

The Best Individual Income Tax Update Course by Surgent

BITU/21/V4-X2

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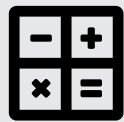
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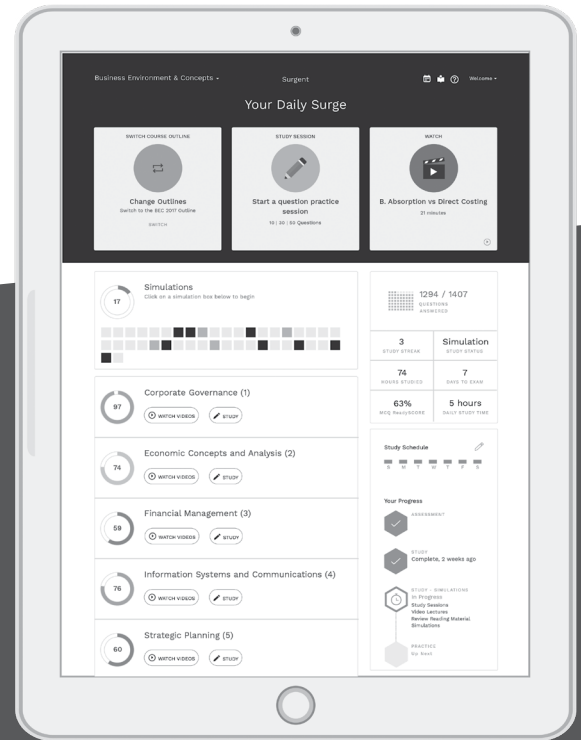
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The Build Back Better Act, The Infrastructure Investment and Jobs Act, and Other Recent Updates

I. The Infrastructure Investment and Jobs Act -- Overview

On November 15, 2021, President Biden signed into law *The Infrastructure Investment and Jobs Act (IIJA)*, containing some important tax-related provisions. It is important to distinguish the IIJA from the proposed Build Back Better Act, both of which have been heavily discussed and debated by Congress over the last quarter of 2021. The proposed Build Back Better Act contains far more tax provisions which will be discussed later in this course.

A. The Employee Retention Tax Credit

One of the most notable provisions of the IIJA is the termination of the Employee Retention Tax Credit (ERTC), effective October 1, 2021. Only recovery startup businesses are eligible to take the ERTC for wages paid before January 1, 2022. (This topic is discussed in further detail later in this course).

B. Cryptocurrency reporting

The IIJA significantly increases cryptocurrency reporting requirements. The IIJA expands the definition of brokers to include “any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person.” A digital asset is “any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary.”

Such brokers must report cryptocurrency transactions or any other digital asset transactions on Form 1099-B, *Proceeds from Broker and Barter Exchange Transactions*. This provision could potentially impact cryptocurrency exchanges, miners, or digital wallet companies.

The IIJA expanded §6050I(a) to include digital assets, meaning individuals engaged in a trade or business will be required to report cryptocurrency transactions over \$10,000. Any person engaged in a trade or business that has a single transaction or related transaction in excess of \$10,000 must file Form 8300, *Report of Cash Payments Over \$10,000 Received in a Trade or Business*. The reporting requirements are effective for transactions entered into as of January 1, 2023.

C. Extension of certain deadlines

If a filing location becomes inaccessible on the date a petition is due, the IIJA extends the filing deadline and provides that the relevant time period for filing such petition shall be tolled for the number of days within the period of inaccessibility plus an additional 14 days.

Under §7508A(d), the Treasury may automatically postpone federal tax deadlines for 60 days if a federally declared disaster occurs. If a significant fire occurs, the IIJA provides authority to postpone certain tax deadlines. A significant fire is any fire with respect to which assistance is provided under §420 of the Stafford Act.

II. The Build Back Better Act -- Overview

In April 2021, President Biden released a fact sheet detailing the *American Families Plan* that would provide an investment in the nation's children, families, and economy. Notable provisions included:

- Increasing the top individual marginal tax rate to 39.6%;
- Eliminating capital gains rates for high income individuals;
- Ending stepped-up basis for high income individuals;
- Closing the carried interest loophole;
- Limiting like-kind exchanges on gains in excess of \$500,000; and
- Making §461(l) excess business loss limitations permanent.

As a complement to the *American Families Plan*, President Biden proposed the *Made in America Tax Plan*. Noteworthy provisions of this plan included:

- Raising the corporate income tax rate from 21% to 28%;
- Strengthening the global minimum tax for U.S. multinational corporations by modifying GILTI and repealing and replacing BEAT;
- Reducing incentives for foreign jurisdictions to maintain ultra-low corporate tax rates by encouraging global adoption of robust minimum taxes;
- Enacting a 15-percent minimum tax on book income of large companies that report high profits, but have little taxable income;
- Replacing flawed incentives that reward excess profits from intangible assets with more generous incentives for new research and development;
- Replacing fossil fuel subsidies with incentives for clean energy production; and
- Ramping up enforcement to address corporate tax avoidance.

The Biden administration and Congressional Democrats compromised on many of the original proposals outlined in the *American Families Plan* and the *Made in America Tax Plan*, and it is likely they will continue to make compromises in order to pass this historic spending bill.

The latest version of the proposed legislation, named the *Build Back Better Act (BBBA)*, was passed by the House of Representatives on November 19, 2021. Notable provisions of this House-passed \$1.6 trillion bill will be discussed in this supplement.

Prior to discussing what is included in the November 2021 House-passed BBBA, it is important to discuss the notably absent provisions. The following provisions previously included in the September 2021 BBBA were **not included** in the November 2021 House-passed BBBA:

- An increase in the top individual income tax rate to 39.6%;
- An increase in the corporate income tax rate to 26.5%;
- An increase in the top capital gains rate to 25%;
- A limitation on the deduction of Qualified Business Income for certain high-income individuals;
- Changes to the rules for partnership interests held in connection with the performance of services (carried interest rules);
- Changes to valuation rules for certain transfers of nonbusiness assets;
- Changes to certain tax rules applicable to grantor trusts; and
- Terminating the temporary increase in the Unified Credit.

A. Business provisions

1. Corporate Alternative Minimum Tax (Minimum Book Tax)

The *Build Back Better Act* would impose a 15% corporate profits alternative minimum tax (AMT) based on adjusted financial statement income for certain corporations (other than S corporations, RICs, or REITs) with three-year average annual adjusted financial statement income in excess of \$1 billion. Corporations under common control are aggregated for purposes of this test.

Adjusted financial statement income will generally refer to a corporation's applicable financial statement (AFS) within the meaning under §451, adjusted for:

- Appropriate adjustments for differences between financial statement reporting and federal income tax reporting;
- Adjustments to exclude AFS income and include dividends received and other gross income for corporations not included in the federal consolidated tax group;
- Adjustments to account for income of any disregarded entities excluded from the AFS;
- Adjustments to reverse the effects of federal and foreign income taxes reflected in the AFS; and
- Adjustments to reflect income earned for mortgage servicing rights under §451.

The corporation's minimum tax would be equal to the amount by which the tentative minimum tax exceeds the corporation's regular tax for the year. The new AMT would allow for net operating losses (NOLs) generally consistent with §172, which permit indefinite carryforward provisions and limitations up to 80% of the taxable income. The NOLs will be considered for those originating after December 31, 2019.

Corporations continue to remain applicable corporations unless, due to either an ownership change or consistent reduction in AFSI beneath the threshold amounts, the Secretary determines that it would not be appropriate to continue to treat such corporation as an applicable corporation. This provision would be effective for taxable years beginning after December 31, 2022.

2. Excise tax on repurchase of corporate stock

The BBBA would impose a 1% excise tax on a publicly traded U.S. corporation for the value of any of its stock that is repurchased by the corporation during the taxable year. "Repurchase" refers to corporate redemptions under §317(b) and can include "economically similar" transactions as determined by the Secretary. Presumably, the IRS could assess step-transaction and substance-over-form doctrines to determine a "repurchase" has occurred.

The repurchases subject to this excise tax are reduced by the value of any new issuance to the public and stock issued to the employees of the corporation. Repurchases facilitated through subsidiary of publicly traded companies would also result in excise tax treatment; a subsidiary is any corporation or partnership which is owned more than 50% directly or indirectly by the covered corporation. The following transactions are specifically excluded from excise tax:

- Tax-free reorganizations (§368(a));
- Aggregate annual repurchases that do not exceed \$1 million;
- Repurchases treated as stock dividends;
- Repurchases contributed to ESOPs or similar plans;
- Repurchases by dealers in securities; and

- Repurchases by RICs/REITs.

The excise tax would apply to repurchases of stock after December 31, 2021.

3. Limitation on deduction of interest expense

The BBBA would add §163(n) to limit the amount of net interest expense of certain domestic corporations that are members of an international financial reporting group. The business interest expense deduction would be limited to an “allowable percentage” of 110% of the domestic corporation’s worldwide net interest expense. The new interest limitation would apply only to domestic corporations whose average excess interest expense over interest includible exceeds \$12 million over a three-year period. The new interest limitation would not apply to small businesses with average earnings over three years of less than \$26 million, partnerships, Subchapter S corporations, REITS, or RICs.

The BBBA would modify §163(j)(4) to apply the limitation of deductibility of business interest at the partner or shareholder level, rather than to the partnership or S corporation as an entity. The BBBA would add §163(o) to allow the carryforward of disallowed interest expense due to §163(j)(1) and §163(n)(1). Taxpayers subject to both §163(j) and §163(n) are eligible to deduct only the lesser of the two limitations in a taxable year.

These provisions would apply to taxable years beginning after December 31, 2022.

4. Modifications to treatment of certain losses

Under current law, if any security becomes **worthless** during the taxable year, the taxpayer may claim a worthless stock loss.

A “security” for this purpose includes a share of stock in a corporation, a right to receive a share of stock in a corporation, or a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form. The loss is treated as occurring on the last day of the tax year.

The proposed legislation would amend §165(g) to provide that losses with respect to securities are treated as realized at the time the identifying event establishing worthlessness occurs, rather than on the last day of the tax year.

The implementation of this proposal could prove to be difficult, as sometimes a series of events, rather than a sole identifying event, establishes worthlessness. Under this scenario, there could be uncertainty as to the timing of which specific event determined worthlessness.

The timing change could potentially impact the holding period to determine whether the loss is short-term or long-term.

Additionally, the proposed legislation would expand the definition of “security” to include a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a partnership, with interest coupons or in registered form.

Essentially, the proposal provides that partnership indebtedness is treated in the same manner as corporate indebtedness.

Under the legislative proposals, §165 would be further amended to provide that a loss on a worthless partnership interest would be treated as a loss from the sale or exchange of the interest in the partnership, as provided in §741, at the time of the identifiable event establishing worthlessness.

Lastly, the legislative proposal would change the treatment of taxable liquidations of corporate subsidiaries so that a loss in a taxable liquidation is deferred until the property received in the liquidation is sold to a third party.

5. Adjusted basis limitation for divisive reorganization

The proposed legislation would amend §361 to provide that a distributing corporation in a divisive reorganization recognizes gain to the extent of controlled corporation debt securities transferred to the creditors of the distributing corporation in excess of the basis in assets (reduced by amounts paid by the controlled corporation to the distributing corporation) transferred from the distributing corporation to the controlled corporation in the transaction.

This provision would apply to reorganizations after the date of enactment.

6. Limitation on certain special rules for §1202 gains

Currently, under §1202, taxpayers other than a corporation can exclude from gross income up to 100% of any gain from the sale or exchange of qualified small business stock held for more than 5 years. The exclusion is limited to the greater of \$10 million or 10 times the taxpayer's basis of their initial investment.

- For stock acquired after September 27, 2010, 100% of the gain may be excluded.
- For stock acquired after February 17, 2009, and before September 28, 2010, 75% of the gain may be excluded.
- For stock acquired after August 10, 1993, and before February 18, 2009, 50% of the gain may be excluded.

The proposed legislation states that the 75% and 100% exclusion rates would not apply to taxpayers with AGI of \$400,000 or more, as well as trusts and estates. The 50% exclusion rate would remain available for all taxpayers, regardless of when the stock was acquired after August 10, 1993.

- The 50% exclusion would be applied against a 28% rate, and it would remain an AMT preference item.

The proposed legislation would generally apply to sales and exchanges on or after September 13, 2021.

7. Constructive sales

Under §1259, if there is a constructive sale of an appreciated financial position, the taxpayer shall recognize a gain as if the position were sold, assigned, or otherwise terminated at its FMV on the date of the constructive sale.

Taxpayers are treated as having made a constructive sale of an appreciated financial position if they:

- 1) Enter into a short sale of the same or substantially identical property;
- 2) Enter into an offsetting notional principal contract with respect to the same or substantially identical property;
- 3) Enter into a futures or forward contract to deliver the same or substantially identical property; or

- 4) In the case of an appreciated financial position that is a short sale or contract described in #2 or #3 above with respect to any property, acquire the same or substantially identical property.

The proposed legislation would include digital assets in the constructive sale rules for taxable years beginning after December 31, 2021. The term “**digital asset**” means any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary.

Additionally, the proposed legislation would expand the definition of a constructive sale in #4 above to include entering into a contract to acquire the same or substantially identical property.

The proposal would apply to constructive sales entered into after the date of enactment.

8. Wash sales

Wash sales occur when a taxpayer sells securities at a loss and within 30 days before or after the sale either buys *substantially identical* securities, acquires substantially identical securities in a taxable trade, or acquires a contract or option to buy substantially identical securities.

The wash sale rule prevents taxpayers from claiming tax losses while retaining an interest in the loss asset. Any loss that is denied for purposes of the loss sale rule is added to the basis of the acquired stock or options.

Under current law, the wash sale rule only applies to stock or securities, including contracts or options to acquire or sell stock or securities.

The proposed legislation would *expand* the wash sale rule to include commodities, currencies, and digital assets. Exceptions would be provided for foreign currency and commodity losses either:

- Directly related to the business needs of a trade or business of the taxpayer (other than the trade or business of trading foreign currencies or commodities); or
- Part of a hedging transaction (as defined by §1221(b)(2)).

If enacted, this provision would apply to wash sales occurring in taxable years beginning after December 31, 2021.

9. Modifications to limitation on deduction of excessive employee remuneration

Under §162(m), in the case of a publicly held corporation, a deduction limit of \$1 million generally applies to compensation of the principal executive officer or the three most highly compensated officers for the taxable year other than the principal executive officer.

ARPA (discussed later) expanded the applicable employees under §162(m) to include the next five highest-paid employees in addition to the CEO, CFO, and next three highest compensated officers.

These next five highest-paid employees are to be determined on an annual basis.

The ARPA provision was scheduled to take effect in 2027; however, the BBBA would accelerate ARPA's changes to take effect in tax years beginning in 2022.

10. Termination of employer credit for paid family and medical leave

Currently, eligible employers may claim a credit equal to 12.5% of the eligible wages paid to qualifying employees during any period such employees are on family and medical leave, if the rate of payment under the program is 50% of the wages typically paid to the employee.

The credit is increased by 0.25 percentage points (but not above 25%) for each percentage point by which the rate of payment exceeds 50%. The maximum amount of family and medical leave that may be taken for any qualifying employee for any taxable year is 12 weeks.

Eligible employers must have a written policy that allows all qualifying full-time employees not less than two weeks of annual paid family and medical leave, and less-than-full-time qualifying employees a commensurate amount of leave.

The Taxpayer Certainty and Disaster Tax Relief Act of 2020 extended the employer credit for paid family and medical leave through December 31, 2025, but the proposed legislation would amend the expiration date of the credit for paid family and medical leave to December 31, 2023.

11. Employer-provided childcare credit

Currently, employers may claim a tax credit of 25% of qualified childcare expenditures plus 10% of qualified childcare resource and referral expenditures, not to exceed a maximum annual credit amount of \$150,000.

Qualified childcare expenditures include the costs of constructing, acquiring, expanding, or rehabilitating property used as a qualified childcare facility or any costs incurred in operating the facility. Qualified childcare facilities must be open to all employees and, if qualified childcare is the principal trade or business of the taxpayer, at least 30% of enrollees must be dependents of employees of the taxpayer.

The BBBA would make the following changes to the employer-provided childcare credit:

- Increase the credit rate for qualified childcare expenditures from 25% to 50%;
- Increase the overall annual credit limitation from \$150,000 to \$500,000; and
- Limit the amount of qualified childcare resource and referral expenditures to \$1.5 million per year.

The BBBA changes would apply to taxable years beginning after December 31, 2021.

12. Miscellaneous business provisions

The BBBA includes certain international provisions and other less commonly applicable provisions, including:

- Modification of §250 deductions related to FDII and GILTI (effective 12/31/2022).
 - The provision provides that certain classes of income are excluded from FDII, and therefore, an offsetting deduction is not available.
- Repeal of one-month deferral election for taxable year of specified foreign corporations (effective after 11/30/2022).
- Modification to foreign tax credits to dual capacity taxpayers (effective after 12/31/2021).
 - Require country-by-country reporting of FTCs.
 - Repeal the carryforward limitations related to GILTI FTCs (5-yr carryforward to 2030; 10-yr carryforward 2030 and beyond.)

- Restrict deductions GILTI Basket of FTCs to only those directly allocable to GILTI income including the GILTI §250 deduction.
- Require FTCs related to covered stock transactions be applied with the principles of §338(h)(16).
- Modifications to Foreign Oil Related Income (effective after 12/31/2021).
- Modifications to GILTI (effective after 12/31/2022).
 - Require application of GILTI on a country-by-country regime.
 - Allow carryover of country-specific net CFC tested losses.
 - Modify net deemed tangible return from 10% of QBAI to 5% of QBAI.
 - Include foreign oil and gas extraction income in GILTI calculation.
- Modifications of Deemed Paid Foreign Taxes Related to GILTI from 80% to 95% (effective after 12/31/2022).
- Modifications to Foreign Source Dividend deductions under §245A and adding §951B related to downward attribution of foreign persons (effective after date of enactment).
- Modifications on Foreign Base Company Sales and Services Income (effective after 12/31/2021).
- Modifications to BEAT Tax Rates (effective after 12/31/2021).
 - 1/1/2022 – 12/31/2022: 10%.
 - 1/1/2023 – 12/31/2023: 12.5%.
 - 1/1/2024 – 12/31/2024: 15%.
 - 1/1/2025 and beyond: 18%.
- Limitations on the Credit for Clinical Testing of Orphan Drugs (effective after 12/31/2021).
- Exclusions of Prison Facility Rents for Purposes of REIT Income Tests (effective after 12/31/2021).
- Modifications of Portfolio Interest Exemptions (effective after date of enactment).
- Enact Dividend Treatment under §871(m) with respect to payments of notional principal contracts and similar payments for PTPs (effective 12/31/2022).
- Adjustments to E&P of CFCs (effective after 12/31/2021).
- Treatment of certain CFC dividends as Extraordinary Dividends (effective after date of enactment).
- Clarification of the meaning of trade/business for purposes of §52(b) aggregation rules (effective after 12/31/2021).
- Modification to delay amortization requirements of Research and Experimental Expenditures to taxable years after 12/31/2025.
- Modifications to Deductibility of Certain Qualified Sound Recording Productions under §181 (effective date of enactment).
- Payroll Credits for Local News Journalist Compensation (effective calendar quarters after date of enactment).
- Increase in Research Credit Against Payroll Tax for Small Businesses (effective after 12/31/2021).

B. Individual provisions

1. Application of Net Investment Income tax to trade or business income of certain high-income individuals

Under current law, §1411 imposes a Net Investment Income (NII) tax of 3.8% on certain individuals, estates, and trusts. The 3.8% NII tax for individuals is imposed on the lesser of:

- Net Investment Income for such taxable year; or
- The excess (if any) of the Modified AGI for such taxable year over the threshold amount.
 - The threshold amount is \$250,000 for married filing jointly taxpayers or surviving spouses.
 - The threshold amount is \$200,000 for head of household and single taxpayers.
 - The threshold amount is \$125,000 for married individuals filing separate returns.

The 3.8% NII tax for trusts and estates is imposed on the lesser of:

- Undistributed Net Investment Income for such taxable year; or
- The excess (if any) of the adjusted gross income for such taxable year over the threshold amount, which is the dollar amount at which the highest estate or trust income tax bracket begins (\$13,050 for 2021 and \$13,450 for 2022).

Typically, the NII tax applies for passive activities, not activities in which the taxpayer materially participates.

The proposed legislation would apply the NII tax to certain high-income taxpayers, regardless of whether they materially participate.

For individuals, the expanded NII tax would apply to the greater of “specified net income” (a new term), or net investment income, as defined by current law.

For trusts and estates, the expanded NII tax would apply to the greater of:

- “Undistributed specified net income” (new term) or undistributed net investment income, as defined by current law; or
- The excess (if any) of the adjusted gross income for such taxable year over the threshold amount, which is the dollar amount at which the highest estate or trust income tax bracket begins (\$13,050 for 2021 and \$13,450 for 2022).

For purposes of the proposed, expanded NII tax, “**specified net income**” is “income derived in the ordinary course of a trade or business without regard to the current limitation that the trade or business is a passive activity with respect to the taxpayer or consists of trading financial instruments or commodities.”

- Specified net income is specified income reduced by deductions allocable to such income.
- Specified income includes gross income from interest, dividends, annuities, royalties, rents, other gross income derived from a trade or business, and net gain attributable to the disposition of property.

The expanded NII tax would cover Net Investment Income derived in the ordinary course of a trade or business for the following income brackets:

- \$500,000 for married filing jointly taxpayers or surviving spouses;
- \$400,000 for head of household or single taxpayers; and
- \$250,000 for married individuals filing a separate return.

Under the proposal, the increase in tax is phased in based on the ratio of:

- The excess of the taxpayer’s modified AGI over the applicable threshold amount, to

- \$100,000 for all taxpayers other than married individuals filing a separate return, in which case this amount is \$50,000.

Example: Married taxpayers Jon and Carol have \$540,000 of modified AGI. The increase in NII tax under the proposal is limited to 40% $((\$540,000 - \$500,000)/\$100,000)$.

The NII proposal would keep the current threshold amounts above which the NII tax applies.

The proposal clarifies that the expanded NII tax is not assessed on wages on which FICA is already imposed.

This proposal would apply to taxable years beginning after December 31, 2021.

2. Limitations on excess business losses of noncorporate taxpayers

Under current law, for taxable years beginning after December 31, 2020, and before January 1, 2027, §461(l) disallows the excess business loss of noncorporate taxpayers.

An **excess business loss** is the excess (if any) of the aggregate deductions of the taxpayer for the taxable year that are attributable to the trades or businesses of such taxpayer, over the sum of the aggregate gross income or gain of the taxpayer for the taxable year that is attributable to such trades or businesses, plus a threshold amount. In 2021, the threshold amount is \$262,000 (\$524,000 for married filing jointly taxpayers).

The aggregate deductions taken into account to determine the taxpayer's excess business loss are determined without regard to the limitation of the provision, and without regard to any NOL deduction or §199A deduction.

The excess business loss limitation applies after the basis limitations for partners and S corporation shareholders, the §465 at-risk limitations, and the §469 passive loss limitations.

The disallowed excess business loss is suspended and carried over to the following tax year as an NOL.

The proposed legislation would make permanent the limitation on any excess business loss of a noncorporate taxpayer.

Any disallowed loss for a particular year would be carried forward to the next taxable year and treated as a deduction attributable to trades or businesses of the taxpayer in that year.

As it would not be considered an NOL carryforward, the loss would be considered as part of the aggregate deductions under §461(l) for the next taxable year, and therefore may be subject to the excess business loss limitation in that year. This provision may limit or delay the ability of the taxpayer to utilize the benefit of such losses.

This provision would apply to taxable years beginning after December 31, 2020.

3. Surcharge on high-income individuals, trusts, and estates

The proposed legislation would create a new five-percent income tax surcharge on modified AGI of an individual, estate, or trust, above the following amounts:

- \$10 million for married filing jointly taxpayers, surviving spouses, head of household filers, and single taxpayers;
- \$5 million for married individuals filing separate returns; and
- \$200,000 for estates and trusts.

Additionally, the proposed legislation includes an additional three-percent surcharge (for a total of eight percent) on taxpayers with modified AGI exceeding \$25 million (\$12.5 million for a married individual filing separately, \$400,000 for estates and trusts).

For purposes of the new income tax surcharges, an individual's modified AGI is the taxpayer's AGI reduced by any deduction (not considered in determining adjusted gross income) allowed for investment interest.

The new income tax surcharge would not be treated as income taxes paid for purposes of the AMT.

This provision would be effective for tax years beginning after December 31, 2021.

4. Child Tax Credit

ARPA significantly expanded the Child Tax Credit (CTC) for the 2021 tax year by increasing the maximum CTC amount, creating advanced CTC payments, and making the CTC fully refundable (details discussed later in the chapter). The BBBA would provide a one-year extension of the expanded CTC and advanced payments. The BBBA would make the CTC fully refundable for tax year 2021 and tax year 2022 forward.

Advanced payments would be equal to 100% of the estimated 2022 CTC and would be made in 12 monthly payments. Advanced payments made to joint return filers would treat half of each payment as being made to each spouse. Taxpayers may elect a "look-back rule" to use their 2021 MAGI to determine their 2022 CTC and advance payment amount. The Secretary would be able to consider any information known when determining eligibility and the amount of advanced CTC payments. Prior to this change, the Secretary was only permitted to use an individual's prior year return information to determine eligibility and payment amount.

Under current law, taxpayers may only receive the CTC for an eligible child if they provide such child's SSN. This SSN must be associated with work authorization in order to qualify for CTC eligibility. The BBBA would repeal the work-authorized SSN requirement and allow taxpayers with eligible children with ITINs to claim the CTC, provided that all other eligibility requirements are met.

Currently, ARPA provides a repayment safe harbor so that taxpayers who receive excess advance payments may be protected from repayment. Currently, the maximum safe harbor amount for 2021 is \$2,000, multiplied by the difference in the number of qualifying children between 2021 and 2020. The BBBA increases the maximum safe harbor amount for 2022 to be \$3,600, multiplied by the number of children under age 6 considered for advanced payments and not claimed on 2022 returns, plus \$3,000, multiplied by the number of children over age 6 considered for advanced payments and not claimed on 2022 returns.

5. Earned Income Tax Credit

ARPA significantly expanded eligibility for the Earned Income Tax Credit (EITC) for the 2021 tax year by lowering the minimum age requirement, eliminating the maximum age requirement, increasing the maximum credit amounts, increasing the phaseout percentages, and increasing the income thresholds (details discussed later in the chapter).

The BBBA would extend the expanded EITC through tax year 2022 and allow taxpayers to elect to use prior year income to compute their EITC.

6. Premium Tax Credit

ARPA changed the affordability percentages used for premium tax credits (PTC) for 2021 and 2022 to increase credits for individuals eligible for assistance and provide credits for taxpayers with income over 400% of the FPL. Additionally, ARPA did not require taxpayers to repay excess advance PTC payments in 2020.

Currently, the PTC is available to individuals who cannot obtain affordable minimum coverage through their employer, defined as contributing no more than 9.5% (9.83% in 2021) of household income toward health insurance premiums.

The BBBA would implement the following changes to the PTC:

- Extend PTC eligibility for taxpayers with income over 400% of the FPL through 2025.
- Modify the definition of affordable minimum-based coverage through an employer to be 8.5% of household income through 2025.
- Eliminate the requirement that taxpayers must include lump-sum Social Security benefits in household income in the year awarded when determining PTC eligibility for tax years beginning after December 31, 2021.
 - Previously, any large lump sum payment could have eliminated an individual's PTC or required them to repay advance PTCs.
- Exclude certain dependent income (up to \$3,500, to be indexed for inflation) from the calculation of household income for purposes of determining the PTC amount through 2026.
- Allow taxpayers with household incomes below 100% of the FPL to be eligible for PTCs, effective through December 31, 2025.
- Extend the ARPA provision that individuals receiving unemployment compensation are treated as if their income is no higher than 150% of the FPL.
 - This provision would be effective through December 31, 2022.
- Make the health coverage tax credit permanent and increase the amount of the qualified health insurance premium covered by the credit from 72.5% to 80%.

7. State and local tax deduction

The TCJA notoriously limited the itemized deduction for state and local taxes (SALT deduction) to \$10,000 for all taxpayers other than estate, trust, or married filing separately taxpayer subject to a \$5,000 limitation.

The BBBA would increase the SALT deduction from \$10,000 to \$80,000 for all taxpayers other than estates, trusts, and married filing separately taxpayers, which would be entitled to a deduction of \$40,000. The BBBA SALT provision would be effective for tax years 2021 through 2031. The SALT deduction

effective from the TCJA would revert to the \$10,000/\$5,000 limitation for tax year 2031 before all limitations expire in 2031.

8. Pell grants

Under current law, if an individual receives a scholarship, including a Pell Grant, that covers room and board or other living expenses, such scholarship or Pell Grant is taxable. Only the portion of the scholarship or Pell Grant that is used to pay for qualified tuition and fees is excludable from income.

The BBBA would provide that any amount received from a Pell Grant is excludable from income, including any portion of the grant used to pay for room and board or other living expenses. Additionally, the BBBA would not reduce expenses eligible for education tax credits by any amount of a Pell Grant. The BBBA changes applicable to Pell Grants would apply to grants received after December 31, 2021 and before January 1, 2026.

9. New above-the-line deductions

As an above-the-line deduction, these deductions are available to all taxpayers, regardless of whether they itemize or take the standard deduction.

- **Union Dues:** The BBBA would provide an above-the-line deduction for union dues, up to \$250, consisting of the performance of services by the taxpayer as an employee. This above-the-line deduction is available to union dues paid in any taxable year beginning after December 31, 2021, and before January 1, 2026.
- **Employee Uniforms:** The BBBA would create a new, above-the-line deduction, up to \$250, for employee uniforms. The uniform must be a condition of the taxpayer's employment and unsuitable for everyday wear. This above-the-line deduction is available for expenses paid in any taxable year beginning after December 31, 2021, and before January 1, 2025.

C. Retirement plans

1. Contribution limit for individual retirement plans of high-income taxpayers with large account balances

There are two main types of IRAs:

- **Traditional IRAs:** Eligible individuals may deduct pre-tax contributions made to the traditional IRA, and any distributions are includible in gross income to the extent of any deductible contributions and earnings on the account. Individuals may make both deductible and nondeductible contributions.
- **Roth IRAs:** Eligible individuals may make after-tax contributions to the Roth IRA. Since all contributions are after-tax, the contributions are nondeductible and all qualified distributions and earnings on the account are not includible in gross income.

An annual contribution limit applies to contributions to both traditional and Roth IRAs. In 2021, the maximum contribution is the lesser of:

- \$6,000 (\$7,000 for those age 50 or older before the end of the taxable year); or
- The individual's compensation.

Additional AGI limitations apply to deductible contributions to traditional IRAs and nondeductible contributions to Roth IRAs.

Individuals who make contributions to an IRA in excess of the contribution limits are subject to an excise tax of 6% of the excess amount contributed. The excise tax continues to apply until the excess amount is distributed.

Under the BBBA, if the total value of an applicable individual's IRA and defined contribution plan exceeds \$10 million as of the end of the prior taxable year, the individual would be prohibited from making further contributions to a Roth or traditional IRA for the taxable year.

Applicable individuals are defined as taxpayers whose adjusted taxable income for the taxable year exceeds:

- \$450,000 for Married Filing Jointly or a Surviving Spouse;
- \$425,000 for Head of Household; and
- \$400,000 for Single or Married Filing Separately Taxpayers.

Both the account limit and adjusted taxable income limits would be adjusted for inflation beginning in 2023.

Additionally, under the BBBA, certain IRAs with high account balances would be subject to additional reporting requirements.

If as of the end of any plan year, one or more participants in an applicable retirement plan has a vested account balance of at least \$2.5 million for the plan year, the plan administrator would be required to file a statement including the following information:

- The name and identifying number of each such participant; and
- The amount to which each participant is entitled.

The enhanced reporting requirements would be effective tax years beginning after December 31, 2028.

2. Increase in RMDs for high-income taxpayers with large retirement account balances

The BBBA would require certain taxpayers to take a minimum distribution in the year following the year in which their combined traditional, Roth IRA, and defined contribution account balances exceed \$10 million as of the end of the taxable year.

The increased minimum required distribution would generally equal:

- The excess of the sum of 100% of the "applicable Roth excess amount" (note: this is generally Roth amounts in excess of \$20 million) plus 50% of the "excess aggregate vested retirement plan balance" that exceeds \$10 million reduced by the applicable Roth excess amount; over,
- The sum of the minimum required distributions, determined without regard to the proposed legislation, for all such plans.

Only taxpayers with taxable incomes above the following thresholds would be required to take a minimum distribution:

- \$450,000 for Married Filing Jointly or a Surviving Spouse;
- \$425,000 for Head of Household; and
- \$400,000 for Single or Married Filing Separately Taxpayers.

Any minimum required distributions made as a result of this proposal would be exempt from the §72(t) 10% early distribution penalty and such minimum required distributions would be subject to 35% withholding.

The proposed legislation would be effective for tax years and plan years beginning after December 31, 2028.

3. Tax treatment of rollovers to Roth IRAs and accounts

Currently, taxpayers may convert any amount in a traditional IRA to a Roth IRA by making a distribution from the traditional IRA and making a rollover to a Roth IRA.

The taxpayer pays income tax on such distribution as if a withdrawal was made, but the §72(t) 10% early distribution penalty does not apply.

Section 401(k), §403(b), and §457(b) plans that maintain a Roth contribution program may allow amounts not held in designated Roth accounts to be converted, and such amounts would be included in the gross income of the taxpayer as if distributed.

The BBBA would eliminate traditional IRA to Roth IRA conversions for “**applicable taxpayers**,” defined as those whose adjusted taxable income for the taxable year exceeds:

- \$450,000 for Married and Filing a Joint Return or Surviving Spouse;
- \$425,000 for Head of Household; and
- \$400,000 for Single or Married Filing Separately.

This provision would apply to distributions, transfers, and contributions made in taxable years beginning after December 31, 2031.

Under the BBBA, applicable taxpayers could no longer convert non-Roth funds in §401(k), §403(b), and §457(b) plans to a designated Roth account for distributions, transfers, and contributions made in tax years beginning after December 31, 2031.

Lastly, the BBBA would prohibit all after-tax amounts held in non-Roth accounts in an employer-sponsored retirement plan or a traditional IRA from being converted to a Roth IRA or a designated Roth account for distributions, transfers, and contributions made after December 31, 2021 for all taxpayers, regardless of income level.

4. Statute of limitations with respect to IRA noncompliance

The proposed legislation would extend the statute of limitations for IRA noncompliance related to valuation-related misreporting and prohibited transactions from 3 years to 6 years to help the IRS pursue violations that may have originated outside the current statute’s 3-year window.

This provision would apply to taxes to which the current 3-year period ends after December 31, 2021.

5. IRA owners treated as disqualified persons for purposes of prohibited transaction rules

If an IRA engages in certain prohibited transactions with a disqualified person, it ceases to be an IRA.

A disqualified person includes:

- A fiduciary of the plan;
- A person providing services to the plan;
- An employer with employees covered by the plan;
- An employee organization any of whose members are covered by the plan;
- A direct or indirect owner of an interest of 50% or more in the employer or employee organization; or
- A corporation, partnership, or trust or estate of which (or in which) an interest of 50% or more is held directly or indirectly by a person described above.

The BBBA would *modify* the definition of a disqualified person for purposes of the prohibited transaction rules to include IRA owners as a disqualified person with respect to the IRA.

The following would also be considered disqualified persons under the proposal:

- A family member of the IRA owner;
- A corporation, partnership, or trust or estate in which an interest of 50% or more is held directly or indirectly by the IRA owner; and
- A 10% or more (in capital or profits) partner or joint venturer of the IRA owner.

The proposal would apply to transactions occurring after December 31, 2021.

D. Taxpayer compliance

1. Funding the IRS and Backup W/H with respect to third-party network transactions

The BBBA would add to the list of reportable payments any payments in settlement of third-party network transactions.

A reportable payment will trigger a backup withholding requirement if:

- The aggregate amount of such payment and all previous payments made by the third-party settlement organization to the participating payee during the calendar year equals or exceeds \$600; or
- The third-party settlement organization was required under §6050W to file an information return for the preceding calendar year with respect to payments to the participating payee.

This proposal would apply to calendar years beginning after December 31, 2021.

A transition rule for 2022 adds the requirement that the aggregate number of annual transactions between the third-party settlement organization and the payee must exceed 200 transactions.

E. Social provisions

1. Childcare and universal preschool

The BBBA would establish a new childcare and early learning entitlement program to provide quality, affordable childcare for eligible children from birth up to age five who have not yet started kindergarten. Additionally, it would increase wages for early childhood care providers and invest in childcare quality.

Payments for childcare would be capped at a maximum of 7% of a family's income based on a sliding scale system. Families earning under 75% of their State Median Income (SMI) would pay nothing for childcare. After a three-year phase in period, families with parent(s) engaged in an eligible activity earning no more than 250% of SMI would be eligible for childcare assistance through a childcare subsidy or grant fund. Eligible activities include employment, job searches, educational or training programs, or family leave.

In addition to expanded early childhood care, the BBBA would establish universal preschool for eligible children ages three to four.

2. Comprehensive paid leave

The BBBA creates four weeks of comprehensive paid leave benefits for both full-time and part-time workers in the public and private sectors. This paid leave program is more expansive than current FMLA leave, as it applies to nearly all employers, self-employed individuals, and employees regardless of employer size or employee classification.

The Weekly Benefit Amount is calculated as follows:

$$\text{Weekly Benefit Amount} = \text{Weekly Benefit Rate} \times \frac{\text{Caregiving hours in a workweek}}{\text{Regular workweek hours}}$$

It is important to note that the number of caregiving hours per workweek may not exceed the number of regular workweek hours.

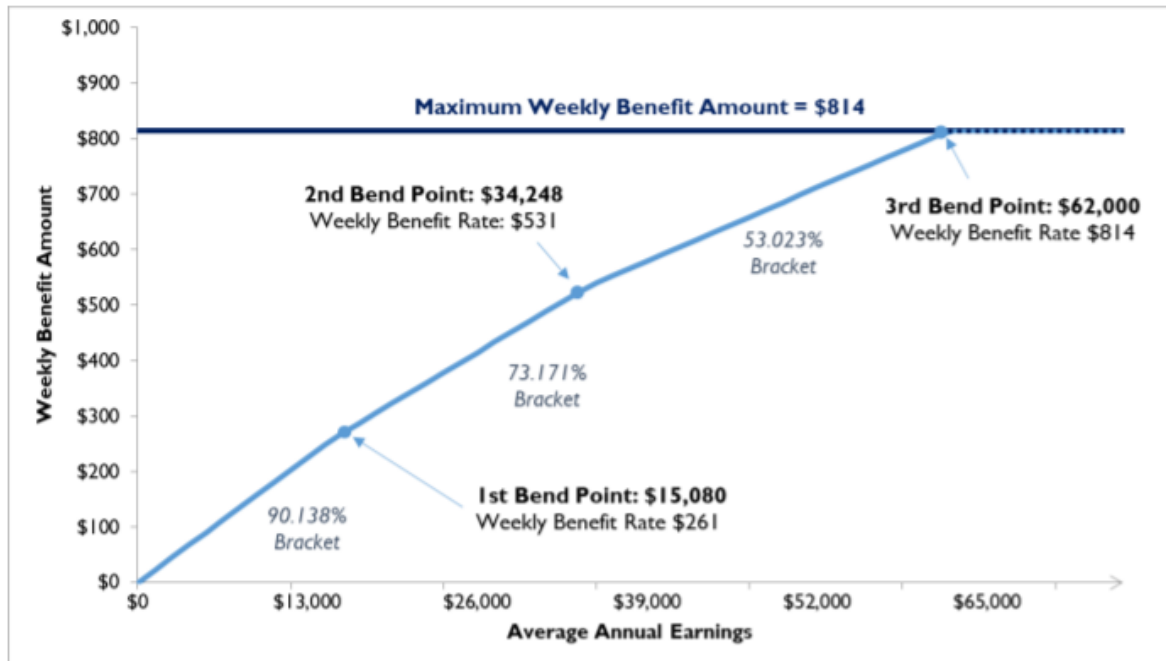
The initial weekly benefit rate in 2024 is the sum of:

- 90.138% x (the first \$15,080 of annual earnings) ÷ 52 weeks
- 73.171% x (the portion of annual earnings between \$15,081 and \$34,248) ÷ 52 weeks
- 53.023% x (the portion of annual earnings between \$34,249 and \$62,000) ÷ 52 weeks

Utilizing this formula, the maximum weekly benefit rate is \$814.10 in 2024. The weekly benefit rate would increase according to the growth in the national average wage index for years after 2024. Under the BBBA, comprehensive paid leave benefits provided to individuals are excluded from gross income. The new paid leave provision is effective as of January 1, 2024.

Figure I. Proposed Initial Weekly Paid Leave Benefit Amount, by Average Annual Earnings

Formula provided in H. Rules Committee Print 117-18



1

III. Other recent updates

A. IRS new FAQ process

The Internal Revenue Bulletin is the authoritative instrument of the IRS to announce official rulings and procedures, and for publishing Treasury Decisions, Executive Orders, Tax Conventions, Court Decisions, Legislation, or any other important items.

- **Final and Temporary Treasury Regulations** may be relied on by taxpayers. Proposed regulations may be relied on if the regulations explicitly state that.
- **Revenue Rulings** provide the IRS's interpretation of the law to facts in the specific ruling. Taxpayers may rely on these rulings if their specific facts and circumstances are substantially the same as the revenue ruling. Revenue rulings have a lower level of authority than Treasury Regulations.
- **Revenue Procedures** are official statements of IRS procedure and administrative practices. Taxpayers may rely on this guidance if their specific facts and circumstances are substantially the same as the revenue procedure. Revenue procedures have a lower level of authority than Treasury Regulations.
- **Frequently Asked Questions (FAQs)** provide the IRS's responses to general inquiries rather than a specific set of facts and circumstances.

On October 15, 2021, the IRS announced that it will update its process for Frequently Asked Questions (FAQs) on new tax legislation and will address concerns of those who rely on such FAQs.

¹ Congressional Research Service, *The Build Back Better Act, Universal Comprehensive Paid Leave Benefit Formula (as in November 3 Text), and State-Level Distribution of Workers: In Brief*, November 12, 2021.

The IRS will announce future significant FAQs on newly enacted tax legislation, as well as any updates or revisions, in a news release. These FAQs will also be posted as a dated Fact Sheet on the IRS.gov website. Prior versions of such fact sheets will be maintained, so if any FAQs are later changed, taxpayers can easily determine which dated version was used.

The IRS clarified that if a taxpayer *reasonably relies* on any FAQ (even those released prior to October 15, 2021) in good faith, they will have a “reasonable cause” defense against any negligence or accuracy-related penalty if the FAQ is later determined to be an incorrect statement of the law as applied to the taxpayer’s particular facts. **Prior to this release, FAQs that had not been published in the Bulletin could not be relied on.**

B. Sneak peak at 2022 inflation-adjusted figures

In November 2021, the IRS released annual inflation adjustments.² The standard deduction amounts in 2022 are as follows:

- \$25,900 for married filing jointly filers;
- \$19,400 for head of household filers; and
- \$12,950 for single and married filing separately filers.

The contribution limit for employees participating in 401(k) plans increases to \$20,500 in 2022.

The limit on annual contributions to an IRA remains unchanged at \$6,000.

The annual exclusion for gifts increases to \$16,000 in 2022 and the federal estate tax exclusion increases to \$12,060,000 in 2022.

C. New foreign reporting requirements: Schedules K-2 and K-3

For tax year 2021, Schedules K-2 and K-3 replace foreign reporting lines previously included on Schedules K and K-1. For partnerships, lines 16 and 20 are replaced by completing Schedule K-2 and K-3 and providing it to partners. For S corporations, the schedules replace lines 14 and certain items of line 17.

The new schedules are provided to partners/shareholders to provide greater clarity on how to determine their U.S. income tax liability with respect to certain items of international relevance, particularly items of deduction and credit.

D. Form 7203 – S corporation shareholder stock and debt basis limitations

For 2021, Form 7203 will be required of S corporation SHs if any of the following apply:

1. A shareholder is claiming a deduction for their share of an aggregate loss from an S corporation;
2. A shareholder received a non-dividend distribution from an S corporation during the tax year;
3. A shareholder disposed of stock in an S corporation during the tax year; or
4. A shareholder received a loan repayment from an S corporation during the tax year.

² Rev. Proc. 2021-45; Notice 2021-61.

Given the above list, for all intents and purposes, basis will be reported on this form and attached to Form 1040 for all S corporation shareholders.

Practice note:

It may be beneficial for shareholders to complete and retain Form 7203 even for years the form is not required to be filed, as this will ensure their bases are consistently maintained year after year.

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Navigating the New Normal: COVID-19; Recent Legislation and Updates

Learning objectives

Upon reviewing this material, the reader will be able to:

- Discuss the key provisions of the FFCRA, the CARES Act, CAA 2021, and ARPA; and
- Understand new IRS guidance released due to the COVID-19 pandemic.

I. Recent IRS filing and payment updates

A. New Form 1040-X

In March 2021, the IRS released a new 2020 version of Form 1040-X, *Amended U.S. Individual Income Tax Return*. Pursuant to the IRS announcement in August 2020, amended returns are now able to be e-filed, as opposed to prior years in which they were only able to be paper filed. Similar to other e-filed returns, an e-filed Form 1040-X will usually result in faster processing time. Taxpayers may electronically file up to three accepted Amended returns, after which all subsequent returns must be paper filed. The Form 1040-X instructions state that Form 1040-X may only be e-filed when amending tax year 2019 or 2020 returns that were originally e-filed. If the tax year 2019 or 2020 return was originally paper filed, the Form 1040-X must also be paper filed. A paper form 1040-X must also be filed if any of the following reasons apply:

- The primary SSN is different from the one on the originally filed return;
- The spouse's SSN (if applicable) is different from the one provided on the originally filed return; or
- The taxpayer's filing status is different from the one stated on the originally filed return.

The most recent paper Form 1040-X revision is from January 2020. If a taxpayer wants to amend the 2020 tax year return, he or she should manually enter "2020" in the entry box next to "calendar year" on the line below the calendar year checkboxes. After, the taxpayer should complete the form as usual.

Taxpayers should note that there are new mailing addresses for Form 1040-X:

IF you are filing Form 1040-X:	THEN mail Form 1040-X to:
In response to a notice you received from the IRS	The address shown in the notice
With Form 1040NR or 1040NR-EZ; or from a foreign country, U.S. possession or territory*; or use an APO or FPO address; or file Form 2555, 2555-EZ, or 4563; or are or were a dual-status alien	Department of the Treasury Internal Revenue Service Austin, TX 73301-0215

*If you live in American Samoa, Puerto Rico, Guam, the U.S. Virgin Islands, or the Northern Mariana Islands, see Pub. 570 at [IRS.gov/Pub570](https://www.irs.gov/pub570).

If you live in:	THEN mail Form 1040-X to:
Alabama, Arkansas, Florida, Georgia, Louisiana, Mississippi, Oklahoma, or Texas	Department of the Treasury Internal Revenue Service Austin, TX 73301-0052
Alaska, California, or Hawaii:	Through June 18, 2021 use: Department of the Treasury Internal Revenue Service Fresno, CA 93888-0422
	Starting June 19, 2021, use: Department of the Treasury Internal Revenue Service Ogden, UT 84201-0052

Connecticut, Delaware, District of Columbia, Illinois, Indiana, Kentucky, Maine, Maryland, Massachusetts, Minnesota, Missouri, New Hampshire, New Jersey, New York, North Carolina, Pennsylvania, Rhode Island, South Carolina, Tennessee, Vermont, Virginia, West Virginia, or Wisconsin	Department of the Treasury Internal Revenue Service Kansas City, MO 64999-0052
Arizona, Colorado, Idaho, Iowa, Kansas, Michigan, Montana, Nebraska, Nevada, New Mexico, North Dakota, Ohio, Oregon, South Dakota, Utah, Washington, or Wyoming	Department of the Treasury Internal Revenue Service Ogden, UT 84201-0052

B. PTIN Fees

Although there was a brief period that the IRS did not charge preparers a fee for a PTIN, the IRS announced the return of the annual fee in July 2020.¹ The fee consists of a \$21 application fee for each new PTIN or renewal, plus a \$14.95 service fee.

C. Tax Pro Account

On July 19, 2021, the IRS released a new Tax Pro Account, allowing tax professionals to digitally initiate Power of Attorneys (POAs) and Tax Information Authorizations (TIAs). The Tax Pro Account will essentially offer simplified digitalized versions of Form 2848, *Power of Attorney and Declaration of Representative*, and Form 8821, *Tax Information Authorization*.

When the tax professional completes and submits either a digitally initiated POA or TIA through the Tax Pro Account, an authorization will appear in the taxpayer's Online Account, where they can review, approve with electronic signature, or reject. A taxpayer's identity is verified at the time they log in to their Online Account, so they can simply check a box to complete their signature and submit the authorization to the IRS.

The new digital authorization process will be much faster, allowing manual processing to be bypassed, with most requests immediately recorded as approved authorizations in the taxpayer's Online Account and the tax professional's Tax Pro Account. The new digital authorization process is only available to individual taxpayers at this time.

In addition to allowing taxpayers to approve and electronically sign POAs and TIAs, an IRS Online Account provides additional benefits, including:

- Accessing tax records;
- Viewing balances and notices;
- Learning about payment plan options;
- Viewing and making payments;
- Opting out of paper notices; and
- Making profile updates.

Over time, additional functionality will be added for taxpayers and tax professionals that will increase the options for electronic interactions between taxpayers and the IRS.

¹ IR-2020-159.

II. COVID-19 Legislative Updates

Over the past year, significant legislation has been enacted to provide relief amidst the COVID-19 pandemic, including:

- *The Families First Coronavirus Response Act (FFCRA)*, March 2020
- *The Coronavirus Aid, Relief, and Economic Security (CARES) Act*, March 2020
- *The Consolidated Appropriations Act of 2021 (CAA 2021)*, December 2020
 - Note: *The COVID-related Tax Relief Act of 2020 (COVIDTRA)* was included in the CAA 2021
- *The American Rescue Plan Act (ARPA) of 2021*, March 2021

The FFCRA and CARES Act established many key provisions that provided economic relief during the COVID-19 pandemic, including FFCRA paid leave and credits, the Paycheck Protection Program, federal unemployment compensation, the Employee Retention Tax Credit, and economic impact payments. Throughout this section, we will discuss major individual and business provisions of each piece of legislation as well as any recent updates.

A. Individual provisions

1. Economic Impact Payments (Stimulus checks)

Many American workers experienced great economic hardship due to the COVID-19 pandemic. Republicans and Democrats made a bipartisan effort to ensure the “average” American worker received a “recovery rebate,” known as an “Economic Impact Payment,” to assist with financial hardships during the COVID-19 public health emergency.

The CARES Act established the first round of Economic Impact Payments for certain individuals.² All U.S. residents who were not a dependent of another taxpayer and had a work eligible Social Security number, were eligible for a first economic impact payment (EIP1) of up to \$1,200 (\$2,400 married filing joint). The rebate amount is reduced (but not below zero) by \$5 for each \$100, or 5%, that the taxpayer's AGI was in excess of:

- \$150,000 for married filing joint returns;
- \$112,500 for head of household returns;
- \$75,000 for all other taxpayers.

The stimulus was completely phased-out for taxpayers with AGI in excess of:

- \$198,000 for married filing joint with no qualifying children;
- \$146,500 for head of household with one child; and
- \$99,000 for single filers.

All taxpayers were required to provide a valid Social Security number for all individuals receiving the EIP1. In other words, a married couple with two children had to provide valid SSNs for both spouses as well as both children in order to receive the EIP1. All individuals with AGI below the threshold were eligible to receive the EIP1, even if they did not have income or had income entirely from non-taxable means-tested benefit programs, such as SSI. Most eligible taxpayers automatically received EIP1 from the IRS.

² CARES Act §2201.

If the taxpayer(s) had any children, they were eligible to receive an additional \$500 EIP1 per child. A qualifying child is a child of the taxpayer, as defined for purposes of the dependency exemption by Section 152(c), who has not attained age 17.

To the disappointment of many taxpayers and practitioners alike, the \$500 EIP1 per child only applied to the taxpayer's children under age 17. If a taxpayer's child was 17 or 18 years old, or a college student aged 19-23, the child is not a qualifying child for purposes of the EIP1, even if such child was a dependent of the taxpayer for tax purposes. Similarly, despite the fact that a taxpayer can claim certain adults as a dependent, such as an adult child or sibling with a disability, or an elderly parent, the taxpayer was not able to receive a \$500 EIP1 for such dependents. Nonresident aliens were ineligible for the EIP1. Estates and trusts were not eligible for the EIP1 either. If one spouse has an SSN, but the other spouse does not, the married couple was ineligible for the EIP1, unless at least one spouse was part of the military at any time during the tax year.

The taxpayer's 2019 return (if filed) or 2018 return was used for AGI threshold purposes when determining the amount of EIP1. As such, many low-income individuals who filed a tax return in order to receive the Earned Income Tax Credit and/or Child Tax Credit automatically received the EIP1 from the IRS.

If the taxpayer did not file either a 2019 or 2018 income tax return, the IRS may have used information provided on Form SSA-1099, *Social Security Benefit Statement*, or Form RRB-1099, *Social Security Equivalent Benefit Statement*, for the 2019 calendar year to calculate the amount of the EIP1.

The EIP1 was an advanced payment of the recovery rebate credit that was re-computed on the taxpayer's 2020 tax return. Even though the credit was technically applicable to the 2020 tax year, the IRS treated it as an overpayment for 2019 and accordingly paid it as soon as possible in 2020. Using the updated 2020 tax return data, the taxpayer re-computed his or her EIP1 and compared it to the amount he or she actually received. If the amount computed was *greater* than what the taxpayer received, he or she was able to receive an excess credit to reduce his or her 2020 tax liability. If the amount computed was *less* than what the taxpayer received, the taxpayer was not required to recognize the excess amount as income. Likewise, the taxpayer was not required to pay back the EIP1 if the recovery rebate credit amount that the taxpayer qualified for in 2020 was less than what the taxpayer received. This is because the 2020 credit cannot be reduced below zero.

An individual who was not eligible for the EIP1 based on 2019 tax return information could be an eligible individual based on 2020 tax return information due to a change in circumstances. For example, an individual could have been a dependent of another individual for the 2019 tax year but not a dependent for the 2020 tax year. In such a case, the individual would have been able to claim the credit when filing his or her income tax return for 2020.

If an advance rebate was made for a joint return, half of the rebate was treated as having been made or allowed to each spouse who filed the joint return. Thus, if taxpayers filed a joint return for 2019 and received an advance rebate, but were divorced or filed separate returns for 2020, each individual took into account half of the advance rebate when reducing the credit allowed for 2020.

Examples of First Round of CARES Act Economic Impact Payments:

Example 1: Tara and Joe are married with two children, aged 7 and 10. Tara and Joe filed a joint return for 2019 and had AGI of \$135,000.

Since Tara and Joe's AGI is beneath the \$150,000 threshold, they will receive a \$2,400 Economic Impact Payment. They will also receive a \$500 Economic Impact Payment for each of their two dependent children. In total, Tara and Joe will receive \$3,400 of Economic Impact Payments for 2019.

Example 2: Lily and Harry are married with two children, aged 18 and 24. Despite being legal adults, both of their children are students living at home and receive more than 50% of support from Lily and Harry. Lily and Harry filed a joint return for 2019 and had AGI of \$160,000.

Since Lily and Harry's AGI is above the \$150,000 threshold, but below the \$198,000 phase-out, they are eligible for a portion of the Economic Impact Payment. The Economic Impact Payment is reduced by 5% of their AGI in excess of \$150,000. Since their AGI exceeds \$150,000 by \$10,000, their Economic Impact Payment is reduced by 5% of \$10,000, or \$500.

Lily and Harry cannot receive an Economic Impact Payment for their children, as they are over the age of 17. It is irrelevant that they can be claimed as dependents on their parent's tax return.

Lily and Harry will receive an Economic Impact Payment of \$1,900.

Example 3: Adam is unmarried with no children. He is a successful entrepreneur and had an AGI of \$125,000 in 2019.

Since Adam's AGI surpassed the phase-out amount for single taxpayers of \$99,000, he will not receive an Economic Impact Payment.

Example 4: Henry received \$10,000 of SSI in 2018 but did not file a tax return in either 2018 or 2019, as his income was less than the standard deduction.

Henry will receive an Economic Impact Payment of \$1,200, because the IRS will see Henry's SSI on his SSA-1099.

COVIDTRA provided taxpayers with a second, albeit smaller, round of stimulus payments (EIP2). Single taxpayers with AGI of \$75,000 or less were eligible to receive a \$600 check, head of household filers with AGI of \$112,500 or less were eligible to receive a \$600 check, and married taxpayers filing joint returns (and surviving spouses) with AGI of \$150,000 or less were eligible to receive a \$1,200 check. Eligible taxpayers could receive an additional \$600 EIP2 per qualifying child. The eligibility criteria for a qualifying child are the same for EIP2 as EIP1. The EIP2 phases out at a rate of \$5 per \$100 of additional income starting at \$75,000 of modified adjusted gross income for single taxpayers, \$112,500 for head of household taxpayers, and \$150,000 for married filing jointly taxpayers.

The EIP2 was issued based on the information provided on the taxpayer's 2019 tax return. Taxpayers treated as providing returns through the non-filer portal during the first round of stimulus payments were eligible to receive the second round of stimulus payments. The Treasury Department issued advance payments for Social Security Old-Age, Survivors, and Disability Insurance beneficiaries, Supplemental Security Income recipients, Railroad Retirement Board beneficiaries, and Veterans Administration beneficiaries who did not file 2019 returns. The EIP2 for these individuals was based on information provided by the Social Security Administration, the Railroad Retirement Board, and the Veterans

Administration. Similar to the first round of stimulus payments, the second round of stimulus payments were an advanced payment of the 2020 recovery rebate credit. If the amount of the credit determined on the taxpayer's 2020 tax return exceeded the amount of the EIP2, the taxpayer could receive the difference as a refundable tax credit. If the amount of the stimulus payment exceeded the amount of the credit determined on the taxpayer's 2020 tax return, the taxpayer was not required to repay the excess payment.

COVIDTRA clarified that any individual who was deceased before January 1, 2020 was not eligible for the EIP2.

Example 1: Facts

In April 2020, Nathan, a single taxpayer, received an EIP1 in the amount of \$1,200. In January 2021, he received an EIP2 of \$600. Both EIP1 and EIP2 were based upon 2019 AGI amounting to \$60,000.

Nathan's AGI for 2020 amounts to \$75,000.

Conclusion and Analysis

Nathan is not entitled to an additional credit on his 2020 tax return, calculated as follows:

Credit calculated utilizing 2020 AGI	\$1,800
Amount of EIP received during 2020	<u>\$1,800</u>
Additional Credit Amount	\$ 0

Example 2: Facts

In April 2020, Mark, a single taxpayer, received an EIP1 in the amount of \$1,200. In January 2021, he received an EIP2 of \$600. Both EIP1 and EIP2 were based upon 2019 AGI amounting to \$75,000.

Mark's AGI for 2020 amounts to \$175,000.

Conclusion and Analysis

Mark is not entitled to an additional credit on his 2020 tax return, calculated as follows:

Credit calculated utilizing 2020 AGI	\$ 0
Amount of EIP received during 2020	<u>1,800</u>
(Excess) EIP	<u>\$(1,800)</u>
Additional Credit Amount	\$ 0

Note: Remember that there is no provision in either the CARES Act or Consolidated Appropriations Act of 2021 requiring repayment of an EIP.

On April 5, 2021, the IRS issued additional guidance regarding the recovery rebate credit claimed on taxpayers' 2020 federal tax returns.³ The IRS noted that if they process a taxpayer's return and determine that there is a mistake with the credit amount on Line 30 of Form 1040, the IRS will calculate the correct amount, make the correction, and continue processing the return. The IRS cautions that if a correction is needed, there may be a slight delay in processing the return, and the IRS will notify the taxpayer of any changes made. Common corrections that the IRS encounters include:

- The individual did not provide an SSN.
- The individual was claimed as a dependent on another taxpayer's 2020 tax return.

³ IR-2021-76.

- The qualifying child that was claimed for purposes of EIP1 or EIP2 was age 17 or older as of January 1, 2020.
- Various math errors related to calculating AGI and EIP1 or EIP2 amounts already received.

The IRS urges taxpayers not to file an amended return if they believe that they made a mistake in calculating their 2020 Recovery Rebate Credit, as the IRS will calculate the correct amount of the credit, make the correction, and continue processing the return. It is important to note that the IRS will **not** calculate the taxpayer's 2020 Recovery Rebate Credit if he or she did not enter any amount on his or her original return. If the taxpayer was eligible for a 2020 Recovery Rebate Credit but did not claim it on his or her 2020 tax return, he or she needs to file Form 1040-X in order to claim the credit. As discussed earlier, the taxpayer may be able to e-file Form 1040-X, provided the original Form 1040 was e-filed and other conditions are met.

ARPA provides eligible individuals with a third stimulus payment (EIP3). Taxpayers can receive an EIP3 of up to \$1,400, plus an additional \$1,400 per each qualifying dependent. Similar to the first (EIP1) and second round (EIP2) of economic impact payments provided by the CARES Act and Consolidated Appropriations Act of 2021, the ARPA recovery rebates are an advanced rebate payment of a 2021 credit. The 2021 EIP3 payment is based on the individual's eligibility had the credit been in effect for 2019. However, if the taxpayer already filed his or her 2020 tax return when the IRS determines the amount of the 2021 recovery rebate, the information on the 2020 tax return will be used to determine the amount of the 2021 recovery rebate. In other words, the 2021 recovery rebate will be treated as an overpayment for 2019 (or 2020, if the 2020 tax return was already filed), that the IRS will pay as soon as possible in 2021; however, no interest will be paid on the overpayment. If an individual has not filed a 2019 or 2020 tax return when the IRS determines the amount of the 2021 EIP3 recovery rebate, the IRS will determine the amount of the rebate using all information available, without regard to phaseout rules.

Under ARPA, dependency is defined under Section 152 for purposes of the dependency exemption. As such, qualifying children and qualifying relatives, including dependent college students, dependent disabled adult children, and dependent adult parents will qualify for the \$1,400 dependent payment. This is an important distinction from both EIP1 and EIP2 which did not allow such individuals to qualify for the additional dependent payment.

For purposes of the 2021 EIP3 payment, an eligible individual is any individual other than:

- A nonresident alien;
- An individual who is a dependent of another taxpayer for the tax year; or
- An estate or trust.

Children who are claimed as dependents by their parents, or who can be claimed as dependents by their parents, are not eligible individuals for purposes of the 2021 EIP3 payment. All individuals claiming the recovery rebate must have provided a valid SSN for both himself or herself, any spouse, and any dependent.

The 2021 EIP3 recovery rebate is reduced (but not below zero) for taxpayers with AGI over:

- \$150,000 for a joint return;
- \$112,500 for a head of household return; and
- \$ 75,000 for all other taxpayers.

The 2021 EIP3 recovery rebate is completely phased out for taxpayers with AGI over:

- \$160,000 for a joint return;
- \$120,000 for a head of household return; and
- \$ 80,000 for all other taxpayers.

The credit is not subject to reduction or offset for past-due support payments; debts owed to federal agencies; past-due, legally enforceable state income tax obligations or debts related to unemployment compensation.

Similar to the first and second round of economic impact payments provided by the CARES Act and Consolidated Appropriations Act of 2021, most individuals will not have to take any action in order to receive the EIP3 payment from the IRS. The IRS will automatically send the 2021 EIP3 recovery rebate to individuals who did not file a return but received Social Security retirement, SSDI benefits, Railroad Retirement benefits, SSI, or VA benefits. The IRS will attempt to electronically pay the recovery rebate credit when possible; however, no advance rebate will be made or allowed after December 31, 2021.

As previously discussed, the amount of EIP3 is generally based on the taxpayer's latest tax return filed, either 2019 or 2020. On April 6, 2021, the IRS announced that if the amount of EIP3 was calculated based on the taxpayer's 2019 tax return, they may qualify for a supplemental payment if the amount they received is less than the full amount to which they are entitled. After the IRS processes the taxpayer's 2020 tax return, they will automatically recalculate the taxpayer's EIP3 credit eligibility based on the new 2020 information. If the taxpayer is eligible for a larger payment, the IRS will issue a supplemental payment for the additional amount.

2. *Pandemic Emergency Unemployment Compensation program*

The CARES Act established a temporary *Pandemic Unemployment Assistance (PUA)* program through December 31, 2020 for workers affected by the COVID-19 pandemic who were ineligible for traditional unemployment benefits.⁴ This unemployment compensation was fully funded by the federal government. Eligible workers included, but were not limited to, self-employed individuals, independent contractors, and workers with limited work history. Employees who were able to telework with pay or receive some form of sick leave or other paid-leave benefits were ineligible for Pandemic Unemployment Assistance. In order to qualify for Pandemic Unemployment Assistance, individuals had to be unable to work due to a direct result of the COVID-19 public health emergency. Benefits were available not only to those who contracted the coronavirus themselves, but also to those who had to leave their jobs to provide full-time care to family and other relatives but did not have access to paid leave benefits. The CARES Act provided a temporary \$600 per week increase to each recipient of traditional unemployment insurance or Pandemic Unemployment Assistance for up to four months.⁵ Individuals already receiving unemployment compensation also received the \$600 monthly increase in benefits.

Effectively, eligible individuals received the sum of whatever benefit was provided at the state level plus an additional \$600 for up to four months. Unemployment benefits varied by state, as some only offered 12 weeks but others offered up to 26 weeks. Per Section 2107 of the CARES Act, unemployed individuals were able to receive an additional 13 weeks of unemployment benefits through December 31, 2020 if they remained unemployed after state unemployment benefits were no longer available.

⁴ CARES Act §2102.

⁵ CARES Act §2104.

COVIDTRA extended the PUA program and provided an additional \$300 of weekly benefits (half of the CARES Act \$600 weekly benefits) to recipients through March 14, 2021. Per COVIDTRA guidance, individuals could claim a maximum of 50 weeks of PUA benefits. Any individuals who did not claim the maximum number of weeks as of March 14, 2021, were eligible for an additional three-week “transition period” through April 5, 2021. Similar to the CARES Act, independent contractors, self-employed individuals, gig workers, and freelancers were eligible for the expanded Pandemic Unemployment Assistance program.

ARPA further extended the Pandemic Unemployment Assistance Program through September 6, 2021 and increased the total number of weeks of benefits available to individuals who are not able to return to work from 50 weeks to 79 weeks. ARPA also extends through September 6, 2021 the \$300 supplemental per week Federal Pandemic Unemployment Compensation (FPUC).

Unemployment compensation is fully taxable to recipients. Congress recognized that many individuals who were receiving unemployment compensation as a result of the COVID-19 pandemic may not have withheld enough income tax from their unemployment compensation throughout the year. As a result, these individuals could have been faced with a hefty tax bill during a time when they were struggling to make ends meet. As a result, ARPA partially excludes unemployment compensation received in 2020 from the income of some taxpayers.

Under ARPA, for tax year 2020, if the taxpayer’s AGI for the tax year is less than \$150,000, the taxpayer could exclude up to \$10,200 of unemployment compensation received (or in the case of a joint return, received by each spouse) from gross income. The same \$150,000 limit applied to returns filed jointly, as head of household, or with single status. In the case of a joint return, the \$10,200 exclusion applied separately to each spouse, meaning that each spouse was eligible for the \$10,200 exclusion, for a total maximum of \$20,400. There was no income phase-out provided for the exclusion, so if the taxpayer’s AGI exceeded \$150,000, the exclusion would not apply, and all of the individual’s unemployment compensation would be included in gross income.

For purposes of determining the partial exclusion, the taxpayer’s AGI is determined after the application of the partial exclusion of Social Security and tier 1 railroad retirement benefits in gross income, exclusion of income from United States savings bonds used to pay higher education tuition and fees, exclusion of any amount received under an adoption assistance program, the deduction for qualified retirement contributions, the student loan deduction, the deduction for qualified tuition and related expenses, the limitation on passive activity losses and credits, and without regard to the inclusion of unemployment compensation in AGI.

In March 2021, the IRS released instructions on their website regarding how to take advantage of the new unemployment compensation exclusion. Per the updated IRS guidance, taxpayers should report any Form 1099-G box 1 unemployment compensation amounts on line 7 of Schedule 1, Form 1040. On line 8 of Schedule 1, Form 1040, the taxpayer should write “UCE” and report the exclusion amount as a negative amount (in parenthesis). As part of the IRS guidance, the IRS released a new “Unemployment Compensation Exclusion Worksheet” (below) to assist taxpayers in calculating the amount they are eligible to exclude. In other words, the taxpayer should transfer step 11 of the Unemployment Compensation Exclusion Worksheet to Form 1040, Schedule 1, Line 8.

Example: Doug and Carrie are married and file a joint tax return. Their modified AGI is \$115,000 for tax year 2020. Doug received \$15,000 of unemployment compensation and Carrie received \$7,000 of unemployment compensation in 2020. Doug and Carrie must report the \$22,000 of unemployment compensation received on line 7 of Schedule 1, Form 1040. On line 8 of Form 1040, Doug and Carrie should report \$17,200 as a negative amount (in parenthesis). The \$17,200 represents the full \$10,200 exclusion amount for Doug and the entire \$7,000 excludable amount for Carrie, as each are entitled to exclude up to a maximum of \$10,200 of unemployment compensation received in 2020.

Unemployment Compensation Exclusion Worksheet – Schedule 1, Line 8

1. If you are filing Form 1040 or 1040-SR, enter the total of lines 1 through 7 of Form 1040 or 1040-SR. If you are filing Form 1040-NR, enter the total of lines 1a, 1b, and lines 2 through 7.
2. Enter the amount from Schedule 1, lines 1 through 6. Don't include any amount of unemployment compensation from Schedule 1, line 7 on this line.
3. Use the line 8 instructions to determine the amount to include on Schedule 1, line 8, and enter here. Do not reduce this amount by the amount of unemployment compensation you may be able to exclude.
4. Add lines 1, 2, and 3.
5. If you are filing Form 1040 or 1040-SR, enter the amount from line 10c. If you are filing Form 1040-NR, enter the amount from line 10d.
6. Subtract line 5 from line 4. This is your modified adjusted gross income.
7. Is the amount on line 6 \$150,000 or more?
 - a. ☐ Yes. Stop You can't exclude any of your employment compensation
 - b. ☐ No. Go to line 8
8. Enter the amount of unemployment compensation paid to you in 2020. Don't enter more than \$10,200.
9. If married filing jointly, enter the amount of unemployment compensation paid to your spouse in 2020. Don't enter more than \$10,200. If you are filing Form 1040-NR, enter -0- .
10. Add lines 8 and 9 and enter the amount here. This is the amount of unemployment compensation excluded from your income.
11. Subtract line 10 from line 3 and enter the amount on Schedule 1, line 8. If the result is less than zero, enter it in parentheses. On the dotted line next to Schedule 1, line 8, enter "UCE" and show the amount of unemployment compensation exclusion in parentheses on the dotted line. Complete the rest of Schedule 1 and Form 1040, 1040-SR, or 1040-NR.

This provision applies to tax years beginning after December 31, 2019 for tax years beginning in 2020.

Planning Point

Taxpayers and practitioners alike were concerned that if they already filed a 2020 income tax return and paid taxes on unemployment compensation that is now excludable from income, they would have to file an amended tax return in order to receive a refund. On March 18, 2020, IRS Commissioner Chuck Rettig stated that such taxpayers should **not** file an amended return, as the IRS planned to automatically issue refunds associated with the unemployment compensation exclusion. This announcement comes as a relief to many who already filed tax returns prior to when ARPA was signed into law.

On March 31, 2021, the IRS released IR-2021-71, stating that the IRS would recalculate taxes on unemployment benefits for those who already filed their 2020 tax return. The IRS noted that they will determine the correct taxable amount of unemployment compensation for any taxpayers who have already filed their returns and calculated their tax liability based on the full amount of unemployment compensation. Any overpayment will either be refunded or applied to outstanding tax owed. The IRS noted that the recalculation would take place in two phases. First, the IRS will review returns of taxpayers eligible for the up to \$10,200 exclusion. Next, the IRS will review returns for married filing jointly taxpayers who are eligible for the up to \$20,400 exclusion. The first refunds became available starting in May and will continue throughout the summer of 2021.

While the IRS will automatically recalculate taxes based on unemployment benefits, taxpayers may consider filing an amended return if doing so would make them eligible for certain credits or deductions. For example, certain taxpayers who filed their returns prior to ARPA may have been ineligible for the EITC due to their income level. If the recalculation of unemployment compensation benefits changed the taxpayer's income level, he or she may subsequently become eligible for the EITC. It is important for taxpayers and practitioners to review both federal and state returns to determine whether filing an amended return would be beneficial.

Thinking Ahead

Although ARPA made up to \$10,200 of unemployment compensation excludable from income for certain taxpayers, this provision was only in effect for tax year 2020. As the COVID-19 pandemic persists throughout 2021, some taxpayers may continue to receive extended unemployment compensation under ARPA. It would be wise for such taxpayers to withhold taxes from benefits received in 2021 to help avoid owing taxes when they file their 2021 tax return. Federal law allows all recipients to choose to have a flat 10 percent withheld from their benefits to cover part or all of their tax liability. Recipients must fill out Form W-4V, *Voluntary Withholding Request*, and provide it to the agency paying the benefits if they wish to withhold federal tax from their benefits. It is possible that future legislation may allow taxpayers to exclude a similar amount of benefits from their 2021 tax returns, but to err on the side of caution, it is best to withhold taxes to help prevent any surprises when the 2021 federal tax return is due.

Recent Updates

While ARPA provides extended pandemic unemployment compensation benefits through September 6, 2021, the following states announced that they are no longer providing PUA and PEUC:

- Alabama
- Alaska
- Arkansas
- Georgia
- Idaho
- Indiana
- Iowa
- Louisiana (announced benefits will end at the end of July 2021)
- Mississippi

- Missouri
- Montana
- Nebraska
- New Hampshire
- North Dakota
- Oklahoma
- South Carolina
- South Dakota
- Tennessee
- Texas
- Utah
- West Virginia
- Wyoming

As a result, individuals in such states could lose the additional \$300 per week federal supplemental payment. Individuals not typically eligible for unemployment compensation, including gig workers, would also lose benefits they previously received through the PUA program. Regular state unemployment benefits are not impacted by the change.

Although these states ceased the PUA and PEUC programs, some states announced incentive programs to encourage individuals to return to work. For example, Oklahoma announced that a \$1,200 “Return to Work Incentive” is available to the first 20,000 Oklahomans receiving unemployment benefits who return to work. New Hampshire offers a similar incentive of \$1,000 to unemployed persons who return to work for at least eight weeks. Many of these state government return-to-work incentive programs are offered on a first-come, first-serve basis.

3. Child Tax Credit expansion

Prior to ARPA, certain taxpayers were eligible to receive a child tax credit (CTC) of \$2,000 per qualifying child. For purposes of determining the credit, a qualifying child must meet all of the following conditions:

- The child is the taxpayer’s son, daughter, stepchild, eligible foster child, brother, sister, stepbrother, stepsister, half brother, half sister, or a descendant of any of them (for example, the taxpayer’s grandchild, niece, or nephew).
- The child was under age 17 at the end of 2020.
- The child did not provide over half of his or her own support for 2020.
- The child lived with the taxpayer for more than half of 2020.
- The child is claimed as a dependent on the taxpayer’s return.
- The child does not file a joint return for the year (or files it only to claim a refund of withheld income tax or estimated tax paid).
- The child was a U.S. citizen, U.S. national, or U.S. resident alien.

Prior to ARPA, the \$2,000 CTC was phased out for taxpayers with modified AGI in excess of \$400,000 for joint filers and \$200,000 for all other filers. The \$2,000 CTC was partially refundable to the extent of 15% of the taxpayer’s earned income exceeding \$2,500. As such, the maximum refundable portion of the credit was \$1,400.

ARPA temporarily amends the CTC for tax year 2021 as follows:

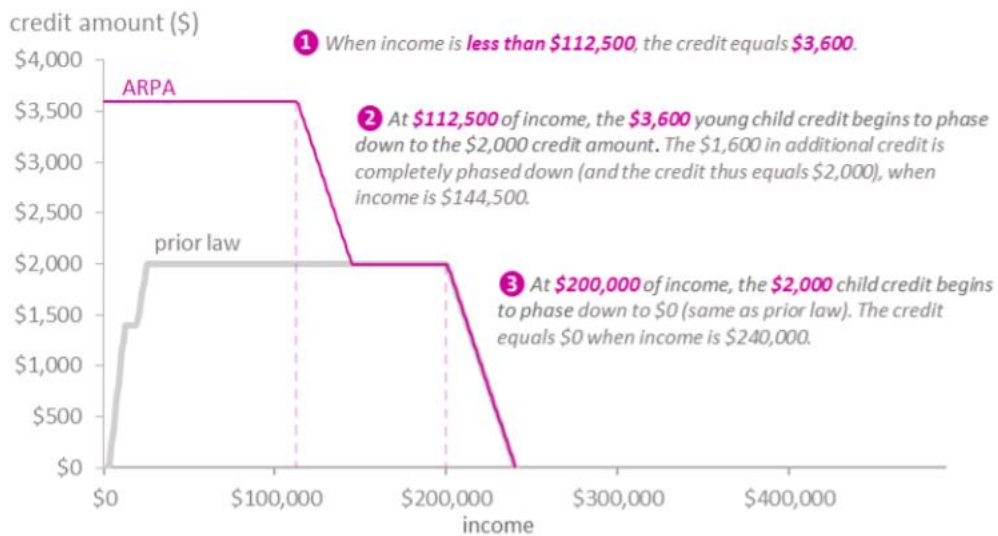
- **Expanded Eligibility:** For tax year 2021, the CTC expands the definition of a qualifying child to include a child who has not turned age 18 by the end of 2021, meaning 17-year-old children are qualifying children for purposes of the CTC in the 2021 tax year.
- **Increased Credit Amount:** ARPA increases the CTC to \$3,000 per child, or \$3,600 for children under age 6 as of the end of the tax year. A phaseout applies to the temporarily increased amounts for 2021, meaning the \$1,600 amount per child under age 6 (\$3,600 increased CTC amount in 2021 less \$2,000 “normal” CTC amount), or the \$1,000 amount per child age 6 or older (\$3,000 increased CTC amount in 2021 less \$2,000 “normal” CTC amount). The increased CTC is phased out at a rate of \$50 for each \$1,000 of modified AGI over the threshold as follows:
 - At modified AGI over \$75,000 for single filers;
 - At modified AGI over \$112,500 for head of household filers; and
 - At modified AGI over \$150,000 for married filing joint filers and surviving spouse filers.

