivisions that perform substantial government functions.
6. Publicly supported charities.
7. Organizations that may not qualify as "publicly supported" but that meet other tests showing they respond to the needs of the general public, not a limited number of donors or other persons. They must normally receive more than one-third of their support either from organizations described in (1) through (6), or from persons other than "disqualified persons."
8. Most organizations operated or controlled by, and operated for the benefit of, those organizations described in (1) through (7).
9. Private operating foundations.
10. Private non-operating foundations that make qualifying distributions of 100% of contributions within 2½ months following the year they receive the contribution. A deduction for charitable contributions to any of these private nonoperating foundations must be supported by evidence from the foundation confirming it made the qualifying distributions timely. It must be attached a copy of this supporting data to the tax return.
11. A private foundation whose contributions are pooled into a common fund, if the foundation would be described in (8) but for the right of substantial contributors to name the public charities that receive contributions from the fund. The foundation must distribute the common fund's income within 2½ months following the tax year in which it was realized and must distribute the corpus not later than 1 year after the donor's death (or after the death of the donor's surviving spouse if the spouse can name the recipients of the corpus).
12. Second category of qualified organizations

The second category includes any type of qualified organization that isn’t in the first category.

#### Deductible Contributions

Deductible contributions generally include contributions of money or property made to, or for the use of, a qualified organization. This includes contributions earmarked for flood relief, hurricane relief, or other disaster relief to a qualified organization. A contribution is for the use of a qualified organization when held in a legally enforceable trust for the qualified organization or in a similar legal arrangement.

If the taxpayer derives a benefit, such as receiving goods or services in return, the taxpayer can deduct only the amount of the contribution that is more than the value of the benefit received.

If a taxpayer pays more than the FMV to a qualified organization for goods or services, the excess can be a charitable contribution.

If the taxpayer receives a right to purchase tickets for a sporting event for a donation to a college or university, only 80% of the payment is a contribution. If the donation includes payment for tickets, reduce the payment by the price of the tickets first, and then 80% of the remainder is an eligible contribution.

For contributions made in the eight tax years beginning after December 31, 2017 until January 1, 2026, the 50% limitation for cash contributions to public charities and certain private foundations is increased to 60%. Contributions exceeding the 60% limitation are generally allowed to be carried forward and deducted for up to five years, subject to the later year's ceiling.

#### Limitations

1. Limits of Deductions

The amount that the taxpayer can deduct for charitable contributions generally is limited to no more than 60% of his or her adjusted gross income (AGI). Taxpayer's deduction may be further limited to 50%, 30%, or 20% of his or her AGI, depending on the type of property given and the type of organization that was given it to. A higher limit applies to certain qualified conservation contributions. Taxpayer's AGI is the amount on Form 1040 or 1040-SR, line 11.

Effective for 2021, cash contributions to certain organizations are limited to 100% of AGI. The 100% limit does not apply to noncash charitable contributions, which are limited to 50% of AGI.

**Out-of-pocket expenses:** Amounts the taxpayer spends performing services for a charitable organization may be deductible as a contribution to a qualified organization. If so, the taxpayer's deduction is subject to the limit applicable to donations to that organization. For example, the 30% limit applies to amounts spent on behalf of a private non-operating foundation.

1. Limit Based on 60% of Adjusted Gross Income (AGI)

If the taxpayer makes cash contributions during the year to an organization described earlier under First category of qualified organizations (50% limit organizations), taxpayer's deduction for the cash contributions is 60% of his/her AGI. This 60% limit doesn’t apply to non-cash charitable contributions.

"For the use of" contribution exception: A 30% limit applies to cash contributions that are "for the use of" the qualified organizations instead of "to" the qualified organization. A contribution is "for the use of" a qualified organization when it is held in a legally enforceable trust for the qualified organization or in a similar legal arrangement.

1. Limits Based on 50% of Adjusted Gross Income (AGI)

There are two 50% limits that may apply to the taxpayer's contributions.

**Non-cash contributions to 50% limit organizations:** If the taxpayer makes non-cash contributions to organizations described earlier under First category of qualified organizations (50% limit organizations), his or her deduction for the non-cash contributions is limited to 50% of his/her AGI minus the cash contributions given subject to the 60% limit.

**Capital gain property exception:** A 30% limit applies to non-cash contributions of capital gain property if the taxpayer figures his or her deduction using fair market value without reduction for appreciation.

**"For the use of" contribution exception:** A 20% or 30% limit applies to non-cash contributions that are "for the use of" the qualified organization instead of "to" the qualified organization.

**Qualified conservation contributions:** Taxpayer's deduction for qualified conservation contributions (QCCs) is limited to 50% of his or her AGI minus his/her deduction for all other charitable contributions.

1. Limits Based on 30% of Adjusted Gross Income (AGI)

These are two 30% limits that may apply to the taxpayer's contributions. The 30% limit for capital gain property contributions to a 50% limit organization is separate from the 30% limit that applies to taxpayer's other contributions. Both are separately reduced by contributions made to a 50% organization, but the amount allowed after applying one of the 30% limits doesn't reduce the amount allowed after applying the other 30% limit. However, as a result of applying the separate limits, the total contributions subject to a 30% limit will never be more than 50% of taxpayer's AGI.

1. Contributions to the second category of qualified organizations or "for the use of" any qualified organization

If the taxpayer makes cash contributions or non-cash contributions (other than capital gain property) during the year:

1. To an organization described earlier under Second category of qualified organizations, or
2. "For the use of" any qualified organization.

Taxpayer's deduction for those contributions is limited to 30% of his or her AGI, or if less, 50% of AGI minus all taxpayer’s contributions to 50% limit organizations (other than contributions subject to a 100% limit or qualified conservation contributions). For this purpose, contributions to 50% limit organizations include all capital gain property contributions to a 50% limit organization (other than qualified conservation contributions), even those that are subject to the 30% limit discussed later.

If the taxpayer makes a contribution of capital gain property to an organization other than a 50% limit organization or "for the use of" any qualified organization, see Limit based on 20% of adjusted gross income, later.

**Student living with the taxpayer:** Deductible amounts the taxpayer spends on behalf of a student living with him/her are subject to this 30% limit. These amounts are considered a contribution for the use of a qualified organization.

**Certain capital gain property contributions to 50% limit organizations:** Taxpayer's non-cash contributions of capital gain property to 50% limit organizations is limited to 30% of his or her AGI minus all contributions made to 50% limit organizations that are subject to the 60% and 50% limits (other than qualified conservation contributions). The limit that applies to capital gain property contributions to 50% limit organizations doesn’t apply to qualified conservation contributions.

**Election to apply the 50% limit:** The taxpayer may choose the 50% limit for contributions of capital gain property to organizations described earlier under First category of qualified organizations (50% limit organizations) instead of the 30% limit that would otherwise apply.

1. Limit Based on 20% of Adjusted Gross Income (AGI)

If the taxpayer makes non-cash contributions of capital gain property during the year to any of the following:

1. An organization described earlier under Second category of qualified organizations.
2. "For the use of" any qualified organization.

Then the taxpayer's deduction for those contributions is limited to 20% of his or her AGI or, if less, the smallest of the following:

1. 30% of taxpayer's AGI minus all contributions given that are subject to a limit based on 30% of AGI.
2. 30% of taxpayer's AGI minus all capital gain contributions given that are subject to the limit based on 30% of AGI.

50% of taxpayer's AGI minus all contributions subject to the limits based on 60%, 50%, and 30% of AGI (other than qualified conservation contributions).

1. Contemporaneous Written Acknowledgement Required for $250 or More

The exception that relieves a taxpayer from obtaining and providing a contemporaneous written acknowledgement for contributions over $250 if the donee organization files a return with the required information was repealed.

Further, taxpayers who used to rely on the charity's reporting of their charitable contribution on the charity's information return are no longer able to use this method for substantiating their gift of $250 or more. Instead, the taxpayer would have to request a separate acknowledgment from the charity to claim a charitable deduction.

The donor must maintain a record of the contribution, regardless of the dollar amount. A record of the contribution can be one of the following:

1. A bank record, such as a canceled check, a bank copy of the canceled check, or a bank statement, containing the name of the charity, the date, and the amount.
2. A written communication from the charity that includes the name of the charity, the date of the contribution, and the amount of the contribution.
3. Payroll deduction records such as a pay stub, Form W-2, pledge card, or a document provided by the employer.

### Nonbusiness Casualty and Theft Losses

For the eight tax years beginning after December 31, 2017 until January 1, 2026, the personal casualty and theft loss deduction is suspended, except for personal casualty losses incurred in a federally declared disaster area. However, where a taxpayer has personal casualty gains, the loss suspension does not apply to the extent that such loss does not exceed the gain.

#### Disaster Area

A federally declared disaster area is a disaster that occurred in an area declared by the President to be eligible for federal assistance under the Robert T. Stafford Disaster Relief and Emergency Assistance Act.

A taxpayer generally deducts a casualty loss in the year it occurred. If the taxpayer has a loss from a federally declared disaster that occurred in an area warranting public or individual assistance, the taxpayer can choose to deduct the loss on the tax return, or amended return, for either the year the casualty occurred or the year immediately preceding the year the disaster occurred.

A personal casualty or theft gain is the recognized gain from a personal casualty or theft, such as where a taxpayer receives an insurance payment or other reimbursement that exceeds the taxpayer's basis in the property affected by the casualty or theft.

The taxpayer calculates the deductible amount of a casualty loss by:

1. Figuring the adjusted basis in the property before the disaster,
2. Calculating the decrease in the property’s fair market value after the disaster, and
3. Subtracting any insurance or other reimbursement received from the smaller of (1) and (2).

The adjusted basis is ordinarily the property’s original cost, plus the cost of permanent improvements.

#### General Rule Limiting Personal Casualty Loss Deductions

The general rule for deducting personal casualty losses is that the taxpayer may take the deduction only if he or she itemize on Schedule A. In order for the taxpayer to itemize, his or her deductible casualty loss and other personal deductions (such as mortgage interest, real estate taxes, and medical expenses) must exceed the standard deduction.

In addition, the taxpayer may deduct only the amount of the loss that exceeds 10 percent of his or her adjusted gross income (AGI) for the year. The 10-percent-of-AGI rule greatly limits or eliminates many casualty loss deductions.

The taxpayer must also subtract $100 from each casualty or theft he or she suffered during the year. This reduction applies to each total casualty loss. It does not matter how many pieces of property are involved in an event. Only a single $100 reduction applies.

For certain federally declared disasters and certain time periods:

1. The 10-percent-of-AGI threshold is eliminated,
2. The $100 floor is increased to $500, and
3. Taxpayers may claim the deduction without itemizing and may increase their standard deduction by the amount of their net disaster losses.

These rules apply only to losses due to “qualified disasters”. For 2021 these are:

1. A major disaster declared by the President under section 401 of the Stafford Act in 2016;
2. Hurricane Harvey;
3. Tropical Storm Harvey;
4. Hurricane Irma;
5. Hurricane Maria;
6. The California wildfires in 2017 and January 2018;
7. A major disaster that was declared by the President under section 401 of the Stafford Act and that occurred in 2018 and before December 21, 2019, and continued no later than January 19, 2020 (except those attributable to the California wildfires in January 2018 that received prior relief); and
8. A major disaster that was declared by Presidential Declaration that is dated between January 1, 2020, and February 25, 2021 (inclusive). However, in order to qualify under this expansion, the major disaster must have an incident period beginning between December 28, 2019, and December 27, 2020 (inclusive).

Further, the major disaster must have an incident period ending no later than January 26, 2021. However, this change does not include those losses attributable to any major disaster which has been declared only by reason of COVID-19.

### Other Itemized Deductions

#### Net Qualified Disaster Loss Reporting

If the taxpayer has a net qualified disaster loss on Form 4684, line 15, of property located in the United States, he or she must report this on form 1040-NR, line 7. Also, the taxpayer must attach Form 4684. If the taxpayer is a student or business apprentice from India who is eligible for the benefits of Article 21(2) of the United States-India Income Tax Treaty and who is electing the standard deduction, the taxpayer will include the loss in his or her standard deduction amount.

Only the expenses listed next can be deducted:

1. Casualty and theft losses of income-producing property from Form 4684, lines 32 and 38b, or Form 4797, line 18a.
2. Deduction for repayment of amounts under a claim of right if over $3,000.
3. Certain unrecovered investment in a pension.
4. Impairment-related work expenses of a disabled person.

#### Miscellaneous Itemized Deductions

The following expenses cannot be deducted:

1. Appraisal fees for a casualty loss or charitable contribution.
2. Casualty and theft losses from property used in performing services as an employee.
3. Clerical help and office rent in caring for investments.
4. Credit or debit card convenience fees.
5. Depreciation on home computers used for investments.
6. Excess deductions (including administrative expenses) allowed a beneficiary on termination of an estate or trust.
7. Fees to collect interest and dividends.
8. Hobby expenses, but generally not more than hobby income.
9. Indirect miscellaneous deductions from pass-through entities.
10. Investment fees and expenses.
11. Legal fees related to producing or collecting taxable income or getting tax advice.
12. Loss on deposits in an insolvent or bankrupt financial institution.
13. Loss on traditional IRAs or Roth IRAs, when all amounts have been distributed to the taxpayer.
14. Repayments of income.
15. Repayments of social security benefits.
16. Safe deposit box rental, except for storing jewelry and other personal effects.
17. Service charges on dividend reinvestment plans.
18. Tax advice fees.
19. Trustee's fees for the taxpayer’s IRA, if separately billed and paid.

### Itemized Deductions for Form 1040-NR

The taxpayer considered a Non-resident Alien must claim certain itemized deductions on form 1040-NR, Schedule A. Items deducted elsewhere, such as on Form 1040-NR or Schedule C, E, or F (Form 1040 or 1040-SR) should not be included in Schedule A.

Non-resident aliens can deduct certain itemized deductions if they receive income effectively connected with their U.S. trade or business. These deductions include:

1. State and local income taxes.
2. Charitable contributions to U.S. non-profit organizations.
3. Casualty theft losses, from a federally declared disaster.
4. Other itemized deductions.

The taxpayer must include only deductions and losses properly allocated and apportioned to income effectively connected with a U.S. trade or business, excepting deductions of certain charitable contributions and casualty and theft losses even if they do not relate the taxpayer’s effectively connected income. The taxpayer must not include deductions and/or losses that relate to exempt income or to income that is not effectively connected with a U.S. trade or business.

#### State and Local Income Taxes

The taxpayer can deduct state and local income taxes he or she paid or that were withheld from taxpayer’s salary during 2021 on income connected with a U.S. trade or business.

1. Safe harbor for certain charitable contributions made in exchange for a state or local income tax credit

If the taxpayer made a charitable contribution in exchange for a state or local income tax credit and his or her charitable contribution deduction must be reduced as a result of receiving or expecting to receive the tax credit, the taxpayer may qualify for a safe harbor that allows him or her to treat some or all of the disallowed charitable contribution as a payment of state and local income taxes.

The safe harbor applies if the following conditions are met:

1. The taxpayer made a cash contribution to an entity described in section 170(c).
2. In return for the cash contribution, the taxpayer received a state or local income tax credit.
3. The taxpayer must reduce his or her charitable contribution amount by the amount of the state or local income tax credit he or she receives.

#### Charitable Contributions to U.S. Non-Profit Organizations

The taxpayer can deduct contributions gave to U.S. organizations that are religious, charitable, educational, scientific, or literary in purpose. Contributions gave to organizations that work to prevent cruelty to children or animals are also deductible.

To verify an organization's charitable status, the taxpayer can do the following.

1. Check with the organization to which the taxpayer made the donation. The organization should be able to provide the verification of its charitable status.
2. Use the online search tool at IRS.gov/TEOS to see if an organization is eligible to receive tax-deductible contributions (Pub. 78 data). Click on Tax Exempt Organization Search.

Examples of U.S. qualified charitable organizations include the following:

1. Churches, mosques, synagogues, temples, and other religious organizations.
2. Boy Scouts, Boys and Girls Clubs of America, CARE, Girl Scouts, Goodwill Industries, Red Cross, Salvation Army, United Way, etc.
3. Fraternal orders, if the gifts will be used for the purposes listed earlier.
4. Veterans' and certain cultural groups.
5. Non-profit hospitals and medical research organizations.
6. Most non-profit educational organizations, such as colleges, but only if the taxpayer contribution is not a substitute for tuition or other enrollment fees.
7. Federal, state, and local governments if the gifts are solely for public purposes.
8. Contributions the taxpayer can deduct

Contributions can be in cash, property, or out-of-pocket expenses that the taxpayer paid to do volunteer work for the kinds of organizations described earlier.

1. Gifts from which the taxpayer benefits

If the taxpayer made a gift and received a benefit in return, such as food, entertainment, or merchandise, he or she can generally deduct only the amount that is more than the value of the benefit. But this rule does not apply to certain membership benefits provided in return for an annual payment of $75 or less or to certain items or benefits of token value.

1. Alicia paid $80 to a charitable organization to attend a fund-raising dinner and the value of the dinner was $20. Alicia can deduct only $60.
2. Gifts of $250 or more

The taxpayer can deduct a gift of $250 or more only if they have a statement from the charitable organization showing the following information:

1. The amount of any money contributed and a description (but not value) of any property donated.
2. Whether the organization did or did not give the taxpayer any goods or services in return for the contribution. If the taxpayer did receive any goods or services, a description and estimate of the value must be included. If the taxpayer received only intangible religious benefits (such as admission to a religious ceremony), the organization must state this, but it does not have to describe or value the benefit.

#### Non-deductible Amounts

1. Certain contributions to charitable organizations, to the extent that the taxpayer receives a state or local tax credit in return for the contribution.
2. An amount paid to or for the benefit of a college or university in exchange for the right to purchase tickets to an athletic event in the college’s or university's stadium.
3. Travel expenses (including meals and lodging) while away from home, unless there was no significant element of personal pleasure, recreation, or vacation in the travel.
4. Political contributions.
5. Dues, fees, or bills paid to country clubs, lodges, fraternal orders, or similar groups.
6. Cost of raffle, bingo, or lottery tickets.
7. Value of the taxpayer time or services.
8. Value of blood given to a blood bank.
9. The transfer of a future interest in tangible personal property. Generally, no deduction is allowed until the entire interest has been transferred.
10. Gifts to individuals and groups that are operated for personal profit.
11. Gifts to foreign organizations. But the taxpayer may be able to deduct gifts to certain U.S. organizations that transfer funds to foreign charities and certain Canadian, Israeli, and Mexican charities. For details and exceptions, see Pub. 526.
12. Gifts to organizations engaged in certain political activities that are of direct financial interest to the taxpayer’s trade or business. See section 170(f)(9).
13. Gifts to groups whose purpose is to lobby for changes in the laws.
14. Gifts to civic leagues, social and sports clubs, labor unions, and chambers of commerce.
15. Value of benefits received in connection with a contribution to a charitable organization.
16. Cost of tuition.
17. Casualty Theft Losses, from a Federally Declared Disaster

The taxpayer can only deduct non-business/personal casualty or theft losses resulting from a federally declared disaster and only to the extent that:

1. The amount of each separate casualty or theft loss is more than $100.
2. The total amount of all losses during the year is more than 10% of the amount shown on Form 1040-NR, line 35.

### Qualified Business Income (QBI) Deduction

Qualified Business Income (QBI) deduction is to be reported on Form 1040, line 13. The deduction is available, regardless of whether taxpayers itemize deductions on Schedule A or take the standard deduction.

The deduction has two components:

1. QBI Component

This component of the deduction equals 20% of QBI from a domestic business operated as a sole proprietorship or through a partnership, S corporation, trust or estate. The QBI Component is subject to limitations, depending on the taxpayer’s taxable income, that may include the type of trade or business, the amount of W-2 wages paid by the qualified trade or business and the unadjusted basis immediately after acquisition (UBIA) of qualified property held by the trade or business. It may also be reduced by the patron reduction if the taxpayer is a patron of an agricultural or horticultural cooperative.

1. REIT/PTP Component

This component of the deduction equals 20% of qualified REIT dividends and qualified PTP income. This component is not limited by W-2 wages or the UBIA of qualified property. Depending on the taxpayer’s taxable income, the amount of PTP income that qualifies may be limited depending on the PTP’s trade or business.

The deduction is limited to the lesser of the QBI component plus the REIT/PTP component or 20% of the taxable income minus net capital gain.

More detailed information is available under section *Qualified Business Income (QBI)*, Chapter 7 - Module: *Business Expenses, Deductions and Credits* of this book, and in general, under such module.

Review Questions

1. Which of the following is not an itemized deduction?
2. Property taxes paid.
3. Charitable contributions.
4. Medical expenses.
5. Depreciation on home computers used for investments.

|  |
| --- |
| **Answer: D** |
| For 2021, Depreciation on home computers used for investments cannot be deducted. |

1. Which of the following is a type of deduction in the category of deductible non-business taxes?
2. Foreign income taxes
3. Foreign financial account taxes
4. A and B are correct
5. None of the above

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| **Answer: A** |
| There exist four types of deductions in the category of deductible non-business taxes:   * State, foreign and local real estate taxes. * State, foreign and local foreign income taxes. * Local and state general sales tax. * Local and state personal property taxes. |

1. Alicia paid $200, for a course which cost if she opts for the verified certificate is $49, as charitable contribution to EdX which is an educational non-profit organization that she so supports. Which is the amount she can deduct?
2. $200
3. $49
4. $0
5. $151

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| --- |
| **Answer: D** |
| If the taxpayer made a gift and received a benefit in return, such as food, entertainment, or merchandise, he or she can generally deduct only the amount that is more than the value of the benefit. But this rule does not apply to certain membership benefits provided in return for an annual payment of $75 or less or to certain items or benefits of token value. |

1. Carolina made a charitable contribution of $200 to a qualified organization and was acknowledged a meal of $80 for such contribution. Marcos made a charitable contribution of $300 and was acknowledged with tickets for a sporting event. Which of them may deduct the full amount of the contribution?
2. Carolina
3. Marcos
4. Both of them
5. None of them

|  |
| --- |
| **Answer: D** |
| Carolina cannot deduct the full amount of the contribution as she received something valuable in exchange. She can only deduct $120; whereas Marcos received tickets for a sporting event, which allows him to deduct only the 80% of the contribution. |

1. Bernarda made a charitable contribution of $100 and received ticket for a sporting event. How much can she deduct for such contribution?
2. $100
3. $80
4. $50
5. $0

|  |
| --- |
| **Answer: B** |
| Bernarda received tickets for a sporting event, which allows her to deduct only the 80% of the contribution, that is to say $100 x 80% = $80. |

## Module: Credits

In general, tax credits may be either refundable or non-refundable. If a credit is non-refundable, it is available only to taxpayers who may use it to reduce positive income tax liability. Thus, nonrefundable tax credits have no value for those with taxable incomes too low to owe taxes. In contrast, if a credit is fully refundable, a taxpayer may receive a refund for the amount by which the credit exceeds his federal income tax liability, meaning that all households who meet the eligibility criteria for the credit may benefit.

### Child and Dependent Care Credit

The Child and Dependent Care Credit is a non-refundable tax credit for the costs of care for a qualifying individual to allow the taxpayer to work or look for work. 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 or for a disabled spouse or dependent, so that he or she could work or look for work.

For 2021, the American Rescue Plan Act of 2021 (the ARP) increases the amount of the credit for child and dependent care expenses. It also makes the credit refundable for taxpayers that meet certain residency requirements, increases the percentage of employment-related expenses for qualifying care considered in calculating the credit, and modifies the phaseout of the credit for higher earners.

This credit is refundable only if the taxpayer, or spouse on a joint return, has a principal place of residence in the U.S. for more than half of the tax year.

The dollar limit on the amount of the expenses the taxpayer can use to figure the credit for 2021 tax year is $8,000 for the care of one qualifying individual or $16,000 for two or more qualifying individuals.

The maximum credit in 2021 increases to 50% of taxpayer’s employment-related expenses, which equals a maximum credit of $4,000 if the taxpayer had one qualifying person (50% of $8,000), or $8,000 (50% of $16,000) if the taxpayer had two or more qualifying persons. The more a taxpayer earns, the lower the percentage of employment-related expenses that are considered in determining the credit.

Under the ARP, the adjusted gross income level at which the credit percentage starts to phase out is raised to $125,000 for 2021. Above $125,000, the 50% credit percentage goes down as income rises. For 2021, the credit figured on Form 2441, Child and Dependent Care Expenses, line 9a, is unavailable for any taxpayer with adjusted gross income over $438,000; however, the taxpayer may still be eligible to claim a credit on Form 2441, line 9b, for 2020 expenses paid in 2021.

The ARP permits employers to increase the maximum amount that can be excluded from an employee’s income through a dependent care assistance program. For 2021, the maximum amount is increased to $10,500 (previously $5,000). For married employees filing separate returns, the maximum amount is increased to $5,250 (previously $2,500).