As a result, the CTC is subject to two sets of phaseout rules for the 2021 tax year. A taxpayer eligible for the temporary increase in CTC first applies the phaseout rules above, and then applies the phaseout rules under existing law (modified AGI in excess of \$400,000 for joint filers and \$200,000 for all other filers). If a taxpayer is ineligible to claim an increased CTC in 2021, he or she can claim a regular CTC of up to \$2,000 subject to the existing law phaseout rules.

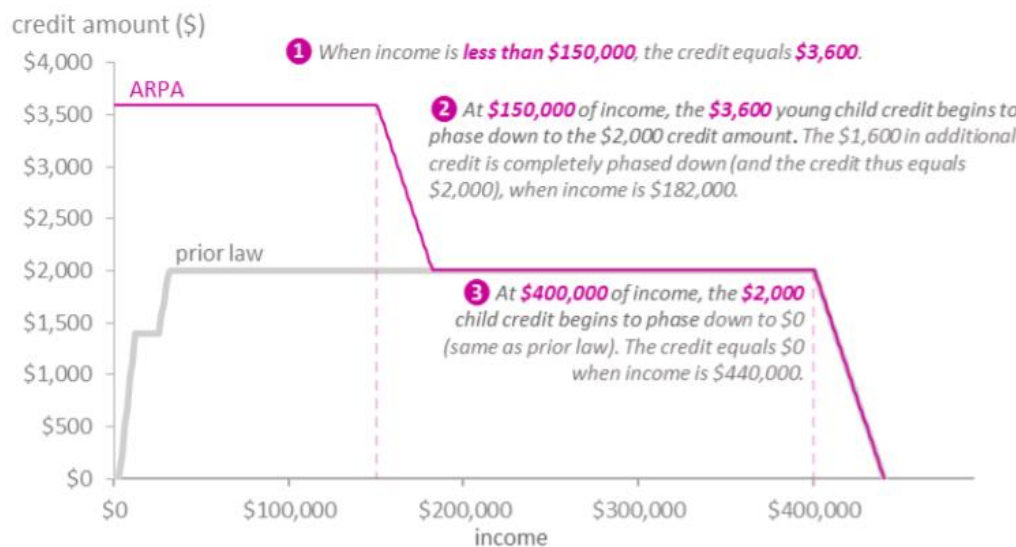
Child Credit Amount for One Young Child (0-5 Years Old) for 2021

Prior Law and the American Rescue Plan Act of 2021 (ARPA; P.L. 117-2)

Unmarried Taxpayer

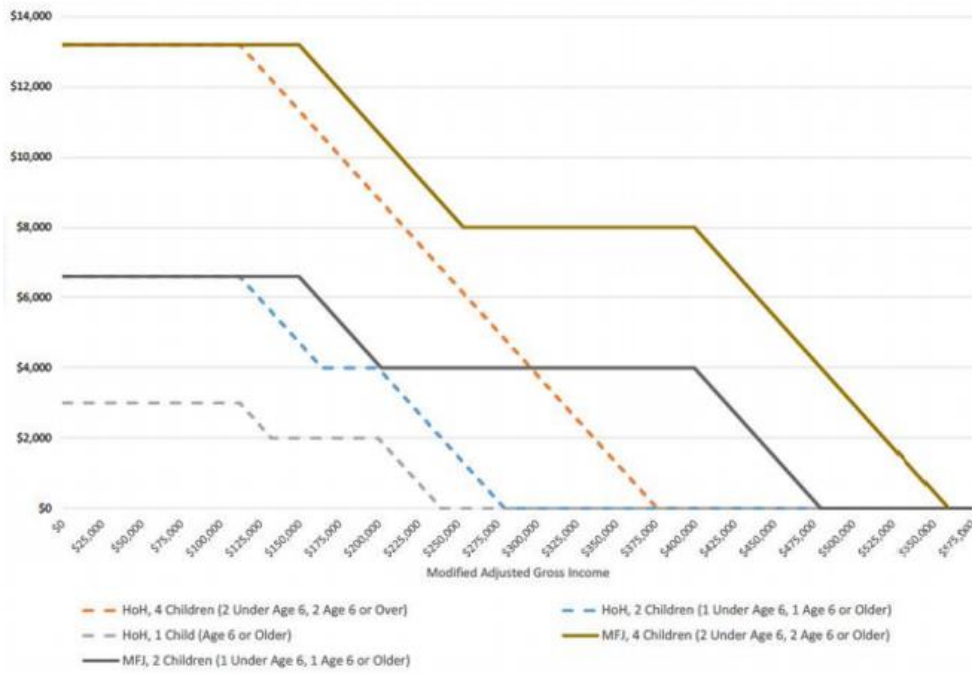


Married Taxpayer



⁶ Congressional Research Service. "The Child Tax Credit: Temporary Expansion for 2021 Under the American Rescue Plan Act of 2021 (ARPA; P.L. 117-2)".

2021 CTC by Modified AGI for Selected Filers



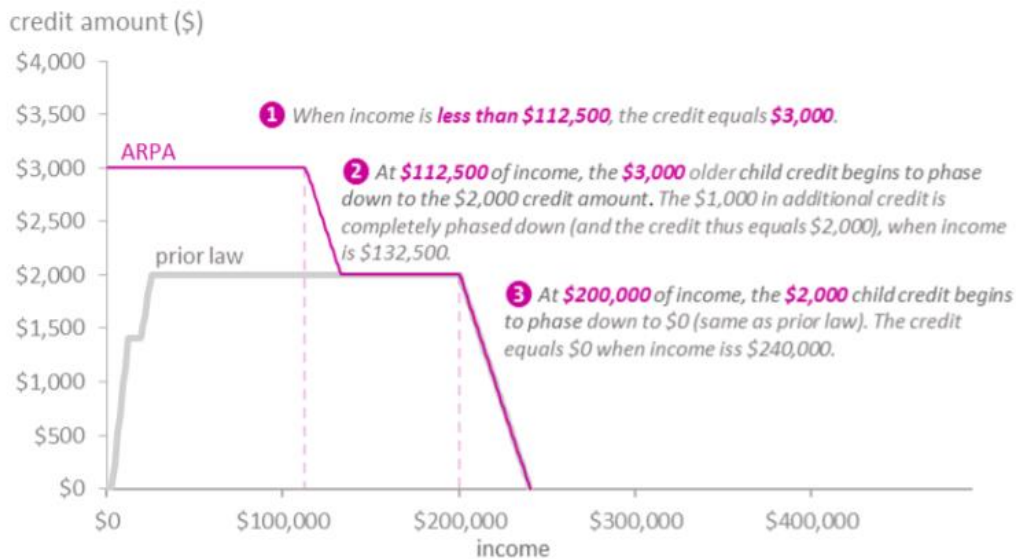
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⁷ Joint Committee on Taxation. "Overview of the Federal Tax System as in Effect for 2021" JCX-18-21, April 15, 2021.

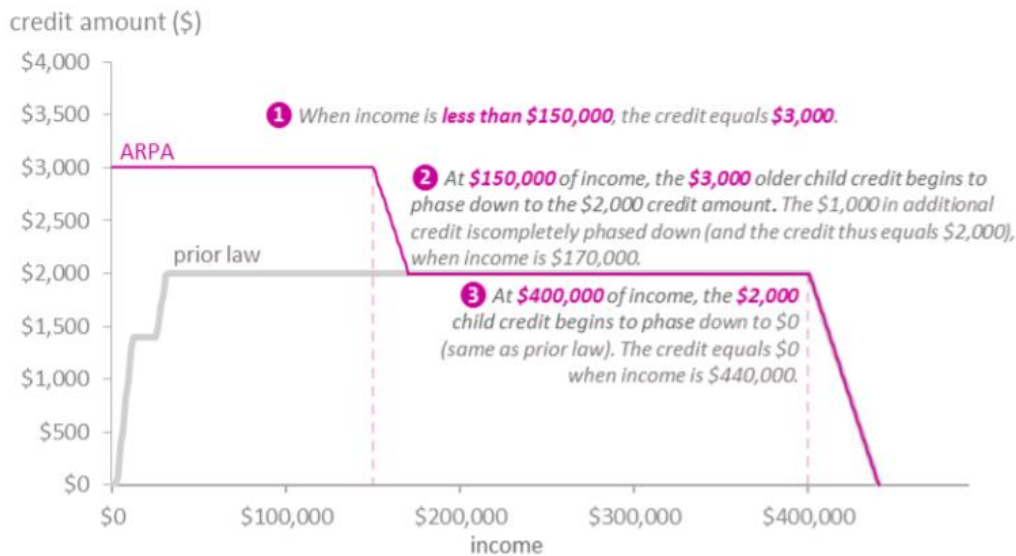
Child Credit Amount for One Older Child (6-17 Years Old) for 2021

Prior Law and the American Rescue Plan Act of 2021 (ARPA; P.L. 117-2)

Unmarried Taxpayer



Married Taxpayer



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Example 1: Julian has sole custody of his ten-year-old son, Eric, and files as head of household. Julian's modified AGI is \$150,000 in 2021. Julian qualifies for the increased CTC credit of \$3,000; however, the increased portion of Julian's CTC (\$1,000) is completely phased out ($(\$150,000 \text{ modified AGI less } \$112,500 \text{ threshold} / 1,000) \text{ multiplied by } 50 \text{ equals a } \$1,875 \text{ reduction in credit, which is limited to a reduction equal to the } \$1,000 \text{ increased amount}$). Under existing CTC phaseout rules, Julian's remaining \$2,000 is not reduced, since his modified AGI

⁸ Congressional Research Service. "The Child Tax Credit: Temporary Expansion for 2021 Under the American Rescue Plan Act of 2021 (ARPA; P.L. 117-2)".

is less than the \$200,000 phaseout threshold. As a result, Julian can claim a \$2,000 CTC in 2021.

Example 2: Rhonda and Sean have a three-year-old daughter, Chloe. Rhonda and Sean file a joint tax return in 2021 and have modified AGI of \$160,000. Since their modified AGI is \$10,000 above the \$150,000 AGI phaseout threshold for the increased CTC, their credit is reduced by \$500 $((\$160,000 - \$150,000) / 1,000) * 50 = \$500$. Rhonda and Sean's CTC for 2021 will be \$3,100 (\$3,600 increased CTC less \$500 credit reduction amount).

Example 3: Aaron and Liz have an eight-year-old son, Kyle. Aaron and Liz file a joint tax return in 2021 and have modified AGI of \$415,000. Due to their income, Aaron and Liz do not qualify for the additional \$1,000 CTC amount provided under ARPA (first phaseout rule). However, Aaron and Liz qualify for a reduced CTC based on the second phaseout rule. Their AGI is \$15,000 above the \$400,000 limit, reducing the CTC by \$750 $((\$415,000 - \$400,000) / 1,000) * 50 = \$750$. Aaron and Liz's CTC for 2021 is \$1,250 (\$2,000 CTC less \$750 credit reduction amount).

- **Refundability:** As mentioned above, under existing law, the \$2,000 CTC was partially refundable to the extent of 15% of the taxpayer's earned income exceeding \$2,500. As such, the maximum refundable portion of the credit was \$1,400 under existing law. ARPA makes the CTC fully refundable in 2021 for a taxpayer with a principal place of abode in the U.S. for more than one-half of the tax year, or for a taxpayer who is a bona fide resident of Puerto Rico for the tax year. The refundability is determined without regard to earned income, meaning the \$2,500 earned income requirement does not apply in 2021. The partial \$500 CTC for dependents other than qualifying children remains nonrefundable.
- **Advanced Payments:** ARPA directed the IRS to establish a program to make monthly, periodic advanced payments starting July 15, 2021, through December 2021. In total, the advanced payments should equal 50% of the IRS estimate of the eligible taxpayer's 2021 CTC. The IRS estimate is to be based on the taxpayer's "reference year," meaning either 2019 or 2020 tax return information (if filed). If paid on a monthly basis, each payment would represent one-twelfth of an annual advance amount for the calendar year. If the IRS determines that it is unable to deliver the payments on a monthly basis, it will issue the payments as frequently as possible.

Example: Anne is eligible for a \$6,000 CTC for 2021 based on her two qualifying children, Robbie, age 8, and Nicholas, age 12. The IRS would make a total of \$3,000 in advance payments to Anne from July through December 2021. If paid on a monthly basis, Anne would receive \$250 per child. However, if the IRS determined that it was feasible to make a payment every two months, each advance payment would total \$500 per child. In either situation, Anne would claim the additional \$3,000 of the \$6,000 CTC on her 2021 tax return.

The taxpayer's CTC claimed on the 2021 tax return is reduced by the aggregate of advance payments paid by the IRS. If a taxpayer receives advance CTC payments from the IRS in excess

of the allowable CTC for the 2021 tax year, the taxpayer generally must repay the excess amounts on his or her 2021 tax return by increasing his or her tax liability. However, if the taxpayer's modified AGI is below certain threshold amounts, the payments received in excess of the allowable CTC may be reduced by a full repayment protection amount of \$2,000. The income threshold amounts are as follows:

- \$40,000 for Single filers;
- \$50,000 for Head of Household filers; and
- \$60,000 for Married Filing Jointly filers.

The full repayment protection amount is equal to \$2,000, multiplied by the number of qualifying children that the IRS took into account in determining the IRS's initial estimate of the taxpayer's advance CTC payments, less the number of qualifying children properly taken into account in determining the allowed CTC amount on the 2021 tax return.

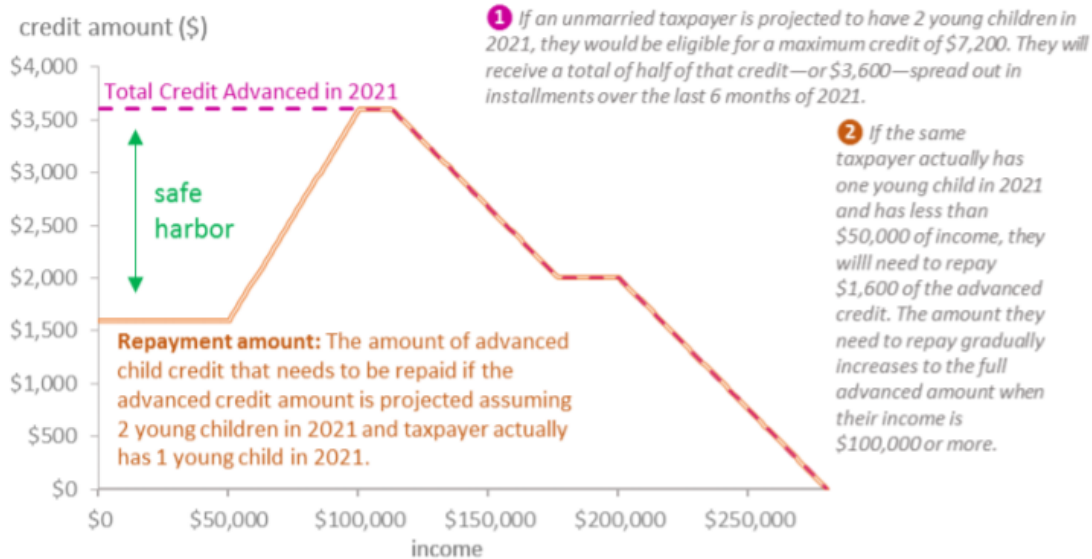
This safe harbor full repayment protection amount limits the amount by which the taxpayer would have to increase his or her tax liability and allows the taxpayer to keep a portion of the excess CTC payment. As such, taxpayers with income below the threshold amounts above are protected from repaying up to \$2,000 in overpayments per child that were incorrectly claimed. This repayment protection amount decreases to \$0 as the taxpayer's income rises to double the threshold amount. Additionally, if taxpayers received an overpayment of the CTC due to a child for whom the advance was paid in 2021, when in fact the child was no longer that taxpayer's dependent, there is no requirement to repay the payment to the IRS.

In January 2022, the IRS will send Letter 6419 to taxpayers. This letter will provide the total amount of advance CTC payments that were distributed to the taxpayer during 2021. Taxpayers should keep this letter with their records in order to reconcile their advance CTC payments with the CTC they claim on their 2021 tax return. As discussed, the advance CTC only covers half of the total 2021 CTC, so Letter 6419 will be used to calculate any remaining CTC amount due on the taxpayer's 2021 Form 1040.

Repayment of Advanced Child Credit for Children Incorrectly Claimed Under the American Rescue Plan Act of 2021 (ARPA; P.L. 117-2)

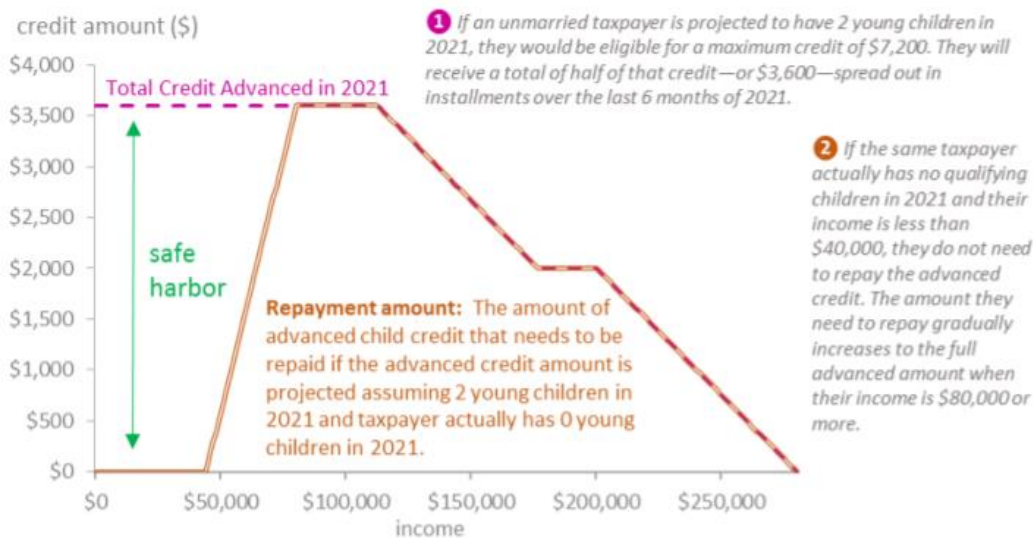
Unmarried Taxpayer, 2021

Advanced: 2 Young Children → Actual: 1 Young Child



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Advanced: 2 Young Children → Actual: 0 Young Children



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Per IRS guidance, advance CTC payments may not be counted as income for purposes of determining whether a taxpayer is eligible for benefits assistance under any federal program, or any state or local program financed in whole or in part with federal funds. Advance CTC payments will not be offset for overdue taxes from previous years, federal or state debts, or past-

⁹ Congressional Research Service. "The Child Tax Credit: Temporary Expansion for 2021 Under the American Rescue Plan Act of 2021 (ARPA; P.L. 117-2)".

¹⁰ Congressional Research Service. "The Child Tax Credit: Temporary Expansion for 2021 Under the American Rescue Plan Act of 2021 (ARPA; P.L. 117-2)".

due child support. However, advance CTC payments are subject to garnishment by state, local government, and private creditors.

- **Online Child Tax Credit Update Portal:** To assist with the administration of the advance CTC payments, ARPA directed the IRS to create an online portal, known as the Child Tax Credit Update Portal, which allowed taxpayers to:
 - **Elect out of advanced monthly payments.**
 - **Update information** relevant to calculating the CTC, such as changing the number of qualifying children, changing the taxpayer's filing or marital status, changing the taxpayer's income, managing bank account information, and any other factors as determined by the IRS. It is important to note that the IRS will issue payments to the bank account that was listed on the taxpayer's 2019 or 2020 tax return, or an account known to the federal government, such as an account where Social Security benefits are deposited. If the taxpayer wishes to change the bank account information, he or she may do so by using the Child Tax Credit Update Portal. On August 20, 2021, the IRS launched a new feature allowing taxpayers to update their mailing address through the Child Tax Credit Update Portal.¹¹ In order for the address change to be effective for the September 15, 2021, payment date, the taxpayer must complete the address change request before midnight EST on August 30, 2021. The new mailing address will be used in all future IRS correspondence, including Letter 6419, a year-end summary statement that will be used in completing the taxpayer's 2021 Form 1040.
 - **View payment history**, including payment dates and amounts.

On September 1, 2021, a new online tool called the "GetCTC Portal" was launched by Code for America Labs Inc. in collaboration with the U.S. Department of Treasury and the Biden administration. The new GetCTC Portal improved upon the shortcomings of the IRS Online Child Tax Credit Update Portal by offering additional features such as mobile device access and multilingual (English/Spanish) capabilities. These features are not offered through the IRS Online Child Tax Credit Update Portal. Code for America has attempted to increase awareness about the new advance Child Tax Credit by hosting webinars and providing outreach materials. The new Code for America GetCTC Portal tool is available at www.GetCTC.org; however, the IRS Online Child Tax Credit Update Portal remains available for use on the IRS webpage.

In June 2021, the IRS began sending Letter 6417 to taxpayers eligible to receive advanced CTC payments. This letter informs the taxpayer of the amount of his or her estimated CTC monthly payment. Taxpayers may opt to elect out of monthly payments if they prefer to claim the full credit on their 2021 tax return, or if they know they are no longer eligible for the credit because of a change in situation during 2021. Taxpayers must unenroll by the unenrollment deadline shown below:

¹¹ IR-2021-171.

Payment Month	Unenrollment Deadline	Payment Date
July	6/28/2021	7/15/2021
August	8/2/2021	8/13/2021
September	8/30/2021	9/15/2021
October	10/4/2021	10/15/2021
November	11/1/2021	11/15/2021
December	11/29/2021	12/15/2021

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Taxpayers are not required to unenroll each month. It takes the IRS up to seven calendar days to process a taxpayer's unenrollment. Unenrollment applies on an individual basis, meaning if a taxpayer unenrolls but his or her spouse does not unenroll, they will receive half of the joint payment they were supposed to receive. There is no option to re-enroll at this time.

On July 15, 2021, the IRS and the Treasury Department began sending electronic and paper advanced CTC payments. According to an IRS release, the first batch of \$15 billion advance monthly payments was sent to 35 million families, with 86% of the payments sent by direct deposit.¹³ Taxpayers with children under age 6 are eligible for up to \$300 per month per child, and taxpayers with children ages 6 through 17 are eligible for up to \$250 per month per child. Payments were based on either 2019 or 2020 income tax return data, provided the 2020 income tax return was filed by June 28, 2020. Per a September 2021 statement by the Department of Treasury, eligible individuals that did not sign up in time to receive the first round of the advance CTC may be eligible to receive increased monthly payments ("catch-up payments") for the previous months they were eligible for the advance CTC but did not receive any payment.

The advance CTC payments will occur on the 15th of each month for the rest of 2021 unless the taxpayer elects to unenroll. Taxpayers who receive an advance child tax credit and wish to return the payment may follow the following instructions:

- **Payment Received by Paper Check:** If a taxpayer received the advance CTC by paper check, he or she should write "void" in the endorsement section on the back of the check, include a brief explanation for why the check is being returned, and mail the check and explanation to the appropriate IRS location.
- **Payment Received by Direct Deposit or Cashed Paper Check:** If a taxpayer received the advanced CTC by direct deposit or cashed a payment received by paper check, he or she should submit a personal check or money order to the appropriate IRS location. The taxpayer should make the check payable to "U.S. Treasury," write "2021 advance CTC" and include his or her SSN or TIN and include a brief explanation for why the check is being returned.

¹² IRS FAQ – 2021 Child Tax Credit and Advance Child Tax Credit Payments – Topic J: Unenrolling from Advance Payments – Question # J2.

¹³ IR-2021-153.

Individuals who believe that they qualify for advance CTC payments should check the Child Tax Credit Update Portal to determine their eligibility. Certain individuals may have a “pending” eligibility status, meaning that the IRS is still determining whether the individual is eligible for advance CTC payments. The advance CTC will only be issued once the IRS confirms the individual’s eligibility. Additionally, individuals should make sure that their mailing address and bank account information is up to date.

If the IRS issued a payment but the individual did not receive the payment, they may file Form 3911, *Taxpayer Statement Regarding Refund*, to request a payment trace to track the payment.

4. Earned Income Tax Credit expansion

Existing tax law provides an earned income tax credit (EITC) for low- and moderate-income taxpayers. One of the key benefits of the EITC is that it is refundable in the event it exceeds the taxpayer’s tax liability. The EITC is calculated based on a percentage of the individual’s earned income amount for the tax year, provided it does not exceed the earned income amount. The amount of the EITC for any taxpayer may not exceed the excess (if any) of:

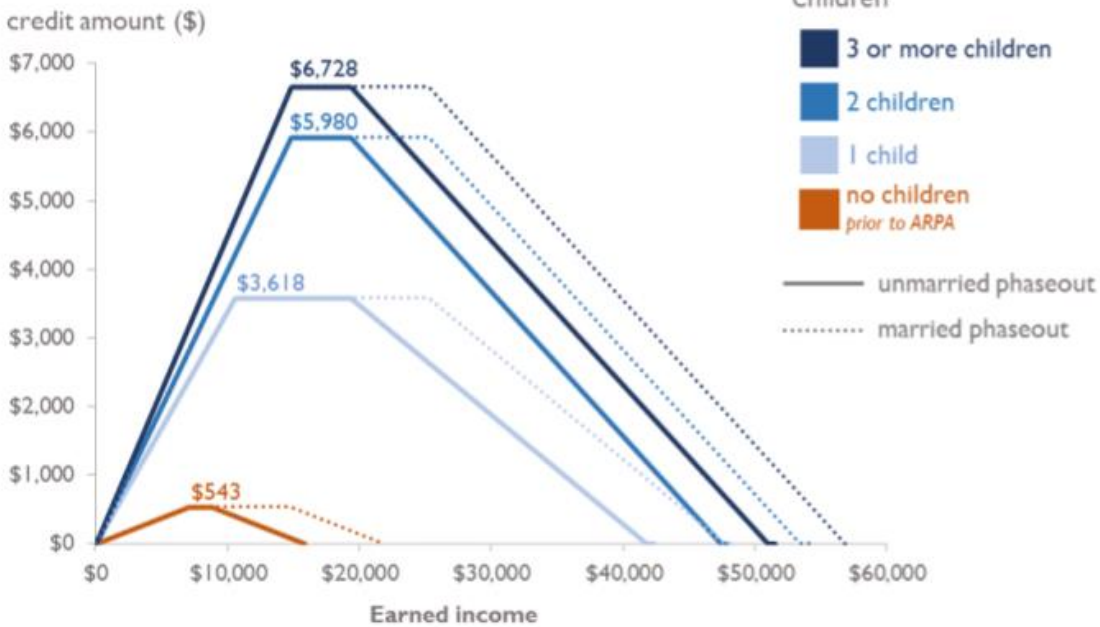
- The credit percentage of the earned income amount, over
- The phaseout percentage of so much of the adjusted gross income (or, if greater, the earned income) of the taxpayer for the tax year as exceeds the phaseout amount.

Additionally, prior to ARPA, taxpayers were generally required to meet the following requirements to be eligible for the EITC:

- **Rules for all taxpayers:**
 - AGI or earned income must be less than the 2021 threshold amounts:
 - \$51,464 (\$57,414 for married filing jointly) with three or more qualifying children.
 - \$47,915 (\$53,865 for married filing jointly) with two qualifying children.
 - \$42,158 (\$48,108 for married filing jointly) with one qualifying child.
 - \$15,980 (\$21,920 for married filing jointly) with no qualifying children.
 - The taxpayer must have a valid SSN by the due date of the return (including extensions).
 - The taxpayer cannot use the married filing separately filing status.
 - The taxpayer must be a U.S. citizen or resident alien for the entire tax year.
 - The taxpayer cannot file Form 2555, *Foreign Earned Income*.
 - The taxpayer’s investment income must be \$3,650 or less.
 - The taxpayer must have earned income.
- **Rules for taxpayers with a qualifying child:**
 - The taxpayer’s child must meet the relationship, age, residency, and joint return tests.
 - The taxpayer’s qualifying child cannot be used by more than one person to claim the EITC.
 - The taxpayer cannot be a qualifying child of another person.
 - The taxpayer must provide the qualifying child’s name, age, and taxpayer identification number.
- **Rules for taxpayers without a qualifying child:**
 - The taxpayer must be at least age 25 but under age 65.
 - The taxpayer cannot be a dependent of another person.
 - The taxpayer cannot be a qualifying child of another person.

- The taxpayer must have lived in the United States for more than half of the year.

EITC Amount by Income for 2021

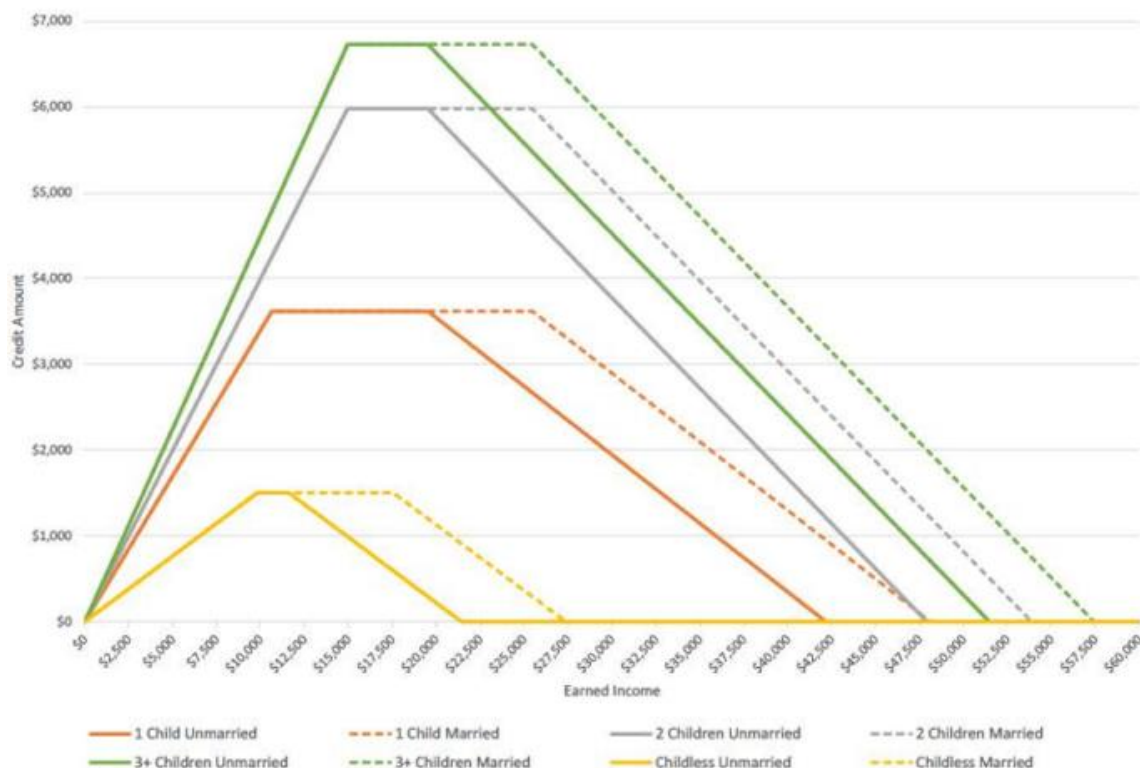


Source: CRS calculations based on IRC §32 and IRS Revenue Procedure 20-45.

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¹⁴ Congressional Research Service. "The "Childless" EITC: Temporary Expansion for 2021 under the American Rescue Plan Act of 2021 (ARPA; P.L. 117-2)".

2021 EITC by Earned Income



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ARPA institutes a variety of changes to the EITC, including:

- Age Requirement:** ARPA reduces the applicable minimum age for the credit from 25 years old to 19 years old, unless the individual is a specified student or qualified former foster youth or qualified homeless youth. If the individual is a specified student, the applicable minimum age for purposes of the EITC is 24 years old. If the individual is a qualified foster youth or qualified homeless youth, the applicable minimum age for purposes of the EITC is 24 years old. ARPA also eliminates the maximum age limit of 65, meaning there is no maximum age limit in 2021 for purposes of claiming the EITC.
- Increase in the Childless EITC Amount:** ARPA makes the following changes to the childless EITC amount for the 2021 tax year:
 - Raises the credit percentage and phaseout percentage from 7.65% to 15.3%.
 - Raises the income at which the maximum EITC is reached to \$9,820.
 - Raises the income at which phaseout begins from \$8,880 to \$11,610 for Single, Head of Household, or Surviving Spouse filers (filers other than married filing jointly filers).
 - Raises the income at which phaseout begins from \$14,820 to \$17,550 for married filers.

As a result of these changes, the maximum “childless” EITC amount in 2021 is increased from \$543 to \$1,502.

"Childless" EITC Amount by Income for 2021

Prior Law and American Rescue Plan Act of 2021 (ARPA; P.L. 117-2)

credit amount (\$)



Source: CRS calculations based on IRC §32, IRS Revenue Procedure 20-45, and P.L. 117-2.

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- Identification Requirement:** Prior to ARPA, a taxpayer was required to provide a qualifying child's name, age, and taxpayer identification number in order to claim the qualifying child when determining the amount of the EITC. If the taxpayer was unable to provide the qualifying child's name, age, and taxpayer identification number, he or she was ineligible to claim the EITC as an eligible individual with no qualifying children. ARPA removes this requirement and allows an eligible individual who has qualifying children, but cannot provide the necessary identification for such children, to claim the EITC as an eligible individual with no qualifying children. This provision is effective for tax years beginning after December 31, 2020.
- Investment Income Requirement:** For purposes of the EITC, certain types of "disqualified income" may cause an individual to be ineligible for the EITC. Disqualified income consists of certain types of investment income, including dividends, royalties and rental income from personal property, capital gain net income, certain passive activities, and interest income. Prior to ARPA, individuals who had disqualified investment income over \$3,650 per year were unable to claim the EITC. ARPA raises the disqualified investment income amount from \$3,650 to \$10,000. Similar to prior law, the new ARPA amount will be indexed for inflation for tax years beginning after 2021. This provision is effective for tax years beginning after December 31, 2020.
- Filing Status Requirement:** Prior to ARPA, married taxpayers were required to file a joint return in order to claim the EITC. Married individuals were not permitted to file separate returns. ARPA loosens this restriction and creates new code §32(d)(2)(A) which states that an individual will not be treated as married for EIC purposes if the individual is:
 - Married under §7703(a);
 - Does not file a joint return for the tax year;
 - Lives with his or her qualifying child for more than half of the tax year; and,

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Congressional Research Service. "The "Childless" EITC: Temporary Expansion for 2021 under the American Rescue Plan Act of 2021 (ARPA; P.L. 117-2)".

- Either:
 - During the last six months of the tax year, does not have the same principal place of abode as his or her spouse, or
 - Has a decree, instrument, or agreement with regard to his or her spouse and is not a member of the same household of his or her spouse by the end of the tax year.

Provided these requirements are met, ARPA allows a separated individual to file a separate tax return and claim the EITC. This provision is effective for tax years beginning after December 31, 2020.

- **Temporary Special Rule:** ARPA establishes a temporary special rule for determining earned income for purposes of the EITC. Similar to the Consolidated Appropriations Act of 2021 that allowed taxpayers to substitute their 2019 earned income for their 2020 earned income for purposes of determining the EITC, ARPA allows taxpayers to substitute their 2019 earned income for their 2021 earned income for purposes of determining the EITC if their 2021 earned income was less than their 2019 earned income. For joint returns, the taxpayer's earned income for 2019 is the sum of each spouse's earned income for 2019.

5. *Enhanced Child and Dependent Care Credit*

A variety of taxpayers incur child or dependent care expenses. Prior to ARPA, the child and dependent care credit was a nonrefundable credit that allowed taxpayers to receive a credit for qualified employment-related expenses paid for the care of qualifying individuals. Prior to ARPA, to be eligible for the child and dependent care credit, certain criteria had to be met, including:

- **The Qualifying Person Test:** A person is a qualifying individual if he or she satisfies any one of three conditions:
 - The person is a dependent of the taxpayer by reason of being a qualifying child of the taxpayer and has not attained age 13.
 - The person is a dependent of the taxpayer, is physically or mentally incapable of caring for himself or herself and has the same principal place of abode as the taxpayer for more than one-half of the taxable year.
 - The person is the spouse of the taxpayer, is physically or mentally incapable of caring for himself or herself and has the same place of abode as the taxpayer for more than one-half of the taxable year.
- **The Earned Income Test:** The taxpayer(s) must have earned income during the year, such as wages, salaries, tips, and net earnings from self-employment. The amount of work-related expenses that may be taken into account in calculating the credit may not exceed earned income. A taxpayer who is married and files a joint return may take into account work-related expenses limited to the lesser of his or her earned income or his or her spouse's earned income.
- **The Work-Related Expense Test:** The child and dependent care expenses must be work related in order to qualify for the child and dependent care credit. Expenses meet this test if both of the following statements are true:
 - The expenses allow the taxpayer (and spouse, if filing joint) to work or look for work. If the taxpayers are married and filing a joint return, both must generally work or look for work.
 - The expenses are for a qualifying person's care.

- **Joint Return Test:** Married couples must file a joint return (not married filing separately) in order to take the child and dependent care credit, unless they are legally separated or living apart from each other.
- **Care Provider Identification Test:** The taxpayer must identify all persons or organizations that provide care for the qualifying child or dependent on Form 2441, *Child and Dependent Care Expenses*.
- **Qualifying Expense Test:** The total deduction was required to be less than the dollar limitation for qualifying expenses, which was generally \$3,000 if one qualifying person was cared for, and \$6,000 if two or more qualifying persons were cared for.
 - The credit was equal to 35% of employment-related expenses for taxpayers whose AGI was \$15,000 or less. As such, the maximum credit was \$1,050 (\$3,000 x 35%) for one qualifying individual and \$2,100 (\$6,000 x 35%) for two or more qualifying individuals. This 35% amount was decreased by one percentage point for each \$2,000 of additional AGI until it was reduced to 20%. Once AGI was in excess of \$43,000, the 20% credit applied.

ARPA makes several changes to the child and dependent care credit, including:

- **Refundability:** As discussed above, prior to ARPA, the child and dependent care credit was nonrefundable. ARPA makes the child and dependent care credit refundable for taxpayers who have a principal place of abode in the U.S. for more than one half of the tax year. In the case of a joint return, either spouse must have a principal place of abode in the U.S. for more than one half of the tax year. The taxpayer's main home is any location where he or she regularly lives, including a house, apartment, shelter, mobile home, or temporary housing. A taxpayer's main home need not be the same physical location throughout the entire tax year.
- **Increased Expense Limits:** ARPA increases the dollar limitation for qualifying expenses from \$3,000 to \$8,000 for one qualifying individual, and from \$6,000 to \$16,000 for two or more qualifying individuals. ARPA also increases the applicable credit percentage from 35% to 50% for taxpayers whose AGI is \$125,000 or less. The 50% applicable credit percentage amount is decreased by one percentage point for each \$2,000 of additional AGI until it is reduced to 20% for taxpayers whose AGI is \$183,000. A 20% applicable credit percentage amount applies to taxpayers with AGI greater than \$183,000 but not greater than \$400,000. If a taxpayer's AGI is above \$400,000, the 20% applicable credit percentage decreases by one percentage point for every \$2,000 of additional AGI until it is completely phased out for taxpayers with AGI greater than \$438,000.
 - As a result of the new ARPA provisions, taxpayers with one qualifying individual and whose AGI is \$125,000 or less can receive a maximum credit amount of \$4,000 (\$8,000 dollar expense limitation x 50% applicable credit percentage amount). Taxpayers with two or more qualifying individuals and whose AGI is \$125,000 or less can receive a maximum credit amount of \$8,000 (\$16,000 dollar expense limitation x 50% applicable credit percentage amount).

Taxpayers may claim the child and dependent care credit by filing Form 2441, *Child and Dependent Care Expenses*, and filing it with their tax return. On this form, the taxpayer must identify all individuals or organizations that provided care for the dependent, including the provider's name, address, and TIN. Taxpayers can request this information from the provider by having them complete Form W-10, *Dependent Care Provider's Identification and Certification*.

- Example 1:** In 2020, Cindy paid \$8,000 in qualified employment-related expenses to care for her two qualifying children. Cindy can only take \$6,000 of the qualified employment-related expenses into account when determining the child and dependent care credit amount.
- Example 2:** Assume the same facts as Example 1, except that Cindy paid the \$8,000 of qualified employment-related expenses to care for her two qualifying children in 2021. Due to the new ARPA provisions, Cindy can consider the entire \$8,000 of qualified employment-related expenses when determining the child and dependent care credit amount.
- Example 3:** Assume the same facts as Example 2, except Cindy's AGI is \$133,000. Her applicable percentage for purposes of calculating the credit is 46% (the 50% amount is reduced due to the \$8,000 of AGI in excess of \$125,000). Cindy is able to claim a child and dependent care credit of \$3,680 (\$8,000 qualified expenses x 46%).
- Example 4:** Assume the same facts as Example 2, except Cindy's AGI is \$200,000. Since Cindy's AGI is greater than \$183,000, but not greater than \$400,000, the 20% credit applies. Cindy is able to claim a child and dependent care credit of \$1,600 (\$8,000 qualified expenses x 20%).
- Example 5:** Assume the same facts as Example 2, except Cindy's AGI is \$450,000. Since Cindy's AGI is above \$438,000, the child and dependent care credit is completely phased out. She is not able to claim a child and dependent care credit.

6. Premium Tax Credit

The premium tax credit, often referred to as the "PTC," is a refundable credit available to eligible taxpayers who purchase health insurance on the Health Insurance Marketplace. In order to qualify for the credit, the taxpayer generally must meet certain criteria, including:

- The taxpayer must have household income within a certain range.
- The taxpayer, if married, must file a joint return (limited exceptions apply)
- The taxpayer cannot be claimed as a dependent by another individual.
- The taxpayer or a family member must have health insurance coverage through the Health Insurance Marketplace, be unable to get affordable coverage through an employer-sponsored plan, be ineligible for coverage through a government program (Medicare, Medicaid, etc.), and pay the share of premiums not covered by advance credit payments.

Generally, the PTC is available to taxpayers with household income between 100% and 400% of the federal poverty line (FPL). The PTC is limited to the excess of the premiums for the applicable benchmark plan covering the taxpayer's family over the taxpayer's contribution amount. This contribution amount is equal to the taxpayer's household income multiplied by an applicable percentage based on the taxpayer's income in relation to the federal poverty line.

ARPA changed the affordability percentages used for premium tax credits for 2021 and 2022 to increase credits for individuals eligible for assistance and provide credits for taxpayers with income over 400% of the FPL. All individuals with premiums in excess of 8.5% of their household income are eligible for the PTC in 2021 and 2022.

Prior to ARPA, taxpayers who were enrolled in an exchange-purchased qualified health plan could receive an advance of the PTC, payable directly to the insurer. This advanced payment was an estimate based on information from prior year tax returns. Taxpayers were required to reconcile any advanced PTC payments received with the PTC for which they were actually eligible. If the taxpayer's advanced payments exceeded the calculated PTC, the excess would be assessed as an additional income tax subject to a repayment cap based on income. For 2020, ARPA changed the repayment obligations for taxpayers receiving excess advance premium tax credits so such payments are not subject to recapture. On April 9, 2021, the IRS released IR-2021-84, stating that taxpayers with excess advanced payments of the PTC were not required to file Form 8962, *Premium Tax Credit*, or report an excess advance PTC repayment on their 2020 Form 1040. However, taxpayers claiming a net PTC were still required to file Form 8962 when filing their 2020 tax return. Per IRS guidance, taxpayers who reported and paid excess advance PTC on their 2020 tax returns before the ARPA legislation was signed into law are not required to file an amended return to receive a refund.

Lastly, ARPA provided advanced premium tax credits as if the taxpayer's income were no higher than 133% of the federal poverty line (FPL) for individuals receiving unemployment compensation. This provision increases the amount of a taxpayer's PTC and applies to tax years beginning after December 31, 2019 and before January 1, 2022.

7. Student Loan Discharges

Sometimes a taxpayer may have his or her debt forgiven or discharged. Generally, if a taxpayer receives cancellation of debt (COD) income, he or she must report it as taxable income on the tax return during the year the cancellation occurs. If a taxpayer receives cancellation of debt income, he or she will receive a Form 1099-C, *Cancellation of Debt*, from the creditor that lists the amount of canceled debt that is taxable. This is the taxable amount that must be reported on the taxpayer's tax return as "other income."

Although COD income is generally taxable, certain canceled debt is specifically excluded from taxable income. Prior to ARPA, certain cancelled student loan debt was specifically excluded from income due to:

- Death or total and permanent disability of a student,
- A provision in the loan that all or part of the debt will be canceled if the taxpayer worked for a certain period of time, in certain professions, and for any broad class of employers (e.g., a doctor in a public hospital in a rural area), or
- As a result of the Department of Education's Closed School process or the Defense to Repayment discharge process.

ARPA expands the student loan debt exclusion to exclude from gross income certain discharges of student loans after December 31, 2020, and before January 1, 2026. The expanded student loan discharge exclusion applies to:

1. Private education loans.
2. Loans provided expressly for postsecondary educational expenses, regardless of whether provided through the educational institution or directly to the borrower, if such

- loan was made, insured, or guaranteed by the United States, a state or local governmental entity, or an eligible educational institution.
3. Loans made by an educational organization qualifying as a 50% charity.
 4. Loans made by an educational organization qualifying as a 50% charity or by a tax-exempt organization to refinance a loan to an individual to assist the individual in attending any educational organization but only if the refinancing loan is under a program of the refinancing organization that is designed as described in bullet point (3) above.

As a result, if a student loan is discharged for any reason above, it will not result in discharge of indebtedness income to the borrower. It is important to note that the discharge of a loan made by either an educational institution or a private education lender is not excluded under the expanded ARPA rules if the discharge is on account of services performed for either the organization or for the private education lender. The new ARPA exclusion applies to either partial or full discharge of a student loan, and it is effective for discharges of loans after December 31, 2020.

8. Student Loan Relief

Due to the economic hardship caused by COVID-19, numerous individuals are struggling to pay their student loans. The CARES Act allows employers to provide a student loan repayment benefit to employees on a tax-free basis.¹⁷ Traditionally, an employee's gross income does not include up to \$5,250 of employer payments made under an educational assistance program for the employee's education.¹⁸ Certain requirements must be met in order to qualify as an educational assistance program, including:

- *Separate Written Plan:* The qualified educational assistance program must be established under an employer's separate written plan.
- *Assistance for only Educational purposes:* The educational assistance program must only provide benefits for educational purposes.
- *Nondiscriminatory:* The educational assistance program can not discriminate in favor of certain highly compensated employees or officers.
- *Exclusive Benefit:* The educational assistance program must solely be for the benefit of employees, not employees' dependents or spouses.
- *Employee Notification:* In order to be considered an educational assistance program, all eligible employees must be given notice of the terms of the program.
- *Benefit Limits:* No more than 5% of the total educational assistance benefit amount paid by the employer may be for more than 5% of shareholders or owners.
- *Substantiation:* Eligible employees who receive benefits generally must provide substantiation to show the payments are for educational assistance.

This exclusion did not apply to the education of spouses or dependents. Under the CARES Act, employers can contribute up to \$5,250 annually toward an employee's student loans, which were previously not considered educational payments. Eligible student loan repayments are payments by the employer, whether paid to the employee or a lender, of principal or interest on any qualified higher education loan. This payment would be excluded from the employee's income. The \$5,250 cap applies to the aggregate of the newly established student loan repayment benefit in the CARES Act, as well as any other educational assistance provided by the employer under current law, including tuition, fees, and books. The initial student loan relief applied to payments made after the enactment date and before January 1, 2021. To prevent a double benefit, student loan repayments for which the exclusion is

¹⁷ CARES Act §2206.
¹⁸ IRC §127.

allowable can't be deducted under §221, which allows the deduction of student loan interest subject to a dollar limit and a phase-out above specified taxpayer income levels. The CAA 2021 extends the exclusion of employer payments of student loans from an employee's gross income through 2025.

9. FSA and Dependent Care Assistance

The Consolidated Appropriations Act of 2021 (CAA 2021) makes temporary changes to health and dependent care Flexible Spending Account (FSA) rules. Prior to CAA 2021, employers could allow a maximum of \$550 to be carried over from a health care FSA, or an unlimited amount could be used to pay for claims incurred during the first 2.5 months of the new year. Balances from dependent care FSAs could be used to pay for claims incurred during the first 2.5 months of the new year, but no carryover was permitted. The CAA 2021 provides that health and dependent care FSAs may carry over unused benefits up to the full annual amount from 2020 to 2021 and from 2021 to 2022. Notice 2021-26, released May 10, 2021, confirmed that amounts carried over to 2021 or 2022 or made available under an extended claims period are excluded from income if used by the participant for dependent care purposes.

Additionally, it provides a 12-month grace period for any unused benefits or contributions for 2020 and 2021 plan years, meaning those who were terminated or otherwise ceased participation in a dependent care FSA could continue to apply unused FSA amounts. Plans may extend the maximum age of eligible dependents for dependent care FSAs from age 12 to age 13 for the 2020 plan year, and any unused amounts from the 2020 plan year may be carried over to the 2021 plan year. A person age 13 or older qualifies if that person is physically or mentally incapable of self-care and regularly spends at least eight hours a day in the employee's household. Lastly, the CAA 2021 permits plans to make a prospective change in election amounts for health and dependent care FSAs for plan years ending in 2021. Prior to the CAA 2021 being enacted into law, an employee's FSA election was irrevocable for the entire plan year, unless there was a change in status.

A Dependent Care Assistance Plan (DCAP) allows an employee to be reimbursed for eligible dependent care expenses so that the employee and his or her spouse may work, look for work, or attend school full time. The employer sets the minimum and maximum an employee contributes, subject to an annual limitation. Prior to ARPA, employer-provided contributions to FSAs for dependent care assistance were limited to \$5,000 per year for married couples filing jointly, \$2,500 for married couples filing separately. Any employer-provided assistance above the annual maximum amounts is included in taxable income. ARPA increases the dollar limit for employer-provided dependent care FSA contributions in 2021 from \$5,000 to \$10,500 for married couples filing jointly. It also increases the dollar limit for employer-provided dependent care FSA contributions in 2021 from \$2,500 to \$5,250 for married couples filing separately. For purposes of these amounts excluded from taxable wages, an employee is considered:

- A current employee;
- A leased employee who has provided services to the employer on a substantially full-time basis for at least 12 months if the services are performed under the employer's primary direction and control;
- A sole proprietor; and
- A partner who performs services for a partnership.

Employers are not required to implement the increased limitations but are allowed to do so by the last day of the plan year. The employer-provided contribution limit increase is applicable to any taxable year beginning after December 31, 2020, and before January 1, 2022.

Example: Natasha, an employee of XYZ Inc., is covered by a calendar year \$125 cafeteria plan that offers a DCAP benefit. Natasha contributed \$5,000 for DCAP benefits for the 2020 plan year but did not incur any dependent care expenses during the plan year. XYZ Inc.'s \$125 cafeteria plan permits employees to carry over unused DCAP benefits to the 2021 plan year. Natasha carries over \$5,000 DCAP benefits to the 2021 plan year and contributes \$10,500 for DCAP benefits in the 2021 plan year.

Natasha incurs \$15,500 of dependent care expenses in 2021, and the DCAP reimburses her \$15,500. This amount is excluded from Natasha's gross income and wages, since \$10,500 is excluded as 2021 benefits and the remaining \$5,000 is attributable to the permitted carryover.

10. COBRA Premium Subsidy

In 1985, the Consolidated Omnibus Budget Reconciliation Act (COBRA) was established, providing workers who lose their health benefits with the right to continue group health benefits provided by their group health plan for limited periods of time under extenuating circumstances such as job loss, reduction in work hours, transition between jobs, death, divorce, or other life events. Generally, employers who had 20 or more employees in the prior year and sponsor a group health plan are required to offer employees and their families the opportunity for a temporary extension of health coverage (called continuation coverage) in certain circumstances where the plan coverage would otherwise end. COBRA coverage generally lasts for an 18-month period.

ARPA established that Assistance Eligible Individuals (AEIs) may receive a 100% subsidy for COBRA premiums paid during any period of COBRA coverage during the period beginning on April 1, 2021 and ending on September 30, 2021 ("subsidy period"). In other words, ARPA provided up to six months of free COBRA coverage to AEIs during the subsidy period beginning on April 1, 2021. This subsidy is non-taxable to the AEI recipient. An individual is considered an AEI if:

1. He or she is enrolled in COBRA coverage during the subsidy period due to a qualifying event;
2. He or she did not have a COBRA election in effect on April 1, 2021, but would be an AEI if he or she did;
3. He or she elected but discontinued COBRA coverage before April 1, 2021 and is still within his or her maximum period of coverage; or
4. He or she was involuntarily terminated or had a reduction in work hours. Individuals who voluntarily terminate their employment are not considered AEIs.

In order to be considered an AEI, the individual had to be involuntarily terminated or had a reduction in work hours. Individuals who voluntarily terminated their employment are not considered AEIs. Additionally, individuals who are currently enrolled in Medicare who become a qualified beneficiary as a result of a reduction of work hours or involuntary termination are not eligible for COBRA premium assistance but may be eligible to elect COBRA continuation coverage. ARPA allows AEIs who were not currently enrolled in COBRA as of April 1, 2021 to make a COBRA election during the period beginning on April 1, 2021 and ending 60 days after they are provided required notification of the extended election period. This special extended election enrollment period applies to AEIs described in points 2 and 3 above. AEIs who enroll during the special enrollment period are eligible for the COBRA subsidy starting April 1, 2021 through the earlier of: 1) the ending date of the AEI's original maximum period of coverage; 2) the date the beneficiary becomes eligible for coverage under another group health plan or Medicare; or 3) September 30, 2021.

Employers were required to notify AEIs about the subsidy and special enrollment period. All AEIs who were eligible to elect COBRA prior to April 1, 2021, were required to be notified by May 31, 2021 under the new ARPA provisions. Secondly, the typical required COBRA paperwork provided to individuals who become AEIs during the subsidy period was required to be updated to explain new ARPA rights. Lastly, employers were required to notify AEIs no less than 15, and no more than 45 days, before their subsidies end, unless the subsidy ends because the AEI has obtained other group health plan coverage. In such case, the AEI is required to timely notify the plan administrator that he or she became eligible for other coverage. Failure to notify the plan administrator results in the AEI receiving a \$250 penalty.

Employers were permitted, but not required, to allow AEIs to enroll in a different type of medical coverage than they previously had within 90 days from receiving the notice described above. However, the premiums for any newly elected coverage must have been equal to or less than the premiums for the coverage that the individual would have had at the time of the original COBRA qualifying event.

The new ARPA provisions applied to all group health plans that are subject to federal or state COBRA obligations. To offset the cost of the ARPA provisions, employers of self-insured health plans were allowed to take a quarterly payroll tax credit against the Medicare payroll tax they are otherwise required to pay (1.45%) equal to the premium amounts not paid by AEIs. The was treated as a refundable overpayment to the extent that it exceeded the quarterly Medicare payroll tax.

Notice 2021-31, published May 18, 2021, clarified certain ARPA provisions related to the COBRA premium subsidy. Per the Notice guidance, employers may require individuals to provide a self-certification that they are eligible for COBRA continuation coverage, which may be used to substantiate eligibility for the premium assistance credit. Employers who claim the premium assistance credit are required to retain in their records either a self-certification from eligible individuals regarding eligibility status or other documentation substantiating an individual's eligibility status for COBRA premium assistance.

11. Mortgage forbearance and foreclosure/eviction moratorium

The CARES Act provided homeowners with financial relief during the COVID-19 public health emergency. Homeowners with a federally backed mortgage for single-family homes are eligible for mortgage forbearance.¹⁹ A federally backed mortgage loan includes any loan secured by a first or subordinate lien on residential real property that is:

- Insured by the Federal Housing Administration ("FHA") under Title II of the National Housing Act;
- Insured under §255 of the National Housing Act;
- Guaranteed under §184 or §184A of the Housing and Community Development Act of 1992;
- Guaranteed or insured by the Department of Veteran Affairs;
- Guaranteed or insured by the Department of Agriculture; or
- Purchased or securitized by the Federal Home Loan Mortgage Corporation or the Federal National Mortgage Association.

Homeowners with a federally backed mortgage loan experiencing financial hardship due, directly or indirectly, to the COVID-19 public health emergency could request forbearance on a federally backed mortgage loan by:

¹⁹ CARES Act §4022.

- Submitting a request to the loan servicer; and
- Affirming that he or she is experiencing a financial hardship during the COVID-19 emergency.

After receiving the homeowner's request, forbearance would be granted for up to 180 days, with the possibility for an additional 180 days at the request of the borrower. During such forbearance time period, no fees, penalties, or interest beyond scheduled amounts were calculated. All payments were considered as if made timely per the mortgage contract. The loan servicer only required the homeowner's attestation of financial hardship; no additional documentation is required.

Servicers of federally backed mortgage loans could not initiate judicial or non-judicial foreclosure process, move for a foreclosure judgment or order of sale, or execute a foreclosure-related eviction or foreclosure sale for a 60-day period beginning on March 18, 2020. An exception was available only if the property is vacant or abandoned.²⁰

Multifamily properties with federally backed loans were also eligible for mortgage forbearance if the borrower was experiencing financial hardship due to the COVID-19 public health emergency.²¹

Multifamily borrowers included borrowers with a residential mortgage loan secured by a lien against a property comprising of five or more dwelling units. A multifamily property borrower with a federally backed mortgage loan must have been current on payments as of February 1, 2020 and must have submitted an oral or written request for forbearance to the loan servicer affirming that he or she was experiencing financial hardship during the COVID-19 public health emergency. The forbearance period for a multifamily borrower was for a period up to 30 days, with an opportunity to extend the forbearance period for two additional 30-day time periods.

Any multifamily borrower that received mortgage loan forbearance could not, for the duration of the forbearance:

- Evict or initiate eviction of a tenant from a dwelling unit located in the multifamily property solely for nonpayment of rent.
- Charge late fees, penalties, or other charges to a tenant due to late payment of rent.
- Require a tenant to vacate a dwelling unit located in multifamily property before the date that is 30 days after the date on which the borrower provides the tenant with a notice to vacate.
- Issue a notice to vacate.

Rev. Proc. 2020-26 defined the "covered period" for federally backed mortgage loan forbearance to be the period beginning on the date of its enactment (March 27, 2020) and ending on the earlier of the termination date of the COVID-19 emergency or December 31, 2020.

On September 4, 2020, the CDC issued an order under Section 361 of the Public Health Service Act, calling for a temporary halt in residential evictions to prevent the further spread of COVID-19. The order was effective September 4, 2020 through December 31, 2020. The order states that any landlord, residential property owner, or other person with a legal right to pursue eviction shall not evict any covered person from any residential property in any jurisdiction. The order did not relieve any individual of any obligation to pay rent, make a housing payment, or comply with any other obligation that the individual

²⁰ CARES Act §4022.

²¹ CARES Act §4023.

may have under a tenancy, lease, or similar contract. Likewise, landlords or property owners could charge and collect fees, penalties, or interest as a result of the failure to pay rent or other housing payment on a timely basis, under the terms of any applicable contract. The order provided affected renters with a declaration of eligibility statement that they could submit to their landlord.

COVIDTRA extended the eviction moratorium from December 31, 2020 to January 31, 2021. COVIDTRA provided \$25 million in rental assistance, to be distributed by the state and local governments, for individuals who lost income during the COVID-19 pandemic. Eligible households could receive rental assistance if one or more individuals in the household were obligated to pay rent, and one or more individuals within the household had:

- Qualified for unemployment benefits, or experienced a reduction in household income, incurred significant costs, or experienced other financial hardship due directly or indirectly to the COVID-19 outbreak; and
- One or more individuals within the household could demonstrate a risk of experiencing homelessness or housing instability, such as a past due utility, rent eviction notice, or unsafe or unhealthy living conditions; and
- Household income is less than 80% of the area median income.

Eligible households could use the rental assistance towards past-due and future rent and past-due and future utility costs.

Hours after his inauguration, President Biden extended the eviction moratorium through March 31, 2021 through an executive order. On February 16, 2021, President Biden announced an expansion of forbearance and foreclosure relief programs through June 30, 2021. This expansion:

- Extended the foreclosure moratorium for homeowners through June 30, 2021;
- Extended the mortgage payment forbearance enrollment window until June 30, 2021 for borrowers who wish to request forbearance; and,
- Provided up to six months of additional mortgage payment forbearance, in three-month increments, for borrowers who entered forbearance on or before June 30, 2020.

On June 29, 2021, the Supreme Court ruled in a 5-4 vote that the CDC lacked authority to grant a nationwide eviction moratorium. The Court allowed the moratorium to remain in place through July 31, 2021 but stated that Congress would have to pass legislation in order for the moratorium to continue after that time.

It is possible that the eviction and/or foreclosure and forbearance moratorium will be extended through future executive action or legislation.

12. Payroll Tax Executive Memorandum

Per former President Trump's Executive Memorandum, issued on August 8, 2020, employers were able to defer withholding of the employee share of Social Security taxes from September 1, 2020, through December 31, 2020. The employee deferral applied to individuals with less than \$4,000 in wages every two weeks, or an equivalent amount for other pay periods. The employee deferral was optional for most employers, but it was mandatory for federal employees and military service members. Per the Executive Memorandum, employers were to increase withholding and pay the deferred amounts ratably from wages and compensation paid between January 1, 2021, and April 30, 2021, with penalties and interest on the deferred unpaid tax liability beginning to accrue on May 1, 2021.

The CAA 2021 extended the timeframe to repay the deferred unpaid payroll tax liability through December 31, 2021. Penalties and interest on deferred unpaid tax liability will not begin to accrue until January 1, 2022.

On March 10, 2021, the IRS issued a “COVID Tax Tip,” providing guidance regarding how employers can pay any deferred payroll taxes pursuant to former President Trump’s Executive Order.²² Per the IRS guidance, employers can make employee deferral payments through the Electronic Federal Tax Payment System (EFTPS). Employers should select the newly added “deferral payment” option as the tax type. After the employer selects deferral payment, they will enter the applicable tax period for the payment. If the employer chooses not to use EFTPS, they may make deferral payments using credit or debit card, check or money order, or electronic funds withdrawal. The IRS emphasizes that the deferral payments must be made separately from other payments, to ensure that they are correctly applied to the deferred payroll tax balance. Currently, the IRS’s system will be unable to recognize the amount of the deferral payment if it is combined with any other tax payments or sent as a tax deposit. Lastly, the IRS states that if an employee whose Social Security tax was deferred no longer works for the employer, the employer is responsible for repayment of the entire deferred amount.

13. Charitable contributions

In order to encourage charitable contributions during the period of economic distress caused by COVID-19, the CARES Act loosens limitations on qualified charitable contributions for tax purposes. The term “qualified charitable contribution” means a charitable contribution:

- Made in cash;
- For which a deduction is allowable;
- Made to an organization described in §170(b)(1)(A) and not to an organization described in §509(a)(3); and
- Which is not for the establishment of a new or maintenance of an existing, donor-advised fund.

Taxpayers may deduct up to \$300 of cash contributions per return made to qualified charitable organizations as an above the line deduction if they do not itemize deductions.²³ The Form 1040 instructions clarified that the \$300 deduction is per return, by stating, “if you don’t itemize deductions on Schedule A (Form 1040), you (or you and your spouse if filing jointly) can take a charitable deduction of up to \$300 for cash contributions made in 2020 to organizations that are religious, charitable, educational, scientific, or literary in purpose.” This provision applies to tax years beginning after December 31, 2019. The CAA 2021 extends the \$300 above-the-line deduction through 2021. The maximum deduction amount is increased to \$600 for married filing joint taxpayers beginning in 2021.

Prior to the CARES Act, taxpayers who itemized their returns were allowed a deduction on Schedule A for cash contributions made to certain charitable organizations described in §170(b)(1)(A), such as churches, hospitals, medical research organizations, or educational organizations, up to 60% of their AGI.²⁴ Any excess amount could be carried forward as a deductible charitable contribution over the next five years. The CARES Act waives the 60% of AGI limit for cash donations made in 2020, and instead allows for cash contributions of up to 100% of AGI.²⁵ The CAA 2021 extends this limit through 2021.

²² COVID Tax Tip 2021-32.

²³ CARES Act §2204(a).

²⁴ IRC §170(b)(1)(G)(i).

²⁵ CARES Act §2205(a)(1).

The CAA 2021 increased the underpayment penalty to 50 percent for any underpayments attributable to overstated cash contributions by non-itemizer taxpayers.

B. Miscellaneous Individual CAA 2021 Tax Extenders

1. Medical expense deduction

Prior to TCDTRA, the 7.5-percent-of-AGI threshold was in place for tax years 2017, 2018, and 2019. The medical expense deduction floor was set to increase to 10 percent of AGI in 2020 prior to the passage of TCDTRA. The TCDTRA makes the 7.5-percent-of-AGI threshold for the medical expense deduction floor permanent for itemizers claiming unreimbursed medical expenses. This provision is applicable for tax years beginning after December 31, 2020.

2. Residence indebtedness

The TCDTRA extends the exclusion from gross income of discharge of qualified principal residence indebtedness through 2025. It also reduces the maximum exclusion amount from \$2,000,000 to \$750,000 (for married filing jointly filers).

3. Student provisions

Under the CAA 2021, certain emergency financial aid grants received pursuant to the CARES Act are excluded from gross income of college and university students.

The TCDTRA extends the exclusion of employer payments of student loans from an employee's gross income through 2025. Employers may contribute up to \$5,250 annually toward an employee's repayment of student loans or other educational assistance, including costs for tuition, fees, or books. Eligible student loan repayments are payments by the employer, whether paid to the employee or a lender, of principle or interest on any qualified higher education loan for the education of the employee, but not of a spouse or dependent. The employer payment is excluded from the employee's income.

4. Lifetime Learning Credit

The TCDTRA repeals the deduction for qualified tuition and related expenses and increases the income limitation phase-out range for the Lifetime Learning Credit. Starting in tax year 2021, the Lifetime Learning Credit phase-out range will increase to 80,000-\$90,000 for single filers, and \$160,000-\$180,000 for joint filers, the same phase-out ranges as the American Opportunity Tax Credit.

5. Volunteer firefighters and emergency medical responder benefits

The TCDTRA makes permanent the exclusion from gross income of any qualified state or local tax benefits and qualified reimbursement payments to members of qualified volunteer emergency response organization. Additionally, the TCDTRA increases the exclusion for qualified reimbursement payments to \$50 for each month during which a volunteer performs services.

6. Educator Expense Above-the-Line Deduction

For purposes of the \$250 educator above-the-line deduction, the CAA 2021 expands eligible educator expenses to include personal protective equipment, disinfectant, and other supplies used for the prevention of the spread of COVID-19.²⁶

²⁶ COVIDTRA §275.

7. Retirement Fund Distributions

Per IRC §72(t), distributions made from qualified retirement plans are subject to a 10% additional tax unless there is an exception.

Similar to the disaster-relief provision, the CARES Act provided special rules for use of retirement funds. The §72(t) 10%-early withdrawal penalty was waived for distributions up to \$100,000 from qualified retirement accounts.²⁷ The \$100,000 limit applied counting all plans of an employer, counting as one employer all organizations and businesses under common control or otherwise affiliated. The term “eligible retirement plan” is defined as one of the following:

- An IRA;
- An individual retirement annuity, other than an endowment contract;
- A profit-sharing or stock bonus plan including §401(k) plans;
- A qualified trust (an employees’ trust described in §401(a) which is exempt from tax under §501(a));
- A qualified annuity plan described in §403(a);
- An eligible deferred compensation plan described in §457(b) which is maintained by an eligible employer described in §457(e)(1)(A); and
- A qualified annuity contract or custodial account described in §403(b).
- Money purchase plans: The CAA 2021 retroactively expands the eligible plans for coronavirus-related distributions to include money purchase pension plans. A money purchase plan is a type of defined-contribution plan that is similar to a profit-sharing plan, except that the contribution amounts are fixed rather than variable.

The distribution was required to have been used for coronavirus-related purposes, and the distribution must have been made on or after January 1, 2020 and before December 31, 2020. A coronavirus-related distribution was required to meet one of the following criteria:

1. A distribution made to an individual who is diagnosed with COVID-19 by a test approved by the Centers for Disease Control and Prevention (“CDC”);
2. A distribution made to an individual whose spouse or dependent is diagnosed with COVID-19 by a test approved by the CDC;
3. A distribution made to an individual whose spouse or a member of the individual’s household (that is, someone who shares the individual’s principal residence) is being quarantined, being furloughed or laid off, having work hours reduced, being unable to work due to lack of childcare, having a reduction in pay (or self-employment income), or having a job offer rescinded or start date for a job delayed, due to COVID-19; or
4. A distribution made to an individual who experiences adverse financial consequences as a result of being quarantined, furloughed, laid off, having work hours reduced, being unable to work due to lack of child care due to COVID-19, having a reduction in pay (or self-employment income), having a job offer rescinded or start date for a job delayed, closing or reducing hours of a business owned or operated by the individual, individual’s spouse, or a member of the individual’s household due to COVID-19, or other factors as determined by the Treasury Secretary.

The administrator of an eligible retirement plan could rely on an employee’s certification that the employee satisfies any of the conditions in determining whether any distribution is a COVID-19-related

²⁷ CARES Act §2202(a)(1)).

distribution. The distribution is taxed ratably over a three-year period, and the taxpayer has an option to repay the distribution amount to the retirement plan within the three-year period. Any amounts repaid are treated as eligible rollover distributions so that they won't be taxable to the individual. IRA and qualified plan distributions made under the §72(t) COVID-19 exception have significant tax advantages, including:

- The 20% federal income tax withholding does not apply;
- The distributions are exempt from the 10% early withdrawal penalty that typically applies if a participant is under age 59.5;
- The distribution can be repaid to the plan within 3 years (the distributee's tax year in which the payout is made and the next two), unless the taxpayer elects not to apply this treatment and gain tax-free rollover treatment (without regard to typical plan limits). The recontributed amounts will **not** count toward the maximum contribution limit in the year that the funds are recontributed; and
- The individual can recognize personal income for the related taxes over a 3-year period that begins when he or she takes the distribution as opposed to having all of the amount included immediately in income.

The CARES Act provided that the maximum loan limit on qualified plans is increased for a 180-day period beginning on the date of enactment. Individuals who were eligible for a COVID-19 related distribution were eligible to borrow up to the lesser of:

- \$100,000 (which is double the normal limit of \$50,000); or
- 100% of their vested account balance (double the normal limit).

Qualified plan documents would have to have been amended to reflect this new loan repayment option if the participants wanted to adopt it, as this provision of the CARES Act was optional.

If an individual took a loan from his or her retirement plan prior to the CARES Act and if the repayment due date for such outstanding loan was between the enactment date, March 27, 2020, and December 31, 2020, the repayment date is automatically delayed for one year. Any subsequent repayments will be adjusted to reflect the delay and any interest accrued during such delay.

Prior to the CARES Act, individuals who reached age 70½ prior to 2020 or 72 in 2020 or a later year were required to take required minimum distributions (RMDs) from an IRA or qualified retirement plan. The CARES Act temporarily waived the RMD rules so individuals need not worry about selling their retirement assets during the economic downturn. The CARES Act provided that the RMD requirements did not apply for calendar year 2020 to:²⁸

- A defined contribution plan.
- Eligible deferred compensation plans under §457(b), excluding those maintained by tax-exempt entities.
- An IRA.

The RMD requirements also did not apply to any distribution which was required to have been made in calendar year 2020 by reason of:

- A required beginning date occurring in calendar year 2020; and
- Such distribution not having been made before January 1, 2020.

²⁸

CARES Act §2203(a).

On June 23, 2020, the IRS released Notice 2020-51, providing relief to individuals who already took an RMD in 2020. Prior to the passage of the CARES Act, many individuals proactively took their RMDs in January and February of 2020. As one would expect, many of these individuals wanted to “give back” their RMD in accordance with the new CARES Act RMD waiver rule. Some individuals who were within the 60-day rollover window were able to accomplish this; however, others were not so lucky if the 60-day window had already expired.

Notice 2020-51 provided that all individuals who took an RMD during 2020 could rollover the distribution into another eligible retirement plan. Additionally, Notice 2020-51 extended the deadline for making the rollover to either the later of 60 days after the distribution or August 31, 2020. Further relief was provided by Notice 2020-51, specifically excluding rollovers of amounts from being counted as part of the once-a-year limitation. The notice clarified that the CARES Act waiver of 2020 RMDs under §401(a)(9)(I) does not change an individual's Required Beginning Date.

III. Business COVID-19 Relief Efforts

A. Extensions, expansions, and new provisions

1. FFCRA Emergency Family and Medical Leave Expansion Act

The FFCRA expanded the Family and Medical Leave Act (“FMLA”) by adding new public health emergency leave provisions for family leave in the Emergency Family and Medical Leave Expansion Act (“EFMLEA”). FMLA coverage usually applies to employers with *at least* 50 employees. The EFMLEA applies to all employers with *fewer* than 500 employees as well as all governmental entities for health emergency leave through December 31, 2020. Similarly, FMLA eligibility typically applies once employees work at least 1,250 hours and at least 12 consecutive months. The EFMLEA expanded coverage to employees that have been employed for at least 30 calendar days by the employer. For example, if an employee needed to take leave on April 1, 2020, he or she would have had to have been on his or her employer's payroll as of March 2, 2020.

Although required EFMLEA leave has expired as of December 31, 2020, ARPA extended the credits for sick and family leave (discussed later) through September 30, 2021. As a result, it is important to have an understanding of EFMLEA leave.

While the EFMLEA modified FMLA in certain aspects, it did not add additional job-protected leave time, but rather provided employees with the same amount of leave (12 weeks) as those who take leave for other FMLA-covered reasons. If an individual already took FMLA leave during 2020 for non-COVID-19 reasons, the maximum 12 weeks of FMLA leave still applied. This is due to the fact that expanded family and medical leave is still a type of FMLA leave.

Example

An eligible employee, Mike, had to take expanded family and medical leave related to COVID-19 in 2020.

In January 2020, Mike had back surgery and took 2 weeks of FMLA leave as part of his recovery. Since Mike already used 2 weeks of FMLA leave, he is only able to take a maximum of 10 additional weeks of EFMLEA leave related to COVID-19, since there is a 12-week maximum of FMLA leave per 12-month period.

In other words, the total FMLA-related leave must not exceed 12 workweeks in any 12-month period. **It is important to emphasize that paid sick leave is not FMLA leave and is excluded from the 12 week / 12 month consideration.**

The EFMLEA leave provided paid leave for eligible employees to be taken after a ten-day period of unpaid leave. During this ten-day period, the employer could require employees to take accrued vacation time, personal time, or sick leave. In addition, the employer could require employees to use two weeks of emergency paid leave, described in other provisions of the FFCRA. Following that 10-day period, an employer was required to provide paid leave to the employee for each additional day of leave.

The employee was required to be paid an amount not less than two-thirds of their regular rate of pay, based on the normal number of hours they worked. If the employee had a variable work schedule, the employer was required to average the employee's work hours over the previous six-month period, or if not employed for six months, average the reasonable number of hours the employee would have been expected to work. The paid leave shall not exceed \$200 per day or \$10,000 in aggregate. Public Health Emergency Leave could be taken by eligible employees unable to work or telework because of a need to care for a son or daughter under 18 years of age due to school closure, daycare closure, or lack of a childcare provider.

Like FMLA, the EFMLEA required employers to allow employees to return to their original position upon return from leave. Smaller employers with under 25 employees were not required to return employees to their original position upon return if any of the following conditions are met:

1. The position held by the employee when the leave commenced did not exist due to economic conditions or other changes in operating conditions of the employer.
2. The employer made reasonable efforts to restore the employee to a position equivalent to the position the employee held when the leave commenced, with equivalent employment benefits, pay, and other terms and conditions of employment.
3. If the reasonable efforts of the employer failed, the employer made reasonable efforts to contact the employee if an equivalent position became available over a one-year period.

Comparison of FMLA and EFMLEA		
	FMLA	EFMLEA
Number of Employees for Eligibility	Applies to employers <i>with at least</i> 50 employees	Applies to employers <i>with fewer than</i> 500 employees and all governmental entities, with some exceptions
Employee Eligibility	Applies once employees work at least 1,250 hours and at least 12 consecutive months	Applies to employees that have been employed for at least 30 calendar days by the employer
Maximum Leave	12 weeks	12 weeks
Employers must allow employees to return to original position upon return	Yes, with some exceptions for employers who have under 25 employees	Yes

The EFMLEA provided an exception to Public Health Emergency Leave for employers with less than 50 employees, if the Department of Labor determined that providing paid leave would jeopardize the viability of the business as a going concern. Health Care Providers were exempt from the Public Health Emergency Leave provision. It is likely that employers with less than 50 employees will not face significant consequences for failing to comply with Public Health Emergency Leave, as the exception criteria is fairly broad.

Individuals were able to take EFMLEA family leave intermittently, if agreed upon with his or her employer. For example, an employee may have had to take care of his or her child for four hours during a typical workday due to COVID-19 school closure. In this scenario, the employee could take four hours of intermittent family leave, while working remotely the additional 4 hours, if discussed and agreed upon by his or her employer. The Department of Labor urges employees and employers to be flexible and work together to achieve a mutually agreeable work solution.