#### Requirements

1. The taxpayer's dependent qualifying child who is under age 13 when the care is provided.
2. The taxpayer's spouse who is physically or mentally incapable of self-care and who has the same principal place of abode as the taxpayer for more than half of the year, or
3. The taxpayer's dependent who is physically or mentally incapable of self-care, and who has the same principal place of abode as the taxpayer for more than half of the year. For this purpose, whether an individual is the taxpayer's dependent is determined without regard to the individual's gross income, whether the individual files a joint return, or whether the taxpayer is a dependent of another taxpayer.
4. The taxpayer's payment must be made to a care provider who is not his or her spouse, the parent of his or her child who is his or her qualifying individual, his or her child under age 19, or a dependent of his or her spouse.
5. The taxpayer must file a joint return if he or she is married.
6. The taxpayer must provide the taxpayer identification number (usually the SSN) of each qualifying individual on the return on which he or she claim the credit.
7. The taxpayer's must report the name, address, and taxpayer identification number (either the social security number, or the employer identification number) of the care provider on his or her return. If the care provider is a tax-exempt organization, he or she need only report the name and address on his or her return. The taxpayer can use Form W-10, Dependent Care Provider's Identification and Certification, to request this information from the care provider. If the taxpayer does not provide information regarding the care provider, he or she may still be eligible for the credit if he or she can show that he or she exercised due diligence in attempting to provide the required information.

Dependent care benefits include:

1. Amounts the taxpayer’s employer paid directly to either he or she or his or her care provider for the care of his or her qualifying person while he or she worked,
2. The fair market value of care in a daycare facility provided or sponsored by the taxpayer’s employer, and
3. Pre-tax contributions the taxpayer made under a dependent care flexible spending arrangement.

The taxpayer’s salary may have been reduced to pay for these benefits. If the taxpayer received benefits as an employee, they should be shown in box 10 of his or her Form W-2, Wage and Tax Statement.

#### Amount of Credit

If the taxpayer received dependent care benefits that he or she excludes or deducts 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 taxpayer’s adjusted gross income shown on Form 1040, 1040-SR, or 1040-NR, line 11. If taxpayer’s adjusted gross income is $125,000 or below, the percentage is 50%. Above $125,000, the 50% credit percentage goes down as income rises. Once your income is $438,000 or above, the credit percentage is zero. The 2021 Phaseout Schedule in the line 8 instructions in the Instructions for Form 2441 shows the percentage to use based on adjusted gross income:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
| **If taxpayer’s AGI is** | | **Then the percentage is** | **If taxpayer’s AGI is** | | **Then the percentage is** |
| **Over** | **But not over** | **Over** | **But not over** |
| $0 | $125,000 | 50% | $175,000 | $177,000 | 24% |
| 125,000 | 127,000 | 49% | 177,000 | 179,000 | 23% |
| 127,000 | 129,000 | 48% | 179,000 | 181,000 | 22% |
| 129,000 | 131,000 | 47% | 181,000 | 183,000 | 21% |
| 131,000 | 133,000 | 46% | 183,000 | 400,000 | 20% |
| 133,000 | 135,000 | 45% | 400,000 | 402,000 | 19% |
| 135,000 | 137,000 | 44% | 402,000 | 404,000 | 18% |
| 137,000 | 139,000 | 43% | 404,000 | 406,000 | 17% |
| 139,000 | 141,000 | 42% | 406,000 | 408,000 | 16% |
| 141,000 | 143,000 | 41% | 408,000 | 410,000 | 15% |
| 143,000 | 145,000 | 40% | 410,000 | 412,000 | 14% |
| 145,000 | 147,000 | 39% | 412,000 | 414,000 | 13% |
| 147,000 | 149,000 | 38% | 414,000 | 416,000 | 12% |
| 149,000 | 151,000 | 37% | 416,000 | 418,000 | 11% |
| 151,000 | 153,000 | 36% | 418,000 | 420,000 | 10% |
| 153,000 | 155,000 | 35% | 420,000 | 422,000 | 9% |
| 155,000 | 157,000 | 34% | 422,000 | 424,000 | 8% |
| 157,000 | 159,000 | 33% | 424,000 | 426,000 | 7% |
| 159,000 | 161,000 | 32% | 426,000 | 428,000 | 6% |
| 161,000 | 163,000 | 31% | 428,000 | 430,000 | 5% |
| 163,000 | 165,000 | 30% | 430,000 | 432,000 | 4% |
| 165,000 | 167,000 | 29% | 432,000 | 434,000 | 3% |
| 167,000 | 169,000 | 28% | 434,000 | 436,000 | 2% |
| 169,000 | 171,000 | 27% | 436,000 | 438,000 | 1% |
| 171,000 | 173,000 | 26% | 438,000 | No limit | 0% |
| 173,000 | 175,000 | 25% |  |  |  |

To qualify for the credit, the taxpayer must have one or more qualifying persons. He or she should show the expenses for each person on Form 2441, line 2, column (c). However, it is possible a qualifying person could have no expenses and a second qualifying person could have expenses exceeding $8,000. In this case it should be listed -0- for the one person and the actual amount for the second person. The $16,000 limit that applies to two or more qualifying persons would still be used to compute his or her credit unless he or she already excluded or deducted, in Part III of Form 2441, certain dependent care benefits paid to the taxpayer (or on his/her behalf) by his or her employer.

To be work-related, the taxpayer’s expenses must allow him or her to work or look for work. If the taxpayer is married, generally both the taxpayer and his or her spouse must work or look for work. One spouse is treated as working during any month he or she is a full-time student or is not physically or mentally able to care for him or herself.

The taxpayer’s work can be for others or in his or her own business or partnership. It can be either full-time or part-time. Work also includes actively looking for work. However, if the taxpayer does not find a job and have no earned income for the year, he or she cannot take this credit.

If the taxpayer works part-time, he or she generally must figure his or her expenses for each day. However, if the taxpayer has to pay for care weekly, monthly, or in another way that includes both days worked and days not worked, he or she can figure the credit including the expenses he or she paid for days he or she did not work. Any day when the taxpayer works at least 1 hour is a day of work.

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

### Child Tax Credit and Credit for Other Dependents

#### Child Tax Credit

A taxpayer will only be able to claim the child tax credit or the additional child tax credit if he or she includes a Social Security number for each qualifying child for whom the credit is claimed on the tax return. The Social Security number must be issued before the due date for the filing of the tax return where the credit is claimed.

A qualifying child is any child who satisfies all the following:

* The child is the taxpayer's son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, half-brother, half-sister, or a descendant of any of them.
* The child is a qualifying child as defined under the dependency rules.
* The child has not attained the age of 17 by the end of the year.
* The child did not provide more than half of his or her own support.
* The child lived with the taxpayer for more than half of the year. An exception applies for a child of divorced or separated parents.
* The taxpayer treats the child as a dependent for his or her return.
* The child does not file a joint return, except if only for a refund of withheld taxes or estimated tax payment.
* The child is a citizen, national, or resident of the United States.
* The child must have an SSN.

1. **REMINDER:** For 2018 and later years, under the TCJA, a child with an ITIN or ATIN will no longer be a qualifying child for the CTC.

The American Rescue Plan Act increased the maximum annual credit from $2,000 per child (under 17) in 2021 to:

* $3,000 per qualifying child ages 6 through 17, or
* $3,600 if the qualifying child is age 5 or under.

The entire child tax credit is refundable if the taxpayer, or either spouse on a joint return, has a principal place of residence in the U.S. for more than half of the tax year or is a *bona fide* resident of Puerto Rico. The taxpayer who does not meet the residence test still have the partial refundable credit of $1,400.

The additional amounts that exceed the $2,000 base credit are reduced by $50 for each $1,000 (or fraction) by which the taxpayer’s MAGI exceeds:

* $150,000 for MFJ or QW,
* $112,500 for HOH, or
* $75,000 for all other filing statuses.

The $2,000 base credit is reduced by $50 for each $1,000 (or fraction) by which the taxpayer’s MAGI exceeds:

* $400,000 for MFJ, or
* $200,000 for all other filing statuses.

The American Rescue Plan Act also provides for advance payments of 50% of the anticipated 2021 child tax credit in equal periodic payments from July 2021 through December 2021. This anticipated credit is calculated using the taxpayer’s filing status, MAGI, and number of qualifying children from 2020 tax returns.

The taxpayer can elect out of advance payments using an online portal that the IRS must create. The IRS will provide notice of advance payments made. The taxpayer has to reconcile advance payments against the actual 2021 credit, and excess advance payments should be repaid on the 2021 tax return.

Unlike the dependent care credit, the education credits, and the earned income tax credit, the child tax credit is available for married taxpayers filing separate returns. If the child is the qualifying child of the non-custodial parent under the rules for children of divorced or separated parents, only the non-custodial parent can claim the child tax credit for that child.

The child tax credit is not allowed where the taxpayer has previously claimed the credit due to reckless or intentional disregard of the rules (two years) or due to fraud (ten years), or where the taxpayer has been denied the credit as a result of deficiency procedures, until the taxpayer can demonstrate he or she is eligible for the credit.

1. **CAUTION:** Paid preparers of federal income tax returns or claims for refund involving the CTC/ACTC must meet due diligence requirements in determining if the taxpayer is eligible for the credits, as well as the amount of the credits. Such preparers must complete Form 8867, Paid Preparer's Due Diligence Checklist, to comply with the due diligence requirements. Failure to do so could result in a $545 penalty for each failure for 2021 tax year.

#### Credit for Other Dependents

The Tax Cuts and Jobs Act allows a $500 non-refundable credit for dependents other than a qualifying child or for a qualifying child without the required SSN.

The credit is further expanded to provide for a $500 non-refundable credit for qualifying dependents other than qualifying children. A qualifying dependent is any dependent of the taxpayer who is not a qualifying child, thus there is no age limit for a qualifying dependent. In addition, the SSN requirement does not apply for qualifying dependents.

A taxpayer must include on his or her return an SSN for each qualifying child for whom the credit is claimed. This requirement does not apply to a non-child dependent for whom the $500 non-refundable credit is claimed. A qualifying child who is ineligible to receive the child tax credit because that child did not have a Social Security number may nonetheless qualify for the non-refundable $500 credit as a qualifying dependent.

The credit begins to phase out for taxpayers with adjusted gross income in excess of $400,000 (in the case of married taxpayers filing a joint return) and $200,000 (for all other taxpayers). These phase-out thresholds are not indexed for inflation. The changes done by the TCJA will revert after 2025.

Review Questions

1. Which of the following could prevent an individual from qualifying for the child and dependent care credit?
2. Unearned income of more than $3,800.
3. Not identifying the care provider on the tax return.
4. Paying for care for more than one qualifying person.
5. Paying for child care while looking for work.

|  |
| --- |
| **Answer: B** |
| The following are requirements needed for the child and dependent care tax credit:   * The taxpayer's dependent qualifying child must be under age 13 when the care is provided. * The taxpayer's spouse must be physically or mentally incapable of self-care and must have the same principal place of abode as the taxpayer for more than half of the year. * The taxpayer's dependent must be physically or mentally incapable of self-care, and must have the same principal place of abode as the taxpayer for more than half of the year. * The taxpayer's payment must be made to a care provider who is not his or her spouse, the parent of his or her child who is his or her qualifying individual, his or her child under age 19, or a dependent of his or her spouse. * The taxpayer must file a joint return if he or she is married. * The taxpayer must provide the taxpayer identification number (usually the social security number) of each qualifying individual on the return on which he or she claim the credit. * The taxpayer's must report the name, address, and taxpayer identification number (either the social security number, or the employer identification number) of the care provider on his or her return. If the care provider is a tax-exempt organization, he or she need only report the name and address on his or her return. If the taxpayer does not provide information regarding the care provider, he or she may still be eligible for the credit if he or she can show that he or she exercised due diligence in attempting to provide the required information. |

1. Regarding the child tax credit, which is the threshold MAGI amount for taxpayers with a married filing jointly filing status?
2. $500,000.
3. $250,000.
4. $400,000.
5. $100,000.

|  |
| --- |
| **Answer: C** |
| The child tax credit is limited to the taxpayer's tax liability. If the taxpayer has no tax liability, the taxpayer cannot claim the child tax credit but may be entitled to the additional child tax credit.  The child tax credit is subject to phase-out if the taxpayer's MAGI exceed a certain amount.  The threshold amounts are as follows:   * $400,000 MFJ. * $200,000 for S, HH, QW, and MFS. |

1. Carlos is to claim the Child and Dependent Care Tax Credit. His AGI is of $28,650. Which is the percentage he is entitled to for this purpose?
2. 34%
3. 31%
4. 28%
5. 50%

|  |
| --- |
| **Answer: D** |
| 50% rate is used for taxpayer’s whose AGI falls between $0 and $125,000 for 2021. |

1. Dalia wants to take the additional child tax credit for her single child. Assuming she had no portion of the child tax credit disallowed because of tax liability limitation, and provided she had an excess in her earned income of $10,000 over $2,500, which is the amount she might claim?
2. $1,500
3. $1,400
4. $1,000
5. $0

|  |
| --- |
| **Answer: A** |
| If Dalia had three or more qualifying children, she would have to subtract her earned income tax credit from her social security taxes, and this amount should be greater than $1,400 and the 15% of the excess of her earned income over $2,500 in order to be the amount she might claim. However, as she has a single child, she might claim the greater of $1,400 or 15% of the excess of her earned income over $2,500. She has an excess of $10,000, which means she must multiply 15% for such amount, totaling $1,500, which is greater than $1,400; therefore, she might claim up to $1,500 as additional child tax credit. |

### Education Credits

The education credit is aimed at reducing tax return with regard to expenses incurred for higher education. There are two tax credits available to help the taxpayer offset the costs of higher education by reducing the amount of his or her income tax. They are:

1. The American opportunity tax credit (AOTC)
2. The lifetime learning credit (LLC)

For each student, the taxpayer can elect for any year only one of the credits. For example, if a taxpayer chooses to claim the American opportunity credit for a child on their 2021 tax return, the taxpayer can’t, for that same child, also claim the lifetime learning credit for 2021.

If the taxpayer is eligible to claim the American opportunity credit and is also eligible to claim the lifetime learning credit for the same student in the same year, they can choose to claim either credit, but not both.

If the taxpayer pays qualified education expenses for more than one student in the same year, they can choose to claim the American opportunity and the lifetime learning credits on a per-student, per-year basis. This means that, for example, the taxpayer can claim the American opportunity credit for one student and the lifetime learning credit for another student in the same year.

1. Form 1098-T Requirement

To be eligible to claim an education credit, the law requires a taxpayer (or a dependent) to have received a Form 1098-T, Tuition Statement, from an eligible educational institution, whether domestic or foreign.

However, one of these education benefits may be claimed if the student does not receive a Form 1098-T because the student’s educational institution is not required to furnish a Form 1098-T to the student under existing rules (for example, if the student is a qualified non-resident alien, has qualified education expenses paid entirely with scholarships, has qualified education expenses paid under a formal billing arrangement, or is enrolled in courses for which no credit is awarded). If a student’s educational institution is not required to provide a Form 1098-T to the student, the taxpayer may claim one of these education benefits without a Form 1098-T if he or she otherwise qualifies, can demonstrate that he or she (or a dependent) was enrolled at an eligible educational institution, and can substantiate the payment of tuition and related expense.

The taxpayer may also claim this credit if the student attended an eligible educational institution required to furnish Form 1098-T but the student doesn't receive Form 1098-T before the taxpayer’s tax return filing (for example, if the institution is otherwise required to furnish the Form 1098-T and doesn't furnish it or refuses to do so) and the taxpayer takes the following required steps:

1. After January 31, 2022, but before the due date for his or her 2021 tax return, the taxpayer or the student must request that the educational institution furnish a Form 1098-T.
2. The taxpayer must fully cooperate with the educational institution's efforts to gather the information needed to furnish the Form 1098-T.
3. The taxpayer also must otherwise qualify for the benefit, be able to demonstrate that he or she (or a dependent) was enrolled at an eligible educational institution, and substantiate the payment of qualified tuition and related expenses.

**NOTE:** To claim the American opportunity credit, the taxpayer must provide the educational institution's employer identification number (EIN) on his or her Form 8863. The taxpayer should be able to obtain this information from Form 1098-T or the educational institution.

1. Ban on claiming the American Opportunity Credit

If the taxpayer claims the American opportunity credit even though he or she is not eligible, the taxpayer may be banned from claiming the credit for 2 or 10 years depending on his or her conduct.

1. Taxpayer identification number (TIN) needed by due date of return

If the taxpayer hasn’t been issued a TIN by the due date of their 2021 return (including extensions), the taxpayer can’t claim the American opportunity credit on either their original or an amended 2021 return, even if the taxpayer later gets a TIN. Also, the American opportunity credit isn’t allowed on either taxpayer’s original or an amended 2021 return for a student who hasn’t been issued a TIN by the due date of their return (including extensions), even if that student later gets a TIN.

1. Form 8862 may be required

If the taxpayer’s American opportunity credit was denied or reduced for any reason other than a math or clerical error for any tax year beginning after 2015, the taxpayer may be required to attach a completed Form 8862, *Information To Claim Certain Credits After Disallowance*, to their tax return to claim the credit.

#### Who Can Claim an Education Credit?

The taxpayer may be able to claim an education credit if he or she, his/her spouse, or a dependent claimed on his/her tax return was a student enrolled at or at-tending an eligible educational institution. For 2021, the credits are based on the amount of qualified education expenses paid for the student in 2020 for academic periods beginning in 2021 and in the first 3 months of 2022.

For example, if the taxpayer paid $1,500 in December 2021 for qualified tuition for the spring 2022 semester beginning in January 2022, he or she may be able to use that $1,500 in figuring 2021 education credit(s).

**Academic period:** An academic period includes a semester, trimester, quarter, or other period of study (such as a summer school session) as reasonably determined by an educational institution. If an educational institution uses credit hours or clock hours and doesn’t have academic terms, each payment period can be treated as an academic period.

**Eligible educational institution:** An eligible educational institution is generally any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the U.S. Department of Education. Virtually all accredited public, non-profit, and proprietary (privately owned profit-making) postsecondary institutions meet this definition. The educational institution should be able to tell the taxpayer if it is an eligible educational institution.

1. Certain educational institutions located outside the United States also participate in the U.S. Department of Education's Federal Student Aid (FSA) programs.

**Who can claim a dependent's expenses:** If a dependent is claimed on a tax return, all qualified education expenses of the student are treated as having been paid by the person claiming the dependent. Therefore, only the person claiming the dependent on a tax return can claim an education credit for the student. If a student is not claimed as a dependent on another person's tax return, only the student can claim a credit.

**Expenses paid by a third party:** Qualified education expenses paid on behalf of the student by someone other than the student (such as a relative) are treated as paid by the student. However, qualified education expenses paid (or treated as paid) by a student who is claimed as a dependent on the taxpayer’s tax return are treated as paid by the taxpayer himself. Therefore, the taxpayer is treated as having paid expenses that were paid by the third party.

#### Who cannot claim a credit?

A taxpayer can’t claim an education credit if any of the following apply:

1. Taxpayer’s filing status is married filing separately.
2. The taxpayer claimed as a dependent on another person's tax return, such as their parent's return.
3. The taxpayer (or their spouse) was a non-resident alien for any part of 2021 and the non-resident alien did not elect to be treated as a resident alien for tax purposes.
4. The taxpayer didn't have a social security number (SSN) (or individual taxpayer identification number (ITIN)) by the due date of their 2021 return (including extensions); They can't claim the American opportunity credit on either their original or an amended 2021 return, even if they later get an SSN (or ITIN). Also, taxpayer can't claim this credit on their original or an amended 2021 return for a student who didn't have an SSN, adoption taxpayer identification number (ATIN), or ITIN by the due date of the return (including extensions), even if the student later gets one of those numbers. If an ATIN or ITIN is applied for on or before the due date of a 2021 return (including extensions) and the IRS issues an ATIN or ITIN as a result of the application, the IRS will consider the ATIN or ITIN as issued on or before the due date of the return.
5. Taxpayer’s MAGI is one of the following:
6. American opportunity credit: $180,000 or more if married filing jointly; or $90,000 or more if single, head of household, or qualifying widow(er).
7. Lifetime learning credit: $180,000 or more if married filing jointly; or $90,000 or more if single, head of household, or qualifying widow(er).

#### Qualified Education Expenses

Generally, qualified education expenses are amounts paid in 2021 for tuition and fees required for the student's enrollment or attendance at an eligible educational institution. It doesn’t matter whether the expenses were paid in cash, by check, by credit or debit card, or with borrowed funds. For course-related books, supplies, and equipment, only certain expenses qualify.

**American opportunity credit:** Qualified education expenses include amounts spent on books, supplies, and equipment needed for a course of study, whether or not the materials are purchased from the educational institution as a condition of enrollment or attendance.

**Lifetime learning credit:** Qualified education expenses include amounts for books, supplies, and equipment only ifrequired to be paid to the institution as a condition of enrollment or attendance.

Qualified education expenses include non-academic fees, such as student activity fees, athletic fees, or other expenses unrelated to the academic course of instruction, only ifthe fee must be paid to the institution as a condition of enrollment or attendance. However, fees for personal expenses (described below) are never qualified education expenses.

Qualified education expenses for either credit do not include amounts paid for the following:

1. **Personal expenses:** This means room and board, insurance, medical expenses (including student health fees), transportation, and other similar personal, living, or family expenses.
2. Any course or other education involving sports, games, or hobbies, or any non-credit course, unless such course or other education is part of the student's degree program or (for the lifetime learning credit only) helps the student acquire or improve job skills.

Qualified education expenses paid on behalf of the student by someone other than the student (such as a relative) is treated as paid by the student. Qualified education expenses paid (or treated as paid) by a student who is claimed as a dependent on the taxpayer’s tax return are treated as paid by the taxpayer himself.

If the taxpayer or the student takes a deduction for higher education expenses, such as on Schedule C (Form 1040 or 1040-SR), the taxpayer can’t use those expenses in his or her qualified education expenses when figuring his or her education credits.

**Prepaid expenses:** Qualified education expenses paid in 2021 for an academic period that begins in the first 3 months of 2022 can be used in figuring an education credit for 2021 only. For example, if the taxpayer pays $2,000 in December 2021 for qualified tuition for the 2022 winter quarter that begins in January 2022, the taxpayer can use that $2,000 in figuring an education credit for 2021 only (if he or she meets all the other requirements).

1. **NOTE:** A taxpayer cannot use any amount they paid in 2020 or 2021 to figure the qualified education expenses used to figure their 2022 education credit(s).

**Paid with borrowed funds:** The taxpayer can claim an education credit for qualified education expenses paid with the proceeds of a loan. Expenses are used to figure the credit for the year in which they are paid, not the year in which the loan is repaid. Treat loan payments sent directly to the educational institution as paid on the date the institution credits the student's account.

**Student withdraws from class(es):** The taxpayer can claim an education credit for qualified education expenses not refunded when a student withdraws.

1. No Double Benefit Allowed

It is not allowed to do any of the following:

1. Deduct higher education expenses on taxpayer’s income tax return (as, for example, a business expense) and also claim an education credit based on those same expenses.
2. Claim more than one education credit based on the same qualified education expenses.
3. Claim an education credit based on the same expenses used to figure the tax-free portion of a distribution from a Coverdell education savings account (ESA) or qualified tuition program (QTP).
4. Claim an education credit based on qualified education expenses paid with educational assistance, such as a tax-free scholarship, grant, or employer-provided educational assistance.
5. Adjustments to Qualified Education Expenses

For each student, the taxpayer reduces the qualified education expenses paid in 2021 by or on behalf of that student under the following rules. The result is the amount of adjusted qualified education expenses for each student.

**Tax-free educational assistance:** For tax-free educational assistance received in 2021, it must be reduced the qualified educational expenses for each academic period by the amount of tax-free educational assistance allocable to that academic period. Tax-free educational assistance includes:

1. The tax-free parts of scholarships and fellowship grants (including Pell grants).
2. The tax-free part of employer-provided educational assistance.
3. Veterans' educational assistance.
4. Any other non-taxable (tax-free) payments (other than gifts or inheritances) received as educational assistance.

#### American Opportunity Tax Credit

Also known as the Hope credit, this education credit may help qualifying low-income and middle-income individuals in alleviating the cost of higher education. The American Opportunity Tax Credit (AOTC) is a credit for qualified education expenses paid for an eligible student for the first four years of higher education. The taxpayer can get a maximum annual credit of $2,500 per eligible student. If the credit brings the amount of tax the taxpayer owes to zero, he or she can have 40% of any remaining amount of the credit (up to $1,000) refunded.

The amount of the credit is 100% of the first $2,000 of qualified education expenses the taxpayer paid for each eligible student and 25% of the next $2,000 of qualified education expenses the taxpayer paid for that student. To be eligible for AOTC, the taxpayer must:

1. Be pursuing a degree or other recognized education credential.
2. Be enrolled at least half time for at least one academic period beginning in the tax year.
3. Not have finished the first four years of higher education at the beginning of the tax year.
4. Not have claimed the AOTC or the former Hope credit for more than four tax years.
5. Not have a felony drug conviction at the end of the tax year.

Academic periods can be semesters, trimesters, quarters or any other period of study such as a summer school session. The schools determine the academic periods. For schools that use clock or credit hours and do not have academic terms, the payment period may be treated as an academic period.

Meeting either of the following criteria precludes claiming the AOTC:

1. Married filing separate status, or
2. Taxpayer is listed as a dependent on another’s return.

Qualifying expenses for the AOTC can be paid on behalf of the taxpayer, his or her spouse, or dependents. As noted previously, expenses paid for room and board, non-academic fees or for expenses that are not related to the student’s course of instruction, do not qualify. Also, expenses for courses that involve sports, games, and hobbies do not qualify for the credit unless the course is part of a degree program. Expenses paid from a gift or inheritance (which is tax-free) do qualify for credits.

1. Mauricio Martinez is a single, 20-year-old full-time student at La Guardia College. Mauricio Martinez earned $11,000 from his part-time accounting job and in 2021, provided over one-half of his own support. As a result, his parents no longer claim him as a dependent. In spite of Mauricio earning over one-half of his support, he may not use the refundable portion of the AOTC because he has a living parent. As a result, Mauricio’s AOTC will be limited to his tax liability.

#### 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.

For 2021 tax year, the amount of the taxpayer’s credit is gradually phased out if his or her MAGI is between $80,000 and $90,000 ($160,000 and $180,000 for married taxpayers filing jointly). Therefore, if the taxpayer’s MAGI is of $90,000 or more ($180,000 if filing a joint return), the credit may not be claimed.

Unlike the American Opportunity credit, the credit is available for undergraduate, graduate, or professional courses at eligible educational institutions. The student can be enrolled in just one course and still get the credit. The credit is not subject to felony drug offense restrictions. The purpose of this credit is to encourage taxpayers to take courses at eligible institutions to acquire or improve job skills.

1. In September 2021, Luis pays $1,200 to take a course to improve his job skills to qualify for a new position at work. His lifetime learning credit for 2021 is $240 (20% x $1,200).

#### Comparison of Education Credits for 2021

There is detailed information about these credits later in this chapter. However, they can be compared as follows:

* American Opportunity Credit

1. Up to $2,500 credit per eligible student.
2. $180,000 if married filing jointly; $90,000 if single, head of household, or qualifying widow(er).
3. 40% of credit may be refundable.
4. Available ONLY if the student had not completed the first 4 years of postsecondary education before 2021.
5. Available ONLY for 4 tax years per eligible student (including any year(s) the Hope scholarship credit was claimed).
6. Student must be pursuing a program leading to a degree or other recognized education credential.
7. Student must be enrolled at least half-time for at least one academic period beginning during 2021 (or the first 3 months of 2022 if he qualified expenses were paid in 2021).
8. At the end of 2021, the student had not been convicted of a felony for possessing or distributing a controlled substance.
9. Qualified expenses are: tuition, required enrollment fees, and course materials that the student needs for course of study whether or not the materials are bought at the educational institution as a condition of enrollment or attendance.
10. Payments for academic periods: payments made in 2021 for academic periods beginning in 2021 or beginning in the first 3 months of 2022.
11. Filers and students must have a TIN by the due date of their 2021 return (including extensions).
12. The taxpayer must provide the educational institution’s employer identification number (EIN) on his or her Form 8863.

* Lifetime Learning Credit

1. Up to $2,000 credit per return.
2. $180,000 if married filing jointly; $90,000 if single, head of household, or qualifying widow(er).
3. Non-refundable - credit limited to the amount of tax that the taxpayer must pay on his or her taxable income.
4. Available for all years of postsecondary education and for courses to acquire or improve job skills.
5. Available for an unlimited number of tax years.
6. Student does not need to be pursuing a program leading to a degree or other recognized education credential.
7. Available for one or more courses
8. Felony drug convictions do not make the student ineligible.
9. Qualified expenses are: Tuition and required enrollment fees (including amounts required to be paid to the institution for course-related books, supplies, and equipment).
10. Payments for academic periods: payments made in 2021 for academic periods beginning in 2021 or beginning in the first 3 months of 2021.

The American opportunity credit will always be greater than or equal to the lifetime learning credit for any student who is eligible for both credits. However, if any of the conditions for the American opportunity credit, described above, aren’t met for any student, the taxpayer can’t take the American opportunity credit for that student.

The taxpayer may be able to take the lifetime learning credit for part or all of that student's qualified education expenses instead. The taxpayer must not claim the American opportunity credit for 2 years after there was a final determination that his or her claim was due to reckless or intentional disregard of the rules, or 10 years after there was a final determination that his or her claim was due to fraud.

### Foreign Tax Credit

At times, a person can pay or accrue tax in a foreign country. The foreign tax credit is a claim for a double taxation on the same income. It is a credit that reduces double taxation of income of foreign source. To qualify for a foreign tax credit, the tax must be all of the following:

1. A legal tax liability.
2. Directly imposed to the taxpayer.
3. The taxpayer must have paid or accrued the tax.
4. Income tax.

However, the tax does not include those taxes that are:

1. Refundable to a person,
2. A form of subsidy to a person or anyone related to that person,
3. Not required by law. It is assumed that those taxes that are not required by the law should have been avoided in the foreign country.
4. Deemed by the U.S. government to be from those countries that the government has sanctioned and supports terrorism etc.

Some situations make it impossible to claim the foreign tax credit. In such a case, a person can carry back and/or carry over the unused income tax from the foreign country.

Some compliance issues are:

1. For a foreign tax credit claim, interest expense is apportioned between the U.S. and the foreign country.
2. Dividends or capital gains acquired from a foreign country must be adjusted to qualify for the credit.
3. In practice, charitable contributions are claimed wholly without apportioning between the U.S. and the foreign country. However, charitable contributions are apportioned if the foreign country is Canada, Mexico, and Israel.
4. The credit cannot be claimed from income excluded from the gross income of the U.S.

Generally, the foreign tax credit is equal to the amount of the taxes paid to foreign governments; however, there is an “overall” annual limitation on the amount of the credit, which is calculated as follows:

|  |  |
| --- | --- |
| 1. Net foreign Income | 1. x U.S. tax liability |
| 1. U.S. taxable income |

A taxpayer generally can choose to claim income taxes paid or accrued during the year to a foreign country or U.S. possession as a credit against U.S. income tax, or elect to deduct the foreign tax as an itemized deduction.

However, a taxpayer cannot take a credit or deduction 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.

### Earned Income Tax Credit (EITC)

EITC, Earned Income Tax Credit, is a benefit for working people who have low to moderate income. A tax credit means more money in taxpayers’ pocket. It reduces the amount of taxes owed and may also give taxpayers a refund. EITC is also called EIC or Earned Income Credit.

If the taxpayer qualifies, the amount of EIC will depend on his or her filing status, whether the taxpayer has children, the number of children, and the amount of wages and income for the tax year. When the EIC exceeds the amount of taxes owed, it results in a tax refund to those who claim and qualify for the credit.

In 2021, the taxpayer can use either his or her 2019 income or his or her 2020 income to calculate his or her EITC, this applies only for EIC calculation.

The threshold phaseout amounts and the completed phaseout amounts for 2021 are:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | **Number of Qualifying Children** | | | |
|  | **None** | **One** | **Two** | **Three or more** |
| Earned Income Amount | $9,820 | $10,640 | $14,950 | $14,950 |
| Maximum Amount of Credit | $1,502 | $3,618 | $5,980 | $6,728 |
| Threshold Phaseout Amount (S, SS or HoH) | $11,610 | $19,520 | $19,520 | $19,520 |
| Completed Phaseout Amount (S, SS or HoH) | $21,430 | $42,158 | $47,915 | $51,464 |
| Threshold Phaseout Amount (MFJ) | $17,560 | $25,470 | $25,470 | $25,470 |
| Completed Phaseout Amount (MFJ) | $27,380 | $48,108 | $53,865 | $57,414 |

#### EITC Eligibility Rules

The taxpayer must meet all seven rules to qualify for the earned income credit. If he or she does not meet all seven rules, the taxpayer cannot get the credit.

1. Adjusted Gross Income (AGI) Limits

For the 2021 tax year, the taxpayer’s adjusted gross income (AGI), their investment income limit and their earned income must be less than:

1. $51,464 ($57,414 for married filing jointly) with three or more qualifying children,
2. $47,915 ($53,865 for married filing jointly) with two qualifying children,
3. $42,158 ($48,108 for married filing jointly) with one qualifying child, or
4. $21,430 ($27,380 for married filing jointly) with no qualifying child.

Investment income: $10,000

The maximum Earned Income Credit is:

1. With no qualifying children, $1,502.
2. With one qualifying child, $3,618.
3. With two qualifying children, $5,980.
4. With three or more qualifying children, $6,728.
5. Valid SSN

To claim the EIC, the taxpayer (and his or her spouse, if filing a joint return) must have a valid SSN issued by the Social Security Administration (SSA). Any qualifying child listed on Schedule EIC also must have a valid SSN.

If the taxpayer’s social security card (or his/her spouse's, if filing a joint return) says “Not valid for employment” and his or her SSN was issued so that the taxpayer (or his/her spouse) could get a federally funded benefit, he or she cannot get the EIC.

1. Filing Status Cannot Be “Married Filing Separately”

To claim the credit, the taxpayer cannot declare as MFS, with the exception that one of the spouses lives with a qualifying child for at least half of the year and has not lived at the same address as the other spouse during the last 6 months of the year or has a separation decree.

1. Taxpayer Must Be a U.S. Citizen or Resident Alien all Year

If the taxpayer (or his or her spouse, if married) was a non-resident alien for any part of the year, he or she cannot claim the earned income credit unless his or her filing status is of married filing jointly. The taxpayer may only use that filing status if:

1. One spouse is a U.S. citizen, or
2. The spouse is a resident alien and the taxpayer chooses to treat the non-resident spouse as a U.S. resident. If this choice is made, the taxpayer and his or her spouse will be taxed on his or her worldwide income.
3. Taxpayer Cannot File Form 2555

If the taxpayer files Form 2555, Foreign Earned Income, he or she cannot claim the earned income. This form is filed in order to exclude income that is earned in foreign countries from the taxpayer’s gross income, or to deduct or exclude a foreign housing amount. U.S. possessions are not foreign countries.

1. Investment Income

Taxpayers with investment income that is more than $10,000 in 2021 cannot claim the EITC. Investment income includes the following:

1. Interest income (taxable and tax-exempt).
2. Dividend income.
3. Capital gain net income.
4. Royalties and rental income.
5. Passive activity income.
6. Taxpayer Must Have Earned Income

This credit is called the “earned income” credit because, to qualify, the taxpayer must work and have earned income. If married and filing jointly, the taxpayer meets this rule if at least one spouse works and has earned income. Earned income includes all of the following types of income:

1. Wages, salaries, tips and other taxable employee pay. Employee pay is earned income only if it is taxable. Non-taxable employee pay, such as certain dependent care benefits and adoption benefits, is not earned income. But there is an exception for non-taxable combat pay, which the taxpayer can choose to include in earned income.
2. Net earnings from self-employment. A taxpayer may have net earnings from self-employment if he or she:
3. Owns his or her own business, or
4. Is a minister or member of a religious order.
5. Gross income received as a statutory employee.

These items are not earned income and must not be included as earned income:

1. Interest and dividends.
2. Pensions and annuities.
3. Social security and railroad retirement benefits (including disability benefits).
4. Alimony and child support.
5. Welfare benefits.
6. Workers' compensation benefits.
7. Unemployment compensation (insurance).
8. Non-taxable foster care payments.
9. Veterans' benefits, including VA rehabilitation payments.

#### Rules for Taxpayers with Qualifying Child

1. Child Must Meet the Relationship, Age, Residency and Joint Return Test

It is important to note that taxpayers that do not meet this specific rule do not have a qualifying child. He or she is to file Form 1040, as well as complete Schedule EIC and attach it to the return.

A qualifying child must be:

1. The taxpayer’s son, daughter, stepchild, foster child, or a descendant of any of them (for example, a grandchild), or
2. The taxpayer’s brother, sister, half-brother, half-sister, stepbrother, stepsister, or a descendant of any of them (for example, a niece or nephew).
3. Under age 19 at the end of the year and younger than the taxpayer (or his/her spouse, if filing jointly),
4. Under age 24 at the end of the year, a student, and younger than the taxpayer (or his/her spouse, if filing jointly), or
5. Permanently and totally disabled at any time during the year, regardless of age.
6. The child must have lived with the taxpayer in the United States for more than half of the year.
7. The child cannot file a joint return for the year.
8. A Qualifying Child Cannot be Used by More than One Person to Claim the EIC

Sometimes a child meets the tests to be a qualifying child of more than one person. However, only one of these persons 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):

1. The exemption for the child.
2. The child tax credit.
3. Head of household filing status.
4. The credit for child and dependent care expenses.
5. The exclusion for dependent care benefits.
6. The EIC.
7. Tiebreaker Rules

To determine which person can treat the child as a qualifying child to claim the six tax benefits just listed, the following tiebreaker rules apply.

1. If only one of the persons is the child's parent, the child is treated as the qualifying child of the parent.
2. If the parents file a joint return together and can claim the child as a qualifying child, the child is treated as the qualifying child of the parents.
3. 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.
4. 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.
5. 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 treating the parents' total AGI as divided evenly between them.
6. Victoria and her 2-year-old son Jimmy lived with her mother all year. Victoria is 25 years old, unmarried, and her AGI is $9,000. Victoria’s only income was $9,000 from a part-time job. Victoria’s mother's only income was $20,000 from her job, and her AGI is $20,000. Jimmy's father did not live with her or Jimmy.   
     
   The special rule for divorced or separated parents (or parents who live apart) does not apply. Jimmy is a qualifying child of both Victoria and her mother because he meets the relationship, age, residency, and joint return tests for both his mother and his grandmother. However, only one of them can treat him as a qualifying child to claim the EIC (and the other tax benefits listed earlier in this chapter for which that person qualifies). He is not a qualifying child of anyone else, including his father.   
     
   If Victoria does not claim Jimmy as a qualifying child for the EIC or any of the other tax benefits listed earlier, her mother can treat him as a qualifying child to claim the EIC (and any of the other tax benefits listed earlier for which she qualifies).
7. Special Rule for Divorced or Separated Parents

A child will be treated as the qualifying child of his or her non-custodial parent (for purposes of claiming an exemption and the child tax credit, but not for the EIC) if all of the following statements are true.

1. The parents:
2. Are divorced or legally separated under a decree of divorce or separate maintenance,
3. Are separated under a written separation agreement, or
4. Lived apart at all time during the last 6 months of the year, whether or not they are or were married.
5. The child received over half of his or her support for the year from the parents.
6. The child is in the custody of one or both parents for more than half of the year.
7. Either of the following statements is true:
8. The custodial parent signs Form 8332 or a substantially similar statement that he or she will not claim the child as a dependent for the year, and the non-custodial parent attaches the form or statement to his or her return. If the divorce decree or separation agreement went into effect after 1984 and before 2009, the non-custodial parent may be able to attach certain pages from the decree or agreement instead of Form 8332.
9. A pre-1985 decree of divorce or separate maintenance or written separation agreement that applies to the current taxable year provides that the non-custodial parent can claim the child as a dependent, and the non-custodial parent provides at least $600 for support of the child during the current taxable year.

**Divorced or separated parents (or parents who live apart):** If a child is treated as the qualifying child of the non-custodial parent under the special rule just described for children of divorced or separated parents (or parents who live apart), only the non-custodial parent can claim an exemption and the child tax credit for the child. However, the custodial parent, if eligible, or another eligible taxpayer can claim the child as a qualifying child for the EIC and other tax benefits listed earlier in this chapter. If the child is the qualifying child of more than one person for these benefits, then the tiebreaker rules determine which person can treat the child as a qualifying child.

1. Alex and his 5-year-old son lived all year with his mother, who paid the entire cost of keeping up the home. His AGI is $10,000. His mother’s AGI is $25,000. His son's mother did not live with him or his son. Under the Special rule for divorced or separated parents (or parents who live apart), Alex’s son is treated as the qualifying child of his mother, who can claim the child tax credit for the child. However, his son's mother cannot claim his son as a qualifying child for head of household filing status, the credit for child and dependent care expenses, the exclusion for dependent care benefits, or the EIC. Alex and Alex’s mother did not have any child care expenses or dependent care benefits. If Alex does not claim his son as a qualifying child, Alex’s mother can claim him as a qualifying child for the EIC and head of household filing status, if she qualifies for these tax benefits.
2. Child Cannot Be Qualifying Child of Another Taxpayer

If the taxpayer (or his/her spouse, if filing a joint return) is a qualifying child of another taxpayer, he or she cannot claim the EIC. This is true even if the person for whom the taxpayer is a qualifying child does not claim the EIC or meet all of the rules to claim the EIC.

1. Taxpayer with No Qualifying Child

If the taxpayer does not have a qualifying child, the previous seven rules must be met along with four additional rules:

1. **Taxpayer’s age:** Generally, the taxpayer or spouse (but not both) must be at least 25 years of age at the end of the tax year but less than 65 years of age. For 2021 only, the age limits have been extended. There is no maximum age. The minimum age is generally 19 years; however, if the taxpayer is a homeless or qualified foster youth, the minimum age is 18 years. The minimum age is 24 years for a taxpayer who is a student of higher education at least half time during the year.
2. **Dependency status:** The taxpayer (or spouse, if filing jointly) must not be eligible to be claimed as a dependent on another taxpayer’s return, whether they are claimed or not.
3. **Cannot be a qualifying child:** The taxpayer claiming the EIC may not be the qualifying child of another taxpayer. Note the qualifying child definition discussed in Chapter 1 applies here with two notable exceptions: (1) the child need not meet the support test, and (2) the child must live in a U.S. home for more than one-half of the year (a slight extension of the domicile test).
4. **U.S. home:** The taxpayer must have lived in the United States for more than one-half of the tax year.

Review Questions

1. Which of the following conditions would not prevent an individual from qualifying for the earned income credit?
2. Married filing separately as filing status and live with the spouse.
3. Having another person reclaim the taxpayer’s qualifying child for his or her EITC.
4. Being age 25.
5. Investment income of more than $10,700.

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| **Answer: C** |
| The taxpayer cannot declare as MFS, with the exception that one of the spouses lives with a qualifying child for at least half of the year and has not lived at the same address as the other spouse during the last 6 months of the year or has a separation decree. |

1. Which of the following is not a test to determine if a child is a qualifying child for the Earned Income Tax Credit (EITC)?
2. Relationship.
3. Age.
4. Residency.
5. Support.

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| **Answer: D** |
| A qualifying child must be:   * Son, daughter, stepchild, foster child, or a descendant of any of them, or * Brother, sister, half-brother, half-sister, stepbrother, stepsister, or a descendant of any of them (for example, a niece or nephew). * Under age 19 at the end of the year and younger than the taxpayer, * Under age 24 at the end of the year, a student, and younger than the taxpayer, or * Permanently and totally disabled at any time during the year, regardless of age. * The child must have lived with the taxpayer in the United States for more than half of the year. * The child cannot file a joint return for the year.   Whether the child can support himself or herself is not a determining factor in being a qualifying child. |

1. Which of the following is not considered earned income for the purposes of earned income credit?
2. Gross income received as a statutory employee.
3. Net earnings for self-employment.
4. Unemployment compensation.
5. None of the above.

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| **Answer: C** |
| These items are not earned income and must not be included as earned income:   * Interest and dividends. * Pensions and annuities. * Social security and railroad retirement benefits (including disability benefits). * Alimony and child support. * Welfare benefits. * Workers' compensation benefits. * Unemployment compensation (insurance). * Non-taxable foster care payments. * Veterans' benefits, including VA rehabilitation payments. |

1. Which of the following statements is not true regarding tax benefits for education?
2. The American opportunity credit may be claimed for tuition expenses incurred in the first 4 years of post-secondary education.
3. The dollar limitations for the American opportunity credit are calculated on a per student basis.
4. The Lifetime Learning Credit is allowed for tuition paid for graduate program studies.
5. Room and board are qualifying expenses for any education credit.

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| **Answer: D** |
| Expenses paid for room and board, non-academic fees or for expenses that are not related to the student’s course of instruction, do not qualify for any of the education tax credits. |

### Adoption Credits

The adoption credit is applicable to a person who incurring expenses while in the course of adopting. The credit is limited to the tax liability and therefore, the credit is not refundable. The excess of the tax credit is carried forward for a maximum of five years. The limit amount for 2021 tax year is $14,440 per child.

#### Qualifying Expenses for Credit

For an expense to qualify for an adoption credit, it must be:

1. Necessary and reasonable adoption fees,
2. Fees or costs paid to the attorney or the court,
3. For the purpose of traveling; other expenses incurred in the process of traveling such as meals and lodging costs also qualify for the credit, and
4. Other expenses incurred for the sole purpose of legal adoption.

The credit that person can claim is dependent on both an individual’s level of income and dollar limitation. For 2021 tax year, the credit starts to phase out for taxpayers with income exceeding $216,660, and fully phased out when AGI exceeds $256,660. Any amount beyond this limit does not qualify for the credit.

To claim the credit, the tax year should be:

1. The time that the expenses were incurred.
2. The type of adoption i.e. domestic or foreign adoption.
3. The time that the adoption process was finalized.

In practice, both domestic and foreign adoptions are liable for a tax credit only that the timing makes them different. Domestic adoption refers to the adoption of a child who is a U.S. citizen at the time of adoption while a foreign adoption refers to the adoption of a foreign child.

In a case of adopting a child that the state acknowledges as having special needs, the tax credit a person can claim is the maximum amount of $14,440 for 2021 tax year. However, modified adjusted gross income is also considered. Any credit in excess of the taxpayer tax liability may be carried forward for up to five years.

### ACA Premium Tax Credit

The premium tax credit is a credit that is meant to help individuals and families who earn a low or a moderate income in order to get affordable health insurance.

Eligible taxpayers may receive a tax credit intended to lower the cost of health care. To be eligible, a taxpayer must meet all of the following requirements:

1. Health insurance is purchased through one of the state exchanges or the federal exchange.
2. The taxpayer is not eligible for coverage through an employer or government plan.
3. The taxpayer’s income falls below certain limits.
4. The taxpayer does not file Married Filing Separately except under very limited conditions.
5. The taxpayer cannot be claimed as a dependent by another.

**IMPORTANT!** For tax years 2021 and 2022, the American Rescue Plan Act of 2021 (ARPA) temporarily expanded eligibility for the premium tax credit by eliminating the rule that a taxpayer with household income above 400% of the federal poverty line cannot qualify for a premium tax credit.

#### Change of Circumstances

A beneficiary of the premium tax credit is supposed to report life changes in his/her life at the right time to avoid paying additional taxes when such changes are realized. Changes in the level of income, family size should be reported for assistance there are factors that changes the amount of premium tax credit such as:

1. A change in the household income i.e. an increase or a decrease, and a lump-sum payment such as social security benefits payments should be reported.
2. Getting married or having a divorce.
3. Adopting a child or birth of a child.
4. Qualifying or being disqualified from other health plans.
5. Change of employment status i.e. getting employed or being fired.
6. Changing the place of residence.

Until 2018, The Affordable Care Act required the taxpayer and each member of his or her family to have basic health coverage (called minimum essential coverage), to qualify for an exemption from the requirement to have coverage, or to make an individual shared responsibility payment when he or she files her or her federal income tax return. Starting from tax year 2019 and onwards, the penalty for failing to meet the aforementioned requirements no longer applies.

#### Filing a Federal Tax Return to Claim and Reconcile the Credit

Taxpayers that received the benefit of advance credit payments are to file a tax return, and use Form 8962, Premium Tax Credit (PTC) to reconcile the amount of advance credit payments made on the taxpayer’s behalf with the amount of his or her actual premium tax credit. For these purposes, the taxpayer is to file an income tax return even if he or she is otherwise not required to file it.

The taxpayer must file an income tax return and attach Form 8962 to it if:

1. The taxpayer’s health insurer was paid advance credit payments for the taxpayer and another individual in his or her tax family.
2. An individual, including the taxpayer, was paid advance credit payments, and the taxpayer told the Marketplace he or she would claim a personal exemption for said individual, and no one, including the taxpayer, claims a personal exemption for said individual.
3. The taxpayer chooses to claim the PTC.

If the premium tax credit computed on the taxpayer’s return is more than the advance credit payments made on his or her behalf during the year, the difference will increase his or her refund or lower the amount of tax he or she owes.

Individuals and families can take a Premium Tax Credit 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.