2. FFCRA Emergency Paid Sick Leave Act

The legislation created emergency paid sick leave for eligible employees unable to work due to certain conditions under the Emergency Paid Sick Leave Act (“EPSLA”). The EPSLA applied to all employers with fewer than 500 employees as well as all governmental entities for health emergency leave through December 31, 2020. Although mandatory EPSLA leave has expired as of December 31, 2020, ARPA extended the credits for sick and family leave (discussed later) through September 30, 2021. As a result, it is important to have an understanding of EFMLEA leave.

Under EPSLA, employers were required to provide paid sick time to impacted employees who were unable to work or telework. An employer of an employee who was a healthcare provider or emergency responder could elect to exclude the employee from this provision. Eligible employees were not required to be employed for a certain length of time in order to take advantage of the paid leave provisions. Employees were eligible for up to 80 hours of paid leave. Full sick pay, calculated at 100% of the employee’s ordinary rate, was limited to \$511 per employee per day, and \$5,110 in aggregate, meeting any of the conditions outlined below:

1. **Quarantine:** The employee was subject to a federal, state, or local quarantine or isolation order related to COVID-19.
2. **Self-Quarantine:** The employee was advised by a health care provider to self-quarantine due to concerns related to COVID-19.

3. **Diagnosis or Treatment:** The employee was experiencing symptoms of COVID-19 and seeking a medical diagnosis.

If an employee was scheduled to work more than 40 hours per week, this was required to be included in the calculation, but it was capped at 80 hours over a two-week period. Pay did not need to include a premium for overtime hours under either the Emergency Paid Sick Leave Act or the Emergency Family and Medical Leave Expansion Act.

Example: An eligible employee, Jessica, needed to take emergency paid sick leave. Jessica was scheduled to work 50 hours per week.

Jessica's employer calculated emergency sick leave based on a 50-hour work week for the first week of Jessica's leave. In the second week, Jessica's employer calculated emergency sick leave based on 30 hours of sick leave, since the total number of hours paid was capped at 80 hours over the two-week period.

Employees were also eligible for full sick pay at 2/3 their regular rate, at the average number of hours typically worked in a two-week period, if they met any of the conditions outlined below:

1. **Care for a Quarantined Individual:** The employee was caring for an individual who is subject to a COVID-19 quarantine or self-isolation order;
2. **Child Care:** The employee was caring for a son or daughter of such employee if the school or place of care of the son or daughter was closed, or the childcare provider of such son or daughter was unavailable, due to COVID-19 precautions; or
3. **Substantially Similar Care:** The employee was experiencing any other substantially similar condition specified by the Secretary of Health and Human Services in consultation with the Secretary of the Treasury and the Secretary of Labor.

If the employee's hours changed from week to week, employers were required to determine the average number of hours the employee worked during the prior 6 months and provide leave equal to the number of hours he or she typically worked in a two-week period. For purposes of the FFCRA, "regular rate of pay" was the average of the employee's regular rate over a period of six months prior to the date leave was taken. If the employee did not work for the employer for six months, the regular rate of pay for FFCRA purposes was the average of the employee's regular rate of pay for each week that he or she worked for the employer. If an employee was paid with commissions, tips, or piece rates, these amounts were incorporated into the FFCRA calculation to the extent they were included in the calculation of the regular rate of pay under the Fair Labor Standards Act (FLSA). Additionally, regular rate of pay for FFCRA purposes was required to be determined for each employee by adding all compensation that was part of the regular rate over the six-month period and dividing that sum by all hours actually worked in the same period. Two-thirds sick pay was limited to \$200 per employee per day, and \$2,000 in aggregate, impacted by any of the conditions outlined above.

Unlike emergency family leave, an individual could not take paid sick leave intermittently while working at his or her usual worksite. COVID-19 paid sick leave had to be taken in full-day increments if the affected employee was not teleworking. Otherwise, the employee had to take paid sick leave until the full amount of paid sick leave was used or he or she no longer had a qualifying reason to take paid sick leave. This protection was established by the EPSLA so individuals would not easily spread COVID-19 to others.

Employers could not discriminate against any employee who took emergency paid leave and could not force an employee to find a replacement to cover the duration of their leave. The emergency paid leave was a supplement to any other sick leave provided by the employer. Employers with existing paid sick leave policies were required to provide workers with emergency paid sick leave under the EPSLA provisions and could not require an employee to use available paid leave before using the emergency paid sick leave. There was no exemption for sick pay for employers with fewer than 50 workers when an employee missed work because the employee was sick, quarantined, or caring for someone who is sick or quarantined.

3. FFCRA Tax credits for paid sick and paid family and medical leave

EPSLA tax credit -- To counter the costs associated with the FFCRA paid sick and family medical leave, employers were eligible for refundable tax credits. The FFCRA provided an employer payroll tax credit equal to 100% of the qualified sick leave wages paid by the employer under the EPSLA.

The refundable credits covered the employer OASDI component of payroll taxes, or the 6.2% employer-paid portion of the tax and applied to wages paid to employees for paid emergency sick leave. Employers could not receive this credit if they were also receiving the payroll tax credit for paid family and medical leave under §45S. Eligible employers were able to retain an amount of payroll taxes equal to the amount of qualifying sick and medical leave that they paid the affected employee, rather than depositing the amount with the IRS. The payroll taxes that were available for retention included withheld federal income taxes, the employee share of Social Security and Medicare taxes, and the employer share of Social Security and Medicare taxes with respect to all employees. In the event there was not a sufficient amount of payroll taxes to cover the cost of qualified sick and childcare paid leave, employers had the ability to file a request for an accelerated payment from the IRS. The CAA 2021 extended the credit to wages paid through March 31, 2021, and ARPA later extended the credit through September 30, 2021. Wages paid after September 30, 2021, may be qualified leave wages under ARPA, provided that the wages were paid with respect to leave taken by employees beginning on April 1, 2021, through September 30, 2021. Similar to the CAA 2021, ARPA did not require employers to actually provide the paid sick leave beyond December 31, 2020.

Example:

In 2020, an eligible employer paid \$5,000 in sick leave and is otherwise required to deposit \$7,000 in payroll taxes, including taxes withheld from all of its employees. The eligible employer could use up to \$5,000 of the \$7,000 of taxes it was going to deposit with the IRS to make qualified leave payments. The employer would be required to deposit the remaining \$2,000 to the IRS on its next regular deposit date.

On the other hand, assume an eligible employer paid \$10,000 in sick leave and is otherwise required to deposit \$7,000 in payroll taxes, including taxes withheld from all of its employees. The eligible employer could use the entire \$7,000 of taxes it was going to deposit with the IRS to make qualified leave payments. The eligible employer could also file for an accelerated credit for the remaining \$3,000 paid for qualified leave.

The sick leave credit for each employee applied to wages and qualified health plan expenses related to wages, of up to \$511 per day, and \$5,110 in aggregate, if the employee was taking emergency sick leave to care for himself or herself. The sick leave credit for each employee applied to wages and qualified health plan expenses related to wages, of up to \$200 per day, and \$2,000 in aggregate, if the employee took emergency family leave to care for a family member or child whose school, daycare, or childcare provider has closed. Prior to ARPA, these credits were limited to 10 days per employee per quarter,

reduced by the number of days taken in preceding calendar quarters. ARPA reset the 10-day limitation on the maximum number of days for which an employer could claim the paid sick leave credit with respect to wages paid to an employee. In other words, ARPA provided employees with a new 10-day limit of employer paid sick leave, without regard to any paid sick leave used prior to April 1, 2021. Additionally, ARPA permitted employers to be eligible for the paid sick leave credit if they provided employees with paid time off to receive the COVID-19 vaccine, recover from an illness related to the immunization, or accompany an individual to obtain the COVID-19 vaccine. Eligible employers were entitled to an additional tax credit based on costs to maintain health insurance coverage for the eligible employee during the leave period, provided such amounts were excluded from the employee's gross income under §106(a). To counter a double benefit, eligible employers had to include the amount of the credits received in their gross income. Similarly, an eligible employer could deduct as a business expense any qualified leave wages paid to an employee for which they expected to claim the EPSLA tax credit. However, to prevent a double benefit, eligible employers had to increase their income by the amount of the credit.

ARPA established a non-discrimination requirement for EPSLA, meaning no EPSLA credits would be permitted to an employer who discriminated by providing leave only to highly compensated individuals, full-time employees, or employees on the basis of employment tenure. In order to receive EPSLA credits, the employer was required to offer leave to all employees.

A self-employed individual was eligible for the credit if he or she would have been entitled to receive paid sick leave himself or herself under the Emergency Paid Sick Leave Act if the individual were an employee of an employer other than himself or herself. The qualified sick leave equivalent was capped at \$511 per day or two-thirds of the average daily self-employment income for the taxable year per day. For an eligible self-employed individual who was caring for a family member or child whose school or place of care was closed due to coronavirus, the qualified sick leave amount was capped at the lesser of \$200 per day or two-thirds the average daily self-employment income for the taxable year per day. Individuals were limited to those days in which they were unable to work for reasons that would entitle them to leave under the EPSLA. Per the CAA 2021, self-employed individuals could elect to use their prior year 2019 average daily self-employment income, rather than their 2020 self-employment income, in determining the FFCRA credits.

Self-employed individuals had to use Form 7202, *Credits for Sick Leave and Family Leave for Certain Self-Employed Individuals*, to report qualified sick leave and qualified family leave wage amounts. This form was to be attached to the self-employed individual's income tax return and reduce (but not below zero) any qualified sick leave or qualified family leave equivalent credits by the amount of these qualified leave wages.

EFMLEA tax credit -- The FFCRA allowed an employer to take a payroll tax credit for each calendar quarter, equal to 100% of the qualified family leave wages paid by the employer for EFMLEA leave. The refundable credits covered the employer OASDI component of payroll taxes, or the 6.2% employer-paid portion of the tax and applied to wages paid to employees for paid emergency family leave. Eligible employers were able to retain an amount of payroll taxes equal to the amount of qualifying family care leave that they paid the affected employee, rather than depositing the amount with the IRS. The payroll taxes that were available for retention included withheld federal income taxes, the employee share of Social Security and Medicare taxes, and the employer share of Social Security and Medicare taxes with respect to all employees. The CAA 2021 extended the credit to wages paid through March 31, 2021, and ARPA later extended the credit through September 30, 2021. Similar to the CAA 2021, ARPA did not

require employers actually provide the paid family leave beyond December 31, 2020. Wages paid after September 30, 2021, could be qualified leave wages under ARPA, provided that the wages were paid with respect to leave taken by employees beginning on April 1, 2021, through September 30, 2021. Lastly, ARPA permitted employers to be eligible for the paid family leave credit if they provided employees with paid time off to receive the COVID-19 vaccine, recover from an illness related to the immunization, or accompany an individual to obtain a COVID-19 vaccine. Similar to EPSLA, ARPA established a non-discrimination requirement for EFMLEA, meaning no EFMLEA credits would be permitted to an employer who discriminated by providing leave only to highly compensated individuals, full-time employees, or employees on the basis of employment tenure. In order to receive EFMLEA credits, the employer was required to offer leave to all employees.

Prior to ARPA, the qualifying wages for the family leave credit could not exceed \$200 per employee per day or \$10,000 in aggregate for all calendar quarters eligible for the credit. ARPA increased the amount of wages for which an employer may claim the paid family credit in a year from \$10,000 to \$12,000 per employee. Eligible employers were entitled to an additional tax credit based on costs to maintain health insurance coverage for the eligible employee during the leave period, provided such amounts were excluded from the employee's gross income under §106(a). Employers could elect not to apply this provision for any calendar quarter. Similarly, an eligible employer could deduct as a business expense any qualified leave wages paid to an employee for which they expected to claim the EFMLEA tax credit. However, to prevent a double benefit, eligible employers had to increase their income by the amount of the credit.

A self-employed individual was eligible for the credit if he or she would have been entitled to receive paid family leave himself or herself under EFMLEA if the individual were an employee of an employer other than himself or herself. The credit was equal to the lesser of two-thirds of average daily self-employment income or \$200 per day. Per the CAA 2021, self-employed individuals could elect to use their prior year 2019 average daily self-employment income, rather than their 2020 self-employment income, in determining the FFCRA credits. ARPA increased the number of days for which a self-employed individual could claim the paid family leave credit from 50 days to 60 days.

IRS Guidance -- The IRS provided additional guidance on the FFCRA tax credits for paid leave.²⁹ It established that the employee sick leave and employee family leave tax credits applied to eligible wages and compensation paid for periods beginning on April 1, 2020 and ending on December 31, 2020. The CAA 2021 extended the FFCRA refundable payroll tax credits for paid sick and family leave through March 31, 2021. ARPA extended the FFCRA credits through September 30, 2021. The same time period applied to refundable credits against the self-employment tax. Employers had to report amounts of qualified sick and family leave wages paid to employees on either Form W-2, Box 14, or on a separate statement.³⁰ Despite the COVID-19 pandemic being a “qualified disaster” under §139, the qualified sick and family leave wages were taxable to employees as compensation and were not excluded from gross income as “qualified disaster relief payments.” This is due to the fact that the intent of the qualified sick and family leave wages was to replace regular wages or compensation that the individual would otherwise earn, rather than offset any expenses incurred due to COVID-19.

The IRS released new FAQs on November 25, 2020, specifically addressing FFCRA provisions related to self-employed individuals. An independent contractor who generally performs services for multiple clients

²⁹ Notice 2020-21.

³⁰ Notice 2020-54.

as a nonemployee is self-employed and was eligible for the FFCRA tax credits for days he or she was not able to work or telework for reasons related to COVID-19. A partner in a partnership is a self-employed individual if the partner's distributive share constitutes net earnings from self-employment or if the partner receives guaranteed payments for his or her services. If the partner is a self-employed individual and was not able to work or telework for reasons related to COVID-19, the partner was eligible for the tax credits. Any FFCRA credits that an individual received are not includible in gross income. Self-employed individuals should maintain documentation establishing their eligibility for the credits as a self-employed individual.

Additional FAQs were released on June 11, 2021, confirming that self-employed individuals could not use Form 7200, *Advance Payment of Employer Credits Due to COVID-19*, to apply for advance payment of FFCRA credits. This form was only available to employers that file Form 941. The FAQs also clarified that eligible self-employed individuals that received a FFCRA credit are not required to include any amount of these credits in gross income.

If an employer closed an employee's worksite prior to April 1, 2020 (the effective date of the FFCRA), such employee was not eligible for paid sick leave or paid expanded family and medical leave. This was true even if the employer told the employee that they plan to reopen the business in the future. Similarly, if an employer reduced an employee's scheduled work hours due to lack of work, such employee could not take paid sick leave or expanded family and medical leave for the hours that he or she was no longer scheduled to work. This is true even if the reduction of hours was related to the COVID-19 economic downturn. However, if an employer closed a worksite while the employee was on paid sick leave or expanded family and medical leave, the employer had to pay the employee any paid sick leave or expanded family and medical leave used prior to the worksite closure. Once the worksite closed, the employee was no longer eligible for paid sick leave or expanded family and medical leave but may have been eligible for unemployment insurance benefits. Employees could receive both "qualified sick leave wages" and "qualified family leave wages," but only at different times.

In March 2020, the IRS issued Notice 2020-22, providing guidance for employers that failed to make tax deposits for qualified sick and family leave wages. Under this Notice, the IRS waived the \$6656 failure to deposit penalty for failure to timely deposit employment taxes, to the extent that the amounts not deposited were equal to or less than the amount of refundable FFCRA tax credits. As such, employers could use the funds that they would have used to make deposits of employment taxes to pay qualified sick and family leave. Notice 2021-24, released April 13, 2021, extended relief provided by Notice 2020-22 for qualified leave wages paid pursuant to the CAA 2021 from January 1, 2021 through March 31, 2021 and for qualified wages paid pursuant to ARPA beginning April 1, 2021 through September 30, 2021.

If an eligible employer did not claim the tax credits for qualified leave wages, the sick and family leave wages paid to its employees were not required to be reported on the employees' Form W-2s, box 14 or in a statement provided with Form W-2. Eligible employers who did not claim the tax credits for qualified leave wages but reported the sick or family leave wages on the employees' Form W-2s had to provide a corrected Form W-2c to such employees in order to correct box 14.

4. Paycheck Protection Program Loans

The CARES Act established a new program, called the Paycheck Protection Program, offering first round PPP loans to small businesses, including any business, private nonprofit organization, or public nonprofit

organization with less than 500 employees. Employers with over 500 employees were eligible for the first round of CARES Act funding if they had no more than 500 employees at each business location. This exception was applicable for businesses in the hospitality and restaurant industries. For example, if a hotel chain had over 500 employees, it could have applied for a first round SBA Paycheck Protection Program loan for a specific location, provided each business location had less than 500 employees. Eligible businesses must have been operational as of February 15, 2020, and paid salaries and payroll taxes for either employees or independent contractors.

Some self-employed individuals, independent contractors, and sole proprietors were eligible for the first round of PPP loans, subject to certain conditions. Such individual must have certified that he or she was in operation as of February 15, 2020. He or she was required to submit documentation necessary to establish eligibility, such as payroll processing records, payroll tax filings, Form 1099-MISC, or income and expenses from a sole proprietorship. If a prospective borrower did not have this information, the borrower had to provide other supporting documentation, such as bank records, to substantiate the qualifying payroll amount.

Taxpayers were ineligible for a first round Paycheck Protection Program loan if:

- Engaged in an activity that is illegal under federal, state, or local law.
- He or she was a household employer who employs nannies or housekeepers.
- An owner of 20% or more of the equity of the applicant is incarcerated, on probation, on parole, or subject to an indictment, arraignment, or other means by which formal criminal charges are brought about or convicted of a felony within the past 5 years.
 - **Note:** On June 12, 2020, the SBA released a revision to the First Interim Rule, expanding eligibility for Paycheck Protection Program loans. The look-back period was reduced from 5 years to 1 year to determine eligibility for applicants, or owners of applicants, who, for non-financial felonies, have: 1) been convicted, 2) pleaded guilty, 3) pleaded nolo contendere, or 4) been placed on any form of parole or probation. If the applicant or owner of applicant is incarcerated, on probation, on parole; presently subject to an indictment, criminal information, arraignment, or other means by which formal charges are brought in any jurisdiction; or has been convicted of a felony involving fraud, bribery, embezzlement, or a false statement in a loan application or application for federal financial assistance, the 5-year lookback period remains.
- Any business owned or controlled by the taxpayer or any owners who obtained a direct or guaranteed loan from the SBA or other federal agency that is currently delinquent or has defaulted in the last 7 years, causing a loss to the government.

To qualify for the first round of Paycheck Protection Program Loans, the borrower was required to certify the following information:

- The loan was necessary due to the uncertainty of current economic conditions caused by COVID-19;
- The loan proceeds were to be used for allowable purposes including but not limited to payroll, group health benefits, rent, and utility payments; and
- The borrower was not receiving duplicative funds for the same uses from another SBA program.

The initial first round Paycheck Protection Program loans were made available through June 30, 2020 by the CARES Act. The \$349 billion initially earmarked in the CARES Act for Paycheck Protection Program loans was quickly depleted in less than 2 weeks, long before the June 30, 2020 application deadline. Congress recognized that despite the initial funding, small businesses were still struggling to survive, and in a bipartisan effort approved an additional \$310 billion of funding to the Paycheck Protection Program through the *Paycheck Protection Program and Health Care Enhancement Act*. Former President Trump signed this \$484 billion supplemental spending package into law on April 24, 2020. Of the additional \$310 billion allocated to the Paycheck Protection Program through the *Paycheck Protection Program and Health Care Enhancement Act*, \$60 billion was allocated as follows:

- \$30 billion was allocated to small banks and lenders with less than \$10 billion in assets. Examples include community credit unions, community banks, and community development financial institutions.
- \$30 billion was allocated to medium-sized banks and credit unions that are FDIC insured. These institutions have between \$10 billion to \$50 billion in assets.

This allocated funding intended to give smaller businesses a better chance at securing a Paycheck Protection Program loan. Hours before the Paycheck Protection Program was set to expire on June 30, 2020, Congress unanimously voted to extend the first round PPP loans until August 8, 2020. Former President Trump signed the extension into law on July 4, 2020.

The Paycheck Protection Program had relatively low barriers to entry to ensure that resources are readily accessible to businesses. Unlike typical SBA loans, they are fully guaranteed by the federal government. The Paycheck Protection Program is unique in that the borrower does not need to provide any personal guarantee or collateral for the loan. The SBA waives all loan fees in connection with the Paycheck Protection Program loans. Borrowers do not necessarily need to demonstrate economic harm to qualify but rather must make a good faith certification that the current economic climate necessitates a loan to support ongoing business operations. Usually, SBA loans require that the borrower cannot achieve credit elsewhere and use the SBA loan as a last resort. The Paycheck Protection Program relaxes the “no credit elsewhere” requirement and allows businesses with open lines of credit to be eligible applicants. Loans were available at any bank that is an SBA lender.

The maximum loan amount for the first round of PPP loans was the lesser of the following amounts:

- 2.5 times the average monthly payroll costs incurred in the one-year period prior to the date of the loan, increased by the outstanding balance of any SBA EIDL loan that the borrower closed between January 31, 2020 and April 3, 2020, less any advance made under an EIDL COVID-19 loan; or
- \$10,000,000.
 - Payroll costs included salaries, wages, tips, paid sick leave, paid family leave, PTO, severance payments, group health insurance benefits, state or local taxes assessed on employee compensation, and retirement benefits. For sole proprietors and independent contractors, it also included compensation or income, including wages, commissions, income, and net earnings. For self-employed individuals, payments made to oneself count as payroll.
 - Independent contractors of an entity could not be counted in the payroll of an eligible entity and do not count as employees for purposes of its Paycheck Protection Program loan calculations since they may obtain their own Paycheck Protection Program loan.

- Salaries were limited to \$100,000 per employee for purposes of this calculation, prorated for the covered period.
- Payroll costs did not include payroll taxes, qualified sick leave or family medical leave for which a credit is allowed under the FFCRA, or compensation for an employee whose principal place of residence is outside of the U.S. territory. If payroll went through a professional employer organization, (PEO) the PEO was considered as a pass-through service provider and payroll was based on what the PEO paid on the borrower's behalf to the employees and/or contractors who provided services on the borrower's benefit.

The Interim Private Rule, released by the Treasury Department provided the following calculation as a guide for most applicants to determine the maximum amount that could be borrowed for the first round of PPP loans³¹:

1. Aggregate payroll costs (defined above) from the last 12 months for employees whose principal place of residence is in the United States.
2. Subtract any compensation paid to an employee in excess of an annual salary of \$100,000 or any amounts paid to an independent contractor in excess of \$100,000.
3. Calculate average monthly payroll costs by dividing Step #2 by 12.
4. Add the outstanding amount of an EIDL loan made between January 31, 2020 and April 3, 2020, less the amount of any advance made under an EIDL COVID-19 loan.

Recipients of the Paycheck Protection Program loan could use the loan to support their operations, including but not limited to the following:

- Payroll support, including paid sick leave, paid medical or family leave, payments to furloughed employees, bonuses, hazard pay, and costs related to group health care benefits or insurance premiums during any leave periods;
- Employee salaries;
- Mortgage interest payments, excluding principal payments;
- Rent;
- Utilities;
- Interest payments on any other debt obligations that were incurred before 2/15/2020; and
- Refinancing an SBA economic injury disaster loan (SBA EIDL) made between 1/31/2020 and 4/3/2020.

COVIDTRA, signed into law as part of the CAA 2021 on December 27, 2020, reauthorized the Paycheck Protection Program with an additional \$284.5 billion of funding. The PPP funds were made available until March 31, 2021 or until funds ran out. Similar to the first round of PPP loans, borrowers could receive up to 2.5 times their average monthly payroll costs incurred in the one-year period prior to the date of the loan. COVIDTRA allows hotels and restaurants (those assigned a North American Industry Classification System code beginning with 72) to borrow up to 3.5 times their average monthly payroll costs incurred in the one-year period prior to the date of the loan.

The second round of funding was open to first-time borrowers with 500 or fewer employees. Sole proprietors, not-for-profits, veterans organizations, tribal concerns, self-employed individuals, and independent contractors were also eligible first-time borrowers for a PPP loan. Section 501(c)(6) business league taxpayers, such as chambers of commerce and visitors' bureaus, as well as destination marketing

³¹ Treasury Interim Rule, Docket No. SB-2020-0015.

organizations, were eligible to apply for PPP loans, provided they had 300 or fewer employees and did not receive more than 15% of receipts from lobbying. The lobbying activities could not comprise more than 15% of the organization's total activities and could not have cost more than \$1 million during the most recent tax year that ended prior to 2/15/2020.

Small business borrowers were eligible to apply for a second PPP loan, provided they met the following requirements:

- Had 300 or fewer employees;
- Experienced a decline in gross receipts of at least 25% during 2020 compared to the same quarter in 2019; and
- Used or would use the full amount of the first PPP loan for authorized uses.

Unlike the first round of PPP loans that allowed borrowers to receive up to \$10 million in loan proceeds, new and second-time borrowers could only receive up to \$2 million in loans.

On March 11, 2021, President Biden signed the American Rescue Plan Act (ARPA) into law. ARPA allocated an additional \$7.25 billion toward PPP funding, but failed to extend the March 31, 2021 application deadline. However, on March 31, 2021, President Biden signed the PPP Extension Act of 2021 into law, extending the PPP authorization through June 30, 2021. As a result of this legislation, the PPP application deadline was extended through May 31, 2021, and the SBA was provided with an additional 30 days to finish processing applications received by May 31, 2021.

In addition to providing additional funding for PPP loans, ARPA made more not-for-profits eligible for PPP loans by creating a new beneficiary category called an "additional covered nonprofit entity" that is eligible for First Draw and Second Draw PPP loans. An "additional covered nonprofit entity" was eligible to apply for a PPP loan if:

- The organization did not receive more than 15% of its receipts from lobbying activities;
- The organization employed no more than 300 employees;
- The organization's lobbying activities did not comprise more than 15% of the organization's total activities; and
- The cost of the organization's lobbying activities did not exceed \$1,000,000 during the most recent tax year that ended prior to February 15, 2020.

ARPA also made some larger not-for-profits eligible for the PPP, including:

- Section 501(c)(3) organizations and veterans' organizations that employed not more than 500 employees per physical location; and
- Section 501(c)(6) organizations (such as business leagues, chambers of commerce, real estate boards, boards of trade and professional football leagues), domestic marketing organizations, and additional covered not-for-profit entities that employed not more than 300 employees per physical location.

Lastly, ARPA expanded PPP eligibility to include internet-only news and periodical publishers with more than one physical location, provided that the business had no more than 500 employees per physical location or the applicable SBA size standard. Additionally, the organization had to certify that it was an internet-only news or periodical publisher and that the loan would support locally focused or emergency information.

ARPA revised prior law to establish that businesses that received a PPP loan after December 27, 2020 were eligible for a Shuttered Venue Operator (SVO) Grant under certain conditions. If a PPP borrower received a First Draw or Second Draw PPP loan after December 27, 2020, the amount of any subsequent SVO grant was to be reduced by the amount of the First Draw or Second Draw PPP Loan. Any PPP loan received prior to December 27, 2020 would not reduce the amount of the SVO grant.

Arguably the greatest benefit of the Paycheck Protection Program loans is that they can be forgiven.³² Specifically, the sum of the following payments made by the employer during the covered period beginning on the date of the loan can be forgiven:

- Any interest payments on a covered mortgage obligation, defined as a mortgage obligation incurred before February 15, 2020;
- Rent payments paid under a lease agreement in force before February 15, 2020*;
- Payroll costs; and
- Utility payments such as internet, electricity, water, gas, and phone, under service agreements dated before 2/15/2020, over the covered period following the date of the loan.

*The SBA released an Interim Final Rule (August 24, 2020), establishing that rent payments to a related party are eligible for loan forgiveness, as long as 1) the amount of loan forgiveness requested for rent or lease payments to a related party is no more than the amount of mortgage interest owed on the property during the Covered Period that is attributable to the space being rented by the business, and (2) the lease and the mortgage were entered into prior to February 15, 2020.

In addition to payroll, mortgage interest, rent, and utilities expenses, COVIDTRA expanded the expenses eligible for forgiveness to include the following:

- **Covered supplier costs**, defined as expenditures made by an entity to a supplier of goods for the supply of goods that are essential to the operations of the entity at the time at which the expenditures are made.
- **Covered operations expenditures**, defined as payments for any business software or cloud computing service that facilitates business operations, product or service delivery, the processing, payment, or tracking of payroll expenses, human resources, sales and billing functions, or accounting or tracking of supplies, inventory, records, and expenses.
- **Covered property damage costs**, defined as costs related to property damage and vandalism or looting due to public disturbances that occurred during 2020 that were not covered by insurance or other compensation.
- **Covered worker protection expenditures**, defined as operating or capital expenditures to facilitate the adaptation of the business activities of an entity to comply with requirements established or guidance issued by the Department of Health and Human Services, CDC, OSHA, or any state or local government.

The amount of the loan that is eligible to be forgiven is *reduced* if:

- The employer reduces its workforce; or
- The employer reduces salary or wages paid by more than 25% to an employee earning less than \$100,000 annualized salary.

³² CARES Act §1106(b).

The forgivable nature of the Paycheck Protection Program loans effectively makes them grants, meaning business will receive an influx of cash without seeing a significant increase in their debt obligations. Cancellation of indebtedness usually results in cancellation of debt (“COD”) income to the debtor.³³ PPP loans are unique in that the amount which would be includible in gross income as COD income is specifically excluded.³⁴ When a lender receives a borrower’s application for forgiveness, the lender must decide to accept or reject the application within 60 days of receipt of the application. The borrower may be asked to verify payments for the allowable use of proceeds through documentation such as IRS Payroll Expense Forms 940 and 941, mortgage statements, lease statements, and utility statements. The borrower may also be asked to submit documents verifying the number of full-time equivalent employees and corresponding pay rates. On September 22, 2020, the IRS issued Announcement 2020-12, stating that lenders do not need to file information returns or furnish payee statements under §6050P to report the amount of qualifying forgiveness with respect to covered loans made under the Paycheck Protection Program. COVIDTRA allows the Treasury to waive information reporting requirements for any amount excluded from income by the exclusion of covered loan amount forgiveness from taxable income, the exclusion of emergency financial aid grants from taxable income or the exclusion of certain loan forgiveness and other business financial assistance under the CARES act from income.

Interim final rules were released (April 14, 2020) by the Treasury and SBA, clarifying guidance on the treatment of partnerships in regard to Paycheck Protection Program loans. The guidance states that self-employment income of general active partners may be reported as a payroll cost, up to \$100,000 annualized, on a Payroll Protection Plan loan filed by a partnership. This determination comes as a surprise to many practitioners, as partners are typically considered self-employed individuals and not employees of the partnership. The Treasury justified this decision by stating that rent, mortgage interest, utilities, and other debt are generally incurred at the partnership level, not the partner level. In other words, partners may not submit a separate Paycheck Protection Program loan application on their own.

On June 5, 2020, the *Paycheck Protection Program Flexibility Act of 2020* (“PPPFA”) was signed into law by former President Trump, modifying certain provisions related to the forgiveness of Paycheck Protection Program loans made to small businesses. The PPPFA made it easier for recipients of Paycheck Protection Program loans to attain loan forgiveness.

- a. **Extension of covered period** -- The CARES Act and corresponding guidance established that eligibility for loan forgiveness would be evaluated over an eight-week (56-day) covered period, beginning on the same day of the PPP loan disbursement date. The Paycheck Protection Program Forgiveness Application, released May 15, 2020, provided borrowers with the option to use the Alternative Payroll Covered Period as an administrative convenience. Under the Alternative Payroll Covered Period, any borrower with a biweekly or more frequent payroll schedule could elect to calculate eligible payroll costs using the eight-week (56-day) forgiveness period beginning on the first day of the first pay period following the PPP loan disbursement date.

The Paycheck Protection Program Flexibility Act of 2020 **increased** the covered period from 8 weeks to 24 weeks, not to extend past December 31, 2020, providing borrowers with more time to obtain loan forgiveness. Existing borrowers with loans originated prior to the enactment of the PPPFA may choose to either use the original 8-week covered period (or alternative covered period) or they may elect to use the new 24-week period of

³³ IRC §61(a)(11).

³⁴ CARES Act §1106(i)

loan forgiveness. New borrowers with loans originating after June 5, 2020 will have a 24-week covered period.

The Paycheck Protection Program Flexibility Act of 2020 extended the Paycheck Protection Program maximum loan term from 2 years to 5 years for borrowers with loans originating after the enactment date of the PPPFA, and the interest rate of 1% remains unchanged. Lenders and borrowers may mutually agree to modify the maturity term of an existing loan but are not required to do so. Borrowers may prepay a Paycheck Protection Program loan without incurring any prepayment penalties or fees.

- b. **Forgiveness amount** -- The CARES Act and SBA guidance stated that borrowers had to spend at least 75% of loan proceeds on payroll costs in order to be eligible for full forgiveness. If less than 75% of the loan proceeds were spent on payroll costs, the borrower would still be eligible for partial loan forgiveness. Similarly, any reduction in the amount of FTE employees could reduce the amount of the loan eligible for forgiveness. Borrowers who rehired employees prior to the June 30, 2020 deadline would still be eligible for full forgiveness.

The PPPFA reduced the 75% threshold, allowing borrowers to only spend at least 60% of the loan proceeds on payroll during the covered period in order to be eligible for loan forgiveness. If less than 60% of loan proceeds were spent on payroll costs during the covered period, borrowers were still eligible to attain partial loan forgiveness.

The PPPFA extended the amount of time that borrowers have to rehire employees to pre-pandemic levels from June 30, 2020 to December 31, 2020. The legislation followed previous guidance, not precluding borrowers from attaining loan forgiveness if they were able to document that employees turned down good faith offers to be rehired. Additionally, the PPPFA provided two new exceptions for loan forgiveness, stating that borrowers unable to restore employment to pre-pandemic levels would still be eligible for loan forgiveness in the following scenarios:

- The borrower had an inability to rehire individuals who were employees of the eligible recipient on February 15, 2020 or an inability to hire similarly qualified employees for unfilled positions on or before December 31, 2020.
- The borrower was able to document an inability to return to the same level of business activity it was operating at prior to February 15, 2020, due to complying with guidance from the Secretary of Health and Human Services, the Director of the Centers for Disease Control and Prevention, or the Occupational Safety and Health Administration during the period beginning on March 1, 2020, and ending December 31, 2020, related to the maintenance of standards for sanitation, social distancing, or any other worker or customer safety requirement related to COVID-19.
 - In the Interim Final Rule, issued in June 2020, the SBA clarified that this exception included both direct and indirect compliance with COVID guidance as a result of state and local government shutdown orders, as a significant amount of the reduction in business activity stemming from these orders was based on guidance from the Secretary of HHS, CDC, and OSHA.

- c. **Other provisions** -- The Paycheck Protection Program Flexibility Act of 2020 amended the CARES Act to allow borrowers to defer payment of the employer portion of their 2020 Social Security payroll taxes.
- Per the CARES Act, Paycheck Protection Program loan recipients were able to defer the repayment of loan principal and interest for six months. The PPPFA extended the payment deferral until the date that the SBA remits the loan forgiveness amount to the lender. The PPPFA provided that if an eligible recipient failed to apply for forgiveness of a covered loan within 10 months after the last day of the covered period, such eligible recipient had to make payments of principal, interest, and fees on such covered loan beginning on the day that is not earlier than the date that is 10 months after the last day of such covered period.

Similar to the first round of loans, borrowers had to spend at least 60% of the loan proceeds on payroll during the covered period of either 8 or 24 weeks in order to be eligible for forgiveness.

The CARES Act did not address deductibility of expenses paid for with PPP loan proceeds. Prior guidance outlined in Notice 2020-32 and Revenue Ruling 2020-27 stipulated that no deduction was allowed for an expense that was otherwise deductible if the payment of the expense resulted in forgiveness of a PPP loan. To the delight of many small businesses and tax practitioners, COVIDTRA diverted from prior IRS guidance and allows PPP borrowers to **deduct expenses** paid for with PPP loan proceeds. This provision is effective as of the date of enactment of the CARES Act (March 27, 2020). Revenue Ruling 2021-02, released January 6, 2021, subsequently obsoletes Notice 2020-32 and Revenue Ruling 2020-27.

Additionally, COVIDTRA affirmed that the tax basis and other attributes of the borrower's assets will not be reduced as a result of PPP loan forgiveness, and forgiven PPP loan proceeds are not included in the borrower's gross income. COVIDTRA clarifies that in the case of an eligible recipient that is a partnership or S corporation, any amount excluded from income shall be treated as tax exempt income for purposes of §705 and §1366. Except as provided by the Secretary of the Treasury, any increase in the adjusted basis of a partner's interest in a partnership under §705 shall equal the partner's distributive share of deductions resulting from costs giving rise to forgiveness. In other words, there is a permanent tax benefit for owners of pass-through entities that obtained PPP loans, as the CAA 2021 provides a basis increase for excluded income and there is no required attribute reduction for such excluded income.

S corporations have a positive basis adjustment for forgiven PPP loan proceeds, since these proceeds are tax-exempt income. Both taxable and tax-exempt income are positive adjustments to basis of S corporation shareholders. Deductible expenses paid with the PPP loan proceeds reduce the shareholder's basis in stock.

Unlike S corporations, a partner in a partnership receives a positive basis adjustment for a PPP loan when the loan proceeds are received, equal to the partner's allocable share of the liability. Section 752 provides that a PPP loan creates basis for the partners by each partner's allocable share of the PPP loan. No partner is personally liable for any portion of a PPP loan, and as such, the §465 at-risk rules provide that the PPP loan amount is not at risk. As a result, losses resulting from spending PPP loan proceeds are suspended due to lack of amounts at risk.

On April 22, 2021, the IRS issued Rev Proc. 2021-20, providing a safe harbor to taxpayers who received a PPP loan, and based on guidance prior to the enactment of COVIDTRA, did not deduct otherwise deductible expenses paid for with PPP loan proceeds during their taxable year ending after March 26, 2020, and on or before December 31, 2020, that resulted in, or were expected to result in, forgiveness of the PPP loan. The safe harbor provided in this notice allows such taxpayer to elect to deduct these expenses on their timely filed original federal income tax return or information return, as applicable, for their first taxable year following their 2020 taxable year rather than filing an amended return or an AAR for their 2020 taxable year in which the expenses were paid or incurred, provided that such taxpayer:

- **Is a “covered taxpayer.”** A “covered taxpayer” is defined as a taxpayer that:
 - Received an original PPP covered loan;
 - Paid or incurred original eligible expenses during their 2020 taxable year;
 - On or before December 27, 2020, timely filed, including extensions, a federal income tax return or information return, as applicable, for the taxpayer’s 2020 taxable year; and
 - On the taxpayer’s federal income tax return or information return, as applicable, the taxpayer did not deduct the original eligible expenses because:
 - The expenses resulted in forgiveness of the original PPP loan; or,
 - The taxpayer reasonably expected at the end of the 2020 taxable year that the expenses would result in such forgiveness.
- **Satisfies all of the requirements described below:**
 - **Election Deadline:** The covered taxpayer must make the election by attaching a statement to their timely filed, including extensions, federal income tax return or information return, as applicable, for the first taxable year following their 2020 taxable year in which the original eligible expenses were paid or incurred.
 - This statement must be titled “Revenue Procedure 2021-20 Statement,” and it must include the following information:
 - The covered taxpayer’s name, address, and SSN or TIN;
 - A statement that the covered taxpayer is applying the safe harbor provided in Rev. Proc. 2021-20;
 - The amount and date of disbursement of the taxpayer’s original PPP covered loan; and,
 - A list that details the descriptions and amounts of the original eligible expenses paid or incurred by the covered taxpayer during their 2020 taxable year that are reported on the federal income tax return or information return, as applicable, for the covered taxpayer’s first taxable year following their 2020 taxable year.
 - It is important to note that COVIDTRA expanded upon the original eligible expenses to include covered supplier costs, covered operations expenditures, covered property damage costs, and covered worker protection expenditures. This expanded list of expenses is **not** included as part of the original eligible expenses, and as such, those expenses are not eligible to be deducted through the safe harbor election provided by Rev. Proc. 2021-20.

- Additionally, Second Draw Loans established by COVIDTRA are **not** considered original PPP covered loans, and therefore, eligible expenses that result in forgiveness of such loans are not covered by Rev. Proc. 2021-20.

On November 18, 2021, the IRS issued three revenue procedures, providing long-awaited guidance on certain PPP loan issues. Rev Proc. 2021-48 addresses the timing and reporting of PPP loan forgiveness. Specifically, Rev. Proc. 2021-48 provides that taxpayers may treat tax-exempt income in connection with the forgiveness of PPP loans as received or accrued:

- As eligible expenses are paid or incurred. Taxpayers who relied on the Rev. Proc. 2021-20 safe harbor will be treated as if they paid eligible expenses in the tax year following the year in which the expenses were actually paid;
- When an application for PPP loan forgiveness is filed; or
- When PPP loan forgiveness is granted.

Rev. Proc. 2021-48 is effective for any taxable year in which a taxpayer paid or incurred eligible expenses, any taxable year in which the taxpayer applied for forgiveness of a PPP Loan, or any taxable year in which the taxpayer's PPP Loan forgiveness is granted.

Additionally, Rev. Proc. 2021-48 provides that if a taxpayer receives PPP loan forgiveness for an amount less than what was previously treated as tax-exempt income, such taxpayer must make adjustments on an amended return or AAR as applicable for the taxable year(s) in which the taxpayer treated tax-exempt income from the forgiveness of such PPP Loan as received or accrued. Similarly, partners and shareholders that receive amended Forms K-1 must file amended returns, information returns, or AARs, as applicable, consistent with the Forms K-1 received.

Rev. Proc. 2021-49 provides guidance for partnerships and consolidated groups regarding tax-exempt income and deductions related to PPP loan forgiveness. If a partnership received a PPP loan and received partial or complete forgiveness of such PPP loan, the IRS will treat the taxpayer's allocation of tax-exempt income from PPP loan forgiveness and allocation of deductions in accordance with §704(b). Under §705(a), partners increase their basis by their distributive share of PPP tax-exempt income and decrease their basis by their distributive share of deductions.

In light of the changes caused by Rev. Proc. 2021-48 and Rev. Proc. 2021-49, Rev. Proc. 2021-50 permits partnerships subject to the centralized partnership audit regime to file amended partnership returns and furnish amended Schedules K-1 in lieu of filing an AAR. This relief is eligible for tax years ending after March 27, 2020 and before the issuance of Rev. Proc. 2021-50. The amended return must be filed, and Schedules K-1 must be furnished, on or before December 31, 2021.

As of May 31, 2021, nearly 12 million PPP loans were approved since the program's establishment, with nearly 7 million of such loans occurring during 2021. The specific breakdown of 2021 PPP loans is as follows:

Loan Breakdown for 2021 PPP

First Draw Loans	Loans Approved	Net Dollars	Average Loan Size	Lender Count
Total First Draw Loans	3,768,309	\$68,915,276,574	\$18,288	5,168
First Draw Loans with 10 or fewer employees	3,724,470	\$56,216,754,824	\$15,094	5,156
First Draw Loans LMI & Less than \$250k	1,343,538	\$21,951,817,118	\$16,339	4,640

Second Draw Loans	Loans Approved	Net Dollars	Average Loan Size	Lender Count
Total Second Draw Loans	2,913,620	\$208,784,831,505	\$71,658	5,216
Second Draw Loans with 10 or fewer employees	2,395,644	\$63,660,158,141	\$26,573	5,199
Second Draw Loans LMI & Less than \$250k	733,471	\$26,754,426,803	\$36,476	4,731

First & Second Draw Loans	Loans Approved	Net Dollars	Average Loan Size	Lender Count
Total First & Second Draw Loans	6,681,929	\$277,700,108,079	\$41,560	5,242
PPP Loans by Community Financial Institutions	1,604,140	\$34,095,035,498	\$21,254	501
PPP Loans by Insured Depository Institutions <\$10B in Assets	1,812,102	\$101,504,685,266	\$56,015	4,105
PPP Loans by Credit Unions <\$10B in Assets	152,366	\$5,160,428,953	\$33,869	851
PPP Loans by Farm Credit System Institutions <\$10B in Assets	19,581	\$406,682,354	\$20,769	41

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The average 2021 PPP loan was \$42,000, with the breakdown as follows:

Loan Size for 2021 PPP

Loan Size	Loan Count	Net Dollars	% of Count	% of Amount
\$50K and Under	5,822,120	\$90,807,493,443	87.1%	32.7%
>\$50K - \$100K	371,459	\$26,487,929,663	5.6%	9.5%
>\$100K - \$150K	181,705	\$22,584,777,740	2.7%	8.1%
>\$150K - \$350K	186,798	\$42,273,269,020	2.8%	15.2%
>\$350K - \$1M	93,092	\$51,987,085,335	1.4%	18.7%
>\$1M - \$2M	26,004	\$39,535,939,472	0.4%	14.2%
>\$2M - \$5M	422	\$1,335,740,553	0.0%	0.5%
>\$5M	329	\$2,687,872,852	0.0%	1.0%

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On July 28, 2021, the SBA issued a final interim rule, streamlining the forgiveness process for second draw PPP loans of \$150,000 or less for which a lender has not issued a loan forgiveness decision. As discussed, borrowers of second draw PPP loans were required to certify on their loan application that they realized a reduction of gross receipts in excess of 25% relative to the relevant comparison time period. If a borrower with a second draw PPP loan of \$150,000 or less did not produce documentation of revenue reduction at the time of application, they were to submit to the lender, on or before the date they applied for loan forgiveness, documentation to establish the 25% reduction of revenue. If the borrower of a second draw PPP loan of \$150,000 or less did not provide documentation of revenue reduction with the loan application, the lender was required to perform a good faith review of the documents provided by the borrower at or before forgiveness.

The new interim final rule issued on July 28, 2021, established an online platform as an alternative form of revenue reduction confirmation for borrowers of second draw PPP loans of \$150,000 or less who did

³⁵ SBA Paycheck Protection Program (PPP) Report, *Approvals through 5/31/2021*.

³⁶ SBA Paycheck Protection Program (PPP) Report, *Approvals through 5/31/2021*.

not submit documentation of revenue reduction at the time of the loan application. An independent third-party SBA contractor developed a COVID Revenue Reduction Score based on a variety of inputs including industry, geography, and business size. The platform will assign a COVID Revenue Reduction Score to each second draw PPP loan borrower with loans \$150,000 or less. If the borrower's COVID Revenue Reduction Score meets or exceeds the value required for validation of revenue reduction, it will satisfy the requirement for the borrower to document revenue reduction. If the borrower's COVID Revenue Reduction Score does not meet the value required for validation of revenue reduction, and the borrower has not provided documentation to the lender to validate revenue reduction, the borrower must either provide documentation directly to the lender or upload such information to the online platform.

Lenders will be able to see this score on the online platform, and they will be able to use this score as an optional alternative to document revenue reduction. Borrowers who submit their loan forgiveness application through the platform and utilize the direct borrower forgiveness process will also be able to see their score.

Additionally, the new interim final regulations directed the SBA to implement a direct borrower forgiveness process for PPP lenders, integrating the streamlined forgiveness application for loans of \$150,000 or less. Such platform will serve as a single secure location for borrowers with loans of \$150,000 or less to apply for forgiveness. Lenders will receive notification when a borrower has applied for forgiveness, and lenders will review the loan forgiveness application on the platform and have the ability to issue a forgiveness decision to the SBA within the platform. The SBA stated that the direct borrower forgiveness process will have reduced costs, increased efficiency, and more timely remittance of forgiveness payments from the SBA. Borrowers will also have less wait time and uncertainty when using the platform as opposed to submission through their lender.

During the transition period after the launch of the direct borrower forgiveness process, lenders that opt-in to the platform must finish processing forgiveness applications already submitted by borrowers, and they must inform such borrowers not to submit a duplicate loan forgiveness application through the platform. After the launch of the direct borrower forgiveness process, borrowers will still be able to submit loan forgiveness applications to their lenders rather than through the platform, provided any of the following circumstances apply:

- The PPP lender did not opt-in to use the direct borrower forgiveness process;
- The borrower's PPP loan amount was greater than \$150,000;
- The borrower does not agree with the SBA's data on record or cannot validate their entity in the platform; or
- The borrower's submission is rejected for any other reason.

The PPP Direct Borrower Forgiveness Portal officially launched on August 4, 2021. Since that time, over one million PPP loan forgiveness applications were submitted to the Portal for borrowers seeking forgiveness of loans \$150,000 or less. This represents roughly 91% of all 2020 PPP loans eligible for direct forgiveness, with over 1,400 lenders participating in the program. Approximately 65% of all 2021 PPP loans eligible for direct forgiveness have been submitted to the PPP Direct Borrower Forgiveness Portal. Borrowers can complete and submit their SBA applications to the PPP Direct Borrower Forgiveness Portal using their smartphone. It takes roughly six minutes for borrowers to complete and submit their forgiveness applications using the Portal. The forgiveness decision is usually made within a week from the submission date.

5. Economic Injury Disaster Loans (“EIDLs”)

On March 6, 2020, as part of the Coronavirus Preparedness and Response Supplemental Appropriations Act, Congress expanded SBA’s disaster assistance loans, specifically Economic Injury Disaster Loans (“EIDLs”). EIDLs of up to \$2 million with low 3.75% interest rates (2.75% for non-profits) and 30-year terms were made available to certain businesses determined on a case-by-case basis, based on the borrower’s ability to repay. Small businesses, as defined for purposes of the EIDL loan, include companies with no more than 500 employees. The CARES Act expanded upon many of the provisions outlined in the original Coronavirus Preparedness and Response Supplemental Appropriations Act.

The CARES Act modified the Coronavirus Preparedness and Response Supplemental Appropriations Act by waiving the following requirements for EIDL Loans:

- A borrower is not required to have been in business for one year in order to qualify for an EIDL loan;
- No personal guarantees are necessary on EIDL loans less than \$200,000;
- No collateral is necessary on EIDL loans less than \$25,000; and
- Borrowers are not required to be unable to obtain credit from other sources in order to qualify for an EIDL loan.

EIDL loans were available to borrowers until December 31, 2020. The *Paycheck Protection Program and Health Care Enhancement Act* provided an additional \$60 billion in funding for EIDL loans.

EIDL loans provided borrowers with a \$10,000 emergency advance within 3 days of submitting the application, even if the loan application is still pending. The advance is not required to be repaid. EIDL loans can be used for the following purposes:

- Fixed debts;
- Accounts payable;
- Payroll; and
- Other costs as defined by EIDL terms.

EIDL loans cannot be used for the following purposes:

- Refinancing debt (except for Payroll Protection Plan loans);
- Replacing lost sales or profits;
- Paying other federal loans;
- Paying tax penalty obligations;
- Paying dividends to stockholders; and
- Repairing damages.

COVIDTRA allocated an additional \$20 billion for EIDL grants and established that gross income does not include forgiveness of certain loans, emergency EIDL grants, and certain loan repayment assistance as provided by the CARES Act. Similar to PPP loan recipients, EIDL loan recipients may deduct otherwise deductible expenses paid with forgiven loan proceeds, and the tax basis and other attributes of the borrower’s assets will not be reduced as a result of loan forgiveness. COVIDTRA extended the EIDL program through December 31, 2021.

The additional EIDL funding is available to covered entities that:

- Are located in a low-income community;
- Suffered an economic loss of at least 30%; and

- Employ 300 employees or fewer.

If a covered entity previously received an EIDL grant through the CARES Act, the maximum grant they are eligible to receive is the difference between \$10,000 and the amount previously received.

COVIDTRA repealed the requirement that PPP borrowers deduct the amount of any EIDL advance from their PPP forgiveness amount.

ARPA allocated an additional \$15 billion in aid for the EIDL program, including \$10 billion to the Targeted EIDL Advance program and \$5 billion for the new Supplemental Targeted EIDL Advance program. Businesses that received a previous EIDL advance in an amount less than \$10,000 had first priority to receive a Targeted EIDL advance. These businesses may only apply when they receive an invite from the SBA.

The second priority group included any businesses and nonprofit organizations that applied for EIDL assistance prior to December 27, 2020 but did not receive an EIDL advance due to exhausted funding. Under the new Supplemental Targeted EIDL Advance program, businesses with 10 or fewer employees were eligible to receive supplemental payments of \$5,000 if they suffered economic losses of more than 50% during the covered period.

On September 9, 2021, the SBA announced new changes to the COVID EIDL Program for small businesses impacted by the COVID-19 pandemic and ongoing Delta variant. Major changes to the EIDL Program include:

- **Increasing the maximum EIDL amount from \$500,000 to \$2,000,000:** These funds can be used for expenses such as payroll, operating expenses, working capital, paying debt, and purchasing equipment.
- **Implementing a Deferred Payment Period:** Borrowers may defer repayment of the COVID EIDL until two years after the loan origination date.
- **Establishing a 30-Day Exclusivity Window:** There will be a 30-day exclusivity window of approving and disbursing funds for loans of \$500,000 or less. Any approval or disbursement of loans over \$500,000 will occur after the initial 30-day exclusivity window, on October 8, 2021.
- **Expanding the Eligible Use of Funds:** Borrowers may use the COVID EIDL for additional purposes, such as to prepay commercial debt and pay federal business debt.
- **Simplifying Affiliation Requirements:** The COVID application process will have more simplified affiliation requirements.

Under the COVID-19 EIDL Program, borrowers seeking loans of \$25,000 or less will pay no fees if applying directly through the SBA, and no collateral is required. Loans greater than \$25,000 will have certain fees associated with them and will require collateral. Personal guaranty is required for loans greater than \$200,000. These loans will have a term of 30 years at a fixed rate of 3.75% for business and 2.75% for private nonprofit organizations. There is no penalty for prepayment.

6. Restaurant Revitalization Fund (RRF) grants

ARPA provided additional relief to struggling restaurants and bars by allocating \$28.6 billion for Restaurant Revitalization Grants administered by the SBA. The funding was divided into government-funded grants with a maximum of \$10 million per restaurant group or \$5 million per individual restaurant

location. Of the \$28.6 billion of funding, \$5 billion was allocated specifically to provide RRFs to businesses with 2019 gross receipts of less than \$500,000. If funds are used for eligible expenses by March 11, 2023, the recipient is not required to repay the grant. The maximum grant amount was limited to the business's "pandemic-related revenue loss," defined as:

- 2020 gross receipts subtracted from 2019 gross receipts.
- If the entity was not in operation for the entirety of 2019, the difference between:
 - The product obtained by multiplying the average monthly gross receipts of the eligible entity in 2019 by 12; and
 - The product obtained by multiplying the average monthly gross receipts of the eligible entity in 2020 by 12.
- If the entity opened during the period beginning on January 1, 2020, and ending on the day before March 11, 2021, any payroll expenses that were incurred by the eligible entity minus any gross receipts received.
- If the entity has not yet opened as of the date of the grant application, the amount of payroll expenses incurred as of March 11, 2021.

For purposes of the RRF program, gross receipts did not include amounts received from first or second draw PPP loans, EIDL loans or advances, or state and local grants. In order to receive a Restaurant Revitalization Grant, the business was required to certify that:

- The uncertainty of current economic conditions makes the grant request necessary to support ongoing operations; and,
- The business has not applied for or received a Shuttered Venue Operators (SVO) grant.

For eligibility purposes, restaurants include any other specified food businesses, including:

- Restaurants, food stands, food trucks, food carts, caterers, saloons, inns, taverns, bars, lounges, brewpubs, tasting rooms, taprooms, licensed facilities or premises of a beverage alcohol producer where the public may taste, sample, or purchase products, or other similar places of business in which the public or patrons assemble for the primary purpose of being served food or drink.
- Any entity mentioned above that is located in an airport terminal.

Any state or local government-operated business, or a company that as of March 13, 2020 operates in more than 20 locations, was ineligible for a Restaurant Revitalization Grant. Publicly traded companies were ineligible to apply for Restaurant Revitalization Grants.

During the initial 21-day period in which the SBA Administrator awarded grants, the SBA was required to prioritize awarding grants to the following groups:

- Small business concerns that are at least 51% owned by one or more individuals who are women, veterans, or socially and economically disadvantaged (defined below per SBA guidelines):
 - **Socially disadvantaged individuals** include those who have been subject to racial or ethnic prejudice or cultural bias because of their identity as a member of a group without regard to their individual qualities.
 - **Economically disadvantaged individuals** include those socially disadvantaged individuals whose ability to compete in the free enterprise system has been impaired due to diminished capital and credit opportunities as compared to others in the same business area who are not socially disadvantaged.

For purposes of establishing priority, an applicant was required to submit a self-certification of eligibility for priority with the grant application. All eligible applicants had the opportunity to apply during the initial 21-day period, but only applications from prioritized groups were processed during this time period. After the initial 21-day period, the SBA began processing applications from all applicants.

The Restaurant Revitalization Grants can be used for certain purposes, including payroll costs, rent, utilities, mortgage payments, supplies, maintenance expenses, food and beverage expenses, operational expenses, covered supplier costs, paid sick leave, and any other expense determined to be essential to maintaining the business. If the business fails to use the grant funds on these allowable expenses, the grant funds must be returned to the SBA. Similarly, if the business goes out of business prior to using all of the grant funds or fails to use all of the grant funds before December 31, 2021 or within two years of March 11, 2021, the entity must return the grant funds to the SBA. The covered period for expenses that can be paid by the RRF grant is between February 15, 2020 and December 31, 2021.

Amounts received from the SBA in the form of a restaurant revitalization grant are not included in the gross income of the person that receives such amounts. No deduction shall be denied, no tax attribute shall be reduced, and no basis increase shall be denied, by reason of the exclusion from gross income and in the case of a partnership or S corporation that receives such amounts. Lastly, any amount excluded from income shall be treated as tax exempt income for purposes of §§705 and 1366.

There was an unprecedented amount of demand for the RRF grants, and as a result, the SBA closed the RRF program as of July 2, 2021. It is possible that Congress will replenish the RRF through future legislation due to ongoing demand.

Shuttered Venue Operators (SVO) grants

The Shuttered Venue Operators grant program was initially established by the Economic Aid to Hard-Hit Small Businesses, Nonprofits, and Venues Act as part of the Consolidated Appropriations Act of 2021. ARPA designates an additional \$1.25 billion to this program to aid eligible “shuttered venue” entities including live venue operators, theatrical producers, museum operators, zoo or aquarium operators, and motion picture theater operators. The SBA accepted applications for this program through August 20, 2021.

Any entity that received a first or second draw PPP loan may still apply for an SVO grant; however, any entity will be ineligible for a PPP loan after they receive an SVO grant. Any entity that receives a PPP loan on or after December 27, 2020 will have the PPP loan amount deducted from the SVO grant amount. If an entity received both a First Draw and Second Draw PPP Loan after December 27, 2020, the combined amount will be deducted from the SVO grant. Any entity that received a PPP loan before December 27, 2020 will not have the PPP loan amount deducted from any subsequent SVO grant.

7. Employee Retention Tax Credit (“ERTC”)

The CARES Act created an employee retention credit for employers subject to closure due to COVID-19. Under the CARES Act, employers were initially eligible to receive a payroll tax credit for 50% of wages paid by employers to employees after March 12, 2020 and before January 1, 2021. ARPA initially extended the ERTC from June 30, 2021 through December 31, 2021. However, *The Infrastructure Investment and Jobs Act*, signed into law on November 15, 2021, retroactively terminated the ERTC effective September 30, 2021, for all entities other than eligible recovery startup businesses.

Qualifying for the ERTC

This section will discuss how to qualify for the ERTC. There are three main ways to qualify for the ERTC, including:

- Experiencing a significant decline in quarterly revenue (gross receipts);
- Experiencing a full or partial government shutdown; or
- Qualifying for the recovery startup provision.

Eligible employers, including tax-exempt organizations, comprise those from a. or b. below.

- a. Employers that fully or partially suspended operation during any calendar quarter in 2020 due to orders from an appropriate governmental authority limiting commerce, travel, or group meetings for commercial, social, religious, or other purposes due to COVID-19.

A governmental order includes:

- An order from the city’s mayor stating that all non-essential businesses must close for a specified period;
- A state’s emergency proclamation that residents must shelter in place for a specified period, other than residents who are employed by an essential business and may travel to and work at the workplace location; or
- An order from a local official imposing a curfew on residents that impacts the operating hours of a trade or business for a specified period.

- b. Employers that experienced a **significant decline in gross receipts** during the calendar year.³⁷

- For **calendar year 2020**, a significant decline in gross receipts is determined by identifying the first calendar quarter in 2020 (if any) in which an employer’s gross receipts are less than 50% of its gross receipts for the same calendar quarter in 2019. The period during which there is a significant decline in gross receipts ends with the earlier of January 1, 2021, or the calendar quarter that follows the first calendar quarter in which the employer’s 2020 quarterly gross receipts are greater than 80% of its gross receipts for the same calendar quarter in 2019.
- For **calendar year 2021**, a significant decline in gross receipts is determined by identifying a decline of at least 20% of the employer’s gross receipts when compared to the same calendar quarter in 2019. Alternately, the employer can use the previous quarter’s gross receipts compared to the same quarter in 2019. The determination of whether an employer is an eligible employer based on a decline in gross receipts is made separately for each calendar quarter.

³⁷

CARES Act §2301(c)(2), updated by COVIDTRA and Notice 2021-20.

- An employer that started its business in the first quarter of 2019 should use the gross receipts for the applicable quarter of 2019 for comparison to the gross receipts for the same quarter in 2020 to determine whether it experienced a significant decline in gross receipts in any quarter of 2020.
- An employer that started its business in the second quarter of 2019 should use that quarter as the base period to determine whether it experienced a significant decline in gross receipts for the first two quarters in 2020 and should use the third and fourth quarters of 2019 for comparison to the third and fourth quarters of 2020, respectively, to determine whether it experienced a significant decline in gross receipts for those quarters.
- An employer that started its business in the third quarter of 2019 should use that quarter as the base period to determine whether it experienced a significant decline in gross receipts for the first three quarters in 2020 and should use the fourth quarter of 2019 for comparison to the fourth quarter of 2020 to determine whether it experienced a significant decline in gross receipts for that quarter.
- An employer that started its business in the fourth quarter of 2019 should use that quarter as the base period to determine whether it experienced a significant decline in gross receipts for any quarter in 2020.
- If an employer commenced business in the middle of a quarter in 2019, the employer should estimate the gross receipts it would have had for the entire quarter based on the gross receipts for the portion of the quarter that the business was in operation. To calculate this amount, the employer may use any reasonable method, including extrapolating the gross receipts for the quarter based on the gross receipts for the number of days its business was operating during the quarter.

Practice note:

Prior to Rev. Proc. 2021-33, it was uncertain whether PPP loan forgiveness in 2021 was required to be included in gross receipts when measuring a 20% decline for ERTC purposes. Rev. Proc. 2021-33 creates a safe harbor, clarifying that the following amounts may be excluded in calculating gross receipts for purposes of the ERTC:

- Forgiveness of a Paycheck Protection Program Loan;
- Shuttered Venue Operators Grants under the Economic Aid to Hard-Hit Small Businesses, Non-Profits, and Venues Act; and
- Restaurant Revitalization Grants under the American Rescue Plan Act of 2021.

Rev. Proc. 2021-33 requires employers to apply the safe harbor consistently for determining eligibility for the ERTC. The employer must exclude the amounts from their gross receipts for each calendar quarter in which gross receipts are relevant to determining eligibility to claim the ERTC. Additionally, the employer claiming the ERTC must also apply the safe harbor to all employers treated as a single employer under the aggregation rules. An employer is not required to apply this safe harbor, and the safe harbor does not permit the exclusion of these amounts from gross receipts for any other federal tax purpose.

The refundable payroll tax credit is based on qualified wages paid to the employee. No credit is available with respect to an employee for which the employer is allowed a Work Opportunity Credit. The same wages cannot be counted for the sick leave or family leave credits and the employee retention credit. Under the CARES Act, the ERTC was equal to 50% of qualified wages, up to \$10,000, for qualified

wages paid or incurred after March 12, 2020 and before January 1, 2021. In other words, the ERTC was worth up to \$5,000 per employee in 2020. The CARES Act definition of qualified wages for purposes of the ERTC was dependent upon the number of employees:

- **More than 100 Full-Time Employees:** For purposes of the ERTC for 2020, if the employer averaged more than 100 full-time employees during 2019, qualified wages were generally wages, including certain health care costs (\$10,000 per employee limit), paid to employees who were not providing services because operations were either suspended due to a governmental order or the business experienced a significant decline in gross receipts. Qualified wages could only be considered to the extent that the employee would have been paid for working an equivalent duration during the 30 days immediately preceding the suspension or decline in gross receipts. This is often referred to as the “30-day” rule.
- **100 or Fewer Full-Time Employees:** For purposes of the ERTC for 2020, if the employer averaged 100 or fewer full-time employees during 2019, qualified wages were generally wages, including certain health care costs (\$10,000 per employee limit) paid to any employee during the period operations were suspended due to a governmental order or there was a decline in gross receipts. In other words, employers that averaged 100 or fewer full-time employees during 2019 could include all wages paid, regardless of whether the employee was providing services.

Who is a Full-Time Employee?

Per Notice 2021-20, a full-time employee for purposes of the ERTC is an employee who, with respect to any calendar month in 2019, had an average of at least 30 hours of service per week or 130 hours of service in the month.

Planning Point

The employer should maintain documentation to show how the employer determined it was an eligible employer that paid qualified wages, including:

- Any governmental order to suspend the employer's business operation;
- Any records the employer relied upon to determine whether more than a nominal portion of its operations were suspended due to a governmental order or whether a governmental order had more than a nominal effect on its business operations;
- Any records the employer used to determine it had experienced a significant decline in gross receipts;
- Any records of which employees received qualified wages and in what amounts; and
- In the case of a large eligible employer, work records, and documentation showing that wages were paid for time an employee was not providing services.

Additionally, the employer should maintain the following records to substantiate eligibility for the ERTC:

- Documentation to show how the employer determined the amount of allocable qualified health plan expenses;
- Documentation related to the determination of whether the employer is a member of an aggregated group treated as a single employer for purposes of the ERTC and, if so, how the aggregation affects the determination and allocation of the credit;
- Copies of any completed Forms 7200 that the employer submitted to the IRS; and
- Copies of the completed federal employment tax returns that the employer submitted to the IRS (or, for employers that use third-party payers to meet their employment tax obligations, records of information provided to the third-party payer regarding the employer's entitlement to the credit claimed on the federal employment tax return).

The Consolidated Appropriations Act of 2021 (CAA 2021) extended the ERTC through June 30, 2021 and implemented other changes related to the ERTC, including:

- Increasing the credit from 50 percent to 70 percent of qualified wages in 2021.
- Expanding the credit eligibility threshold for "the significant decline in gross receipts" from a 50-percent decline in year-over-year gross receipts to a 20-percent decline in year-over-year gross receipts.
 - It establishes a safe harbor, allowing employers to use prior quarter gross receipts to determine eligibility.
- Increasing the wage limit on a per-employee basis from \$10,000 per year to \$10,000 per quarter in 2021 (i.e. \$10,000 for the first quarter of 2021 and \$10,000 for the second quarter of 2021). CAA 2021 clarified that group health plan expenses are considered qualified wages, even when no other wages are paid to the employee.
- Increasing the 100 or fewer employee wage base to 500 or fewer employees.
- Removing the 30-day wage limitation and allowing employers to claim the credit on bonus pay to essential workers.
- Allowing businesses with 500 or fewer employees to advance the credit at any point during the quarter based on wages paid in the same quarter in a previous year.
- Allowing employers who were not in existence for all or part of 2019 to claim the credit.

For purposes of determining the ERTC, all wages of employers with 500 or fewer full-time-equivalent employees qualify. Wages and healthcare costs only qualify for taxpayers with over 500 full-time or full-time equivalent employees if paid while employees are not providing full services. Employers can use any

reasonable method to determine amounts paid to salaried employees for time not worked, although mere reductions in productivity do not qualify.

ARPA initially extended the ERTC from June 30, 2021 through December 31, 2021, and implemented the following provisions:

- Maintained the credit at 70 percent of qualified wages in 2021.
- Maintained the wage limit on a per-employee basis of \$10,000 per quarter in 2021.
- Established that the ERTC in any calendar quarter may not exceed the applicable employment taxes, reduced by any credits allowed under IRC §§3131 and 3132 for qualified sick leave and family leave, on the wages paid with respect to the employment of all the employees of the eligible employer.
 - However, if the amount of the ERTC exceeded this limitation for any calendar quarter, the excess was treated as an overpayment and refunded to the employer under IRC §§6402 and 6413.
- Created a limitation for the credit for *recovery startup businesses*, defined as employers who: (i) began operations after February 15, 2020; (ii) who have average annual gross receipts for a three-taxable-year period ending with the taxable year which precedes such quarter not in excess of \$1,000,000; and (iii) is not otherwise an eligible employer due to a full or partial suspension of operations or a decline in gross receipts. As clarified by Notice 2021-49, such recovery startup businesses are limited to a credit of \$50,000 for each of the third and fourth calendar quarters of 2021. Businesses that meet the definition of a recovery startup business are neither required to meet the gross receipts test nor have been subject to a government shutdown in order to claim the credit.
 - The determination of whether an employer is a recovery startup business is made separately for each calendar quarter.
- Provided special rules for severely financially distressed employers, defined as an employer who has suffered a decline in quarterly gross receipts of 90% or more compared to the same calendar quarter in 2019 (or 2020 if the employer did not exist in 2019). These financially distressed employers can treat all wages paid during those quarters (subject to the limitation) as qualified wages, rather than only wages paid to employees when they do not provide services. Additionally, Notice 2021-49 clarified that employers may claim the ERTC for qualified wages paid in the same quarter the credit is being claimed.
- Created a new provision for employers not in existence in 2019 by allowing such employers to define qualified wages by substituting 2019 with 2020.

As discussed, on November 15, 2021, President Biden signed *The Infrastructure Investment and Jobs Act* into law, retroactively terminating the ERTC as of September 30, 2021 for all entities other than eligible recovery startup businesses. As a result, wages paid after September 30, 2021 by entities other than eligible recovery startup businesses are not eligible for the ERTC. Recovery startup businesses may continue to take the Employee Retention Tax Credit through December 31, 2021.

As a result of *The Infrastructure Investment and Jobs Act*, the maximum ERTC per employee of nonrecovery startup businesses in 2021 is \$21,000 (\$10,000 wage limitation per quarter x 70% credit x 3 quarters) instead of \$28,000. Employers may have reduced their tax deposits in anticipation of the ERTC or retained payroll taxes in anticipation of the fourth quarter ERTC. The IRS issued Notice 2021-65, clarifying that employers that reduced deposits on or before Dec. 20, 2021, for wages paid during the fourth calendar quarter of 2021 in anticipation of the ERTC, will not be subject to a failure to deposit penalty with respect to the retained deposits, provided that:

- The employer reduced deposits in anticipation of the ERTC consistent with the rules provided in Notice 2021-24;
- The employer deposits the amounts initially retained in anticipation of the ERTC on or before the relevant due date for wages paid on December 31, 2021; and
- The employer reports the tax liability resulting from the termination of the employer's ERTC on the applicable employment tax return or schedule that includes the period from October 1, 2021, through December 31, 2021.

Notice 2021-65 also clarifies that employers who are no longer eligible for the ERTC in the fourth quarter of 2021 but received advance payments for fourth quarter wages of 2021 will avoid failure to pay penalties if they repay such amounts by the due date of their applicable employment tax return that includes the fourth calendar quarter of 2021.

Notice 2021-49: A Strange Twist

The IRS issued Notice 2021-49 on August 4, 2021, clarifying many aspects regarding the ERTC, but also creating a predicament for many majority owners of corporations. Per the Notice, any wages paid to a majority owner or his or her spouse are not eligible for the ERTC due to attribution rules if they have any living related family members, including:

- A child or a descendant of a child;
- A brother, sister, stepbrother, or stepsister;
- A father or mother, or an ancestor of either;
- A stepfather or stepmother;
- A niece or nephew;
- An aunt or uncle;
- A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law.

In other words, wages paid to a majority owner of a corporation will only be considered qualified wages for purposes of the ERTC if such majority owner has no living family relatives. The Notice provides four examples to demonstrate these rules:

Example 1: Corporation A is owned 80 percent by Individual E and 20 percent by Individual F. Individual F is the child of Individual E. Corporation A is an eligible employer with respect to the first calendar quarter of 2021. Both Individual E and Individual F are employees of Corporation A. Pursuant to the attribution rules of §267(c) of the Code, both Individual E and Individual F are treated as 100-percent owners of Corporation A. Individual E has the relationship to Individual F described in §152(d)(2)(C) of the Code, and Individual F has the relationship to Individual E described in §152(d)(2)(A). Accordingly, Corporation A may not treat as qualified wages any wages paid to either Individual E or Individual F because both Individual E and Individual F are each related individuals for purposes of the employee retention credit.

Example 2: Corporation B is owned 100 percent by Individual G. Individual H is the child of Individual G. Corporation B is an eligible employer with respect to the first calendar quarter of 2021. Individual G is an employee of Corporation B, but Individual H is not. Pursuant to the attribution rules of §267(c) of the Code, Individual H is attributed 100-percent ownership of Corporation B, and both Individual G and Individual H are treated as 100-percent owners. Individual G has the relationship to Individual H described in §152(d)(2)(C) of the Code. Accordingly, Corporation B may not treat as qualified wages any wages paid to Individual G because Individual G is a related individual for purposes of the employee retention credit.

Example 3: Corporation C is owned 100 percent by Individual J. Corporation C is an eligible employer with respect to the first calendar quarter of 2021. Individual J is married to Individual K, and they have no other family members as defined in §267(c)(4) of the Code. Individual J and Individual K are both employees of Corporation C. Pursuant to the attribution rules of §267(c), Individual K is attributed 100-percent ownership of Corporation C, and both Individual J and Individual K are treated as 100-percent owners. However, Individuals J and K do not have any of the relationships to each other described in §152(d)(2)(A)-(H) of the Code. Accordingly, wages paid by Corporation C to Individual J and Individual K in the first calendar quarter of 2021 may be treated as qualified wages if the amounts satisfy the other requirements to be treated as qualified wages.

Example 4: Corporation D is owned 34 percent by Individual L, 33 percent by Individual M, and 33 percent by Individual N. Individual L, Individual M, and Individual N are siblings. Corporation D is an eligible employer with respect to the first calendar quarter of 2021. Individual L, Individual M, and Individual N are employees of Corporation D. Pursuant to the attribution rules of §267(c) of the Code, Individual L, Individual M, and Individual N are treated as 100-percent owners. Individual L, Individual M, and Individual N have the

relationship to each other described in §152(d)(2)(B) of the Code. Accordingly, Corporation D may not treat as qualified wages any wages paid to Individual L, Individual M, or Individual N.

Unlike certain portions of Notice 2021-49 that specifically address the ERTC for the third and fourth quarters of 2021, the specific guidance regarding attribution rules applies for both 2020 and 2021.

On April 2, 2021, the IRS issued an advance version of Notice 2021-23, detailing how employers could take advantage of the ERTC in 2021. In 2020, there were no restrictions on claiming the ERTC in advance nor a maximum amount of credit advance that could be obtained. All employers could claim the ERTC in the first and second quarters of 2021 prior to filing their employment tax returns by reducing employment tax deposits in anticipation of the employee retention credit. However, only **small** eligible employers could elect to receive an advance payment of the ERTC in an amount not to exceed 70 percent of the average quarterly wages paid in calendar year 2019. This is also referred to as “the 70 percent advance rule.” Small eligible employers are defined as employers with an average of 500 or less full-time employees in 2019. For purposes of the 70-percent advance rule, “average quarterly wages” is the average of wages or compensation determined without regard to the Social Security wage base, paid in each calendar quarter in 2019. If the small eligible employer employs seasonal workers, they may elect to determine average quarterly wages by taking into account the wages for the calendar quarter in 2019 which correspond to the calendar quarter to which the election relates rather than the average quarterly wages paid in calendar year 2019. These small eligible employers were still required to reduce deposits in anticipation of the ERTC before requesting an advance.

Notice 2021-49 addressed changes to claiming the ERTC in the third quarter and fourth quarter (prior to the passage of *The Infrastructure Investment and Jobs Act*) of 2021. During 2020 and the first and second quarter of 2021, an eligible employer could claim the credit against the employer share of Social Security tax. During the third quarter of 2021, eligible employers can claim the credit against the employer’s share of Medicare tax. Any excess ERTC is refundable under IRC §§6402 and 6413.

The CARES Act initially provided that an eligible employer that received a PPP loan would not be eligible for the ERTC. The CAA 2021 retroactively amended the CARES Act and provided that employers who receive a PPP loan are still eligible to claim the ERTC for wages paid for funds other than those used to obtain PPP loan forgiveness. The same is true if the business used funds forgiven under another recovery relief provision, such as a restaurant revitalization grant.

Example 1: Employer ABC used 50% of payroll for PPP forgiveness. As such the remaining 50% of payroll is available to use for other programs, such as ERTC, FFCRA, and WOTC, if the employer otherwise qualifies. If the organization should qualify for PPP forgiveness, ERTC, FFCRA, and WOTC, it needs to specifically indicate which dollars should be applied to which program and in which order. However, there is no rule prohibiting a taxpayer from using the same pay period’s payroll for each of these credit and relief options. Practitioners beware: no “double dipping” allowed!

Notice 2021-20 provided additional guidance, stating that employers can elect out of claiming the ERTC so that the wages can count towards PPP loan forgiveness. Per Notice 2021-20, an eligible employer generally makes the election by not claiming the ERTC for those qualified wages on Form 941. Additionally, an eligible employer that received a PPP loan is deemed to have made the election for the

amount of qualified wages included in the amount reported as payroll costs on the PPP loan forgiveness application, up to (but not exceeding) the minimum amount of payroll costs, together with any other eligible expenses reported on the PPP Loan Forgiveness Application. An eligible employer is not deemed to have made an election for any qualified wages paid by the eligible employer that are not included in the payroll costs reported on the PPP Loan Forgiveness Application. Notice 2021-20 is taxpayer friendly in that it allows the taxpayer to pick and choose which wages are reported on the PPP forgiveness application. The ERTC does not apply to the qualified wages for which the election or deemed election is made.