When applying for assistance to help pay the premiums for health coverage through the Marketplace, the Marketplace will estimate the amount of the premium tax credit that the taxpayer may be able to claim for the tax year using information that he or she provides about his or her family composition, his or her projected household income, whether those that he or she is enrolling are eligible for other non-Marketplace coverage, and certain other information.

Based on the estimate from the Marketplace, a taxpayer is able to choose to have all, some, or none of his or her estimated credit paid in advance directly to his or her insurance company on his or her behalf to lower what the taxpayer pays out-of-pocket for his or her monthly premiums.

The American Rescue Plan Act of 2021, enacted on March 11, 2021, suspended the requirement to repay excess advance payments of the premium tax credit (excess APTC) for tax year 2020 only.

If a taxpayer already filed a 2020 return and reported excess APTC or made an excess APTC repayment, the taxpayer doesn’t need to file an amended return or take any other action.

For 2021, there is no exception, the taxpayer must repay every excess advance payment of the premium tax credit.

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| **Repayment Limitation Table** | | |
| **Household Income Percentage of Federal Poverty Line** | **Limitation amount for Single** | **Limitation amount for all other filing statuses** |
| Less than 200% | $325 | $650 |
| At least 200%, but less than 300% | $800 | $1,600 |
| At least 300%, but less than 400% | $1,350 | $2,700 |

#### Failing to File the Tax Return May Prevent Future Advance Credit Payments

If the taxpayer chooses to get the benefit of advance credit payments, he or she is to file his or her tax return as soon as possible so that the taxpayer can get advance credit payments on his or her behalf from the Marketplace in future years. It is recommended that the taxpayer does not wait to file, for this reason, and so that he or she can maintain his or her eligibility for future premium assistance.

If an individual makes advance credit payments on behalf of the taxpayer or an individual in the taxpayer’s family, and the taxpayer does not file a tax return, the taxpayer will not be eligible for advance credit payments or cost-sharing reductions to help pay for his or her Marketplace health insurance coverage in future years.

Thus, the taxpayer will be responsible for the full cost of the taxpayer’s monthly premiums and all covered services. Additionally, the IRS may contact him or her so that the taxpayer pays back some or all of the advance credit payments that are made on behalf of him or her or an individual in the taxpayer’s family.

### Other Credits

#### Health Coverage Tax Credit

The Health Coverage Tax Credit (HCTC) allows eligible individuals to receive a tax credit to offset the cost of their monthly health insurance premiums for 2021 if they have qualified health coverage for the HCTC. A qualified health plan offered through a Health Insurance Marketplace is not qualified coverage for the HCTC.

With the HCTC, participants may be able to work with their vendors/providers to be placed back on health coverage that qualifies for the HCTC and either re-enroll in the HCTC Advance Monthly Program or claim the HCTC on their annual Federal income tax return filed next year.

Participant's next steps to re-enroll in the HCTC Advance Monthly Program:

1. Individuals who were previously enrolled in the HCTC Advance Monthly Program must submit a new Form 13441-A, HCTC Monthly Registration and Update, to re-enroll for 2021 and provide all required documentation including a copy of the health insurance bill reflecting their 2021 insurance rates.

Individuals should continue to pay the entire amounts of their premiums directly to their insurance providers until they receive the HCTC approval letter confirming their 2021 Advance Monthly Program payment amounts.

1. Enrolled participants may request reimbursement for 72.5% of the payments they paid directly to the vendor/provider for 2021 qualified health coverage by using Form 14095, HCTC Reimbursement Request, once they have submitted a payment through the program, or may claim reimbursement on their annual Federal income tax return by using Form 8885, Health Coverage Tax Credit.

Individuals who choose not to enroll in the HCTC Advance Monthly Program, or those enrolled with vendors/providers who are not participating in the program, may be eligible to claim reimbursement for 72.5% of their payments for 2021 qualified health coverage on their annual Federal tax return by filing Form 8885, *Health Care Tax Credit*.

1. Eligibility

Eligibility for the HCTC is restricted to the following groups of individuals:

1. Individuals eligible for Trade Adjustment Assistance (TAA) allowances because of a qualifying job loss.
2. Individuals between 55 and 64 years old whose defined-benefit pension plans were taken over by the Pension Benefit Guaranty Corporation (PBGC).

A taxpayer may be eligible to elect the HCTC only if they are one of the following:

1. An eligible trade adjustment assistance recipient, alternative TAA recipient, or reemployment TAA recipient.
2. An eligible Pension Benefit Guaranty Corporation payee.
3. The family member of an eligible TAA, ATAA, or RTAA recipient, or PBGC payee who is deceased or who finalized a divorce with the taxpayer.

The taxpayer is not eligible for the HCTC if he or she:

1. Can be claimed as a dependent on another person’s federal income tax return.
2. Is enrolled in Medicare, Medicaid, the Children’s Health Insurance Program, or the Federal Employees Health Benefits Program or is eligible to receive benefits under the U.S. military health system (TRICARE).
3. Is enrolled in an Affordable Care Act Marketplace insurance.

The HCTC expires at the end of 2021. The HCTC can't be claimed for coverage months beginning in 2022. The advance monthly payment program will continue through December 2021 but will not accept HCTC payments in 2022.

#### General Business Credits

Taxpayer’s general business credit for the year consists of his or her carryforward of business credits from prior years plus the total of taxpayer’s current year business credits. In addition, taxpayer’s general business credit for the current year may be increased later by the carryback of business credits from later years. The taxpayer must subtract this credit directly from his or her tax.

All of the following credits, with the exception of the electric vehicle credit, are part of the general business credit. The form that the taxpayer must use to figure each credit is specified below:

1. Investment Credit: This consists of the sum of the rehabilitation, energy, and reforestation credits (Form 3468).
2. American Samoa Economic Development Credit (Form 5735).
3. Work Opportunity Credit (Form 5884).
4. Alcohol and Cellulosic Biofuel Fuels Credit (Form 6478).
5. Credit for Increasing Research Activities (Form 6765).
6. Low-Income Housing Credit (Form 8586).
7. Recapture of Low-Income Housing Credit (Form 8611).
8. Orphan Drug Credit (Form 8820).
9. Disabled Access Credit (Form 8826).
10. Qualified Plug-in Electric and Electric Vehicle Credit (Form 8834).
11. Renewable Electricity, Refined Coal, and Indian Coal Production Credit (Form 8835).
12. Empowerment Zone and Renewal Community Employment Credit (Form 8844).
13. Indian Employment Credit (Form 8845).
14. Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips (Form 8846).
15. Credit for Contributions to Selected Community Development Corporations (Form 8847).
16. Biodiesel and Renewable Diesel Fuels Credit (Form 8864).
17. New Markets Credit (Form 8874).
18. Credit for Small Employer Pension Plan Startup Costs (Form 8881).
19. Credit for Employer-Provided Childcare Facilities and Services (Form 8882)
20. Low Sulfur Diesel Fuel Production Credit (Form 8896)
21. Qualified Railroad Track Maintenance Credit (Form 8900)
22. Distilled Spirits Credit (Form 8906)
23. Energy Efficient Home Credit (Form 8908)
24. Alternative Motor Vehicle Credit (Form 8910)
25. Alternative Fuel Vehicle Refueling Property Credit (Form 8911).
26. Mine Rescue Team Training Credit (Form 8923).
27. How to Claim the Credit

To claim a general business credit, the taxpayer will first have to get the forms he or she needs to claim his or her current year business credits. In addition to the credit form, in most cases the taxpayer may also need to file Form 3800.

If the taxpayer files a Form 1040 or 1040-SR Schedule C, he or she may be eligible to claim the Earned Income Tax Credit (EITC).

#### Energy Credits

A taxpayer may be able to take energy credits if they made energy saving improvements to their home located in the United States in 2021. Such credits are:

1. The residential energy efficient property credit.
2. The nonbusiness energy property credit.
3. Residential Energy Credits.

The taxpayer must use Form 5695 to take any residential energy efficient property credit.

**Costs:** For purposes of both credits, costs are treated as being paid when the original installation of the item is completed, or, in the case of costs connected with the reconstruction of taxpayer’s home, when taxpayer’s original use of the reconstructed home begins. For purposes of the residential energy efficient property credit only, costs connected with the construction of a home are treated as being paid when taxpayer’s original use of the constructed home begins. If less than 80% of the use of an item is for nonbusiness purposes, only that portion of the costs that is allocable to the nonbusiness use can be used to determine either credit.

**Association or cooperative costs**: If the taxpayer is a member of a condominium management association for a condominium he or she owns or a tenant-stockholder in a cooperative housing corporation, the taxpayer is treated as having paid their proportionate share of any costs of such association or corporation.

1. **NOTE:** If the taxpayer received a subsidy from a public utility for the purchase or installation of an energy conservation product and that subsidy wasn't included in taxpayer’s gross income, it must be reduced the taxpayer’s cost for the product by the amount of that subsidy before the taxpayer’s credit is figured. This rule also applies if a third party (such as a contractor) receives the subsidy on taxpayer’s behalf.

#### Residential Energy Credits

Residential energy credits are divided into two main categories, nonbusiness energy property and residential energy efficient property. For both credits the following information applies.

* **Manufacturer’s certification:** A taxpayer can rely on a manufacture’s certification in writing that the property qualifies for the credit. Do no attach the certification to the tax return.
* **Basis adjustments:** For improvements that would otherwise add to the basis of the property, the increase in the basis is reduced by the amount of the credit allowed.
* **Original use:** The original use of the property must be by the taxpayer.

1. Residential Energy Efficient Property Credit

The taxpayer may be able to take a credit of 26% of their costs of qualified solar electric property, solar water heating property, small wind energy property, geothermal heat pump property, and fuel cell property. It must be included any labor costs properly allocable to the onsite preparation, assembly, or original installation of the residential energy efficient property and for piping or wiring to interconnect such property to the home. The credit amount for costs paid for qualified fuel cell property is limited to $500 for each one-half kilowatt of capacity of the property.

1. Qualified solar electric property costs

Qualified solar electric property costs are costs for property that uses solar energy to generate electricity for use in taxpayer’s home located in the United States. No costs relating to a solar panel or other property installed as a roof (or portion thereof) will fail to qualify solely because the property constitutes a structural component of the structure on which it is installed. Some solar roofing tiles and solar roofing shingles serve the function of both traditional roofing and solar electric collectors, and thus serve functions of both solar electric generation and structural support. These solar roofing tiles and solar roofing shingles can qualify for the credit. This is in contrast to structural components such as a roof's decking or rafters that serve only a roofing or structural function and thus do not qualify for the credit. The home doesn't have to be the taxpayer’s main home.

1. Qualified solar water heating property costs

Qualified solar water heating property costs are costs for property to heat water for use in taxpayer’s home located in the United States if at least half of the energy used by the solar water heating property for such purpose is derived from the sun. To qualify for the credit, the property must be certified for performance by the nonprofit Solar Rating Certification Corporation or a comparable entity endorsed by the government of the state in which the property is installed.

1. Qualified small wind energy property costs

Qualified small wind energy property costs are costs for property that uses a wind turbine to generate electricity for use in connection with taxpayer’s home located in the United States. The home doesn't have to be taxpayer’s main home.

1. Qualified geothermal heat pump property costs

Qualified geothermal heat pump property costs are costs for qualified geothermal heat pump property installed on or in connection with taxpayer’s home located in the United States. Qualified geothermal heat pump property is any equipment that uses the ground or ground water as a thermal energy source to heat taxpayer’s home or as a thermal energy sink to cool the home. To qualify for the credit, the geothermal heat pump property must meet the requirements of the Energy Star program that are in effect at the time of purchase. The home doesn't have to be taxpayer’s main home.

1. Qualified fuel cell property costs

Qualified fuel cell property costs are costs for qualified fuel cell property installed on or in connection with taxpayer’s main home located in the United States. Qualified fuel cell property is an integrated system comprised of a fuel cell stack assembly and associated balance of plant components that converts a fuel into electricity using electrochemical means. To qualify for the credit, the fuel cell property must have a nameplate capacity of at least one-half kilowatt of electricity using an electrochemical process and an electricity-only generation efficiency greater than 30%.

**CAUTION:** Costs allocable to a swimming pool, hot tub, or any other energy storage medium which has a function other than the function of such storage don't qualify for the residential energy efficient property credit.

1. Joint occupancy

If the taxpayer occupied their home jointly with someone other than their spouse, each occupant must complete his or her own Form 5695. To figure the credit, the maximum qualifying costs that can be taken into account by all occupants for qualified fuel cell property costs is $1,667 for each one-half kilowatt of capacity of the property. The amount allocable to the taxpayer for qualified fuel cell property costs is the lesser of either:

1. The amount paid by the taxpayer.
2. The maximum qualifying cost of the property multiplied by a fraction. The numerator is the amount paid by the taxpayer and the denominator is the total amount paid by the taxpayer and all other occupants.

These rules don't apply to married individuals filing a joint return.

1. Marco owns a house with Juan where they both reside. In 2021, they installed qualified fuel cell property at a cost of $20,000 with a kilowatt capacity of 5. Marco paid $12,000 towards the cost of the property and Juan paid the remaining $8,000. The amount to be allocated is $16,670 ($1,667 x 10 (kilowatt capacity x 2)). The amount of cost allocable to Marco is $10,002 ($16,670 x $12,000/$20,000). The amount of cost allocable to Juan is $6,668 ($16,670 x $8,000/$20,000).
2. Nonbusiness Energy Property Credit

The taxpayer may be able to take a credit equal to the sum of:

1. 10% of the amount paid or incurred for qualified energy efficiency improvements installed during 2021.
2. Any residential energy property costs paid or incurred in 2021.

However, this credit is limited as follows.

1. A total combined credit limit of $500 for all tax years after 2005.
2. A combined credit limit of $200 for windows for all tax years after 2005.
3. A credit limit for residential energy property costs for 2021 of $50 for any advanced main air circulating fan; $150 for any qualified natural gas, propane, or oil furnace or hot water boiler; and $300 for any item of energy efficient building property.

**IMPORTANT:** If the total of any nonbusiness energy property credits the taxpayer has taken in previous years (after 2005) is more than $500, the taxpayer generally can't take the credit in 2021.

1. Subsidized energy financing

Any amounts provided for by subsidized energy financing can't be used to figure the nonbusiness energy property credit.

1. Qualified energy efficiency improvements

Qualified energy efficiency improvements are the following building envelope components installed on or in taxpayer’s main home that the taxpayer owned during 2021 located in the United States if the original use of the component begins with him/her, the component can be expected to remain in use at least 5 years, and the component meets certain energy standards.

1. Any insulation material or system that is specifically and primarily designed to reduce heat loss or gain of a home when installed in or on such a home.
2. Exterior windows and skylights.
3. Exterior doors.
4. Any metal roof with appropriate pigmented coatings or asphalt roof with appropriate cooling granules that are specifically and primarily designed to reduce the heat gain of taxpayer’s home.

For purposes of figuring the credit, it must not be included amounts paid for the onsite preparation, assembly, or original installation of the building envelope component.

**NOTE:** To qualify for the credit, qualified energy efficiency improvements must meet certain energy efficiency requirements.

1. Residential energy property costs

Residential energy property costs are costs of new qualified energy property that is installed on or in connection with taxpayer’s main home that the taxpayer owned during 2021 located in the United States. Include any labor costs properly allocable to the onsite preparation, assembly, or original installation of the energy property. Qualified energy property is any of the following.

1. Certain electric heat pump water heaters; electric heat pumps; central air conditioners; natural gas, propane, or oil water heaters; and stoves that use biomass fuel.
2. Qualified natural gas, propane, or oil furnaces and qualified natural gas, propane, or oil hot water boilers.
3. Certain advanced main air circulating fans used in natural gas, propane, or oil furnaces.

**NOTE:** To qualify for the credit, qualified energy property must meet certain energy efficiency requirements.

1. Joint ownership of qualified property

If the taxpayer and a neighbor shared the cost of qualifying property to benefit each of taxpayer’s main homes, both of them can take the nonbusiness energy property credit. Figure taxpayer’s credit on the part of the cost the taxpayer paid. The limit on the amount of the credit applies to each of them separately.

1. Married taxpayers with more than one home

If both the taxpayer and their spouse owned and lived apart in separate main homes, the limit on the amount of the credit applies to each of them separately. If they are filing separate returns, both of them would complete a separate Form 5695. If they are filing a joint return, figure taxpayer’s nonbusiness energy property credit as follows.

1. Complete lines 17a through 17c and 19 through 24 of a separate Form 5695 for each main home.
2. Figure the amount to be entered on line 24 of both forms (but not more than $500 for each form) and enter the combined amount on line 24 of one of the forms.
3. On line 25 of the form with the combined amount on line 24, cross out the preprinted $500 and enter $1,000.
4. On the dotted line to the left of line 25, enter "More than one main home." Then, complete the rest of this form, including line 18. The amount on line 18 can exceed $500.
5. Attach both forms to taxpayer’s return.
6. Joint occupancy

If the taxpayer owned his or her home jointly with someone other than taxpayer’s spouse, each owner must complete his or her own Form 5695. To figure the credit, there are no maximum qualifying costs for insulation, exterior doors, and a metal or asphalt roof. Enter the amounts paid by the taxpayer for these items on the appropriate lines of Form 5695, Part II. For windows and residential energy property costs, the amount allocable to the taxpayer is the smaller of either:

1. The amount the taxpayer paid.
2. The maximum qualifying cost\* of the property multiplied by a fraction. The numerator is the amount the taxpayer paid and the denominator is the total amount paid by the taxpayer and all other owners.

**\*** $2,000 for windows; $300 for energy-efficient building property; $150 for qualified natural gas, propane, or oil furnace or hot water boiler; or $50 for an advanced main air circulating fan.

#### Retirement Savings Contribution Credit

Also called *Saver’s Credit*, retirement savings contribution credit may be claimed for the amount of contributions the taxpayer, as the designated beneficiary of an ABLE account, makes before January 1, 2026, to the ABLE account.

1. Amount of the Credit

Depending on taxpayer’s adjusted gross income reported on the Form 1040 series return, the amount of the credit is 50%, 20% or 10% of:

1. Contributions the taxpayer makes to a traditional or Roth IRA.
2. Elective salary deferral contributions to a 401(k), 403(b), governmental 457(b), SARSEP, or SIMPLE plan.
3. Voluntary after-tax employee contributions made to a qualified retirement plan (including the federal Thrift Savings Plan) or 403(b) plan.
4. Contributions to a 501(c)(18)(D) plan.
5. Contributions made to an ABLE account for which the taxpayer is the designated beneficiary.

Rollover contributions do not qualify for the credit. Also, taxpayer’s eligible contributions may be reduced by any recent distributions the taxpayer received from a retirement plan or IRA, or from an ABLE account. The maximum contribution amount that may qualify for the credit is $2,000 ($4,000 if married filing jointly), making the maximum credit $1,000 ($2,000 if married filing jointly). Use the chart below to calculate the credit.

1. Cristina, who works at a retail store, is married and earned $41,000 in 2021. Cristina’s spouse was unemployed in 2021 and didn’t have any earnings. Cristina contributed $2,000 to her IRA for 2021. After deducting her IRA contribution, the adjusted gross income shown on her joint return is $39,000. Cristina may claim a 50% credit of $1,000 for her $2,000 IRA contribution on her 2021 tax return.

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| 1. **Credit Rate** | 1. **Married Filing Jointly** | 1. **Head of Household** | 1. **All Other Filers** |
| 1. 50% of taxpayer’s contribution | AGI not more than $39,500 | AGI not more than $29,625 | AGI not more than $19,750 |
| 1. 20% of taxpayer’s contribution | $39,501 - $43,000 | $29,626 - $32,250 | $19,751 - $21,500 |
| 1. 10% of taxpayer’s contribution | $43,001 - $66,000 | $32,251 - $49,500 | $21,501 - $33,000 |
| 1. 0% of taxpayer’s contribution | More than $66,000 | More than $49,500 | More than $33,000 |

Review Questions

1. Which of the following is not a qualified adoption expense?
2. Fees or costs paid to the attorney or the court.
3. Expenses for the purposes of traveling.
4. Necessary and reasonable adoption fees.
5. All of the above are qualified adoption expenses.

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| **Answer: D** |
| For an expense to qualify for an adoption credit, it must be:   * Necessary and reasonable adoption fees, * Fees or costs paid to the attorney or the court, * For the purpose of traveling; other expenses incurred in the process of traveling such as meals and lodging costs also qualify for the credit, and * Other expenses incurred for the sole purpose of legal adoption. |

1. If a child is adopted and the state acknowledges that he or she has special needs, which is the amount of adoption tax credit that a taxpayer may claim?
2. $14,300.
3. $14,440.
4. $14,080.
5. $14,100.

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| **Answer: A** |
| In a case of adopting a child that the state acknowledges having special needs, the tax credit a person can claim is the maximum amount i.e. $14,440 in the 2021 tax year. However, modified adjusted gross income is also considered. |

1. Which of these is not a requirement to be eligible for the ACA Net Premium Tax Credit?
2. The taxpayer’s income exceeds certain limits.
3. The taxpayer is eligible for coverage through an employer or government plan.
4. The taxpayer does not file Married Filing Separately except under very limited conditions.
5. Neither A nor B.

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| **Answer: D** |
| Under the Affordable Care Act (ACA), eligible taxpayers may receive a tax credit intended to lower the cost of health care. To be eligible, a taxpayer must meet all of the following requirements:   * Health insurance is purchased through one of the state exchanges or the federal exchange. * The taxpayer is not eligible for coverage through an employer or government plan. * The taxpayer’s income falls below certain limits. * The taxpayer does not file Married Filing Separately except under very limited conditions. * The taxpayer cannot be claimed as a dependent by another. |

1. Which of the following individuals are eligible for the Healthcare Coverage Tax Credit?
2. Alicia, who is an eligible trade adjustment recipient.
3. Marco, who is eligible to receive benefits under the U.S. military health system (TRICARE).
4. A and B individuals are eligible.
5. Neither A nor B individuals are eligible.

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| **Answer: A** |
| Eligibility for the HCTC is restricted to the following groups of individuals:   * Individuals eligible for Trade Adjustment Assistance (TAA) allowances because of a qualifying job loss. * Individuals between 55 and 64 years old whose defined-benefit pension plans were taken over by the Pension Benefit Guaranty Corporation (PBGC).   The taxpayer may be eligible to elect the HCTC only if he or she is one of the following:   * An eligible trade adjustment assistance recipient, alternative TAA recipient, or reemployment TAA recipient. * An eligible Pension Benefit Guaranty Corporation payee. * The family member of an eligible TAA, ATAA, or RTAA recipient, or PBGC payee who is deceased or who finalized a divorce with you.   The taxpayer is not eligible for the HCTC if he or she:   * Can be claimed as a dependent on another person’s federal income tax return. * Is enrolled in Medicare, Medicaid, the Children’s Health Insurance Program, or the Federal Employees Health Benefits Program or is eligible to receive benefits under the U.S. military health system (TRICARE). * Is enrolled in an Affordable Care Act Marketplace insurance. |

CHAPTER 4   
  
Taxation and Advice

## Module: Taxation

### Alternative Minimum Tax and Credit for Prior Year

This is a supplemental tax levy imposed by the federal government of the United States, which is an addition to the baseline tax levied on individual income earners, estates, corporates, and trusts. The alternative minimum tax (AMT) set limits for taxpayers with high economic income. This precept ensures at least high-income taxpayers are eligible to pay a small amount of tax. As a matter of fact, AMT is defined as a tentative of minimum tax over the regular tax.

AMT is owed only if the individual’s tentative minimum tax is greater than the regular tax. Tax calculators classify minimum tax apart from the normal regular tax. AMT exhibits two rates: A 26% is paid on the first $199,900, and a 28% is charged on income exceeding that amount. However, the rates may fluctuate depending on the current level of inflation. Generally, the AMT is calculated as follows:

1. Computation of the taxable income by eliminating and reducing certain deductions.
2. The amount for an exception of tax is considered.
3. The figure computed above is multiplied by the appropriate tax rates.
4. Foreign tax credit is subtracted from the figure in (3) above.

For 2021 tax year, the exemption amounts are the following:

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| 1. Married filing jointly or surviving spouses | 1. $114,600 |
| 1. Single | 1. $73,600 |
| 1. Married individuals filing separately | 1. $57,300 |

The exceeding amounts of taxable income above which the 28% tax rate applies are the following:

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| 1. Married filing separately | 1. $99,950 |
| 1. All other filing statuses | 1. $199,900 |

The amounts to determine the phase-out of the exemption amounts are as follows:

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| 1. Married individuals filing jointly or surviving spouses | 1. $1,047,200 |
| 1. All other filing statuses | 1. $523,600 |

Even if the tax rate is adjusted for inflation, some taxpayers need to calculate the AMT. For tax filers who may be uncomfortable with the manual system, they may consider using their preferred tax software to find out if they may be subject to the AMT.

#### Credit for Prior Year Minimum Tax

The main purpose of AMT provisions is to ensure that corporations and individuals benefit from tax deductions so that they can pay at least a minimum amount of tax. Such individuals and corporations are entitled to the credit for prior year minimum tax.

This is a provision that lets the taxpayer get back his or her money paid as AMT in the prior year. Individuals can claim it in a year when they do not need to pay AMT. However, it is not allowed to use of this credit to reduce the AMT liability in the future. On the other hand, the law allows an individual to carry over the unused portion of AMT to future years.

The credit for prior year minimum tax is permissible for AMT caused by deferral terms. Some of the deferral terms inherent to AMT may include depreciation, incentive stock option held and not sold and disallowed non-conventional credit source fuel. Individuals and corporations using this must use Form 8801 to file their returns as required by the law of taxation. Credit for prior year minimum tax provision is used:

1. When calculating the amount, the taxpayer has calculated all year.
2. In calculation of credit.
3. If he or she had a timing issue term, even for a deferral item.
4. If the taxpayer had a deferral item or an AMT liability for another item other than exclusionary items.

### Household Employees

As defined by the IRS, an employee is someone hired to work in and around a home and under the instruction to perform his duties as delegated by the homeowner. Some of the common household work is usually done by babysitters, caretakers, domestic workers, drivers, health fitness aides, private nurses and yard workers. The IRS requires the homeowner to pay taxes on the behalf of the household employee.

An IRS provision states that if a taxpayer pays a worker cash wages amounting to $2,200 or more, then he or she must withhold about 6.2% of Social Security and 1.45% of Medicare taxes. Additionally, the law requires that the employer pays about 7.65% of cash wages to act as coverage for Social Security taxes. However, if an employer pays the employee Medicare and Social Security taxes from his own funds, he must withhold at least 7.65% of the cash wages.

Domestic employers only have to report FICA, federal income tax withholding, and FUTA taxes once a year. The taxpayer completes Schedule H and reports it with their Form 1040. Taxpayers who have non-domestic workers in addition to domestic workers can choose to report any FICA taxes and withholding on Forms 941 and 940 with their regular employees. Additionally, at the close of a tax year, taxpayers must file Form W-2 (Copy A) and Form W-3 with the Social Security Administration for each household employee who earned $2,200 or more in cash wages subject to the FICA tax or income tax withheld from wages.

### Underpayment Penalties and Interest

The U.S. tax structure is based on the pay-as-you-go principle. This means that an individual pays taxes as he receives income during the year. Provisionally, the taxpayer can do this through withholding or make estimated inherent to tax payments. Individuals who do not pay taxes or pay a lesser amount through withholding cost compensate this by paying estimated taxes. Failure to pay estimated taxes either through withholding or appropriation attracts a penalty for underpayment of tax.

Individuals may owe a certain penalty for a year if their total withholding and the timely tax payment estimates are not equal to 90% of that year tax or they did not equal to 100% of the previous year taxes. However, there are special rules for certain individuals. For fishermen and farmers, the provision is upheld if at least the two-thirds of the gross income come out from farming or fishing.

For all income earners, the penalty is fixed and it is figured separately in each payment period. Fines and penalty may be upheld even if the taxpayer paid earlier, enough to cover for the underpayment. For instance, in 2021 tax year, an individual owes a penalty for that specific year payment period if his or her estimate tax payment in addition to withholding for that year was less than:

1. 22.5% of year 2021 tax.
2. 25% of the previous year.

If the taxpayer realizes that he or she underpaid, he or she must pay the difference plus a penalty which is calculated based on the outstanding amount owed and how long the amount has been overdue. Typically, the penalty is 0.5% of the amount owed, for each month of nonpayment. Penalized taxpayers may be subjected to interest rates on the penalty.

### Self-Employment Tax

Self-employment tax is comprised of Medicare taxes and Social Security, which is primarily for individuals who are self-employed. Individuals classified as self-employed include:

1. Individuals carrying business and trade as independent contractors or a sole proprietor.
2. Members in a partnership that carries trade and business.

A taxpayer must pay self-employment tax if either:

1. The taxpayer was self-employed and his net self-employment earnings (excluding any church employee income) were $400 or more.
2. The taxpayer performed services for a church as an employee and received income of $108.28 or more. However, if a taxpayer is a member of the clergy or a religious worker, the taxpayer may not have to pay SE tax.

For 2021, the first $142,800 of the taxpayer's combined wages, tips, and net earnings is subject to any combination of the 12.4% Social Security part of SE tax, or railroad retirement (tier 1) tax. The total of all combined wages, tips, and net earnings in 2021 tax year are subject to any combination of the 2.9% Medicare part of SE tax, Social Security tax, or railroad retirement (tier 1) tax.

**Fiscal year filer:** If the taxpayer uses a tax year other than the calendar year, he or she must use the tax rate and maximum earnings limit in effect at the beginning of his or her tax year. Even if the tax rate or maximum earnings limit changes during his or her tax year, he or she should continue to use the same rate and limit throughout his tax year.

The regular self-employment tax rate is 15.3%. The rate consists of two parts:

1. 12.4% for Social Security (Old Age, Survivors, and Disability Insurance).
2. 2.9% for Medicare (hospital insurance).

Under the CARES Act, self-employed individuals may defer the payment of 50% of the Social Security tax imposed on net earnings from self-employment income for the period beginning on March 27, 2020 and ending December 31, 2020. The deferral is calculated on Schedule SE (Form 1040) and will be paid at 50% in 2021 and the remaining amount in 2022.

### Excess Social Security Withholding

Most employers must withhold Social Security tax from the taxpayer’s wages. Certain government employers (some federal, state and local governments) don't have to withhold Social Security tax.

If the taxpayer had more than one employer during the taxable year and their 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.

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 the taxpayer’s income tax on their 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.

Review Questions

1. The alternative minimum tax (AMT) is tentative minimum tax over:
2. Taxable income.
3. Regular tax.
4. Alternative minimum taxable income.
5. Tax preference items.

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| **Answer: B** |
| The AMT is defined as a tentative of minimum tax over the regular tax. |

1. Which of the following statements is not correct regarding who must pay the self-employment tax?
2. The taxpayer was self-employed, with self-employment earnings of $200 or less.
3. The taxpayer was self-employed and his net self-employment earnings were $400 or more.
4. Taxpayers who are members of the clergy or religious workers may not have to pay the SE tax.
5. The taxpayer performed services for a church as an employee and received income of $108.28 or more.

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| **Answer: A** |
| A taxpayer must pay self-employment tax if either:   * The taxpayer was self-employed and his net self-employment earnings (excluding any church employee income) were $400 or more. * The taxpayer performed services for a church as an employee and received income of $108.28 or more. However, if a taxpayer is a member of the clergy or a religious worker, the taxpayer may not have to pay SE tax. |

1. Danilo is an employee in his hometown church. For the services he performed he received income of $100. Marta sells homemade candies; thereof she had an income of $450. Which of them must pay SE tax?
2. Danilo
3. Marta
4. Both of them
5. None of them

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| **Answer: B** |
| A taxpayer must pay self-employment tax if either:   * The taxpayer was self-employed and his net self-employment earnings (excluding any church employee income) were $400 or more. * The taxpayer performed services for a church as an employee and received income of $108.28 or more. However, if a taxpayer is a member of the clergy or a religious worker, the taxpayer may not have to pay SE tax. |

1. For purposes of the AMT, which is the exemption amount for single taxpayers?
2. $114,600
3. $73,600
4. $57,300
5. $99,950

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| **Answer: B** |
| For 2021 tax year, the exemption amount for single taxpayers is $73,600, $57,300 for married individuals filing separately and $114,600 for MFJ or surviving spouses. |

1. Last year Cecilia had a timing issue term for a deferral item when she paid the AMT. Mario had AMT liability for an exclusionary item. Which of them is entitled to use the Credit for prior year minimum tax provision for purposes of AMT this year?
2. Cecilia
3. Mario
4. Both of them
5. None of them

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| **Answer: A** |
| Credit for prior year minimum tax provision is used:   * When calculating the amount, the taxpayer has calculated all year. * In calculation of credit. * If he or she had a timing issue term, even for a deferral item. * If the taxpayer had a deferral item or an AMT liability for another item other than exclusionary items.   Cecilia meets one requirement, whereas Mario had AMT liability for an exclusionary item, for which he is not entitled for the credit. |

1. If a taxpayer is to claim the Credit for Prior Year Minimum Tax, which is the form the taxpayer is to use?
2. Form 8902
3. Form 1040
4. Form 8801
5. Form 2335

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| **Answer: C** |
| Individuals and corporations using the Credit for Prior Year Minimum Tax must use Form 8801 to file their returns as required by the law of taxation. |

1. Which is the regular self-employment tax rate?
2. 12.4%
3. 2.9%
4. 15.3%
5. 22.5%

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| **Answer: C** |
| The regular self-employment tax rate is 15.3%. The rate consists of two parts:   * 12.4% for Social Security. * 2.9% for Medicare. |

1. If a taxpayer is to figure out the maximum tax credit for AMT that was incurred IN PRIOR YEARS, which is the form they must file?
2. 8300
3. 8801
4. 8938
5. 8857

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| **Answer: B** |
| Form 8801 is crucial when it comes to figuring out the maximum tax credit for AMT (alternative minimum tax) that was incurred in prior tax years. |

1. Lisa’s income was of $196,000 for 2021 tax year, whereas Gerardo’s income was of $201,000. Provided both individuals’ tentative minimum tax is greater than regular tax and both have a filing status of single, which of them is charged with a 26% rate for purposes of AMT?
2. Lisa
3. Gerardo
4. Both of them
5. None of them

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| **Answer: A** |
| AMT is owed only if the individual’s tentative minimum tax is greater than the regular tax. Tax calculators classify minimum tax apart from the normal regular tax. AMT exhibits two rates: A 26% is paid on the first $199,900, and a 28% is charged on income exceeding that amount. |

1. Karina is a household employee and she earned $2,300 for 2021 tax year. Mary has a household employee, and she paid $2,550 in wages for 2021 tax year. Which of them are required to report FICA?
2. Karina
3. Mary
4. Both of them
5. None of them

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| **Answer: B** |
| Domestic employers only have to report FICA, federal income tax withholding, and FUTA taxes once a year. Additionally, at the close of a tax year, taxpayers must file Form W-2 (Copy A) and Form W-3 with the Social Security Administration for each household employee who earned $2,200 or more in cash wages subject to the FICA tax or income tax withheld from wages. |

### Tax Provisions for Members of the Clergy

A licensed or an ordained minister is generally a common law employee of a religious organization or a sect. Additionally, members of the clergy can be considered as persons employed by an organization to provide ministerial services. However, the provision exempts traveling evangelists who work as independent contractors. Independent contractors’ tax obligations are governed by the common law.

The earnings of ministers performing ministerial duties are subjected to income tax law. Such earnings come from offerings, wages, and fees that emanate from performing baptism, burials and marriages. Fundamentally, this provision is upheld whether the clergy is the self-employed person, or he or she is an employee of a religious organization. Most members of the clergy are considered as self-employed individuals; thus, they are subject to self-employment tax. Circumstances and facts determine whether an individual can be considered as an employee or a self-employed person.

Members of clergy are considered as employees if the organization they are in can control what they do and how they do it, even if they have freedom on the scope of the duties they are performing. Their salary is considered as wages to be used for tax withholding procedures. Salaries received from the congregation and fees received from the congregation as a result of services rendered are subjected to self-employment tax. An ordained clergy person that may receive house allowance is exempted from being taxed from the gross income, since the expenses can be used to buy a home. In general terms, the excesses include utilities, mortgage fees, and rent and repairs. However, the IRS provisions state that the amount excluded from cannot be more than the minister compensation for his services.

1. Social Security Coverage

The services the taxpayer performs in the exercise of his or her ministry are generally covered by social security and Medicare under the self-employment tax system, regardless of the taxpayer status under the common law. This means that the taxpayer’s salary on Form W-2, Wage and Tax Statement, the net profit on Schedule C, and the taxpayer’s housing allowance less pertinent deductible expenses are subject to self-employment tax on Schedule SE, Self-Employment Tax.

1. Exemption from Self-Employment Tax

The taxpayer can request an exemption from self-employment tax for his or her ministerial earnings, if he or she is opposed to certain public insurance for religious or conscientious reasons. The taxpayer cannot request exemption for economic reasons. To request the exemption, file Form 4361, Application for Exemption from Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners with the IRS.

The taxpayer must file it by the due date of his or her income tax return (including extensions) for the second tax year in which he or she has net earnings from self-employment of at least $400. This rule applies if any part of the taxpayer’s net earnings from each of the two years came from the performance of ministerial services. The two years don't have to be consecutive. The exemption is granted if IRS approves the taxpayer’s application. Once granted, the exemption is irrevocable.

### Tax Provisions for Members of the Military

The Internal Revenue Service is committed to helping military members, veterans and their families meet their federal income tax filing obligations.

Active duty or reserve members of the armed forces listed below may be eligible for military tax benefits. Recently retired or separated members may also be eligible for benefits.

1. United States Army (including Army Reserve and Army National Guard)
2. United States Navy (including Navy Reserve)
3. United States Air Force (including Air Force Reserve and Air National Guard)
4. United States Marine Corps (including Marine Corps Reserve)
5. United States Coast Guard (including Coast Guard Reserve)
6. Military OneSource

Military OneSource, a program offered by the Department of Defense provides a range of free resources for military members, veterans and their families. MilTax, Military OneSource's tax service, provides online software to electronically file a federal and up to three state tax returns for free, regardless of income. Military OneSource is available online at MilitaryOneSource.mil or by calling 800-342-9647.

1. Special Military Tax Rules

Active-duty military stationed in combat zones often have more time to file their tax returns. However, those with spouses and families may wish to file as soon as they are able to claim various tax benefits and get their refund. If only one spouse is present to file a joint return, they must have proper authorization to file a joint tax return on behalf of their spouse.

IRS Publication 3, Armed Forces' Tax Guide, covers the special tax situations of active members of the U.S. Armed Forces.

1. Earned Income Tax Credit

Many military members are eligible for various tax credits including the Earned Income Tax Credit, a refundable federal income tax credit worth up to $6,728 for eligible taxpayers. The credits provide a tax break for eligible service members, allowing them to keep more of what they've earned.

### Income in Respect of Decedent

The decedent and his entity are two separable entities. The taxation on the estate comes into realization after the death of the owner individual. Additionally, the existence of the estate exists until a final distribution of the estate to the beneficiary and other heirs. Income derived from the estate during this period must be reported by the beneficiaries of the estate. The conferring taxation to the estate is done the same way on the same basis as for individuals. The IRS has established that just like the individual income, the estate income must be reported on an annual basis, either by calendar or by fiscal year basis.

Upon filing Form 1041, U.S. Income Tax Return for Estates and Trusts, the personal representative chooses the estate accounting time lapse. Consequently, the first tax year of the estate is always the last day of the second month. However, the IRS requires that this period does not exceed a 12-month period. On the first month, IRS has no power to choose another tax year. In addition to the first income return, the personal estate representative is required to choose the accounting method whether cash or accrual that will be used to report the estate income. Ordinarily, when a method has been chosen, it cannot be changed without the approval of the IRS. Most importantly, an estate with a gross income of $600 or more has to file Form 1041.

When completing Form 1041, a taxpayer must take into account any items that are income in respect of a decedent (IRD).

In general, IRD is income that a decedent was entitled to receive but that was not properly includible in the decedent's final income tax return under the decedent's method of accounting.

IRD includes:

1. All accrued income of a decedent who reported his or her income on the cash method of accounting,
2. Income accrued solely because of the decedent's death in the case of a decedent who reported his or her income on the accrual method of accounting, and
3. Income to which the decedent had a contingent claim at the time of his or her death.

Some examples of IRD for a decedent who kept his or her books on the cash method are:

1. Deferred salary payments that are payable to the decedent's estate,
2. Uncollected interest on U.S. savings bonds,
3. Proceeds from the completed sale of farm produce, and
4. The portion of a lump-sum distribution to the beneficiary of a decedent's IRA that equals the balance in the IRA at the time of the owner's death. This includes unrealized appreciation and income accrued to that date, less the aggregate amount of the owner's non-deductible contributions to the IRA. Such amounts are included in the beneficiary's gross income in the tax year that the distribution is received.

The IRD has the same character it would have had if the decedent had lived and received such amount.

### Net Investment Income Tax

Section 1411 of the IRC imposed the net investment income tax (NIIT). The NIIT is a surtax, which is paid in addition to any other tax for which a taxpayer is liable. In other words, the NIIT is paid in addition to the taxpayer's regular income tax and any Alternative Minimum Tax (AMT) liability. It consists of a 3.8% Medicare tax on the net investment income of individuals with a MAGI over certain thresholds:

1. $250,000 for married couples filing jointly and qualified widow(er)s.
2. $125,000 for married couples filing separately.
3. $200,000 for all others.

Investment income subject to the additional 3.8% tax includes the following:

1. Interest and dividends.
2. Royalties.
3. Annuities.
4. Net rental income, with some exceptions.
5. Passive activities.
6. Most gains on the sale of capital and other asset.

Income not subject to the 3.8% tax includes the following:

1. Tax-exempt interest.
2. Excluded gain on the sale of a principal residence.
3. Distributions from retirement plans and individual retirement accounts.
4. Wages and self-employment income (earned income), however, this income may be subject to a 0.9% tax.

Investment income is reduced by certain expenses properly allocable to the income. Examples of deductions include investment interest expense, investment advisory and brokerage fees, expenses related to rental and royalty income, tax preparation fees, fiduciary expenses (in the case of an estate or trust) and state and local income taxes.

#### Higher-Income Taxpayers may be Subject to a Higher Rate of 23.8%

When the NIIT of 3.8% is combined with the 20% capital gain rate, higher-income taxpayers may be subject to a tax on "investment gains" that totals 23.8%, which should be taken into consideration when calculating estimated tax requirements.

A taxpayer will owe the additional 3.8% NIIT if he has net investment income, and his MAGI exceeds the threshold for his filing status. As an unmarried taxpayer with a MAGI of $220,000, his MAGI exceed the $200,000 threshold.

For example, if an unmarried taxpayer has $100,000 of net investment income and $220,000 of modified adjusted gross income, he will pay the 3.8% Net Investment Income Tax (NIIT).

For his single filing status by $20,000. Hence, the NIIT will be 3.8% of $20,000.

1. The NIIT is an additional 3.8% that applies to the lesser of:
2. Unearned net investment income, or
3. The excess of the taxpayer’s modified adjusted gross income (MAGI) over the threshold.
4. The NIIT is a surtax, which is paid in addition to any other tax for which a taxpayer is liable. In other words, the NIIT is paid in addition to the taxpayer's regular income tax and any Alternative Minimum Tax (AMT) liability.
5. Ana and Luis, a married couple filing jointly, sold their principal residence that they owned and resided in for the last 10 years for $1,300,000. The sum of their cost basis in the home plus selling expenses (including real estate commission) is $700,000, bringing their realized gain on the sale to $600,000. Ana and Luis have $125,000 of other Net Investment Income and their total modified adjusted gross income (MAGI) is $300,000. The amount of their investment income that is subject to the ACA Medicare Net Investment Income Tax should calculate as follows:  
     
   **1.** The recognized gain on the sale of their principal residence, which is subject to regular income taxes is $100,000 ($600,000 realized gain less the $500,000 Section 121 exclusion).  
     
   **2.** Ana and Luis have $125,000 of other net investment income, which brings their total net investment income to $225,000 ($100,000 taxable portion of the gain on sale of principal residence + $125,000 other Net Investment Income).  
     
   **3.** Since their MAGI of $300,000 is greater than the $250,000 threshold for the married filing jointly status, they are subject to the ACA Medicare Net Investment Income Tax (NIIT).  
    **4.** The NIIT liability is based on the lesser of the taxpayer's total net investment income ($225,000) or the amount their total MAGI ($300,000) exceeds their filing status threshold ($300,000 - $250,000 = $50,000).  
     
   **5.** The couple's NIIT owed is $1,900 ($50,000 x 3.8%).

Examples of excluded income items under the 3.8% ACA Medicare Net Investment Income Tax (NIIT) include:

1. Wages.
2. Unemployment compensation.
3. Alaska Permanent Fund Dividends.
4. Alimony.
5. Social Security benefits.
6. Tax-exempt interest income.
7. Income from certain qualified retirement plan distributions.
8. Income subject to self-employment taxes.

Retirement distributions include distributions from qualified pensions, stock bonus plans, profit-sharing plans, qualified tax-sheltered annuities (under Section 403(b), IRAs, Roth IRAs, and Section 457 plans).

Deductions allowed in arriving at net investment income subject to tax include:

1. State income taxes reasonably allocated to the investment income.
2. Investment interest expense.
3. Allocable investment expenses exceeding the 2% of AGI floor.

The $3,000 net deduction allowed for capital losses in excess of capital gains for regular tax purposes and net operating losses are not allowed to reduce net investment income. Additional rules govern which income and deductions are included in calculating net investment income. However, the values above are not indexed to inflation. In addition to that, individuals who are exempted from Medicare taxes may still be subjected to net investment income taxes. The amount of the Net Investment Income Tax is calculated in Form 8960.

### Additional Medicare Tax

The ACA imposes a 0.9% Medicare surtax on earned income, such as wages, self-employment and employee income that exceed the required threshold amount received in taxable years. The rate recommended by the IRS is 0.9%. The filing status as recommended by the IRS is illustrated below:

|  |  |
| --- | --- |
| **Filing Status** | **Threshold Amounts** |
| Married (filing jointly) | $250,000 |
| Married (filing separately) | $125,000 |
| Single or Head of Household | $200,000 |

Use Form 8959 to calculate the additional Medicare taxes the taxpayer owes.

1. Karina is single and earns wages of $300,000 in 2021 from her work at a surgery center. Her employer must withhold 0.9%, or $900, on the $100,000 of income she earns in excess of $200,000. This amount is reported with Karina’s total Medicare taxes on her Form W-2. If Karina were self-employed as a doctor and earned the same income, she would report her $100,000 in excess income on Form 8959 and pay the $900 with the tax calculated on her Form 1040, Individual Income Tax Return.

The IRS suggests that all wages that are subject to Medicare taxes are presumed to be subjected to additional Medicare tax if they exceeded the required threshold when filed individually.

### Uncollected Social Security and Medicare Tax

Use Form 8919 to figure and report a taxpayer’s share of uncollected Social Security and Medicare taxes due on the taxpayer’s compensation if he or she was an employee but was treated as an independent contractor by his or her employer.

Generally, a taxpayer who receives Form 1099 for services he or she had offered earlier as an independent contractor must report income on Schedule C. Additionally, he or she must pay the SE tax. Sometimes, however, the taxpayer is classified as an independent contractor while he or she actually was an employee, so, if the employer did not withhold the taxpayer’s share of Social Security and Medicare taxes, that is when Form 8919 is used. However, the provision requires the worker to meet certain conditions indicating he was an employee while performing the services. Some of those conditions include:

1. The employee had earlier received a statement from the IRS that denotes he or she is an employee.
2. The worker had filed Form SS-8 that indicated the worker status for the purposes of income tax withholding.
3. The worker had been previously treated as an employee, and thus, performed duties in similar capacity under similar direction and control.
4. If the employee co-workers performed analogous services under similar control and direction, and consequently, were treated as employees.

By using Form 8919, the worker’s Social Security and Medicare taxes will be credited to his Social Security record. Moreover, the filing of the form is made easier when the IRS shares the Form electronically with the SSA.

### Other Taxes

#### First-time Homebuyer Credit Repayment

The first-time homebuyer credit was a provision was first brought forward by the Housing and Recovery Act in 2008, consisting of a non-refundable tax credit to individuals who were first-time homebuyers. If the purchase of the house was done between April 9 and December 31, 2008, the credit must be repaid over 15 years. To compute this, increase the taxpayer’s federal income taxes by 6⅔% (or 1/15) of the amount of the credit for each tax year in that 15-year period. The repayment period begins with the second tax year succeeding the year in which the home was purchase.

1. Julia was allowed a $7,500 first-time homebuyer credit for 2008, and she must repay it. The repayment period started with 2010, which was the second tax year from 2008. To repay the credit, Julia must add $500 (6⅔% of $7,500) to her federal income tax for each tax year in the repayment period.

**Repayment acceleration:** If a taxpayer disposes of the home for which he or she applied the credit, or the home stops being the taxpayer’s principal residence during the 15-year repayment period, the credit repayment is accelerated, and the taxpayer must file Form 5405, Repayment of the First-Time Homebuyer Credit, for the tax year in which he or she disposed of the home or stopped using it as a principal residence.