Lastly, Notice 2021-20 clarifies that if an eligible employer reports any qualified wages as payroll costs on a PPP Loan Forgiveness Application, but the loan amount is not forgiven, those qualified wages may be considered for purposes of the ERTC. If an eligible employer obtains forgiveness of only a portion of the PPP loan amount, then the employer is deemed to have made an election for the minimum amount of qualified wages included in the payroll costs reported on the PPP Loan Forgiveness Application necessary to obtain the forgiveness of that amount of the PPP loan. If a taxpayer qualified for the ERTC in 2020 and did not claim the ERTC on its original Form 941, the taxpayer can file a Form 941-X for each qualifying quarter.

Example 1: Employer XYZ received a PPP loan of \$100,000 and paid \$100,000 of qualified wages during the second and third quarters of 2020 that would qualify for the ERTC.

- In order to receive forgiveness of the PPP loan, Employer XYZ was required under the SBA rules to report a total of \$100,000 of payroll costs and other eligible expenses.
- Employer XYZ submitted a PPP Loan Forgiveness Application and reported the \$100,000 of qualified wages as payroll costs in support of forgiveness of the entire PPP loan.
- In the first quarter of 2021, employer XYZ received a decision that the entire PPP loan amount of \$100,000 was forgiven.
- Employer XYZ is deemed to have made an election not to take into account \$100,000 of the qualified wages for purposes of the ERTC.

Example 2: Employer XYZ received a PPP loan of \$200,000 and paid \$250,000 of qualified wages during the second and third quarters of 2020 that would qualify for the ERTC.

- In order to receive forgiveness of the PPP loan, Employer XYZ was required under the SBA rules to report a total of \$200,000 of payroll costs and other eligible expenses.
- Employer XYZ submitted a PPP Loan Forgiveness Application and reported the \$250,000 of qualified wages as payroll costs in support of forgiveness of the entire PPP loan.
- In the first quarter of 2021, employer XYZ received a decision that the entire PPP loan amount of \$200,000 was forgiven.
- Employer XYZ is deemed to have made an election not to take into account \$200,000 of the qualified wages for purposes of the ERTC.

- Employer XYZ is not treated as having made an election with respect to the remaining \$50,000 of wages, so these wages may be treated as qualified wages for purposes of the ERTC.

Planning Point

Since taxpayers may use the same payroll for PPP forgiveness, ERTC, and FFCRA credits, it is important to plan to determine what provides such taxpayers with the greatest benefit. Generally, taxpayers will receive the greatest benefit by prioritizing PPP loan forgiveness, followed by the FFCRA credits (as these are dollar-for-dollar credits), followed by the ERTC (as only a smaller percentage of qualified wages are considered for purposes of the credit).

Notice 2021-24 (discussed earlier with respect to FFCRA credits) also waives the §6656 failure to deposit penalty for failure to timely deposit employment taxes with respect to qualified wages paid related to the ERTC for the period beginning January 1, 2021 and ending June 30, 2021 (under the CAA 2021) and for the period beginning April 1, 2021 and ending September 30, 2021 (under ARPA).

8. Charitable contributions

Corporate charitable contribution deductions cannot exceed 10% of taxable income prior to the contribution or any dividends received deduction.³⁸ Similar to individuals, if a corporation has charitable contributions in excess of the 10% limit, the excess is allowed as a charitable contribution deduction over the next five years. The CARES Act temporarily increases the 10% corporate limitation to 25% for contributions made in 2020. The CAA 2021 extends the corporate limitation of 25% through 2021. Contributions must be made to a public charity or foundation described in §170(b)(1)(A). Contributions to a supporting organization or a donor-advised fund do not qualify for the increased limits.

Lastly, §2205 increases the limitation on deductions for contributions of food inventory from 15% to 25% of taxable income. A donation of food inventory to a charitable contribution is used to care for sick and needy individuals. The CARES Act does not specify that charitable contributions must be made for COVID-19 relief efforts, so the taxpayer may choose to take advantage of higher percentage limitations to any qualified charity of its choosing.

9. Payroll tax deferral

In addition to the refundable payroll tax credit (ERTC), the CARES Act allowed employers and self-employed individuals to defer payment of the employer share of the payroll tax that they were otherwise responsible for paying to the federal government with respect to their employees.³⁹ The employer share of the Social Security tax is 6.2% of employee wages. Payroll taxes that can be deferred include the employer portion of FICA taxes, the employer and employee representative portion of Railroad Retirement taxes (that are attributable to the employer FICA rate), and half of SECA tax liability. The payroll tax deferral period began on March 27, 2020 and ended on December 31, 2020. The deferred payroll tax payment must be paid over the following two years, with half of the total deferred payment to be paid by December 31, 2021, and the remaining half of the deferred payment to be paid by December 31, 2022. Form 941, *Employer's Quarterly Federal Tax Return*, instructs employers how to reflect deferred deposits. Employers were not required to make a special election in order to defer payroll taxes.

³⁸ IRC §170(b)(2)(A).
³⁹ CARES Act §2302.

Any taxpayer who has SBA Paycheck Protection Program loan indebtedness forgiven through the CARES Act is eligible for payroll tax deferral per new guidance enacted by the PPPFA.

10. Modification of NOL Carryback

Due to the COVID-19 economic downturn, many companies faced significant net operating losses in 2020. The TCJA provided that NOL carryovers generally were allowed for a taxable year up to the lesser of the carryover amount or 80 percent of taxable income determined without regard to the deduction for NOLs. NOL carrybacks of post-2017 tax years were eliminated.

The CARES Act amended the TCJA and allowed NOLs arising in a tax year beginning after December 31, 2017 and before January 1, 2021 to be carried back to each of the five tax years preceding the tax year of such loss.⁴⁰ It also temporarily suspended the taxable income limitation in the TCJA to allow an NOL to fully offset income. For taxable years beginning before 2021, taxpayers were eligible for an NOL deduction equal to 100% of taxable income. For taxable years beginning after 2021, the taxpayer will be eligible for a 100% deduction of NOLs arising in tax years prior to 2018 and will be eligible for a deduction limited to 80% of modified taxable income for NOLs arising in tax years after 2017.

NOL Generated in Tax Years	Eligible for Carryback	Eligible for Carryforward	Eligible to Offset % of Taxable Income
Beginning on or before 12/31/17	2 tax years	20 tax years	• 100% of taxable income
2018-2020	5 tax years	Indefinite	• 100% of taxable income prior to 2021 • 80% of taxable income after 2020
2021 and beyond	Generally, no carryback	Indefinite	• 80% of taxable income

A taxpayer had the option to elect to forgo the 5-year carryback of NOLs arising in tax years beginning in 2018 and 2019. Per Notice 2020-24, taxpayers could make the election by preparing a statement stating, "Taxpayer is electing to apply section 172(b)(3) under Rev. Proc. 2020-24 for [tax year]." The election statement was required to have been made by the due date (including extensions) for filing the taxpayer's return for the first tax year ending after March 27, 2020. The election statement can be made for either or both tax years, but the election to forgo the 5-year NOL carryback period is irrevocable.

The CARES Act clarified that for tax years beginning after 2021, the 80% limitation of taxable income applies to taxable income *after* reduction for any pre-2018 NOLs. It also specifies that taxable income is determined without giving effect to the deductions for qualified business income under §199(A), or FDII and GILTI under §250. Another TCJA technical correction made by the CARES Act is that it makes the carryforward and carryback rules effective for NOLs arising in tax years beginning after December 31, 2017, rather than in tax years ending after that date. The intent of §2303 of the CARES Act was to allow companies to utilize losses and amend prior year returns, providing increased cash flow during the COVID-19 public health emergency. NOL carryforwards provide a future tax benefit, contingent upon future income for the NOL deduction to offset. Due to the COVID-19 economic downturn, some

⁴⁰ CARES Act §2303.

companies may not have future income for the NOL deduction to offset. On the other hand, NOL carrybacks provide an immediate benefit to taxpayers regardless of future income.

Example: NOL Limitations

Corporation XYZ has \$150 of pre-TCJA NOL carryovers and \$80 of post-TCJA NOL carryovers to Year 1. In Years 1 and 2, Corporation XYZ has \$100 of taxable income before any NOL deduction.

In this scenario, Corporation XYZ's pre-TCJA NOL deduction is limited to \$100 in Year 1, with \$50 of carryover to Year 2, along with \$80 post-TCJA NOL carryovers.

In Year 2, Corporation XYZ has an allowable NOL deduction of \$50 pre-TCJA NOL plus \$40 of post-TCJA NOLs, or 80% of the taxable income after accounting for the pre-TCJA NOL deduction of \$50 ($\$100 - \$50 = \$50 * 80\% = \$40$ post-TCJA allowable NOL deduction).

Companies should be especially mindful of the tax planning opportunities afforded by the new 5-year carryback period. To the extent that an NOL can offset pre-2018 income, it provides a benefit at the old pre-TCJA corporate rate of 35%. If the same NOL was taken against post-2018 income, it would only provide a benefit of the post-TCJA corporate rate of 21%. It is prudent for a taxpayer to consider accelerating deductions or deferring revenue in 2019 or 2020 in order to increase the NOLs in those years that can be carried back to a pre-2018 tax year to be taken at the pre-TCJA 35% corporate tax rate.

Planning Opportunity: Corporate NOLs

A significant planning opportunity exists for corporations who experienced NOLs in 2020, especially if said corporations experienced profits in previous years. Take the below example into consideration:

Corporation XYZ is a well-known profitable restaurant chain. Each year, thousands of customers dine at its establishments, but in 2020, each restaurant was forced to close for 4 weeks due to the COVID-19 pandemic. As a result, Corporation XYZ incurred a \$10 million loss in 2020.

Per the CARES Act §2303, Corporation XYZ can carry back the NOL generated in 2020 for any of the previous 5 years.

If Corporation XYZ had taxable income of \$10 million in 2017, the NOL generated in 2020 could be carried back to offset such income at the pre-TCJA 35% corporate tax rate. Corporation XYZ could amend its 2017 return and get a \$3.5 million refund. If the same NOL was taken in a post-TCJA year, assuming 100% deductibility, Corporation XYZ would only receive a \$2.1 million refund based on the post-TCJA 21% corporate rate.

The CARES Act presents a rare tax planning strategy, allowing taxpayers to utilize NOLs and receive the benefit of the pre-TCJA 35% corporate rate, if the taxpayer had taxable income in pre-TCJA years.

The CARES Act implemented special rules for Real Estate Investment Trusts ("REITs"). A REIT may not carry back NOLs to any tax year, regardless of whether the taxpayer was a REIT in the carryback year. Similarly, a taxpayer (who is not currently a REIT) may not carry back an NOL to any tax year in which the taxpayer was a REIT.

Taxpayers should be mindful that the carryback of NOLs could impact deductions and credits that were previously claimed in prior tax years. If a taxpayer made a §179 election to expense depreciable assets,

the deduction is limited to taxable income, with the excess carried forward to subsequent years. Carrying back a NOL would impact taxable income, and thus the §179 election. Similarly, if a taxpayer claimed a §199 DPAD deduction for a tax year prior to 2018 and intended to carry a NOL back to such tax year, taxable income will change. The DPAD deduction is limited to taxable income, so the taxpayer should consider this implication when planning NOL usage.

11. Modification of excess business losses

For taxable years beginning after December 31, 2017 and before January 1, 2026, the TCJA provided that “excess business losses” of a taxpayer other than a corporation were not allowed for the taxable year.⁴¹ ARPA extended this provision for one year, to include tax years beginning before January 1, 2027. An “excess business loss” is defined as the excess of aggregate deductions of the taxpayer attributable to trades or businesses over the sum of aggregate gross income or gain of the taxpayer plus a threshold amount (\$250,000 for individuals or \$500,000 for joint filers, not indexed for inflation).

Since the §461(l) limitation applied solely to taxpayers other than C-corporations, it caused a disproportionate impact on small business owners. The CARES Act temporarily modifies the loss limitation for noncorporate taxpayers set forth in the TCJA and allows them to deduct excess business losses arising in a tax year beginning after December 31, 2017 and before January 1, 2021.⁴² It also turns off active farming loss rules for tax years beginning after December 31, 2017 and before December 31, 2020. As a result, taxpayers who had a limited loss in either 2018 or 2019 can file an amended return and receive a refund. Taxpayers who had large losses in 2018 or 2019 resulting from the TCJA’s 100% bonus depreciation provision would especially benefit from the CARES Act excess business loss modification, as they may be able to deduct these large losses that would otherwise be limited.

The CARES Act provided a few additional technical corrections to the TCJA relating to excess business losses. The CARES Act clarifies that excess business losses do not include any net operating loss deduction under §172 or qualified business income deductions under §199(A). The §461(l) limitation excludes deductions, gross income, or gains attributable to any trade or business of performing services as an employee. In other words, W-2 income is not considered business income under §461(l). Additionally, the CARES Act specifies that per the NOL rules, capital losses cannot offset ordinary income, and thus capital loss deductions are not taken into account in computing the §461(l) limitation. The amount of capital gain considered in calculating the §461(l) limitation cannot exceed the lesser of capital gain net income from a trade or business or capital gain net income. As a result, taxpayers will no longer have the ability to potentially convert capital losses into NOLs. These technical corrections are retroactive for tax years 2018 and 2019.

The technical corrections that the CARES Act made to §461(l) require taxpayers to amend their 2018 or 2019 return. These taxpayers must consider that the technical corrections may alter a prior year limitation calculation, in turn impacting any potential refund amount. As noncorporate taxpayers gain the ability to amend their returns and utilize excess business losses, they will have access to greater cash flow to maintain operations and provide payroll to employees during the COVID-19 pandemic.

12. Modification of §163(j)

TCJA §2306(a) amended §163(j) to reflect a limitation on the deduction for business interest expense for certain taxpayers in tax years beginning after 2017. Per the TCJA rules, if §163(j) applies to a business,

⁴¹ IRC §461(l)(1).

⁴² CARES Act §2304(a).

an interest expense deduction is allowed for the tax year limited to the sum of business interest income, 30% of the adjusted taxable income ("ATI"), and floor plan financing interest expense. For most taxpayers the relevant limitation is the 30% of the taxpayer's ATI for the tax year. ATI is computed as taxable income computed without regard to:

- Any item of income, gain, deduction, or loss that is not properly allocable to a trade or business;
- Business interest or business interest income;
- The amount of any net operating loss ("NOL") deduction;
- The 20% deduction for certain passthrough income; and
- In the case of tax years beginning before 1/1/2022, any deduction allowable for depreciation, amortization, or depletion.

Any amount of business interest expense that was not allowed as a deduction under §163(j) for the tax year was carried forward to the following year as a disallowed business interest expense carryforward. The disallowed §163(j) deduction could be carried forward indefinitely.

The CARES Act temporarily amended the TCJA §163(j) limitation by retroactively increasing the limitation on the deductibility of interest expense from 30% to 50% for tax years beginning after December 31, 2018 and before January 1, 2021.⁴³ In the event that the business did not have taxable income in 2020, such business could elect to use its 2019 adjusted taxable income in computing its 2020 limitation. This provision of the CARES Act essentially gave businesses a reduced cost of capital and provided for increased liquidity during the COVID-19 public health emergency. In March 2021, the IRS updated its Form 8990, *Limitation on Business Interest Expense Under Section 163(j)*, instructions. Taxpayers who elect to use their 2019 ATI in determining the §163(j) limitation in 2020 should complete line 22, adjusted taxable income, on Form 8990 and leave lines 6 through 21 blank. No additional statement is required to make this election.

The CARES Act provided a special carve out rule for partnerships so that a partnership could not use the increased limitation in 2019, thereby deferring any potential benefits from the 50% threshold to 2020. Any interest disallowed at the partner level was treated under 2019 applicable law. The 50% suspended interest frees up in 2020 and becomes fully deductible. The remaining 50% is suspended until the partnership allocates interest income or excess taxable income to the partner. A partnership could elect, at the partnership level, to use 2019 adjusted taxable income in computing its 2020 limitation. Partnerships could also elect out of §163(j) at the partnership level.

In April 2020, the IRS released Rev. Proc. 2020-22, addressing recent changes made to §163(j) by the CARES Act. Under the TCJA proposed regs (REG-106089-18), certain eligible real property trades or businesses or farming businesses could elect to be an excepted trade or business, meaning they were not subject to the application of the §163(j) limitation. An electing real property trade or business is any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. An electing farming business includes livestock, dairy, poultry, fish, fruit, nuts, and truck farms. It also includes plantations, ranches, ranges, and orchards.

An election by a real property trade or business or farming business to be an excepted trade or business was irrevocable and binding on the trade or business for all succeeding tax years. Additionally, any real

⁴³ CARES Act §2306(a).

property trades or businesses or farming businesses claiming such election were required to depreciate the following assets using the alternative depreciation system (ADS), and were not eligible for a bonus depreciation deduction under §168(k) for:

- Nonresidential real property;
- Residential rental property; and
- Qualified improvement property.

The real property trade or business or farming election had to be made on a timely filed original return. If a business made an irrevocable election to be an excepted trade or business prior to the CARES Act being signed into law, it would have been ineligible for the §163(j) relief provisions provided in the CARES Act. Rev. Proc. 2020-22 allowed an electing real property trade or business or farming business to withdraw an election made under §163(j)(7) during the 2018 or 2019 tax years. It would have been beneficial for previously electing businesses to withdraw their §163(j)(7) election during the 2018 or 2019 tax years if their interest payments were below the new 50% limit. Per Rev. Proc. 2020-22, if a taxpayer withdraws a previous election made under §163(j)(7), the taxpayer is treated as if the election were never made.

To withdraw a §163(j)(7) election, a taxpayer has to timely file an amended federal income tax return, or AAR, as applicable, for the taxable year in which the election was made, with an election withdrawal statement. The election withdrawal statement should be titled, "Revenue Procedure 2020-22 Section 163(j)(7) Election Withdrawal." Except as provided in Rev. Proc. 2020-23 (see below), the amended return must be filed on or before October 15, 2021, but no later than the period of limitations on assessment for the taxable year for which the amended return is being filed.

The amended return must include the adjustment to taxable income for the withdrawn §163(j)(7) election and any other adjustments to taxable income or tax liability due to this change. Taxpayers must also consider depreciation adjustments as a result of withdrawing the §163(j)(7) election. Such businesses previously were required to use the ADS to calculate depreciation for QIP. Businesses who withdraw their §163(j)(7) election become retroactively eligible for bonus depreciation for QIP in 2018 or 2019 tax years.

A taxpayer may elect not to apply the CARES Act 50% ATI limitation for the 2019 or 2020 tax year, with the exception of partnerships. Partnerships can make this election only for a 2020 taxable year, because they cannot use the 50% ATI limitation for a 2019 tax year. No formal statement is required to make the election; the taxpayer simply uses the 30% ATI limitation. Such election must be made for each taxable year, except for partnerships who only make the election for the 2020 tax year. If the taxpayer later wants to revoke the election not to use the 50% ATI limitation, the taxpayer must timely file an amended Federal income tax return for the applicable tax year using the 50% ATI limitation.

The IRS issued final and proposed regulations under §163(j) on July 28, 2020. The final regulations provide guidance regarding provisions of the TCJA that limit the deduction for business interest expense, as well as recent changes made by the CARES Act. The final regulations discuss how to calculate the §163(j) limitation, the definition of interest for purposes of the limitation, how the limitation applies to certain groups or partnerships, and which businesses are subject to the limitation.

The proposed regulations provide guidance on additional business interest expense issues not addressed in the final regulations, including additional CARES Act considerations. Notably, the proposed regulations provide a safe harbor that allows taxpayers operating qualified residential living facilities as a trade or

business to treat the trade or business as a real property trade or business for purposes of qualifying as an electing real property trade or business. The proposed regs also discuss rules for characterizing interest expense associated with debt proceeds of passthrough entities.

The final and new proposed regulations are generally effective for tax years beginning after the date that is 60 days from September 14, 2020 (the date they were published in the federal register). Taxpayers, however, may choose to rely on the newly released regulations or continue to rely upon the initial set of proposed regulations issued in December 2018 for taxable years beginning after 12/31/2017 and before November 13, 2020. If the taxpayer applies the initial set of proposed regulations issued in December 2018 to a tax year, there is no requirement that these proposed regulations must be applied to a subsequent tax year. In either case, the regulations must be applied consistently, and barring certain exceptions, in their entirety.

13. Qualified Improvement Property technical correction

Who would have imagined that only a worldwide pandemic could bring a fix to the Qualified Improvement Property (QIP) drafting mistake in the TCJA? The TCJA allowed 100% additional first-year depreciation deductions for certain qualified property and eliminated pre-existing definitions for:

- Qualified Leasehold Improvement Property;
- Qualified Restaurant Property; and
- Qualified Retail Improvement Property.

The TCJA replaced those three categories of property with one category called qualified improvement property. QIP is any improvement to an interior portion of a building that is nonresidential real property if such improvement is placed in service after the date such building was first placed in service. Common QIP includes interior remodels of a business, such as when a restaurant refurbishes its interior with new tables and booths, updated flooring, and new paint. QIP does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building. The TCJA did not reflect the intended 15-year recovery period for QIP due to a drafting error, and instead assigned it a tax life of 39 years. The TCJA provided for significant increases to bonus depreciation for property assigned a life of 15 years or less. As such, QIP was ineligible for bonus depreciation as it was not considered 15-year property.

The CARES Act reclassifies QIP as 15-year property (20-year ADS life) and allows businesses to immediately write off costs associated with QIP instead of depreciating the improvements over a 39-year life.⁴⁴ The CARES Act QIP fix is effective for property placed in service after December 31, 2017. The CARES Act accomplishes multiple goals by corrected the error in the TCJA, increasing company cash flow through prior year return amendments, and incentivizing investment in the country during the COVID-19 public health emergency.

As discussed above, Rev. Proc. 2020-22 allows electing real property trades or businesses or farming businesses to withdraw an election made under §163(j)(7) for the 2018 and 2019 tax years. Such businesses previously were required to use the ADS to calculate depreciation for QIP. Businesses who withdraw their §163(j)(7) election become retroactively eligible for bonus depreciation for QIP in 2018 or 2019 tax years and must consider such changes when preparing their amended return.

⁴⁴ CARES Act §2307.

The IRS issued Rev. Proc. 2020-25 on April 17, 2020 addressing the process for taxpayers to change the depreciation method of QIP placed in service in the 2018, 2019, or 2020 tax year. Taxpayers may either file an amended return, Form 3115, *Application for Change in Accounting Method*, or an AAR to change the depreciation method of QIP placed in service in the 2018, 2019, or 2020 tax year, unless:

- Such QIP was placed in service after December 31, 2017 and such taxpayer made a late election, or withdrew an election, under §163(j)(7). Changes to depreciation for such QIP should be made in accordance with Rev. Proc. 2020-22 (see above).
- Such taxpayer deducted cost or other basis of such QIP as an expense.

Form 3115 is to be filed in the subsequent year the property is placed in service, meaning the §481(a) adjustment will be taken in the subsequent year. The guidance modifies Rev. Proc. 2019-43 to add two new automatic method changes. DCN 24 is an automatic method change to change the depreciation method of QIP placed in service after December 31, 2017. DCN 245 is an automatic method change to make a late election out of bonus depreciation or to revoke an election out of bonus depreciation.

Rev. Proc. 2020-25 also permits taxpayers to either make or revoke a §168 election for property placed in service by the taxpayer in either its 2018, 2019, or 2020 taxable year by either filing an amended federal return or Form 1065 for the property placed in service on or before October 15, 2021 (but no later than the period of limitations on assessment) or by filing Form 3115 with the taxpayer's original timely filed federal return or Form 1065 for the taxpayer's first or second tax year succeeding the tax year in which the property was placed in service.

On September 21, 2020, the IRS and Department of Treasury released the second round of final bonus depreciation regulations, making further clarifications and addressing the CARES Act QIP fix.⁴⁵ The CARES Act reclassified QIP as 15-year property (20-year ADS life) and allowed businesses to immediately write off costs associated with QIP instead of depreciating the improvements over a 39-year life, but it stated that the improvement must be "made by the taxpayer." The final regulations clarify this terminology and state that an improvement is made by a taxpayer if the taxpayer makes, manufactures, constructs, or produces the improvement for itself, or if the improvement is made, manufactured, constructed, or produced for the taxpayer by another person under a written contract. On the other hand, the final regulations clarify that if a taxpayer acquired nonresidential property in a taxable transaction and such property had an existing improvement placed in service by the seller of such property, the existing improvement is not considered to have been made by the taxpayer. Property with preexisting QIP transferred in a nonrecognition event does not qualify for bonus depreciation, since the basis of the QIP is dependent upon the transferor's basis.

14. Business Meals Deduction

The CAA 2021 temporarily increases the 50-percent limit on the business meals deduction to 100 percent. To qualify for the increased deduction, expenses must be paid or incurred in 2021 and 2022 for business meal food and beverage expenses, including delivery and carry-out meals, provided by a restaurant. Final §274 regulations confirm that the food and beverage expenses include the full cost of the meal, including any delivery fees, sales tax, or tips. On April 8, 2021, the IRS issued Notice 2021-25, clarifying when the increased 100% deduction applies. Notice 2021-25 defines a "restaurant" as "a business that prepares and sells food or beverages to retail customers for immediate consumption, regardless of whether the food or beverages are consumed on the business's premises. A restaurant does not include a business that primarily sells pre-packaged food or beverages not for immediate

⁴⁵ T.D. 9916.

consumption, such as a grocery store; specialty food store; beer, wine, or liquor store; drug store; convenience store; newsstand; or a vending machine or kiosk.” For such aforementioned businesses, a 50% deduction continues to apply. Lastly, Notice 2021-25 clarifies that an employer may not treat as a restaurant:

- An eating facility located on the business premises of the employer and used in furnishing meals excluded from an employee's gross income; or,
- Any employer-operated eating facility treated as a de minimis fringe benefit, even if such eating facility is operated by a third party under contract with the employer.

Planning Opportunity: Putting it all Together

The CARES Act provides welcomed, favorable tax changes to taxpayers, including the QIP technical correction, NOL modification, and §163(j) modification. It is important for taxpayers to analyze all changes to determine whether the combination of certain changes brings the greatest benefit.

For example, C-corporations that are now eligible to claim bonus depreciation on an amended return may potentially generate NOLs in the amended return year. These NOLs may not have otherwise been generated.

The NOLs generated on the amended return could potentially be carried back to pre-2018 tax years at the 35% pre-TCJA corporate rate, even if the NOL was generated in a post-2018 tax year when the corporate rate was 21%.

In this case, utilizing multiple provisions of the CARES Act would bring the C-corporation taxpayer the greatest benefit.

15. Executive Compensation

Prior to ARPA, the deduction for executive compensation was capped at \$1 million for certain covered employees of publicly traded companies, including the CEO, CFO, and next three highest compensated officers. For purposes of the §162(m), these five covered employees are permanently considered covered employees, often referred to as the “once a covered employee, always a covered employee” rule. ARPA modifies §162(m) by capping the deduction at \$1 million for the next five highest-paid employees in addition to the CEO, CFO, and next three highest compensated officers. These next five highest-paid employees are to be determined on an annual basis and are not subject to the “once a covered employee, always a covered employee” rule. As a result of this new modification, companies with highly paid non-officer employees may be subject to a disallowed deduction. Companies may also face increased recordkeeping requirements, as they will track their “permanent” covered employees, as well as the next five highest-paid covered employees on a yearly basis. Companies should begin to think about what systems they need to put into place in order to track this information. This provision takes effect for tax years beginning after December 31, 2026, providing companies with adequate time to prepare for the change. However, it would be wise for companies to begin reviewing compensation agreements sooner rather than later to determine the impact of the new ARPA provisions.

16. Modification of AMT

The TCJA repealed the corporate alternative minimum tax effective for taxable years beginning after December 31, 2017 and allows the AMT credit to offset the regular tax liability for any taxable year. The AMT credit was made refundable for any taxable year beginning after 2017 and before 2021 in an amount equal to 50 percent of the excess of the minimum tax credit for the taxable year over the amount of the credit allowable for the year against regular tax liability. For tax years beginning in 2021, the AMT credit

was made refundable in an amount equal to 100% of the excess of the minimum tax credit for the taxable year over the amount of the credit allowable for the year against regular tax liability. As such, any AMT credit was set to be refunded to the taxpayer by 2021.

The CARES Act accelerated the ability of companies to recover such AMT credits established by the TCJA.⁴⁶ Taxpayers could either elect to receive a 50% AMT credit for 2018 and a 100% credit for 2019 or can claim the entire AMT credit for 2018. Luckily, the CARES Act recognized the need for taxpayers to swiftly take advantage of the refundable AMT credits and allowed the taxpayer to file for a tentative refund for the refundable AMT credit for the 2018 tax year. The taxpayer was not required to file an amended return if the tentative refund application was filed by December 31, 2020.

If the taxpayer wished to forgo filing a 2018 amended return (or filing for a refund relating to 2018), it could have claimed its outstanding AMT credits on the 2019 return. Any AMT credits not claimed in either 2018 or 2019 were forfeited.

17. Putting it all together -- Partnership implications

Many partnerships were not able to realize the full benefit of the §163(j) modification or QIP technical correction that the CARES Act provided due to the Centralized Audit Regime. The Bipartisan Budget Act of 2015 created centralized partnership audit procedures that apply to all partnerships unless a valid election is made. Partnerships under the Centralized Audit Regime are not able to file amended returns, and instead must file Administrative Adjustment Requests (AARs). When an AAR results in an underpayment, the partnership can pay the amount due or can push out the amount due to partners at the partner-level. On the other hand, if an AAR results in an overpayment, refunds generally are not available, and partners must take into account adjustments in the year they received them.

Example: QIP Technical Correction for a Partnership

Partnership ABC spent \$50 million in 2019 on Qualified Improvement Property. On its 2019 return, Partnership ABC reported \$1.28 million of depreciation (\$50 million divided by 39-year life). Partnership ABC is subject to the Centralized Audit Regime.

In 2020, the QIP that Partnership ABC placed in service in 2019 becomes eligible for bonus depreciation in 2019 due to the CARES Act QIP technical correction. With this correction, Partnership ABC is eligible to deduct an additional \$48.72 million as bonus depreciation in 2019, and the individual partners would end up paying \$18 million less in tax.

Since Partnership ABC is subject to the Centralized Audit Regime, they must file an AAR in 2020 to report the \$50 million of bonus depreciation for tax year 2019, resulting in \$18 million that can be used in the same manner as a nonrefundable credit for tax year 2020 (the year the AAR is filed).

Partnership ABC has net losses in 2020, so they do not receive any tax benefit from the \$18 million. Since Partnership ABC cannot carry the \$18 million back to a prior year or carry it forward to a future year, Partnership ABC and its partners receive no benefit from the CARES Act QIP technical correction.

To make matters worse, an individual partner of Partnership ABC may need to reduce his or her basis due to the \$50 million of bonus depreciation reported on the AAR, even though he or she did not receive a corresponding tax benefit from the depreciation.

⁴⁶ CARES Act §2305.

On April 8, 2020, the IRS issued Rev. Proc 2020-23, providing a workaround to the Centralized Audit Regime's procedural rules to allow partnerships to take advantage of certain provisions in the CARES Act as intended. Rev. Proc. 2020-23 allows partnerships to file amended returns for tax years 2018 and 2019 instead of filing an AAR to obtain the benefits of the CARES Act. In the event a partnership files an amended return, it is still subject to the centralized partnership audit procedures enacted by the Bipartisan Budget Act of 2015. Rev. Proc. 2020-23 does not prevent a partnership from filing an AAR instead of an amended return.

To file an amended return, the partnership must file Form 1065 with the "amended" box checked and must furnish amended Schedules K-1 to the partners. "FILED PURSUANT TO REV. PROC. 2020-23" must be written across the top of both Form 1065 and the Schedules K-1. The amended return may be filed electronically or by mail.

In the event that a partnership is under examination for a tax year beginning in 2018 or 2019 and wants to file an amended return pursuant to Rev. Proc 2020-23, the partnership must notify its revenue agent in writing prior to or contemporaneously with filing the amended return. Upon filing, the partnership must provide the revenue agent with a copy of the amended return.

If the partnership already filed an AAR for a tax year beginning in 2018 or 2019 and wants to file an amended return pursuant to Rev. Proc 2020-23, the partnership should use any adjusted amounts in the AAR instead of amounts from the originally filed return.

18. Modification of excise taxes

The COVID-19 pandemic brought about widespread shortages of nonperishable food, toilet paper, antibacterial cleaners, and hand soaps and sanitizers. Many retailers enforced purchase limits on these items. To incentivize certain companies to produce much-needed hand sanitizer, §2308 of the CARES Act provided a temporary exception from excise tax for alcohol used to produce hand sanitizer for 2020. The federal excise tax on distilled spirits ranges between \$2.70 per proof gallon to \$13.50 per proof gallon.

This provision was intended to aid distillers, many of whom have been forced to shutdown tasting tours or tasting rooms, as part of the COVID-19 public health emergency. Unfortunately, distillers are currently unable to take advantage of the CARES Act excise tax relief for alcohol, as it does not apply to the type of alcohol used to produce hand sanitizer. The FDA lists denatured alcohol as approved for use in hand sanitizers, but has yet to approve unadentured alcohol, the type of alcohol distillers are able to produce for hand sanitizer use. In order for the CARES Act excise tax relief to apply for unadentured alcohol used in producing hand sanitizer, the FDA must approve its use for hand sanitizer, and it has not taken this step due to safety concerns.

The CARES Act also included an "excise tax holiday" from taxes for amounts paid for transportation by air for persons and property through January 1, 2021.⁴⁷ Currently, aviation excise taxes are comprised of a 7.5% ticket tax and domestic and international segment tax paid by all passengers, as well as a 6.25% tax on the transportation of air cargo and per gallon aviation fuel excise taxes, ranging up to 21.8 cents per gallon. This assistance provided in the CARES Act is intended to alleviate the economic pressure on the airline industry due to COVID-19.

⁴⁷ CARES Act §4007.

19. Low-income housing tax credit

Section 42 provides an annual credit for investment in certain low-income housing. A low-income housing tax credit (LIHTC) is allowed annually over a 10-year credit period beginning with the tax year a qualified building is placed in service, or, under an irrevocable election, the next tax year. The low-income housing credit for the tax year is equal to the applicable percentage of the qualified basis of each qualified low-income building. This is intended to result in a credit in the aggregate over the 10-year credit period, of a present value of 70 percent of the qualified basis for certain new buildings not federally subsidized and 30 percent of the qualified basis for certain other existing or federally subsidized buildings.⁴⁸

There is a 9-percent-per-year floor on the credit for new buildings that are not federally subsidized. The CAA 2021 provides a 4-percent-per-year credit floor for buildings that are not eligible for the 9-percent credit floor. The credit applies to buildings placed in service after December 31, 2020, that:

- Receive an allocation of housing credit dollar amount after December 31, 2020; and
- Are for obligations issued after December 31, 2020, if any portion of the building is financed with certain tax-exempt obligations.

This provision intends to aid in the creation and maintenance of affordable housing in the future.

20. 30-year depreciation of certain residential rental property

The TCJA changed the ADS recovery period for residential rental property from 40 years to 30 years for property placed in service after December 31, 2017. It also allowed real property trades or businesses to elect out of the §163(j) business interest deduction limitations; however, such taxpayers making the election for tax years ending after December 31, 2017, were required to treat nonresidential real property, qualified improvement property and residential rental property as subject to the alternative depreciation system (ADS).

The CAA 2021 amends the TCJA and assigns a 30-year ADS depreciation period to residential rental property placed in service before January 1, 2018, if the property is held by an electing real property trade or business and, before January 1, 2018, was not subject to ADS. In effect, taxpayers may use the 30-year recovery period for all residential rental property, regardless of the placed-in-service date.

21. Farming NOLs

The CARES Act provided that NOLs arising in a tax year beginning after December 31, 2017, and before January 1, 2021, could be carried back to each of the five tax years preceding the tax year of such loss. The CAA 2021 clarifies the NOL carryback provision for farmers, allowing those who elected a two-year NOL carryback prior to the CARES Act to elect to retain that two-year carryback, rather than claim the five-year NOL carryback provided in the CARES Act.⁴⁹

⁴⁸ Rev. Rul. 2004-82.

⁴⁹ COVIDTRA §281.

Miscellaneous Practice and Reporting Issues

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Miscellaneous Practice and Reporting Issues

Learning Objective

Upon reviewing this material, the reader will be able to discuss advanced practice and reporting issues a practitioner currently may encounter.

Review Exercise: Where do you place armor?¹ What is missing?

Military aircraft engineers face a delicate assessment, if they armor aircraft they find protection from enemy fire, yet the added weight lessens speed, range, and maneuverability. In the early 1940s, the military wanted to determine which sections of aircraft were more prone to attack, then allow engineers concentrate heavier armor to those “prone” areas. In this quest, they studied the number of holes in returning engaged aircraft. They found the following:

<u>Section of Aircraft</u>	<u>Holes per Square Foot</u>
Engine	1.11
Fuselage	1.73
Fuel System	1.55

Where would you place the armor?

If your answer is to arm “where the holes are,” the fuselage, you would agree with key military officers of the time. Fortunately, the military officers then engaged a research group to recommend **how much more armor should be added**.

A mathematician with the research group advised otherwise, arguing they should not place armor where the holes are, but rather where they ARE NOT – that is, on the engines. The reason aircraft were returning with fewer strikes to the engine was that aircraft struck in the engines were not always returning. The mathematicians pointed out to the military that they could not quantify the holes on MISSING aircraft.

Over the past several years the IRS has followed somewhat similar logic. Income and deduction audits are time consuming, manually slow, and costly. Several years ago, the IRS started looking for what is MISSING, where clients WERE NOT always following procedures. A recent example is the now very large penalties associated with the failure to issue informational returns (W-2 and 1099) timely, or in some cases not at all. The simple and seemingly ridiculous questions regarding 1099s on every business return, including Schedule C and E, is yet another missing hole. Most answer those two questions without much second thought. Yet, if the IRS finds error within these two simple questions, could this lead to the intentional disregard penalty?²

The FBAR, the higher accuracy penalty, Form 8867, and the additions to Form 1098 are examples of the IRS seeking/finding revenue from the previously MISSING information. This chapter’s goal is to discuss some of those hidden items practitioners can use for planning with clients, and items to avoid.

Surgent Professional Education designs material to assist in arming practitioners against the seen and the unseen.

¹ For more details of a quite fascinating story, and others, artfully told, see; Ellenberg, Jordan; *How Not to Be Wrong: the Power of Mathematical Thinking*; Penguin Books, 2014.

² Or could it limit our “Reasonable Cause” defense? Could it be a precursor to willful preparer penalties?

I. Advanced practice issues

A. Virtual currency update

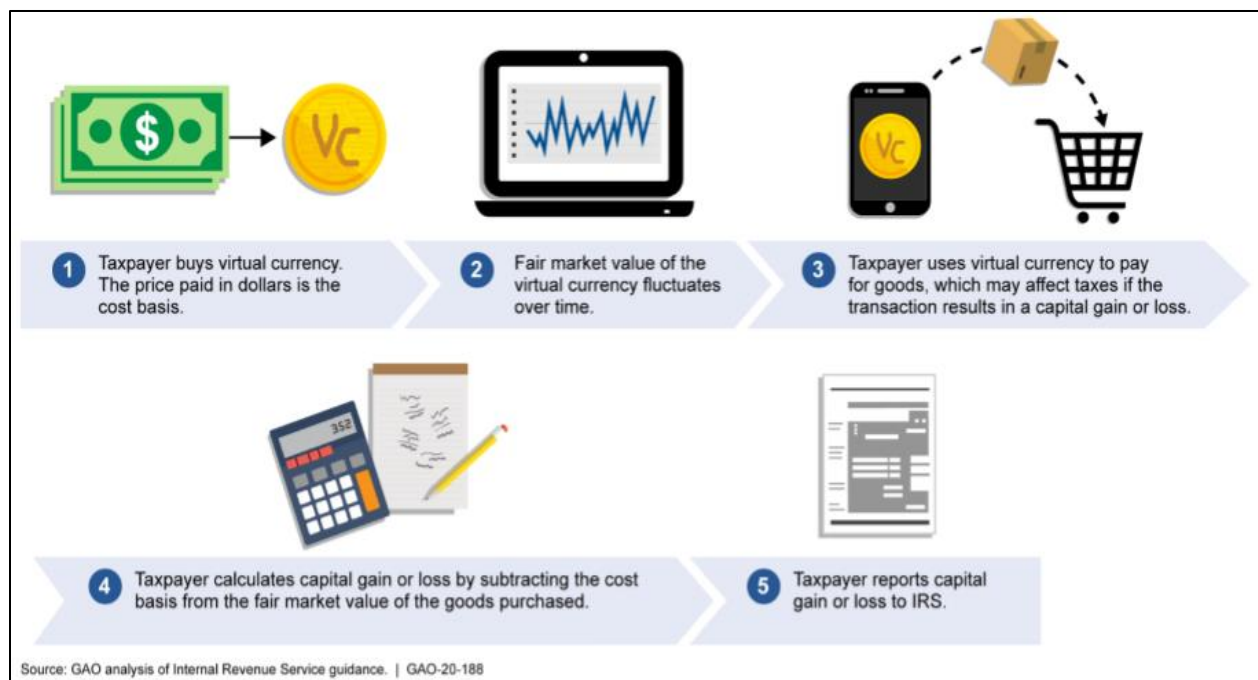
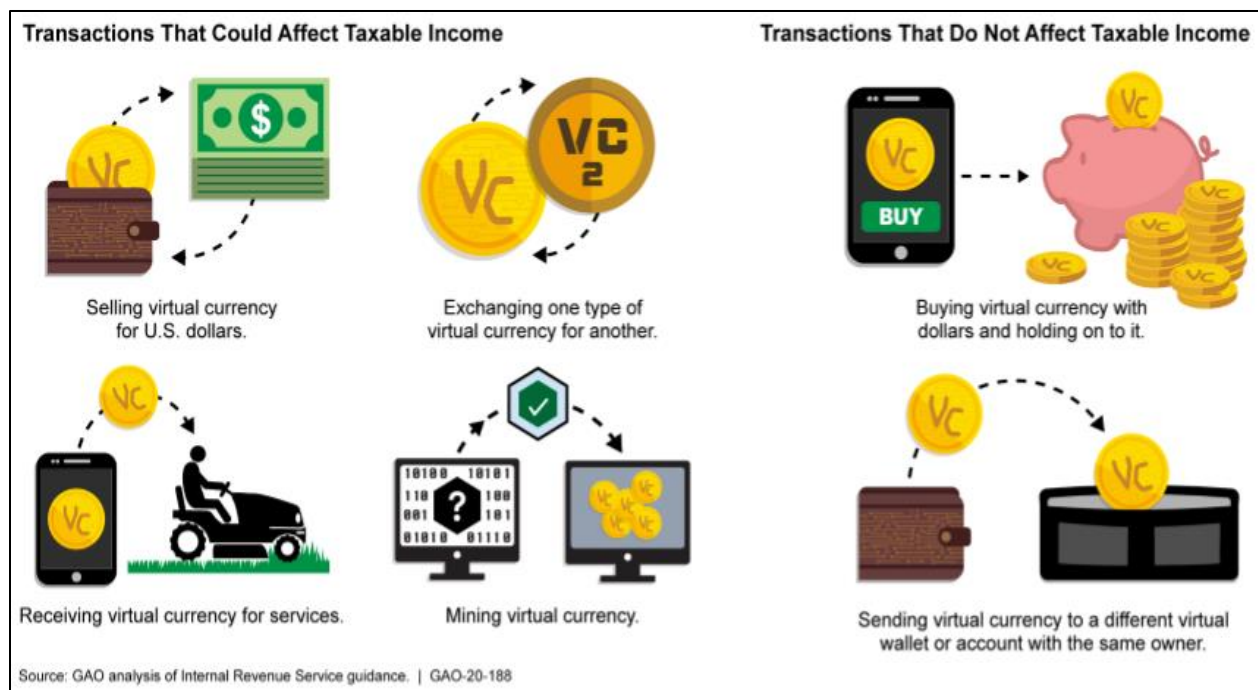
1. Introduction to cryptocurrency and key terms

Virtual currency, cryptocurrency, blockchain, mining... what do these terms really mean? The IRS defines virtual currency as “a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value”. In some environments, it operates like “real” currency (i.e., the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance), but it does not have legal tender status in any jurisdiction.³ When virtual currency has an equivalent value in real, tangible currency, it is considered a “convertible virtual currency.” Cryptocurrency is a specific type of virtual currency that uses “cryptography” to validate and secure transactions that are digitally recorded on a distributed ledger or record keeper. A “blockchain” is a chain or blocks that store digital information in a public database, that functions similar to a ledger. The individual blocks making up the chain contain information about transactions including the date, time, and dollar amount of a transaction. The individual block also contains information about the parties participating in a transaction (via unique digital signatures) as well as a unique “hash,” or string of text and numbers, updated for each transaction. A single block can hold up to a few thousand transactions. Transactions are pseudonymous as accounts and transactions are not connected to individual identities. As such, one cannot easily connect the identity of a user with an address or transaction. Each transaction on a network must be confirmed by a miner, and once a transaction is confirmed, it cannot be reversed. Anyone can become a miner – for Bitcoins, miners can confirm a transaction through solving a cryptologic puzzle. Once the miner solves the problem and confirms the transaction, he or she is rewarded with a specific number of Bitcoins. The only legitimate way that Bitcoins are created are through mining / confirming transactions. Bitcoin is the first and most well-known cryptocurrency, although there are several other cryptocurrencies available. The Bitcoin is not unique in that transactions must be mined in order to be verified; all cryptocurrency transactions require a puzzle or problem to be solved by a miner before the transaction is verified. Like Bitcoin miners, all cryptocurrency miners are rewarded with payment in the form of cryptocurrency as an incentive for solving the problem and verifying the transaction. The entire legitimacy of the cryptocurrency network depends on the legitimacy of the underlying blockchain.

In order to send and receive cryptocurrency, an individual must have a cryptocurrency wallet. The wallet stores the individual’s public, and possibly private, keys that are used to send or receive cryptocurrency. Unlike a traditional wallet that one uses to hold cash or credit cards, the cryptocurrency wallet does not hold the actual cryptocurrency. The cryptocurrency is stored and maintained on the blockchain. The public key provides a public address that is capable of receiving cryptocurrency transactions, and acts as the spot where funds are deposited. The corresponding private key is unique to an individual user. Without the private key, the individual won’t be able to withdraw any cryptocurrency. A simple way to think about cryptocurrency keys is to think about a physical mailbox. Anyone can insert mail into the mailbox slot – neighbors, postal workers, even strangers; however, only the individual who owns the mailbox and has a private key is able to open the mailbox to retrieve the contents. It is important for individuals to keep their private key safe as to not compromise their wallet. If a private key is lost, there is no way to access the cryptocurrency.

³ IRS website, “Virtual Currencies”

2. Chronology of cryptocurrency





The history of cryptocurrency dates back to January 2009, when Satoshi Nakamoto (pseudonym) launched the first units of virtual cryptocurrency, called Bitcoins. The bitcoin network was created when Nakamoto mined the first block of the chain, known as the “genesis” block. Nakamoto created the Bitcoin to create digital cash on a decentralized network. Cryptography and the underlying math problems secure the network. In November 2019, the IRS discussed virtual currency for the first time, posting on their website that virtual currency transactions could potentially be considered taxable income or gain. Soon after Bitcoin, various other cryptocurrencies were developed and began to be traded and exchanged. Throughout 2012, major companies such as Microsoft, Expedia, and Newegg began to accept payment in Bitcoin, legitimizing cryptocurrency as having real, tangible value.

In May 2013, the GAO issued its first report on cryptocurrency, indicating the various ways that virtual currency exchange could produce taxable income.⁴ “Closed-Flow” transactions involve the purchase of virtual goods or services, and thus do not produce taxable income. On the other hand, “Open-Flow” transactions have the potential to produce taxable income, as the virtual currency could be exchanged as payment for services. Additionally, the report highlighted the risk of tax compliance, and more importantly, noncompliance. The GAO recognized that tracking the transactions was difficult and noted that some individuals may use cryptocurrency as a means to evade taxes. In the report, the GAO recommended that the IRS provide basic information to taxpayers regarding the tax reporting requirements for virtual currency transactions. The IRS agreed to comply with the GAO’s recommendations.

In the interim timeframe, the SEC charged Trendon Shavers, founder of the Bitcoin hedge fund, Bitcoin Savings and Trust (BTCST) for defrauding investors of more than \$23 million (based on Bitcoin exchange rates at that time) from February 2011 through August 2012 using a Ponzi-type scheme.⁵ Shavers promised investors a 7% return on their investment per week, or 1% per day, with little risk or downside potential. In classic Ponzi-scheme fashion, Shavers paid established investors the promised return using the new bitcoin investment from new investors. He also diverted some of the invested amounts into his own personal accounts to pay for personal expenses such as rent, car payments, food, and utilities. Like all Ponzi schemes, the money ran out, and in August 2012, Shavers announced that BTCST was in default.

The Securities Act of 1933 defines a security as “any note, stock, treasury stock, security future, security-based swap, bond, or investment contract.” An investment contract can be defined as any contract, transaction, or scheme involving an investment of money in a common enterprise, with the expectation

⁴ GAO-13-516, May 15, 2013.

⁵ *Securities and Exchange Commission v. Trendon T. Shavers and Bitcoin Savings and Trust*.

that profits will be derived from the efforts of the promoter or a third party⁶ Shavers argued that the United States District Court of the Eastern District of Texas did not have subject matter jurisdiction, as he could not be charged under the Securities Act of 1933 or the Exchange Act of 1934 since Bitcoins were not securities or notes. On August 6, 2013, the Court determined that Bitcoin was, in fact, a currency, stating that the BTCST investments Defendants sold meet the definition of investment contract and, as such, are securities, giving the Court jurisdiction over the case. Moreover, the Court determined that Shavers acted with scienter and intentionally operated BTCST as a Ponzi scheme and made misrepresentative claims to investors. He was ultimately fined penalties of over \$40 million.

Shortly thereafter, the IRS issued Notice 2014-21 in March 2014 in the form of a FAQ document for taxpayers. Below is a summary of some of the key highlights of the Notice:

- The IRS determined that virtual / cryptocurrency is considered property for federal tax purposes and as such is subject to general tax principles applicable to property transactions.
- Virtual currency is not treated as currency that could generate foreign currency gain or loss.
- A taxpayer who receives virtual currency as payment for goods or services must include in gross income the FMV of the virtual currency, measured in U.S. dollars, as of the date the currency was received.
- The basis of virtual currency that a taxpayer receives as payment for goods or services is the FMV of the virtual currency as of the date of receipt.
- For U.S. tax purposes, transactions using virtual currency must be reported in U.S. dollars. If the virtual currency is listed on an exchange with the exchange rate established by market supply and demand, the FMV of the virtual currency is determined by converting the virtual currency into U.S. dollars at the exchange rate, in a reasonable manner that is consistently applied.
- When FMV of property received in exchange for virtual currency exceeds the taxpayer's adjusted basis of the virtual currency, the taxpayer has taxable gain. Similarly, the taxpayer has a loss if the FMV of the property received is less than the adjusted basis of the virtual currency.
- The character of the gain depends on whether the virtual currency is a capital asset in the hands of the taxpayer. If so, capital gain or loss treatment is used. Ordinary gain or loss is recognized on the sale or exchange of virtual currency if it is not a capital asset in the hands of the taxpayer.
- When a taxpayer successfully mines virtual currency, the fair market value of the virtual currency as of the date of receipt is includible in gross income.
- If a taxpayer's "mining" of virtual currency constitutes a trade or business, and the "mining" activity is not undertaken by the taxpayer as an employee, the net earnings from self-employment resulting from those activities constitute self-employment income and are subject to the self-employment tax.
- The fair market value of the virtual currency received for services performed as an independent contractor, measured in U.S. dollars as of the date of receipt, constitutes self-employment income and is subject to the self-employment tax.
- The fair market value of virtual currency paid as wages is subject to federal income tax withholding, FICA, and FUTA, and must be reported on Form W-2.

⁶ The Securities Act of 1933, section 77b, 15 U.S.C.A. section 77b.

- A payment made using virtual currency is subject to information reporting to the same extent as any other payment made in property.
- A person who, in the course of a trade or business, makes a payment of \$600 or more to an independent contractor for the performance of services is required to report the payment on Form 1099-MISC. The amount that should be reported can be determined using the fair market value of the virtual currency in U.S. dollars as of the date of payment.
- Payments made using virtual currency are subject to backup withholding to the same extent as other payments made in property.
- In general, a third party that contracts with a substantial number of unrelated merchants to settle payments between the merchants and their customers is a third-party settlement organization and is required to report payments made to a merchant on a Form 1099-K if the number of transactions exceeds 200 and the gross amount of payments made to the merchant exceeds \$20,000.
- Taxpayers may be subject to penalties for failure to comply with tax laws. Underpayments may be subject to accuracy-related penalties under §6662. Failure to timely or correctly report transactions may be subject to information reporting penalties under §6721 and §6722. Penalty relief may be available to persons required to file an information return who are able to establish that the underpayment is due to reasonable cause.

The key takeaways from Notice 2014-21 are that cryptocurrency is treated as property, rather than currency. As such, it is critical for individuals to track the underlying basis of each unit of cryptocurrency in order to correctly calculate any potential gain or loss triggered upon sale or transfer. The tracking of each unit of cryptocurrency can be very complex, as there is a lack of reporting requirement. The IRS requested comments in response to Notice 2014-21 but did not take any action to address such comments and remained silent. In September 2016, the Treasury Inspector General for Tax Administration (TIGTA) issued a report calling attention to the IRS's lack of further guidance on virtual currency transactions and recommending the IRS take action.⁷ Spoiler alert: the IRS did not take immediate action.

In November 2016, the IRS became involved in the prolific “Coinbase” court case. The IRS was granted permission to serve a “John Doe” administrative summons on Coinbase, Inc. (Coinbase). A “John Doe” summons is a request that does not specifically identify any one person, but rather a group or class of person(s) based on their activities. Specifically, the IRS sought information on any U.S. person who was involved in virtual currency transactions between 1/1/2013 and 12/31/2015 in excess of \$20,000 (USD equivalent) in any one transaction, who was not issued a Form 1099-K, and whose identity was already known by the IRS.⁸ Originally, the IRS wanted all records during the 2013 through 2015 timeframe, but had to narrow its request as per the Court. The IRS had evidence that certain Coinbase customers were involved in underreporting and noncompliance but needed more information. More than 14,000 Coinbase customers were involved in transactions in excess of \$20,000 during the time period in question, but only around 800-900 of these customers reported the information to the IRS. Ultimately, Coinbase complied with the request, and in March 2018 notified the customers in question that they would be turning over information to the IRS.

⁷ “As the Use of Virtual Currencies in Taxable Transactions Becomes More Common, Additional Actions Are Needed to Ensure Taxpayer Compliance” TIGTA Report (9/21/2016).

⁸ *United States v. Coinbase, Inc.*

In March 2018, the IRS also reminded individuals to report virtual currency transactions, as they are taxable by law just as any other property transaction.⁹ The IRS warned taxpayers that failure to report income and gain from virtual currency transactions would be subject to penalties and interest, and in more extreme circumstance, criminal prosecution and fines.

Following in the footsteps of Coinbase, Bitfinex, a cryptocurrency trading platform, sent a letter to its users on May 17, 2018, informing them that they must disclose certain information for tax reporting purposes. Based in the Virgin Islands, Bitfinex is required to report certain information to the BVI government, who can then exchange information with tax authorities in the customer's country of residence. For Bitfinex customers, this meant that the BVI government could potentially share information with U.S. tax authorities on account of the Foreign Account Tax Compliance Act (FATCA).

In July of 2018, the IRS's Large Business and International Division announced a *Virtual Currency Compliance* campaign addressing virtual currency noncompliance and urged taxpayers to correct their returns and report previously unreported virtual currency, as the IRS would not create a voluntary disclosure program for such transactions. During the same time period, multiple groups, such as members from Congress, the AICPA, and the House Ways and Means Committee continued to press the IRS for more guidance on virtual currency transactions. The IRS responded to Congress in May 2019, confirming that it would issue further guidance sooner rather than later.

In July 2019, the IRS announced it had begun sending letters to taxpayers who completed virtual currency transactions but potentially failed to report income and pay the resulting tax from virtual currency transactions or did not report their transactions properly for tax years 2013 through 2017. "Taxpayers should take these letters very seriously by reviewing their tax filings and when appropriate, amend past returns and pay back taxes, interest and penalties," said IRS Commissioner Chuck Rettig. "The IRS is expanding our efforts involving virtual currency, including increased use of data analytics. We are focused on enforcing the law and helping taxpayers fully understand and meet their obligations."

By the end of August 2019, more than 10,000 taxpayers received these letters. The names of these taxpayers were obtained through various ongoing IRS compliance efforts (see Coinbase John Doe Summons above). **There are four variations of IRS correspondence: Letter 6173, Notice CP2000, Letter 6174, or Letter 6174-A.** All four versions strive to help taxpayers understand their tax and filing obligations and how to correct past errors.

Caution:

Not to insinuate all cases qualify; however, practitioners must remember virtual currency is an ongoing focus area for IRS Criminal Investigation. Should practitioners find themselves dealing with a Criminal Investigation case, they should seek proper legal counsel.

⁹ IR-2018-71.



Letter	Purpose	Action
IRS Letter 6173	The IRS send Letter 6173 to individuals who failed to report one or more virtual currency transactions.	Individuals must respond to the IRS with an amended or delinquent return by the date included in the original letter.
CP2000	The IRS sends this Letter / Notice CP2000 to individuals who they believe owe taxes on virtual currency transactions due to information on file not matching what was reported on the individual's tax return	Individuals must respond to the IRS agreeing with the proposed change in tax owed or providing documentation on why he or she disagrees with the IRS's findings.
IRS Letter 6174-A	The IRS sends Letter 6174-A to individuals who have (or had) or more accounts containing virtual currency but may not have properly reported transactions. This letter is nearly identical to Letter 6174 but contains an additional warning note that the IRS may issue future correspondence about enforcement activity	No response required
IRS Letter 6174	The IRS sends Letter 6174 to individuals who have (or had) one or more accounts containing virtual currency but may not know the requirements for reporting transactions. This letter is mainly educational in nature to make the individual aware of his or her potential tax obligations associated with virtual currency transactions.	No response required

3. Letter 6173

Note:

This form of the letter requires a response by the taxpayer. The heading includes a "respond by" date; however, the taxpayer may send a request for a 30-day extension.



Department of the Treasury
Internal Revenue Service
[Operating Division / Program Name]
[Street address]
[City, State ZIP]

Date:
07/16/2019
Taxpayer ID number:

Hotline telephone number:

eFax number:

Respond by:

[Recipient name]
[Address line 1]
[Address line 2]
[Address line 3]

Reporting Virtual Currency Transactions

Dear [Name]:

Why we're writing to you

We have information that you have or had one or more accounts containing virtual currency and may not have met your U.S. tax filing and reporting requirements for transactions involving virtual currency, which include cryptocurrency and non-crypto virtual currencies.

Virtual currency is considered property for federal income tax purposes. Generally, U.S. taxpayers must report all sales, exchanges, and other dispositions of virtual currency. An exchange of a virtual currency (such as Bitcoin, Ether, etc.) includes the use of the virtual currency to pay for goods, services, or other property, including another virtual currency such as exchanging Bitcoin for Ether. This obligation applies regardless of whether the account is held in the U.S. or abroad. More information can be found on www.irs.gov and in Notice 2014-21, found at www.irs.gov/pub/irs-drop/n-14-21.pdf, which describes how general tax principles for property transactions apply to transactions using virtual currency.

For one or more of tax years 2013 through 2017, we haven't received either a federal income tax return or an applicable form or schedule reporting your virtual currency transactions.

What you need to do by the "respond by" date above

Take one of the following actions:

- If you failed to file one or more income tax returns, file the delinquent returns and report your virtual currency transactions as soon as possible. For more information see www.irs.gov/filing
- If you made a mistake on your income tax return, such as not reporting your virtual currency transactions or incorrectly calculating your income, gain, or loss; you can file an amended return. For more information, visit www.irs.gov/forms-pubs/about-form-1040x
- If you believe you followed all tax and information reporting requirements relating to your virtual currency accounts, mail or eFax the following to the address or eFax number shown at the top of this letter.
 - A statement of facts explaining your position. Include a complete history of previously reported income from your virtual currency transactions. Explain the actions you took to become compliant with U.S. reporting requirements and provide copies of previously filed documents that confirm your compliance.
 - Your contact information, including your telephone number, complete address, and the address where you receive mail (if different).

Letter 6173 (6-2019)
Catalog Number 72154R

- The following statements with your signature and date:

I, _____, declare under penalties of perjury that I have examined this entire document, ^(Name)including all attachments and accompanying statements, and that the enclosed is true, correct, and complete.

I also understand with respect to any submission that the IRS reserves the right to make further contacts with me and my representatives to clarify any written explanation or any other documents. Statements and documents sent under this option will be checked against information received from banks, financial advisors, and other sources for accuracy.

Signature _____ Date

Please note that there is a 10MB limit for data sent to the eFax number. If your electronic file exceeds this size, either mail your documents or fax the information in multiple, smaller transmissions to fit the size requirements.

Do not send original returns or amended returns for processing via eFax. Instead, send original returns to the address below and include a copy in your response to this letter. Write "Letter 6173" at the top of the first page of the amended or delinquent return. Mail the originals to:

Internal Revenue Service
2970 Market Street
Philadelphia, PA 19104

If you need more time, send a request for a 30-day extension to the address above by the "respond by" date shown at the top of this letter.

If we don't hear from you by the "respond by" date

We may refer your tax account for examination. Please be aware that underpayments of tax are subject to interest and penalties.

Someone may represent you

If you want someone to represent you in this matter, send a completed Form 2848, Power of Attorney and Declaration of Representative, with your response to the address above.

Additional information

You can find the forms and publications for reporting your virtual currency transactions by visiting our website at www.irs.gov/forms-pubs or by calling 800-TAX-FORMS (800-829-3676).

If you have questions, you can call the hotline telephone number shown at the top of this letter and leave a message. We'll respond to all messages within three business days.

Thank you for your cooperation.

Sincerely,

[Name]
Program Manager

Letter 6173 (6-2019)
Catalog Number 72154R

4. Letters 6174 and 6174-A

Note:

Each of these two versions includes the closing...

- **You do not need to respond to this letter.**

The **difference** between the two letters is one more sentence added to the 6174-A letter (that is, it does not appear in the 6174 version)...

- **Note, however, we may send other correspondence about potential enforcement activity in the future.**



Department of the Treasury
Internal Revenue Service
[Operating Division / Program Name]
[Street address]
[City, State ZIP]

Date:
07/16/2019
Taxpayer ID number:

Hotline telephone number:

Tax form:
Form 1040

[Recipient name]
[Address line 1]
[Address line 2]
[Address line 3]

Reporting Virtual Currency Transactions

Dear [Name]:

Why we're writing to you

We have information that you have or had one or more accounts containing virtual currency but may not have properly reported your transactions involving virtual currency, which include cryptocurrency and non-crypto virtual currencies.

What you need to do

After reviewing the information below, if you believe you didn't accurately report your virtual currency transactions on a federal income tax return, you should file amended returns or delinquent returns if you didn't file a return for one or more taxable years. If you do not accurately report your virtual currency transactions, you may be subject to future civil and criminal enforcement activity. For more information, visit www.irs.gov/filing.

When filing amended or delinquent returns, write "Letter 6174-A" at the top of the first page of the return. Mail the original amended or delinquent return to:

Internal Revenue Service
2970 Market Street
Philadelphia, PA 19104

Reporting virtual currency transactions

Virtual currency is considered property for federal income tax purposes. Generally, U.S. taxpayers must report all sales, exchanges, and other dispositions of virtual currency. An exchange of a virtual currency (such as Bitcoin, Ether, etc.) includes the use of the virtual currency to pay for goods, services, or other property, including another virtual currency such as exchanging Bitcoin for Ether. This obligation applies regardless of whether the account is held in the U.S. or abroad. More information can be found on www.irs.gov and in Notice 2014-21, found at www.irs.gov/pub/irs-drop/n-14-21.pdf, which describes how general tax principles for property transactions apply to transactions involving virtual currency.

You must report virtual currency transactions on your return, regardless of whether you received a payee statement for the transaction (such as a Form W-2, Form 1099, etc.).

Letter 6174-A (6-2019)
Catalog Number 72597M

Common schedules for reporting virtual currency transactions include the following:

Schedule C

If you were an independent contractor and received payment in virtual currency, you must report it in gross income for the amount of the virtual currency's fair market value, measured in U.S. dollars, as of the date and time you received the virtual currency. Gross income derived by an individual from a trade or business, carried on by the individual as other than an employee, is reported on Schedule C. This constitutes self-employment income and is subject to the self-employment tax.

For more information, you can refer to the instructions for Schedule C.

Schedule D

If you sold, exchanged, or disposed of virtual currency (e.g. Bitcoin, Ether), or used it to pay for goods or services, you have engaged in a reportable transaction and may have a tax liability. These transactions may be reportable on Schedule D. On the tax return, report the virtual currency received at its fair market value, measured in U.S. dollars, as of the date and time of the transaction.

You should maintain and review all transaction records, including bank, wallet, and exchange reports and statements to determine your basis, amount received, and other information needed for reporting on Schedule D.

For more information, you can refer to the instructions for Schedule D.

Schedule E

If you received supplemental income in the form of virtual currency, including income from rental real estate, royalties, partnerships, S corporations, estates, trusts, and residual interests in REMICs, you may need to report this on Schedule E. On the tax return, report the virtual currency received at its fair market value, measured in U.S. dollars, as of the date and time of the transaction.

You may also need to file supplemental forms (e.g. Form 8582, Passive Activity Loss Limitations). See the instructions for Schedule E for any other circumstances that may apply.

For more information, you can refer to the instructions for Schedule E.

Additional Resources

- Publication 17, Your Federal Income Tax (For Individuals)
- Instructions for Form 1040, U.S. Individual Income Tax Return
- Instructions for Form 8949, Sales and Other Dispositions of Capital Assets
- Instructions for Form 1041, U.S. Income Tax Return for Estates and Trusts
- Instructions for Form 1120, U.S. Corporation Income Tax Return
- Instructions for Form 1120-S, U.S. Income Tax Return for an S Corporation
- Instructions for Form 1065, U.S. Return of Partnership Income

You can get the forms, instructions, and publications mentioned in this letter by visiting our website at www.irs.gov/forms-pubs or by calling 800-TAX-FORM (800-829-3676).

You do not need to respond to this letter. Note, however, we may send other correspondence about potential enforcement activity in the future.

Letter 6174-A (6-2019)
Catalog Number 72597M

As a result of sending these letters, the IRS reported that taxpayers filed amended returns and reported virtual currency transactions for the tax years in question, resulting in more than \$13.1 million in assessments.

On October 9, 2019, breaking nearly five years of silence, the IRS released additional guidance on the tax treatment of virtual currency and reporting obligations. The “Frequently Asked Questions” addresses 45 common questions about cryptocurrency transactions, such as gain/loss recognition, basis, and recordkeeping. Revenue Ruling 2019-24 addresses the tax treatment of cryptocurrency “hard forks” and “airdrops,” and distinguishes that not every hard fork should be treated as an airdrop. When an individual whose cryptocurrency undergoes a hard fork immediately receives units of the new cryptocurrency, the individual should recognize ordinary income at the FMV of the new cryptocurrency in the year which the new units are received.

Note:

The IRS did not include a disclaimer that the “Frequently Asked Questions” are *not legally binding authoritative literature*. The “Frequently Asked Questions” were not published in the Internal Revenue Bulletin (IRB), and per IRS guidelines, only guidance published in the IRB can be relied on as authoritative interpretation of the law. The Government Accountability Office (GAO) published a report on February 12, 2020 recommending that the IRS clarify that the 2019 FAQs are “not binding guidance, subject to change, and cannot be relied upon by taxpayers as authoritative or as precedent for their individual facts and circumstances.”¹⁰

Starting in tax year 2019, taxpayers are required to answer whether, at any time during the tax year, they sold, sent, exchanged, or otherwise acquired any financial interest in virtual currency. This information is reported in a “check the box” question on Form 1040, Schedule 1. The IRS is hopeful that this question will prompt taxpayers and their tax accountants to take a closer look at cryptocurrency activity and any resulting tax implications. Even if there is no taxable event, and the taxpayer solely held cryptocurrency during the tax year, a taxpayer must check “yes” on Schedule 1, alerting the IRS that perhaps there is an unrealized gain that could be recognized in the future. Taxpayers who do not properly report the income tax consequences of virtual currency transactions are, when appropriate, liable for tax, penalties and interest. In some cases, **taxpayers could be subject to criminal prosecution.**

- a. Taxpayers sign their tax returns under penalty of perjury. A taxpayer who has cryptocurrency and fails to check the box on Schedule 1 could be in violation of §7206(1), subscribing a tax return that is false about a material matter. If the matter was taken to court, the government would need to establish that the taxpayer sold, sent, exchanged, or otherwise acquired any financial interest in virtual currency during the tax year in question, and further establish the taxpayer willfully did not check the box on Schedule 1. This criminal enforcement strategy may appeal to the IRS, as §7206(1) allows for prosecution even if no tax deficiency exists.
- b. In *United States v. Peter Horowitz et al* (January 2019), the Justice Department Tax Division determined that failure to check a box, in the FBAR reporting context, constitutes willfulness. Willful failures bring a greater possibility of criminal prosecution and higher penalties. If the findings in *United States v. Peter Horowitz et al* are applied to the new virtual currency “check the box” question on Form 1040 Schedule 1, one can expect increased virtual currency criminal investigations in the near future.

¹⁰ GAO-20-188 Taxation of Virtual Currencies.

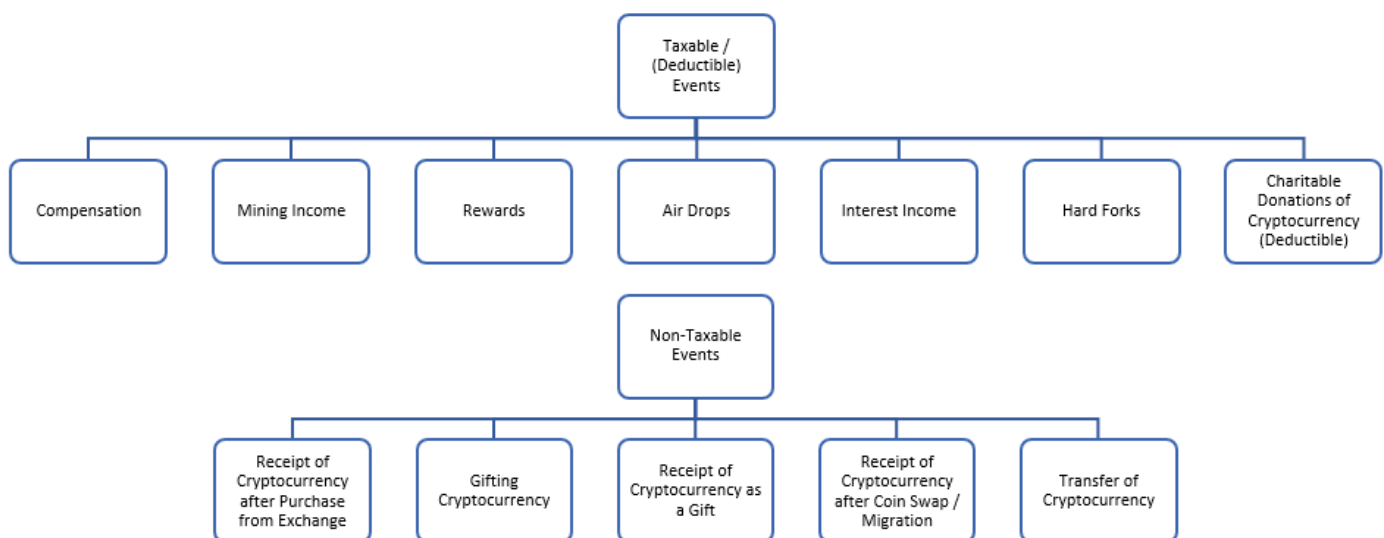
As of February 2020, the IRS Criminal Investigation (CI) division is routinely tracking cryptocurrency transactions. In fact, it is often easier for the CI division to track cryptocurrency transactions than cash transactions due to technological advances. One aspect that may create issues in cryptocurrency cases is that the government has the burden to prove the defendant's basis in the cryptocurrency assets. The government having only part of the picture of a transaction can be a problem in a criminal case because the prosecution will bear the burden of proving a tax loss. The government may have a piece of the transaction, but it can still be difficult as the transaction's value must be determined.

In a letter sent on February 28, 2020, the AICPA sent a letter to the IRS, asking the IRS to revise or clarify Rev. Rul. 2019-24, the FAQs, and the cryptocurrency question on 2019 Form 1040, Schedule 1. Specifically, the AICPA asks the IRS to clarify the meaning of the terms "airdrop," "hard fork," and "chain split." In addition, the AICPA noted that the FAQs issued are not binding authority, and suggested that the IRS issue guidance in the form of proposed regulations. Finally, the AICPA noted that some individuals may not be aware of the new "check the box" cryptocurrency question on the 2019 Form 1040, Schedule 1. Individuals who do not have other income or deductions for AGI may be unaware of the new question, as they would not be required to file Schedule 1 for any other reason but answering the cryptocurrency question. The AICPA urges the IRS to take additional steps to alert taxpayers of the new question as well as provide filing relief.¹¹

On March 3, 2020, the IRS held a Virtual Currency Summit to discuss the cryptocurrency industry. IRS agents spoke about the current classification of cryptocurrency as "property." While the IRS considers cryptocurrency as property as per Notice 2014-21, the SEC treats some cryptocurrency as securities and the Commodities Futures and Trading Commission treats some cryptocurrency as commodities, perhaps hinting that updated guidance may soon follow. The IRS also discussed a proposed "Central Depository" comprised of all transactions and activity on cryptocurrency exchanges, in an effort to improve cryptocurrency tax compliance. If implemented, regulators would have access to any data if needed.

5. Virtual currency taxation

Notice 2014-21 and Revenue Ruling 2019-24 established that cryptocurrency is subject to taxation. In a broad sense, cryptocurrency can be taxed as either capital gain/loss or ordinary income/loss. Investors



¹¹ AMERICAN INSTITUTE OF CPAs Comments on Revenue Ruling 2019-24, the New Question on Schedule 1 (Form 1040), and IRS Frequently Asked Questions on Virtual Currency Transactions.

who trade and exchange cryptocurrency are taxed according to capital gain rates and are subject to a maximum \$3,000 capital loss per year. Alternately, those who are actively involved in acquiring cryptocurrency, including miners, traders, dealers, and those who receive cryptocurrency as compensation or hard forks, are taxed at ordinary income rates, and can only deduct ordinary losses if associated with a §162 trade or business.

Unlike certain stock market investors who are issued a 1099-B for tax reporting purposes, there is very little regulation in the cryptocurrency community. Some US taxpayers may receive a 1099-K, *Payment Card and Third Party Network Transactions*, from an exchange if they had gross payments exceeding \$20,000 and more than 200 transactions on the exchange.¹² A Form 1099-K includes the gross amount of all reportable payment transactions. The dollar amount of each transaction is determined on the date of the transaction. As only a small segment of the population will receive a 1099-K for their cryptocurrency activity, some taxpayers may wrongly believe they have no reporting obligations due to not receiving any documents. In addition, those who receive a 1099-K from a cryptocurrency exchange cannot rely solely on the document to calculate their tax liability, as it does not contain information about the basis of each asset. On the other hand, some individuals may wrongly believe that they have a reporting obligation due to receipt of a 1099-K. If a taxpayer transfers cryptocurrency between exchanges, there is no taxable event.

Practice point:

ARPA amended the de minimis threshold for Form 1099-K, *Payment Card and Third Party Network Transactions* reporting. As noted above, through December 31, 2021, a **two-step** de minimis standard exists, in which Third Party Settlement Organizations are required to report third-party network transactions of a participating payee on Form 1099-K if:

- The amount that would otherwise be reported exceeds \$20,000; and
- There were over 200 transactions.

ARPA amends the two-step de minimis standard and instead creates a **single standard** with a single \$600 reporting threshold beginning in 2022. In other words, beginning on January 1, 2022, Third Party Settlement Organizations will be required to file a Form 1099-K for participating payees receiving over \$600. This new change mirrors the Form 1099-MISC and Form 1099-NEC reporting requirements for payments of compensation of \$600 or more.

For purposes of this change, a reportable payment transaction is any payment card transaction and any third-party network transaction. Transactions meeting the \$600 aggregate payment de minimis standard must be reported to all payees who accept payment from a third-party settlement organization.

Although only a small portion of the population currently receives a Form 1099-K for their cryptocurrency activity, many more taxpayers could receive this form beginning in 2023. Taxpayers who receive a 1099-K have an increased risk of receiving a CP2000 Notice from the IRS. As discussed earlier, a CP2000 Notice is sent to taxpayers when the information the IRS has on file does not match the information reported on an individual's tax return.

Other exchanges, such as Coinbase, issue Form 1099-MISC to certain individuals. Starting in tax year 2020, Coinbase stated that they would issue Form 1099-MISC instead of Form 1099-K to certain U.S. customers who earned \$600 or more in cryptocurrency in 2020. Prior to this change, Coinbase sent Form 1099-K to certain customers.

¹² www.irs.gov/Understanding-Your-Form-1099-K.