**Reporting the repayment:** If the taxpayer is required to repay the first-time homebuyer credit, a federal income tax return must be filed, even if his or her gross income is not over the filing threshold. A taxpayer that made a qualifying home purchase in 2008 and owned and used the home as a principal residence for the entire 2021 must enter the additional federal income tax on Schedule 2 (Form 1040 or 1040-SR), Additional Taxes.

Form 5405, Repayment of the First-Time Homebuyer Credit, does not need to be attached. In the case the taxpayer disposes of the home, or if the taxpayer (and his or her spouse, if married) stops using it as his or her principal residence in 2021, a completed Form 5405 must be attached to Form 1040 or Form 1040-SR.

Review Questions

1. Which are the thresholds for the net investment income tax?
2. $250,000 MFJ and qualifying widow(er)s or widow(er)s with dependent children, $125,000 MFS, $150,000 all others.
3. $500,000 MFJ, $200,000 all others.
4. $250,000 for all filing status.
5. $250,000 MFJ and qualifying widow(er)s or widow(er)s with dependent children, $125,000 MFS, $200,000 all others.

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| **Answer: D** |
| The thresholds are:   * $250,000 for married couples filing jointly and qualified widows or widowers with dependent children. * $125,000 for married couples filing separately. * $200,000 for all others. |

1. Alexander, with a married filing jointly filing status, earns wages of $400,000 in 2021 as a stockbroker. Which is the amount his employer must withhold, as the additional Medicare tax of 0.9%?
2. $3,600.
3. $1,350.
4. $40,000.
5. $8,000.

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| **Answer: B** |
| The ACA imposes a 0.9% Medicare surtax on earned income, such as wages, self-employment and employee income, that exceeds the required threshold amount received in taxable years.  Alexander’s threshold amount, as a taxpayer with a married filing jointly filing status, is of $250,000, so the surtax will be imposed on the $150,000 exceeding the limit. The operation is as follows: $150,000 x 0.9% = $1,350. |

1. Which of the following is subject to the additional 3.8% net investment income tax?
2. Tax exempt interest.
3. Distributions from retirement plans and individual retirement accounts.
4. Excluded gain on the sale of a principal residence.
5. None of the above.

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| **Answer: D** |
| Income not subject to the 3.8 percent tax includes the following:   * Tax-exempt interest. * Excluded gain on the sale of a principal residence. * Distributions from retirement plans and individual retirement accounts. * Wages and self-employment income (earned income), however, this income may be subject to a 0.9% tax. |

1. Which Form is used to figure and collect employee share on Medicare due to his or her compensation?
2. Form 8919.
3. Form 8929.
4. Form 8949.
5. Form 8979.

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| **Answer: A** |
| For Uncollected Social Security and Medicare tax, Form 8919 is used to figure and collect employee share on Medicare due to his or her compensation. |

1. Which is the form a taxpayer who has ministerial earnings, provided he or she is opposed to certain public insurance for religious reasons, is to use to claim an exemption from SE tax?
2. Form 4482
3. Schedule C
4. Form 8801
5. Form 4361

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| **Answer: D** |
| The taxpayer can request an exemption from self-employment tax for his or her ministerial earnings, if he or she is opposed to certain public insurance for religious or conscientious reasons. The taxpayer cannot request exemption for economic reasons. To request the exemption, file Form 4361, Application for Exemption from Self-Employment Tax for Use by Ministers, Members of Religious Orders and Christian Science Practitioners with the IRS. |

1. Which is the maximum federal income tax credit for military members for 2021?
2. $6,660
3. $6,557
4. $6,728
5. $7,125

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| **Answer: C** |
| Many military members are eligible for various tax credits including the Earned Income Tax Credit, a refundable federal income tax credit worth up to $6,728 for eligible taxpayers. |

1. An estate has a $890 of gross income for 2021. What Form should the estate file?
2. Form 8965
3. Form 1041
4. Form 1040
5. An estate with $1,000 or less of gross income does not have to file.

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| **Answer: B** |
| Most importantly, an estate with a gross income of $600 or more has to file Form 1041.  When completing Form 1041, a taxpayer must take into account any items that are income in respect of a decedent (IRD). |

CHAPTER 5   
  
Advising the Individual Taxpayer

## Module: Advising the Individual Taxpayer

### Reporting Obligation for Individual Taxpayers

Tax reporting is primarily the duty of the taxpayer. The authorities are only responsible for confirming the details submitted to prevent possible tax evasion. Every individual is supposed to submit their tax return forms, which vary depending on the type of tax that is being filed. Tax is inevitable, no matter which tax jurisdiction one is subject to.

Because the U.S. government relies on collected tax to run their operations, it must ensure that all loopholes have been sealed to allow for maximum tax collection. Government institutions, such as the IRS, are usually very keen on collecting data about tax remittance. Every individual is obliged by the law, both local and federal, to submit their tax returns on time and in an accurate manner.

Tax payment has been diversified to make it easier for individual taxpayers. Almost every tax has a specific form with detailed information to be filled when filing. There are different types of tax returns that an individual must submit, and the amount varies from one state to another unless it is a federal tax. In accordance with the IRS, each tax is assigned a different form to simplify the process of filing returns, as well as make a clear difference between almost similar taxes. For example, for an individual filing for their property’s income, the tax will be different from that of real estate agents filing for income tax from the same properties.

Individuals are obliged to pay their taxes. Failure to do so is considered a serious crime payable by penalties, jail term, or both. It is crucial to provide accurate data about tax returns, since the authorities have the necessary devices and systems to screen through the data and detect possible frauds.

There are different forms of individual taxes as provided by the IRS. Each form is created in a manner that it is very specific, up to the finest details, to avoid double taxation.

1. Form 1099 Reporting Obligations

If the taxpayer made or received a payment during the calendar year as a small business or self-employed (individual), he or she is most likely required to file an information return to the IRS.

More detailed information on this topic is available under section 1099-MISC, 1099-NEC, 1099 K Reporting, Irregularities and Corrections, Chapter 2 - Module: Income.

1. Reporting Bartering Income

Bartering is the exchange of goods or services. A barter exchange is an organization whose members contract with each other (or with the barter exchange) to exchange property or services.

It must be included in gross income in the year of receipt the fair market value of goods or services received from bartering. Generally, this income is reported on Schedule C (Form 1040), Profit or Loss from Business (Sole Proprietorship). If the taxpayer failed to report this income, their return is corrected by filing a Form 1040-X, Amended U.S. Individual Income Tax Return.

1. Reporting Cash Payments of Over $10,000

Generally, if a taxpayer is in a trade or business and receives more than $10,000 in cash in a single transaction or in related transactions, the taxpayer must file Form 8300.

A "person" who must file Form 8300 includes an individual, company, corporation, partnership, association, trust or estate.

The taxpayer must file Form 8300 with the IRS if any part of the transaction occurs within any of the 50 states, the District of Columbia or a U.S. possession or territory (American Samoa, The Commonwealth of the Northern Mariana Islands, Guam, Puerto Rico and the U.S. Virgin Islands). Form 8300 is to be filed by the 15th day after the date the cash transaction occurred.

Besides filing Form 8300, the taxpayer also needs to provide a written statement to each party whose name the taxpayer included on the Form 8300 by January 31 of the year following the reportable transaction. This statement must include the name, address, contact person and telephone number of taxpayer’s business and the aggregate amount of reportable cash. The statement must also indicate that the taxpayer provided this information to the IRS.

### Property Sales

The property sales tax is indeed one of the main taxes collected in the form of capital tax. The tax applies when a taxpayer gives up ownership of property, such as a home, by selling it. Unlike other taxes that are returned within a particular period of the year, a property sale tax is entirely different. It is a type of tax that cannot be scheduled for a specific period of the year, since they do happen periodically, and they are mostly filed while the transactions are being carried out. This can vary from one state to the other state by the local tax law. Moreover, not all properties can be subjected to taxation.

According to the IRS, there are clear guidelines or details explaining how the capital tax is applied in property sales with home selling taken as an example. The first thing that an individual should note is that only profit-making properties are subject to property sale taxations. If a taxpayer incurs a loss, and it is proven beyond reasonable doubt that the loss is factual and not a fraud, no taxes will be imposed on that transaction. The type of home that the taxpayer is selling will also determine the amount of tax to be filed.

Individuals selling their main home are exempt from a substantial amount of tax. But said home must be examined to prove that it is, in fact, the main place of residence. Several eligibility tests help the owner get tax reliefs, and they include ownership, residence, look-back, exceptions and reviews test. Once these tests are declared positive, the sale qualifies for the exclusion of $250,000 gain ($500,000 if married filing jointly)

Property sale taxation is very dynamic, especially when it comes to tax breaks. There are many ways through which the owner can maneuver through the provided avenues, such as spouses and work-related issues, to pass the eligibility test. For example, if a taxpayer is transferred to a new job location at least 50 miles away from his or her home, then he or she might qualify for tax exception if the taxpayer decides to sell it.

Property to be taxed may be, but is not limited to:

1. Homes
2. Stock
3. Businesses
4. Antiques
5. Collectibles

#### Antiques and Collectibles

The capital gains tax on the taxpayer’s net gain from selling a collectible is 28%. The taxpayer may also be subject to a 3.8% net investment income tax, depending on their adjusted gross income (AGI).

Collectibles under IRC Section 408(m)(2) include:

1. Any work of art,
2. Any rug or antique,
3. Any metal or gem (with limited exceptions, below),
4. Any stamp or coin (with limited exceptions, below)
5. Any alcoholic beverage, or
6. Any other tangible personal property that the IRS determines is a "collectible" under IRC Section 408(m).
7. Gold, Silver, Platinum, Palladium, and Coins

The following coins and metals are not included in the definition of “collectible” under IRC Section 408(m):

1. Certain gold, silver, or platinum coins described in 31 USC Section 5112. See IRC Section 408(m)(3)(A) for the full definition.
2. Any coin issued under the laws of any state.
3. Any gold, silver, platinum, or palladium bullion of a certain fineness if a bank or approved non-bank trustee keeps physical possession of it. See IRC Section 408(m)(3).

### Education Planning

It is a good idea to advise a taxpayer paying for higher education that he has different options he or she can look into in order to alleviate his or her costs of education. There are two main tax credits that help in reducing the amount of income tax for students pursuing higher education: The American Opportunity Tax Credit (AOTC) and the Lifetime Learning Credit (LLC). The LLC is one of the best programs since it does not have the limit of years set for an individual to file for the credit. What the program does is reduce the amount of income tax paid. Unlike a deduction that reduces the amount of income subjected to tax, the LLC reduces the tax itself. It is the reason why it has a great impact the on amount of tax payable. The tax program enables the student to claim up to $2,000 of credit per return.

But not every student is qualified to claim the credit. To request the lifetime learning credit, he or she must have paid for qualified education expenses of higher education, such as tuition and enrollment or attendance fee. The student must also have paid (or pay) these education expenses to eligible educational institutions as defined by the law. The last requirement for eligibility entails the student having paid the education expenses for an eligible student including himself or herself, a dependent or even a spouse. Marital status can also mean a lot while claiming for this credit, since it will have an effect on the modified adjusted gross income (MAGI). For taxpayers who are married filing jointly, they cannot claim the credit if their MAGI is $180,000 or more. For all others, their MAGI must be $90,000 or less, else they will not be able to claim the credit.

Certain factors can disqualify an individual from getting LLC benefits. The marital status must always be updated in case there is a change. If the taxpayer is filing separately and the record shows that he or she is still married, then he or she might be disqualified on technicalities. This may also happen if the person claiming the credit is found to be a dependent on another person’s tax return.

Another option for the taxpayer is to elect a 529 plan, named after IRC Section 529. A 529 plan is a college savings plan offering tax and financial aid benefits. It may also be used to save and invest for K-12 tuition, in addition to college costs. There are two types of 529 plans:

**College saving plans:** Similar to a Roth 401(k) or a Roth IRA, these work by investing the taxpayer’s after-tax contributions in mutual funds or similar investments. The 529 college savings plan offers several investment options from which to choose. The 529 plan account will go up or down in value based on the performance of the investment options.

**Prepaid tuition plans:** These plans let the taxpayer pre-pay all or part of the costs of an in-state public college education. They may also be converted for use at private and out-of-state colleges. The Private College 529 Plan is a separate prepaid plan for private colleges, sponsored by more than 250 private colleges.

### Estate Planning

Estate planning is a crucial aspect to look into, especially if a taxpayer has gathered a large amount of properties. This aspect of real estate helps in managing the estate while the owner is alive and when they are deceased. It assists in reducing the amount of property tax and any associated court cost during transfers. There are different types of taxes that are imposed on properties while they are being transferred from the owner to the recipient.

Trust is another key instrument for estate planning. A trust is simply an arrangement that the donor transfers legal title of the trust property to the third party. With just a little planning, a trust can create a charitable tax deduction, significantly lower the estate tax and avoid capital gain tax on the sale of appreciated assets. There are different types of trust as provided by the IRS, and each may be used for the specific property it is designed for. There are plenty of tax benefits associated with trusts, such as the exemption from income earned by the trust.

Estates are subject to various taxes, but by the use of right tools, the amount payable as the income taxes can be reduced. Estate planning is crucial, especially when the owner is planning to transfer the property to the third party after he or she passes away. Whether the property is to be left as an inheritance, charity, trust or any other transfer to the third party, some tax will be imposed, but the amount can be reduced by proper planning when the donor or grantor is still alive.

It is important to note in this section the difference between a gift and an inheritance. With a gift, the giver (not the receiver) is responsible for reporting it on their taxes, but only if the gift's value exceeds $15,000 for 2021. With an inheritance, the recipient may be responsible for reporting a portion of the inheritance. Usually, the inheritance itself is not taxable but any income produced as a result of the inheritance is for federal tax purposes. Some states have an inheritance tax.

Another good advice for a taxpayer looking to plan for his or her estate is to establish a family limited partnership. This type of legal structure allows a taxpayer to transfer his or her assets, such as stocks, bonds, real estate, art, collectibles and more to his or her heirs, by gifting partnership equity each year, up to the aforementioned gift tax limit. It is a great way to help the taxpayer keep the investments built up through decades of hard work in the family.

Another choice advisable to an individual taxpayer is the Long-Term Care (LTC) Insurance. This coverage provides nursing-home care, home-health care, personal or adult day care for individuals that are either above 65 or have a chronic or disabling condition needing constant supervision. Most LTC insurance policies will only cover only a specific dollar amount for each day spent in a nursing facility. It is recommended to read the policies carefully and compare the benefits so that the taxpayer determines which policy will suit his or her needs.

### Retirement Planning

Retirement planning is a great idea that guarantees future financial independence to the worker. The earlier the taxpayer starts saving up for his or her retirement, the better, since it will have an impact on the amount of the money that he or she will enjoy at old age. There are different savings or retirement plans that an employee can be registered in, depending on the employer and the level of income. The IRA is one of the most popular retirement plans and the easiest one to start with. Retirement benefits are also subject to taxation, primarily federal taxing, but there are also ways through which the taxpayer can earn credit.

There are several tax advantages associated with a retirement plan that anyone on a pension plan should have an eye on. First, tax on the employee contribution is deferred until distributed; this will enable the compounded amount to keep on increasing at a higher rate. A taxpayer can also get tax breaks by investing in the plan. If his or her retirement is used in investment, the gains gotten from such investments are not taxed until distributed to the employee. The money in the plan grows tax-free and thus at a particular time, the interest will be massive.

It is the duty of an individual citizen to register in a retirement plan, whether they are employed or self-employed. In many instances, the contributor will decide the amount of money to contribute but the more, the better.

The taxpayer also has the option to choose annuities. One of the main tax advantages of annuities is that they allow investments to grow tax-free until the funds are withdrawn. This includes dividends, interest and capital gains, all of which may be fully reinvested while they remain in the annuity. However, when the taxpayer receives income payments from his or her annuity, these will be taxed as ordinary income, and not as capital gains.

More detailed information on this topic is available under Chapter 2 - Module: *Retirement Income*.

### Marriage and Divorce

Marriages and divorces are a daily occurrence all over the United States. Regardless of the side the split leans to, the government will always find a way of obtaining revenue. By marrying, a lot of aspects will change, and this will also affect the taxes returns and also the possible credits from other tax plans. Divorce is one of the areas where most of the taxation is imposed on various transactions. Payments such as those ordered by the court, child support, transfer of the individual retirement benefits, and alimony are just a few of the areas that affect a taxpayer’s returns.

For married couples, there are numerous tax benefits of filing a joint return. One of the main advantages for joint return is that it reduces the amount of income tax that could have been calculated if the couples filed separate tax returns. This mode of tax filing also helps significantly in that either of the couples may settle the tax return, even if the other has not earned any income.

As a married couple, there are other benefits in the form of claims such as deductions and credits that can help in reducing the amount of income tax significantly. What matters is making sure that the records with the IRS remain unchanged unless something happens.

Divorced or separated individuals may have a lot of problems with taxes, especially if they were earlier using a joint tax return. Until the divorce is finalized, the couple will be jointly responsible for all the taxes, penalties and interest due on the joint return. Although some of the legal fees and court costs for getting a divorce are not deductible, a taxpayer can legally deduct legal fees paid for advice with divorce and getting alimony. The community property law also enables the taxpayer to get some credit if they pass the eligibility test.

The purpose of a divorce settlement agreement is to memorialize any agreements reached between divorcing (or separating) spouses as to child custody, child support, alimony (also referred to as “spousal support” or “maintenance”), and the division of property.

Review Questions

1. Where should a taxpayer report bartering income?
2. Form 1099-MISC
3. Schedule B (form 1040)
4. Form 1099-NEC
5. Schedule C (form 1040)

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| **Answer: D** |
| Generally, bartering income is reported on Schedule C (Form 1040), Profit or Loss from Business (Sole Proprietorship). |

1. Which is the capital gains tax rate on a taxpayer’s net gain from selling a collectible?
2. 25%
3. 26%
4. 28%
5. 30%

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| **Answer: C** |
| The capital gains tax on the taxpayer’s net gain from selling a collectible is 28%. |

1. Dayana, a single taxpayer, has a MAGI of $70,000. Miriam, a MFJ taxpayer, has a MAGI of $137,000. Which of them may claim an education credit for 2021 tax year?
2. Dayana
3. Miriam
4. Both of them
5. None of them

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| **Answer: C** |
| For taxpayers who are married filing jointly, they cannot claim any education credit if their MAGI is $180,000 or more. For all others, their MAGI must be $90,000 or less. |

1. Which is the schedule used to total up the taxpayer’s gains and losses?
2. Schedule A
3. Schedule B
4. Schedule C
5. Schedule D

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| **Answer: D** |
| Schedule D is used to total up the taxpayer’s gains and losses. The taxpayer’s loss can offset his or her regular income up to a net $3,000 loss limit. |

1. Berta sold her property and as the agreement stated, she received a first payment of $6,000, a second of $3,000 and a last of $1,000. These payments were done in month-by-month basis; they totaled $10,000. Eduardo also sold his property, along with Berta, but he received a single payment of $10,000 in cash. Which of them is required to file Form 8300?
2. Berta
3. Eduardo
4. Both of them
5. None of them

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| **Answer: B** |
| Generally, if a taxpayer is in a trade or business and receives more than $10,000 in cash in a single transaction or in related transactions, the taxpayer must file Form 8300. |

1. If a taxpayer does not meet the tax requirement, which of the following situations is possible?
2. Taxpayer will be charged with penalties and will go to court.
3. Taxpayer may have to face penalties.
4. Taxpayer will be sent to jail.
5. A and C.

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| **Answer: B** |
| It is the obligation of individuals to pay the tax as provided for by the law. Failure to meet the tax requirement is a serious crime payable by penalties or jail term. Providing accurate data about tax returns is crucial since the authorities have the necessary devices and systems to screen through the data and detect possible frauds. |

1. Which of these is true regarding the retirement benefits?
2. Retirement benefits are not subject to taxation.
3. It is better that the taxpayer waits until reaching age 65 to contribute to a retirement plan.
4. A and B are correct.
5. It is the duty of a citizen to register in a retirement plan.

|  |
| --- |
| **Answer: D** |
| There are different savings or retirement schemes that an employee can be registered in, depending on the employer and the level of income. The IRA is one of the popular retirement plans and the easiest to start. Retirement benefits are also subject to taxation, primarily federal taxing, but there are also ways through which the taxpayer can earn credit.  It is the duty of an individual citizen to register in a retirement plan, whether they are employed or self-employed. |

### Items That Will Affect Future/Past Returns

Whether the taxpayer operates as an individual, or as an estate or trust, few things in taxation can significantly affect his or her return. A few things need to be understood so as to help the taxpayer in the areas that they can protect themselves from possible reduced incomes due to taxation. Carryovers and carrybacks are terms that are regularly used in the taxation, especially if the individual is operating in the foreign markets. They aim at reducing the amount of income tax payable by preventing double taxation brought about by the taxation in the foreign country and the United States. The individual has two choices to make: Either take a credit, or a deduction. By choosing credit over deduction, the taxpayer will alleviate a double tax burden when the foreign source income is taxed.

**NOLS:** There can also be a problem if a taxpayer’s deductions for the year surpass his or her income. It is in such a situation that the term Net Operating Loss (NOL) starts appearing. Once the tax return for the year has been filed, and an NOL position has been established, then everything about the tax return changes. An NOL will have a great impact on the taxpayer’s income. The tax collector also provides an NOL deduction claim, which is calculated as provided for by the IRS regulations.

1. **NOTE:** The special rules in section 172 permitting 5-year carrybacks for 2018, 2019, and 2020 net operating losses (NOLs) added by the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) of 2020 have expired. Generally, you can only carry NOLs arising in tax years ending after 2020 to a later year. An exception applies to certain farming losses, which may be carried back 2 years.

**Form 8801:** This form is crucial when it comes to figuring out the maximum tax credit for AMT (alternative minimum tax) that was incurred in prior tax years. The tax credit can be filed by individuals that have an ATM liability and adjustment. Those with carry forward for the last year and an allowed qualified electric credit are also eligible to file for this tax credit. These are some areas of taxation that can significantly affect return income. There are ways to maneuver through the provided legal avenues to avoid some of the negative impacts of these occurrences.

**QBI:** Any negative amount from QBI will be carried forward to the next year. This carryforward doesn’t affect the deductibility of the loss for purposes of any other provisions of the Code.

**Schedule D:** This schedule is used to total up the taxpayer’s gains and losses. The taxpayer’s loss can offset his or her regular income up to a net $3,000 loss limit. If the taxpayer reported a net loss greater than the annual limit, it can be carried forward to use against gains in future tax years until it is used completely.

### Injured Spouse

The injured spouse relief is filed when a part of one of the spouse’s (injured spouse) refund is applied against the other spouse’s past-due state income tax, spousal support or federal non-tax debt. But to be considered as an injured spouse and to file Form 8379, the taxpayer must have reported tax payments, such as estimated tax payment, and not be legally obliged to meet the past-due amount. If these conditions are met and the individual taxpayer is proven beyond reasonable doubt that they are indeed an injured spouse, they will get back their joint refund. More on this topic was detailed earlier, in *Special Filing Requirements*, Chapter 1, Module: *Preliminary Work and Taxpayer Data*.

### Innocent Spouse

This is another form of tax break affecting married spouses on a joint income tax return. The relief is awarded to either of the spouses if they file Form 8857. Once the other spouse comes to realize that there is a considerable tax burden that they have nothing to do with, they may choose to claim this relief.

To do that, this taxpayer must prove that by the time he or she signed the joint return, the taxpayer had no idea that there was an understatement of tax, and thus, he or she is not liable to pay such tax. The taxpayer can also prove this by taking into account all the circumstances surrounding the situation that led to the understatement, and by demonstrating that it would be unwarranted if the taxpayer were to be held liable for the tax understatements the other spouse is responsible for. The taxpayer should also file Form 8379 when he or she becomes aware that all or part of the over-payment share is to be applied against the taxpayer’s spouse’s legally enforceable past-due obligations.

There are three types of relief available regarding this topic:

1. Innocent spouse relief

Taxpayers must meet all of the following conditions to qualify for innocent spouse relief:

1. Filed a joint return which has an understatement of tax due to erroneous items of the taxpayer’s spouse (or former spouse).
2. Establish that at the time taxpayer signed the joint return the taxpayer 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.
4. Separation of liability

Applies to joint filers who are divorced, widowed, legally separated, or have not lived together for the 12 months ending on the date election of this relief is filed.

1. Equitable relief

Applies to all joint filers who do not qualify for innocent spouse relief or separation of liability and to married couples filing separate returns in community property states.

### Estimated Tax and Penalty Avoidance

Taxation is very strict, and one thing that any individual should always avoid is penalties due to tax irregularities. Two main terms are at play here are estimated tax and penalty avoidance. Estimated tax is a form of income return that is filed then the taxpayer has an income that is not subject to withholding. Such filing may include income from interest, gains, awards and sale of assets, self-employment, dividends and many others. An individual may also pay estimated tax if the amount that is being held from their pension, salary, or other income cannot meet their tax liability. It is also important to note that estimated tax payments are used to pay self-employment tax and income tax.