- a. **Compensation** -- As with any other form of compensation, any individual who receives compensation in the form of cryptocurrency must include the compensation on Form 1040, taxed at ordinary rates. This applies to both employees (W-2), contractors (Form 1099), or any other individual receiving compensation. Even if the employer does not issue a W-2 or Form 1099, the individual receiving compensation in the form of cryptocurrency must report it at the FMV at the time of receipt.
- b. **Mining Income** -- As discussed earlier, cryptocurrency miners verify and authenticate cryptocurrency transactions in exchange for cryptocurrency. Cryptocurrency miners can be broadly categorized into two main categories: professional miners (as part of a trade or business) and hobby miners.

Professional miners conduct mining activity as part of a §162 trade or business. Professional miners must include the FMV of the mined cryptocurrency as part of their ordinary income. Additionally, as with any §162 trade or business, professional miners can deduct mining-related expenses on Schedule C.

Hobby miners may mine cryptocurrency in their spare time, but it is not their main source of income. Hobby miners must include the FMV of the mined cryptocurrency in their gross income. Since the hobby does not rise to the level of a §162 trade or business, hobby miners cannot deduct mining-related expenses.

- c. **Rewards** -- Staking rewards are earned by individuals who hold a cryptocurrency for a specified period of time. The individual who earns a staking reward should include the FMV of the cryptocurrency reward at the time of receipt in their taxable income. Similarly, if an individual receives a “reward” in the form of cryptocurrency while shopping on an online platform, the individual should err on the side of caution (no clear IRS guidance exists) and include the FMV of the cryptocurrency reward received in taxable income.
- d. **Airdrops** -- The IRS recently released guidance (Rev. Rul. 2019-24) confirms that individuals are liable for taxes on cryptocurrencies resulting from an airdrop, regardless of whether or not the cryptocurrency is actually received. Airdrops occur when a company distributes cryptocurrency to an individual’s wallet, usually free of charge, to promote a new cryptocurrency or draw awareness. Sometimes airdrops are unsolicited, and other times individuals may complete small tasks (like sending a tweet) in exchange for the airdrop. The IRS defines an airdrop as “a means of distributing units of a cryptocurrency to the distributed ledger addresses of multiple taxpayers.” Individuals should recognize ordinary income at the FMV of the airdropped cryptocurrency at time of receipt.
- e. **Interest Income** -- Some cryptocurrency platforms allow users to generate interest income on the cryptocurrency held. Individuals receiving interest income should report the amount as interest income on Form 1040.
- f. **Hard Fork** -- Similar to how computers require software updates or phones require app updates, cryptocurrency networks also require updates in order to improve performance and resolve any known issues. This “update” is often referred to as a “fork” in the cryptocurrency community. Forks arise when there are two different blocks in the same blockchain that have an identical set of blocks preceding it. In Rev. Rul. 2019-24, the IRS defines a “hard fork” as “unique to distributed ledger technology and occurs when a cryptocurrency on a distributed ledger undergoes a protocol change resulting in a permanent diversion from the legacy or existing distributed ledger. A hard fork may result in the creation of a new cryptocurrency on a new distributed ledger in addition to the

legacy cryptocurrency on the legacy distributed ledger. Following a hard fork, transactions involving the new cryptocurrency are recorded on the new distributed ledger and transactions involving the legacy cryptocurrency continue to be recorded on the legacy distributed ledger.” Hard forks arise if a software or network update is not backwards-compatible with the previous non-updated software. If buyer A purchases 100 units of cryptocurrency X using non-updated software, the transaction would not be recognized by the updated software. Similarly, if buyer A purchases 100 units of cryptocurrency X using updated software, the transaction would not be recognized by the non-updated software. In the event a hard fork results in the creation of a new cryptocurrency, all transactions involving the old (“legacy”) cryptocurrency remain recorded on the legacy cryptocurrency ledger, but all new cryptocurrency transactions are recorded on the new cryptocurrency ledger. Both blockchains continue to develop separately.

Sometimes an airdrop occurs after the hard fork, distributing the new cryptocurrency to the individual who owned the original (“legacy”) cryptocurrency. The IRS clarifies that if an individual receives an airdrop of new cryptocurrency resulting from a hard fork and has complete control over the new cryptocurrency, the individual must include the FMV of the new cryptocurrency in ordinary income.

Example: Hard Fork

Kathy purchased 500 units of cryptocurrency X on blockchain A. A few months later, a hard fork occurs, and Kathy receives 500 units of cryptocurrency X on new blockchain B for free. Additionally, as a result of the hard fork, Kathy receives an airdrop of 100 units of cryptocurrency Y on blockchain B for free. At the time Kathy receives new cryptocurrency Y, it has an FMV of \$1/unit. Under Rev. Rul. 2019-24, Kathy must recognize \$100 of ordinary income, the equivalent FMV of new cryptocurrency Y upon receipt.

Revenue Ruling 2019-24 outlined a scenario in which an airdrop followed a hard fork, but this caused some confusion amidst the cryptocurrency community, as airdrops do not always follow hard forks. A legal memorandum, released by the IRS on April 9, 2021, clarified that “the specific means by which the new cryptocurrency is distributed or otherwise made available to a taxpayer following a hard fork does not affect the Revenue Ruling’s holding.”¹³

- g. **Charitable Donations of Cryptocurrency** -- Questions 33 through 36 of the IRS FAQs on Virtual Currency transactions address Charitable Donations of cryptocurrency. An individual who donates cryptocurrency to a charitable organization will not recognize income, gain, or loss from the donation. If the individual held the cryptocurrency for more than a year, the amount of the charitable deduction is equal to the FMV of the cryptocurrency at the time of donation. If the individual held the cryptocurrency for less than a year, the amount of the charitable deduction is equal to the lesser of the basis in the cryptocurrency or the FMV of the cryptocurrency at the time of donation. If the individual donor claims a charitable deduction of more than \$5,000, the charity is required to sign the donor’s Form 8283, *Noncash Charitable Contributions*. The signature of the donee on Form 8283 does not substantiate the appraised value of the contributed property, it only acknowledges receipt of the property.

¹³ ILM 202114020.

- h. **Crowdsourcing** – An IRS legal memorandum, dated June 29 and released August 28, states that taxpayers who receive convertible virtual currency in exchange for performing a microtask through a crowdsourcing platform have received consideration that is taxable as ordinary income.¹⁴ Crowdsourcing involves outsourcing various assignments, usually small tasks, to a large group of individuals. After the assignments are broadcasted, workers can accept the microtask, perform the work, and receive compensation, often in the form of a “reward.” Oftentimes, the reward amount may be minimal, potentially even less than \$1 in value. The memo provided a few examples of what is considered a “microtask,” including workers processing data, reviewing images, downloading apps and leaving positive reviews, downloading games to unlock a certain level, completing online surveys or quizzes, and registering accounts with various service providers. If a worker completed any of these microtasks in exchange for convertible virtual currency, such as Bitcoin, the IRS considers the worker to have performed a task with the expectation of receiving compensation, and as such, the value of the virtual convertible currency is taxable as ordinary income.

Other events fail to rise to a taxable receipt of cryptocurrency, including:

- **Receipt of Cryptocurrency after Purchase from Exchange:** If an individual purchases a cryptocurrency on an exchange, it is not a taxable event. However, this purchase will be helpful for calculating basis.
- **Receipt of Cryptocurrency as a Gift:** Receiving cryptocurrency as a gift does not constitute a taxable event. However, similar to purchasing cryptocurrency from an exchange, the recipient must note the FMV of the cryptocurrency on the date the gift was made as well as the donor’s basis in the gifted cryptocurrency. These items are critical for future basis calculations.
- **Gifting Cryptocurrency:** Just as the receipt of cryptocurrency does not constitute a taxable event, the gifting of cryptocurrency is not a taxable event.
- **Receipt of Cryptocurrency after Coin Swap / Migration:** Coin swaps function similarly to stock splits and thus are not considered a taxable event. However, the individual should allocate basis among the new coins in order to properly calculate basis going forward.
- **Transfer of Cryptocurrency:** The transfer of cryptocurrency between exchanges or wallets is not a taxable event.

Below is a table summarizing some of the forms and schedules that taxpayers involved with cryptocurrency should consider when reviewing cryptocurrency compliance obligations.

Cryptocurrency Compliance

Form 1040	Schedule 1	Schedule A	Schedule B	Schedule C	Schedule D	Form 8949
• “Check the box” question on page 1 of Form 1040 • Report Ordinary Income (Wages / Compensation) • Line 1 • Report Capital Gains / Losses • Line 6	• Report Ordinary Income (Other Income) • Line 8	• Report Charitable Deductions of cryptocurrency donations • Line 12	• Report Interest Income • Part I • Report Rewards (Staking) • Part I	• Report income generated as part of §162 trade or business • Line 1 • Deduct any expenses associated with §162 trade or business • Part 2	• Summarize cryptocurrency Capital Gains / Losses from Form 8949	• Report cryptocurrency gains and losses

As time goes on, cryptocurrency compliance will continue to be a top area of interest of IRS inquiries and audits. More and more individuals are investing in cryptocurrency as its popularity grows. It is important

¹⁴ ILM 202035011.

for practitioners to familiarize themselves with common cryptocurrency situations and verify with clients whether or not they engaged in any cryptocurrency activity.

6. IRS Form 1040 – Virtual Currency Question

The IRS Form 1040 for 2020 included an update to the cryptocurrency question. Instead of including the “check the box” question on Form 1040, Schedule 1, the Form 1040 for 2020 incorporated the cryptocurrency question at the top of page one. The wording of the question is unchanged, but its new placement at the beginning of Form 1040 under the name and address field indicates that the IRS has an increased focus on cryptocurrency activities. Not all taxpayers are required to file Schedule 1, so by moving the cryptocurrency question to page one of the 1040, all taxpayers will be required to disclose whether they engaged in a transaction involving cryptocurrency. Specifically, the question on page one of Form 1040 asks whether the taxpayer received, sold, sent, exchanged, or otherwise acquired any financial interest in any virtual currency.

Form 1040		Department of the Treasury—Internal Revenue Service (99)		2020	OMB No. 1545-0074	IRS Use Only—Do not write or staple in this space.
U.S. Individual Income Tax Return						
Filing Status ☐ Single ☐ Married filing jointly ☐ Married filing separately (MFS) ☐ Head of household (HOH) ☐ Qualifying widow(er) (QW) Check only one box. If you checked the MFS box, enter the name of your spouse. If you checked the HOH or QW box, enter the child's name if the qualifying person is a child but not your dependent ▶						
Your first name and middle initial		Last name			Your social security number	
If joint return, spouse's first name and middle initial		Last name			Spouse's social security number	
Home address (number and street). If you have a P.O. box, see instructions.					Apt. no.	Presidential Election Campaign Check here if you, or your spouse if filing jointly, want \$3 to go to this fund. Checking a box below will not change your tax or refund. ☐ You ☐ Spouse
City, town, or post office. If you have a foreign address, also complete spaces below.			State	ZIP code		
Foreign country name		Foreign province/state/county		Foreign postal code		
At any time during 2020, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency? ☐ Yes ☐ No						

Looking Ahead: Draft 2021 Form 1040

The virtual currency question remains on page 1 of the 2021 Draft Form 1040, but the wording of the question has changed. The 2020 Form 1040 virtual currency question asked, “At any time during 2020, did you receive, sell, send, exchange, or otherwise acquire any financial interest in virtual currency?” The draft 2021 Form 1040 slightly modified this question, asking “At any time during 2021, did you receive, sell, exchange, or otherwise dispose of any financial interest in any virtual currency?”

The new question posed on the draft 2021 Form 1040 focuses on taxable transactions and states that if a taxpayer purchased a virtual currency with real currency and had no other virtual currency transactions during the year, he or she was not required to answer yes to the Form 1040 question. Similarly, the 2021 virtual currency question also does not ask about “sending” virtual currency.

Form 1040 Department of the Treasury—Internal Revenue Service (99) **2021** U.S. Individual Income Tax Return OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

Filing Status ☐ Single ☐ Married filing jointly ☐ Married filing separately (MFS) ☐ Head of household (HOH) ☐ Qualifying widow(er) (QW)
Check only one box. If you checked the MFS box, enter the name of your spouse. If you checked the HOH or QW box, enter the child's name if the qualifying person is a child but not your dependent ▶

Your first name and middle initial Last name Your social security number
If joint return, spouse's first name and middle initial Last name Spouse's social security number

Home address (number and street). If you have a P.O. box, see instructions. Apt. no. Presidential Election Campaign
City, town, or post office. If you have a foreign address, also complete spaces below. State ZIP code Check here if you, or your spouse if filing jointly, want \$3 to go to this fund. Checking a box below will not change your tax or refund.
Foreign country name Foreign province/state/county Foreign postal code ☐ You ☐ Spouse

At any time during 2021, did you receive, sell, exchange, or otherwise dispose of any financial interest in any virtual currency? ☐ Yes ☐ No

7. Cryptocurrency Like-Kind Exchange Treatment

The IRS released a legal memorandum on June 8, 2021, clarifying whether certain exchanges of cryptocurrency qualified for §1031 like-kind exchange treatment. Specifically, the legal memorandum addresses the following question: “If completed prior to January 1, 2018, does an exchange of: (i) Bitcoin for Ether; (ii) Bitcoin for Litecoin; or (iii) Ether for Litecoin qualify as a like-kind exchange under §1031 of the Code?” The short answer is no; exchanges of Bitcoin for Ether, Bitcoin for Litecoin, or Ether for Litecoin completed prior to January 1, 2018, do not qualify as a like-kind exchange under §1031 of the Code.¹⁵

Per IRC §1031(a)(1), “no gain or loss may be recognized on the exchange of property held for productive use in a trade or business or for investment if such real property is exchanged solely for real property of like kind which is to be held either for productive use in a trade or business or for investment.”

Essentially, under a §1031 like-kind exchange, the taxpayer's economic situation prior to and after the exchange is the same. Like-kind property is similar in nature or character, and as a result, different classes of property cannot be exchanged in a §1031 exchange. Prior to the TCJA, §1031 like-kind exchange treatment could apply to the exchange of personal property, but since the enactment of the TCJA, it only applies to exchanges of real property held for use in a trade or business.

¹⁵

ILM 202124008.

In 2016 and 2017, Bitcoin and Ether were considered to be substantially different from other types of cryptocurrencies, such as Litecoin, as referenced in the legal memorandum. If an individual was interested in investing in Litecoin, they likely had to first acquire Bitcoin or Ether. If an individual was interested in liquidating their Litecoin holdings, they likely had to first exchange the Litecoin for either Bitcoin or Ether. As such, the IRS determined that both Bitcoin and Ether were fundamentally different from Litecoin, and therefore, neither Bitcoin and Litecoin nor Ether and Litecoin qualify as like-kind property for purposes of §1031.

Additionally, both Bitcoin and Ether differ from each other in that the Bitcoin network is a payment network where Bitcoin essentially acts as a unit of payment; whereas the Ethereum network acts as a payment network and platform for other applications, with Ether being the “fuel” for these features. Both Bitcoin and Ether can be used for payment purposes, but Ether offers additional functionality features, and as such, Bitcoin and Ether are not considered like-kind property for purposes of §1031.¹⁶

Lastly, as a result of the TCJA, all exchanges of cryptocurrency from 2018 forward do not qualify as like-kind property for purposes of §1031. The chief counsel advice rendered in ILM 202124008 only applies to an exchange of Bitcoin for Ether, Bitcoin for Litecoin, or Ether for Litecoin, and may not be used or cited as precedent.

8. Harper v. Rettig

Court cases have begun to arise as a result of the Coinbase lawsuit. James Harper filed a lawsuit on July 15, 2020 with the U.S. District Court for the District of New Hampshire, stating that his constitutional rights were violated when the IRS likely obtained his account information via John Doe summonses issued to Coinbase, Abra, and Uphold. Harper argues that the IRS obtained his account data without having “any particularized suspicion of wrongdoing.”

Harper opened his first account with Coinbase in 2013 and deposited virtual currency that he received in exchange for consulting services. Harper declared this consulting income on his 2013 tax return. Harper continued to receive consulting income in 2014, which he also reported on his 2014 tax return. In 2015, Harper began liquidating his Coinbase account and transferring his holdings to a hardware wallet. As of 2016, Harper had no holdings on the Coinbase platform.

Harper also liquidated virtual currency through Abra and Uphold from 2016 through present day. In 2016, 2017, 2018, and 2019, Harper declared capital gains for his virtual currency holdings and paid applicable taxes. On August 9, 2019, Harper received a “Reporting Virtual Currency Transactions” letter from the IRS, stating that the IRS had information that Harper held one or more accounts containing virtual currency but may not have properly reported such transactions. The letter also stated that if Harper did not accurately report his virtual currency transactions, he may be subject to civil and criminal enforcement activity.

As of August 9, 2019, Harper had no virtual currency records on any exchange besides Abra, Coinbase, and Uphold. Since Harper accurately reported and paid taxes on all virtual currency transactions for the applicable years in question, he argues that the IRS lacked any particularized suspicion that he violated any law prior to obtaining the financial records referenced in the letter. Additionally, Harper claimed that he never received any notice of third-party summons from the IRS.

¹⁶ ILM 202124008.

Under 26 U.S.C. §7602(a), the IRS has the statutory authority to issue administrative summonses. This includes issuing summonses “for the purposes of ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax or . . . collecting any such liability.” If the IRS exercises this authority, it must notify the taxpayer of the summons pursuant to 26 U.S.C. §7609(a), which was passed by Congress to protect the rights of taxpayers subject to IRS third-party summonses. Moreover, §7609(f) states that in the case of a John Doe summons, the summons is not valid unless and until it is authorized by a judicial officer after a hearing. In such case, it must be established that:

- The summons relates to the investigation of a particular person or ascertainable group or class of persons;
- There is a reasonable basis for believing that such person or group or class of persons may fail or may have failed to comply with any provision of any internal revenue law; and,
- The information sought to be obtained from the examination of the records or testimony (and the identity of the person or persons with respect to whose liability the summons is issued) is not readily available from other sources.

Harper asserts that his fourth amendment right to be protected against unreasonable search and seizure was violated, as he had a reasonable expectation of privacy in the financial records held by Abra, Coinbase, and Uphold. Additionally, Harper asserts that his fifth amendment right of due process under the law was violated, as his information was seized prior to providing him notice and opportunity to challenge the seizure of property. Harper claims that unless the IRS expunges his information, they are unlawfully holding his information. The suit seeks declaratory judgment and injunctive relief, including an order expunging Harper’s financial information from the IRS’s records.

In December 2020, the Department of Justice (DOJ) filed a motion to dismiss Harper’s lawsuit, citing lack of jurisdiction and that the complaint failed to state a claim on which relief could be granted. The DOJ stated that there is a lack of jurisdiction, as Harper’s complaint is essentially a lawsuit against the United States for which there has been no waiver of sovereign immunity. Moreover, the DOJ asserted that the lawsuit is barred by the Anti-Injunction Act under §7421. Under this provision, interfering with the IRS’s information gathering process by ordering the IRS to destroy information is barred. Responding to Harper’s claim that his fourth amendment rights were violated, the DOJ stated that Harper placed his information in the hands of a third party, which does not give rise to an expectation of privacy. As for Harper’s claim that his fifth amendment rights were violated, the DOJ stated that the constitutionality of John Doe summonses is “beyond reproach.”

On January 19, 2021, Harper responded to the DOJ’s motion to dismiss, stating the court has jurisdiction to hear his case, arguing that the government waived sovereign immunity under §702 of the Administrative Procedure Act, since his suit seeks non-monetary damages for wrongful action by an agency. Additionally, Harper states that the case does not fall under the Anti-Injunction Act, because his suit does not prevent the IRS from assessing and collecting income taxes, as he already paid all applicable taxes related to his virtual currency holdings. In other words, Harper claims that his lawsuit is not a tax collection claim.

On February 8, 2021, the DOJ replied to Harper’s opposition to the dismissal of his lawsuit. The DOJ reaffirmed that the court has no jurisdiction to hear the case and that Harper’s lawsuit would impede the IRS’s information gathering process if the case proceeded.

On March 23, 2020, Judge Joseph DiClerico in the District of New Hampshire granted a motion to dismiss the case. Judge DiClerico stated that Harper's suit is barred by the Anti-Injunction Act. As previously discussed, Harper claimed that he already paid the IRS all applicable taxes on his cryptocurrency holdings and argued that the IRS said he may have additional tax liability. Continuing his statement, Judge DiClerico responded that "Harper's argument that his proposed injunction and declaratory judgment are not aimed at restraining the assessment or collection of taxes is incorrect." This decision was a blow to many taxpayers who hold cryptocurrency, as they likely will have little recourse going forward if their information is provided to the IRS in response to a subpoena or request for information.

9. *The Ongoing Saga of John Doe*

The IRS is ramping up their cryptocurrency compliance efforts through the use of "John Doe" summonses, similar to the initial Coinbase John Doe summons. On March 30, 2021, the United States government filed a petition asking the United States District Court for the Northern District of California to authorize an IRS John Doe summons. Specifically, the John Doe summons would collect cryptocurrency transaction information from the cryptocurrency exchange "Kraken" for account holders who completed transactions of at least \$20,000 in value between the period January 1, 2016 through December 31, 2020. The IRS asserted that there is a reasonable basis to believe that the taxpayers being investigated have failed, or potentially have failed, to comply with U.S. internal revenue laws regarding the reporting of income from cryptocurrency transactions. At the time the petition was filed, Kraken does not file any third-party reports to the IRS regarding cryptocurrency transactions occurring on its platform. The IRS believes that this lack of information makes the risk of noncompliance or underreporting significant. On March 31, 2021, the Court responded to the summons and stated that the request was "too broad," requesting the IRS to file a tailored version of its request by April 14, 2021.

On April 1, 2021, the United States District Court for the District of Massachusetts authorized the IRS to serve a John Doe summons to Circle Internet Financial, a cryptocurrency exchange. Specifically, the John Doe summons will collect information regarding individuals who completed cryptocurrency transactions of at least \$20,000 in any one year, for the period beginning January 1, 2016 through December 31, 2020. The Circle Internet Financial John Doe summons used the same arguments presented in the Kraken John Doe summons request but resulted in a different outcome. Both summonses requested the same account threshold (\$20,000 in transactions) and same time period (2016 through 2020). The Massachusetts district court found that the IRS met the requirements for the John Doe summons, whereas the California district court required the request to be more narrowly tailored.

While these district courts may not have reached the same conclusion, it is clear to conclude that the IRS is increasingly seeking out cryptocurrency noncompliance. One can expect such John Doe summonses to become more common in the future, as the IRS looks for ways to identify taxpayers who are not properly reporting cryptocurrency income.

10. *Operation Hidden Treasure*

The IRS not-so-subtly announced that they are on the hunt for buried treasure. The IRS created "Operation Hidden Treasure," a joint effort between the IRS Criminal Investigation Division and the IRS Office of Fraud Enforcement (OFE). The main goal of this initiative is to seek out fraud and uncover omitted income related to cryptocurrency. Damon Rowe, Director of the Office of Fraud Enforcement, stated that the IRS trained 200 employees across all business divisions to address noncompliance related to cryptocurrency. Through this training, the employees became knowledgeable about

cryptocurrency and how to spot issues when examining returns. These employees are in addition to the in-house experts in the OFE and IRS Criminal Investigation Division.

One goal of the Operation Hidden Treasure initiative is to determine whether there is a common, recognizable tax evasion pattern amongst cryptocurrency holders. An example of this is structuring a series of transactions, each under \$10,000, to avoid reporting requirements. The OFE plans to create a virtual currency network to assist with tracking cryptocurrency basis and computing gain. This network will not only help train IRS employees, but also generate insightful data about cryptocurrency transactions.

As part of a civil effort, the Criminal Investigation Division will investigate cryptocurrency transactions that may be occurring on the dark web. Such transactions could be used to hide assets or income or possibly be used in illegal transactions. Officials are concerned that terrorists, counterfeiters, money launderers, criminals, and scammers, are using virtual currency as part of money laundering schemes. A 2020 Crypto Crime Report estimated that 1% of overall convertible virtual currency (CVC) transaction volume in 2019, or \$10 billion, was for illicit activities.¹⁷ Other figures released by FinCEN indicate that approximately \$119 billion in suspicious and potentially illicit activities took place through CVC transactions, representing approximately 11.9% of the total CVC transaction volume in 2019.

Carolyn Schenk, the National Fraud Counsel & Assistance Division Counsel for the Office of Chief Counsel, gave a not-so-cryptic warning to holders of virtual currency holders: “We see you.” Surgent will continue to provide updates as more information regarding the Operation Hidden Treasure initiative becomes available.

11. FinCEN Proposed Rulemaking

On December 18, 2020, the US Financial Crimes Enforcement Network (FinCEN) issued a Notice of Proposed Rulemaking, which would require exchanges or banks to submit reports, keep records, and verify the identity of customers in relation to transactions above certain thresholds involving convertible virtual currency (CVC), or legal tender digital asset (LTDA) wallets not hosted by a financial institution (unhosted wallets) or CVC/LTDA wallets hosted by a financial institution in certain jurisdictions identified by FinCEN.

CVC is a medium of exchange, such as a cryptocurrency, that either has an equivalent value as currency, or acts as a substitute for currency, but lacks legal tender status. Types of CVC that are blockchain based, such as Bitcoin, allow two parties to transfer value directly amongst themselves without the need for a centralized intermediary like a bank or money services business. Blockchain-based CVC generally consist of computers operating the network software that enable, validate, and store transaction records on a blockchain. When transferring an asset on the blockchain, an individual enters a private key (known only to the transferor) into the hash function enabled by the network software. Then, the transferor may request that the network software validate a new entry on the ledger showing that control of an asset has been assigned to the recipient. Once the transfer is validated by the network software, the ledger is updated, and the recipient may transfer the asset to another party using their own private key.

Some individuals use financial institutions to acquire or transact CVC, and such financial institutions may provide custody services for these individuals’ CVCs in “hosted wallets.” These institutions execute transactions on the blockchain behalf of the individual by using a private key under the financial institution’s control. Other individuals do not use the service of a financial institution and instead use the

¹⁷ Chainalysis, “2020 Crypto Crime Report,” (Jan. 2020).

private key that controls the CVC to transact directly on the blockchain. These individuals who do not use a financial institution maintain what is referred to as an “unhosted wallet,” as the private key is stored through either a software program or written record.

This proposed rulemaking would fall under the Anti-Money Laundering Act of 2020 (AML), which became law on January 1, 2021. The AML definition of “monetary instruments,” originally defined by the Bank Secrecy Act (BSA), includes “United States coins and currency; as the Secretary may prescribe by regulation, coins and currency of a foreign country, travelers' checks, bearer negotiable instruments, bearer investment securities, bearer securities, stock on which title is passed on delivery, and similar material; as the Secretary of the Treasury shall provide by regulation for purposes of sections 5316 and 5331, checks, drafts, notes, money orders, and other similar instruments which are drawn on or by a foreign financial institution and are not in bearer form; and, as the Secretary shall provide by regulation, value that substitutes for any monetary instrument described in the other categories.”¹⁸

The proposed rulemaking would mandate verification, recordkeeping, and reporting requirements for certain exchanges, withdrawals, deposits, or transfers of LTDA or CVC by a bank or money services business, or to a bank or money services business, that use an unhosted or “otherwise covered wallet.” An “otherwise covered wallet” is defined as wallets held at a financial institution that is not subject to the BSA and is located in certain foreign jurisdictions that are of primary money laundering concern, such as Iran, Burma, and North Korea. Under the proposed rulemaking, banks and money services businesses would be required to file a report with FinCEN that contains information about the customer's CVC or LTDA transaction, including the counterparty's name and physical address. As part of this report, the bank or money services business would also have to verify the identity of their customer if the transaction is greater than \$10,000 (or the transaction is one of multiple CVC transactions involving the counterparty wallets and the customer occurring within a 24-hour period that total more than \$10,000) and the counterparty used an unhosted or otherwise covered wallet. Such banks or money services businesses would have 15 days from the date in which the reportable transaction occurred to file the report with FinCEN.

Secondly, under the proposed rulemaking, the bank or money services business would be required to keep records of a customer's CVC or LTDA transaction and counterparty, including the verification of their customer's identity if a counterparty used an unhosted or otherwise covered wallet if the transaction was greater than \$3,000. The required information to be collected includes:

- The name and address of the financial institution's customer;
- The type of CVC or LTDA used in the transaction;
- The amount of CVC or LTDA in the transaction;
- The time of the transaction;
- The assessed value of the transaction, in U.S. Dollars, based on the prevailing exchange rate at the time of the transaction;
- Any payment instructions received from the financial institution's customer;
- The name and physical address of each counterparty to the transaction of the financial institution's customer;
- Other counterparty information the Secretary may prescribe as mandatory on the reporting form for transactions subject to reporting pursuant to § 1010.316(b);

¹⁸ FinCEN Notice of Proposed Rulemaking, *Requirements for Certain Transactions Involving Convertible Virtual Currency or Digital Assets*

- Any other information that uniquely identifies the transaction, the accounts, and, to the extent reasonably available, the parties involved; and,
- Any form relating to the transaction that is completed or signed by the financial institution's customer.

On January 21, 2021, President Biden froze all Treasury Department rulemaking for 60 days, pending review. Surgent will continue to provide updates regarding this proposed rulemaking as they occur.

12. FinCEN Notice 2020-2

On December 31, 2020, FinCEN issued Notice 2020-2, stating that they intended to propose to amend the regulations implementing the BSA regarding reports of foreign financial accounts (FBAR) to include virtual currency as a type of reportable account. Under current law, a United States person, including a citizen, resident, corporation, partnership, LLC, trust, or estate, must file an FBAR if:

- They hold a financial interest in, or signature authority over, at least one financial account located outside of the U.S.; and
- The aggregate value of those foreign financial accounts exceeded \$10,000 at any time during the calendar year reported.

If enacted, individuals who fail to properly report their cryptocurrency holdings will face potential civil monetary or criminal penalties, including up to \$12,921 in penalties for non-willful violations and up to \$129,210 or 50% of the account balance for willful violations.

B. State of the IRS: Operations during COVID-19

The COVID-19 pandemic initially struck in the middle of the IRS's busiest time of year: filing season. A typical IRS filing season lasts between January through mid-April, as during this time period, many individuals and businesses contact the IRS with any tax questions and subsequently file their tax returns. TIGTA prepared a report detailing the results of the 2020 filing season and impacts of COVID-19 on IRS operations.¹⁹ Numerous IRS sites closed in late March and early April of 2020 and reopened months later in early to late June 2020. The IRS had to quickly approve employees who were not yet approved to telework but able to telework from home and provide them with necessary equipment. It is important to note that much of the work performed at the IRS processing centers is not conducive to a telework environment, including:

- Receiving and sorting returns;
- Distributing mail;
- Processing paper tax returns, including manually inputting information from the tax return into IRS systems;
- Correcting errors; and,
- Corresponding with taxpayers.

Since reopening the IRS Tax Processing Centers, the IRS has faced continued backlog. The figure below provides estimates of work remaining to be processed as of the weeks ending in May 2020, November 2020, and December 2019.

¹⁹ TIGTA – "Final Audit Report — Results of the 2020 Filing Season and Effects of COVID-19 on Tax Processing Operations (Audit # 202040513)".

Type of Work Remaining	Week Ending May 23, 2020	Week Ending November 14, 2020	Prior Year Week Ending December 28, 2019
Unopened Mail Volumes	10,276,573	2,964,216	<i>Not Available</i>
Paper Tax Returns — Individual	10,070,000	4,702,000	183,000
Error Resolution — Individual	1,535,229	601,917	24,621
Rejects — Individual	1,110,332	1,681,994	121,397
Unpostables — Individual	585,457	1,195,850	193,536
Accounts Management — Individual and Business (Adjustments)	1,176,723	1,471,862	1,263,397
<i>Source: IRS Filing Season Statistics, Mail Receipts, and Accounts Management Inventory Reports for the weeks ending December 28, 2019; May 23, 2020; and November 14, 2020.</i>			

As shown in the figure above, a much larger amount of work remained to be processed as of the end of 2020 compared to the end of 2019. As of November 14, 2020, almost 3 million pieces of mail remained unopened. Per the TIGTA report, this unopened mail includes tax returns, payments, taxpayer correspondence, and mail that was returned as undeliverable. Additionally, nearly 5 million paper tax returns still had to be processed as of November 14, 2020.

Although the Tax Processing Centers opened as of June 2020, they were not always able to operate at full capacity due to social distancing requirements and workers remaining on weather and safety leave if they were at high risk for severe illness from COVID-19. As of November 2020, approximately 78% of all IRS workers were working either at the Tax Processing Center or teleworking, while the remaining 22% of IRS workers remained on weather and safety leave. In an effort to reduce backlogs, the IRS incentivized workers to return to key service areas, such as mail sorting, by offering incentive pay. Additionally, the IRS offered overtime to all employees. Lastly, the IRS also plans on hiring additional employees in 2021 to assist with the backlog.

In addition to the backlog from the 2020 tax filing season, the IRS announced a delayed start to the 2021 tax filing season.²⁰ Traditionally, the IRS begins processing tax returns in late January; however, the IRS

²⁰ IR-2021-16.

announced that 2021 tax filing season would begin on February 12, 2021. The delayed tax filing season start date was not a result of prior year backlog, but rather the result of additional time needed for programming and testing of IRS systems following the CAA 2021 legislative provisions, including the EIP2. Despite the delayed tax filing season start date, the IRS was unable to adjust its forms and systems for certain CAA 2021 provisions prior to the beginning of filing season, including corrections to the recovery rebate credit and verification of the 2019 lookback election for the EITC or ACTC. These items are being manually processed by the IRS's Error Resolution System (ERS) unit, resulting in refund delays for impacted taxpayers.

The IRS provides updates regarding the 2021 filing season on its webpage. The IRS continues to experience delays in services such as:

- Live phone support;
- Processing tax returns filed on paper;
- Answering mail from taxpayers; and
- Reviewing tax returns, even for returns filed electronically.

As of the week ending April 9, 2021, more than 8 million individual returns (Form 1040 or 1040-SR) were in "suspense" status awaiting review and manual processing. During "normal" tax seasons, the IRS does not suspend returns, as they are able to be reviewed and processed as they come in. An April 22, 2021 National Taxpayer Advocate blog post reported that "a combination of the high-volume of 2020 tax returns requiring manual processing, the backlog of unprocessed 2019 paper tax returns, congressional mandates to issue economic impact payments (EIPs) and provide other relief to taxpayers during the pandemic, limited resources, and technology issues have contributed to more refund delays and longer refund delays than are typical in a normal filing season."²¹ To date, a staggering 29 million returns are awaiting manual processing.

The IRS emphasized that they understand the importance of timely processing tax returns and issuing refunds and that all returns are opened in the order they are received. Similar to prior years, the "Where's my refund?" tool can help taxpayers determine whether the return is received, is being processed, or is being reviewed.

C. Keep your eyes and ears open

1. Spotting signs of client data theft²²

The IRS and its Security Summit partners urge tax professionals to learn the tell-tale signs that their office may have experienced a data theft that resulted in fraudulent tax returns being filed in their clients' names. In recent years, especially as a result of the COVID-19 pandemic, tax and identity theft schemes are becoming increasingly more common.

The IRS, state tax agencies, and the private-sector tax industry, working together as the Security Summit, warned practitioners that global criminal syndicates remain active, and they are well financed, high skilled and tax savvy in their attempts to gain sensitive tax data.

The IRS and Summit partners have created a list of warning signs that tax professionals or their office may have experienced a data theft:

²¹ NTA Blog: 2021 Filing Season Bumps in the Road: Part I, April 22, 2021.

²² News Release 2019-140, 08/06/2019.

- Client e-filed returns begin to be rejected by the IRS or state tax agencies because returns with their Social Security numbers were already filed;
- Clients who haven't filed tax returns begin to receive taxpayer authentication letters (5071C, 4883C, 5747C) from the IRS to confirm their identity for a submitted tax return;
- Clients who haven't filed tax returns receive refunds;
- Clients receive tax transcripts that they did not request;
- Clients who created an IRS Online Services account receive an IRS notice that their account was accessed or IRS emails stating their account has been disabled. Another variation: Clients unexpectedly receive an IRS notice that an IRS online account was created in their names;
- The number of returns filed with the tax professional's Electronic Filing Identification Number (EFIN) exceeds the number of clients;
- Tax professionals or clients responding to emails that the firm did not send;
- Network computers running slower than normal;
- Computer cursors moving or changing numbers without touching the keyboard;
- Network computers locking out employees.

"Tax professionals should be on the lookout for these scary scenarios that have hit firms across the country, jeopardizing data of the company and their clients," says IRS Commissioner Rettig.

Practitioner's Note:

During the tax filing season, tax professionals should make a weekly review of returns filed with the office's Electronic Filing Identification Number, or EFIN. A report is updated weekly. Tax preparers can access their e-File applications and select "check EFIN status" to see a count. If the numbers are inflated, practitioners should contact the IRS e-Help Desk.

Tax professionals may also notice IRS acknowledgements for returns they did not e-file. Acknowledgements are sent soon after a return is transmitted.

Tax professionals who notice any signs of identity theft should contact their state's IRS Stakeholder Liaison immediately. The process for reporting data theft to the IRS is outlined in Data Theft Information for Tax Professionals.

In some states, data thefts must be reported to various authorities. To help tax professionals find where to report data security incidents at the state level, the Federation of Tax Administrators has created a special page with state-by-state listings.

The Security Summit reminds all professional tax preparers to have a written data security plan as required by the Federal Trade Commission and its Safeguards Rule. They can also get help with security recommendations by reviewing IRS Publication 4557, *Safeguarding Taxpayer Data*, and *Small Business Information Security: The Fundamentals* by the National Institute of Standards and Technology.

Publication 5293, *Data Security Resource Guide for Tax Professionals*, provides a compilation of data theft information available on IRS.gov.

2. Identity Theft Central – Recent Updates²³

The IRS strengthened awareness of identity theft and data security protection for taxpayers, tax professionals, and businesses by launching “Identity Theft Central,” a 24/7 resource on how to identify theft and protective measures to guard against these actions.

Information for Individual Taxpayers

Taxpayers have access to the “Taxpayer Guide to Identity Theft,” including information about steps to take if one falls victim to identity theft. The Identity Theft Central preemptively alerts taxpayers to possible tax-related identity theft schemes. They warn that you may be involved in an identity theft scheme if:

- You get a letter from the IRS inquiring about a suspicious tax return that you did not file;
- You can’t e-file your tax return because of a duplicate Social Security number;
- You get a tax transcript in the mail that you did not request;
- You get an IRS notice that an online account has been created in your name;
- You get an IRS notice that your existing online account has been accessed or disabled when you took no action;
- You get an IRS notice that you owe additional tax or refund offset, or that you have had collection actions taken against you for a year you did not file a tax return; or
- IRS records indicate you received wages or other income from an employer for which you didn’t work.

The Identity Theft Central lists several ways that taxpayers can protect themselves from becoming victims of identity theft. Some suggested tips for protecting data and identity on cell phones and computers include:

- Use security software and make sure it updates automatically; essential tools include virus/malware protection and a firewall.
- Use encryption programs to protect sensitive digital data.
- Treat your personal information like cash; don’t leave it lying around.
- Use multi-factor authentication when it’s offered.
- Give personal and financial information only over encrypted websites; look for “https” addresses.
- Back up your files.
- Create strong, unique passwords:
 - Use long phrases that you can remember, combined with characters and numbers.
 - Use a different password for each account and use a password manager.
 - When possible, don’t use your email address as your login ID.
 - Use two-factor authentication whenever it’s offered. This is particularly important for protecting your email, financial, and social media accounts.

Sometimes identity theft will present itself in the form of a phishing email or scam. The IRS estimates that 91 percent of all data breaches and cyber-attacks begin with a phishing email. These emails may appear to come from a trusted source, such as a bank, or contain an urgent message that prompts one to follow a link to update information. Taxpayers should always verify the source of these emails and report suspicious activity to the IRS.

²³ News Release 2020-27, 02/03/2020.

The Identity Theft Central reminds taxpayers that the IRS will **never** contact taxpayers via email, social media, or text to request personal information or taxpayer Identity Protection PINs. The IRS will **never** threaten taxpayers with lawsuits or arrest. If a taxpayer is ever unsure of suspicious activity, it is better to be safe than sorry, and call the IRS to verify activity.

In the event that a taxpayer's Social Security number is stolen or compromised, the IRS recommends following these steps:

- Respond immediately to any IRS notice: Call the number provided.
- If your e-filed return is rejected because of a duplicate filing under your Social Security number, or if the IRS instructs you to do so, complete IRS Form 14039, *Identity Theft Affidavit* (PDF). Attach the completed form to your return and mail your return according to instructions.
- Visit [IdentityTheft.gov](https://www.irs.gov/identitytheft) for steps you should take right away to protect yourself and your financial accounts.

In the event a taxpayer believes that a fraudulent return has been filed using his or her name, he or she may request a copy by completing Form 4506-F, *Request for a Copy of a Fraudulent Tax Return*. In the event a taxpayer e-files his or her tax return and receives a message that a dependent on his or her return has been claimed on another tax return, or if he or she receives an IRS Notice CP87A, he or she may be a victim of identity theft. Form 886-H-DEP lists acceptable documents that the taxpayer can use to prove that he or she was entitled to claim the dependent.

Additional Safeguards

Eligible individuals are encouraged to enroll in the IRS's Identity Protection Personal Identification Number (IP PIN) program. Designed to prevent identity thieves from filing fraudulent tax returns with stolen SSN info, the IP PIN program verifies the taxpayer's identity before accepting electronic or paper tax returns for processing.

IP PINs are automatically issued to confirmed identity theft victims, but other taxpayers may "opt in" to the IP PIN program, if eligible. As of the 2020 filing season, a taxpayer may opt into the IP PIN program if he or she files a federal return and resides in Arizona, California, Colorado, Connecticut, Delaware, Washington, D.C., Georgia, Florida, Illinois, Maryland, Michigan, Nevada, New Jersey, New Mexico, New York, North Carolina, Pennsylvania, Rhode Island, Texas, and Washington. The IRS intends to increase availability of the IP PIN program in future filing seasons.

Individuals must undergo a thorough identity verification process, but once approved, the IP PIN is valid for an entire calendar year. For more information on obtaining an IP PIN, see *IRS Publication 5367*.

Information for Individual Tax Professionals

The unfortunate reality is that identity thieves often target tax professionals as they are often custodians of highly sensitive client data.

The Federal Trade Commission (FTC) Safeguard Rule requires financial institutions to protect the consumer information they collect. The Gramm-Leach-Bliley (GLB) Act requires companies defined under the law as "financial institutions" to ensure the security and confidentiality of this type of information. **The "financial institutions" definition includes professional tax preparers.** As part of the law, tax preparers are required to create, implement, and maintain a written information security plan to protect

client data, **regardless the size of the firm**. IRS Publication 4557, *Safeguarding Taxpayer Data*, clarifies FTC information security plan requirements for tax preparers. Specifically, each information security plan must:

- Designate one or more employees to coordinate its information security program.
- Identify and assess the risks to customer information in each relevant area of the company's operation, and evaluate the effectiveness of the current safeguards for controlling these risks.
- Design and implement a safeguards program, and regularly monitor and test it.
- Select service providers that can maintain appropriate safeguards, make sure your contract requires them to maintain safeguards, and oversee their handling of customer information.
- Evaluate and adjust the program in light of relevant circumstances, including changes in the firm's business or operations, or the results of security testing and monitoring.

The best way to guard against identity theft is to take measures to prevent it in the first place. The IRS Identity Theft Central recommends that tax professionals take the following preventative measures:

- Install anti-malware/anti-virus security software on all devices (laptops, desktops, routers, tablets and phones) and keep software set to automatically update.
- Use strong, responsible passwords and consider a password management program.
- Encrypt all sensitive files/emails and use strong password protections. Send password-protected and encrypted documents only.
- Back up sensitive data to a safe and secure external source not connected fulltime to a network.
- Wipe clean or destroy old computer hard drives and printers that contain sensitive data.
- Limit access to taxpayer data to individuals who need to know.
- Use separate personal and business email accounts.
- Protect email accounts with strong passwords and two-factor authentication if available.
- Install an anti-phishing tool bar to help identify known phishing sites.
- Use security software to help protect systems from malware and scan emails for viruses.
- Never open or download attachments from unknown senders, including potential clients; verify the email is authentic by calling them.
- Do not respond to suspicious or unknown emails; if the email is IRS-related, forward it to phishing@irs.gov.
- Track filed returns through daily e-file acknowledgements. If you receive more acknowledgements than returns you know you filed, dig deeper.
- Track weekly EFIN usage using your e-Services account. If the number of returns filed with your EFIN does not match your records, contact the e-Help desk.
- Make sure all EFIN information (phone number, address, personnel changes) are up to date.
- Check your PTIN account for a weekly report of returns filed with your PTIN if you are a 'Circular 230 practitioner' or an 'annual filing season program participant,' and you file 50 or more returns a year.

In the event a tax professional or his or her firm are the victim of identity theft, the IRS recommends to immediately report it to his or her local stakeholder liaison. The liaisons will notify the IRS Criminal Investigation division on your behalf. The IRS can potentially block fraudulent returns of clients if a timely report is made. Next, the practitioner should email the Federation of Tax Administrators to receive

information regarding how to report victim information on a state-by-state basis. This usually entails notifying the state attorney general of a data breach.

Information for Businesses

The Identity Theft Central provides businesses with access to information about how to recognize signs of identity theft. Among preventative steps listed above for individuals and tax preparers, the IRS recommends businesses take the following preventative measures:

- Deploy firewall protections on the business network.
- Choose multi-factor authentication when available.
- Back up sensitive data to a secure, external source not connected to the business network.
- Enter personal data only on secure sites with web addresses that begin with "https."
- Educate employees about data security information and identity theft prevention.

The IRS, as part of the Security Summit, takes additional measures to protect business (corporation, partnership, estate and trust) taxpayer data. If a business return is flagged as a potentially fraudulent return, the IRS issues either Letter 6042C seeking information to validate the return or Letter 5263C seeking information to validate the entity. If a tax professional prepares a business return, the IRS may ask a series of questions to authenticate the validity of the business return.

The Taxpayer Protection Program

The IRS established the Taxpayer Protection Program to identify and prevent potential identity theft cases and assist taxpayers whose identities are compromised. Taxpayers identified during this process must authenticate their identity. The chart below outlines some of the letters that the IRS may send to taxpayers:

Taxpayer Protection Program Letters

Letter	Purpose	Type	Action
4883C	IRS detects potential Identity Theft during Original Processing - issued on accounts for returns filed with an address in the United States	Individual	Call the IRS to verify identity
5071C	IRS detects potential Identity Theft During Original Processing - issued for accounts meeting specific criteria	Individual	Use the online tool or call to verify identity
5747C	IRS detects potential Identity Theft during Original Processing	Individual	Visit an IRS office to verify identity
5447C	IRS detects potential Identity Theft during Original Processing - issued on accounts for returns filed with an address outside the United States / foreign address	Individual	Call the IRS to verify identity
No Letter	Taxpayer receives E-File reject for duplicate SSN	Individual	Taxpayer should file Form 14039, <i>Identity Theft Affidavit</i> , if the taxpayer attempts to file an electronic tax return and the IRS rejects it because a return bearing the taxpayer's Social Security number already has been filed.
6042C	IRS needs more information about the taxpayer's business, estate, or trust entity.	Business	Complete and return the questionnaire within 30 days
6217C	IRS needs more information about the taxpayer's business, estate, or trust entity.	Business	If requested provide the additional information requested within 30 days.
5263C	IRS needs more information about the taxpayer's business, estate, or trust entity.	Business	Complete and return the questionnaire within 30 days

On July 16, 2020, the IRS released a “Dirty Dozen” list of tax schemes in 2020 and urged taxpayers to be especially aware of potential schemes during the COVID-19 pandemic.²⁴ During times of economic uncertainty and crisis, scam artists and schemers look to take advantage of unsuspecting individuals. Below is a list of the 2020 “Dirty Dozen” tax scams to be on the lookout for:

- **Phishing:** Identity theft scammers often use fake emails, texts, links, or websites to lure unsuspecting individuals into providing personal information. The IRS notes that scam artists may pose as IRS agents and ask about Economic Impact Payments. The IRS emphasizes that they will never communicate with taxpayers via email regarding this information.
- **Fake Charities:** The IRS warns that scammers have been setting up fake charities to steal from well-intentioned individuals during the COVID-19 pandemic. Usually, scammers will try to contact such individuals for “donations” via telephone, text, email, or social media. The scammers often use similar names as legitimate charities in order to trick unsuspecting individuals into providing a donation. Taxpayers should always verify the legitimacy of a charity prior to providing a donation.

²⁴ IR-2020-160.

- **Threatening Impersonator Phone Calls:** The IRS warns that a common scheme involves individuals receiving threatening calls from a scammer posing as an IRS agent. The goal of the scammer is to instill fear into the innocent individual by threatening things such as arrest if the innocent individual does not pay a fake tax bill. The IRS notes that these scams are common and reported throughout the year. Sometimes taxpayers will receive a “robocall,” or a robotic recorded message with prerecorded instructions as to how to return the call. The IRS reminds individuals that they will never threaten taxpayers regarding tax bills.
- **Social Media Scams:** Scammers use social media to trick individuals, or family and friends of individuals, into falling for a scheme. Sometimes the scammer will impersonate an individual’s family member, friend, or co-worker over social media. Posing as the individual’s family member, friend, or co-worker, the scammer will often send links to the unsuspecting individual. If the unsuspecting individual clicks on the link, their computer or phone may become compromised with malware.
- **EIP or Refund Theft:** Similar to prior years in which refund fraud was a threat, EIP threat is a newly designated high threat priority. Scammers often use stolen personal identity information to file false tax returns or divert refunds and EIPs to the wrong address or bank account. The IRS noted that they were particularly concerned that certain individuals and businesses taking advantage of vulnerable individuals receiving economic impact payments, such as individuals in nursing homes. The IRS warned nursing homes and care facilities that economic impact payments belong to recipients, not the nursing home or care provider.
- **Senior Fraud:** Sadly, in addition to targeting vulnerable individuals, scammers often target senior taxpayers who are less familiar with technology or phishing emails, calls, or texts. The IRS urges trusted friends or family members to take an interest in the senior taxpayer’s financial affairs in order to minimize the risk that they are a victim of a scam.
- **Scams targeting non-English speakers:** The IRS warns that scams often target those with limited English language proficiency. The IRS states that recent scams often involve the potential promise of an Economic Impact payment. Sometimes, the scammer will threaten deportation or jail time in order to instill fear in the potential victim. Taxpayers who are immigrants are most likely to be the victim of these scams.
- **Unscrupulous Return Preparers:** Many tax professionals are honest and provide legitimate, valued services to taxpayers. However, some bad apples exist and intend to harm innocent taxpayers. The IRS urges taxpayers to be on the lookout for “ghost preparers.” These ghost preparers actually prepare the return, but they do not sign the return and instead tell the taxpayer to sign it and mail it to the IRS. Per IRS guidelines, all paid preparers must sign the tax return and provide their PTINs.
- **Offer in Compromise (OIC) Mills:** The IRS warns taxpayers to be mindful of Offer in Compromise mills that make exaggerated claims, stating they will settle tax debts “for pennies on the dollar” through an OIC. Sadly, many of these companies have poor intentions and attempt to charge high fees to individuals already struggling with tax debt. Often, the taxpayer may not even qualify for the OIC. Individuals considering an OIC should use the IRS OIC Pre-Qualifier tool to see if they are eligible for the program.
- **Fake Payments with Repayment Demands:** Sometimes, scammers go as far as putting a fake refund into a victim’s actual bank account in order to get the victim to play along with their scheme. In this scenario, a scammer will steal the taxpayer’s personal information such as their SSN and bank account info. The scammer will use this

information to file a fake tax return resulting in a fake refund that is actually deposited in the taxpayer's bank account. Then, the scammer calls the taxpayer and poses as an IRS agent, claiming that there has been an error and that the taxpayer needs to return the fake refund funds immediately. The scammer will usually direct the taxpayer to purchase gift cards for a specific amount. The IRS reminds taxpayers that they will never call taxpayers and demand a refund repayment in the form of gift cards.

- **Payroll and HR Scams:** Many individuals are working from home during the COVID-19 pandemic. The IRS warns that there are new scams targeting taxpayers who work from home. One scam involves a compromised email account that the scammer uses to send requests to pay fake invoices or make wire transfers. The scammer may also impersonate their victim by requesting the victim's employer change the victim's direct deposit information to reroute their deposit to an account the fraudster controls. These are Business Email Compromise (BEC) or Business Email Spoofing (BES) schemes. Both taxpayers and their employers should be on the lookout for these potential scams.
- **Ransomware:** Ransomware is malware or invasive software that targets human and technical weaknesses to infect a potential victim's computer, network, or server. Usually, this malware is unintentionally downloaded by the user, but once downloaded, it can track keystrokes and other computer activity. Scammers can use this data to obtain sensitive account information, such as usernames or passwords.

In addition to the "Dirty Dozen" tax fraud schemes, the IRS warns that individuals are at a heightened risk to be victims of identity theft related to unemployment compensation as a result of the COVID-19 pandemic.²⁵ Numerous states have seen an increased amount of fraudulent unemployment claims filed by criminals using stolen identities. Some of these criminals even use the stolen identity to fraudulently collect benefits in multiple states. Individuals who receive unemployment compensation receive a Form 1099-G, *Certain Government Payments*, from the state that they receive unemployment compensation from, since unemployment compensation is generally considered taxable income (Note: due to ARPA, unemployment compensation was partially excluded from income during the 2020 tax year). An individual may be a victim of a fraudulent unemployment compensation identity theft scam if:

- He or she received a Form 1099-G and did not file for unemployment benefits.
- He or she received mail from a government agency regarding unemployment claims or benefits that he or she did not file for.
- While employed, he or she received a notice from his or her employer indicating a request for information about an unemployment claim in his or her name.

If an individual receives an incorrect Form 1099-G for unemployment benefits that he or she did not claim, such individual should report the unemployment identity theft to the state where it occurred. The state will issue a corrected Form 1099-G to the identity theft victim and alert the IRS.

Practitioner's Note: IP PINs

On January 12, 2021, the IRS announced that the Identity Protection PIN (IP PIN) program was expanded for all taxpayers.²⁶ Prior to the announcement, the IRS only offered IP PINs to victims of identity theft. An IP PIN is a unique six-digit code known only to the taxpayer and the IRS. The IP PIN acts as a safeguard to protect the taxpayer from fraudulent tax return filings. Electronic returns must be filed with a correct IP PIN, otherwise, they will be rejected.

²⁵ COVID Tax Tip 2021-24.

²⁶ IR-2021-09.

Taxpayers should be aware about certain aspects of the IP PIN Opt-In Program, including:

- The IP PIN Opt-In Program is *optional*
- Spouses and dependents are eligible for an IP PIN if they can verify their identities.
- An IP PIN is valid for a calendar year, and the taxpayer must obtain a new IP PIN each filing season
- Correct IP PINs must be entered on electronic and paper tax returns to avoid rejections or delays
- There is no opt-out option

Taxpayers may apply online for an IP PIN using the “Get an IP PIN” tool. This process requires taxpayers to verify their identities using the Secure Access authentication process if they do not have an IRS account. During this process, the taxpayer must provide his or her SSN and a financial account number linked in his or her name (such as a credit card or home or auto loan).

Once the taxpayer authenticates his or her identity using Secure Access, his or her 2021 IP PIN will immediately be revealed.

Taxpayers whose adjusted gross income is \$72,000 or less may complete Form 15227, *Application for an Identity Protection Personal Identification Number*, and mail or fax the form to the IRS. An IRS customer service representative will verify the taxpayer’s identity by phone. For security reasons, the IRS will mail the taxpayer an IP PIN during the following tax year.

Taxpayers who cannot verify their identities online or by phone and who are ineligible to file Form 15227 can contact the IRS and make an appointment at a Taxpayer Assistance Center to verify their identities in person. Taxpayers should bring two forms of identification, including one government-issued picture identification.

There is no change in the process of obtaining an IP PIN for victims of identity theft. Taxpayers who filed a Form 14039, *Identity Theft Affidavit*, will automatically receive an IP PIN via mail once their cases are resolved.

D. Increased scrutiny of nonfilers and high-income taxpayers

On February 19, 2020, the IRS issued an Information Release and Fact sheet, announcing that it will increase focus on high-income nonfilers. These individuals include those who received income in excess of \$100,000 during the tax year and did not file a return with the IRS. The IRS intends to accomplish this goal through the use of data analytics and increased face-to-face visits of individuals who failed to file returns prior to 2018. ²⁷

The IRS notes that individuals will have received numerous letters from the IRS informing them of their tax liability prior to receiving an in-person visit from a revenue officer. In-person visits from a revenue officer are typically unannounced, but the revenue officer will have two forms of identification to verify their credentials to the taxpayer. The revenue officer will explain the tax liability to the individual, methods to provide payment, and consequences of non-compliance.

To promote voluntary compliance with tax laws, the IRS outlined the following processes:

- **Increased identification and case creation for individual and business nonfilers:** New cases will be assigned to IRS employees for resolution. The IRS has hired additional enforcement personnel to assist with high-income nonfiler cases.
- **Automated Substitute for Return program (ASFR):** The purpose of the ASFR program is to secure valid voluntary delinquent tax returns and to compute tax, interest, and

²⁷ Information Release 2020-34 and Fact Sheet 2020-2 (February 2020).

penalties based on income information submitted by payers when no return is filed. The IRS sends notices to the individuals alerting them of their tax liability.

- **Automated 6020(b) process:** This process identifies businesses who are liable for employment taxes but have not filed the appropriate forms (Form 940, Form 941, Form 943, or Form 944). The IRS aims to help these businesses become filing compliant and alert them of their tax liability.
- **Delinquent Return Refund Hold program (DRRH):** The IRS will hold an individual's income tax refunds and credits when a current or prior year refund return is filed and the individual's account has at least one unfiled tax return within the five years prior to the current tax year.

A variety of payment options exist for individuals to pay their tax liability. Non-compliance can result in civil and even criminal actions, so it is imperative that individuals take action as soon as possible. The IRS reminds individuals that not filing because of the inability to pay at the time of filing only makes the situation worse, as penalties and interest will accrue. Being upfront and working with the IRS will help individuals get back on track with their compliance requirements.

New research from a report by the National Bureau of Economic Research (NBER) indicates that relatively high audit rates in top income brackets drive such high-income individuals to adopt sophisticated tax evasion schemes. The NBER estimates that random audits are usually ill-equipped to detect such sophisticated schemes, leading to an underestimation of income tax evasion amongst high-income individuals. In fact, the NBER estimates that "unreported income as a fraction of true income rises from 7% in the bottom 50% to more than 20% in the top 1%, of which 6 percentage points correspond to undetected sophisticated evasion."²⁸

On March 10, 2021, the Treasury Inspector General For Tax Administration (TIGTA) released a report regarding high-income taxpayers who owe delinquent taxes.²⁹ TIGTA published this report, as the IRS typically has focused on the dollar amount of taxes due when prioritizing Taxpayer Delinquent Accounts, rather than the taxpayer's income or wealth. TIGTA believes that this creates a larger risk that wealthy taxpayers are not paying their tax debts despite having the ability to pay. According to the TIGTA report and IRS data, taxpayers having an average AGI of over \$1.5 million paid the IRS an average of only 39% of what they owed:

Average AGI of Taxpayers in This Group	Balance Due	Actual Recovery Rate	Remaining Balance Due
\$1,563,390	\$4,009,955,107	39%	\$2,442,387,519
\$98,289	\$1,089,010,998	17%	\$906,586,760
\$24,985	\$1,157,135,371	12%	\$1,014,227,292

As part of the report, TIGTA made seven recommendations to the IRS as to how to more effectively prioritize high-income taxpayers who owe delinquent taxes:

1. The Small Business/Self-Employed Division should incorporate the use of income information to identify high-income taxpayers who can pay their delinquent taxes,

²⁸ National Bureau of Economic Research, Working Paper 28542.

²⁹ TIGTA Report 2021-30-015.

- establish high-income taxpayer delinquent account cases as a higher collection priority, and develop a strategy for working high-income taxpayer delinquent account cases.
2. The Small Business/Self-Employed Division should evaluate the predictive model to determine whether refinements could improve the correlation of the predicted recovery rate and actual recovery rate for the highest income individual taxpayers with a balance due.
 3. The Small Business/Self-Employed Division should Consider adding a field or indicator to inform group managers that the taxpayer reported high income on his or her most recent returns, which would allow managers to consider the taxpayers' potential ability to pay as a factor when assigning cases.
 4. The Small Business/Self-Employed Division should conduct a review to measure Field Collection group managers' compliance with guidelines to assign cases by alpha rank within each priority level.
 5. The Small Business/Self-Employed Division should revise procedures for shelving cases so that high-income taxpayer cases that meet certain criteria are selected for assignment to a private collection agency immediately after being shelved.
 6. The Small Business/Self-Employed Division should revise the criteria for identifying cases for assignment to the private collection agencies. TIGTA suggests that the revised criteria could include a factor for high-income taxpayers who may show a greater potential of having the ability to pay.
 7. The Small Business/Self-Employed Division should consider conducting revenue officer compliance sweeps that focus on high-income taxpayer tax delinquent account cases in locations where high-income taxpayer cases far outweigh the number of revenue officers assigned to those areas.

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Individual Taxation Issues

Learning objectives

Upon reviewing this material, the reader will be able to:

- Understand what practitioners may expect in the future, and what they will expect in 2021;
- Identify areas the Professional Practice may encounter within the next year;
- Understand some of the penalties and how to protect against them in a professional practice.

Note: Forewarned, forearmed; to be prepared is half the victory

Why does Surgent Professional Education occasionally look forward? Accounting and tax professionals have a tendency to look toward the past, and not toward the future. What is on your desk, last year's tax returns, last quarter's financial statement, last month's compliance or write up work?

Upon researching prior editions of Surgent publications, we note the 2013 tangible personal property regulation changes were first discussed in 2007 publications. The 2016 changes to business tax return due dates were first discussed in our manuals in 2012. The TCJA changes in inflation calculations, from the traditional CPI to a Chained CPI, were first discussed in 2014.

What Washington is talking about or thinking about (NOT politically, but fiscally and financially) is worth a short discussion.

What is around the next corner? Preparation is half the victory!

I. Getting caught watching the paint dry – Failing to look ahead

A. Is the “Employee vs. Independent Contractor” conundrum ready to explode?

1. Serve Cold - Federal Issues – findings favoring independent contractor status

In 2013, Uber Technologies, Inc. (the “Employer” or “Uber”), based in San Francisco, California, released a smart-phone application allowing consumers to request personal transportation by car and for drivers to fulfill those requests (the “App”). Since that time, rides through the App have become available in an increasing number of regions throughout the United States and abroad. **Uber has always asserted that the drivers providing those rides are independent contractors.**

Three cases were submitted to the National Labor Relations Board (NLRB) for advice as to whether drivers providing personal transportation services using the Employer's app-based ride-share platform were employees of the Employer or independent contractors.¹

The burden of proving that workers are independent contractors rests with the party asserting independent contractor status. To determine whether workers are employees or independent contractors,

¹ United States Government National Labor Relations Board OFFICE OF THE GENERAL COUNSEL Advice Memorandum April 16, 2019; Cases 13-CA-163062, 14-CA-158833, and 29-CA-177483.

the Board applies the common-law agency test. The inquiry involves application of ten non-exhaustive common-law factors:

- a. The extent of control which, by the agreement, the master may exercise over the details of the work.
- b. Whether or not the one employed is engaged in a distinct occupation or business.
- c. The kind of occupation, with reference to whether, in the locality, the work is usually done under the direction of the employer or by a specialist without supervision.
- d. The skill required in the particular occupation.
- e. Whether the employer or the workman supplies the instrumentalities, tools, and the place of work for the person doing the work.
- f. The length of time for which the person is employed.
- g. The method of payment, whether by the time or by the job.
- h. Whether or not the work is part of the regular business of the employer.
- i. Whether or not the parties believe they are creating the relation of master and servant.
- j. Whether the principal is or is not in business.

The Board's analysis of these factors is "qualitative" rather than "strictly quantitative." There is no "shorthand formula" and "all of the incidents of the relationship must be assessed and weighed with no one factor being decisive." However, "an important animating principle by which to evaluate those factors . . . is whether the position presents the opportunities and risks inherent in entrepreneurialism."

Note:

Where the common-law factors, considered together, demonstrate that the workers in question are afforded significant entrepreneurial opportunity, [the Board] will likely find independent contractor status, as it did in this case.

Three features of the Uber system afforded drivers significant opportunities for economic gain and, ultimately, entrepreneurial independence.

- **First, drivers had virtually unfettered freedom to set their own work schedules**—they chose when to log in to the App to receive trip requests and how long to remain online. Drivers needed only to fulfill one trip request per month, and there was no upper limit. For any reason or no reason, the driver could simply log off.
- **Second, drivers controlled their work locations** by choosing where to log in to the App, within the broad confines of a geographic market, rather than being restricted to assigned routes or neighborhoods. Even though drivers' later locations over the course of an outing depended on riders' destinations, drivers could predict likely destinations from particular origins and choose their log-in locations accordingly.
- **Third, drivers could, and often did, work for competitors.** In fact, drivers could toggle between different ride-sharing apps at will over the course of an outing. Moreover, Uber placed no limits on this freedom such as restrictions on drivers' use of their cars or fees that drivers must pay even if they perform no Uber rides.

Drivers' entrepreneurial independence is also apparent in contractual requirements that they indemnify Uber and hold it harmless for liability based on their own conduct. To similar effect is a provision through which Uber disclaimed responsibility for the conduct of riders. These contractual provisions greatly

lessened Uber's motivation to control drivers' actions, since Uber was not liable for drivers' or riders' negligent or intentionally harmful acts.

Although Uber maintained minimum service standards and customer feedback channels to learn of and respond to any relevant customer service issues, none of these facts indicate significant employer control nor interfere with the drivers' economic opportunities.

Three of the remaining factors support independent-contractor status.

- Drivers provided the "principal instrumentality" of their work, the car, the control of which afforded them significant entrepreneurial opportunity. Drivers were also responsible for chief operating expenses such as gas, cleaning, and maintenance for their cars. Uber provided only the App, commercial liability insurance, and minor assistance such as reimbursement for the costs of cleaning spills and repairing damage caused by riders. Drivers shouldered significant risk of loss, since they invested significant capital and time to use the App, and fare earnings could fluctuate depending on where and when drivers logged in. Given that the drivers provided the cars and incurred most of the expenses associated therewith, the instrumentalities factor strongly favors independent-contractor status.
- With regard to the "supervision" factor, drivers operated without supervision by Uber. They did not report to supervisors and generally interacted with Uber agents only when a problem arose. Uber did not "assign" trips through the App as drivers maintained the right to reject any particular trip. Although, as discussed above, Uber maintained minimum service standards to the extent necessary to address specific customer complaints, which could affect drivers' relationship with Uber and earnings opportunities, those customer-driven standards do not amount to the kind of supervision normally indicative of employee status. Overall, drivers had "near-absolute autonomy in performing their daily work without supervision," supporting independent-contractor status.
- With regard to the parties' self-assessment of their relationship, both parties understood their relationship to be one of independent contractors. Drivers' contracts explicitly characterized the relationship this way. Uber withheld neither taxes nor social security and provided drivers with IRS 1099 forms. Uber provided no benefits, paid leave, or holiday pay. These facts support independent-contractor status.

Although there are several factors that point toward employee status, the strength of the evidence supporting independent-contractor status overwhelms those factors. One factor that supports employee status is that no special skills or experience were required to begin driving for Uber. In addition, although Uber disagrees, we assume *arguendo* that drivers did not work in a distinct occupation or business but worked as part of the Employer's regular business of transporting passengers. But the Board has not deemed this to be a strong or dispositive factor. Indeed, there are a number of decisions in which individuals were held to be independent contractors, even though their services were integral to the business of the company that engaged them, given the extent of entrepreneurial opportunity afforded them. Whereas, in situations of greater company control, this factor has been cited in favor of employee status.

Considering all the common-law factors through “the prism of entrepreneurial opportunity,” NLRB concluded that Uber drivers were independent contractors. Drivers’ virtually complete control of their cars, work schedules, and log-in locations, together with their freedom to work for competitors of Uber, provided them with significant entrepreneurial opportunity.

Practice Note: A New Pathway?

In the Uber case it appears the NLRB has reversed course from rulings with similar facts finding employer-employee status issued as recently as 2016.²

In addition, on April 29, 2019³ the Department of Labor Wage and Hour Division appears to have reversed course from a previous 2015 ruling.

- This case involved a virtual marketplace company (VMC) that operates in the so-called “on-demand” or “sharing” economy. Generally, a VMC is an online and/or smartphone-based referral service that connects service providers to end-market consumers to provide a wide variety of services, such as transportation, delivery, shopping, moving, cleaning, plumbing, painting, and household services.
- Prior to allowing service providers to use a platform, the VMC required them to provide certain basic information, self-certify their experience and qualifications, complete a background check, and complete an identity check through a different vendor.
- The VMC also required service providers to acknowledge and accept a terms of use agreement and a service agreement, which states that the VMC provides only a platform for connecting providers with customers and disclaims any employment relationship. The agreements also classify the service providers as independent contractors.
- Upon consideration of “the circumstances of the whole activity,” WHD does not see any indication that the service providers are economically dependent on the VMC within the meaning of the FLSA.

Practitioners must consider that future rulings may reverse these current findings. See Elements of Engagement Discussion, below.

2. Simmering - State Issues – findings favoring Employee Status

Two individual delivery drivers, suing on their own behalf and on behalf of a class of allegedly similarly situated drivers, filed a complaint against Dynamex Operations West, Inc. (Dynamex), a nationwide package and document delivery company, alleging that Dynamex had misclassified its delivery drivers as independent contractors rather than employees.⁴

In determining whether, under the suffer or permit to work definition, a worker is properly considered the type of independent contractor to whom the wage order does not apply, it is appropriate to look to a standard, commonly referred to as the “**ABC**” test, that is utilized in other jurisdictions in a variety of contexts to distinguish employees from independent contractors. **Under this test, a worker is properly considered an independent contractor to whom a wage order does not apply only if the hiring entity establishes each of the following:**

² United States Government National Labor Relations Board OFFICE OF THE GENERAL COUNSEL Advice Memorandum September 19, 2016; Postmates, Inc. (“Employer”) operates a website and a software application available on smartphones, through which customers can order food from restaurants or other items from stores, and have them delivered within a short period of time by one of the Employer’s couriers. This case involves a charge filed by a courier that worked for the Employer in 2015.

³ Keith E. Sonderling, Acting Administrator, U.S. Department of Labor Wage and Hour Division, FLSA 2019-6; April 29, 2019.

⁴ Dynamex Operations West, Inc. v. Superior Court of Los Angeles; SUPREME COURT OF CALIFORNIA, April 30, 2018.

- a. That the worker is free from the control and direction of the hirer in connection with the performance of the work, both under the contract for the performance of such work and in fact;
- b. That the worker performs work that is outside the usual course of the hiring entity's business; and
- c. That the worker is customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed for the hiring entity.

A recap of some of the pertinent facts of the case include:

- Dynamex is a nationwide same-day courier and delivery service that operates a number of business centers in California. Dynamex offers on-demand, same-day pickup and delivery services to the public generally and also has a number of large business customers — including Office Depot and Home Depot — for whom it delivers purchased goods and picks up returns on a regular basis.
 - Prior to 2004, Dynamex classified its California drivers as employees and compensated them pursuant to this state's wage and hour laws.
 - In 2004, Dynamex converted all of its drivers to independent contractors after management concluded that such a conversion would generate economic savings for the company. Under the current policy, all drivers are treated as independent contractors and are required to provide their own vehicles and pay for all of their transportation expenses, including fuel, tolls, vehicle maintenance, and vehicle liability insurance, as well as all taxes and workers' compensation insurance.
- Dynamex obtains its own customers and sets the rates to be charged to those customers for its delivery services. It also negotiates the amount to be paid to drivers on an individual basis.
- Drivers are generally free to set their own schedule but must notify Dynamex of the days they intend to work for Dynamex.
 - Drivers performing on demand work are required to obtain and pay for a Nextel cellular telephone through which the drivers maintain contact with Dynamex.
 - On-demand drivers are assigned deliveries by Dynamex dispatchers at Dynamex's sole discretion; drivers have no guarantee of the number or type of deliveries they will be offered.
 - Although drivers are not required to make all of the deliveries they are assigned, they must promptly notify Dynamex if they intend to reject an offered delivery so that Dynamex can quickly contact another driver; drivers are liable for any loss Dynamex incurs if they fail to do so.
- In the absence of any special arrangement between Dynamex and a customer, drivers are generally free to choose the sequence in which they will make deliveries and the routes they will take, but are required to complete all assigned deliveries on the day of assignment.
- Drivers hired by Dynamex are permitted to hire other persons to make deliveries assigned by Dynamex.
- Drivers are ordinarily hired for an indefinite period of time but Dynamex retains the authority to terminate its agreement with any driver without cause, on three days' notice.

In applying the ABC test, the Supreme Court of California found Dynamex did not meet its burden to establish that the drivers were independent contractors:

First, with respect to part B of the ABC test, it is quite clear that there is a sufficient commonality of interest with regard to the question whether the work provided by the delivery drivers within the certified class is outside the usual course of the hiring entity's business to permit plaintiffs' claim of misclassification to be resolved on a class basis. In the present case, Dynamex's entire business is that of a delivery service. Unlike other types of businesses in which the delivery of a product may or may not be viewed as within the usual course of the hiring company's business, here the hiring entity is a delivery company and the question whether the work performed by the delivery drivers within the certified class is outside the usual course of its business is clearly amenable to determination on a class basis.

Second, with regard to part C of the ABC test, it is equally clear from the record that there is a sufficient commonality of interest as to whether the drivers in the certified class are customarily engaged in an independently established trade, occupation, or business to permit resolution of that issue on a class basis. ... Here the class of drivers certified by the trial court is limited to drivers who, during the relevant time periods, performed delivery services only for Dynamex. The class excludes drivers who performed delivery services for another delivery service or for the driver's own personal customers; the class also excludes drivers who had employees of their own....For this class of drivers, the pertinent question under part C of the ABC test is amenable to resolution on a class basis.

3. Festering - Localities jumping into the game? Practitioners beware

Unlocking a potential slippery slope, three of the largest cities in Texas (Austin, San Antonio and Dallas⁵) have each recently passed legislation requiring almost all employers to provide paid sick leave to any employee. The provision applies to any employee (including temporary or employment agency) who performed at least 80 hours of work for pay within the city in a year. Even if the employer does not have a location within the city, if their employee(s) works within the city, they must be awarded this benefit.

One hour of earned paid sick leave is inured for every 30 hours the employee worked within the city. Employees working for smaller companies may earn 48 hours of paid sick benefit per year, and those working for larger employers may earn 64 hours per year.

The Texas Supreme Court is expected to hear arguments regarding the constitutionality of local paid sick leave legislation.

⁵ The Austin statute has been enjoined and deemed unconstitutional. However, the Dallas and San Antonio versions are both set to take effect August 1, 2019.

Practice Note:

In the ever-changing world of responsibility, practitioners are the trusted advisor many companies rely upon for compliance. For many smaller or closely held clients, practitioners are the only advisor regarding compliance issues.

Should this trend of localities promoting local ordinances regarding employment issues continue, which seems undoubtable, practitioners must expand their purview and know exactly where each employee of a client works and have the time and ability to research local laws.

B. Employee vs. independent contractor – 2021 Updates

1. California's Assembly Bill No. 5

California Assembly Bill No. 5 was introduced December 3, 2018. After nine months of discussion with minor amendments, the bill was passed September 11, 2019 and signed by Governor Newsom September 18, 2019. Most of its provisions are to take effect January 1, 2020.

Existing California law, as established in the case of *Dynamex* (see above) creates a presumption that a worker who performs services for a hirer is an employee for purposes of claims for wages and benefits. The (*Dynamex*) law requires a 3-part test, commonly known as the “ABC” test, to establish that a worker is an independent contractor for those purposes.

Assembly Bill 5 states the intent of the Legislature to codify the decision in the *Dynamex* case and clarify its application. The bill provides that for purposes of the provisions of the Labor Code, the Unemployment Insurance Code, and the wage orders of the Industrial Welfare Commission, a person providing labor or services for remuneration shall be considered an employee rather than an independent contractor unless the hiring entity demonstrates that the person is free from the control and direction of the hiring entity in connection with the performance of the work, the person performs work that is outside the usual course of the hiring entity's business, and the person is customarily engaged in an independently established trade, occupation or business.

- The bill exempts specified occupations from the application of *Dynamex* and would instead provide that these occupations are governed by *Borello*.⁶
- These exempt occupations include, among others, licensed insurance agents, certain licensed health care professionals, registered securities broker-dealers or investment advisers, direct sales salespersons, real estate licensees, commercial fishermen, workers providing licensed barber or cosmetology services, and others performing work under a contract for professional services, with another business entity, or pursuant to a subcontract in the construction industry. Also, any individual who holds an active license from the State of California and is practicing one of the following recognized professions: lawyer, architect, engineer, private investigator, or accountant.

Assembly Bill 5 also redefines the definition of “employee” for purposes of unemployment insurance provisions, to include an individual providing labor or services for remuneration who has the status of an employee rather than an independent contractor, unless the hiring entity demonstrates that the individual meets all of specified conditions, including that the individual performs work that is outside the usual course of the hiring entity's business.

⁶ *S. G. Borello & Sons, Inc. v. Department of Industrial Relations* (1989) 48 Cal.3d 341, is California case which followed common law tradition, that the principal test of an employment relationship is whether the person to whom service is rendered has the right to control the manner and means of accomplishing the result desired.

- Because this bill increases the categories of individuals eligible to receive benefits from, and thus would result in additional moneys being deposited into, the Unemployment Fund, a continuously appropriated fund, the bill would make an appropriation.
- The bill also states that specified Labor Code provisions of the bill apply retroactively to existing claims and actions to the maximum extent permitted by law while other provisions apply to work performed on or after January 1, 2020.
- The bill additionally provides that its provisions do not permit an employer to reclassify an individual who was an employee on January 1, 2019, to an independent contractor due to the bill's enactment.