Tax penalties are common, especially for filing late and paying taxes late. There could be many reasons behind the failure to meet the obligations on time, but the law is clear: there must be a tax penalty for that. If a taxpayer files his or her tax return over 60 days after the due date, the minimum penalty that he or she is likely to attract is the lesser of $435, or 100% of the tax due for 2021 and 2022.

If a taxpayer has a problem with a tax understatement penalty, he or she can avoid it by having a substantial authority for his or her tax treatment, especially item treatment, or through adequate disclosure. To achieve this by disclosure, the taxpayer needs to disclose the situation on the tax return properly with a reasonable basis for the position.

The tax law guarantees penalty avoidance, but the taxpayer must also prove beyond reasonable doubt why. Some of the acceptable arguments will be if the individual has already lost a job, the business was destroyed, and they have no way of making income. In such cases, the imposed penalties may be exempted.

#### Mid-year Estimated Tax Planning

Mid-year tax planning is recommended when there are changes in taxpayer’s personal or financial situation that could lead to a change in estimated tax payments or withholding. For 2021 tax year, these are some major considerations to take into account:

1. If the taxpayer had substantial investment income in 2021, the taxpayer may be subject to the net investment income tax (NIIT), a surtax equal to 3.8% of the lower of their net investment income or the excess of their modified adjusted gross income over a threshold amount (e.g., $250,000 for joint filers or surviving spouses).
2. If the taxpayer retired sometime in 2021, the taxpayer may have winded up in a lower tax bracket for the year and may want to reduce their withholding.
3. An IRA-to-Roth-IRA rollover (including a so-called “backdoor conversion”) results in taxable income. If the taxpayer makes such a rollover this year, the income from it must be included in estimated tax calculations.
4. If the taxpayer received one or more stimulus payments during 2021, the taxpayer should be aware that such payments are structured as an advance tax credit and tied to income. If the taxpayer earned more than the qualifying amounts in 2021, he or she may be required to return some or all of the money.

### Adjustments, Deductions and Credits for Tax Planning

Many will sometimes refer to them as “deductions to arrive at adjusted gross income”, meaning, above-the-line deductions. They are simply the expenses that directly reduce the income such as itemized or standard deductions. Some of the common deductions are for example, a student’s loan, especially for taxpayers under age 30. After the total income is calculated, all expenses that are considered as adjustments will be subtracted from the amount to arrive at adjusted gross income. For those individuals who are self-employed, the possible deductions include self-employed health insurance and self-employed tax. Other adjustments may include IRA deductions, educator expenses and moving expenses.

What deduction does is reducing the amount income tax that a taxpayer could have paid. Once the deductions have been subtracted from that income and arrive at adjusted gross income, they are not added back while computing alternative minimum tax (AMT). This simply means that the taxable income will be less and thus lower taxes.

Credits are indeed the most merited tax benefits available. They directly reduce a tax significantly if they are filed. Credit is money that is given back to the taxpayer after they have filed for a credit claim. For example, if an individual normally pays $7,000 in federal taxes annually, and he is given a credit of $2,000, that will lower his tax to $5,000, which is a significant amount.

Smart timing of income and expenses can reduce the taxpayer’s tax liability, and poor timing can unnecessarily increase it. When the taxpayer doesn’t expect to be subject to the AMT in the current year or the next year, deferring income to the next year and accelerating deductible expenses into the current year may be a good idea because it will defer tax, which usually is beneficial.

But when the taxpayer expects to be in a higher tax bracket next year the opposite approach may be beneficial: Accelerating income will allow more income to be taxed at the taxpayer’s current year’s lower rate. And deferring expenses will make the deductions more valuable, because deductions save more tax when the taxpayer is subject to a higher tax rate.

### Character of Transaction

There is a difference in tax rates in different fields while taxing the income returns. Capital gain taxation and ordinary income taxation may have some similarities, but they have a different model of collections. The rates also differ significantly between the two. For ordinary income tax, the income is earned from service provision or sales of goods. The category includes wages, rents, interests, royalties and other similar income streams. Ordinary rates differ depending on the amount of income a taxpayer earns each year.

Capital gain tax, on the other hand, is associated with the sales or property exchange characterized by the capital assets. The rates under this tax are determined by the gains as calculated by the amount received by the taxpayer and the original purchase of the house. Capital gain taxation is further broken down into long term and short-term capital gain. Any property that is sold with one year of purchase (short term) is taxed as ordinary income.

### Advantages and Disadvantages of MFJ/MFS/HOH Filing Status in Various Scenarios

There are both advantages and disadvantages of filing returns as MFJ (married filing jointly), MFS (married filing separately), or HOH (head of household).

1. HOH

A taxpayer qualifies to be given the head of household status if he or she unmarried and if he or she provides more than 50% child support as a parent or as other qualifying relatives. Some of the advantages include a lower tax rate, the ability to claim credits such as education credits, and greater eligibility for other tax benefits. Among the disadvantages are that this filing status is audited more frequently by the IRS than any other filing status.

1. MFS

If an individual is married, he or she may decide to file his or her returns separately. The advantages of filing returns separately are that the taxpayer will be held responsible for their own liabilities, they will evade unnecessary taxes from the spouse, they refund will be protected, and lastly, the taxpayer might get a bigger refund. There are few disadvantages, however, such as missing the standard deduction in case the taxpayer’s spouse itemizes their deductions, a lower deduction amount, a higher tax rate and lastly, the taxpayer cannot claim some credits, such as the Child and Dependent Care Credit.

1. MFJ

This filing status has numerous benefits compared to the rest. The main advantages are a bigger refund, less tax due, education benefits, the eligibility for Child and Dependent Care Credit, adoption credits and itemized deductions, among others. The disadvantages are the possibility of failure by one spouse to meet their side of the liability, and that both spouses are equally responsible for unpaid taxes.

1. Joint and Several Liability

IRC 6013(d)(3) provides that a husband and wife who file a joint return under IRC 6013(a) have joint and several liability with respect to the income tax liability. This means each spouse is individually responsible for:

1. The accuracy and completeness of the return; and
2. The payment of the income tax liability as reported on the return as well as any additional tax, penalties, additions to tax, and interest.

Thus, under the joint and several liability concept, each spouse is responsible for the entire income tax liability even though all or part of the liability arises from income earned by or a deduction attributable to the other spouse.

An election to file a joint return may only be revoked before the due date of the return, including extensions. However, an executor or administrator may revoke a joint return election made by a surviving spouse within one year of the due date of the surviving spouse’s return, (including any extension of time for filing such return).

### Conditions for Filing a Claim for Refund

Many people may lose out on a tax refund simply because they did not file a federal income tax return.

Many taxpayers may not file because they didn’t earn enough money to be required to file. However, taxpayers who had federal taxes withheld by their employer may be eligible for a refund of those taxes. Also, even if a taxpayer isn’t required to file, they may qualify for benefits like the Earned Income Tax Credit. The taxpayer must file a tax return to get the money.

In most cases, an original return claiming a refund must be filed within three years of its due date for the IRS to issue a refund. Generally, after the three-year window closes, the IRS can neither send a refund for the specific tax year. nor apply any credits, including overpayments of estimated or withholding taxes, to other tax years that are underpaid.

Taxpayers are eligible to claim a tax refund if they have filed excess tax returns. To claim a refund, the taxpayer must prove beyond reasonable doubt that, indeed, he or she actually overpaid the tax. According to the IRS, taxpayers can claim a refund by filing Form 1040X. For a refund claim to be accepted a taxpayer must:

1. File a tax form to amend his or her return by applying the rule of disclosure.
2. Determine if the special referral to another function is required.
3. Determine whether the claim is allowable and able to be processed.
4. Check whether the time limit to file a tax return has lapsed. The period of three years is the required time to file Form 1040X to claim a refund.

#### Amended Returns

If, after filing a return, the taxpayer discovers there was an error in it, he or she may need to amend it. If there is a change in the taxpayer’s filing status, income, deductions or credits, filing an amended return is required, but if there is a mathematical or clerical error on a return, the IRS may accept returns without certain required forms or schedules.

The taxpayer must use Form 1040X to correct a previously filed Form 1040 or to change amounts that were previously adjusted by the IRS. Form 1040X must also be filed in the taxpayer needs to make a claim for a carryback due to a loss or unused credit, though he or she may also use Form 1045, *Application for Tentative Refund*, instead of Form 1040X.

If Form 8938, *Statement of Foreign Financial Assets*, applies to the taxpayer, he or she may file it with an annual or an amended return.

Form 1040X must generally be filed in the later of the following:

1. 3 years after the date the taxpayer filed his or her original return.
2. 2 years after the date the taxpayer paid the tax.

If a return is filed before the due date, it is regarded as if it was paid on the due date, for refund claims related to net operating losses, foreign tax credits, bad debts, and other issues, special rules apply.

### Penalty 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:

* 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; or
* In connection with an offer in compromise and closing agreement (section 7122 or 7122), 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. The taxpayer is declared guilty will be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned not more than 3 years, or both, together with the costs of prosecution.

Review Questions

1. Carla filed her tax return over 60 days after the due date. The tax she owes is of $520. For this failure, which is the penalty amount she might be assessed?
2. $540
3. $435
4. $520
5. $100

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| **Answer: B** |
| If a taxpayer files his or her tax return over 60 days after the due date, the minimum penalty that he or she is likely to attract is the lesser of $435, or 100% of the tax due for 2021. In this case, the lesser amount is $435. |

1. Vinicio filed a return he has to amend on April 10, 2019. Due to hardship, he paid his taxes as reflected in the original return on September 15, 2022. Which is the due date for Vinicio to file Form 1040X?
2. April 10, 2022
3. September 15, 2022
4. April 10, 2023
5. September 15, 2023

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| **Answer: B** |
| Form 1040X must generally be filed in the later of the following:   * 3 years after the date the taxpayer filed his or her original return. * 2 years after the date the taxpayer paid the tax.   In this case, the latter due date for Vinicio is two years after he paid the tax, which is September 15, 2022. |

1. The director of NRA, Wayne LaPierre is facing prosecution by the IRS in Texas state, Dallas, for taxes due for an approximate amount of $3.4 million. Mr. LaPierre declared Chapter 11 (bankruptcy); however, Dallas judge did not accept such terms and declared Mr. LaPierre guilty of perjury. Which is the maximum penalty of perjury Mr. LaPierre could be fined?
2. $400,000
3. $500,000
4. $100,000
5. $200,000

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| **Answer: C** |
| Regarding the penalty of perjury, if the taxpayer is declared guilty, he or she will be fined not more than $100,000 ($500,000 in the case of a corporation), or imprisoned not more than 3 years, or both, together with the costs of prosecution. |

1. Which of these is true regarding adjustments, deductions and credits?
2. Tax credits are the most merited tax benefits available.
3. The student loan deduction is common for taxpayers that are under age 30.
4. Credits reduce a tax considerably.
5. All statements are correct.

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| **Answer: D** |
| Many will sometimes refer to deductions as “deductions to arrive at Adjusted Gross Income”, meaning, above-the-line deductions. They are simply the expenses that directly reduce the income such as itemized or standard deduction. Some of the common deductions are for example, a student’s loan, especially for taxpayers under 30 years of age. After the total income is calculated, all expenses that are considered as adjustments will be subtracted from the amount to arrive at adjusted gross income. For those individuals who are self-employed, the possible deductions include self-employed health insurance and self-employed tax. Other adjustments may include IRA deductions, educator expenses and moving expenses.  Credits are indeed the most merited tax benefits available. They directly reduce a tax significantly if they are filed. Credit is money that is given back to the taxpayer after they have filed for a credit claim. |

1. Which one of these is an advantage of the Head of Household filing status?
2. A bigger tax rate.
3. Eligibility for other benefits associated with taxation.
4. Both A and B.
5. None of the above.

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| **Answer: B** |
| A taxpayer qualifies to be given the head of household filing status if he or she is unmarried and if he or she provides more than 50% child support as a parent or as other qualifying relatives. Some of the advantages include lower tax rate, ability to claim credits such as education credits, and greater eligibility for other benefits associated with taxation. Disadvantages include not being eligible for considerable tax benefits and credits awarded to married couples. |

CHAPTER 6   
  
Specialized Returns for Individuals

## Module: Estate Tax

### Gross Estate, Taxable Estate (Calculations and Payments), Unified Credit, Life Insurance, and Filing Requirements

The laws on estate and gift taxes are some of the most complicated in the IRC. This lesson will present a basic overview of the estate and gift taxes imposed by the IRC, beginning with a few principles:

1. Estate taxes may be imposed on the estate a person leaves to heirs.
2. A gift is the transfer of any property. A gift is made if property (including money) is given, or the use of or income from property is given, without expecting to receive something of at least equal value in return. If an item is sold at less than its full value or if an interest-free or reduced interest loan is made, that sale or loan may be a gift.
3. Gift taxes address the amount a person can gift to another person without tax consequences, as well as the tax consequences when that amount is exceeded.
4. Recipients of gifts made by U.S. citizens have no tax issues to worry about, no matter the size of the transfer, because gifts received are not taxable income.
5. Persons who made a gift less than $15,000 to another person in 2021 also do not need to pay the gift tax. If a person made gifts of more than $15,000 to an individual in 2021, that's considered a "lifetime gift" which raises the issue of a required reporting of such gifts using Form 709, U.S. Gift (and Generation Skipping Transfer) Tax Return.
6. Note that gifts are never deductible from a gift-giver's gross income. Do not confuse gifts with charitable contributions made during a taxpayer's lifetime which may be deductible for income tax purposes.
7. Estates are discussed with gift taxes because transfers while a person is living (i.e., gifts) can influence estate taxes.
8. The estate tax, for 2021 tax year, is of 40% of the inheritance amount.

**Annual exclusion:** The annual exclusion is the amount a person can gift annually without needing to pay tax. In 2021, any U.S. taxpayer could gift up to $15,000 to a single person.

#### Gross Estate

Gross estate comprises the value of a person’s property, all of it (personal or real, intangible or tangible) that was possessed by a decedent, or the decedent had interest on at the period of demise. On the time of the decedent’s demise, all properties are incorporated in the gross estate their FMV. However, the IRS notes that there can be an alternative where an assessment date can be used, which is six months after the death of the decedent.

Gross estate includes:

1. Certain transfers made during the decedent's life without an adequate and full consideration in money or money's worth.
2. Annuities.
3. The includible portion of joint estates with right of survivorship.
4. The includible portion of tenancies by the entirety.
5. Certain life insurance proceeds (even though payable to beneficiaries other than the estate).
6. Property over which the decedent possessed a general power of appointment.
7. Dower or curtesy (or statutory estate) of the surviving spouse.
8. Community property to the extent of the decedent's interest as defined by applicable law.

Generally, the gross estate does not include the following:

1. Property owned solely by the decedent's spouse or other individuals.
2. Lifetime gifts that are complete (no powers or other control over the gifts are retained).
3. Life estates given to the decedent by others in which the decedent has no further control or power at the date of death.
4. Valuation of Qualified Real Property in Decedent's Gross Estate

For an estate of a decedent dying in calendar year 2021, if the executor elects to use the special use valuation method under S2032A for qualified real property, the aggregate decrease in the value of qualified real property resulting from electing to use S2032A for purposes of the estate tax cannot exceed $1,190,000.

1. Interest on a Certain Portion of the Estate Tax Payable in Installments

For an estate of a decedent dying in calendar year 2021, the dollar amount used to determine the "2%-portion” of the estate tax extended is $1,590,000.

1. Consistent Basis Reporting

Any executor of an estate (or other person) required to file an estate tax return must provide Form 8971, along with its Schedules A to the IRS, as well as copy of the beneficiary’s Schedule A (of that form) to each beneficiary currently receiving, or who will receive property from the estate.

Said Schedule A must show the final estate tax value of the property the beneficiary receives or will receive. If the executor only files a estate tax return to make an election relating to the generation-skipping transfer tax (GSTT) or the portability of the deceased spousal unused exclusion (DSUE), it is not required to provide Form 8971 and its Schedule A.

If Part 2, column C of the Schedule A received by the beneficiary indicates that the property increases the estate tax liability, the beneficiary must use a basis consistent with the final estate tax value of the property to determine the beneficiary’s basis in that property. To calculate a basis consistent with the final estate tax value, start with the reported value and then make any allowed adjustments.

#### Real Property

Real property possessed by a decedent at the time of death, whether it was located at the state of residence or not, is included in the gross estate. Some forms of real property securities include a vacation home, condominium, individual habitation, or a leasing property. In case someone was in between buying property and dies before the deal is closed, this property is incorporated in gross estate, but in case there was mortgage involved, the mortgage is deducted from the decedent debts.

1. Transfers Before Death

The value of property transferred by a person before death is generally not included in the gross estate, with the following exceptions:

1. Transfers with retained life estate.
2. Transfers taking effect at death.
3. Revocable transfers, and
4. Transfers of life insurance (made within 3 years of death).

Also, if the decedent within 3 years of death transferred the retained interest, the reversionary interest, or the power relating to the above transfers, the value of the property is included in the gross estate. These transfers are included in the gross estate whether or not a gift tax return was required to be filed.

#### Bonds and Stocks

All bonds and stocks, regardless of who issues them (foreign or domestic companies or governments) are incorporated in gross estate. If the decedent passed away on or after the agreement day but before the imbursement day, the dividend is includable as a distinct property as the decedent (through her/his property) is still eligible to the bonus.

If the person becomes deceased after the belongings, he or she possessed became ex bonuses, but before the agreement date, the sum of the bonus is added to the price of the possessions.

#### Estate Valuation

Generally, the value of the decedent's property interest for estate tax purposes is its FMV at the date of death or at the alternate valuation date.

#### Alternate Valuation

An executor may elect to use the alternate valuation method. Under this method, property included in the decedent's gross estate is valued as of a date other than the date of death. If the alternate valuation method is properly elected, the property in the estate is valued according to the following rules:

1. Any property distributed, sold, exchanged, or otherwise disposed of within 6 months after the decedent's death is valued as of the date on which it is first distributed, sold, or exchanged, or otherwise disposed of.
2. Any property not disposed of within 6 months after the decedent's death is valued as of 6 months after the date of the decedent's death.
3. Any property, interests, or estate that is affected by mere lapse of time is valued as of the date of the decedent's death. However, this is adjusted for any difference in value not due to mere lapse of time as of 6 months after the decedent's death, or, if earlier, as of the date of its disposition.

Properties, interests, or estates that are affected by mere lapse of time include patents, estates for the lives of persons other than the decedent, remainders, and reversions.

The subsequent provisions apply to the election of the alternate valuation method:

1. The election must be made on the first estate tax return filed for the estate. The return does not have to be filed on time for the election to apply. However, the election must be made on a return filed within 1 year of the due date (including extensions) for filing the return. The election cannot be changed.
2. The election may be made only if it will decrease the value of the gross estate and the sum of the estate tax and the generation-skipping transfer tax (reduced by any allowable credits). The election is effective only if a return is required to be filed. The election applies to all of the property in the estate.

#### Insurance

Life insurance proceeds are added in the gross estate if:

1. The property of the decedent is the heir of the rule; or
2. The heir has a lawfully obligatory responsibility to use the ensues for the advantage of the decedent’s property; or
3. The decedent owned, at his or her death, to some extent “events of possession,” which the decedent might have applied at the period that he or she passed on.

#### Taxable Estate: Calculations and Payments

Taxable estate is the value of gross estate less several deductions. In order to compute for aggregate taxable transfers, one has to add adjustable taxable gifts to gross estate.

However, on aggregate taxable transfers and on the adjusted taxable gifts, one has to compute the tentative tax, but under the Unified Tax Rate Schedule.

The computation is the following:

1. **Gross estate – deductions = taxable estate + adjusted taxable gifts = cumulative taxable transfers – tax – tax on adjusted taxable gifts = tentative estate tax – credits = estate tax owed.**

However, in order to determine what is taxable, one has to know the property he/she owns; in other words, the gross estate. Overall, one’s property usually includes real estate, personal property (such as jewelry, cars, furniture), and intangible property (such as patents and copyrights).

#### Life Insurance and Taxable Estate

The two concepts (life insurance and taxable estate) are two different things, and thus, it is important for one to understand each concept distinctively. The IRS has set standards and requirements, which all life insurance agreements must oblige. For federal income tax purposes, an insurance agreement cannot be deliberated as a life insurance agreement (and be suitable for encouraging tax treatment) unless the contract meets state law requests and fits the IRS's constitutional descriptions of what is or is not a life insurance policy. The IRS contemplates the form of the policy, the date of issue, the amount of the benefit for the demise, and bonuses compensated. The IRS descriptions are fundamentally assessments to certify, for example, that an insurance policy is not actually a venture car. The insurance corporation ought to observe these guidelines and apply the provisions.

However, the taxpayer cannot deduct premiums paid for insurance coverage from life insurance because life insurance is seen as a personal expense. Nonetheless, owning a life insurance coverage has its own advantages. For instance, the coverage generates considerable sums of money which are payable to one’s heirs after their death. When life insurance proceeds have been paid, the beneficiaries receive the federal income tax free benefits. However, these proceeds are included in taxable estate. The value of life insurance proceeds covering a person’s life are included in their gross estate if the proceeds are payable to:

1. The taxpayer’s assets, either unswervingly or meanderingly; or
2. Entitled heirs, if the individuals owned any occurrences of possession in the policy at the period of their death.

Estates that will be obliged taxes, whether life insurance proceeds are involved as part of the taxable estate, rest on the possession of the policy at the time of the insured's demise. However, for life insurance proceeds to avoid federal taxation, the best option is for one to transfer their policy to another person. Also, individuals can remove their life insurance proceeds from their taxable estate by creating an Irrevocable Life Insurance Trust (ILIT). This method has been considered the most appropriate, rather than transferring ownership, because the owner of the policy continues to be the legal controller of the policy.

### Jointly-Held Property

If the deceased owned property as a joint venture, this property is encompassed in the gross estate of the deceased. IRC Section 2040(a) notes that the amount contributed by the surviving partner can reduce the full inclusion amount to purchase an asset.

For instance, if Janet and Ricardo own a particular building as joint ventures both possessing rights of survivorship, and the building is worth $500,000, if Janet dies, the entire value of the building is incorporated in her gross estate. However, if Ricardo can prove that Janet only contributed $200,000 during the time of the acquisition of the property, Ricardo’s gross estate will include $300,000.

Nonetheless, if the joint interest is referred to as “occupancy by totality” (a type of joint occupancy with a right of survivorship possessed by the decedent and his or her partner as the only joint renters), the rules changes.

IRC Section 2040(b) notes that in this type of joint tenancy, gross estate of the first spouse (joint partner) includes only half of the value of the property. Therefore, details about who offered the money to acquire the property become irrelevant.

### Marital Deduction and Other Marital Issues

1. Tax Marital Deduction

The estate tax marital deduction, otherwise called the unlimited marital deduction or more simply the marital deduction, is a valuable estate planning device for certain married couples. It allows one marriage partner to transfer an unlimited amount of assets to his or her spouse without incurring a tax. The marital deduction is determinable from the overall gross estate. The total value of the assets passed on to the spouse is subtracted from that amount, giving us the marital deduction. This inter-spousal transfer can occur during the couple’s lifetime or after one spouse’s death, according to a will.

The marital deduction applies to both estate and gift taxes as well. You can find the provision under Section 2056 of the Internal Revenue Code as the marital deduction rule.

1. Portability

Portability, a provision that is taxpayer-friendly, has become a permanent estate and gift tax provision as an outcome of the American Taxpayer Relief Act of 2012 (ATRA). Portability is an estate and gift tax provision that allows the personal representative (or executor) of a deceased spouse to make an election on the decedent’s estate tax return to transfer or “port” said deceased partner’s unused exclusion amount (referred to as the “DSUE amount”) to the surviving spouse.

The IRS establishes that the DSUE amount is the lesser of:

1. the basic exclusion amount in effect in the year of the decedent’s demise; or
2. the excess of the decedent’s applicable exclusion amount exceeding the amount of the decedent’s:
   * + Taxable estate, and
     + Adjusted taxable gifts.

Therefore:

**Applicable exclusion amount = basic exclusion amount + DSUE amount**

Before portability was introduced, every spouse was mandated by the IRS to only use their lifetime exclusion before or after their death, and if they did not do so, it was lost. However, not all states that use the estate tax have adopted portability, which makes it limited. Originally, portability was only a federal estate and gift tax rule.

### Life Insurance, IRAs and Retirement Plans

At the taxpayer’s death, their retirement plan benefits will generally be included in their gross estate for federal estate tax purposes. However, if the taxpayer retirement benefits consist of annuity payments for life that end at their death, there is nothing remaining to include in the gross estate. There is an unlimited marital deduction for property the taxpayer leaves to his or her surviving spouse, and an unlimited charitable deduction for property he or she leaves to charity. The taxpayer has an applicable exclusion amount that can protect some or all of their taxable estate from estate tax, for 2021, the amount is $11,700,000.