Existing provisions of the Labor Code make it a crime for an employer to violate specified provisions of law with regard to an employee. The Unemployment Insurance Code also makes it a crime to violate specified provisions of law with regard to benefits and payments. By expanding the definition of an employee for purposes of these provisions, the bill expands the definition of a crime, thereby imposing a state-mandated local program.

Practice Note: Practitioners working with Independent Contractors

California has been referred to as the birthplace of app-based business. Assembly Bill No. 5 is expected to directly hit Uber and Lyft. During the progression of this bill, Uber and Lyft proposed a special category for their drivers, tucked between employer and independent contractor status. That carve out proposal was not favorable to unions and legislators, each worried about future side effects.

After passage of Assembly Bill No. 5, Uber's chief legal officer indicated that Uber would not treat its drivers as employees, indicating their business model was not a riding service but **"serving as a technology platform for several different types of digital marketplaces."**

If that quote sounds familiar, it is almost identical to the April 29, 2019 phraseology used by Keith E. Sonderling, Acting Administrator, U.S. Department of Labor Wage and Hour Division, regarding a virtual marketplace company (VMC) that operates in the so-called "on-demand" or "sharing" economy – see above.

Element of Discussion:

How many states legislatures will follow this lead? Secondly, how long will it take?

California has been a leader in progressive policies. One can imagine many states legislators desire to ensure exploited workers have the basic workplace rights of employee status. Rights and protections to provide a level of economic security, including a minimum wage, workers' compensation if they are injured on the job, unemployment insurance, paid sick leave, and paid family leave.

For practitioners, we must continue to be the trusted professional, and stay ahead of this quickly changing area.

As one can imagine, some groups were quick to challenge Assembly Bill 5 once it was signed into law.

In November 2019, the California Trucking Association, representing over 70,000 truck drivers in California, filed suit in the U.S. District Court for the Southern District of California, challenging both the *Dynamex* ruling and Assembly Bill 5. The California Trucking Association argued that the U.S. Constitution commerce clause and supremacy clause take precedence over Assembly Bill 5. They also argued that the Federal Aviation Administration Authorization Act of 1994 preempts Assembly Bill 5.

Many truck drivers chose to be treated as independent contractors for perks such as choosing their own work hours or driving their personal trucks (owner-operators). Assembly Bill 5 would force these individuals to be treated as employees.

On December 31, 2019, U.S. District Court Judge Hon. Roger Benitez issued a temporary restraining order to keep officials from enforcing Assembly Bill 5 against truck drivers and motor carriers. Subsequently on January 16, 2020, Judge Benitez granted a preliminary injunction, preventing the enforcement of Assembly Bill 5 against California truck drivers on the basis that the Federal Aviation Administration Authorization Act of 1994 preempts Assembly Bill 5.⁷ The International Brotherhood of Teamsters and Attorney General Xavier Becerra intend to appeal Judge Benitez's ruling in the United States Court of Appeals for the Ninth Circuit in 2020. Stay tuned for the potential of this case to reach the United States Supreme Court.

Following the lead of the California Trucking Association, the American Society of Journalists and Authors (ASJA) and the National Press Photographers Association (NPPA) filed suit in the United States District Court for the Central District of California, Western Division on December 17, 2019. These organizations specifically challenge the provision of Assembly Bill 5 that prevents an individual from submitting more than 35 pieces to a publication per year unless it employs him or her. They claim that Assembly Bill 5 is unconstitutional as it restricts free speech of writers and photographers, without placing the same restrictions on similar professionals such as graphic designers, marketers, fine artists, and grant writers. ASJA and NPPA argue that Assembly Bill 5 specifically violates the First and Fourteenth Amendments to the U.S. Constitution. Look for further updates in 2021 as this case develops.⁸

It should not come as a surprise that Uber and Postmates filed suit along with two of their drivers in United States District Court for the Central District of California, Western Division on December 30, 2019. The plaintiffs argue that Assembly Bill 5 “violates the Equal Protection and Due Process Clauses of the Fourteenth Amendment to the United States Constitution, the Ninth Amendment to the United States Constitution, and the Contracts Clause of Article I of the United States Constitution, as well as the Equal Protection Clause, Inalienable Rights Clause, Due Process Clause, Baby Ninth Amendment, and Contracts Clause of the California Constitution.” They further argue that Assembly Bill 5 unfairly targets “gig-economy” or freelance workers, as the bill specifically excludes some professions, such as doctors, psychologists, dentists, accountants, lawyers, stock brokers, etc. Uber and Postmates (along with DoorDash, not involved in the aforementioned lawsuit) pledged \$90 million in campaign contributions for a November 2020 ballot measure to overturn Assembly Bill 5. All eyes will certainly be on these companies as 2020 progresses.

On August 10, 2020, a California state judge ordered both Uber and Lyft to reclassify their California drivers from independent contractors to employees with benefits. Both companies were accused of violating California Assembly Bill 5, which provides that an individual shall be considered an employee rather than an independent contractor unless the hiring entity demonstrates that the person is free from the control and direction of the hiring entity in connection with the performance of the work, the person performs work that is outside the usual course of the hiring entity's business, and the person is customarily engaged in an independently established trade, occupation or business. Uber and Lyft, along with DoorDash, Postmates, and Instacart, spent more than \$200 million combined to campaign for the

⁷ *California Trucking Association et al v. Attorney General Xavier Becerra, et al, and the International Brotherhood of Teamsters, Case Number 3:18-cv-02458-BEN-BLM.*

⁸ *American Society of Journalists and Authors Inc. et al v. Becerra.*

passage of Proposition 22, a ballot measure to overturn CA Assembly Bill 5. On November 3, 2020, 58.6% of California voters approved the measure to classify app-based drivers as contractors.

Unsurprisingly, there have already been lawsuits filed in relation to the passage of Proposition 22. On January 12, 2021, the Service Employees International Union (SEIU), along with four workers, sued the CA Supreme Court, arguing that Proposition 22 should be declared unconstitutional, invalid, and unenforceable. The petitioners argued that although Proposition 22 was titled the “Protect App-Based Drivers and Services Act,” it does not live up to its namesake, as it actually withdrew several minimum employment protections from thousands of California workers. Moreover, the petitioners state that Section 4 of Article XIV of the California Constitution provides the Legislature with the power to establish and enforce a complete system of workers’ compensation. They argue that Proposition 22 conflicts with Article XIV, section 4, by removing certain workers from California’s workers’ compensation system and limiting the legislature’s authority to extend workers’ compensation benefits to this group in the future. Additionally, the plaintiffs assert that Proposition 22 deceived voters who were not informed that they were voting to prevent the Legislature from granting certain workers collective bargaining rights. On February 3, 2021, the CA Supreme Court rejected the case for direct review. The plaintiffs subsequently filed the lawsuit in the Alameda County Superior Court on February 11, 2021. Surgent will continue to provide updates as this case progresses.

2. U.S. Department of Labor Proposed Rule

On September 22, 2020, the Department of Labor (DOL) issued a proposed rule to clarify the definition of employee under the Fair Labor Standards Act (FLSA) as it relates to independent contractors.⁹ On January 7, 2021, the DOL announced a final rule, largely substantiating the September 2020 proposed rule with additional clarifications. The final rule outlined an “economic reality” test, centered around the idea of whether the worker is economically dependent on the potential employer for work in order to determine worker classification. For example, an individual may be considered to be economically dependent if they rely on others to provide work opportunities, whereas an individual would be less likely to be considered economically dependent if he or she was able to create work opportunities for himself or herself. If the final rule was adopted, the economic reality test factors would have been used to determine whether the individual was economically dependent on a potential employer, and therefore classified as an employee, or whether the individual was in business for himself or herself, and therefore classified as an independent contractor. The economic reality test outlined the following two “core” factors to determine worker status:

1. **The nature and degree of the worker’s control over the work:** If an individual has the ability to exercise substantial control over key aspects of the performance of work, as opposed to the potential employer, the individual is more likely to be considered an independent contractor than an employee.
 - a. Activities that demonstrate an individual’s substantial control over key aspects of the performance of work include setting one’s own work schedule, working with little to no supervision, choosing work assignments, and being able to work for others, including the potential employer’s competition.
 - b. Activities that demonstrate a potential employer’s substantial control over key aspects of the performance of work include requiring an exclusive working relationship with the individual, setting the individual’s work schedule, requiring the individual to work with significant supervision or oversight, and assigning work to the individual.

⁹ DOL Proposed Rule (85 FR 60600).

2. **The worker's opportunity for profit or loss:** This factor analyzes whether the individual has the ability to earn profits or incur losses based on his or her personal initiative, managerial skill, or business acumen.

There are three other factors that make up the “economic reality” test, but these factors are given less weight in the analysis of determining worker status:

1. **Degree of Skill Required:** This factor considers the degree of skill required to perform the work. An individual would be more likely to be considered an independent contractor if the work performed required specialized skills or training that was not provided by the employer.
2. **Permanence of the Working Relationship:** This factor considers the permanence and duration of the working relationship between the individual and potential employer. An individual is more likely to be classified as an independent contractor if his or her working relationship with the potential employer is definitive in nature or sporadic. On the other hand, an individual is more likely to be classified as an employee if his or her working relationship with the employer is continuous and indefinite. It is important to note that seasonal work does not preclude an individual from being classified as an employee if the individual has completed the same type of work throughout multiple seasons and the individual's position is permanent throughout the duration of such season.
3. **Integrated Unit:** This factor considers the extent to which services rendered by an individual are an “integral part” of the potential employer's business and production. An individual is more likely to be considered an independent contractor if the performance of services is not integrated into the potential employer's production process. An individual is more likely to be considered an employee if the work that he or she performs is an integral part of the potential employer's business.

The DOL emphasizes that the worker's actual day-to-day practice is more relevant in the determination of worker status than what may be theoretically possible. Upon analyzing the worker's status using the “economic reality” test, if the two “core” factors arrived at the same conclusion as to the worker's classification, the combined weight of these factors would outweigh the other three factors of less importance. If the two “core” factors did not arrive at the same worker classification conclusion, the remaining three factors could help determine the correct worker classification. The remaining three factors would always be evaluated in the context of the two core factors.

On March 11, 2021, the DOL Wage and Hour Division (WHD) announced a proposal to rescind the January 7, 2021 final rule outlining the economic reality test, stating that the final rules would minimize other factors traditionally considered by courts. The DOL stated that this would make it less likely that the worker would be classified as an employee under the FLSA, resulting in more workers being classified as independent contractors.

The DOL also announced a proposal to withdraw the “joint employer” final rule that became effective in March 2020 but was largely vacated by a federal district court in September 2020. The joint employer final rule provided guidance for determining joint employer status when an employee performs work for his or her employer that simultaneously benefits another individual or entity. Under this final rule, a joint employer would be jointly and severally liable with the employer for the employee's wages. The final rule established a four-factor test is used to determine whether the potential joint employer is directly or indirectly controlling the employee by assessing whether the potential joint employer can:

- Hire or fire the employee;
- Determine the employee's rate and payment method;
- Supervise or control the employee's work schedule or conditions of employment; and
- Maintain the employee's employment records.

The Southern District of New York found that the DOL joint employer final rule violated the Administrative Procedures Act and subsequently vacated most of the rule.

II. Donor-Advised Funds

A. Overview

In the realm of tax planning for high-net worth taxpayers and families ("HNW"), clients are asking more questions or pursuing investment tools known as donor-advised funds ("DAF") as a means of receiving tax benefits for charitable giving without the current burden of designating gifts and executing funding to various organizations. In a general sense, a DAF is a charitable giving investment vehicle used to manage charitable funds for families, individuals, and organizations. The investment vehicle is administered and operated by §501(c)(3) public charities known as sponsoring organizations.

Taxpayers can participate with a DAF by opening an account with the sponsoring organization by making contributions to the account in the form of cash or other financial instruments. Once the funds are contributed to the account, the contributions are owned and controlled by the sponsoring organization; however, the taxpayer retains advisory privileges over the account with respect to how the funds are invested and both how and when distributions to charities are made.

Contributions to the DAF are irrevocable, and as a result, the contributions to the DAF are usually qualified charitable deductions for tax purposes, though the final destination of the funds is undetermined. In a practical sense, DAFs represent a convenient and flexible means to make contributions to charities without the need to give directly to organizations or creating a private foundation. As a practical consideration, private foundations are more costly and administratively burdensome making them a less attractive means in executing planned charitable giving.

B. DAFs, Private Foundations and Supporting Organizations

The first DAF is noted to have been created in 1931 by the New York Community Trust, though the DAF term was not codified until the Pension Protection Act of 2006.¹⁰ As codified in §4966(d)(2), a DAF is a fund or account, owned and controlled by a sponsoring organization ("SO"), that is separately identified by reference to contributions of a donor or donors who retain advisory rights over the account with respect to the distribution of or investment of amounts held in such fund or account by reason of the donor's status as a donor.

As noted above, the funds of a DAF are owned and controlled by an SO, and for purposes of a DAF, SOs are defined as any organization described in §170(c), is not a private foundation under §509(a), and maintains 1 or more DAFs.¹¹ Section 170 distinguishes types of donors between individuals and corporations, donees between public charities and private foundations, property contributed, the

¹⁰ See Victoria B. Bjorklund, "The Emergence of the Donor-Advised Fund," 3 Paul Streckfus' EO Tax J. 15 (May 1998) and Victoria B. Bjorklund, "Choosing Among the Private Foundation, Supporting Organization and Donor Advised Fund," (May 2003), p. 27.

¹¹ §4966(d)(1)

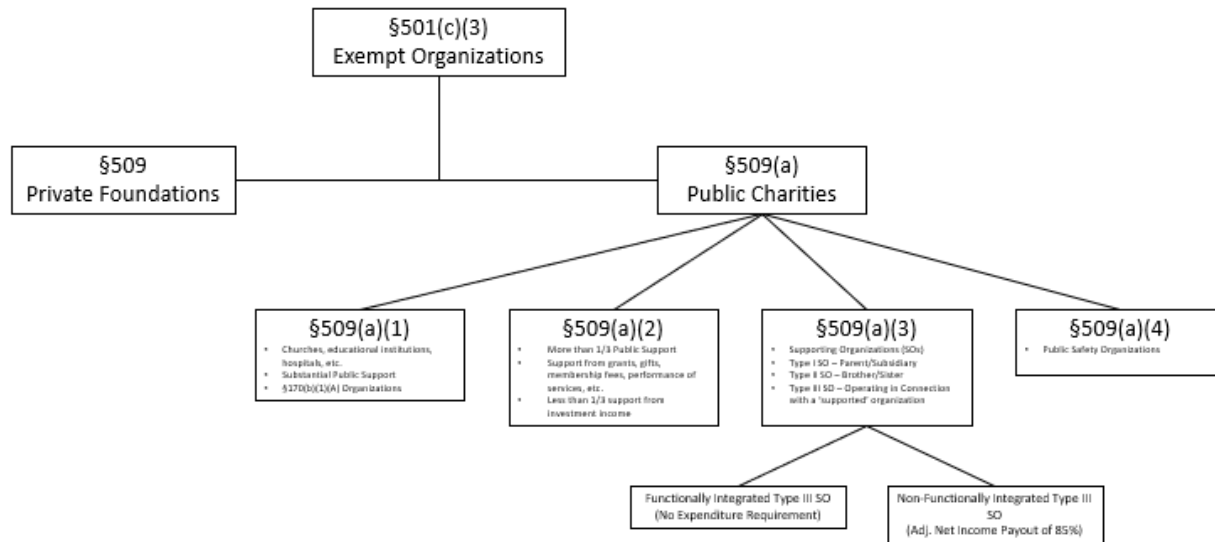
applicable limitations regarding charitable contribution deductions, and the carryover of the excess contributions related to excess charitable contribution deductions.

In general, §501(c)(3) provides tax-exempt charity status to both public charities and private foundations, including SOs. Though SOs can sometimes look like private foundations, they are separate and distinct from private foundations in that they are specifically treated as public charities for tax purposes under §509 with applicability of all relevant regulations as well as the tax benefits available to donors. With that, organizations funded by only a few donors exercising control usually are private foundations. Organizations funded by many donors with limited advisory privileges and no control tend to be considered supporting organizations.

The distinction between public charities and the private foundations relates primarily to the oversight of the organization and the extent to which public support provides for the operation of the entity. Some key distinctions are highlighted below.

<u>Features</u>	<u>Public Charity</u>	<u>Private Foundation</u>
Mandatory Distribution Requirements	Generally, No	Yes
Limitations on Contribution Deductions	Generally 60% through 2027	30% Limitation
Excise Tax	No for qualifying distributions	Yes
Restrictions on investments and distributions	No	Yes
Donor control of Investments and Distribution	No	Yes

SOs in a general sense qualify as public charities under §501(c)(3) because of the relationship the organization shares with other charities that carry out more traditional tax-exempt activities. SOs keep their tax-exempt status by passing tests based on organization, operation, control, and relationship tests. Section 509 provides definitions of different types of SOs, and the underlying requirements for each type of charitable organization, and the structure of charitable organizations can generally be thought of as is illustrated graphically below.



1. Regulation of Donor-Advised Funds and Supporting Organizations

As noted above, prior to 2006, there was no formal definition of a DAF, and because of this, abusive practices arose in the industry. A mainstay example can be found in the *New Dynamics Foundation v. U.S.* case of 2006.

New Dynamics Foundation (NDF) was a California, public benefit, nonprofit entity granted state tax exemption in California. The entity, when formed, planned to work with tax and other financial professionals to establish individual accounts where the funds could be directed for charitable purposes. This was consistent with the NDF's articles of incorporation that indicated its purpose was to promote and contribute to public good causes as defined §170(c). The issues arose both in marketing materials as well as in the oversight and administration of the funds. Several promotional materials of NDF sought investment by marketing "tax-free" growth of funds within a public charity.

As funds were contributed to NDF and operational manuals were reviewed by contributors, several nuances demonstrated inconsistencies with the entity's purpose of public benefit with how the funds were actually administered. Operational manuals outlined that directors of the funds could be contributors themselves (resulting in conflicts of interests) and that administrative expenses could include personal expenses of the contributors and fund directors. Further, the NDF founder indicated on several occasions to donors that the administrative/personal expenses could account for 95% of the money contributed to the funds, indicating the identified purpose of the organization and the actual administration were inconsistent.

NDF filed an application with the IRS for federal, tax-exempt status under §501(c)(3). Section 501(c)(3) requires entities to be organized and operated for religious, education, or charitable purposes exclusively, and no part of the earnings can be directed for private individual or shareholder benefit. Entities unable to meet the requirements will not be granted tax exemption. In the case of NDF, the IRS found insufficient cause for tax-exempt status and denied the application.

Subsequently, NDF filed suit to have the IRS's determination overturned on the grounds of it being a DAF as upheld in the *National Foundation, Inc.* case of 1987. The court agreed with the IRS citing an intent

from formation to accrue inappropriate tax benefits by reducing and eliminating estate taxes, avoiding taxes on capital gains, and using the funds as a tax-free vehicle for accruing retirement benefits. Furthermore, while some of the contributed funds were eventually used to fund legitimate and recognized tax-exempt organizations, these donations represented fewer than 5% of contributions. In the National Foundation, Inc. case, it was demonstrated that great efforts were taken to ensure expenditures of the fund were legitimate and not personal in nature. Similar facts were not present in the NDF case.

These abusive practices were curtailed with the Pension Protection Act of 2006 (PPA) codifying DAFs. The goal was to take steps in regulating the supporting organizations owning and controlling the accounts. This came about by amending §509 of the code, which as noted, above, provides the framework for tax-exempt entities along with the general responsibilities applicable to maintain tax-exempt status. The PPA defined SOs along with the distinction of applicable regulations for Type I, II, and III SOs; provided guidance on functionally and non-functionally integrated SOs; and imposed excess business holdings excise taxes on non-functionally integrated Type III SOs along with certain Type II SOs. To the extent practitioners are advising supporting organizations, the regulations are complex and require specialized experience to appropriately navigate compliance.

C. Tax planning and DAFs

As a review, contributions to a DAF are generally treated the same as donations to any other public charity as defined under §501(c)(3) and are generally subject to the general charitable contributions limitations as outlined §170. Strategies around charitable giving are most often highly subjective to the goals of the taxpayer, but general strategies exist during the donate, growth, and support phases of a DAF.

1. **Donate** -- As many practitioners know, taxpayers become much more interested in total taxes and taxes expected to be due at the end of a tax year and often seek to implement tax reduction strategies when it is somewhat after-the-fact. The general advice to generate more deductions, usually through charitable contributions, is the same for nearly every filer with taxable income. However, to the extent a taxpayer appreciates a more proactive approach, a DAF is a good way to automate charitable donations without having to make specific charitable giving decisions throughout the year. This can be done by setting up automatic drafts to the DAF. With contributions made throughout the year rather than just at year-end, there is greater potential for compounding and growth on the contributed funds, which provides greater funding opportunities for charitable causes.

DAFs also provide charitably minded taxpayers the opportunity to pre-fund charitable giving to be executed in retirement years and or to pre-fund charitable giving in tax years of higher income. To the extent a taxpayer is aware of higher income years, this becomes a greater planning opportunity, and educating our clients on economic events triggering higher income years can be an effective strategy in planning. Taxpayers that may be selling a business, selling appreciated real estate, or exercising stock options are great candidates for considering DAFs.

2. **Grow** -- As a contributor to a DAF, the donor usually has input into how the funds are invested and can make recommendations for capital preservation. The funds in the DAF grow tax-free according to the investment strategy implemented by a specific DAF. The strategies can range from money market, growth, emerging markets, fixed-income, etc.

Because there are investment opportunities with DAFs, it can sometimes be used to rebalance a portfolio of assets while also securing charitable contribution deductions. In the rebalancing process, a donor can select the most appreciated assets in a portfolio, contribute them to DAF for a deduction of the fair value of the assets (subject to limitations), and avoid the capital gain that would have been generated if the asset had been sold. This allows the donor to realign their portfolio with the overall strategy, gain access to charitable contribution deductions, and fund future charities with tax-free growth.

Additionally, taxpayers trying to avoid §1091 wash sale transaction rules may consider using charitable deductions to dispose of securities and subsequently purchasing the stock for a different basis in a loss-harvesting strategy for capital gains.

With the investment component of DAFs, there is great potential for tax efficiency, but there is also potential for loss on investments resulting in a reduction in ability to fund future charitable grants. This reminds advisors and taxpayers alike to remember the market exposure on DAF accounts and to plan accordingly for down markets.

3. **Support Charitable Operations and Grants** -- As individuals are so inclined, they can make recommendations regarding when and how those funds are paid out. Because of this, DAFs are a great opportunity to provide charitable support to organizations when needed most in economic downturns without pressuring the cash-flow of individual taxpayers also subject to the same economic environment. In a sense, the charitable support is prepaid and available when a cause close to a taxpayer is in need.

Donors should remember that the contributions are irrevocable, and the funds are ultimately controlled and liquidated as the discretion of the board overseeing the supporting organization and/or the underlying DAFs, though most supporting organizations and DAF boards executing giving as directed if permissible under IRS regulations. This leaves all due diligence and reporting responsibilities to the supporting organization and simplifying the reporting requirements of individual donors. Taxpayers utilizing DAFs will receive consolidated contribution support for contribution deductions from the DAF directly rather than need to obtain and retain documentation charitable activities for each organization supported. With annual fees sometimes less than 1% and some individual donor entry points as low as \$5,000, DAFs have become and continue to be tools growing in popularity for all levels of income and assets.

1. Tax efficiency example

A donor has long-term appreciated stock in Publicly Traded, Inc. with a basis of \$125,000 and market price of \$200,000. The donor is interested in making a charitable donation to DAF, Inc., his donor-advised fund, with a value of \$200,000. He approaches his tax advisor to understand what the best way is to maximize the deduction, and the tax advisor demonstrates the following scenario.

	<u>Sell Stock / Donate Cash</u>	<u>Donate Stock</u>
(A) FMV	\$200,000	\$200,000
(B) BASIS	\$125,000	\$125,000
(C) Capital Gain	\$75,000 (A - B)	\$0
(D) Applicable Capital Gain Rate	20%	0%
(E) Capital Gain Tax	\$15,000	\$0
(F) Charitable Deduction	\$200,000	\$200,000
(G) Marginal Tax Rate	37%	37%
(H) Tax Saved with Charitable Contribution	\$74,000 (F * G)	\$74,000 (F * G)
(I) Total Cost to Donor	\$141,000 (E + F - H)	\$126,000 (E + F - H)
<i>This example assumes marginal tax rate of 37% and no applicable limitation of contribution deductions of capital gain property.</i>		

As illustrated above, there can be a notable advantage to donating stock rather than selling stock and donating the cash. Because some charitable organizations are not set up to receive stock, a DAF can be great to donate stock, liquidate the stock within the DAF tax-free, and subsequently donate the funds to the desired charitable organization.

D. What legislators are considering

On June 9, 2021, the Accelerating Charitable Efforts Act (“ACE Act”) was introduced to the 117th Congress and proposes several changes to DAFs and PFs. As previously mentioned, one of the primary differences between private foundations and DAFs is the requirement for minimum distributions to operating charitable organizations from private foundations. There is no such requirement for DAFs. This bill attempts to shorten the gap between when donors to DAFs receive charitable deductions and when the funds are provisioned to operating charities. Specifically, the legislation would create two types of DAFs: a 15-year DAF and a 50-year DAF.

- **15-year DAFs:** For the 15-year DAF, donors would receive immediate charitable deductions if all the contributed funds are distributed within 15 years of donation. The 15-year DAF would also limit the current charitable deduction related to complex assets to the amount of cash made available to DAF after sale of the asset rather than based on FMV upon donation (a potential problem if the contributed asset depreciates significantly after contribution but before being converted to cash inside the DAF).
- **50-year DAFs:** For the 50-year DAF, there would be no deduction until the DAF distributed the contributed funds, but the contribution would still benefit by avoiding capital gain and estate taxes. All funds would be required to be distributed within 50 years accordingly.

The ACE Act would make FIFO accounting mandatory for all assets managed by the DAF. Additionally, for private foundations paying out at least 7% of net FMV of assets (excluding assets for operation), the annual excise tax would be waived. While it appears DAFs will remain in place for future tax years, the specifics regarding the ongoing management of the assets may change amidst legislative considerations.

III. Loss Limitations – A Mechanical Review

A. Individual and Passthrough Entities

There are four limitations that apply before individuals and passthrough entities can claim deductions and losses passed through from a partnership or S corporation. These limitations must be applied in a specific order as outlined below:

- Limitation 1: *Basis Limitation*
- Limitation 2: *At-Risk Limitations*
- Limitation 3: *Passive Loss Limitations*
- Limitation 4: *Excess Business Loss Limitations*

In general, the legislative goal of passthrough entities is to provide tax-free distributions before allowing taxpayers to claim losses on tax returns. This preference will be seen in the various ordering rules for basis adjustments. Considering the losses generated during the pandemic, it is important to have an increased familiarity with these issues, as they will impact the next couple of filing seasons along with any related tax planning that may be executed. This review will focus on the mechanics of each limitation, providing the tax professional with an understanding of the impact of loss limitations on taxpayers. This will allow for more effective planning as it relates to loss utilization in future periods.

1. Limitation 1: Basis Limitation

The first limitation to apply to losses passed through partnerships and S corporations is the basis limitation. Partnership basis limitations are required under §704(d). S Corporation basis limitations are required under §1366(d)(1). There is no specific form to support these calculations and the related basis limitations, or lack thereof, in a passthrough entity interest. Though there is no specific form, there are various examples of calculations provided throughout several IRS publications. Generally, the calculation for basis in a partnership interest or S corporation stock is the same, but there are some specific differences and nuances. The primary differences relate to the treatment of debt as it relates to a partnership interest and S corporation stock.

2. Partnership mechanics

The starting point for calculating basis in a partnership interest is the ending basis from the prior year. For the initial year of a partnership interest, there is no ending basis from prior year, so the beginning basis is equal to zero. Partnership basis is always adjusted first for certain increases to basis, then for distributions, then applicable basis decreases. The basis for determining any applicable loss/deduction limitations is summarized below:

Beginning Basis
(+) Current Year Income from Schedule K-1
(+) Contributions
(+) Increase in share of partnership liabilities
(-) Distributions
= Basis for decrease limitations

For purposes of the basis limitation, partnership liabilities will include all types of liabilities allocated to the partner/member (i.e., nonrecourse, qualified nonrecourse financing, and recourse debt). Basis decreases include current year losses, deductions, and nondeductible expenses. If current year basis decreases

plus prior year suspended basis decreases exceed the basis for loss limitation considerations, the excess is disallowed and carried forward indefinitely. Limitations apply to all categories of basis decreases on a pro rata basis based on the total of current year and prior year disallowed amounts by category (Reg. §1.704-1(d)). Disallowed losses preserve basis from falling below zero as required under §704(a)(2). When basis is restored, basis decrease items will then be allowed (absent any other limitations). To the extent distributions create negative basis for basis decrease limitations, the extent to which the basis limitation becomes negative results in distributions being treated at a minimum of partially taxable (i.e., distributions in excess of basis).

Guaranteed Payments and health insurance are not included in basis computations as they are payments made to partners based on their services to the partnership, without reference to current year operating results. With new partnership reporting requirements, basis is tracked on Schedule K-1 and can be determined by adding together the tax capital and allocable share of partnership liabilities at the end of the tax year.

Example 1 – Partnership Mechanics: Heather Anderson is a 70% partner in XYZ partnership, a new partnership. Her year 1 capital contributions consisted of cash in the amount of \$20,000. The year 1 Schedule K-1 indicates the following activity. As this is a new activity, there are no carryover amounts related to prior year disallowed amounts. There were no distributions from the partnership in year 1.

Category	Year 1 Activity
Ordinary Income (Loss)	\$ (35,000)
Charitable Contributions	\$ 2,000
Nondeductible Expenses	\$ 3,000

Additionally, the Schedule K-1 indicates no beginning of year liabilities but includes nonrecourse liabilities allocable to Heather in the amount of \$5,000. The year 1 basis decrease limitations will be determined as follows:

Adjusted Basis, BOY	\$ -
Current year income items	\$ -
Current capital contributions	\$ 20,000
Current year increase in liabilities	\$ 5,000
Distributions	\$ -
Adjusted basis used for basis limitation	\$ 25,000

Losses/Deductions/Expenses	Current Year	Prior Year	Total	Pro Rata %	CY Allowed Amounts	Carryover Amounts
Ordinary Loss	\$ 35,000	\$ -	\$ 35,000	87.50%	\$ 21,875	\$ 13,125
Charitable Contributions	\$ 2,000	\$ -	\$ 2,000	5.00%	\$ 1,250	\$ 750
Nondeductible Expenses	\$ 3,000	\$ -	\$ 3,000	7.50%	\$ 1,875	\$ 1,125
Total	\$ 40,000	\$ -	\$ 40,000	100.00%	\$ 25,000	\$ 15,000

Note the current year allowed amounts totaling \$25,000 equals the current year adjusted basis for basis limitation purposes. The carryover amounts total of \$15,000 equals the current year basis decrease items totaling \$40,000 less the adjusted basis used for the basis limitation of \$25,000. This can be a useful check figure to make sure everything is being considered and calculated correctly.

Example 2 – Partnership Mechanics: John Smith is a 50% partner in ABC partnership. His ending basis in his partnership interest in year 5 is \$5,000. The year 6 Schedule K-1 indicates the activity indicated below. The taxpayer also has a schedule of year 5 carryover/disallowed amounts, indicated below.

Category	Year 6 Activity	Year 5 Carryovers
Ordinary Income (Loss)	\$ (11,000)	\$ (3,000)
Rental Real Estate Income (Loss)	\$ (2,000)	\$ (2,000)
Charitable Contributions	\$ 1,000	
Nondeductible Expenses	\$ 1,000	
Distributions	\$ 3,000	

Additionally, the Schedule K-1 indicates beginning Year 6 nonrecourse liabilities allocable to John of \$6,000 and end of Year 6 liabilities allocable to John of \$7,000. The year 6 basis decrease limitations will be determined as follows:

Adjusted Basis, BOY	\$ 5,000
Current year income items	\$ -
Current capital contributions	\$ -
Current year increases in liabilities	\$ 1,000
Distributions	\$ (3,000)
Adjusted basis used for basis limitation	\$ 3,000

Losses/Deductions/Expenses	Current Year	Prior Year	Total	Pro Rata %	CY Allowed Amounts	Carryover Amounts
Ordinary Loss	\$ 11,000	\$ 3,000	\$ 14,000	70%	\$ 2,100	\$ 11,900
Rental Real Estate Loss	\$ 2,000	\$ 2,000	\$ 4,000	20%	\$ 600	\$ 3,400
Charitable Contributions	\$ 1,000	\$ 0	\$ 1,000	5%	\$ 150	\$ 850
Nondeductible Expenses	\$ 1,000	\$ 0	\$ 1,000	5%	\$ 150	\$ 850
Total	\$ 15,000	\$ 5,000	\$ 20,000	100%	\$ 3,000	\$ 17,000

Note the current year allowed amounts totaling \$3,000 equals the current year adjusted basis for basis limitation purposes. The carryover amounts totaling \$17,000 equal the prior year disallowed amounts of \$5,000 plus the current year basis decrease items totaling \$15,000 less the adjusted basis used for the basis limitation of \$3,000 (\$15k + \$5k - \$3k = \$17k). This can be a useful check figure to make sure everything is being considered and calculated correctly.

3. S Corporation mechanics

The overall methodology for S corporations is very similar to that found in partnership basis limitations. Unlike partnerships, the basis in S corporation stock cannot be determined by reference to Schedule K-1. Like partnerships, basis cannot be less than zero. Partnerships only pay distributions, but S Corporations can pay distributions similar to partnerships or make payments out of Accumulated Earnings and Profits taxed as Dividends. Payments out of E&P do not affect the shareholder basis; however, payments out of the S corporation capital are treated as tax-free to the extent of basis and are included in the basis formula. Partnership basis includes the allocable share of partnership liabilities in determining a partner's basis, but an S Corporation shareholder only has debt basis to the extent a shareholder loaned money to the corporation in addition to their stock basis. Note that an S corporation shareholder guaranteeing the loan of a corporate debt does not provide debt basis to a shareholder; the shareholder must have contributed capital in exchange for future repayment. Basis reductions are first applied to stock basis and then applied against debt basis. Basis restorations are applied against debt basis to the extent of the loan made and secondly applied to stock basis.

The General Ordering Rules for Items Affecting Stock Basis on or after 8/18/1998 (Reg. §1.1367-1(f)) are as follows:

- Step 1: Income items increasing basis (including tax-exempt income)
- Step 2: Distributions
- Step 3: Decreases attributable to nondeductible expense
- Step 4: Decrease attributable to losses/deductions

Special Considerations

It is important to note that excess nondeductible expenses do not carryforward unless a special election is made regarding ordering rules. This contrasts with partnerships. Excess losses/deductions carry forward like partnerships and are applied on a pro rata basis (§1366(d)(2); Reg §1.1366-2(a)(5)). Effectively, loss/deduction items reduce basis before nondeductible items. There is no change in treatment of excess losses. With this election, excess nondeductible items are carried forward and affect tax basis in future periods as basis is restored. This special election is made by attaching a statement to the shareholder's timely filed original or amended return stating the taxpayer agrees to the carryover rules. Once made, the election must be applied consistently for all future periods unless the taxpayer receives permission to begin applying the general ordering rules. This election may be helpful in preserving basis to deduct losses currently. However, this could lower basis to a point where future non-dividend distributions become taxable. Depending on the facts and circumstances, this election may be a better answer for a client, but careful consideration and analysis should be done in advising taxpayers.

Debt Basis Basics

S Corporation shareholders only have debt basis to the extent of capital provided to the corporation in agreement and expectation of future repayment. An S corporation shareholder guarantee of corporate loan does not provide the shareholder with debt basis (Reg. §1.1366-2(a)(2)(ii)). If a shareholder makes an actual payment on a corporate loan that was guaranteed by the shareholder, the shareholder can increase their debt basis (actual economic outlay test; TC Memo 2016-232). Debt basis is ignored in determining the taxability of distributions; distributions are taxable to the extent they exceed stock basis (§1368(b)(1)). Losses and deductions exceeding stock basis and claimed against debt basis reduce the debt basis of the shareholder. Basis reductions are first applied to stock basis and then applied against debt basis. Basis restorations are applied against debt basis to the extent of the loan made and secondly applied to stock basis.

The debt basis formula for S corporations is as follows:

- Step 1: Debt Basis at the beginning of the tax year
- Step 2: Income used to restore debt basis (+)
- Step 3: Additional loans made to S corporation during tax year (+)
- Step 4: Loan repayments to shareholder (-)
- Step 5: Debt basis used for basis limitation
- Step 6: Losses allowed by debt basis (not to exceed Step 5)
- Step 7: Debt basis at the end of the tax year

If debt basis is used to deduct losses, net increases for any subsequent taxable year will apply first to restore any reductions in debt basis before any of it is used to increase the shareholders' basis in the S corporation stock (§1367(b)(2)(B)).

Example 1 – S Corporation Basis Limitation Mechanics: Patrick Miller is a 35% owner in S Corporation A. At the end of tax year 8, his basis in his S corporation stock was \$4,000, and the amount of his outstanding loans to the S corporation was \$2,000. Patrick's Schedule K-1 from the S corporation indicated the activity below. There were no loan repayments made by the S corporation during the tax year, and no distributions were paid.

Category	Year 8 Activity
Ordinary Income (Loss)	\$ (12,000)
Interest Income	\$ 2,000
Charitable Contributions	\$ 3,000
Nondeductible Expenses	\$ 2,000

The current year basis and loss limitations would be determined as follows:

Stock Basis		Debt Basis	
Adjusted Basis, BOY	\$ 4,000	Debt Basis, BOY	\$ 2,000
Current year income items (+)	\$ 2,000	Income used to restore debt basis (+)	\$ -
Current capital contributions (+)	\$ -	Loans made to S Corp during the year (+)	\$ -
Distributions (-)	\$ -	Loan repayments (-)	\$ -
Adjusted basis used for basis limitation	\$ 6,000	Debt basis used for basis limitation	\$ 2,000
Total Basis for loss/deduction/expense items	\$ 8,000		

Losses/Deduction/Expenses	Current Year Loss/Ded/Exp	Prior Year Unallowed Basis Loss	Items Available for Carryforward	Items Available for Carryforward %	Regular Tax Amount Allowed by Basis	Regular Tax Basis Carryover
Ordinary Loss	\$ 12,000	\$ -	\$ 12,000	80%	\$ 4,800	\$ 7,200
Charitable Contributions	\$ 3,000	\$ -	\$ 3,000	20%	\$ 1,200	\$ 1,800
Nondeductible Expenses	\$ 2,000	\$ -	-0-	-0-	\$ 2,000	\$ -
Total	\$ 17,000	\$ -	\$ 15,000	100%	\$ 8,000	\$ 9,000
Adj. stock basis used for basis limitation	\$ 6,000		Debt basis used for basis limitation		\$ 2,000	
Nondeductible expense	\$ (2,000)		Ordinary Loss/Charitables attr. to debt		\$ (2,000)	
Ordinary Loss/Charitables attributable to stock basis	\$ (4,000)		Debt basis, EOY 8		\$ -	
Stock basis, EOY 8	\$ -					

Note that the nondeductible items reduce stock basis first and will not be applied as a carryforward on a pro rata basis. The remaining basis for loss and deduction items is \$6,000 (\$8,000 - \$2,000) allocable pro rata between ordinary losses and charitable contributions.

Example 2 – S Corporation Basis Limitation Mechanics: Neil Harmon is a 25% owner of Z Best S Corporation. His stock basis at the beginning of year 4 is \$7,000, and his debt basis is \$1,000. The corporation made no principal payments on Neil's shareholder loan to the corporation during the tax year, and the outstanding principal balance is \$5,000 at year end. Below is a summary of the current year activity and the carryforward items related to Neil's ownership interest in the S corporation.

Category	Year 4 Activity	Prior Year Unallowed Amounts
Ordinary Income (Loss)	\$ 5,000	\$ (1,000)
Interest Income	\$ 500	
Charitable Contributions	\$ 1,000	
Nondeductible Expenses	\$ 1,500	

Because the shareholder's debt basis is different from the outstanding principal balance in the loan, this indicates that losses/deduction have been claimed against the debt basis. We must determine what net increase, if any, will be used to restore the debt basis. The maximum amount of increase to restore the debt basis is limited to \$4,000 (\$5,000 - \$1,000), the difference between the outstanding principal balance and the shareholder's debt basis. The current year net increase is determined as follows:

Category	Year 4 Activity	Prior Year Unallowed Amounts
Ordinary Income (Loss) (+/-)	\$ 5,000	\$ (1,000)
Interest Income (+)	\$ 500	
Charitable Contributions (-)	\$ 1,000	
Nondeductible Expenses (-)	\$ 1,500	
Net Increase (Decrease)	\$ 2,000	

The year 4 basis limitations would be determined as follows:

Stock Basis		Debt basis	
Stock Basis, BOY	\$ 7,000	Debt Basis, BOY	\$ 1,000
Current Year Capital Contributions	\$ -	Income used to restore debt basis	\$ 2,000
Current Year Income Items	\$ 5,500	Loans made to S corp during year	\$ -
Less: income for debt restoration	\$ (2,000)	Less: Loan Repayments	\$ -
Less: distributions	\$ -	Debt basis used for basis limitation	\$ 3,000
Adj basis for basis limitation	\$ 10,500	Loss allowed against debt basis	\$ -
Loss allowed by basis limitation	\$ (3,500)	Debt Basis, EOY	\$ 3,000
Stock Basis, EOY	\$ 7,000		

Losses/ Deduction/ Expenses	Current Year Loss/Ded/ Exp	Prior Year Unallowed Basis Loss	Regular Tax Amount Allowed by Basis	Regular Tax Basis Carryover
Ordinary Loss	\$ -	\$ 1,000	\$ 1,000	\$ -
Charitable Contributions	\$ 1,000	\$ -	\$ 1,000	\$ -
Nondeductible Expenses	\$ 1,500	\$ -	\$ 1,500	\$ -
Total	\$ 2,500	\$ 1,000	\$ 3,500	\$ -

Basis Limitations – Closing Thoughts

Determining basis is straightforward but coordinating suspended amounts can be tricky. Unlike other limitations, basis limitations apply to all taxpayers, C corporations included. With the new partner tax capital reporting requirements for Schedule K-1, much of the work is being done on behalf of the taxpayer from a basis perspective; however, the actual limitations and carryforward items will be determined at the individual taxpayer level. Because S corporation Schedules K-1 do not report shareholder basis, Schedule E of Form 1040 requires a basis calculation to be included/attached with the return if the taxpayer is claiming a loss. Individual taxpayers are not required to separately attach basis calculations for partnership losses being claimed on the return.

4. Limitation 2: At-Risk Limitations

After computing basis limitations for losses and deductions, taxpayers must then have sufficient “at-risk” basis to claim losses from S corporations or partnerships. At-risk limitation calculations are much like calculating basis in a partnership interest or S corporation stock, but the nuances and differences primarily relate to the treatment of debt items attributable to the partner/shareholder. It is important to calculate at-risk basis independent of basis in the partnership interest/S corporation stock, as they frequently are not the same. Form 6198 is completed in reporting At-risk limitations. A form is prepared for each activity/group of activities.

Similarities between partnership interest/S corporation basis and at-risk basis are outlined below:

- **Contributions of Cash/Other Property:** Basis and at-risk basis are both increased by the amount of unencumbered cash and the adjusted basis of unencumbered property contributed to a partnership or S corporation (§465(b)(1)(A)).
- **Purchase of interest:** Purchasing an additional interest in an activity is treated as a contribution to the activity, and thus, increases at-risk basis in the activity (Prop. Reg. §1.465-22(d)).
- **Income/Gain/Loss/Deduction Adjustments:** Pro rata share of partnership and S corporation items of income, gain, loss, and deduction including tax-exempt income and nondeductible items increase and decrease the at-risk basis in the same manner as it does to the basis in the partnership interest or S corporation stock (Prop. Reg. §1.465-22(c)).
- **Carryforward of Disallowed Amounts:** If income/gain from an activity exceeds deduction/loss items, no at-risk limitation will apply. Deductions/losses exceeding income are allowed to the extent of at-risk basis with the remaining disallowed amount being carried forward to the succeeding taxable year with the same character as originally incurred (§465(d); Prop. Reg. §1.465-38(b)). Carryforward is indefinite.

- Effectively, losses and deductions cannot reduce at-risk basis below zero, similar to the general basis limitations.
- **Character of Disallowed Amounts:** Partially allowed deductions/losses and fully disallowed amounts are generally treated on a pro-rata basis to the extent of income.
 - Prop. Reg. §1.465-38(a) suggests ordering the allowed amounts as follows: (1) capital losses, (2) §1231 losses/deduction, (3) deductions that are non-tax preference items under §57, and (4) all items representing tax preferences under §57.
 - While the proposed regulations suggest this, the Form 6198 instructions describe allowing and disallowing amounts on pro rata basis consistent with the basis limitations (Reg §1.704-1(d)(2); Reg. §1.1366-2(a)(5)).
 - Most professional tax software will default to a pro rata treatment. This methodology will likely hold under audit.

Differences between partnership interest/S corporation basis interest and at-risk basis are outlined below:

- **Partnership Liabilities:** Partnership basis includes all allocable liabilities to the taxpayer whereas at-risk basis only considers recourse and qualified nonrecourse financing debt (§465(b)(6)).
 - Guarantees of partnership liabilities usually result in the liability allocation being treated as recourse for partnership basis purposes (Reg. §1.752-2). However, at-risk basis is increased only when payment is actually made on a guaranteed loan, and there is no legal right of indemnification for the paying partner(s) (Prop. Reg. §1.465-6(d)).
- **Contributions of Borrowed Funds:** A partner/shareholder cannot be at risk for amounts contributed to the interest/activity if the funds were borrowed from another taxpayer (or person related to another shareholder) with an interest in the same activity (§465(b)(3)).
- **Limited Amount At-Risk From Nonrecourse Liabilities, Guarantees, Stop Loss, and Other Arrangements:** Taxpayers protected against any loss through nonrecourse borrowing are not treated as at-risk to the extent of protection (§465(b)(4)), as excepted for qualified nonrecourse financing (§465(b)(6)).
- **Negative At-Risk Basis/Recapture of Prior Year Losses:** While basis in a partnership interest/shareholder stock cannot be reduced below zero, at-risk basis can be reduced by distributions to a taxpayer, recourse loans subsequently converted to nonrecourse loans, the initiation of a stop loss or similar arrangement (Prop. Reg. §1.465-3(b)).
 - **Negative at-risk basis** results in recapture of the negative at-risk basis for the lesser of (1) absolute value of the negative at-risk amount or (2) the total amount of at-risk losses previously deducted net of amounts previously recaptured (§465(e)(2)).
 - **Recaptured income** is treated as a deduction for the activity in the next taxable year (§465(e)(1)(b)).
 - There is no guidance as to the character of the recapture, but points can be made that the income should retain the character to which the losses had been allowed. Most professional tax software will adopt a conservative approach and treat the recapture as ordinary income.
- **S corporation shareholder basis (including debt basis) is not necessarily the same as at-risk basis though debt basis is quite restrictive.**

- Shareholder basis is generally increased by direct loans to the S corporation.
- At-risk basis is increased only by the direct loans made to the S corporation where the shareholder is: (a) personally liable for the repayments of such amounts or (b) had pledged unencumbered property (not used in the activity) as security for the borrowed amount (§465(b)(2)).
 - A shareholder borrowing funds from a bank and then loaning funds to S corporation creates debt basis but will only create at-risk basis based on the terms of the note providing no indemnity to the borrowing shareholder.

Example 1 – At-Risk Limitations: James Wright has a 50% interest in ABC Partnership. The allocable share of partnership liabilities and partnership activity for Year 3 are outlined below. His adjusted basis in the partnership interest at the beginning of year 3 was \$7,000, and James received \$2,000 of cash distributions from the partnership during the tax year. The at-risk basis at the beginning of the year was \$1,000, and previously allowed at-risk losses totaled \$1,500.

Allocable Share of Partnership Liabilities	BOY	EOY
Nonrecourse	\$2,000	\$1,000
Qualified Nonrecourse Financing	\$5,000	\$4,200
Recourse	<u>\$10,000</u>	<u>\$9,800</u>
Total	\$17,000	\$15,000

Allocable Share of K-1 Activity Items	Current Year	Carryover
Ordinary Income (Loss)	\$(5,000)	\$ -
Rental Income (Loss)	\$(3,000)	\$ -
Interest Income	\$1,000	\$ -
Charitable Contributions	\$500	\$ -
Nondeductible Expenses	\$1,500	\$ -

Year 3 allowed losses/deductions/expenses are \$4,000, for purposes of basis limitations. The allowed amounts are then considered for at-risk basis purposes.

Adjusted Basis, BOY	\$ 7,000
Current year income items	\$ 1,000
Current capital contributions	\$ -
Current year change in liabilities	\$ (2,000)
Distributions	<u>\$ (2,000)</u>
Adjusted basis used for basis limitation	\$ 4,000

Losses/Deduction/Expenses	Current Year Loss/Ded/Exp	Prior Year CFWD	Regular Tax Allowed by Basis	Regular Tax CFWD
Ordinary Loss	\$ 5,000	\$ -	\$2,000	\$3,000
Rental Loss	\$ 3,000	\$ -	\$1,200	\$1,800
Charitable Contributions	\$ 500	\$ -	\$ 200	\$ 300
Nondeductible Expenses	<u>\$ 1,500</u>	<u>\$ -</u>	<u>\$ 600</u>	<u>\$ 900</u>
Total	\$10,000	\$ -	\$4,000	\$6,000

Year 3 allowed at risk losses/deductions/nondeductible items will be as follows:

- Ordinary Loss of \$500
- Rental Loss of \$300
- Charitable Contributions of \$50
- Nondeductible Expenses of \$150

Note the current year losses couldn't create negative at-risk basis but distributions and decreases in at-risk liabilities can create negative at-risk basis and create the potential for recapture. The year 3 recapture will be \$1,500, which is the amount of prior year at-risk losses allowed.

- Recapture is capped at the lesser of the absolute value of the current year negative at-risk basis and the previous allowed at-risk losses.

Carryforward items are available as a deduction in the subsequent tax year if there is sufficient at-risk regardless of there being sufficient basis in the partnership interest in the subsequent year.

- Because the items were previously allowed subject to the basis limitations, they will not be subsequently disallowed.

Step 1: Determine Current Year Profit (Loss)	
Ordinary Loss/Rental Loss (allowed after basis limitation)	\$ (3,200)
Other Income (Interest)	\$ 1,000
Other deductions, expenses, losses, nondeductible items (allowed after basis limitation)	<u>\$ (800)</u>
Current Year Profit (Loss) from Activity after basis limitations	\$ (3,000)
Net Losses are allowed only to the extent of sufficient At-Risk basis.	

Step 2: Determine At-Risk Basis Before Losses/Ded/Exp	
Adjusted At-Risk basis, BOY	\$ 1,000
Current year increases	\$ -
Current year decreases:	
- Distributions	\$(2,000)
- Decrease in qualified nonrecourse financing	\$ (800)
- Decrease in recourse	\$ (200)
Subtotal	\$(2,000)
Recapture the \$2,000 to the extent of previous allowed losses. As indicated in the facts, previously allowed losses were \$1,500, thus, that is our recapture amount.	
Current Year Increases: capital contributions, increases in allocable share of recourse and qualified nonrecourse financing, and current year profit from activity	
Current Year Decreases: distributions, decreases in allocable share of recourse and qualified nonrecourse financing	

Step 3: At-Risk Limitations Allocations			
Income Items	Total	Allowed Loss	At-Risk CFWD
Interest Income	\$1,000		
Losses/Deduction/Expenses			
Ordinary Loss	\$2,000	\$500	\$1,500
Rental Loss	\$1,200	\$300	\$900
Charitable Contributions	\$200	\$50	\$150
Nondeductible Expenses	\$600	\$150	\$450
Total	\$4,000	\$1,000	\$3,000
Current year losses allowed for at-risk purposes to the extent of income in the activity.			
At-risk carryforward amounts equal the current year loss from the activity due to there being no at-risk basis in the activity after considering decreases and changes in partnership liabilities.			

Example 2 – At-Risk Basis Limitations: Kathy Ferguson owns 30% of the outstanding stock of An S Corporation. The allocable shares of S corporation income, gain, expense, and loss items related to Year 5 activity are outlined below. Kathy received \$3,000 in distributions from the S corporation during Year 5. Kathy has a \$3,000 outstanding loan to the S corporation; however, her basis in the debt at the beginning of year 5 is \$1,000. No payments on the outstanding loan were made to Kathy during the tax

year. Additionally, her basis in the S corporation stock is \$4,000 at the beginning of the year, and her at-risk basis at the beginning of the year was \$2,000. Cumulative allowed at-risk losses are \$500.

Allocable Share of K-1 Activity Items	Current Year	Basis Carryover	At-Risk Carryover
Ordinary Income (Loss)	\$(1,000)	\$(500)	\$(700)
Interest Income	\$ 500	\$ -	\$ -
Charitable Contributions	\$1,000	\$ -	\$ -
Nondeductible Expenses	<u>\$1,500</u>	<u>\$ -</u>	<u>\$ -</u>
Total	\$2,000	\$(500)	\$(700)

Stock Basis		Debt basis	
Stock Basis, BOY	\$ 4,000	Debt Basis, BOY	\$1,000
Current Year Capital Contributions	\$ 0	Income used to restore debt basis	\$ -
Current Year Income Items	\$ 500	Loans made to S corp during year	\$ -
Less: income for debt restoration	\$ -	Less: Loan Repayments	\$ -
Less: distributions	<u>\$(3,000)</u>	Debt basis used for basis limitation	\$1,000
Adj basis for basis limitation	\$ 1,500	Loss allowed against debt basis	<u>\$ -</u>
		Debt Basis, end of tax year	\$1,000
Total Basis for Loss Limitation	\$2,500		

Losses/Deduction/Expenses	Current Year Loss/Ded/Exp	Prior Year CFWD	Total CY and PY	Total CY and PY %	Regular Tax Allowed by Basis	Regular Tax CFWD
Ordinary Loss	\$1,000	\$500	\$1,500	60%	\$ 600	\$ 900
Charitable Contributions	\$1,000	\$ -	\$1,000	40%	\$ 400	\$ 600
Nondeductible Expenses	<u>\$1,500</u>	<u>\$ -</u>	<u>\$ -</u>	<u>0%</u>	<u>\$1,500</u>	<u>\$ -</u>
Total	\$3,500	\$500	\$2,500	100%	\$2,500	\$1,500

Year 5 allowed at-risk losses/deductions/nondeductible items will be as follows:

- Ordinary Loss of \$203.
- Charitable Contributions of \$63.
- Nondeductible Expenses of \$234.

Note the current year losses could not create negative at-risk basis but distributions and decreases in at-risk liabilities can create negative at-risk basis and create the potential for recapture. The year 5 recapture will be \$500, which is the amount of prior year at-risk losses allowed.

- Recapture is capped at the lesser of the absolute value of the current year negative at-risk basis and the previous allowed at-risk losses.

Carryforward items are available as a deduction in the subsequent tax year if there is sufficient at-risk basis regardless of there being sufficient basis in the partnership interest in the subsequent year.

- Because the items were previously allowed subject to the basis limitations, they will not be subsequently disallowed due to a basis limitation.

Step 1: Determine Current Year Profit (Loss)	
Ordinary Loss (Current Year and Prior Year Carryforward (\$600 + \$700))	\$(1,300)
Other Income (Interest)	\$ 500
Other deductions/expenses/losses/nondeductible items (\$1500 nondeductible + \$400 charitable contributions)	<u>\$(1,900)</u>
Current Year Profit (Loss) from Activity	\$(2,700)
Net Losses are allowed only to the extent of sufficient At-Risk basis	

Step 2: Determine At-Risk Basis Before Losses/Ded/Exp	
Adjusted At-Risk basis, BOY	\$ 2,000
Current year increases	\$ -
Current year decreases:	
- Distributions	\$(3,000)
- Loan repayment on S corporation debt	<u>\$ -</u>
Subtotal	\$(1,000)
Recapture the \$1,000 to the extent of previous allowed losses. As indicated in the facts, previously allowed losses not previously recaptured are in the amount of \$500, thus, that is the recaptured amount.	
Current Year Increases: capital contributions, additional qualifying loans made to S corp, and current year profit from activity	
Current Year Decreases: distributions, loan repayments on S corporation debt	

Step 3: At-Risk Limitations Allocation			
Income Items	Total	Allowed Loss	At-Risk CFWD
Interest Income	\$500		
Losses/Deduction/Expenses			
Ordinary Loss	\$1,300	\$203	\$1,097
Charitable Contributions	\$400	\$63	\$337
Nondeductible Expenses	\$1,500	\$234	\$1,266
Total	\$3,200	\$500	\$2,700

At-Risk Limitations: Closing Thoughts

Debt basis creates at-risk basis to the extent of:

- #1: The taxpayer is personally liable for the debt, and
- #2: The taxpayer is not otherwise protected from loss.

At-risk basis limitations are applicable to Individuals, Estates, Trusts, and closely-held C Corporations. A closely held C corporation includes any corporation owned directly or indirectly by or for five or fewer individual owners at any point during the past half of the tax year. Ownership attribution can apply. Significant changes in ownership of a C corporation that trigger short-year tax filing obligations can make these rules more complicated in application and can unexpectedly trigger application of the at-risk limitation rules in a particular organization that would not have previously been subject to the provisions.

Planning opportunities are available for aggregating at-risk basis for related activities. Aggregating activities allows a taxpayer to treat multiple, related trades or businesses as one activity to the extent the taxpayer: (1) actively participates in the management of the trade/business; OR (2) the trade or business is carried on by a partnership or S corporation and 65% or more of its losses for the tax year are allocable to a person who actively participates in the management of the trade or business. Active participation is determined based on all available facts and circumstances.

5. Limitation 3: Passive Loss Limitations (§469)

After computing basis limitations and at-risk loss limitations, the allowable losses, deductions, and credits are then subject to the §469 passive-activity loss limitations (PALs). PALs restrict the utilization of losses and deductions along with the allowability of credits to the extent of passive income each year, with any excess amounts carried forward indefinitely.

- If a passive activity is **fully disposed**, the activity no longer meets the definition of a passive activity, and all carryforward items are released for utilization in claiming the carryover losses, deductions, and credits.
- **Portfolio income** (i.e., interest dividends, and capital gains) from passthrough income and directly allocable/related deductions are not considered from a passive activity for purposes of §469.
- **Charitable Contribution Deductions** are not considered in the passive activity loss limitations but are considered for both basis and at-risk basis limitation calculations. Nondeductible items are not considered in the passive activity limitations.

- **Guaranteed payments** (including partner health insurance premiums) are excluded from passive activity calculations and are included in the taxpayer's ordinary income regardless of the other types of income distributed by the partnership. It is worth noting that a partner receiving guaranteed payments will often meet the material participation requirements (as discussed later), and thus, not be subject to the passive loss limitations.

PALs apply to individuals, estates, trusts, closely held C corporations, and personal service corporations (§469(a)(2)). The closely held C corporation definition is the same as it is for the at-risk basis limitations (§465(j)(1)). Personal service corporations are characterized as such where the principal activity is the performance of personal services executed substantially by employee-owners. This definition is similar to the definition included in §269A(b)(1), with further details outlined in the instructions of Form 8810. PALs are calculated and presented on different forms depending on the type of taxpayers. Form 8582 is prepared for individuals, estates, and trusts, whereas Form 8810 is prepared for closely held C corporations and personal service corporations.

So what constitutes a passive activity? A passive activity is one in which the taxpayer did not:

- Materially participate in the activity, OR
- Engage in any rental activity, subject to specific exception.

Material participation is met by fulfilling one of the following seven tests (Temp. Reg. §1.469-5T(a)):

- **Test 1:** Participation is more than 500 hours in a given tax year;
- **Test 2:** Participation constitutes substantially all the participation of all individuals (both owners and non-owners);
- **Test 3:** Participates more than 100 hours in a year and more than anyone else;
- **Test 4:** Significant participation in the activity and all significant participation activities in aggregate exceeds 500 hours;
- **Test 5:** Prior year material participation in any five of the preceding ten taxable years;
- **Test 6:** Activity is personal service in nature and the taxpayer material participated in any three preceding taxable years; **OR**
- **Test 7:** Facts and circumstances (last resort, good luck)!

Rental Activities are passive activities by default (§469(c)(2)), subject to 8 exceptions outlined below:

- **Exception 1:** Real Estate Professionals (§469(c)(7))
- **Exception 2:** Average customer use of property is seven days or less (e.g., vacation condo) (Temp. Reg. §1.469-1T(e)(3)(II)(A))
- **Exception 3:** Average period of use is 30 days or less and significant personal services are provided (e.g., dude ranch)
- **Exception 4:** Extraordinary personal services are provided (e.g., boarding school dormitories, hospitals)
- **Exception 5:** Rental activity is incidental to the nonrental activity
- **Exception 6:** Property is available to nonexclusive customers during defined business hours (e.g., golf course)
- **Exception 7:** Taxpayer provides the property for use in a partnership, S corporation, or JV which the taxpayer owns an interest in (e.g., taxpayer solely owns warehouse that is used by S corporation distribution company the taxpayer is a shareholder of and provides the warehouse for use to the S corporation distribution company (PLR 9722007))

- **Exception 8:** A special \$25,000 loss is allowed for a taxpayer and/or spouse that **actively participated** in a passive rental real estate activity, subject to phaseout rules. Losses in excess of \$25,000 are still subject to the passive activity loss limitations.
 - Active participation is different from material participation and is less stringent.
 - IRS Publication 925 is a convenient tool for understanding the applicability of the active participation rules/exception.

Grouping Activities is also available, similar to the at-risk limitations. One or more trade or business activities, including rental activities, can be treated as a single activity/economic unit, which can allow a taxpayer to materially participate across several activities rather than a single activity, and thus, avoid PAL limitations. Grouping can also impact the active participation requirements for rental activities, so if a taxpayer is attempting to group rental activities, he should think holistically regarding the effects of all passive activities.

6. PAL limitation mechanics

PALs are looked at in the aggregate of passive income against passive losses (§469(d)(1)). Basis limitations and at-risk basis limitations look at an activity/entity-by-entity basis, while PALs bring all separate, passive activities together to look at a total loss/deduction/credit profile of a taxpayer in a given tax year. PALs are allocated to activities and within activities on a pro-rata basis in accordance with the regulations (§469(j)(4)). The \$25,000 special loss allowance is also allocated to and within activities on a pro-rata basis like other passive loss limitations. The character of losses and deductions still apply, like both the basis limitations and the at-risk basis limitations. Closely held C corporations may offset active income to the extent of any net active income (§469(e)(2)). Net active income refers to the taxable income of the taxpayer for a taxable year without consideration for income or loss from a passive activity and portfolio income. Essentially passive activities cannot create an NOL.

The amounts being carried forward for a former passive activity are allowed in subsequent years to the extent of income/regular tax liability for such activity, with the unused balance being carried forward as though the unused losses/credits arose from a passive activity (§469(f)). Passive activity losses/deductions/credits are only completely freed up upon disposal. For the disposition of substantially all of a passive activity, the carryforward amounts of disallowed losses, deductions, and credits are freed up to be used in the year of disposition and no longer carried forward (§469(g)).

Like the at-risk basis limitations, grouping activities is available, as Reg. §1.469-4(c)(1) defines an activity in terms of appropriate economic units. Regulation §1.469-4(c)(2) provides a facts and circumstances test for determining whether activities being grouped results in an appropriate economic unit. Factors to consider include: 1) similarities and differences in types of trades or businesses, (2) the extent of common control, (3) the extent of common ownership, (4) geography of activities, and (5) interdependencies between/among activities. Because grouping activities can result in activities being treated more beneficially than nonpassive activities, consideration should be given to this where a taxpayer has many activities.

Example 1: PALs Mechanics -- Moira has ownership interests in three separate distribution companies, Distributor 1, LLC (D1), Distributor 2, LLC (D2), and Distributor 3, S Corp Inc. (D3). Moira treats all activities as separate passive activities. After consideration of all relevant capital/debt basis limitations and at-risk limitations, the allowable income/losses, deductions, etc. are as presented below:

Category (not representative of Schedule K-1 box numbers)	D1, LLC	D2, LLC	D3, S Corp
1. Ordinary Income (Loss)	\$(11,600)	\$(1,200)	\$12,000
2. Guaranteed Payments/Partner Health Insurance Premiums	\$10,000		
3. Interest income		\$4,000	
4. Rental Income (Loss)	\$(3,600)		
5. Section 1231 Gain (Loss) Passive		\$(500)	
6. Section 179	\$1,800		\$4,000
7. Charitable Contributions	\$1,000		\$500
8. Nondeductible Expenses	\$800	\$700	\$2,500
Prior Year Unallowed Amounts			
1. Ordinary Income (Loss)	\$(1,000)		\$(4,500)
5. Section 1231 Gain (Loss) Passive		\$(300)	

Step 1 requires that we determine the overall gain or loss from all activities. This will consider current year amounts, and any carried forward disallowed losses/deductions amounts from prior year.

Category (not representative of Schedule K-1 box numbers)	D1, LLC	D2, LLC	D3, S Corp	Total
1. Ordinary Income (Loss)	\$(11,600)	\$(1,200)	\$12,000	
2. Guaranteed Payments/Partner Health Insurance Premiums	\$10,000			
3. Interest income		\$4,000		
4. Rental Income (Loss)	\$(3,600)			
5. Section 1231 Gain (Loss) Passive		\$(500)		
6. Section 179	\$1,800		\$4,000	
7. Charitable Contributions	\$1,000		\$500	
8. Nondeductible Expenses	\$800	\$700	\$2,500	
Activity Net Passive Income (1 + 4 + 5 - 6)			\$8,000	\$8,000
Activity Net Passive (Loss) (1+ 4 + 5 - 6)	\$(17,000)	\$(1,700)		\$(18,700)

Prior Year Unallowed Amounts				
1. Ordinary Income (Loss)	\$(1,000)		\$(4,500)	\$(5,500)
5. Section 1231 Gain (Loss) Passive		\$(300)		\$(300)
All Passive Activities Net Income (Loss)				\$(16,500)
Total Losses Allowed (to the extent of passive income)				\$8,000

Step 2 requires us to allocate allowed losses between activities on a pro rata basis for all loss activities.

Loss Allocation Between Activities	D1, LLC	D2, LLC	D3, S Corp	Total
Overall Loss (Absolute Value)	\$18,000	\$2,000	N/A Net Passive Income in Activity	\$20,000
Ratio	90%	10%		100%
Unallowed Loss	\$(14,850)	\$(1,650)		\$(16,500)
Allowed Loss	\$3,150	\$350	\$4,500	\$8,000

Step 3 requires us to allocate allowed losses within activities on a pro rata basis based on category.

Unallowed Loss Carryforward Allocation within Activities *	D1, LLC				D2, LLC				D3, S Corp	Total
	Total Activity Loss	Pro Rata %	Unallowed Loss	Allowed Loss	Total Activity Loss	Pro Rata %	Unallowed Loss	Allowed Loss	N/A - Net Passive	Total Unallowed Loss by Character
1. Ordinary Loss/Rental Loss (Incl Section 179)	\$18,000	100%	\$14,850	\$3,150	\$1,200	100%	\$990	\$210		\$15,840
2. Section 1231 Loss Passive	\$0	0%	\$0	\$0	\$800	0%	\$660	\$140		\$660
Total Carryforward	\$18,000	100%	\$14,850	\$3,150	\$2,000	100%	\$1,650	\$350		\$16,500

7. Limitation 4: Excess Business Loss Limitation §461(l)

The last limitation after the PALs limitation is the Excess Business Loss Limitation under §461(l). Prior to the CARES act and applicable to individuals, trusts, and estates, this provision limited the NOL deduction by disallowing excess business losses for tax years beginning after December 31, 2017, and ending before January 1, 2026. Excess business losses are defined as the excess of:

- (1) The taxpayer's aggregate trade/business deductions for a given tax year (excluding NOL and 199A deductions), over
- (2) The taxpayer's aggregate trade/business income plus \$262,000 (\$524,000 MFJ) for tax year 2021. This amount is indexed for inflation annually.
- The excess amount is to be carried forward as an NOL. In effect, the NOL deduction is limited to \$262,000 (\$524,000 MFJ) for tax year 2021.

The CARES Act amended §461(l) limiting its application to tax years 2021 through 2026 and repealed the applicability for tax years 2018 through 2020. As such, individuals that were subject to the limitation in

prior years can file an amended return to allow the deduction. An activity qualifies as a trade or business and should be included in the limitation calculation if the taxpayer engages in the activity for a profit with continuity and regularity based on all facts and circumstances. The fact of a profit being generated is not a factor considered. This can include salaries; tips; business income from Schedules C, F, and E; capital gains/losses from Schedule D; and business gain/losses from Form 4797. Furthermore, to the extent a taxpayer is a trader in securities, dividends, interest, etc., he could be considered for the §461 limitation in a given tax year. Calculations should be completed on Form 461, and the form should be attached to the return. Note that while the other limitations discussed applied in a successive order, there is potential for other limitations to apply before the §461 limitation including capital loss limitations, §179 limitations, basis, at-risk, and passive loss limitations.

Example 1 – Excess Business Loss Limitation: Bill and Kathy's MFJ tax return is being completed. Their return shows portfolio income totaling \$250,000. Their return shows wages of \$190,000. They have ownership interest in one partnership and one S corporation. The partnership loss allowed before the excess business loss limitation is \$945,000, and the S corporation income is \$215,000. The net business loss is \$730,000 (\$215,000 - \$945,000), and the excess business loss is \$206,000 (\$730,000 - \$524,000). This amount is carried forward as an NOL to future tax years.

Every partnership and S corporation activity should be tracking basis and at-risk basis to determine the allowance of any losses/deductions. At-risk basis includes debt only to the extent of unmitigated risk of loss. Tax practitioners need to think about the payor of last resort to determine if the debt basis should be included in the at-risk basis. Each partnership and S corporation activity should be evaluated for material participation to determine if the passive activity loss limitations apply. Grouping elections should be evaluated for at-risk and passive activity loss purposes to determine if there are any advantages to the taxpayer. The IRS has continued to crackdown on the application of these loss limitations, and with the increase in tax losses due to the COVID-19 pandemic, tax practitioners need to be more aware of the mechanical issues at play for both proper annual compliance as well as planning for the utilization of such losses.

Corporate Net Operating Losses – A Quick Note

The enactment of TCJA brought about significant changes to the corporate NOL rules including the limitation of the NOL deduction to 80% of taxable income, the disallowance of NOL carrybacks, and the removal of the 20-year carryforward limitation. The CARES Act of 2020 changed the NOL deductions again for tax years 2018 through 2020 by allowing NOL carrybacks for five years and removing the 80% NOL deduction limitation for tax years 2018 through 2020. Due to the suspension of certain TCJA NOL limitations, taxpayers can use the various amended return processes and/or superseded returns to claim refunds as an additional source of cash flow for struggling entities.

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Numbers Applicable to Rulings

Learning objectives

Upon reviewing this chapter, the reader will be able to:

- Describe the structure of the tax brackets for 2021;
- Quantify the standard deduction, the personal exemption, and the phase out of personal exemptions and itemized deductions;
- Identify the factors that determine the amount of earned income tax credit;
- Explain how and to what extent interest from certain bonds may be excluded from gross income;
- Define a dependent for purposes of, and calculate, the dependent-care credit;
- Discuss the various education credits;
- Describe what other education-related expenditures may be deductible;
- Quantify the mileage rates for automobiles owned or used in a trade or business, the SIFL rates for aircraft usage, and the per-diem rates that may be applicable to employee business expenses;
- Discuss the Social Security benefits applicable to retirees and their spouses;
- Explain the limitations that apply to long-term care insurance and health savings accounts; and
- Discuss other limitations applicable to taxpayers in 2021.

I. Tax rates and other information for 2021

A. Tax rates for the individual

The tax rate brackets for 2021 are as follows.¹

Single:

If taxable income is:	The tax is:
Not over \$9,950	10 percent of taxable income.
Over \$9,950 but not over \$40,525	\$995, plus 12 percent of the excess over \$9,950.
Over \$40,525 but not over \$86,375	\$4,664, plus 22 percent of the excess over \$40,525.
Over \$86,375 but not over \$164,925	\$14,751, plus 24 percent of the excess over \$86,375.
Over \$164,925 but not over \$209,425	\$33,603, plus 32 percent of the excess over \$164,925.
Over \$209,425 but not over \$523,600	\$47,843, plus 35 percent of the excess over \$209,425.
Over \$523,600	\$157,804.25, plus 37 percent of the excess over \$523,600.

Head of Household:

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

¹ Rev. Proc. 2020-45.

Married Filing Jointly and Surviving Spouse:

If taxable income is:	The tax is:
Not over \$19,900	10 percent of taxable income.
Over \$19,900 but not over \$81,050	\$1,990, plus 12 percent of the excess over \$19,900.
Over \$81,050 but not over \$172,750	\$9,328, plus 22 percent of the excess over \$81,050.
Over \$172,750 but not over \$329,850	\$29,502, plus 24 percent of the excess over \$172,750.
Over \$329,850 but not over \$418,850	\$67,206, plus 32 percent of the excess over \$329,850.
Over \$418,850 but not over \$628,300	\$95,686, plus 35 percent of the excess over \$418,850.
Over \$628,300	\$168,993.50, plus 37 percent of the excess over \$628,300.

Married Filing Separately:

If taxable income is:	The tax is:
Not over \$9,950	10 percent of taxable income.
Over \$9,950 but not over \$40,525	\$995, plus 12 percent of the excess over \$9,950.
Over \$40,525 but not over \$86,375	\$4,664, plus 22 percent of the excess over \$40,525.
Over \$86,375 but not over \$164,925	\$14,751, plus 24 percent of the excess over \$86,375.
Over \$164,925 but not over \$209,425	\$33,603, plus 32 percent of the excess over \$164,925.
Over \$209,425 but not over \$314,150	\$47,843, plus 35 percent of the excess over \$209,425.
Over \$314,150	\$84,496.75 plus 37 percent of the excess over \$314,150.

Estates and Trusts:

If taxable income is:	The tax is:
Not over \$2,650	10 percent of taxable income.
Over \$2,650 but not over \$9,550	\$265, plus 24 percent of the excess over \$2,650.
Over \$9,550 but not over \$13,050	\$1,921, plus 35 percent of the excess over \$9,550.
Over \$13,050	\$3,146, plus 37 percent of the excess over \$13,050.

Capital Gains Rate:

For 2021, the tax rate on capital gain and/or qualifying dividend income is available to individuals only with ordinary taxable income of the following:

Ordinary Taxable Incomes	0% Capital Gains Rate	15% Capital Gains Rate	20% Capital Gains Rate
Single	\$40,400 and below	\$40,401 to \$445,850	Over \$445,850
Joint filers and surviving spouses	\$80,800 and below	\$80,801 to \$501,600	Over \$501,600
HOH	\$54,100 and below	\$54,101 to \$473,750	Over \$473,750
Married Filing Separate	\$40,400 and below	\$40,401 to \$250,800	Over \$250,800
Trusts & Estates	\$2,700 and below	\$2,701 to \$13,250	Over \$13,250

B. Standard deduction²

The standard deduction in 2021 is as follows:

Filing status:	2021
Married filing jointly and Surviving spouses (§1(a))	\$25,100
Heads of Households (§1(b))	\$18,800
Unmarried (§1(c))	\$12,550
Married filing separately (§1(d))	\$12,550

For 2021, the standard deduction for a dependent is the lesser of: (i) the deduction for a single taxpayer; and (ii) the greater of (x) \$1,100, or (y) the sum of \$350 and the dependent's earned income.

Additional standard deductions for the elderly and blind in 2021:³

Taxpayer	Either	Both
Unmarried	\$1,700	\$3,400
Married	\$1,350	\$2,700

C. Personal exemptions

The personal exemption amount under §151(d) is \$4,300.⁴ However, the personal exemption and dependency exemption deductions are reduced to \$0 for years 2018 through 2025 by the Tax Cuts and Jobs Act of 2017 (TCJA).

The amount of the personal exemption still matters. The way TCJA suspends the deduction is to reduce the amount of the deduction for an exemption to “zero.” However, the reduction to zero is only for the tax deduction. The amount still applies for other purposes, such as the income limit for a qualified relative.⁵

Example: Bob and Mary are married and file a joint return for 2021. Their son, Jay, is 20 years old. Jay graduated from college in 2020 but cannot find a job that utilizes his education. The family decided it would be better for Jay to live at home and not seek other full-time employment so that he can continue to seek employment in his chosen field. Jay worked at a local store part-time and earned \$4,000.

Jay is not a qualifying child because he is over 18 years old and is not a student. However, he is a qualifying relative to Bob and Mary because he lived with them all year, they provided over half of Jay's support, and Jay's gross income is less than the exemption amount for 2021 of \$4,300. If they are not subject to the child and family credit income limitation, Bob and Mary can take a family credit of \$500 for 2021.

On September 16, 2020, the IRS and Department of Treasury released final regulations, confirming that the definition of a qualifying relative is based on the inflation-adjusted personal exemption threshold, even though personal exemptions are suspended under the TCJA. Additionally, the final regulations clarify that

² Rev. Proc. 2020-45.

³ Rev. Proc. 2020-45.

⁴ Rev. Proc. 2020-45.

⁵ I.R.C. §151(d), created by the Tax Cuts and Jobs Act of 2017.

the definition of a qualifying relative for purposes other than determining the deduction under §151(a) is based on the inflation-adjusted personal exemption threshold.⁶

D. Reduction of itemized deductions

The overall limitation on itemized deductions does not apply for 2021. The limitation is suspended for years 2018 through 2025 by TCJA.

E. Earned income tax credit (EITC)⁷

1. Earned income and AGI limits

The American Rescue Plan Act (ARPA) of 2021, signed into law by President Biden on March 11, 2021, expanded the EITC for taxpayers, allowing more individuals to meet eligibility requirements for the credit.