#### Life Insurance

One of the benefits of owning life insurance is the ability to generate a large sum of money payable to the taxpayer’s heirs upon his or her death. An even greater advantage is the federal income-tax-free benefit that life insurance proceeds receive when they are paid to the taxpayer’s beneficiary. However, while the proceeds are income-tax-free, they may still be included as part of the taxpayer’s taxable estate for estate tax purposes.

Section 2042 of the Internal Revenue Code states that the value of life insurance proceeds insuring the taxpayer’s life are included in his or her gross estate if the proceeds are payable:

1. To the taxpayer’s estate, either directly or indirectly, or
2. To named beneficiaries if the taxpayer possessed any incidents of ownership in the policy at the time of his or her death.

#### Deductions

The taxpayer can deduct the expenses incurred by an estate for its administration either as an expense against the estate tax or against the annual income tax of the estate.

The taxpayer:

* May deduct the expense from the gross estate in figuring the federal estate tax on Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, or
* May deduct the expense from the estate's gross income in figuring the estate's income tax on Form 1041, U.S. Income Tax Return for Estates and Trusts.
* However, they cannot claim these expenses for both estate tax and income tax purposes.
* In most cases, these rules also apply to expenses incurred in the sale of property by the estate. For more information, refer to Publication 559, Survivors, Executors, and Administrators. It is designed to help those in charge (e.g., an executor or administrator) of the property (estate) of an individual who has died.

In general, administration expenses deductible in figuring the estate tax include:

* Fees paid to the fiduciary for administering the estate;
* Attorney, accountant, and return preparer fees;
* Expenses incurred for the management, conservation, or maintenance of property;
* Expenses in connection with the determination, collection, or refund of the estate's tax liability.

### Estate Filing Requirements and Due Dates

For decedents who died in 2021, Form 706 must be filed by the executor of the estate of every U.S. citizen or resident:

1. Whose gross estate, plus adjusted taxable gifts and specific exemption, is more than $11,700,000; or
2. Whose executor elects to transfer the DSUE amount to the surviving spouse, regardless of the size of the decedent's gross estate.

To determine whether the taxpayer must file a return for the estate under (1) above, add:

1. The adjusted taxable gifts (as defined in section 2503) made by the decedent after December 31, 1976;
2. The total specific exemption allowed under section 2521 (as in effect before its repeal by the Tax Reform Act of 1976) for gifts made by the decedent after September 8, 1976; and
3. The decedent's gross estate valued as of the date of death.
4. **NOTE:** Under the special rule of Regulations section 20.2010-2(a)(7)(ii), executors of estates who are not required to file Form 706 under section 6018(a), but who are filing to elect portability of the DSUE amount to the surviving spouse, are not required to report the value of certain property eligible for the marital deduction under section 2056 or 2056A or the charitable deduction under section 2055. However, the value of those assets must be estimated and included in the total value of the gross estate.

#### When to File

Form 706 must be filed to report estate and/or GST tax within 9 months after the date of the decedent's death. If the taxpayer is unable to file Form 706 by the due date, he or she may receive an extension of time to file. The taxpayer is to use Form 4768, *Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes*, to apply for an automatic 6-month extension of time to file.

1. Portability Election

An executor can only elect to transfer the DSUE amount to the surviving spouse if the Form 706 is filed timely; that is, within 9 months of the decedent's date of death or, if the taxpayer has received an extension of time to file, before the 6-month extension period ends.

1. Extension to elect portability

Executors who did not have a filing requirement under section 6018(a) but failed to timely file Form 706 to make the portability election may be eligible for an extension. Executors filing to elect portability may now file Form 706 on or before the second anniversary of the decedent’s death.

An executor wishing to elect portability under this extension must state at the top of the Form 706 being filed that the return is “Filed Pursuant to Rev. Proc. 2017-34 to Elect Portability under 2010(c)(5)(A).”

Review Questions

1. When are life insurance proceeds added in the gross estate?
2. It applies to all kinds of heirs.
3. When the heir has a lawfully obligatory responsibility to use the ensues for the advantage of the decedent’s property.
4. B and D are correct.
5. When the decedent owned, at his or her death, to some extent “events of possession,” which the decedent might have applied at the period that he or she passed on.

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| **Answer: C** |
| Life insurance proceeds are added in the gross estate if:   * The property of the decedent is the heir of the rule; or * The heir has a lawfully obligatory responsibility to use the ensues for the advantage of the decedent’s property; or * The decedent owned, at his or her death, to some extent “events of possession,” which the decedent might have applied at the period that he or she passed on. |

1. Provided an estate is valued at $50,000,000, which is the amount of the estate tax to be imposed?
2. $15,000,000
3. $20,000,000
4. $40,000,000
5. $50,000,000

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| **Answer: C** |
| The estate tax, for 2021 tax year, is of 40% of the inheritance amount. In this example, the 40% of $50,000,000 is $20,000,000. |

1. Which is the dollar amount used to determine the 2%-portion of the estate tax?
2. $1,180,000
3. $1,590,000
4. $1,570,000
5. $1,400,000

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| **Answer: B** |
| For an estate of a decedent dying in calendar year 2021, the dollar amount used to determine the “2%-portion” of the estate tax extended is $1,590,000. |

1. If an executor elects to use the special use valuation method under S2032A for qualified real property, which is the maximum amount the estate tax can reach?
2. $1,180,000
3. $1,050,000
4. $1,590,000
5. $1,190,000

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| **Answer: D** |
| For an estate of a decedent dying in calendar year 2021, if the executor elects to use the special use valuation method under S2032A for qualified real property, the aggregate decrease in the value of qualified real property resulting from electing to use S2032A for purposes of the estate tax cannot exceed $1,190,000. |

1. Janet and Ricardo own a particular building as joint ventures both possessing rights of survivorship, and the building is worth $500,000. If Janet dies, and Ricardo can prove that Janet only contributed $200,000 during the time of the acquisition of the property, which is Ricardo’s gross estate?
2. $300,000
3. $200,000
4. $100,000
5. $0

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| **Answer: A** |
| If Janet dies, and Ricardo can prove that Janet only contributed $200,000 during the time of the acquisition of the property, Ricardo’s gross estate will include $300,000. |

1. Lenin died in 2021. Provided Lenin’s estate is valued at $11,800,000, which is the form the executor of the estate is to file?
2. Form 802
3. Form 709
4. Form 706
5. Form 820

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| **Answer: C** |
| For decedents who died in 2021, 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 $11,700,000; or * Whose executor elects to transfer the DSUE amount to the surviving spouse, regardless of the size of the decedent's gross estate. |

1. Gross Estate includes the following, except:
2. Property owned solely by the decedent's spouse or other individuals.
3. Property over which the decedent possessed a general power of appointment.
4. The includable portion of tenancies by the entirety.
5. Annuities.

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| **Answer: A** |
| Gross estate includes the following:   * Certain transfers made during the decedent's life without an adequate and full consideration in money or money's worth. * Annuities. * The includable portion of joint estates with right of survivorship. * The includable portion of tenancies by the entirety. * Certain life insurance proceeds (even though payable to beneficiaries other than the estate). * Property over which the decedent possessed a general power of appointment. * Dower or curtesy (or statutory estate) of the surviving spouse. * Community property to the extent of the decedent's interest as defined by applicable law.   Generally, the gross estate does not include the following:   * 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). * Life estates given to the decedent by others in which the decedent has no further control or power at the date of death. |

1. When are estate taxes due after the date of the decedent’s death?
2. 9 months.
3. 12 months.
4. 18 months.
5. 3 months.

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| **Answer: A** |
| The estate taxes are due within 9 months after the date of the decedent's death, unless an extension of time for payment has been granted, or unless the representative has properly elected under Section 6166 to pay in installments, or under Section 6163 to postpone the part of the tax attributable to a reversionary or remainder interest. |

1. Regarding real property, which of these statements is incorrect?
2. In case there was mortgage involved, the mortgage is deducted from the decedent’s debts.
3. Real property possessed by a decedent at the time of death, whether it was located at the state of residence or not, is not to be included in the gross estate.
4. In case someone was in between buying property and dies before the deal is closed, this property is incorporated in gross estate.
5. All above are incorrect.

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| **Answer: B** |
| Real property possessed by a decedent at the time of death, whether it was located at the state of residence or not, is included in the gross estate. Some forms of real property securities include a vacation home, condominium, individual habitation, or a leasing property. In case someone was in between buying property and dies before the deal is closed, this property is incorporated in gross estate, but in case there was mortgage involved, the mortgage is deducted from the decedent’s debts. |

1. Regarding estate valuation, which one of these statements is correct?
2. The value of the property is its FMV, minus depreciation, if it applies.
3. The value of the decedent’s property is its FMV at the date it was obtained.
4. The value of the decedent’s property is its FMV at the date of death or at the alternate valuation date.
5. None of the above.

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| **Answer: C** |
| Generally, the value of the decedent's property interest for estate tax purposes is its FMV at the date of death or at the alternate valuation date. |

## Module: 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. A taxpayer makes a gift if he or she gives property (including money), or the use of or income from property, without expecting to receive something of at least equal value in return. If the taxpayer sells something at less than its full value or if he or she makes an interest-free or reduced-interest loan, he or she may be making a gift.

Persons who made a gift less than $15,000 to another person in 2021 do not need to pay the gift tax. If a taxpayer made gifts more than $15,000 to an individual in 2021, that is considered a "lifetime gift", and so the taxpayer must report the gift using Form 709, U.S. Gift (and Generation Skipping Transfer) Tax Return. The value of a gift is the FMV of the property on the date the gift is made. Keep in mind that the FMV is the price at which the property would change hands between a willing buyer and a willing seller, when neither is forced to buy or sell, and both having reasonable knowledge of relevant facts.

### Gift-Splitting

Gift splitting can be argued as the process involving a third party. For instance, if a decedent or a partner made a gift to a third party, the gift can be reflected so that one half was given by the decedent and the other half by the decedent’s spouse. Spouses have to decide to divide the gift, but in the case of a deceased partner, his or her representative acts on their behalf. However, sometimes, there is no agreement on splitting the gift; spouses are allowed to apply for the yearly exclusion to one half of the gift.

In 2021, for the gifts made, gift splitting allowed married couples to give up to $30,000 to a third party before being taxed on the amount. Thus, in case a gift is split, couples are required to file a gift tax return to indicate there was actually an agreement to apply gift splitting.

Consent to gift-splitting causes the liability for gift tax on all gifts made during the calendar year by either spouse to be joint and several. Each spouse, therefore, should be fully informed of all gifts made by the other spouse before giving consent.

### Annual Exclusion

Transfers by gift have an annual exclusion per donor per donee. This exclusion is indexed for inflation. For 2021 tax year, this exclusion is of $15,000.

The annual exclusion for gifts made to a non-citizen spouse is $159,000 for 2021.

1. Gifts of a current interest are obliged to yearly exclusions (the unobstructed right to the instant use, ownership, or amusement of the assets or the income presently) and not to gifts of a future interest (the right that comes into existence at some future date)
2. The transfer gift of a future interest is made up by accumulating the income in a trust instead of paying it presently.
3. When transfers are under age 21, and specific requirements are met, the future interest rule is provided an exemption by the IRC.

### Unified Credit

This is a tax credit offering an exclusion amount upon which the taxpayer is exempted from the transfer taxes. The unified credit assists people in avoiding transfer taxes centered on specific amounts. The credit eliminates and reduces taxes. The IRS states that the applicable credit is applied to the estate tax and gift tax and is usually the same as the tax on the applicable exclusion amount. In order for the taxpayer to know their applicable credit, they must deduct it from estate and gift tax owed. In 2021 tax year, the credit is of $11,700,000. The full amount of applicable credit accessible to an individual will be equivalent to the tax on the rudimentary exclusion amount, plus the tax on any deceased spousal unused exclusion (DSUE) amount.

1. Roberto left $13,800,000 in non-exempt assets to his children. By subtracting $11,700,000, the unified credit amount, $2,100,000 are left. This is the amount that will be subject to estate tax, so, multiply the remaining amount by 40%. The estate tax is of $840,000.

This credit is referred to as the unified credit because ultimately the federal gift and estate taxation are integrated into one unified tax system.

### Effect on Estate Tax

A generation-skipping transfer tax (GSTT) was enacted by Congress to prevent evasion of gift or estate tax on every generation by making transfers that bypassed the following younger generation. When there is a direct skip, or a taxable termination takes place, the GSTT is triggered. For instance, if a grandfather created a trust which had a life estate to a son and a granddaughter, the death of the son leads to a termination event and it is subject to GSST. On the other hand, in order to determine when a generation is skipped, some conditions have to be met. For instance, the spouses, despite their age difference, have to be of the same generation, and one has to be aware that it is difficult to skip a generation if the skip person’s parent is deceased. The GSTT tax rate is a flat 40%. The tax only applies when the transferred amount exceeds $11,700,000 per individual for 2021.

### Filing Requirements

Requirements for a gift usually involve a contributor able and willing to make a gift, a donee willing to accept and own the possessions, and an actual delivery of the assets to the donee. Transfers that are incomplete transfers are deemed as not gifts but will be gifts in the case of an event that makes the transfer complete. A gift transfer will not occur if adequate considerations are involved (not including affection, or love), regardless of the setting where the transfer takes place, personal or business. When loans are made or forgiven in a personal setting, depending on the circumstances, they can be considered as gifts.

Form 709, United States Gift, is used to report:

1. Transfers subject to the federal gift and certain generation-skipping transfer (GST) taxes.
2. Allocation of the lifetime GST exemption to property transferred during the transferor's lifetime.

If a taxpayer makes a transfer by gift during a calendar year, Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, must be filed for that year.

Generally, the following gifts are not taxable, and a return does not need to be filed for:

1. The first $15,000 for 2021, given to any person during a calendar year (the annual exclusion).
2. Tuition or medical expenses paid for someone (the tuition and educational exclusions). No educational exclusion is allowed for amounts paid for books, supplies, room and board, or other similar expenses that do not constitute direct tuition costs.
3. Gifts to a spouse.
4. Gifts to a political organization for its use.
5. Gifts to charities.

#### QTP Contributions

Generally, if contributions to a Qualified Tuition Plan (QTP, also known as a 529 Plan) on behalf of an account beneficiary, together with all other gifts by the taxpayer to the beneficiary do not exceed the federal annual exclusion amount of $15,000 per year ($30,000 if married and gift-splitting has been elected with the taxpayer's spouse), such contributions will not be subject to the federal gift tax or generation-skipping transfer tax:

1. A contributor may elect to apply the contribution against the annual exclusion equally over a five-year period while filing a gift tax return for the year in which the gift was made.
2. This option is applicable only for contributions up to five times the available annual exclusion amount in the year of the contribution. For example, for 2021, the maximum contribution that may be made using this rule would be $75,000 (or $150,000 for married couples filing jointly).
3. The entire amount of the contribution in excess of $75,000 in 2021 must be reported.
4. For each of the 5 years, report in Form 709 $15,000 (20% x $75,000) of the amount for which taxpayer made the election. By applying the annual exclusion, the first $15,000 would not be taxable.

#### Skip Person

If a gift is made to a "natural person", it is always considered a gift of an interest in property for purposes of the GST tax. A donee who is a natural person is a skip person if that donee belongs to a generation that is two or more generations below the generation of the donor (the donor, most commonly, would be a grandparent of the donee).

**Use Form 8892 for extension if no income tax return extension is filed:** If the taxpayer does not request an extension for his income tax return, use Form 8892, Application for Automatic Extension of Time to File Form 709 and/or Payment of Gift/Generation-Skipping Transfer Tax, to request an automatic 6-month extension of time to file the federal gift tax return.

Review Questions

1. Which of the following is correct, regarding the gift tax?
2. Taxpayers do not need to pay the gift tax as long as they give less than $15,000.
3. Taxpayers gifting less than $15,000 may still need to pay the gift tax, at a lesser percentage.
4. The value of a gift is the fair market value of the property on the date the donor obtains it.
5. Taxpayers reporting the gift tax must do so on Form 799.

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| **Answer: A** |
| Persons who gift less than $15,000 to another person in 2021 have no tax ramifications. If a person gifts more than $15,000 to an individual in 2021, that is considered a "lifetime gift" which raises the issue of reporting such gifts using Form 709, U.S. Gift (and Generation Skipping Transfer) Tax Return. The value of a gift is the fair market value of the property on the date the gift is made. |

1. Sandra made a gift valued at $14,890, whereas Antonio received a gift valued at $16,802. Which of them must report the gift’s value on their tax return?
2. Sandra
3. Antonio
4. Both of them
5. None of them

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| **Answer: D** |
| Persons who made a gift less than $15,000 to another person in 2021 do not need to pay the gift tax. With a gift, the giver (not the receiver) is responsible for reporting it on their taxes. |

1. Which is the tax rate for generation-skipping transfer tax?
2. 37%
3. 0%
4. 21%
5. 40%

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| **Answer: D** |
| The GSTT tax rate is a flat 40%. The tax only applies when the transferred amount exceeds $11,700,000 per individual for 2021. |

1. Ernesto transfer $25,000 to his son Eduardo as a gift. Which of the following is true?
2. Eduardo has to file Form 709.
3. Ernesto has to file Form 709.
4. They both can exclude the income and the expense from their tax returns.
5. None of the above are true.

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| **Answer: B** |
| If a taxpayer makes a transfer by gift during a calendar year, Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, must be filed for that year.  Generally, the following gifts are not taxable, and a return does not need to be filed for:   * The first $15,000 for 2021, given to any person during a calendar year (the annual exclusion). |

## Module: International Information Reporting

### Filing and Reporting Requirements and Due Dates

FATCA was enacted in 2010 by Congress to target non-compliance by U.S. taxpayers using foreign accounts. FATCA requires foreign financial institutions (FFIs) to report to the IRS information about financial accounts held by U.S. taxpayers, or by foreign entities in which U.S. taxpayers hold a substantial ownership interest. FFIs are encouraged to either directly register with the IRS to comply with the FATCA regulations (and FFI agreement, if applicable) or comply with the FATCA Intergovernmental Agreements (IGA) treated as in effect in their jurisdictions.

U.S. citizens, U.S. individual residents, and a very limited number of non-resident individuals who own certain foreign financial accounts or other offshore assets (specified foreign financial assets) must report those assets.

Use Form 8938 to report these assets.Attach Form 8938 to the annual income tax return (usually Form 1040).Taxpayers with a total value of specified foreign financial assets below a certain threshold do not have to file Form 8938:

1. If the total value is at or below $50,000 at the end of the tax year, there is no reporting requirement for the year, unless the total value was more than $75,000 at any time during the tax year.
2. The threshold is higher for individuals who live outside the United States.
3. Thresholds are different for married and single taxpayers.
4. Taxpayers who do not have to file an income tax return for the tax year do not have to file Form 8938, regardless of the value of their specified foreign financial assets.

To file with FBAR, the taxpayer should do so if the cumulative value of the foreign financial accounts surpasses $10,000 at any time during the calendar year.

Form 8865 is used 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).

Form 5471 is required along with your expat taxes for US citizens and resident aliens who are considered to be officers, directors or shareholders in certain foreign corporations.

Form 3520 is used by U.S. persons (and executors of estates of U.S. decedents) to report certain transactions with foreign trusts, ownership of foreign trusts under the rules of sections 671 through 679, and receipt of certain large gifts or bequests from certain foreign persons. A separate Form 3520 must be filed for transactions with each foreign trust.

The taxpayer should individually own a reportable foreign financial account that requires the filing of FBAR for the reportable year. On the other hand, a CPA, enrolled agent, or an attorney filing on behalf of client is required to record to become a BSA E-Filer and file as an institution rather than an individual. The due date for all mentioned forms above is April 15, 2022.

### Covered Accounts

Foreign Bank Account Reporting (FBAR) covers several accounts which include bank accounts, insurance policies with a cash value, mutual funds, securities, and option accounts. Other covered accounts include:

1. Canadian Registered Retirement Savings Plan (RRSP)
2. Canadian Tax-Free Savings Account (TFSA)
3. Mexican Individual Retirement Accounts (Fondos para el Retiro) and
4. Administradoras de Fondos para el Retiro (AFORE).

However, the IRS provides several illustrations to show when an account becomes a foreign account (an account that is managed by financial institutions outside the U.S).

### Potential Penalties

The IRS can impose a $10,000 penalty for each non-deliberate defilement of the FBAR filing requirement. In case an individual deliberately nose-dives to file an FBAR, the IRS might enforce a penalty identical to the greater of $100,000 or 50% of the account’s highest balance. In addition, criminal penalties for a willful failure to file can reach $250,000, 5 years in prison or both. Civil and criminal FBAR penalties might be executed together. Normally, as a matter of law, the IRS has six years to assert an FBAR penalty.

In the past, the IRS has not been constant in applying the FBAR penalty. In some cases, the IRS has violently stressed FBAR penalties over several years whether the taxpayer was deliberate or not in dwindling to file an FBAR. The IRS has even taken the position that the $10,000 non-willful penalty should apply per account in each year rather than being limited to a one-time $10,000 penalty per FBAR in each year. The clear concern for taxpayers is that the IRS’s assertive approach could result in the issuing of multiple penalties over several years, which could lead to penalty amounts that far exceed the value of the account.

A taxpayer will have to complete and file other reports about foreign assets, such as FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR) (formerly TD F 90-22.1), in addition to Form 8938.

1. The FBAR Statute of Limitations is 6 Years

For other reporting forms, the statute of limitation on assessment of taxes on a tax return is three years under IRC section 6501(a). There are two exceptions unique to offshore compliance cases:

1. Where income attributed to a specified foreign financial asset is omitted and in excess of $5,000, the statute may be extended to 6 years with respect to the omitted income from the specified asset.
2. Where Form 8938 or any other international information return is required to be filed with a tax return, the statute is extended for any tax imposed under Title 26 with respect to any tax return, event, or period to which such information relates for three years after the information is provided (i.e., filing an accurate and complete form).

### Distinctions Between FBAR and Form 8938 Requirements

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| 1. **Features** | 1. **Form 8938 requirements** | 1. **FBAR requirements** |
| 1. Who to file | 1. Specified individuals | 1. U.S citizens |
| 1. Includes U.S territories? | 1. No | 1. Yes |
| 1. Reporting threshold | 1. Applies to taxpayers living in the U.S and outside the U.S 2. $50,000 on the last day of the tax year or $75,000 at any time during the tax year | 1. Cumulative worth of financial accounts surpasses $10,000 at any time during the calendar year |
| 1. What is reported | 1. The maximum value of specified foreign financial assets | 1. Extreme worth of financial accounts maintained by a financial institution which is physically located in a foreign nation |

Review Questions

1. Which one of the following accounts is not covered by the FBAR?
2. Canadian Tax-Free Savings Account (TFSA).
3. Canadian Registered Retirement Savings Plan (RRSP).
4. Administradoras de Fondos para el Retiro (AFORE).
5. Canadian Individual Retirement Account (CIRA).

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| **Answer: D** |
| The Foreign Bank Account Reporting (FBAR) covers several accounts, which include: bank accounts, insurance policies with a cash value, mutual funds, securities, and option accounts. Other covered accounts include:   * Canadian Registered Retirement Savings Plan (RRSP). * Canadian Tax-Free Savings Account (TFSA). * Mexican Individual Retirement Accounts (Fondos para el Retiro), and * Administradoras de Fondos para el Retiro (AFORE). |

1. When should a taxpayer file with FBAR?
2. When the cumulative value of the foreign financial accounts surpasses $10,000 at any time during the calendar year.
3. When one is a non-resident alien.
4. When the total value is at $50,000 or less.
5. When the cumulative value of the foreign financial accounts surpasses $100,000 at any time during the calendar year.

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| **Answer: A** |
| The taxpayer must file with FBAR if the cumulative value of the foreign financial accounts surpasses $10,000 at any time during the calendar year.  U. S. citizens, U.S. individual residents, and a very limited number of nonresident individuals who own certain foreign financial accounts or other offshore assets (specified foreign financial assets) must report those assets. If the total value is at or below $50,000 at the end of the tax year, there is no reporting requirement for the year. |

1. What is the maximum penalty that the IRS can imposed to a taxpayer for non-deliberate defilement of the FBAR filing requirement?
2. $10,000.
3. $100,000.
4. $250,0000.
5. $0.

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| **Answer: A** |
| The IRS can impose a $10,000 penalty for each non-deliberate defilement of the FBAR filing requirement. In case an individual deliberately nose-dives to file an FBAR, the IRS might enforce a penalty identical to the greater of $100,000 or 50% of the account’s highest balance. In addition, criminal penalties for a willful failure to file can reach $250,000, 5 years in prison or both. Civil and criminal FBAR penalties might be executed together. Normally, as a matter of law, the IRS has six years to assert an FBAR penalty. |