ARPA amends prior law as follows:

- a. **Age Requirement** -- Under prior law, individuals who were at least age 25 but under age 65 were eligible for the credit. For tax year 2021, ARPA amends prior law to decrease the minimum age requirement from 25 years old to 19 years old. Special requirements apply to specified students and former foster youth or former homeless youth.
 - **Specified student exception:** Under ARPA, the minimum age requirement for a specified student is age 25.
 - **Former foster youth or former homeless youth exception:** In the case of a former foster youth or former homeless youth, the minimum age requirement is age 18. ARPA also removes the age limitation of 65 years old for tax year 2021, meaning there is no age limit requirement when determining the credit.
- b. **Qualifying Child Requirement** -- In order to qualify for the EITC with qualifying children, taxpayers typically have to provide information about the qualifying child, including name, age, and TIN/SSN. ARPA removes this requirement, essentially allowing individuals who have qualifying children to claim the EITC, despite not being able to provide proper documentation.
- c. **Joint Return Requirement** -- Under prior law, individuals who were married were required to file a joint return in order to be eligible to claim the EITC. ARPA modifies this requirement and provides that certain separated married individuals are not required to file jointly in order to claim the EITC. For EITC purposes, an individual will not be treated as “married” if the individual:
 - Is considered married per §7703(a).
 - Lives with his or her qualifying child for more than half of the tax year.
 - Does not file a joint return for the tax year.
 - Does not have the same principal place of abode as his or her spouse during the last six months of the tax year or has a decree, instrument, or agreement with regard to his or her spouse and is not a member of the same household with his or her spouse by the end of the tax year.

This provision applies to the tax years beginning after December 31, 2020.

⁶ T.D. 9913.

⁷ All numbers from section E. are from Rev. Proc. 2020-45.

- d. **Investment Income Requirement** -- Under prior law, individuals with certain types of investment over \$3,650 were unable to claim the EITC. ARPA increases the threshold amount to \$10,000 for tax years beginning after December 31, 2020. Similar to prior law, the \$10,000 threshold will be indexed for inflation for tax years beginning after 2021.
- e. **Identification Requirement** -- Prior to ARPA, a taxpayer was required to provide a qualifying child's name, age, and taxpayer identification number in order to claim the qualifying child when determining the amount of the EITC. If the taxpayer was unable to provide the qualifying child's name, age, and taxpayer identification number, he or she was ineligible to claim the EITC as an eligible individual with no qualifying children. ARPA removes this requirement and allows an eligible individual who has qualifying children, but cannot provide the necessary identification for such children, to claim the EITC as an eligible individual with no qualifying children. This provision is effective for tax years beginning after December 31, 2020.
- f. **Increase in the Childless EITC Amount** -- ARPA makes the following changes to the childless EITC amount for the 2021 tax year:
- Raises the credit percentage and phaseout percentage from 7.65% to 15.3%;
 - Raises the income at which the maximum EITC is reached to \$9,820; and
 - Raises the income at which the phaseout begins to \$11,610 for Single, Head of Household, or Surviving Spouse filers (filers other than married filing jointly).

2021 earned income and adjusted gross income (AGI) must each be less than:⁸

If filing...	Qualifying Children Claimed			
	Zero	One	Two	Three or more
Single, Head of Household or Widowed	\$21,430*	\$42,158	\$47,915	\$51,464
Married Filing Jointly	\$27,830	\$48,108	\$53,865	\$57,414

*As modified by ARPA

2. Investment income limit

Per ARPA, investment income must be \$10,000 or less for 2021.

3. Maximum credit amounts

The maximum amount of credit for tax year 2021 is:⁹

- \$6,728 with three or more qualifying children;
- \$5,980 with two qualifying children;
- \$3,618 with one qualifying child; and
- \$1,502 with no qualifying children.

⁸ Rev. Proc. 2021-23.

⁹ Rev. Proc. 2021-23.

Note:

The Welfare Reform Act of 1996 changed the definition of “adjusted gross income” for purposes of the phase out of the earned income credit. Adjusted gross income is now determined by disregarding net capital losses, net losses from trusts and estates, net losses from nonbusiness rents and royalties, and 50 percent of net losses from businesses.

F. Exclusion from income for certain redemptions of bonds

An exclusion is available for income from the redemption of United States savings bonds for taxpayers who pay qualified higher-education expenses (as defined in §135). This exclusion, however, is phased out by reducing the exclusion by the amount otherwise excludable income multiplied by a fraction. The numerator of the fraction is the excess of the taxpayer’s modified adjusted gross income over the threshold amount, and the denominator of the fraction is \$30,000 for joint returns or \$15,000 for all others. For tax years beginning in 2021, taxpayers with modified adjusted gross income above the “threshold phase-out amount” are subject to this phase out, up to a “completed phase-out amount,” the point at which the benefit is no longer available.

The Service has announced that for 2021:¹⁰

Filing status	2021 threshold phase-out amount
Married filing jointly	\$124,800
Others	\$83,200

Example: In 2021, Mr. and Mrs. Smith redeem \$15,000 in U.S. savings bonds in order to help pay for their daughter’s college tuition. Mr. and Mrs. Smith file a joint income tax return for the 2021 taxable year. Their combined adjusted gross income for 2021 is \$134,800. The amount of the exclusion is \$10,000 ($\$15,000 - (\$15,000 \times \$10,000/\$30,000)$).

G. Dependent-care credit

1. In general

ARPA makes several changes to the dependent-care credit beginning in the 2021 tax year.

For purposes of the dependent-care credit, a taxpayer who maintains a household that includes one or more qualifying individuals may claim a nonrefundable credit against income-tax liability for up to a certain percent of a limited amount of employment-related expenses. Prior to ARPA, eligible employment-related expenses were limited to \$3,000 if there was one qualifying individual or \$6,000 if there were two or more qualifying individuals. Thus, the maximum credit was \$1,050 if there was one qualifying individual and \$2,100 if there were two or more qualifying individuals. The 35-percent credit rate was reduced, but not below 20 percent, by one percentage point for each \$2,000 (or a fraction thereof) of adjusted gross income above \$15,000 until it reached \$43,001. The credit is not available to married taxpayers unless they file a joint return. The applicable dollar limit of otherwise eligible employment-related expenses was reduced by any amount excluded from income under an employer-provided dependent-care-assistance program.

¹⁰ Rev. Proc. 2019-44.

Starting in tax year 2021, ARPA increases the eligible employment-related expenses limit to \$8,000 if there is one qualifying individual with respect to the taxpayer, or \$16,000 if there are two or more qualifying individuals with respect to the taxpayer. Under ARPA, the applicable credit percentage is increased to 50%, reduced by 1 percentage point for each \$2,000 (or fraction thereof) by which the taxpayer's AGI for the tax year exceeds \$125,000. As such, for taxpayers with AGI of \$125,000 or less, the maximum amount of the credit is \$4,000 (\$8,000 x 50%) for taxpayers with one qualifying individual and \$8,000 (\$16,000 x 50%) for taxpayers with two or more qualifying individuals.

Example 1: In 2020, Karen pays \$10,000 in eligible employment-related expenses to care for her three daughters while she works. The children are qualifying individuals for purposes of the dependent-care credit. Karen's AGI is \$97,000. Since the eligible employment-related expenses occurred during the 2020 tax year, the maximum amount of qualified employment-related expenses that Karen can use to determine the dependent-care credit is \$6,000.

Example 2: Assume the same facts in Example 1, except Karen pays \$10,000 in eligible employment-related expenses in 2021. Since the eligible employment-related expenses occurred during the 2021 tax year, Karen can take into account the entire \$10,000 of eligible employment-related expenses when determining the dependent-care credit.

For high income taxpayers, the applicable percentage is not reduced below the phaseout percentage, which is defined as 20% reduced (but not below zero) by 1 percent for each \$2,000 (or fraction thereof) by which the taxpayer's AGI for the tax year exceeds \$400,000. In other words, if the taxpayer's AGI is \$125,000 or below, the applicable credit percentage is 50%. This applicable percentage decreases by 1 percent for every \$2,000 by which the taxpayer's AGI exceeds \$125,000, up to \$185,000 of AGI. If the taxpayer's AGI is greater than \$185,000, but not in excess of \$400,000, the applicable credit percentage is 20%. If the taxpayer's AGI is over \$400,000, the applicable credit percentage decreases by 1% for every \$2,000, completely phasing out when the taxpayer's AGI is greater than \$400,000.

Example 3: Assume the same facts in Example 2, except Karen's AGI is \$197,000. Since her AGI is greater than \$185,000, but not in excess of \$400,000, the applicable credit percentage is 20%. Her allowable credit is 20% of \$10,000 qualified expenses, or \$2,000.

2. Exclusion

Amounts paid or incurred by an employer for dependent-care assistance provided to an employee generally are excluded from the employee's gross income and wages if the assistance is furnished under a program meeting certain requirements. These requirements stipulate that the program be described in writing, satisfy certain nondiscrimination rules, and provide for notification to all eligible employees. Dependent-care assistance expenses eligible for the exclusion are defined the same as employment-related expenses with respect to a qualifying individual under the dependent-care tax credit. Prior to ARPA, the dependent-care exclusion was limited to \$5,000 per year, except that a married taxpayer filing a separate return could exclude only \$2,500. ARPA increases the exclusion amount for employer-provided dependent care assistance to \$10,500 for 2021. Dependent-care expenses excluded from income are not eligible for the dependent-care tax credit.

3. Planning notes

- a. The dependent-care credit was nonrefundable under prior law; however, ARPA makes the dependent-care credit refundable for taxpayers who have a principal place of abode

in the U.S. for more than half of the tax year. If taxpayers are filing a joint return, either spouse must have a principal place of abode in the U.S. for more than half of the tax year in order for the credit to be refundable.

- b. Many taxpayers and accountants wrongly assume that the \$16,000 (\$6,000 for years other than 2021) must be prorated between the two qualifying individuals. This is untrue. If \$15,900 is paid on behalf of one qualifying individual and \$100 on the other, the full \$16,000 is taken into account in computing the credit. This means that if the taxpayer had only the one qualifying individual, only \$8,000 would qualify, and, assuming the 20-percent rate applies, only a \$1,600 credit. But if the taxpayer pays out-of-pocket for an otherwise qualifying individual, the credit increases to \$3,200. For a \$100 investment, the taxpayer gets an additional \$1,600. For example, if a 12-year-old child, who doesn't ordinarily require child care, were sick for one day, and the parent pays \$100 for the care of that second individual, the taxpayer reaps a tax benefit.
- c. Another often overlooked area is a non-child individual can be a qualifying individual. An individual who is incapable of self-care, such as one of the parents following certain surgical procedures after returning home for a few days, can be a qualifying individual.
- d. Payments to a non-dependent parent of the taxpayer for the care of the taxpayer's child qualify as payments for dependent care.

H. Education benefits

1. Education credits

An individual taxpayer is allowed a nonrefundable education tax credit against income tax for the taxable year. The amount of the education tax credit is the total of the Hope Scholarship credit plus the Lifetime Learning credit.¹¹

- a. In the same taxable year, a taxpayer may claim a Hope Scholarship credit for each eligible student's **qualified tuition and related expenses** and a Lifetime Learning credit for one or more other students' qualified tuition and related expenses. However, a taxpayer may not claim both a Hope Scholarship credit and a Lifetime Learning credit with respect to the same student in the same taxable year.¹²
- b. Subject to certain limitations, a Hope Scholarship credit may be claimed for the qualified tuition and related expenses paid during a taxable year with respect to each eligible student. Qualified tuition and related expenses paid during a taxable year with respect to one student may not be taken into account in computing the amount of the Hope Scholarship credit with respect to any other student. In addition, qualified tuition and related expenses paid during a taxable year with respect to any student for whom a Hope Scholarship credit is claimed may not be taken into account in computing the amount of the Lifetime Learning credit.¹³
- c. Subject to certain limitations, a Lifetime Learning credit may be claimed for the aggregate amount of qualified tuition and related expenses paid during a taxable year with respect to students for whom no Hope Scholarship credit is claimed.¹⁴
- d. As a result of the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (TCDTRA), for tax years beginning in 2021, the Lifetime Learning tax credit that a taxpayer may

¹¹ Treas. Regs. §1.25A-1(a).

¹² Treas. Regs. §1.25A-1(b)(1).

¹³ Treas. Regs. §1.25A-1(b)(2).

¹⁴ Treas. Regs. §1.25A-1(b)(3).

otherwise claim is phased out ratably for taxpayers with modified adjusted gross income between \$80,000 and \$90,000 (\$160,000 and \$180,000 for married individuals who file a joint return). Thus, taxpayers with modified adjusted gross income above \$90,000 (or \$180,000 for joint filers) may not claim an education tax credit.

- The increased limitations are the result of TCDTRA repealing the tuition and fees deduction for tax years beginning after 2020. Previously, §222 provided taxpayers with a deduction for qualified tuition and related expenses.

For 2021, the Lifetime Learning tax credit phases out as follows:

Taxpayer	MAGI Level Where Phase Out Begins	MAGI Level Where Phase Out Is Complete
Married, filing jointly	\$160,000	\$180,000
All other taxpayers	\$80,000	\$90,000

- e. Subject to the phase out of the education tax credit described above, the Lifetime Learning credit amount is 20 percent of up to \$10,000 of qualified tuition and related expenses paid during the taxable year for education furnished to the taxpayer, the taxpayer's spouse, and any claimed dependent during any academic period beginning in the taxable year (or treated as beginning in the taxable year).¹⁵ Those expenses paid with respect to a student for whom the Hope Scholarship credit is claimed are not eligible for the Lifetime Learning credit.¹⁶ Thus, in 2021, the maximum Lifetime Learning credit is \$2,000.

Note:

The Lifetime Learning credit is available to eligible students when the Hope credit/American Opportunity credit is not available. In 2021, the Lifetime Learning credit is 20 percent of the first \$10,000 of qualifying expenses. The qualifying expense limit is not subject to an annual inflation adjustment.

- f. For any taxable year beginning after 2008, the Hope Scholarship is redesignated as the American Opportunity credit.¹⁷ For 2021, the American Opportunity credit is an amount equal to the sum of¹⁸ 100 percent of so much of the qualified tuition and related expenses paid by the taxpayer during the taxable year (for education furnished to the eligible student during any academic period beginning in such taxable year) as does not exceed \$2,000,¹⁹ plus 25 percent of such expenses so paid as exceeds \$2,000 but does not exceed \$4,000.²⁰ For 2021, the maximum American Opportunity credit is \$2,500.

¹⁵ Treas. Regs. §1.25A-4(a)(2).

¹⁶ Treas. Regs. §1.25A-4(a)(3).

¹⁷ The American Recovery and Reinvestment Act of 2009.

¹⁸ I.R.C. §25A(i)(1).

¹⁹ I.R.C. §25A(i)(1)(A).

²⁰ I.R.C. §25A(i)(1)(B).

The change generally increases the credit:

Qualified expenses	Hope Scholarship credit (as if still in force in 2021)	American Opportunity credit (in force for 2021)	Lifetime Learning credit
\$500	\$500	\$500	\$100
\$1,000	\$1,000	\$1,000	\$200
\$1,300	\$1,300	\$1,300	\$260
\$1,500	\$1,400	\$1,500	\$300
\$2,000	\$1,650	\$2,000	\$400
\$2,400	\$1,850	\$2,100	\$480
\$2,600	\$1,950	\$2,150	\$500
\$3,000	\$1,950	\$2,250	\$600
\$3,500	\$1,950	\$2,375	\$700
\$4,000	\$1,950	\$2,500	\$800
\$5,000	\$1,950	\$2,500	\$1,000
\$9,000	\$1,950	\$2,500	\$1,800
\$10,000	\$1,950	\$2,500	\$2,000

- (i) The Act extends the period during which the credit applies. It not only applies to as many as four years of post-secondary education (provided that the student has not completed the first four years of post-secondary education before the beginning of the fourth taxable year),²¹ but also to all four years of post-secondary education.²²

Planning point:

Looking at the above table, the American Opportunity tax credit exceeds the Lifetime Learning credit at all levels of qualified expense. Formerly, one could squeeze an additional \$200 (.20 x \$10,000) at expense levels of or more than \$10,000. The Lifetime Learning credit was larger for qualified expenses above \$9,000. The effect of the provision is to limit Lifetime Learning credits to situations in which the taxpayer (or taxpayer's dependent) is a less-than-half-time student or has been convicted of a federal or state felony offense consisting of the possession or distribution of a controlled substance before the end of the taxable year within which such period ends, since in either case an individual does not qualify for the Hope Scholarship (or its surrogate, the American Opportunity, for 2009 through 2021) credit.²³

- (iv) In general, the personal credits are applicable only to the excess of the regular tax liability over the tentative tax; it is not applicable against any AMT, i.e., the excess of the tentative tax over the regular tax liability as reduced by the personal nonrefundable credits.²⁴ However, since 2000, Congress has enabled this and other such nonrefundable personal credits to be applied against the sum of the regular tax liability (reduced by the foreign tax credit) and the AMT (essentially the tentative tax).²⁵ This was made permanent by the 2012 ATRA legislation. That, in effect, permits this credit to offset and reduce an AMT liability.
- (v) The Hope credit is a nonrefundable personal credit. However, the Act treats 40 percent of so much of the education credit allowed as is attributable to the Hope Scholarship (American Opportunity) credit (after taking into account the income

²¹ I.R.C. §25A(b)(2)(A). I.R.C. §25A(i)(2).

²² I.R.C. §25A(b)(2)(C). I.R.C. §25A(i)(2).

²³ I.R.C. §25A(b)(2)(B) and §25A(b)(2)(D).

²⁴ I.R.C. §26(a)(1).

²⁵ I.R.C. §26(a)(2).

phase out, but without regard to the limitation of the credit against the AMT or regular tax liability, as the case may be) as a refundable credit.²⁶

Note:

This means that the American Opportunity tax credit must be bifurcated into the refundable and nonrefundable portions after computing the aggregate amount after income phase out, then the nonrefundable portion of the credit must be applied against the AMT or the regular tax liability in excess of tentative tax²⁷ and then the refundable portion must be applied as other refundable credits are.

Caution:

However, no portion of the modified credit is refundable if the taxpayer claiming the credit is a **child to whom the kiddie tax applies for such taxable year** (generally, any child under age 18 or any child under age 24 who is a student providing less than one-half of his or her own support who has at least one living parent and does not file a joint return).

Example 1: Married Taxpayer has MAGI of \$128,000 and has graduate school Lifetime Learning expenses of \$10,000 and \$5,000 of qualifying undergraduate expenses. Prior to TCDTRA, the Lifetime Learning Credit was \$1,000 (\$2,000 credit reduced by 50% due to AGI threshold). As a result of TCDTRA, the taxpayer can claim the entire \$2,000 credit as her MAGI is under the new threshold limits.

Example 2: Same as **Example 1** above, except that Taxpayer's MAGI is \$170,000. In this case, the Lifetime Learning credit is phased out 50 percent (\$170,000 MAGI - \$160,000 threshold)/\$20,000 to \$1,000.

Comparison of American Opportunity Tax Credit and Lifetime Learning Credit

Credit	Maximum Amount	Refundability	Qualifying Expenses	Education Level	MAGI Phaseout
American Opportunity Tax Credit (AOTC)	\$2,500 per student	40% Refundable	• Tuition and Enrollment Fees • Required Books, supplies, and course materials	• Unlimited years • All levels of post-secondary education or courses to improve job skills	Single: \$80,000-\$90,000 MFJ: \$160,000 - \$180,000
Lifetime Learning Credit	\$2,000 per return	Nonrefundable	• Tuition and Enrollment Fees	• Maximum 4 years of post-secondary education • Must pursue degree	Single: \$80,000-\$90,000 MFJ: \$160,000 - \$180,000

²⁶ I.R.C. §25A(i)(6). It is not treated as a Hope credit, so the limitations (other than the income phase out) of §25A do not apply.

²⁷ Any reference in §25A or §§24, 25, 26, 25B, 904, or 1400C to a credit allowable under this subsection shall be treated as a reference to so much of the credit allowable as is attributable to the Hope Scholarship Credit.

Planning point:

Sometimes these credits can be utilized by the child/student because the parents cannot qualify under the AGI phase outs. In order to do so, the taxpayer who is eligible to claim the student as a dependent (usually the parent) must choose not to do so (and lose the dependency exemption). Then the student may claim the education credit for the student's qualified tuition and related expenses **even if** the tuition and expenses were paid by the parent. The surprise in the proposed regulations was the specific reference to the possibility of a parent to waive the exemption. Most practitioners believed that the exemption was mandatory because of "there shall be allowed" language.

Example 1: In 2021, Client pays qualified tuition and related expenses for Client's dependent, Child, to attend Ole Alma Mater during 2021. Client claims Child as a dependent on Client's federal income tax return. Therefore, assuming all other relevant requirements are met, Client is allowed an education credit on Client's federal income tax return, and Child is **not** allowed an education credit on Child's federal income tax return. The result would be the same if Child paid the qualified tuition and related expenses.²⁸

Example 2: In 2021, Client has one dependent, Child. In 2021, Child pays qualified tuition and related expenses to attend Ole Alma Mater during 2021. Although Client is eligible to claim Child as a dependent on Client's federal income tax return, Client does not do so. Therefore, assuming all other relevant requirements are met, Child is allowed an education credit on Child's federal income tax return, and Client is not allowed an education credit on Client's federal income tax return with respect to Child's education expenses. The result would be the same if Client paid the qualified tuition and related expenses on behalf of Child.²⁹

The new tax structure may suggest higher wages to be paid to certain children, since now the kiddie tax applies to a student who has not attained age 24 or a child who has not attained age 19 unless, in either case, the child has earned income in excess of one-half of the child's support. This means that a child, assuming all other conditions are met, may earn up to \$34,850 of earned income and pay no income tax if eligible for the American Opportunity credit or \$30,683 if eligible for the Lifetime Learning credit.

Earned income	\$35,000
Less Standard deduction	\$12,550
Taxable income	\$22,450
Tax before credits	\$2,500
American Opportunity credit	\$2,500
Net tax	\$0

Earned income	\$30,833
Less Standard deduction	\$12,550
Taxable income	\$18,283
Tax before credits	\$2,000
Lifetime Learning credit	\$2,000
Net tax	\$0

2. Qualified tuition expenses

For taxable years through 2017, taxpayers were allowed an above-the-line deduction for qualified tuition and related expenses paid by the taxpayer during a taxable year. The deduction was not allowed if the individual elects to apply the Hope/American Opportunity or Lifetime Learning credits. This popular

²⁸ See Treas. Regs. §1.25A-1(f)(2), Ex. 1.

²⁹ See Treas. Regs. §1.25A-1(f)(2), Ex. 2.

provision was renewed on December 20, 2019 through December 31, 2020 for tax years 2018, 2019, and 2020.³⁰ During these tax years, a taxpayer was allowed to claim an above-the-line deduction of qualified tuition and related expenses, up to \$4,000 if AGI did not exceed \$65,000 (\$130,000 joint) and up to \$2,000 if AGI did not exceed \$80,000 (\$160,000 joint). To claim this deduction, eligible taxpayers had to file Form 8917.

Form 8917 (Rev. January 2020) Department of the Treasury Internal Revenue Service	Tuition and Fees Deduction ▶ Attach to Form 1040 or 1040-SR. ▶ Go to www.irs.gov/Form8917 for the latest information.	OMB No. 1545-0074 Attachment Sequence No. 60																				
Name(s) shown on return		Your social security number																				
CAUTION Use this form for qualified tuition and fees paid in 2018, 2019, or 2020, and later years if legislation extends the deduction (see instructions). File a separate Form 8917 for each year after 2017 for which you qualify to take the deduction. You can't take both an education credit from Form 8863 and the tuition and fees deduction from this form for the same student for the same tax year.																						
Before you begin: ✓ To see if you qualify for this deduction, see <i>Who Can Take the Deduction</i> in the instructions below. ✓ If you file Form 1040 or 1040-SR, figure any write-in adjustments. • For 2018: Figure any write-in adjustments to be entered on the dotted line next to Schedule 1 (Form 1040), line 36. • For 2019: Figure any write-in adjustments to be entered on the dotted line next to Schedule 1 (Form 1040 or 1040-SR), line 22. • For 2020 and later years: Figure any write-in adjustments for Schedule 1 (Form 1040 or 1040-SR); see the Instructions for Forms 1040 and 1040-SR.																						
<table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="width: 5%;">1</th> <th style="width: 45%;">(a) Student's name (as shown on page 1 of your tax return)</th> <th style="width: 20%;">(b) Student's social security number (as shown on page 1 of your tax return)</th> <th style="width: 30%;">(c) Adjusted qualified expenses (see instructions)</th> </tr> <tr> <th></th> <th>First name</th> <th>Last name</th> <th></th> </tr> </thead> <tbody> <tr><td> </td><td> </td><td> </td><td> </td></tr> <tr><td> </td><td> </td><td> </td><td> </td></tr> <tr><td> </td><td> </td><td> </td><td> </td></tr> </tbody> </table>			1	(a) Student's name (as shown on page 1 of your tax return)	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Adjusted qualified expenses (see instructions)		First name	Last name													
1	(a) Student's name (as shown on page 1 of your tax return)	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Adjusted qualified expenses (see instructions)																			
	First name	Last name																				
2	Add the amounts on line 1, column (c), and enter the total		2																			
3	Enter the amount from your "total income" line of Form 1040 or 1040-SR		3																			
4	• For 2018: Enter the total of the amounts on your 2018 Schedule 1 (Form 1040), lines 23 through 33, plus any write-in adjustments you entered on the dotted line next to Schedule 1 (Form 1040), line 36. • For 2019 and 2020: Enter the total of the amounts on your 2019 Schedule 1 (Form 1040 or 1040-SR), lines 10 through 20, plus any write-in adjustments you entered on the dotted line next to Schedule 1 (Form 1040 or 1040-SR), line 22. • For later years: See www.irs.gov/Form8917 to find out if the line references above for 2019 have changed		4																			
5	Subtract line 4 from line 3.* If the result is more than \$80,000 (\$160,000 if married filing jointly), stop; you can't take the deduction for tuition and fees * If you're filing Form 2555, 2555-EZ, or 4563, or you're excluding income from Puerto Rico, see <i>Effect of the Amount of Your Income on the Amount of Your Deduction</i> in Pub. 970 to figure the amount to enter on line 5.		5																			
6	Tuition and fees deduction. Is the amount on line 5 more than \$65,000 (\$130,000 if married filing jointly)? ☐ Yes. Enter the smaller of line 2, or \$2,000. ☐ No. Enter the smaller of line 2, or \$4,000.		6																			
Also enter this amount on line 21 of the 2019 and 2020 Schedule 1 (Form 1040 or 1040-SR), or line 34 of the 2018 Schedule 1 (Form 1040). See www.irs.gov/Form8917 to find out if the line references above for 2019 have changed.																						

³⁰ The Consolidated Appropriations Act, 2021.

Beginning in 2021, the TCDTRA repealed the deduction for qualified tuition and related expenses and increased the income limitation phaseout range for the Lifetime Learning credit.

3. Coverdell education savings accounts (CESAs)

A Coverdell education savings account (CESA), a product of the Taxpayer Relief Act of 1997, is a tax-free savings account for educational expenses. A CESA is a trust or custodial account that is created or organized in the United States exclusively for the purpose of paying the qualified higher-education expenses of the designated beneficiary of the account. The account must be designated as a Coverdell education savings account when it is created in order to be treated as a Coverdell savings account for tax purposes.³¹

- a. Taxpayers may deposit up to \$2,000 per year into a CESA for a child younger than age 18. Parents, grandparents, other family members, friends, and the child may contribute to the child's CESA, provided that the total contributions for the child during the taxable year do not exceed the \$2,000 limit. Amounts deposited in the account grow tax-free until distributed, and the child will not owe tax on any withdrawal from the account if the child's qualified higher-education expenses at an eligible educational institution for the year equal or exceed the amount of the withdrawal.
- b. Any individual, again including the beneficiary, can contribute to a CESA if their modified adjusted gross income is under \$110,000 (\$220,000 for joint returns).
- c. Distributions from a CESA are not included in the gross income of the distributee to the extent of the beneficiary's qualified higher-education expenses during the taxable year.³² "Qualified higher-education expenses" are defined as tuition, fees, books, supplies, and equipment required for the enrollment or attendance at a college or university (or certain vocational schools). They now include reasonable costs for room and board incurred by the designated beneficiary who is an eligible student for any academic period while attending such institution.³³ Unique to a CESA is the inclusion as qualified higher-education expenses "qualified elementary and secondary school expenses,"³⁴ meaning expenses for:
 - (i) Tuition, fees, academic tutoring, special-needs services, books, supplies, and other equipment incurred in connection with the enrollment or attendance of the beneficiary at a public, private, or religious school providing elementary or secondary education (kindergarten through grade 12) as determined under state law;
 - (ii) Room and board, uniforms, transportation, and supplementary items or services (including extended day programs) required or provided by such a school in connection with such enrollment or attendance of the beneficiary; and
 - (iii) The purchase of any computer technology, equipment, or Internet access and related services, if such technology, equipment, or services are to be used by the beneficiary and the beneficiary's family during any of the years the beneficiary is in school. Computer software primarily involving sports, games, or hobbies is not considered a qualified elementary and secondary school expense unless the software is educational in nature.

³¹ Notice 97-60, 1997-46 I.R.B. 8, §3, Q&A-1.

³² I.R.C. §530(d)(2)(A).

³³ I.R.C. §529(e)(3)(B)(i).

³⁴ I.R.C. §530(b)(4)(A).

- d. A distribution otherwise taxable from a CESA to the extent that the amount received is paid into another CESA for the benefit of the same beneficiary or a **member of the family** of such beneficiary not later than the sixtieth day after the date of such payment or distribution is not included in the gross income of the distributee.³⁵ A member of the family means: (i) the spouse of the beneficiary; (ii) a son or daughter of the beneficiary, or a descendant of either; (iii) a stepson or stepdaughter of the beneficiary; (iv) a brother, sister, stepbrother, or stepsister of the beneficiary; (v) the father or mother of the beneficiary, or an ancestor of either; (vi) a stepfather or stepmother of the beneficiary; (vii) a son or daughter of a brother or sister of the beneficiary; (viii) a brother or sister of the father or mother of the beneficiary; (ix) a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law of the beneficiary; (x) a first cousin of the beneficiary, but not the spouse of a first cousin; or (xi) any spouse of an individual named in (ii) - (ix).³⁶ However, the rollover does not avoid tax with respect to any payment or distribution if the rollover was applied to any prior payment or distribution during the 12-month period ending on the date of the payment or distribution.
- e. Tax-free transfers or rollovers of account balances may be made from one CESA benefiting one beneficiary to another CESA benefiting another beneficiary (as well as redesignations of the named beneficiary), provided that the new beneficiary is a **member of the family of the old beneficiary** and is under age 30. Any balance remaining in a CESA is deemed distributed within 30 days after the date that the beneficiary reaches age 30 (or, if earlier, within 30 days of the date that the beneficiary dies). The age limitations with respect to rollovers and required distributions are eliminated in the case of a beneficiary who is a special-needs beneficiary. Thus, a deemed distribution of any balance in a CESA does not occur when a special-needs beneficiary reaches age 30.
- f. Finally, the age-30 limitation does not apply in the case of a rollover contribution for the benefit of a special-needs beneficiary or a change in beneficiaries to a special-needs beneficiary.

Note:

The Department of Education has announced that for financial-aid purposes, it will no longer treat the CESA as the student's asset, but the parent's. Generally 35 percent of the student's assets are considered available resources while only 5.6 percent of a parent's assets are so treated.

The Case to Kill the Coverdell:

Once an attractive option for families looking to save for college, the popularity of CESAs have dwindled in recent years, especially due to the impact of the TCJA of 2017 and the SECURE Act of 2019. Consider the following:

- CESAs once had the advantage of allowing qualified withdrawals for K-12 expenses. The TCJA of 2017 expanded §529 plans by allowing qualified withdrawals for K-12 expenses, eliminating that advantage of CESAs over §529 plans.
- The SECURE Act expanded §529 plans by allowing qualified withdrawals for student loan repayment (up to \$10,000) and apprenticeship programs. Student loan repayment and apprenticeship program expenses are not considered qualified withdrawals for CESAs.
- Combined contributions are capped at \$2,000 per beneficiary, per year, not indexed for inflation.

³⁵ I.R.C. §530(d)(5). This includes, besides the taxpayer and spouse, sons, daughters, brothers, sisters, nephews and nieces, certain in-laws, etc. and any spouse of such persons.

³⁶ I.R.C. §529(e)(2).

- Section 529 plans have an indefinite life and can last for generations, whereas CESAs must be disbursed for qualified education expenses or given to another family member under age 30 by the time the original beneficiary turns 30 years old.
- Section 529 plans can qualify for state tax deductions and credits, whereas CESAs do not.

CESAs are not necessarily **bad** college savings instruments. CESAs generally provide a broad range of investment options, while §529 plan investment options are more limited in nature. Despite the broader range of investment options, recent law has made other options, such as §529 plans, much more attractive.

4. Qualified Tuition programs (§529 plans)

Prior to 2002, a qualified tuition program (QTP) generally referred to a program established and maintained by a **state**. The basic thrust of the program was to permit persons to: (i) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher-education expenses of the beneficiary; or (ii) make contributions to an account that is established for the purpose of meeting qualified higher-education expenses of the designated beneficiary of the account (a “savings-account plan”). The terms and conditions of these programs vary from state to state.³⁷ However, there are some standard federal income-tax rules that apply to these programs.³⁸ The tax on earnings attributable to prepayments or contributions is deferred until the earnings are distributed from the QTP.

Note:

Prepaid tuition plan: Account Owner (e.g., a parent) contributes cash to a plan account for Beneficiary (e.g., a child), and the contribution purchases tuition credits (e.g., credit hours) based on then-current tuition rates. Account Owner’s contribution qualifies for the annual gift-tax exclusion. When Beneficiary attends a college participating in the program, Beneficiary’s tuition credits may be used to pay for all or a portion of Beneficiary’s tuition and other college expenses, regardless of tuition rates at that time. If Beneficiary does not go to college or goes to a nonparticipating college, the tuition credits will be refunded in cash (based on a set formula or index), which may then of course be used to pay tuition and other college expenses at a nonparticipating college. Prior to the 2001 Act, the difference between: (i) the value of the tuition and other expenses covered by the plan; and (ii) the total amount of Account Owner’s contributions to the plan was taxable ordinary income to Beneficiary. Under the 2001 Act, that difference is generally tax-free.

College-savings plan: Account Owner contributes cash to a plan account for Beneficiary, and the contribution is invested according to the terms of the plan. Account Owner’s contribution qualifies for the annual gift-tax exclusion. When Beneficiary attends virtually any college, the funds in the account (that is, Account Owner’s contributions plus all of the investment earnings thereon) may be used to pay for Beneficiary’s tuition and other college expenses. Prior to the 2001 Act, the investment earnings were taxable ordinary income to Beneficiary, but only at the time they were used for Beneficiary’s tuition and other college expenses.

A specified individual must be designated as the beneficiary at the commencement of participation in a qualified tuition program (i.e., when contributions are first made to purchase an interest in such a program), unless interests in such a program are purchased by a state or local government or a tax-exempt §501(c)(3) charity as part of a scholarship program operated by such government or charity under which beneficiaries to be named in the future will receive such interests as scholarships.

³⁷ Notice 97-60, 1997-46 I.R.B. 8, §6.
³⁸ I.R.C. §529.

- a. Under the 2001 Act, tax-exempt status is granted to a qualified tuition program, which includes both a qualified tuition program as before and prepaid tuition programs established and maintained by one or more eligible educational institutions (which may be private institutions) that satisfy the requirements under §529 (other than the state-sponsorship rule).³⁹ In the case of a qualified tuition program maintained by one or more **private eligible educational institutions**, persons are able to purchase tuition credits or certificates on behalf of a designated beneficiary, but would not be able to make contributions to a savings-account plan.⁴⁰ For these purposes, the term “eligible educational institution” means an institution that is described in §481 of the Higher Education Act of 1965,⁴¹ as in effect on June 7, 2001 (the date of the enactment), and is eligible to participate in programs under Title IV of that Act.⁴²
- b. The beneficiary pays tax on the earnings at the time of distribution. If amounts saved through a QTP are used to pay for college, the student or the student’s parents still may be eligible to claim either the Hope Scholarship credit or the Lifetime Learning credit.⁴³ However, an amount contributed to a Coverdell savings account on behalf of a designated beneficiary during any taxable year in which an amount is also contributed to a qualified tuition program on behalf of the same beneficiary will not be treated as an excess contribution to the CESA.⁴⁴ However, cash distributions made in taxable years beginning after December 31, 2001 from qualified tuition programs are excluded from gross income to the extent that the distribution is used to pay for qualified higher-education expenses (as reduced by any in-kind distributions). This exclusion from gross income is extended to distributions from qualified tuition programs established and maintained by an entity other than a state (or agency or instrumentality thereof) for distributions made in taxable years after December 31, 2003.
- c. Contributions by donors are eligible for the \$15,000 annual gift-tax exclusion (\$30,000 for “split” gifts by married couples). Therefore, for transfer-tax purposes such contributions are treated as a completed gift to the beneficiary.

Questions to ponder:

Should, say, grandparents, consider the implications of fully funding grandkids’ secondary education taking that obligation away from the parents? Should that conversation be undertaken with the parents?

Planning point:

If the contribution is larger than the amount of the gift-tax annual exclusion, the donor may prorate the contribution to the prepaid tuition plan over five years for purposes of claiming the gift-tax annual exclusion. This allows the contribution of **up to five times the amount of the annual exclusion (up to \$75,000 for an individual and up to \$150,000 for split gifts)** to be made **without gift-tax consequences**.

The limits on the amount of contributions imposed by state plans vary. Some, however, have limits high enough to take advantage of this advantage. For example, Fidelity Investments’ Unique College Investing Plan, which is open to residents of all states, has an account maximum of \$542,000 per beneficiary. New York has one of the largest limits, currently set at \$520,000.

³⁹ I.R.C. §529(b)(1).

⁴⁰ I.R.C. §529(b)(1)(A)(i).

⁴¹ 20 U.S.C. 1088.

⁴² I.R.C. §529(e)(5).

⁴³ Notice 97-60, 1997-46 I.R.B. 8, §6, Q&A-2.

⁴⁴ Notice 97-60, 1997-46 I.R.B. 8, §6, Q&A-4.

The gift-tax annual exclusion remains at \$15,000 for 2021. Although the amount is indexed for inflation, it rounds down to the next lowest multiple of \$1,000.⁴⁵ It did not increase enough to exceed \$15,000.

Note:

The exemption of gifts of QTPs on a change of beneficiary is limited to cases where the new beneficiary is a member of the family of the old beneficiary. Also, the exemption does not apply if the new beneficiary is of a lower generation than the old beneficiary.

- d. PPA repealed the sunset provisions of Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) that would have expired at the end of 2010 and that relate to qualified tuition programs (§529 plans):
 - (i) The provision that makes qualified withdrawals from qualified tuition accounts exempt from income tax;
 - (ii) The repeal of a pre-EGTRRA requirement that there be more than a de minimis penalty imposed on amounts not used for educational purposes and the imposition of the 10-percent additional tax on distributions not used for qualified higher education purposes;
 - (iii) A provision permitting certain private educational institutions to establish prepaid tuition programs that qualify under §529 if they receive a ruling or determination to that effect from the Internal Revenue Service, and if the assets are held in a trust created or organized for the exclusive benefit of designated beneficiaries;
 - (iv) Certain provisions permitting rollovers from one account to another account;
 - (v) Certain rules regarding the treatment of room and board as qualifying expenses;
 - (vi) Certain rules regarding coordination with Hope and Lifetime Learning credit provisions;
 - (vii) The provision that treats first cousins as members of the family for purposes of the rollover and change-in-beneficiary rules; and
 - (viii) Certain provisions regarding the education expenses of special-needs beneficiaries.
- e. Three significant changes have been made recently to the rules for §529 plans:
 - (i) The PATH Act of 2015 expanded the definition of qualified expenses to include computers and peripheral equipment. This modernized the rules to be more in step with today's use of technology in education.
 - (ii) The Tax Cuts and Jobs Act of 2017 added a provision to allow distributions to cover grades K-12, with an annual limit of \$10,000.
 - (iii) The SECURE Act expanded §529 education savings accounts coverage (discussed later).

⁴⁵

I.R.C. §26(b)(2).

Note:

The Pension Protection Act of 2006 permanently extended the amendments to §529, which previously were scheduled to expire at the end of 2010, including the provision that exempts from federal income tax distributions made from §529 accounts that are used to pay qualified higher education expenses. At the same time, it also enacted §529(f), which provides that, notwithstanding any other provision of §529, such regulations as may be necessary or appropriate to carry out the purposes of §529 and to prevent abuse of such purposes are authorized. The Joint Committee on Taxation provided two examples of how present law creates the opportunity for abuse of §529 accounts. Abuse may arise because of the ability to change designated beneficiaries (DBs) in certain circumstances without triggering transfer tax. For example, taxpayers may seek to establish and contribute to multiple accounts (taking advantage of the five-year rule) with different DBs with the intention of subsequently changing the DBs of such accounts to a single, common beneficiary and distributing the entire amount to such beneficiary without further transfer-tax consequences. Abuse may also arise because taxpayers seek to use §529 accounts as retirement accounts, with all of the tax benefits but none of the restrictions and requirements of qualified retirement accounts.

The Service is aware of other situations where current law raises the potential for abuse of §529 accounts. For example, abuse may also arise if a person contributes a large sum to an account for himself or herself and then changes the DB to a member of his or her family who is in the same or a higher generation as the contributor. The contributor's contributions to his or her own account would not trigger the gift tax because an individual cannot make a gift to himself or herself. The contributor may claim that the subsequent change of DB to a member of the contributor's family who is in the same or a higher generation avoids the gift tax under the special transfer tax rules of §529. Abuse may also arise because contributions to accounts are treated as completed gifts to the DB even though the account owner (AO) may be able to withdraw the money at his or her discretion.

Accordingly, **the Service intends to issue a notice of proposed rulemaking to address the potential for abuse of §529 accounts.** The notice of proposed rulemaking will provide a general anti-abuse rule that will apply when §529 accounts are established or used for purposes of avoiding or evading transfer tax or for other purposes inconsistent with §529. In addition, the notice of proposed rulemaking will include rules relating to the tax treatment of contributions to and participants in QTPs, including rules addressing the inconsistency between §529 and the generally applicable income and transfer tax provisions of the Code. The notice of proposed rulemaking also will include rules relating to the function and operation of QTPs and §529 accounts. The Service anticipates that the forthcoming notice of proposed rulemaking also will address additional comments that have been received with regard to certain administrative, income tax, and other issues affecting QTPs and §529 accounts.

The Service anticipates that the new rules to be provided in the notice of proposed rulemaking will generally apply prospectively to all §529 accounts. However, the anti-abuse rule may be applied on a retroactive basis.

The IRS and the Treasury Department also anticipate that the notice may require some states (or agencies or instrumentalities thereof) and eligible educational institutions that have established and maintained QTPs to make changes to the terms and operating provisions of their programs in order to ensure that their programs remain qualified under §529. The forthcoming notice of proposed rulemaking will provide a grace period of no less than 15 months to implement most changes.

These changes are not proposed to apply to a CESA (§530). So presumably the changing beneficiary strategy outlined above will survive the modification proposed.

Note:

Present law creates opportunities for abuse of qualified tuition programs. For example, taxpayers may seek to avoid gift and generation-skipping transfer taxes by establishing and contributing to multiple qualified tuition program accounts with different designated beneficiaries (using the provision of §529 that permits a contributor to contribute up to five times the annual exclusion amount per donee in a single year and treat the contribution as having been made ratably over five years), with the **intention of subsequently changing the designated beneficiaries of such accounts to a single, common beneficiary and distributing the entire amount to such beneficiary** without further transfer-tax consequences. Taxpayers also may seek to use qualified tuition program accounts as retirement accounts with all of the tax benefits but none of the restrictions and requirements of qualified retirement accounts. The provision grants the Secretary broad regulatory authority to clarify the tax treatment of certain transfers and to ensure that qualified tuition program accounts are used for the intended purpose of saving for higher education expenses of the designated beneficiary, including the authority to impose related record-keeping and reporting requirements. The provision also authorizes the Secretary to limit the persons who may be contributors to a qualified tuition program and to determine any special rules for the operation and federal tax consequences of such programs if such contributors are not individuals.

5. SECURE Act update: Section 529 plans

Section 302 of the SECURE Act expands §529 education savings accounts coverage to include expenses associated with registered apprenticeship programs and distributions for qualified education loan repayments. In the past, distributions were only considered qualified to the extent that the expenses were incurred at a qualified higher education institution. With the rising costs of college, it has become increasingly common for individuals to go into trades or apprenticeships, and now §529 accounts can be used to pay related expenses.

In addition, the SECURE Act allows for up to \$10,000 (lifetime maximum) to be withdrawn from a §529 plan to pay student loan principal amounts and related interest expenses for the beneficiary or the beneficiary's siblings. This provision applies to distributions made after December 31, 2018.

6. Student loan interest

There is an **above-the-line deduction for interest** paid on certain loans used to pay **qualified higher-education expenses**. This deduction applies to payments that would otherwise be treated as nondeductible personal interest except for the new special rules.⁴⁶ The amount allowable cannot exceed \$2,500. It is not indexed for inflation.

Under current law, married couples are penalized, as the above-the-line deduction for interest is capped at \$2,500 per return, not per individual. Legislation has been introduced, such as H.R. 5683, *The Student Loan Marriage Penalty Elimination Act*, to attempt to amend §221(b)(1) to allow married couples to apply the student loan interest deduction limitation separately to each spouse. Ultimately, no legislation has been passed to provide a \$2,500 above-the-line deduction per individual (rather than per return), but it is possible that future legislation may be introduced to provide an expanded above-the-line deduction for interest.

Note:

These income phase-out ranges are adjusted annually for inflation, rounded down to the closest multiple of \$5,000.

⁴⁶ I.R.C. §221.

In 2021, the education interest-expense deduction phases out as follows:

Taxpayer	MAGI Level Where Phase Out Begins	MAGI Level Where Phase Out is Complete
Married filing jointly	\$140,000	\$170,000
Single (including head of household)	\$70,000	\$85,000

While the student loan interest deduction is available to eligible taxpayers, federal student loan interest payments have been suspended since March 13, 2020 through September 30, 2021. The Department of Education initially announced the suspension in March 2020, and President Biden extended the suspension through September 30, 2021 through executive order. The suspension of student loan interest payments only applies to federal loans, not private loans.

Planning Point:

Many taxpayers have taken advantage of federal student loan interest suspension. Since March 2020, outstanding student loan debt in the U.S. has grown at double the rate it had in previous years. It is currently at a record high of over \$1.57 trillion. As of February 2021, the number of student loans currently in forbearance or deferral is more than double what it was a year ago.⁴⁷

As a result of the federal student loan interest payment suspension, taxpayers will likely have a much smaller student loan interest deduction in the 2020 and 2021 tax years.

I. Transportation

1. Mileage

- a. For automobiles first provided by employers to employees that meet certain requirements, the value to the employee of the use of the automobile may be determined under the vehicle cents-per-mile valuation rule,⁴⁸ but only if the fair market value of the automobile on the first date the automobile is made available to the employee does not exceed a “base value” amount. For years prior to 2018 this base value was \$16,000 (\$17,900 for vans and trucks). In IRS Notice 2019-08, the Treasury Department raised these amounts for 2018 significantly to \$50,000. The IRS Notice 2019-08 was issued to adjust the numbers because of the changes to the luxury automobile depreciation limits made by the Tax Cuts and Jobs Act of 2017. The \$50,000 limit for 2018 also applies for the fleet-average valuation rules. The 2021 figure is \$51,100.⁴⁹

Planning note:

The limitation on using the cents-per-mile method has been low for so long that many business owners have disregarded the method as an option. The increased limit should be considered by business owners to simplify record keeping.

- b. In 2021, the cents-per-mile rate is 56 cents per mile (down from 57.5 cents per mile in 2020) for business miles driven and 16 cents per mile driven for medical or moving

⁴⁷ Experian Data, *Student Loan Debt Reaches Record High as Most Repayment is Paused*

⁴⁸ Treas. Regs. §1.61-21(e).

⁴⁹ IRS Notice 2021-02.

purposes (down from 17 cents per mile in 2020). The rate for charitable mileage is 14 cents per mile and is not indexed for inflation.

2. Lease-deduction reduction

For leased automobiles, §280F(c) requires a reduction in the deduction allowed to the lessee of the automobile. The reduction must be substantially equivalent to the limitations on the depreciation deductions imposed on owners of automobiles. This reduction requires the lessees to include in gross income an inclusion amount determined by applying a formula to the amount obtained from a table.

Table for Autos with a Lease Term Beginning in 2021⁵⁰

REV. PROC. 2021-31 TABLE 3 DOLLAR AMOUNTS FOR PASSENGER AUTOMOBILES WITH A LEASE TERM BEGINNING IN CALENDAR YEAR 2021						
Fair Market Value of Passenger Automobile		Tax Year During Lease				
Over	Not Over	1 st	2 nd	3 rd	4 th	5 th & later
\$51,000	\$52,000	0	0	1	0	1
52,000	53,000	1	1	1	2	2
53,000	54,000	1	2	2	3	4
54,000	55,000	1	3	3	5	5
55,000	56,000	2	3	5	6	6
56,000	57,000	2	4	6	7	8
57,000	58,000	2	5	7	8	10
58,000	59,000	3	5	8	10	11
59,000	60,000	3	6	9	11	13
60,000	62,000	3	7	11	13	15
62,000	64,000	4	9	13	15	18
64,000	66,000	5	10	15	18	21
66,000	68,000	5	12	17	21	24
68,000	70,000	6	13	20	23	27
70,000	72,000	7	14	22	26	30
72,000	74,000	7	16	24	29	33
74,000	76,000	8	18	26	31	36
76,000	78,000	9	19	28	34	39
78,000	80,000	9	21	30	37	42
80,000	85,000	11	23	34	41	48
85,000	90,000	12	27	40	47	55
90,000	95,000	14	30	45	55	62
95,000	100,000	16	34	50	61	70
100,000	110,000	18	40	58	71	81
110,000	120,000	21	47	70	83	97
120,000	130,000	25	54	81	96	112
130,000	140,000	28	62	91	110	127
140,000	150,000	31	69	103	123	141
150,000	160,000	35	76	114	136	157
160,000	170,000	38	84	124	149	172
170,000	180,000	41	91	135	163	187
180,000	190,000	45	98	146	176	202
190,000	200,000	48	106	157	188	218
200,000	210,000	51	113	168	202	232
210,000	220,000	55	120	179	215	247
220,000	230,000	58	128	190	227	263
230,000	240,000	61	135	201	241	278
240,000	and over	65	142	212	254	293

⁵⁰ Rev Proc. 2021-31.

3. Depreciation

There are limitations to the allowable depreciation on luxury vehicles. The depreciation limitations are applied, by reference to the year the vehicle was first placed in service. The §280F “luxury car” caps continue to be avoided by purchasing cars with “unloaded gross curb weights” of over 6,000 pounds and trucks and vans with a load capacity over 6,000 pounds. Leasing the car or vehicle also serves to avoid these caps, although there is a minimal add-back (i.e., annual income inclusion) that serves to offset the write-off.

The Tax Cuts and Jobs Act of 2017 (TCJA) made changes to the luxury auto limits for tax years beginning after December 31, 2017.

- a. Prior to TCJA, there were two sets of limits. One set of limits applied to autos (not trucks and vans), and the other applied to trucks and vans. Under TCJA, there is one set of limits for all passenger automobiles.
- b. The law maintained the difference in how the 6,000-pound maximum weight is calculated for autos and for trucks and vans. For autos that are not trucks and vans, the maximum weight is the unloaded weight, but for trucks and vans it is the loaded weight (gross vehicle weight rating).

Note:

Certain “qualified non-personal-use vehicles” continue to be exempt from the luxury-auto limits regardless of their weight.

The annual depreciation dollar caps for vehicles that are in fact subject to the luxury-auto limits of §280F and placed in service in calendar year 2021 follow.

Autos (including trucks or vans):

- \$10,200 for the placed-in-service year;
- \$16,400 for the second tax year;
- \$9,800 for the third tax year; and
- \$5,860 for each succeeding year.

The additional-first-year (bonus) depreciation amount of \$8,000 was reinstated by TCJA for vehicles acquired and placed in service after September 27, 2017.

Note:

As always, the dollar limits must be proportionately reduced if business/investment use of a vehicle is less than 100 percent.

Note:

The rule under §179 limiting the amount of the expensing deduction (after application of the phase-out rule) to the amount of taxable income from any of the taxpayer's active trades or businesses was not affected. Any amount that cannot be deducted because of the taxable-income limit may be carried over indefinitely until it can be deducted.

Note:

There is no AMT adjustment with respect to property expensed under §179.⁵¹

Caution:

For tax years beginning in 2021, the maximum is \$1,050,000, phasing out for expenditures in excess of \$2,620,000.⁵²

The §179 expense limitation with respect to a sport-utility vehicle placed in service after October 22, 2004 is limited to \$25,000. TCJA added a provision to index the \$25,000 for inflation for years after 2018. The indexed amount for 2021 is \$26,200.

- c. A sport-utility vehicle is a four-wheeled vehicle that:
 - Is primarily designed or which can be used to carry passengers over public streets, roads, or highways (except any vehicle operated exclusively on a rail or rails);
 - Is not subject to §280F; and
 - Is rated at not more than 14,000 pounds gross vehicle weight.
- d. However, a sport-utility vehicle does **not** include any vehicle that:
 - Is designed to have a seating capacity of more than nine persons behind the driver's seat;
 - Is equipped with a cargo area of at least six feet in interior length, which is an open area or is designed for use as an open area but is enclosed by a cap and is not readily accessible directly from the passenger compartment; or
 - Has an integral enclosure, fully enclosing the driver compartment and load carrying device, does not have seating rearward of the driver's seat, and has no body section protruding more than 30 inches ahead of the leading edge of the windshield.

Note:

There are a number of vehicles that still do not meet the definition of a sport-utility vehicle. The provision does not make the sport-utility vehicle a passenger automobile, so it is eligible for depreciation using the general depreciation recovery scheme (20 percent, 32 percent, etc.) without recourse to the annual caps that apply to passenger automobiles.

Example: A purchases and places in service a used Hummer for \$50,000 in 2021 and elects out of bonus depreciation. A takes a \$26,200 §179 expense and \$5,000 regular depreciation, a total of \$31,200.

Because of changes included in the Tax Cuts and Jobs Act, used property now qualifies for bonus depreciation. Since the vehicle is over 6,000 pounds, A can take 100-percent bonus depreciation on the vehicle.

4. Qualified transportation expenses

Employees can exclude a limited amount of **qualified transportation fringe** benefits provided by the employer from gross income and wages for both income and payroll taxes within specific limitations,

⁵¹ S. Rept. (1986).

⁵² Tax Cuts and Jobs Act of 2017, Rev. Proc. 2019-44.

without regard to working-condition fringe benefits and de minimis fringe benefits.⁵³ However, for tax years beginning after December 31, 2017, the amounts are not deductible by the employer.⁵⁴

- a. Qualified transportation fringe benefits include the following.
 - (i) Transportation in a **commuter highway vehicle** is transportation provided by an employer to an employee in connection with travel between the employee's residence and place of employment.⁵⁵ A commuter highway vehicle is a highway vehicle with a seating capacity of at least six adults (excluding the driver) and with respect to which at least 80 percent of the vehicle's mileage is reasonably expected to be used for transporting employees in connection with travel between their residences and their place of employment and on trips during which the number of employees transported for commuting is at least one-half of the adult seating capacity of the vehicle (excluding the driver).⁵⁶ Transportation is considered provided by the employer if the transportation is furnished in a commuter highway vehicle operated by or for the employer.⁵⁷
 - (ii) Also included is any **transit pass**,⁵⁸ which is any pass, token, farecard, voucher, or similar item (including an item exchangeable for fare media) that entitles a person to transportation or transportation at a reduced price if such transportation is on mass-transit facilities (whether or not publicly owned), or is provided by any person in the business of transporting persons for compensation or hire in a highway vehicle with a seating capacity of at least six adults (excluding the driver).⁵⁹
 - (iii) Finally, any **qualified parking** that is parking provided to an employee by an employer.⁶⁰
 - On or near the employer's business premises; or
 - At a location from which the employee commutes to work by carpool, commuter highway vehicle, mass-transit facilities, transportation provided by any person in the business of transporting persons for compensation or hire, or by any other means.⁶¹
- b. The amount of the fringe benefits that are provided to any employee and that may be excluded may not exceed \$270 per month in the aggregate for transportation in a commuter highway vehicle and transit passes,⁶² and \$270 per month in the case of qualified parking.⁶³ These fringe benefits limitations are for 2021 (unchanged from 2020).
- c. Only employees are eligible for a qualified transportation fringe. For these purposes, an employee does not include a sole proprietor, a partner, or a more-than-two-percent shareholder of an S corporation.⁶⁴
- d. Unlike the de minimis fringe benefits rule, under which \$1 above the facts-and-circumstances amount converts the entire benefit into a taxable benefit, the statute with respect to qualified transportation fringes merely places a limitation on the amount of the

⁵³ I.R.C. §132(a)(5).

⁵⁴ I.R.C. §274(a)(4), as amended by the Tax Cuts and Jobs Act of 2017.

⁵⁵ Treas. Regs. §1.132-9, A-2.

⁵⁶ I.R.C. §132(f)(5)(B).

⁵⁷ I.R.C. §132(f)(5)(D).

⁵⁸ I.R.C. §132(f)(1)(B).

⁵⁹ Treas. Regs. §1.132-9, A-3.

⁶⁰ I.R.C. §132(f)(1)(C).

⁶¹ Treas. Regs. §1.132-9, A-4(a).

⁶² I.R.C. §132(f)(2)(A), Rev. Proc. 2019-44.

⁶³ I.R.C. §132(f)(2)(B). Both of these limitations will be adjusted to the nearest \$5 to account for inflation.

⁶⁴ I.R.C. §132(f)(7). A more-than-two-percent shareholder is treated the same as a partner for purposes of fringe benefits.

exclusion. Thus, the employer's payment of a \$271 monthly parking fee only subjects \$1 to tax in 2021.

5. Federal per-diem rates

The General Services Administration changed the COLI adjustment that affects the period October 1, 2021 through September 30, 2022. The per diem for 10/1/21 to 9/30/22 is \$296 for any high-cost locality, consisting of \$222 for lodging and \$74 for meals and incidentals. The 2022 per diem is \$202 for travel to any other locality, consisting of \$138 for lodging and \$64 for meals and incidentals.⁶⁵ Taxpayers may elect to treat this table as applicable to the calendar year 2022. The special M&IE rates for transportation workers are \$69 for the continental United States and \$74 for any locality outside the continental United States.

- a. For travel away from home, the term "incidental expenses" has the meaning given to it in the Federal Travel Regulations.⁶⁶ For example, the term "incidental expenses" includes fees and tips given to porters, baggage carriers, bellhops, hotel maids, stewards or stewardesses and others on ships, and hotel servants in foreign countries but does not include expenses for laundry, cleaning and pressing of clothing, lodging taxes, or the costs of telegrams or telephone calls.
- b. In lieu of using actual expenses in computing the amount allowable as a deduction for ordinary and necessary incidental expenses paid or incurred for travel away from home, employees and self-employed individuals who do not pay or incur meal expenses for a calendar day (or partial day) of travel away from home may use an amount computed at the rate of \$5 per day for each calendar day (or partial day) the employee or self-employed individual is away from home.

Note:

In 2010, the Internal Revenue Service requested public comment on the continuing need for the high-low method for substantiating, under §274(d) of the Internal Revenue Code, lodging, meal, and incidental expenses incurred in traveling away from home. The Service received no comments.⁶⁷ Accordingly, the Service announced that it intended to **discontinue authorizing the high-low substantiation method**.⁶⁸ In 2011, the Service planned to publish a revenue procedure providing the general rules and procedures for substantiating lodging, meal, and incidental expenses incurred in traveling away from home (omitting the high-low substantiation method). However, based on comments received from tax professionals, the Service withdrew this guidance and reinstated the high-low method.

⁶⁵ Notice 2020-71.

⁶⁶ 41 C.F.R. Part 300 (2003).

⁶⁷ Rev. Proc. 2010-39, 2010-42 I.R.B. 459.

⁶⁸ Ann. 2011-42, 2011-32 I.R.B. 1.

Localities eligible for \$296 (\$74 M & IE) Per-Diem Under High-Low Substantiation Method in 2021-2022		
State	Key city	County or other defined location
Arizona	Sedona (October 1-December 31, March 1-April 30, and September 1-September 30)	City limits of Sedona
California	Los Angeles (October 1-October 31 and January 1-September 30)	Los Angeles, Orange, Ventura, Edwards AFB less the city of Santa Monica
	Mill Valley/San Rafael/Novato (October 1-October 31 and June 1-September 30)	Marin
	Monterey (June 1-August 31)	Monterey
	Napa (October 1-November 30 and April 1-September 30)	Napa
	Oakland	Alameda
	San Diego (February 1-July 31)	San Diego
	San Francisco	San Francisco
	San Mateo/Foster City/Belmont	San Mateo
	Santa Barbara (October 1-September 30)	Santa Barbara
	Santa Monica	City limits of Santa Monica
	Sunnyvale/Palo Alto/San Jose	Santa Clara
Colorado	Aspen (October 1-March 31 and June 1-September 30)	Pitkin
	Crested Butte/Gunnison (December 1-March 31)	Gunnison
	Denver/Aurora (October 1-October 31 and April 1-September 30)	Denver, Adams, Arapahoe, and Jefferson
	Grand Lake (December 1-March 31)	Grand
	Silverthorne/Breckenridge (December 1-March 31)	Summit
	Telluride	San Miguel
	Vail	Eagle
Delaware	Lewes (July 1-August 31)	Sussex
District of Columbia	Washington D.C. (also the cities of Alexandria, Falls Church, and Fairfax, and the counties of Arlington and Fairfax, in Virginia; and the counties of Montgomery and Prince George's in Maryland) (See also Maryland and Virginia) (October 1-September 30)	
Florida	Boca Raton/Delray Beach/Jupiter (December 1-April 30)	Palm Beach and Hendry

	Fort Lauderdale (January 1-April 30)	Broward
	Fort Meyers (February 1-March 31)	Lee
	Fort Walton Beach/De Funiak Springs (June 1-July 31)	Okaloosa and Walton
	Key West (October 1-July 31)	Monroe
	Miami (December 1-March 31)	Miami-Dade
	Naples (December 1-April 30)	Collier
	Vero Beach (December 1-April 30)	Indian River
Georgia	Jekyll Island/Brunswick (March 1-July 31)	Glynn
Illinois	Chicago (October 1-November 30 and April 1-September 30)	Cook and Lake
Maine	Bar Harbor/Rockport (July 1-August 31)	Hancock and Knox
	Kennebunk/Kittery/Sanford (July 1-August 31)	York
Maryland	Ocean City (July 1-August 31)	Worcester
	Washington DC Metro Area (October 1-September 30)	Montgomery and Prince George's
Massachusetts	Boston/Cambridge (October 1-September 30)	Suffolk, city of Cambridge
	Falmouth (July 1-August 31)	City limits of Falmouth
	Hyannis (July 1-August 31)	Barnstable less the city of Falmouth
	Martha's Vineyard (June 1-September 30)	Dukes
	Nantucket (June 1-September 30)	Nantucket
Michigan	Petoskey (July 1-August 31)	Emmet
	Traverse City (July 1-August 31)	Grand Traverse
Montana	Big Sky/West Yellowstone/Gardiner (June 1-September 30)	Gallatin and Park
New Mexico	Carlsbad	Eddy
New York	Lake Placid (July 1-August 31)	Essex
	New York City (October 1-December 31 and March 1-September 30)	Bronx, Kings, New York, Queens, and Richmond
Oregon	Portland (October 1-October 31 and June 1-September 30)	Multnomah
	Seaside (July 1-August 31)	Clatsop
Pennsylvania	Hershey (June 1-August 31)	Hershey
	Philadelphia (October 1-November 30, March 1-June 30, and September 1- September 30)	Philadelphia
Rhode Island	Jamestown/Middletown/Newport (June 1- August 31)	Newport
South Carolina	Charleston (October 1-November 30 and March 1-September 30)	Charleston, Berkeley and Dorchester
	Hilton Head (June 1-August 31)	Beaufort
Tennessee	Nashville	Davidson
Utah	Park City (December 1-March 31)	Summit
Virginia	Virginia Beach (June 1-August 31)	City of Virginia Beach

	Wallops Island (July 1-August 31)	Accomack
	Washington, DC Metro Area (October 1-September 30)	Cities of Alexandria, Fairfax, and Falls Church; counties of Arlington and Fairfax
Washington	Seattle	King
	Vancouver (October 1-October 31 and June 1-September 30)	Clark, Cowlitz, and Skamania
Wyoming	Cody (June 1-September 30)	Park
	Jackson/Pinedale (June 1-September 30)	Teton and Sublette
*The per diem rate for all other localities within the continental U.S. is \$202 (\$64 M & IE)		

6. SIFL rates

Note:

The SIFL rates increased substantially from the second half of 2020 to the first half of 2021. Much of this increase resulted from the COVID-19 pandemic. Per the Department of Transportation, as of the third quarter of 2020, available seat miles fell 30% year over year, while total operating expenses fell 14%. The industry capacity reduced faster than industry expenses.

- a. The final regulations retain the aircraft travel valuation method based upon Standard Industry Fare Level ("SIFL") statistics published semiannually by the Civil Aeronautics Board of the Department of Transportation ("CAB/DOT"). The regulations provide the applicable SIFL statistics for the first half of 1989; updates are provided unless or until such time as the CAB/DOT discontinues publication of these statistics.⁷⁰

Rates for the second half of 2021 were released by the DOT on August 18, 2021.

2021	Terminal Charge	Rate for Miles 0-500	Rate for Miles 501-1500	Rate for Miles Over 1,500
Jul.-Dec.	\$81.43	\$0.4455	\$0.3396	\$0.3265

- b. To determine the value of any employee's flight on a noncommercial aircraft, these cents-per-mile SIFL rates are multiplied by a percentage that varies with both the weight of the aircraft and the kind of employee (as a control or noncontrol employee), and that product is added to the terminal charge. Because the SIFL statistics have not kept pace with inflation in airline travel, these safe-harbor valuation rates offer a bargain, especially for noncontrol employees, in valuing any flight.

Aircraft Take-Off Weight	Multiple for a Control Employee	Multiple for a Noncontrol Employee
0-6,000	0.625	0.156
6,001-10,000	1.25	0.234
10,001-25,000	3	0.313
25,001 and above	4	0.313

Example: An executive flies 1,000 miles on the corporate aircraft having 15,000 lbs. take-off weight in September 2021; the value of this trip is \$1,259.08 ((500 x \$0.4455

⁷⁰ Treas. Regs. §§1.61-21(g)(5) and (6).

+ 500 x \$0.3396) x 3) + \$81.43); for the noncontrol employee it is \$204.30 (((500 x \$0.4455 + 500 x \$0.3396) x 0.313) + \$81.43).

Planning point:

Under the special valuation rules, the value of a flight is determined by using the Standard Industry Fare Level (SIFL) formula, which involves multiplying the SIFL cents-per-mile rates applicable for the period during which the flight was taken by an appropriate aircraft multiple, and then adding an applicable terminal charge for the period in which the flight was taken. The value of personal flights provided to employees under these special rules does not correspond with the employer's actual costs in providing the flights. In a recent case, the employer was entitled to deduct the full costs of providing its executives with a company jet for vacation flights, even though those costs exceeded the compensation that the employees included in income because of the flights.⁷¹ This ran contrary to the Service's position, which caps the employer's deduction for a noncash fringe benefit by the amount of the recipient's reported income from the benefit.⁷²

J. Social Security adjustments

1. Wage base

In 2021, the taxable wage base is \$142,800⁷³ resulting in a maximum OASDI tax of \$8,853.60 (employer's share), \$8,853.60 (employee's share), or \$17,707.20 (self-employed individual). The Medicare portion of the tax remains a combined 2.9 percent on all earned income.

Note:

The retirement benefits of a worker are determined with reference to the worker's primary insurance amount (PIA). The PIA is determined by the worker's adjusted indexed monthly earnings (AIME) over a computation period that generally encompasses the worker's "highest average" 35 years of AIME multiplied by "break point" percentages. (Earnings for this purpose cannot exceed the taxable wage base for the year the earnings accrue.) The indexing takes into account a recalculation of actual earnings increased to reflect percentage increases in the average wages of the population in the interim between the time the earnings are earned and the current year (but generally not after the time the worker turns 60).

2. Excess earnings

- a. Deductions are made from the monthly benefits payable to a worker who is under normal retirement age and to the worker's dependents for each month the worker is charged with earnings in excess of certain amounts. A similar deduction is made in the dependent's benefits when the dependent has excess earnings. These rates do not apply to Social Security benefits based on disability, to persons who are age 70 or older, or to work performed outside the United States not covered by Social Security. Likewise, a divorced spouse's benefits are not reduced because of the insured's excess earnings, provided the divorce has been in effect for two years.
- b. The maximum amount that a beneficiary, the year he or she reaches normal retirement age, might earn in 2021 without affecting the beneficiary's own benefit or those of dependents is \$50,520 (\$4,210 per month). Benefits are reduced by \$1 for every \$3 earned over the annual exempt amount. (Note that this limitation ends with the month in which the beneficiary attains full retirement age. Hereafter, a periodic cost-of-living

⁷¹ *Sutherland Lumber-Southwest, Inc. v. Commissioner*, 114 T.C. 14 (2000).

⁷² TAM 9615002 and 9715001. The case was overturned by the enactment of I.R.C. §274(e)(2).

⁷³ SSA.gov Update 2020, <https://www.ssa.gov/OACT/COLA/cbb.html>.

increase in these benefits will be provided. There is no reduction for persons from full retirement age through age 69.

- c. A lower number is used as a ceiling for those under the normal retirement age; this is \$18,960 (\$1,580 monthly) in 2021. Benefits are reduced \$1 for every \$2 if the individual is between 62 and the year preceding the year he reaches full retirement age. However, an individual is entitled to one grace year, usually the calendar year during which retirement occurs, when excess earnings are not offset against old-age benefits. The grace year occurs when a retiree or survivor entitled to benefits does not receive excess earnings for at least one month, called a **nonservice month**.

Planning point:

The excess earnings reduce the direct and derivative benefits that arise from that earner. Thus, the decision to take early benefits must be tempered by the reduction not just to the worker but also the spouse. Those intending to continue working may find the early retirement decision to result in a greater reduction than the nominal 25-percent reduction. However, note the repayment planning option discussed below.

3. Full retirement age

Listed below are the ages to receive full Social Security benefits (called "full retirement age" or "normal retirement age"). Persons born on January 1 of any year should refer to the previous year. Persons born in 1943 through 1954 may receive full retirement benefits beginning at age 66 years.

Year of Birth	Full Retirement Age
1937 or earlier	65
1938	65 and 2 months
1939	65 and 4 months
1940	65 and 6 months
1941	65 and 8 months
1942	65 and 10 months
1943-1954	66
1955	66 and 2 months
1956	66 and 4 months
1957	66 and 6 months
1958	66 and 8 months
1959	66 and 10 months
1960 and later	67

Note:

The basic benefits of a worker and the worker's dependents and survivors are reduced by early retirement. The wage earner's benefits are reduced five-ninths of one percent for each month the worker receives benefits before normal retirement age, up to 36 months, and five-twelfths of one percent for each month the worker receives benefits before normal retirement age in excess of 36 months.

If the full retirement age is older than 65 (that is, someone born after 1937), retirement benefits may still be taken at age 62, but the reduction in the benefit amount will be greater than it is for people retiring earlier. If your full retirement age is 67 (1960 and later birth years), the reduction for starting benefits at 62 is about 30 percent; at age 63, it is about 25 percent; at age 64, about 20 percent; at age 65, about 13-1/3 percent; and at age 66, about 6-2/3 percent.

If the full retirement age is 66, then the reduction for starting benefits at age 62 is 25 percent.

Year of Birth Full Retirement Age Age 62 Reduction Months Monthly % Reduction Total % Reduction	
1937 or earlier 65 36 0.555 20.00	1955 66 and 2 months 50 0.516 25.84
1938 65 and 2 months 38 0.548 20.83	1956 66 and 4 months 52 0.512 26.66
1939 65 and 4 months 40 0.541 21.67	1957 66 and 6 months 54 0.509 27.50
1940 65 and 6 months 42 0.535 22.50	1958 66 and 8 months 56 0.505 28.33
1941 65 and 8 months 44 0.530 23.33	1959 66 and 10 months 58 0.502 29.17
1942 65 and 10 months 46 0.525 24.17	1960 and later 67 60 0.500 30.00
1943-1954 66 48 0.520 25.00	

Note:

Workers who delay retirement beyond age 66 and consequently do not receive benefits are entitled to an increase in old-age benefits of 8 percent per year for workers reaching retirement age in 2021.

Note:

A husband or wife of an insured individual is entitled to 50 percent of the PIA when the husband or wife reaches normal retirement age. Reduced benefits will be paid if the husband or wife is younger than the normal retirement age, if either spouse has excess earnings under the retirement test, or if either spouse is entitled to a public pension based on the person's own work in noncovered government employment. The benefit of a surviving widow or widower of a worker who died fully insured is generally entitled to 100 percent of the benefit the worker would receive if still living. The widow or widower receives the full benefit if the widow or widower is normal retirement age, or a smaller benefit if between ages 60 and normal retirement age (19/40 percent reduction in benefit per month for retirement prior to normal retirement age). Of course, a spouse may claim benefits based on his or her status as a worker rather than as a spouse. But since the spouse will automatically receive 50 percent of the retirement amount of the other spouse as a floor, certain spouses rejoining the workforce may have to work for some period of time in order to be entitled to a higher retirement benefit than a spousal Social Security benefit.

4. Medicare

The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 imposes a new premium on high-income enrollees in Medicare Part B (physician services) that will vary based on the income reported by each enrollee to the IRS for federal income-tax purposes.⁷⁴ The premium is calculated based on the most-recently-available tax returns (usually a two-year look back). The 2021 premium is based on taxable income for 2019. Termed the "income-related reduction in Part B subsidy," the new premium will effectively constitute an income-tax surcharge. The premium will be in addition to the current flat Part B premium. The two premiums together will be capped at 85 percent of the per-enrollee Part B program costs.⁷⁵ The premium applies to individual seniors with adjusted gross income exceeding \$88,000 per year (adjusted for inflation) and to married couples with adjusted gross income exceeding \$176,000 per year (adjusted for inflation). Furthermore, the Act phases in the maximum premium, so that seniors with even the highest incomes will pay only a fraction of the amount of the Part B subsidy in the early years.⁷⁶

⁷⁴ 42 U.S.C. §1395r(i), I.R.C. §6103(l)(20).

⁷⁵ 42 U.S.C. §1395r(i)(3).

⁷⁶ The statute does not prescribe an explicit rate for the new premium. Rather, the rate will vary from year to year, based on the actuarial value of the Part B benefits for each year. In broadest terms, the fully phased-in rate will be the percentage that, when applied to \$120,000 of a single enrollee's income (i.e., income between \$80,000 and \$200,000) or \$240,000 of a married couple's income (i.e., income between \$160,000 and \$400,000), will equal 55 percent of the actuarial value of the Part B benefits.

In 2021:⁷⁷

2019† AGI more than:	2019† AGI less than:	Premium
Single		
\$0	\$88,000	\$148.50
\$88,000	\$111,000	\$207.90
\$111,000	\$138,000	\$297.00
\$138,000	\$165,000	\$386.10
\$165,000	\$500,000	\$475.20
\$500,000		\$504.90
Married filing jointly		
\$0	\$176,000	\$148.50
\$176,000	\$222,000	\$207.90
\$222,000	\$276,000	\$297.00
\$276,000	\$330,000	\$386.10
\$330,000	\$750,000	\$475.20
\$750,000		\$504.90

5. Premiums for prescription drugs

The drug prescription program is implemented through private insurers so premiums vary from plan-to-plan. Starting January 1, 2011, the Part D monthly premium could be higher based on income. This includes Part D coverage from a Medicare Prescription Drug Plan, a Medicare Advantage Plan, or Medicare Cost Plan that includes Medicare prescription drug coverage. If modified adjusted gross income as reported on your IRS tax return from the most recent tax return information provided to Social Security by the IRS is above a certain amount, you will pay a higher monthly premium.

In 2021:

2019 MAGI more than:	2019 MAGI less than:	Monthly premium addition
Single		
\$0	\$88,000	\$0
\$88,000	\$111,000	\$12.30
\$111,000	\$138,000	\$31.80
\$138,000	\$165,000	\$51.20
\$165,000	\$500,000	\$70.70
\$500,000		\$77.10
Married filing jointly		
\$0	\$176,000	\$0
\$176,000	\$222,000	\$12.30
\$222,000	\$276,000	\$31.80
\$276,000	\$330,000	\$51.20
\$330,000	\$750,000	\$70.70
\$750,000		\$77.10

† The Social Security Administration will use the most recent Form 1040 available to it. Consequently, as of some point during 2021 the MAGI could reference 2020, rather than the current 2019.

⁷⁷

Data for Medicare Parts B and D are available at Medicare.gov.

K. Medical expenses

1. Long-term-care insurance

Under the law, medical care includes **eligible long-term care premiums** for **qualified long-term-care insurance contracts**.⁷⁸ A qualified long-term-care insurance contract means any insurance contract if the only insurance protection provided under such contract is coverage of **qualified long-term care services**, the contract does not pay or reimburse expenses incurred for services or items to the extent that such expenses are reimbursable under Title XVIII of the Social Security Act or would be so reimbursable, but for the application of a deductible or coinsurance amount, they are guaranteed renewable, the contract does not provide for a cash-surrender value or other money that can be paid, assigned, or pledged as collateral for a loan, or borrowed, and all refunds of premiums and all policyholder dividends or similar amounts under such contract are to be applied as a reduction in future premiums or to increase future benefits. They must also generally conform to the long-term-care insurance model act promulgated by the National Association of Insurance Commissioners (as adopted as of January 1993).

- a. For these purposes, **qualified long-term care services** means necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services, and **maintenance or personal care services**, which are required by a chronically ill individual, and are provided pursuant to a plan of care prescribed by a licensed health care practitioner.
 - (i) For these purposes, a chronically ill individual means any individual who has been certified by a licensed health care practitioner as:
 - Being unable to perform (without substantial assistance from another individual) at least two **activities of daily living** for a period of at least 90 days due to a loss of functional capacity;
 - Having a level of disability similar to the level of disability with respect to two activities of daily living; or
 - Requiring substantial supervision to protect such individual from threats to health and safety due to severe cognitive impairment.

Such term does not include any individual otherwise meeting the requirements of the preceding sentence, unless within the preceding 12-month period a licensed health care practitioner has certified that such individual meets such requirements.

- (ii) For these purposes, each of the following is an activity of daily living:
 - Eating;
 - Toileting;
 - Transferring;
 - Bathing;
 - Dressing; and
 - Continence.

A contract shall not be treated as a qualified long-term-care insurance contract unless the determination of whether an individual is a chronically ill individual takes into account at least five of such activities.

⁷⁸ I.R.C. §213(d)(1) [flush language].

- (iii) For these purposes, maintenance or personal care services means any care the primary purpose of which is the provision of needed assistance with any of the disabilities as a result of which the individual is a chronically ill individual (including the protection from threats to health and safety due to severe cognitive impairment).
- b. If the long-term-care insurance contract is an indemnity policy (one which reimburses actual long-term-care costs), all benefits received under the policy are tax-free. If, on the other hand, the long-term-care insurance contract is a per-diem policy (one which pays a set amount per day regardless of actual expenses), a taxpayer can exclude the greater of \$400 per day or actual daily expenses.⁷⁹

Planning point:

The provision of long-term-care insurance is fast becoming a significant part of any retirement plan. Medicaid can only be relied on by the indigent (and, even then, not in every circumstance). It is often impossible (and always time-consuming and frustrating) to try to qualify for Medicaid as a member of the middle class. In addition, there is little personal choice in the context of Medicaid.

Age	2021 Maximum Deductible Premium
40 or less	\$450
More than 40 but not more than 50	\$850
More than 50 but not more than 60	\$1,690
More than 60 but not more than 70	\$4,520
More than 70	\$5,640

If you would like to learn more about Long-Term Care, sign up for *Long-term Care and College Saving: Critical Topics for Today's Practitioner* (LCCS) at surgentcpe.com.

2. Health savings accounts

The Medicare Act of 2003 established a new tax-favored vehicle, the **health savings account (HSA)**, which permits, effective for taxable years beginning after December 31, 2003, an eligible individual for any month during the taxable year to deduct for the taxable year an amount equal to the aggregate amount paid in cash during such taxable year by or on behalf of such individual to the HSA.⁸⁰ This deduction is taken above-the-line in determining adjusted gross income.⁸¹

- a. The amount allowable as a deduction to an individual for the taxable year may not exceed the sum of the **monthly limitations** for months during such taxable year that the individual is an eligible individual.⁸²
 - (i) The monthly limitation for any month is one-twelfth of an amount that depends on the kind of coverage under a high-deductible health plan as of the first day of such month:⁸³

⁷⁹ Per diem amount and maximum deductible premiums are from Rev. Proc. 2020-45.

⁸⁰ I.R.C. §223(a).

⁸¹ I.R.C. §62(19).

⁸² I.R.C. §223(b)(1).

⁸³ I.R.C. §223(b)(2).

- In the case of an eligible individual who has self-only coverage, the amount of \$3,600 in 2021,⁸⁴ or
 - In the case of an eligible individual who has family coverage, the amount of \$7,200 in 2021.⁸⁵
- (ii) In the case of an individual who has attained age 55 before the close of the taxable year, the applicable limitation is increased by the additional contribution amount.⁸⁶ The additional contribution amount is the amount determined in accordance with the following table.⁸⁷

For taxable years beginning in:	The additional contribution amount is:
2009 and thereafter	\$1,000

- (iii) The limitation that would otherwise apply to an individual for any taxable year is reduced (but not below zero) by the sum of:
- The aggregate amount paid for such taxable year to Archer MSAs of such individual,⁸⁸ and
 - The aggregate amount contributed to health savings accounts of such individual, which is excludable from the taxpayer's gross income for such taxable year under §106(d) and such amount shall not be allowed as a deduction.⁸⁹ The aggregate amount paid for such taxable year to Archer MSAs of such individual is not a reduction with respect to any individual in the following paragraph.
- (iv) In the case of individuals who are married to each other, if either spouse has family coverage: both spouses are treated as having only such family coverage (and if such spouses each have family coverage under different plans, as having the family coverage with the lowest annual deductible)⁹⁰ and the monthly limitation (after the application of the reduction for aggregate contribution to Archer MSAs, and without regard to any additional contribution amount):
- Shall be reduced by the aggregate amount paid to Archer MSAs of such spouses for the taxable year; and
 - After such reduction, shall be divided equally between them unless they agree on a different division.
- (v) No deduction is allowed to any individual with respect to whom a deduction under §151 is allowable to another taxpayer for a taxable year beginning in the calendar year in which such individual's taxable year begins.⁹¹

Caution:

The limitation for any month with respect to an individual is **zero** for the first month such individual is entitled to benefits under Title XVIII of the Social Security Act and for each month thereafter.⁹²

⁸⁴ Rev. Proc. 2020-32.

⁸⁵ Rev. Proc. 2020-32.

⁸⁶ I.R.C. §223(b)(3)(A).

⁸⁷ I.R.C. §223(b)(3)(B).

⁸⁸ I.R.C. §223(b)(4)(A).

⁸⁹ I.R.C. §223(b)(4)(B).

⁹⁰ I.R.C. §223(b)(5)(A).

⁹¹ I.R.C. §223(b)(6).

⁹² I.R.C. §223(b)(7).

- b. An “eligible individual” means, with respect to any month, any individual if such individual is covered under a high-deductible health plan as of the first day of such month, and such individual is not, while covered under a high-deductible health plan, covered under any health plan that is not a high-deductible health plan, and that provides coverage for any benefit that is covered under the high-deductible health plan.⁹³ The term “high-deductible health plan” means a health plan:⁹⁴ (i) that has an annual deductible that is not less than \$1,400⁹⁵ for self-only coverage, and twice that dollar amount for family coverage; and (ii) the sum of the annual deductible and the other annual out-of-pocket expenses required to be paid under the plan (other than for premiums) for covered benefits does not exceed \$7,000⁹⁶ for self-only coverage, and twice that dollar amount for family coverage. Such term **does not** include a health plan if substantially all of its coverage is permitted insurance or coverage (whether through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care.⁹⁷ A plan does not fail to be treated as a high-deductible health plan by reason of failing to have a deductible for preventive care (within the meaning of §1871 of the Social Security Act).⁹⁸
- c. Notice 2020-15, released March 11, 2020, addresses the usage of High Deductible Health Plans (HDHPs) and HSAs in relation to 2019 Novel Coronavirus (COVID-19). An HSA-eligible HDHP will not lose its HDHP status under §223(c)(2)(A) if it covers costs for COVID-19 testing and treatment before plan deductibles are met. An individual with an HDHP that covers COVID-19 costs can continue to contribute to an HSA. The intent of this notice is to eliminate financial and administrative barriers to COVID-19 testing and treatment.

L. Other

1. Tax benefits effective for individuals

- a. The deductible limit for health insurance premiums for self-employed taxpayers in 2021 is the lesser of 100 percent of the premium or the earned income derived by the taxpayer from the trade or business with respect to which the plan providing the medical-care coverage is established.
- b. The exclusion for foreign-earned income is \$108,700 in 2021.
 - (i) Under the new law, the base housing amount used in calculating the foreign housing cost exclusion in a taxable year is 16 percent of the amount (computed on a daily basis) of the foreign-earned-income exclusion limitation (instead of the present-law 16 percent of the grade GS-14, step 1 amount), multiplied by the number of days of foreign residence or presence (as previously described) in that year.
 - (ii) Reasonable foreign-housing expenses in excess of the base housing amount remain excluded from gross income (or, if paid by the taxpayer, are deductible), **but** the amount of the exclusion is limited to 30 percent of the maximum amount of a taxpayer's foreign-earned-income exclusion. Under the 30-percent rule, the maximum amount of the foreign-housing-cost exclusion in 2021 is (assuming

⁹³ I.R.C. §223(c)(1)(A).

⁹⁴ I.R.C. §223(c)(2)(A).

⁹⁵ Rev. Proc. 2020-32.

⁹⁶ Rev. Proc. 2020-32.

⁹⁷ I.R.C. §223(c)(2)(B).

⁹⁸ I.R.C. §223(c)(2)(C).

foreign residence or presence on all days in the year) \$15,218 (($\$108,700 \times 30$ percent) – ($\$108,700 \times 16$ percent)).

Caution:

In a major change in calculating income tax, if an individual excludes an amount from income under §911, any income in excess of the exclusion amount determined under §911 is taxed (under the regular tax and alternative minimum tax) by applying to that income the tax rates that would have been applicable had the individual not elected the §911 exclusion.

The Service has issued a notice that uses a higher daily rate for certain higher-priced foreign localities that is taken into account in determining the 30-percent multiplier.⁹⁹

Example: An individual with \$108,700 of foreign-earned income that is excluded under §911 and with \$20,000 in other taxable income (after deductions) would be subject to tax on that \$20,000 at the rate or rates applicable to taxable income in the range of \$108,700 to \$128,700.

- c. In order for taxpayers in 2021 having adjusted gross income in excess of \$150,000 in 2020 to avoid estimated tax penalties, estimated tax payments must be at least 110 percent of the 2019 tax liability.
- d. The Disaster Act, passed on December 20, 2019 as part of the 2020 year-end spending package, amends IRC §213(f) and provides for a reduction in the medical expense deduction floor from 10% to 7.5%. Individuals were eligible to claim an itemized deduction for unreimbursed medical expenses to the extent that the expenses exceeded 7.5% of AGI for tax years beginning after December 31, 2018 and before January 1, 2021. The Consolidated Appropriations Act of 2021 makes the 7.5-percent-of-AGI threshold for the medical expense deduction floor permanent for itemizers claiming unreimbursed medical expenses. This provision is applicable for tax years beginning after December 31, 2020.

2. Interest rates for fourth quarter of 2021

The IRS has announced that the interest rates for the quarter beginning January 1, 2021, are 3 percent for overpayments (2 percent for a corporation), 3 percent for underpayments (noncorporate taxpayers and corporations), 5 percent for large corporate underpayments, and 0.5 percent for the portion of a corporate overpayment exceeding \$10,000.¹⁰⁰

Note:

For taxpayers other than corporations, the overpayment and underpayment rate is the federal short-term rate plus 3 percentage points. Generally, in the case of a corporation, the underpayment rate is the federal short-term rate plus 3 percentage points and the overpayment rate is the federal short-term rate plus 2 percentage points. The rate for large corporate underpayments is the federal short-term rate plus 5 percentage points. The rate on the portion of a corporate overpayment of tax exceeding \$10,000 for a taxable period is the federal short-term rate plus one-half of a percentage point.

⁹⁹ Notice 2007-77; 2007-40 I.R.B. 1.
¹⁰⁰ IR-2020-52.

3. Adoption expenses

A tax credit is allowed for **qualified adoption expenses** paid or incurred by a taxpayer. In 2021 the maximum credit is \$14,440¹⁰¹ per eligible child, including special-needs children. A \$14,440 credit is provided in the year a special-needs adoption is finalized, regardless of whether the taxpayer has qualified adoption expenses.

- a. Qualified adoption expenses are reasonable and necessary adoption fees, court costs, attorneys' fees, and other expenses that are: (i) directly related to, and the principal purpose of which is for, the legal adoption of an eligible child by the taxpayer; (ii) not incurred in violation of state or federal law, or in carrying out any surrogate parenting arrangement; (iii) not for the adoption of the child of the taxpayer's spouse; and (iv) not reimbursed (e.g., by an employer).
- b. A taxpayer may exclude up to \$14,440 in 2021 per eligible child, including special-needs children, for employer-provided adoption assistance to reimburse qualified adoption expenses. In the case of a special-needs adoption, the exclusion is provided regardless of whether the taxpayer has qualified adoption expenses. The exclusion does not apply for purposes of payroll taxes.

Note:

Adoption expenses paid or reimbursed by the employer under an adoption assistance program are not eligible for the adoption credit. A taxpayer may be eligible for the adoption credit (with respect to qualified adoption expenses he or she incurs) and also for the exclusion (with respect to different qualified adoption expenses paid or reimbursed by his or her employer).

- c. The adoption credit (and the employer-provided adoption assistance exclusion) is phased out ratably for taxpayers with modified adjusted gross income between \$216,660 and \$256,660 in 2021.¹⁰²
- d. An eligible child is an individual who: (i) has not attained age 18; or (ii) is physically or mentally incapable of caring for himself or herself. A special-needs child is an eligible child who is a citizen or resident of the United States who a state has determined: (i) cannot or should not be returned to the home of the birth parents; and (ii) will not be adopted unless special assistance is provided to the adoptive parents. Factors include whether the child has a specific factor or condition (such as the child's ethnic background, age, or membership in a minority or sibling group), and whether the child has a medical condition, or a physical, mental, or emotional handicap.
- e. The newly passed SECURE Act contains favorable updates for both **qualified adoption expenses** and **qualified births**. The SECURE Act allows for penalty-free withdrawals from retirement plans of up to \$5,000 per individual in the event of a qualified birth of a child or adoption for distributions made after December 31, 2019. This provision is a new exemption from the 10% penalty tax of §72(t) for early withdrawals from qualified plans and IRAs.

Married couples may separately take a \$5,000 distribution for a qualified birth or adoption, providing for a \$10,000 total distribution allowance per married couple. An eligible adoptee includes any individual under the age of 18 or who is incapable of self-support, specifically excluding any child(ren) of the taxpayer's spouse. The distribution

¹⁰¹ Rev. Proc. 2020-45.

¹⁰² Adoption credit amounts and limitations updated by Rev. Proc. 2019-44.

must be taken within a one-year period beginning on the date on which the child is born or on which the adoption of a child is finalized.

4. FUTA surtax reduced

Unemployment insurance (UI) is financed by a combination of state and federal taxes on employers based on the wages of each employee. The Federal Unemployment Tax Act (FUTA) had imposed a federal payroll tax on employers of 6.2 percent of the first \$7,000 paid annually to each employee. The tax funds a portion of the federal/state unemployment benefits system. This 6.2-percent rate included a temporary (set in 1985 and extended thereafter) surtax of 0.2 percent. Employers in states that meet certain federal requirements were allowed a credit for state unemployment taxes of up to 5.4 percent, making the minimum net federal tax rate 0.8 percent. The surtax has expired, and the minimum net federal tax rate is now 0.6 percent.

5. Section 448(c)(1) gross receipts limitation

The gross receipts limitation of §448(c)(1) is \$26,000,000. Section 448(c)'s primary purpose has been to limit the ability of C corporations to use the cash method of accounting. C corporations may use the cash method of accounting if their average gross receipts for the prior three years do not exceed the §448(c)(1) amount. However, the Tax Cuts and Jobs Act references the §448(c) limit for other purposes. Some impacted code sections include:

- a. **Section 163(j) business interest limitation:** Businesses are not subject to the new business interest limitation if they meet the gross receipts test of §448(c).¹⁰³
- b. **Section 263A capitalization rules:** A business is exempt from the §263A Unicap rules if it meets the gross receipts test of §448(c).¹⁰⁴
- c. **Section 460 accounting for long-term contracts:** A contractor that meets the gross receipts test of §448(c) may use the completed contract method to account for contracts if the taxpayer and contracts qualify under the provisions of §460.¹⁰⁵
- d. **Section 471 inventory requirement:** A business is not required to follow the inventory rules of §471 if they meet the gross receipts test of §448(c). They may instead treat inventories in a manner consistent with applicable financial statements or as non-essential materials and supplies. This means that businesses who were required to use the accrual method of accounting in the past because they had inventories and their gross receipts exceeded \$1,000,000 may now use the cash method of accounting and change their inventory method.¹⁰⁶

M. Retirement plan 2021 numbers¹⁰⁷

1. Maximum annual benefit

The maximum single-life annuity for a defined-benefit plan in 2021 is \$230,000 (unchanged from 2020).

2. Maximum annual addition

The maximum annual addition to a defined-contribution plan in 2021 is \$58,000, increased from \$57,000 in 2020.

¹⁰³ I.R.C. §163(j)(3).

¹⁰⁴ I.R.C. §263A(i).

¹⁰⁵ I.R.C. §460(e)(1)(B)(ii).

¹⁰⁶ I.R.C. §471(c)(1).

¹⁰⁷ Retirement plan numbers updated by IRS Notice 2020-79.

3. Maximum compensation considered

The maximum amount of compensation that can be taken into account under any qualified plan allocation or benefit formula in 2021 is \$290,000, increased from \$285,000 in 2020.

Note:

Generalizations with respect to a defined-benefit plan are more difficult, as the contributions not only depend on compensation level but also the age of the participant and the number of years before the normal retirement age under the plan when the benefits must be fully funded. If the benefit formula is a fixed amount (\$3,000 per month), the change in the limit has no effect. If the formula is a unit benefit type, where the benefit that is earned each year is based solely on the compensation for that year, the change in the maximum will require marginally more funding in all succeeding years for the highly compensated employee. The most interesting and potentially most expensive case is where the benefit formula is based on some percentage of a career-high average. As the higher compensation is taken into account, it not only increases the funding requirement for the current year, but generates in effect liabilities in respect of past years. Quantifying the effect for budgeting purposes requires the services of an actuary. Again, while the effect may be to require a higher funding level for the highly compensated to the extent there is an increased benefit, now is the time to have the additional costs determined so as to choose whether to continue the plan as is, or reduce, in respect of future years, the benefit formula.

Note:

Qualified retirement-planning services provided to an employee and his or her spouse by an employer maintaining a qualified plan after December 31, 2001 are excludable from income and wages without regard to the requirements of an education-assistance program or fringe benefit. "Qualified retirement-planning services" are retirement-planning advice and information. The exclusion is not limited to information regarding the qualified plan, and thus, for example, applies to advice and information regarding retirement-income planning for an individual and his or her spouse and how the employer's plan fits into the individual's overall retirement-income plan.

Caution:

On the other hand, the exclusion does not apply to services that may be related to retirement planning, such as tax-preparation, accounting, legal, or brokerage services.

The exclusion does not apply with respect to highly compensated employees unless the services are available on substantially the same terms to each member of the group of employees that is normally provided education and information regarding the employer's qualified plan. It is intended that the treatment of retirement advice will be provided in a nondiscriminatory manner. It is intended that, in determining the application of the exclusion to highly compensated employees, the Service may permit employers to take into consideration employee circumstances other than compensation and position in providing advice to classifications of employees. Thus, for example, the Secretary may permit employers to limit certain advice to individuals nearing retirement age under the plan.

4. SIMPLE deferral maximum

The maximum amount of deferral in a SIMPLE plan in 2021 is \$13,500 (unchanged from 2020).

Table 1 -- SIMPLE Deferral Limits

For year beginning in calendar year:	The applicable dollar amount:
2021	\$13,500

Table 2 -- Catch-Up Elective Deferrals for SIMPLE and SIMPLE-§401(k) Plans

For taxable years beginning in:	The applicable dollar amount is:
2021	\$3,000

Under a SIMPLE plan, an employer is generally required to make a contribution on behalf of each eligible employee in an amount equal to the employee's salary-reduction contributions, up to a limit of three percent of the employee's compensation for the entire calendar year.¹⁰⁸

Note:

For the business owner concerned about the maximum tax-shelter potential of the SIMPLE, note that the maximum matching contribution for an individual with \$450,000 of compensation or more is \$13,500. A \$13,500 salary deferral, plus the \$13,500 match, results in a maximum contribution of \$27,000. Above \$450,000 in compensation, the match cannot exceed \$13,500. If the participant earns less than \$450,000, the maximum contribution is less. For example, a person with compensation of \$150,000 is eligible for the matching contribution of \$4,500 (three percent of \$150,000). The table below identifies the maximum contribution for individuals at various salary levels.

In 2021:

Maximum SIMPLE IRA Contribution			
Salary	Maximum salary deferral	Matching contribution	Total contribution
\$50,000	\$13,500	\$1,500	\$15,000
\$75,000	\$13,500	\$2,250	\$15,750
\$100,000	\$13,500	\$3,000	\$16,500
\$125,000	\$13,500	\$3,750	\$17,250
\$150,000	\$13,500	\$4,500	\$18,000
\$160,000	\$13,500	\$4,800	\$18,300
\$175,000	\$13,500	\$5,250	\$18,750
\$450,000 or more	\$13,500	\$13,500	\$27,000

5. SEP minimum compensation

The threshold level of compensation at which an employer must cover an employee in a SEP in 2021 is \$650, increased from \$600 in 2020.

- a. If an employer establishes and maintains an individual retirement account or annuity that qualifies as a SEP, the maximum amount that the employer may contribute is the lesser of \$58,000 in 2021 or 25 percent of the employee's compensation.¹⁰⁹ An employee for whom an employer contributes under a SEP is allowed a deduction for the employee's contributions to an IRA subject to the phase out rule for active participants.
- b. Generally, any employee is protected from current tax only if the employer's contribution does not exceed the lesser of 25 percent of the employee's compensation from that employer or \$58,000 in 2021.

Example: Corporation Q has established a SEP arrangement for the benefit of its eligible employees. Employee A earns \$100,000 in compensation from Q in 2021. For 2021, the most Q can contribute to the SEP of A (without causing tax to A) is \$25,000 (25 percent of \$100,000). Twenty-five percent of A's compensation is less than \$58,000, so this is the applicable prong of the two-part limitation. Note that for purposes of calculating 25 percent of the employee's compensation, the employer's contribution to the employee's SEP is ignored. Thus, the limitation for Q is 25 percent of \$100,000, not 25 percent of \$125,000.

¹⁰⁸ I.R.C. §§408(p)(2)(A)(iii) and (C)(ii)(I). See Notice 98-4, 1998-2 I.R.B. 25, Q&A, D-4.

¹⁰⁹ For the self-employed person, compensation means earned income as reduced for other contributions. I.R.C. §408(k)(7)(B). This is further reduced by the deduction for self-employment taxes.

- c. If an employer contributes more than the lesser of 25 percent of compensation or \$58,000 in 2021 to the SEP of an employee, the amount in excess of that limitation is treated as an excess contribution by the employee to an IRA. On or before the due date for filing the employee's tax return (including extensions), the employee should withdraw the amount of the excess and any income on that amount. The employee thus would avoid a six-percent excise tax on the excess contribution, but must pay tax on the amount of the contribution that exceeds the limitation.

6. Maximum elective deferral

The maximum amount of deferral in a §401(k) plan or §403(b) plan in 2021 is \$19,500 (unchanged from 2020).

Elective deferrals increase to the applicable amount in accordance with the following schedule.

Table 3 -- Elective-Deferral Limits

For taxable years beginning in calendar year:	The applicable dollar amount is:
2021	\$19,500

A qualified plan may now allow additional elective deferrals to be made to the plan by a participant who attains the age of 50 before the end of the plan year.

Table 4 -- Catch-Up Elective Deferrals for §401(k) and Other Qualified Plans

For taxable years beginning in:	The applicable dollar amount is:
2021	\$6,500

The additional elective deferrals are generally not taken into account under the actual deferral percentage (ADP) or other limitations on such contributions. The applicable dollar amount increases in the cost of living at the same time and in the same manner as adjustments for annual benefits and additions, except that the base period taken into account is the calendar quarter beginning July 1, 2005, and any increase that is not a multiple of \$500 is rounded to the next lower multiple of \$500.

Note:

Since elective deferrals generally represent amounts the employer would have deducted under §162 for reasonable compensation but for the preemptive effect of §404 with respect to amounts contributed to a qualified plan, the elective-deferral component of the contribution is deducted as compensation rather than as a contribution.

Planning point:

Elective deferrals remain an annual addition, but the amount subject to the 25-percent-of-compensation limitation does not include them, but only the matching and any other nonelective employer contributions. Subject to any other limitations (such as the annual-additions limitation), an employee may defer 100 percent of current salary **and** the employer may deduct not only the amount so deferred by the employee but also up to 25 percent of the total participant compensation for the year for other contributions.

Planning point:

One of the major motivations for the use of a money-purchase pension plan rather than a profit-sharing plan lay in the enhanced deductibility of contributions up to 25 percent of total compensation to “fully fund” the annual additions. The disadvantage of a money-purchase pension plan is that as a pension plan, the formula for contributions is fixed and creates an annual liability much as a defined-benefit plan does. The change in the deductibility of contributions to a profit-sharing plan puts the future of the money-purchase plan in some doubt, as the enhanced deductibility and the annual-additions limitation can now be met by a profit-sharing plan that does not commit the employer to any specific level of contributions annually.

7. Highly compensated employee

The minimum compensation of an employee owning less than five percent of the stock of the employer to be treated as a highly compensated employee is \$130,000 in 2021 (unchanged from 2020).

8. Self-employed persons

- a. The §401(k) plan is essentially a profit-sharing plan with elective deferrals. The following worksheet assumes that the employer's contributions are allocated to each participant's account in accordance with compensation, i.e., the plan is not age-weighted or otherwise cross-tested.
- b. Since the base of contributions to a SEP is earned income, the following worksheet is necessary to determine the contribution to a SEP on behalf of that self-employed person.

In 2021:

1. Nominal plan stated rate	
2. Add “1” to Step (1)	
3. Self-employed rate Step 1/Step 2	
4. Net earnings (Line 31, Sch. C; Line 3; Line 15a, Schedule K-1 of Form 1065)	
5. Self-employment income Step (4) x 0.9235)	
6. Taxable wage base	
7. Lesser of Step (5) or Step (6)	
8. Step (7) x 0.124	
9. Step (5) x 0.029	
10. Total self-employment tax Step (8) plus Step (9)	
11. Self-employment tax deduction Step (8) x 0.5 + .5 x Step (9)	
12. Earned income Step (4) – Step (11)	
13. Nominal contribution Step (12) x Step (3)	
14. \$290,000 x Step (3)	
15. Maximum dollar annual addition	
16. Lesser of Step (14) and Step (15)	
17. Maximum deductible contribution lesser of Step (13) and Step (16)	
18. Elective deferral	
19. Catch-up contribution†	
20. Total maximum contribution (Step (17) + Step (18) + Step (19)	

† Only available to SARSEPS in place as of December 31, 1996. All other SEPS stop at line 17.

In 2021:

Representative Table of Maximum SEP contributions

Schedule C	Employer contribution	Under-50 Maximum	Catch-up†	Over-50 Maximum†
\$50,000	\$9,294	\$9,294	\$6,500	\$15,794
\$100,000	\$18,587	\$18,587	\$6,500	\$25,087
\$150,000	\$27,826	\$27,826	\$6,500	\$34,326
\$200,000	\$37,683	\$37,683	\$6,500	\$44,183
\$300,000	\$57,321	\$57,321	\$6,500	\$63,821
\$400,000	\$58,000	\$58,000	\$6,500	\$64,500

- c. The contribution level for self-employed persons in a SIMPLE plan depends on the net earnings from self-employment. Remember, neither the \$415 nor the compensation limitations generally apply.

1. Net earnings (Line 31, Schedule C; Line 3 Schedule C-EZ; Line 15a, Schedule K-1 of Form 1065)	
2. Self-employment income Step (1) x 0.9235)	
3. Contribution rate	
4. Contribution Step (2) x Step (3)	
5. Elective deferral	
6. Total contribution sum of Step (4) and Step (5)	
7. Catch-up contribution	
8. Total contributions Step (6) and Step (7)	

To obtain the maximum contribution to a SIMPLE, the self-employed person must have bottom-line Schedule C income of at least \$487,277.

1. Net earnings (Line 31, Schedule C; Line 3 Schedule C-EZ; Line 15a, Schedule K-1 of Form 1065)	\$487,277
2. Self-employment income Step (1) x 0.9235)	\$450,000
3. Contribution rate	0.03
4. Contribution Step (2) x Step (3)	\$13,500
5. Elective deferral	\$13,500
6. Total contribution Sum of Step (4) and Step (5)	\$27,000
7. Catch-up contribution	\$3,000
8. Total contributions Step (6) and Step (7)	\$30,000

Representative Table of Maximum SIMPLE contributions

Schedule C	Employer contribution	Elective deferral	Under-50 Maximum	Catch-up	Over-50 Maximum
\$50,000	\$1,500	\$13,500	\$15,000	\$3,000	\$18,000
\$100,000	\$3,000	\$13,500	\$16,500	\$3,000	\$19,500
\$150,000	\$4,500	\$13,500	\$18,000	\$3,000	\$21,000
\$200,000	\$6,000	\$13,500	\$19,500	\$3,000	\$22,500
\$250,000	\$7,500	\$13,500	\$21,000	\$3,000	\$24,000

9. IRAs

An IRA (other than SEP or SIMPLE) cannot accept more than \$6,000 (\$7,000 if age 50 or older) in contributions for any taxable year (not including rollover amounts) in 2021 (unchanged from 2020).¹¹⁰ This limit applies to both regular and Roth IRAs, but the annual contribution limit may be divided between such IRAs as the owner may determine. In certain circumstances, a married individual may make IRA contributions of more than \$6,000 (\$7,000 if age 50 or older) per taxable year. The contributions must be made to a combination of the married individual's own IRA and the nonworking spouse's IRA, because

¹¹⁰ I.R.C. §408(o)(2).

neither IRA is permitted to receive more than \$6,000 (\$7,000 if age 50 or older) in contributions per taxable year (excluding rollover contributions).

- a. An IRA owner may never deduct more than the lesser of \$6,000 (\$7,000 if age 50 or older) or taxable compensation.¹¹¹ This amount may be further limited if the IRA owner or the owner's spouse is an "active participant" in an employer-sponsored retirement plan.
- b. In 2021, the deductibility of contributions to regular IRAs for active participants is phased out in a pro rata fashion over the applicable phase out range of AGI. For example, if the applicable phase out range of AGI is \$66,000 to \$76,000, a taxpayer with AGI of \$69,000 who actively participates in a qualified plan would be permitted to contribute \$6,000 to an IRA, but would only be permitted to deduct \$4,200 of that \$6,000 contribution. The remaining \$1,800 (0.3 of \$6,000) would be a nondeductible contribution.
- c. **AGI phase out ranges** -- The phase out range depends upon filing status and the year in which the contribution is made.

Taxable years beginning in:	Joint returns phase out range	Single taxpayers phase out range
2021	\$105,000 - \$125,000	\$66,000 - \$76,000

- d. The maximum deductible IRA contribution for an individual who is not an active participant, but whose spouse is, is phased out for taxpayers with AGI between \$198,000 and \$208,000 in 2021.
- e. For 2021, the dollar amount an individual who is not married may contribute to a Roth IRA is phased out ratably between modified AGI of \$125,000 and \$140,000; for a married individual filing a joint return, between modified AGI of \$198,000 and \$208,000 and for married individual filing separately, between modified AGI of \$0 and \$10,000.

¹¹¹ I.R.C. §219(b)(1).

Investments, Retirement, and Miscellaneous

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Investments, Retirement, and Miscellaneous

Learning objectives

Upon reviewing this material, the reader will be able to:

- Explain what constitutes a real estate professional in terms of participation and what constitutes a real property trade or business; and
- Discuss the challenges of self-employed (unincorporated) individuals with no common-law employees, who typically are looking to shelter some income but need the flexibility to make varying contributions each year.

I. Investments

A. Real estate

1. The law

A taxpayer qualifies as a real estate professional and is not engaged in a passive activity from rental activities if: (i) more than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates; and (ii) such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates [750-hour service performance requirement]. In the case of a joint return, the foregoing requirements for qualification as a real estate professional are satisfied if, and only if, either spouse separately satisfies the requirements. Thus, if either spouse qualifies as a real estate professional, the rental activities of the real estate professional are not per se passive.

With respect to the evidence that a taxpayer may use to establish his or her hours of participation in a trade or business, the extent of participation in an activity may be established by any reasonable means. Contemporaneous daily time reports, logs, or similar documents are not required if the extent of participation may be established by other reasonable means. Reasonable means may include but are not limited to the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries. While the regulations allow taxpayers some latitude in establishing the extent of their participation in an activity, Tax Courts have consistently held that they do not allow a post-event “ballpark guesstimate.”¹ With respect to the requirement that the hours a taxpayer spent on real property trades or businesses accounted for more than one-half of the total hours of personal services the taxpayer performed in all trades or businesses during the subject years, to qualify as a real estate professional, the taxpayer must aggregate all hours of personal services in trades or businesses.

For purposes of determining whether a taxpayer is a real estate professional, a taxpayer’s material participation is determined separately with respect to each rental property, unless the taxpayer makes an explicit election to treat all interests in rental real estate as a single rental real estate activity.² The Court will evaluate each of a taxpayer’s properties separately in order to determine whether taxpayer materially participated in real estate activity for each property.

¹ See *Goshorn v. Commissioner*, T.C. Memo. 1993-578; see also *Moss v. Commissioner*, 135 T.C. 365, 369 (2010); *Fowler v. Commissioner*, T.C. Memo. 2002-223.

² I.R.C. §469(c)(7)(A); *Bailey v. Commissioner*, T.C. Memo. 2001-296; Treas. Regs. §§1.469-9(c)(3), (e)(1).

An individual may meet the material participation requirement by demonstrating that he or she participated in the rental activity for more than 100 hours during the taxable year and that his or her participation is not less than the participation of any other individual (including individuals who are not owners of interests in the activity) during that year. For purposes of the material participation requirement, participation by an individual's spouse can be added to the participation of the individual. Additionally, material participation can be met if historical material participation was met during any five of the ten immediately preceding tax years.

An individual must establish that he or she materially participated in each of the rental activities unless the individual makes an election to treat all interests in rental real estate as a single rental activity.³

2. Procedures to obtain extensions for single rental real estate activity treatment

Effective June 13, 2011, the IRS issued guidance allowing some taxpayers to make late elections to treat all interests in rental real estate as a single rental real estate activity.⁴ The guidance provides special procedures, in lieu of the letter ruling procedure under §9100, to obtain relief for late elections under Regs. §1.469-9(g). A taxpayer ineligible for relief under this guidance may request relief by applying for a letter ruling.

- a. In general, §469(c)(7)(A) provides that a taxpayer's interests in rental real estate are treated as separate activities for determining whether the taxpayer materially participates in each rental real estate activity unless the taxpayer elects to treat all of the taxpayer's interests in rental real estate as a single rental real estate activity. A qualifying taxpayer may make an election to treat all of the taxpayer's interests in rental real estate as a single rental real estate activity. A qualifying taxpayer makes the election to treat all interests in rental real estate as a single rental real estate activity by filing a statement with the taxpayer's **original income tax return** for the taxable year.

The law:

For purposes of determining whether a taxpayer is a real estate professional, a taxpayer's material participation is determined separately with respect to each rental property, unless the taxpayer makes an explicit election to treat all interests in rental real estate as a single rental real estate activity.⁵ The Court will evaluate each of a taxpayer's properties separately in order to determine whether taxpayer materially participated in real estate activity for each property.

- b. The Commissioner may under §9100 grant a reasonable extension of time to make a regulatory election, or a statutory election. Requests for relief will be granted when the taxpayer provides evidence to establish that the taxpayer acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer meets one of the requirements, which include that the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make, or advise the taxpayer to make the election.
- c. The procedures in this revenue procedure are in lieu of the letter ruling procedure that is used to obtain relief for a late §1.469-9(g) election. Accordingly, user fees do not apply to corrective action under this revenue procedure. However, a taxpayer that is not eligible

³ Treas. Regs. §1.469-9(e)(1).

⁴ Rev. Proc. 2011-34; 2011-24 I.R.B. 875.

⁵ I.R.C. §469(c)(7)(A); *Bailey v. Commissioner*, T.C. Memo. 2001-296; Treas. Regs. §§1.469-9(c)(3), (e)(1).

for relief under this revenue procedure may request relief by applying for a private letter ruling, but the Service will not ordinarily issue a private letter ruling if the period of limitations on assessment has lapsed for any taxable year that would be affected by the requested late election. Any taxpayer receiving relief under the guidance is **treated as having made a timely election to treat all interests in rental real estate as a single rental real estate activity** as of the tax year for which the late election is requested.

- d. A taxpayer is eligible for an extension of time to file an election if the taxpayer represents on a statement that satisfies the procedural requirements and under penalties of perjury that it meets all of the following requirements.
- (i) The taxpayer failed to make an election **solely because the taxpayer failed to timely meet the requirements** in §1.469-9(g).
 - (ii) The taxpayer **filed consistently with having made an election** on any return that would have been affected if the taxpayer had timely made the election. The taxpayer must have filed all required federal income tax returns consistent with the requested aggregation for all of the years including and following the year the taxpayer intends the requested aggregation to be effective and no tax returns containing positions inconsistent with the requested aggregation may have been filed by or with respect to the taxpayer during any of the taxable years.
 - (iii) The taxpayer **timely filed each return** that would have been affected by the election if it had been timely made. The taxpayer will be treated as having timely filed a required tax or information return if the return is filed within six months after its due date, excluding extensions.
 - (iv) The taxpayer has **reasonable cause for its failure to meet the requirements**.

Note:

The taxpayer must attach the statement to an amended return for the most recent tax year and mail the amended return to the IRS service center where the taxpayer will file its current year tax return. The statement must contain the **declaration** required, must explain the **reason for the failure to file a timely election**, and must include the representations required in this revenue procedure. The statement must identify the taxable year for which it seeks to make the late election. Finally, the statement must state at the top of the document "FILED PURSUANT TO REV. PROC. 2011-34."

The declaration and representations required in this revenue procedure must be accompanied by a dated declaration, signed by the taxpayer which states: "Under penalties of perjury I (we) declare that I (we) have examined this election, including any accompanying documents, and, to the best of my (our) knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete." The individual or individuals who sign must have personal knowledge of the facts and circumstances related to the election.

Note:

The granting of an extension of time to file an election and the issuance of a notification do not constitute an express or implied determination concerning whether the taxpayer satisfies the eligibility requirements of this revenue procedure, whether the taxpayer satisfies the real estate professional requirements, or whether the taxpayer materially participates in any activity.

The law:

An individual may meet the material participation requirement by demonstrating that he or she participated in the rental activity for more than 100 hours during the taxable year and that his or her participation is not less than the participation of any other individual (including individuals who are not owners of interests in the activity) during that year. For purposes of the material participation requirement, participation by an individual's spouse can be added to the participation of the individual.

An individual must establish that he or she materially participated in each of the rental activities unless the individual makes an election to treat all interests in rental real estate as a single rental activity.⁶

Planning point:

The additional tax on unearned income also permits a taxpayer to make a grouping election if the taxpayer is first subject to the net investment income tax.

B. Cases

1. *Taryn L. Dodd v. Comm'r, T.C. Memo. 2021-118*

Facts:

In 2013, Taryn Dodd was employed as an office manager at Braude & Marguiles, P.C. (B&M), a law firm in Washington, D.C. that specialized in real estate and construction law. Additionally, Dodd was a managing member of Cadillac Investment Partners, LLC, which was involved in the purchase, leasing, and sale of real property. She held a 33.5% share of Cadillac's profit, loss, and capital account, and she regularly signed agreements, tax returns, and documents on Cadillac's behalf. Herman Braude held the remaining 66.5% interest in Cadillac's profit, loss, and capital account. He was also the founding member of B&M.

In 2013, Cadillac sold commercial real property for \$4 million and generated a net \$1231 gain of \$3,203,916, which was reported on Form 1065 that was signed by Dodd. As Cadillac's managing member, Dodd received a Schedule K-1 with her \$1,073,312 share of the net \$1231 gain. She also was allocated ordinary business income, net rental real estate income, and distributions.

Dodd timely filed her 2013 Form 1040 and included Form 4797 with her return, reporting net \$1231 gain of \$1,073,312. While she reported a tax liability of \$183,976, withholding credits of \$14,245, and "amount you owe" as \$169,882, she included no payment with her return. On August 18, 2014, the IRS assessed the tax shown on the return as due, as well as imposed an addition to tax for failure to pay and interest. Dodd did not pay the liability upon receiving this notice. On September 5, 2016, the IRS issued Dodd a Notice CP92, *Seizure of Your State Tax Refund and Your Right to a Hearing*. Dodd timely requested a CDP hearing and challenged the tax liability, citing her inability to pay the tax as she never received the \$1,073,312 reported on her return. Rather, Dodd claimed the proceeds from the sale of commercial real property were used to pay off the Bank credit line of B&M law firm. She claimed that such gain was reported in error and she would like to resolve the issue at the CDP hearing.

During the first CDP hearing, the Settlement Officer told Dodd that no collection alternatives could be considered because she had supplied no financial information. Dodd was not offered additional time to supply this information and did not address her challenge to the tax liability. The IRS subsequently issued

⁶ Treas. Regs. §1.469-9(e)(1).

Dodd a notice of determination sustaining the collection action, asserting incorrectly that she did not raise a challenge to the existence or amount of the underlying liability.

During the first supplemental CDP hearing, the Settlement Officer sent Dodd a letter, stating that the 2013 tax liability was determined based on the documents that Dodd submitted and the return that was filed by Dodd. It further asked that if any figures were in error, that Dodd submit an amended return for review within three weeks. Dodd did not submit an amended return within three weeks, so the Settlement Officer informed Dodd that the collection would be sustained, and a supplemental notice of determination issued. It was later determined that the Settlement Officer failed to determine Dodd's underlying liability challenge, and the case was remanded to the Appeals Office for a second supplemental hearing.

During the second supplemental hearing, a new Settlement Officer, along with an Appeals Officer, were assigned to Dodd's case and confirmed that her 2013 tax was properly assessed. The Appeals Officer requested certain documents from Dodd, including Cadillac's partnership agreement and loan documents. The loan documents stated that certain property was held as collateral for the loan, and provided that repayment of the loan would be accelerated if such property was sold. The property that generated the 2013 net §1231 gain served as collateral for this loan, and as a result, the sale of the property triggered the acceleration clause. The funds from the sale of the property were wired to pay off the loan in 2013. Dodd provided the Settlement Officer with a reconciliation of her adjusted basis in Cadillac at year-end 2013. Dodd's adjusted basis included an increase of \$1,073,312 attributable to her share of the net §1231 gain, a subsequent \$611,994 decrease in basis related to the reduction of her share of partnership liabilities, and a \$201,601 decrease in basis as a result of a distribution.

The Appeals Officer and Settlement Officer concluded that Dodd constructively received the net §1231 gain and would be taxed on it. Dodd provided Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals*, to the Settlement Officer, which demonstrated her ability to pay for the 2013 tax liability. The Settlement Officer offered an installment agreement, but Dodd never followed up on this matter. As a result, several months later, the Settlement Officer closed the case and issued a supplemental notice of determination sustaining the collection action. The case was remanded to the Tax Court for further proceedings and the parties agreed to submit the case for decision without trial under Rule 122.

Issues & Analysis

Section 702(a) provides that a partner is taxable on their distributive share of partnership income, regardless of whether the income is actually distributed. Dodd claimed that the property sale proceeds went directly to the bank to pay off the loan and she never received the money directly or indirectly. The Court stated that this was not true, as Dodd benefited from the repayment since her basis was reduced by her share of Cadillac's liabilities in 2013. Dodd asserted the balance of the proceeds was used to pay off a line of credit at the B&M law firm, but she never submitted evidence that this occurred. Under §702(a), it does not matter whether Dodd benefitted from any repayment, as she is taxed on her share of net §1231 gain, regardless of whether it was distributed.

Preparers may have heard of similar situations of "phantom income" haunting certain partners. It does not matter whether a partner actually receives cash as a result of their share of gain; they are still liable for any tax resulting from their share of the gain.

Conclusion

The Court concluded Dodd was required to include \$1,072,312 of net \$1231 gain in gross income for 2013, rejected her challenge to the tax liability, and sustained the collection action.

2. Estate of Charles P. Morgan, Deceased, Roxanna L. Morgan, Personal Representative and Roxanna L. Morgan v. Commissioner of Internal Revenue, T.C. Memo 2021-104

Facts:

As a result of COVID-19, many businesses are experiencing financial hardship. Some of these businesses may be forced to close their doors, and owners may be eager to search for their next new endeavors. The case *Estate of Charles P. Morgan, Deceased, Roxanna L. Morgan, Personal Representative and Roxanna L. Morgan v. Commissioner of Internal Revenue* serves as a reminder of the §162(a) rules that business owners must follow.

This particular case revolves around three main issues:

1. Whether the couple was carrying on a trade or business and, therefore, was entitled to deductions claimed on Schedule C and Schedule E;
2. Whether the couple was entitled to an NOL deduction attributable to an alleged NOL carryover; and
3. Whether the couple was liable for an accuracy-related penalty.

Charles Morgan was a real estate developer who had over 26 years of experience; his companies built over 26,000 homes throughout Indiana and North Carolina between 1983 and 2009. Similar to many other real estate developers, Mr. Morgan's businesses experienced financial decline leading up to 2009, resulting in approximately \$75 million in defaulted and unpaid obligations as of February 2009. Creditors filed a "Complaint on Unpaid Indebtedness and for the Appointment of Receiver" in the Indiana superior court. At the time, Morgan's companies were allegedly insolvent. The Indiana superior court appointed LS Associates, LLC to be a receiver for all Morgan companies as of March 2009. In its role as a receiver for all Morgan companies, LS Associates, LLC was tasked with identifying, taking possession of, and liquidating all of Morgan's company assets. Mr. Morgan was prohibited from incurring any expenses on behalf of his companies during this time.

Another entity owned by Mr. Morgan, Falcon, was not placed into receivership. Falcon was formed in 1996 to hold, operate, and maintain aircraft. Before the receivership was established, Mr. Morgan flew on aircraft held by Falcon to visit potential building sites as well as current developments. Falcon did not lease its aircrafts to any third parties at any time; however, Mr. Morgan was passionate about aviation and often piloted the aircrafts himself in his free time. Throughout 2010 and 2011, Falcon was taxed as a partnership, with Mr. Morgan and an S corporation as the sole partners. In 2012, Mr. Morgan was the sole owner of Falcon; as such, it was taxed as a disregarded entity.

During tax years 2010 through 2012 (the years in question), LS Associates, LLC was in sole control of the Morgan companies, acting under the supervision and approval of the Indiana superior court. The receivership ultimately concluded in 2013 when the company assets were liquidated and final tax returns were filed.

Although his existing real estate development companies were insolvent, Mr. Morgan was determined to begin a new business in the real estate development industry. In December 2008, he formed Legacy, a single-member LLC that he used to conduct a search for his new trade or business. Legacy employed former employees of Morgan's insolvent companies in addition to other outside consultants. During the

receivership, Mr. Morgan continued to use Falcon aircraft to search for new business opportunities through Legacy. Legacy entertained various business opportunities, but ultimately did not purchase any new businesses as of the end of 2012.

In 2012, Charles Morgan and his wife, Roxanna, filed a joint Form 1040 and attached Schedule C for Falcon to their return. Falcon reported a gross loss of \$303,302 and gross income totaling \$516,654 (gross income comprised a \$315,000 fee that Legacy paid for consulting and \$201,654 paid by the Morgans for their personal use of Falcon's aircrafts). A total of \$819,956 of aircraft use and maintenance expenses was reported as an offset to income. The Morgans also attached Schedule E to their 2012 Form 1040, reporting \$648,118 of total expenses related to Legacy with no offsetting gross receipts. Lastly, the Morgans claimed an NOL deduction of \$966,121 on their 2012 Form 1040 attributable to NOL carryforwards from Falcon and Legacy from the 2010 and 2011 tax years.

The notice of deficiency disallowed the Morgans' Form 1040 Schedule C deduction of \$819,956 for Falcon's expenses, the Schedule E deduction of \$648,118 for Legacy's loss, and the \$966,121 NOL carryforward. The notice of deficiency determined that the Morgans were liable for \$407,214 of tax due in 2012, and since they only reported \$38,555 of tax on their 2012 Form 1040, they were liable for a \$368,659 deficiency. Additionally, a \$6662 penalty was imposed for underpayment due to negligence and/or substantial understatement of income tax.

Issues & Analysis:

The primary issue at hand in this case was whether the Morgans were carrying on a trade or business in 2012, as §162(a) allows taxpayers to deduct all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Generally, a taxpayer can be considered to be carrying on a trade or business if:

- The taxpayer undertook the activity with intention to earn a profit;
- The taxpayer is regularly and actively involved in the activity; and
- The taxpayer's activity has actually commenced. In other words, the taxpayer must do more than simply research or investigate an activity in order to be considered carrying on a trade or business.

Section 195(a) states that no current deduction is allowed for start-up expenditures. A start-up expenditure is defined by §195(c)(1) as any amount:

- Paid or incurred in connection with:
 - Investigating the creation or acquisition of an active trade or business;
 - Creating an active trade or business; or
 - Engaging in any activity for profit or the production of income before the day on which the active trade or business begins in anticipation of such activity becoming an active trade or business; AND
- That, if paid or incurred in connection with the operation of an existing trade or business, would be allowable as a deduction for the taxable year in which it was paid or incurred.

Such start-up expenditures may be immediately deducted or capitalized and deducted over time once the taxpayer actually commences carrying on a trade or business. If a taxpayer acquires a trade or business, the business is considered to have commenced when the taxpayer actually acquires it. If a prior trade or business never ceased, any business investigation expenses are deductible if they are incidental to an existing trade or business.

The IRS commissioner argued that the Morgans were no longer carrying on a trade or business because their companies were placed into receivership in 2009 and, as such, the expenses they deducted on their 2012 Form 1040 were not deductible under §162. The IRS commissioner stated that the expenses incurred were either for the purpose of searching for a new trade or business or for personal use. As discussed, §195(a) states that no current deduction is allowed for start-up expenditures. Under §262(a), personal expense deductions are disallowed unless the Code provides otherwise. The Morgans countered that they were carrying on a §162 trade or business in 2012 and, as a result, Falcon's expenses deducted on Schedule C and Legacy's expenses deducted on Schedule E were deductible. Mr. Morgan claimed that he did not begin a new trade or business because his homebuilding activities never ceased. The commissioner countered that the homebuilding activities ceased in 2009, as LS Associates, LLC was appointed as receiver, all homebuilding activity ceased, and all employees associated with the homebuilding activities were terminated. No homes were built after February 2009. Additionally, the commissioner cited that while Mr. Morgan expressed interest in creating a new business endeavor, he expressed uncertainty regarding what that specific business activity would be. Since the commissioner found that the Morgans did not participate in an active trade or business as of the end of 2012, there was no active trade or business associated with the expenses incurred by Falcon or Legacy; thus, these deductions were disallowed.

The Morgans also insisted that Mr. Morgan's search for a new trade or business conducted through Legacy constituted a trade or business in itself. The Morgans cited that they hired employees and outside consultants to assist in the search and that Falcon assisted Legacy in its search. Again, the commissioner responded that Legacy did not meet the §162 requirements to be classified as a trade or business, and the business investigation expenses that Legacy incurred were considered start-up expenditures. Since no business began or was acquired by the end of 2012, such expenses were not deductible.

Lastly, the Morgans asserted that the economic recession was an event occurring outside the normal course of trade or business and, as such, they were entitled to deduct business expenses for 2010 through 2012 to preserve their business. They cited the opinion found in *T.J. Enters., Inc. v. Commissioner* that expenses "incurred to protect, maintain, or preserve a taxpayer's business, even though not in the normal course of such business, may be deductible as ordinary and necessary business expenses." The commissioner countered that this interpretation would widen the scope of §162 too broadly, as it would essentially eliminate the requirement of "carrying on" a trade or business.

Conclusion:

The Court ultimately sided with the Commissioner, stating that Mr. Morgan was not carrying on a trade or business through Legacy in 2010, 2011, or 2012. Mr. Morgan's business was deemed to have ended in 2009 when his real estate development companies were placed under receivership. Additionally, it was concluded that Falcon's business activities by themselves did not constitute an active trade or business. As previously stated, Falcon did not lease aircraft or provide services to any third parties, and its only gross receipts came from the Morgans and Legacy.

The secondary issue at hand was whether the Morgans were entitled to an NOL deduction for the 2012 tax year related to NOL carryovers from 2010 and 2011. Section 172 allows a taxpayer to deduct NOLs for a taxable year equal to the aggregate of the NOL carryforwards and carrybacks to that year. The commissioner argued that the NOL carryover was not valid because the expenses in 2010 and 2011 were related to Legacy and Falcon, and since neither was carrying on a §162 trade or business in 2010 or 2011, the expenses could not give rise to an NOL. The Morgans responded that both Falcon and Legacy were subject to TEFRA audit procedures in 2010 and 2011 (the years in question), and thus the claimed

deductions could not be disallowed. The commissioner did not complete a TEFRA audit of either Legacy or Falcon in 2010 or 2011 within the valid time period under §6229(a); as a result, the commissioner was required to accept the 2010 and 2011 Forms 1065 as filed.

However, the argument did not end there. Items that are considered nonpartnership items are not resolved under the TEFRA rules. Per *Greenwald v. Commissioner*, the need for partner-level factual development is enough to except an item from the definition of a partnership item. Particularly, Mr. Morgan's outside basis in Falcon, defined as his adjusted basis in the partnership interest, could prevent the deduction of Falcon's 2010 and 2011 losses. The Morgans were unable to provide sufficient evidence to affirm their outside basis in Falcon; therefore, it was determined by the Court that they were unable to deduct Falcon's 2010 and 2011 NOLs.

In summary, the Court concluded that the Morgans were not entitled to the NOL carryforward because Legacy's 2010 and 2011 expenses were not deductible under §162 and Falcon's NOL carryforward was disallowed due to the fact that Mr. Morgan was unable to prove his outside basis. The Court further determined that the Morgans were not liable for an accuracy-related penalty under §6662(a) because they relied on advice from a tax preparer who prepared their return.

This case should serve as a reminder to clients that they should be mindful that the mere search for a trade or business does not rise to the level of a §162 trade or business in and of itself. Though COVID-19 has certainly caused unprecedented challenges for many businesses, the IRS remains clear in its assertion that the scope of §162 may not be interpreted so broadly as to essentially eliminate the requirement of "carrying on" a trade or business.

3. *Blum v. Comm'r, T.C. Memo. 2021-18*

Facts:

In this case, Debra Blum ("taxpayer") received \$125,000 in 2015 in settlement of a lawsuit filed against her personal injury attorneys, which was excluded from income on her 2015 tax return. The original personal injury case was against a hospital where the taxpayer received a knee replacement surgery and involved a negligence assertion for a faulty wheelchair. The taxpayer fell out of the faulty wheelchair and claimed to have sustained significant injuries. The case was granted summary judgment for the hospital.

Following the failed suit against the hospital, Ms. Blum filed suit against her own attorneys for malpractice in breach of their duty to properly pursue her lawsuit against the hospital. Her suit against her attorneys did not allege she suffered any personal injuries to the fault of her attorneys. The malpractice suit against her attorneys was settled where the taxpayer agreed to drop any claims against the former attorneys. Additionally, the settlement documents state that the taxpayer did not sustain physical injuries as a result of the negligence of the attorneys.

The IRS selected the taxpayer's 2015 federal tax return for examination, as they received a Form 1099-MISC from the attorneys' insurance company which reported the \$125,000, but the taxpayer failed to include the corresponding payment on the 2015 federal tax return.

Issues & Analysis:

The main issue regarding this case is whether the taxpayer is eligible to exclude the \$125,000 from gross income on the grounds of settlement based on personal injury or physical illness. Per §61, gross income includes all income from whatever source derived unless otherwise excluded. Historical court proceedings, such as *States v. Burke*, demonstrate exclusions from income should be narrowly

construed. Section 104 provides the exclusion of settlement proceeds from gross income on the grounds of personal injury or physical illness. The nature of the claim is the controlling argument as to whether damages are excludable from gross income. Additionally, the settlement agreement must expressly state the damages were compensation for personal physical injuries or physical illness (TC Memo 2019-142) and if it fails to expressly state such, the court looks to the intent of payor (TC Memo 2017-111).

Conclusion:

Due to the fact that the settlement proceeds related to the malpractice suit rather than personal injury, the taxpayer should have included \$125,000 in gross income on the 2015 tax return. The taxpayer attempted to claim the settlement was compensation for what should have been received by the hospital, but the nature of the suit against her attorneys was malpractice, not personal injury. The tax court sustained the IRS judgement and the deficiency of the tax was sustained. The IRS conceded the accuracy-related penalty against taxpayer.

It is important for practitioners to be aware that the settlement agreement language can be the determining factor for purposes of §104. Counsel should advise to the language included in the settlement agreement. As a result of COVID-19, there could be many suits arising against hospitals in future years and analyzing settlement agreements will become much more common during return filing season.

4. San Jose Wellness v. Comm'r, 156 T.C. No. 4

Facts:

Pursuant to California law, San Jose Wellness operated as a medical cannabis dispensary and sold other non-cannabis related items and services. Expenses incurred for the operation were deducted on tax returns in 2010, 2011, 2012, 2014, and 2015. Such deducted expenses included both depreciation and charitable contributions. The deductions were disallowed under §280E by the IRS for applicable years on the grounds the amounts paid/incurred are disallowed for carrying on a trade or business consisting of trafficking a controlled substance.

Issues & Analysis:

The main issue of this case centers around whether the deductions are disallowed under §280E and whether the taxpayer is liable for an accuracy-related penalty on the 2015 tax return.

Per §280E, "...no deduction or credit shall be allowed for any amount paid or incurred in the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in [certain defined] controlled substances." The court was asked to determine whether depreciation deductions under §167 and charitable contribution deductions under §170 fall within the prohibition of §280E. San Jose Wellness argued that depreciation did not fall within the scope of §280E, as depreciation is not paid or incurred during the tax year. Additionally, they argued that charitable contributions did not fall within the scope of §280E, as they were not paid in carrying on a trade or business.

Section 63 defines taxable as: Gross Income less any allowable deductions. Allowable deductions include those under §167 and §170. One main question to consider was whether depreciation is considered paid or incurred in the taxable year.

Conclusion:

The court held that based on legislative framework and previous case law, §167 depreciation is treated as paid or incurred during the taxable year in which a deduction would otherwise be allowed. Section 170 charitable contribution deductions are generally made for purposes of building goodwill, thus related to trade or business and nondeductible under §280E for San Jose Wellness as a medical cannabis business. Previous rulings indicated that though San Jose Wellness offered ancillary goods and services unrelated to the controlled substance business, all deductions are still disallowed. Ultimately, the court sustained the IRS assessed deficiencies and accuracy-related penalties.

Section 280E does not generally disallow deductions for COGS, as COGS is considered a reduction in gross income rather than a deduction. This was a distinction that the IRS tried to impose in the initial regulations for §163(j), as updated by TCJA. The final regulations were updated to reflect that the COGS were allowable in determining §163(j) interest limitations as the disallowance of COGS was not within the scope of legislative intent.

Generally, cannabis businesses are taxed on Gross Profit for federal tax purposes. Where it is legal for state purposes, the state generally allows deductions for state tax return filings. Care should be taken in claiming deductions for cannabis-related businesses because of the broad-disallowance of §280E. Section 263A generally cannot be used to shift deductions to COGS and §471 should be used to determine COGS (*Alterman v. Commissioner*, T.C. Memo 2018-67). Thus, this results in an unfavorable outcome for cannabis-related businesses. Section 263A (enacted in 1986) was never intended to change nondeductible expenses of §280E (enacted in 1982) to deductible expenses. With a change in administration and Congress, should cannabis be made legal federally, the cannabis income tax landscape would change drastically as it would no longer be considered a controlled substance.

5. Konstantin Anikeev and Nadezhda Anikeev v. Comm’r, T.C. Memo 2021-23**Facts:**

Mr. and Mrs. Anikeev (“the taxpayers”) each had Blue Cash American Express (“Amex”) credit cards where they earned Reward Dollars up to 5% of everyday purchases. Reward dollars could be redeemed for Amazon gift cards or as credits on their Amex card balances as statement credits with no limit on the amount of Reward Dollars a card user could earn. To maximize the earning of Reward Dollars, the taxpayers developed a system:

- **Purchase of Visa Gift Cards with Amex:** Taxpayers would use their Amex cards to purchase as many Visa gift cards as possible from local grocery stores and pharmacies, resulting in Reward Dollars being earned. The Visa gift cards would be used to purchase money orders that would be deposited in the taxpayers' bank account, which would then be used to pay off the Amex card balance.
- **Purchase of Money Orders with Amex:** Occasionally, the taxpayers would purchase money orders from Rite Aid with the Amex, which would generate Reward Dollars. The money orders would be deposited into the taxpayers' bank account.

Total money order deposits to the taxpayers' bank account in 2013 and 2014 was a combined total of \$4,028,743. To manage the credit limits on the credit cards, the taxpayers made frequent payments on the cards to allow them to keep purchasing Visa Gift Cards and Money Orders in order to continue accruing Reward Dollars. For tax year 2013, total Amex Charges were \$1,219,077, of which \$1,208,376 were purchases of Visa gift cards and money orders. Of the total amount, \$10,701 were purchases more personal in nature. Reward Dollars redeemed in 2013 were \$36,200.

For tax year 2014, the Anikeevs' total Amex purchases for Visa gift cards and money orders were \$5,184,033. The couple redeemed \$277,275 of reward dollars in 2014. The joint tax returns filed by the taxpayers for 2013 and 2014 reported total income of \$152,410 and \$163,124, respectively. The IRS issued a deficiency notice to the taxpayers for the redeemed rewards not being included in gross income.

Issues & Analysis:

The main issue at hand is whether cash rewards paid to taxpayers as statement credits are considered a cash equivalent or an accession to wealth, and therefore constitute taxable income.

Section 61 broadly defines income as being from whatever source derived unless specifically excluded. Services and goods received with purchase price adjustments are generally not considered taxable. Rev. Rule 76-96 provides that credit card rewards are generally not taxable as they are treated as a reduction in purchase price of goods or services rather than income. This is consistent with the IRS policy on cash rebates as discussed in Publication 17.

Conclusion:

The IRS argued that the Reward Dollars received relating to purchases of Visa gift cards and money orders were cash equivalents rather than a reduction of purchase price of goods or services. The IRS attempted to argue Visa gift cards and money orders are not goods or services, and thus, cannot have a price reduction. The term "cash equivalents" references the landmark *Cowden* case; the Court rejected the argument that the transactions of the taxpayers were inconsistent with the cash equivalent doctrine. The Court concluded the Reward Dollars redeemed associated with the purchase of Visa gift cards were not taxable. Though neither a good nor service, the gift cards had product characteristics, consistent with the longstanding IRS policy, and thus, the Reward Dollars related to the Visa Gift Cards closely resembled rebates and should not be taxable.

The Court concluded the Reward Dollars redeemed associated with the purchase of money orders were taxable. Money orders (and reloadable debit cards) are neither a good nor service. Additionally, they do not offer any product characteristics, and thus, the Reward Dollars associated with those purchases were deemed cash equivalents rather than as rebates. As such, they were considered taxable. The Court noted the case looked primarily at inconsistencies of the facts with the IRS policy. The Court asked the IRS to refine its policies for future use rather than to piecemeal rules using the tax courts.

Accession to wealth was not a determinative factor in this case. A less aggressive taxpayer seeking Reward Dollars may not have caught the attention of the IRS (as noted in the decision). These cases can be very subjective to the particular facts and circumstances. Due to the fact that practitioners rarely have insights in credit card rewards redeemed by clients, these circumstances can arise without the practitioner being aware of them. It could be worthwhile to note any changes in standard of living without changes in taxable income or inherited assets to identify if there are inconsistencies worth asking questions about.

6. Self-certification procedure for a waiver of the 60-day rollover limit

The IRS has provided a self-certification procedure designed to help recipients of retirement plan distributions who inadvertently miss the 60-day time limit for properly rolling these amounts into another retirement plan or IRA.⁷ Eligible taxpayers, encountering a variety of mitigating circumstances, can qualify

⁷ Rev. Proc. 2016-47.

for a waiver of the 60-day time limit and avoid possible early distribution taxes. Normally, an eligible distribution from an IRA or workplace retirement plan can only qualify for tax-free rollover treatment if it is contributed to another IRA or workplace plan by the 60th day after it was received. In most cases, taxpayers who failed to meet the time limit could only obtain a waiver by requesting a private letter ruling from the IRS. Taxpayers who missed the time limit will now ordinarily qualify for a waiver if one or more of 11 circumstances, listed in the revenue procedure, apply to them. They are: (1) an error was committed by the financial institution receiving the contribution or making the distribution to which the contribution relates; (2) the distribution, having been made in the form of a check, was misplaced and never cashed; (3) the distribution was deposited into and remained in an account that the taxpayer mistakenly thought was an eligible retirement plan; (4) the taxpayer's principal residence was severely damaged; (5) a member of the taxpayer's family died; (6) the taxpayer or a member of the taxpayer's family was seriously ill; (7) the taxpayer was incarcerated; (8) restrictions were imposed by a foreign country; (9) a postal error occurred; (10) the distribution was made on account of a levy under §6331 and the proceeds of the levy have been returned to the taxpayer; or (11) the party making the distribution to which the rollover relates delayed providing information that the receiving plan or IRA required to complete the rollover despite the taxpayer's reasonable efforts to obtain the information. Another requirement is that the contribution must be made to the plan or IRA as soon as practicable after the reason or reasons (of the listed 11) no longer prevent taxpayer from making the contribution. This requirement is deemed to be satisfied if the contribution is made within 30 days after the reason or reasons no longer prevent taxpayer from making the contribution.

Ordinarily, the IRS and plan administrators and trustees will honor a taxpayer's self-certification that the taxpayer qualifies for a waiver under these circumstances. Moreover, even if a taxpayer does not self-certify, the IRS now has the authority to grant a waiver during a subsequent examination. It is important to remember that this self-certification is not a per se waiver by the IRS of the 60-day rollover requirement; however, a taxpayer may report the contribution as a valid rollover unless later informed otherwise by the IRS. In addition, the revenue procedure includes a sample self-certification letter that taxpayers can use to notify the administrator or trustee of the retirement plan or IRA receiving the rollover that they qualify for the waiver. The sample letter is replicated herein as follows.

Certification for Late Rollover Contribution

Name

Address

City, State, ZIP Code

Date: _____

Plan Administrator/Financial Institution

Address

City, State, ZIP Code

Dear Sir or Madam:

Pursuant to Internal Revenue Service Revenue Procedure 2016-47, I certify that my contribution of \$ [ENTER AMOUNT] missed the 60-day rollover deadline for the reason(s) listed below under Reasons for Late Contribution. I am making this contribution as soon as practicable after the reason or reasons listed below no longer prevent me from making the contribution. I understand that this certification concerns only the 60-day requirement for a rollover and that, to complete the rollover, I must comply with all other tax law requirements for a valid rollover and with your rollover procedures.

Pursuant to Revenue Procedure 2016-47, unless you have actual knowledge to the contrary, you may rely on this certification to show that I have satisfied the conditions for a waiver of the 60-day rollover requirement for the amount identified above. You may not rely on this certification in determining whether the contribution satisfies other requirements for a valid rollover.

(1) Reasons for Late Contribution

I intended to make the rollover within 60 days after receiving the distribution but was unable to do so for the following reason(s) (check all that apply):

☐ An error was committed by the financial institution making the distribution or receiving the contribution.

☐ The distribution was in the form of a check and the check was misplaced and never cashed.

☐ The distribution was deposited into and remained in an account that I mistakenly thought was a retirement plan or IRA.

☐ My principal residence was severely damaged.

☐ One of my family members died.

☐ I or one of my family members was seriously ill.

☐ I was incarcerated.

☐ Restrictions were imposed by a foreign country.

☐ A postal error occurred.

☐ The distribution was made on account of an IRS levy and the proceeds of the levy have been returned to me.

____ The party making the distribution delayed providing information that the receiving plan or IRA required to complete the rollover despite my reasonable efforts to obtain the information.

(2) **Signature**

I declare that the representations made in this document are true and that the IRS has not previously denied a request for a waiver of the 60-day rollover requirement with respect to a rollover of all or part of the distribution to which this contribution relates. I understand that in the event I am audited and the IRS does not grant a waiver for this contribution, I may be subject to income and excise taxes, interest, and penalties. If the contribution is made to an IRA, I understand you will be required to report the contribution to the IRS. I also understand that I should retain a copy of this signed certification with my tax records.

Question to ponder:

Despite no single factor being determinative, is the taxpayer's financial status given more weight?

7. No doormat rule akin to mailbox rule

Undoubtedly, the grand majority of people reading this are aware the mailbox rule deems a return filed as it is placed in the mailbox and correspondingly postmarked the same day. An enterprising taxpayer unsuccessfully attempted to extend the rationale of the mailbox rule in *Plato v. Commissioner*.⁸ Mr. Plato and his bride separated in December, 2007 and did not cohabit thereafter. He prepared and signed a 2007 Form 1040 with MFJ status and a liability of \$46,073. On April 15, 2008, he left the joint return along with a check for the \$46,073 “under the mat at the front door” of his wife’s residence ostensibly for her to sign and mail to the IRS. There was absolutely zero evidence that the return was mailed or the check cashed. Mr. Plato requested no extension but asked his wife to request one. Just as with the 1040, no extension was filed.

In response to the inevitable failure to timely file penalty, Mr. Plato argued without avail that reasonable cause existed to vitiate his willful neglect in not filing the 2007 return. Yes, wait for it – The reasonable cause was signing the joint return and leaving it with the check under the mat of his wife’s residence. He also referenced his history of compliance in filing tax returns. Now, there are some interesting implications. Foremost is the need for both signatures on the return, and the Court pointed out that even in the situation where a couple is separated, failure to obtain the second signature on a MFJ filing does not always form reasonable cause to avoid a tax penalty. The second takeaway is the notion that a taxpayer is unable to rely on an agent to timely file a tax return. Could this logic based in the law of agency be extended to include USPS, FedEx and UPS as agents? Aren’t they acting as agents in delivering a taxpayer’s return? If the admittedly tenuous but thought-provoking argument is considered at any length, then perhaps belt-and-suspenders taxpayers would need to hand deliver returns to IRS service centers and not rely on agent carriers. Obviously, that is a bit much on hyperbole and not really grounded in practicality, but you get the point.

As for taxpayer, his attempt to extend the mailbox rule to the doormat rule was unsuccessful; necessity, who is the mother of invention – words attributed to another Plato.

⁸ USTC 1/24/2018.

C. Section 401(k) limitations

1. Maximum elective deferral

The maximum amount of deferral in a §401(k) plan in 2021 is \$19,500 (unchanged from 2020).

A qualified plan may now allow up to a \$6,500 (2021, unchanged from 2020) additional elective deferral to be made to the plan by a participant who attains the age of 50 before the end of the plan year.

The additional elective deferrals are generally not taken into account under the actual deferral percentage (ADP) or other limitations on such contributions. The applicable dollar amount increases in the cost of living at the same time and in the same manner as adjustments for annual benefits and additions, except that the base period taken into account is the calendar quarter beginning July 1, 2005, and any increase that is not a multiple of \$500 is rounded to the next lower multiple of \$500.

Planning point:

Elective deferrals remain an annual addition; however, the amount subject to the 25-percent-of-compensation limitation does not include them, but only the matching and any other nonelective employer contributions. Subject to any other limitations (such as the annual-additions limitation), an employee may defer 100 percent of current salary **and** the employer may deduct not only the amount so deferred by the employee, but also up to 25 percent of the total participant compensation for the year for other contributions.

2. Roth contribution programs

A §401(k) plan may permit an employee who makes elective contributions under a qualified cash or deferred arrangement to designate some or all of those contributions as **designated Roth contributions**. Although designated Roth contributions are elective contributions under a qualified cash or deferred arrangement, unlike pre-tax elective contributions, they are currently includible in gross income. However, a **qualified distribution of designated Roth contributions is excludable from gross income**.

D. Self-employed persons

Self-employed (unincorporated) individuals with no common-law employees provide a specific challenge. This group typically is looking to shelter some income but needs the flexibility to make varying contributions each year.

1. Simplified Employee Pension (SEP)

The SEP works quite well for most self-employed persons. The individual can contribute 20 percent of self-employment income (after reducing income by the deduction for 1/2 of the Social Security taxes paid). Contributions are **flexible**, the plan can be established with a simple document, and no annual reporting is required. The maximum contribution is \$58,000. As noted below, this has advantages over a profit-sharing plan in all instances where the self-employed has no other employees. But the allocation of contributions is not flexible and is pro rata with compensation levels (and no more than \$290,000 may be taken into account).⁹

Note:

A SEP is another excellent choice for the employer looking for a plan that provides for discretionary contributions. The rules are as flexible as the profit-sharing plan. However, the

⁹ Notice 2020-79.

employer also wanting to skew contributions toward the business owner will choose the cross-tested profit-sharing plan over the SEP.

2. SIMPLE

For self-employed persons with relatively small income, the SIMPLE can result in a larger contribution than a SEP. An individual can defer up to \$13,500 to the SIMPLE, and the employer is then **required** to make a matching contribution of 3 percent of compensation of a participating employee or an additional contribution (2-percent of compensation of all eligible employees). Eligibility is narrower than a SEP, using employees who make a certain amount in compensation over the immediate three years. The maximum total contribution to a SIMPLE is \$27,000.¹⁰

Note:

In contrast to a §401(k) plan, the SIMPLE is an easy way to give employees the opportunity to participate in a pre-tax salary-reduction plan, although there are required contributions by the employee. The IRS has provided model documents, participant election forms, and instructions. And, for most part, these documents even satisfy participant notification requirements. Other than determining the required contribution and monitoring the \$13,500 deferral limit, the employer has little other responsibility. Unlike qualified plans, the service providers are required to prepare the summary plan description and provide benefit statements. No annual reporting is required and there are few rules to violate.

- a. Employers with 100 or fewer employees that already sponsor §401(k) plans may not want to switch to SIMPLEs due to the tremendous flexibility that the §401(k) plan provides. The maximum salary deferrals are higher (\$19,500 a year in 2021) and the employer can sponsor other plans in addition to the §401(k) plan. With a §401(k) plan, the eligibility, vesting, and contributions requirements are more flexible. The employer matching contribution can take various forms and be subject to a vesting schedule. Employer profit-sharing contributions are discretionary and allocations can be skewed to the highly compensated through Social Security integration or cross-testing. Another important §401(k) feature is the ability to allow participant loans, giving participants access to their savings without income tax consequences.
- b. If a business owner is looking for a plan that allows contributions for the owner in excess of \$27,000,¹¹ the SIMPLE is generally not the right plan. With other defined-contribution type plans -- or combination of plans -- the business owner can often have total contributions of \$58,000¹² for the year. However, the higher contribution amount will have a cost -- both in terms of contributions for employees and the cost of administering the more complicated plans. If the owner's spouse is providing services to the company, the owner could leave the spouse off the payroll, because of the additional income increased taxable income and increased payroll taxes. However, with a SIMPLE, adding the spouse to the payroll is a way to get more money into the SIMPLE, for the cost of only payroll taxes.
- c. Since the SIMPLE salary deferral and matching contribution are not subject to either the 25-percent deduction limits or the §415 allocation limits that apply to other plans, an individual with low earnings can actually make larger deductible contributions to the SIMPLE than other plans. This might be helpful to a second wage-earner in a family that

¹⁰ Notice 2020-79.

¹¹ Maximum is less for the individual earning less than \$450,000.

¹² I.R.C. §415 provides that contributions to all qualified plans that are defined-contribution plans, as well as contributions to SEPs, cannot exceed the lesser of \$57,000 (inflation adjusted) or 25 percent of compensation for the year.

can afford to contribute significant amounts to a retirement plan. It can also be helpful for an individual that has self-employment income in addition to employment income. However, for this second type of individual, there are several possible traps. First, income earned from personal services could be aggregated with the individual's employer under the controlled group or affiliated service group rules. Second, remember that if an individual sponsoring the SIMPLE is also a participant in a §401(k) plan, §403(b) plan, SARSEP or SIMPLE of another employer, total salary deferrals for a calendar year cannot exceed \$19,500.¹³

3. Profit-sharing

The profit-sharing plan is the most common form of defined-contribution plan. The other types of defined-contribution plans are simply a variation of a profit-sharing plan combined with features of a pension plan. A profit-sharing plan is a type of defined-contribution plan. A defined-contribution plan is one in which individual accounts for each participant are maintained. The account balance at any time measures the participant's accrued benefit. At any time, the participant is entitled to the product of the participant's account balance and vested percentage.

- a. The profit-sharing plan is another alternative that provides the same contribution opportunity. The profit-sharing plan for the sole proprietor is generally not very complicated, since the plan's service provider may supply a prototype document at no or little cost. Also, a plan that only covers an owner (and the owner's spouse) that has less than \$250,000 in assets is not required to file IRS Form 5500. In most cases; however, the SEP seems more appropriate, since no reports are ever required, and IRA assets can be withdrawn or rolled over more easily. The profit-sharing plan does allow investments in life insurance, and if the sole proprietor expects to have employees in the near future, the sole proprietor may prefer the qualified plan eligibility and vesting provisions. The maximum annual addition to an individual's account balance is \$58,000.
- b. The profit-sharing plan is incredibly versatile. Contributions are completely discretionary (unless the plan is drafted to require employer contributions), and, if contributions are made, can be allocated in ways favorable to the business owner (see discussion of cross-tested allocations). There are several limitations to the discretionary contribution rule.
 - (i) If there is a "complete discontinuance" of contributions, the plan is deemed to be terminated and participants become 100-percent vested in their benefits. As a rule of thumb, if an employer makes no contributions for more than two years, the plan could be considered terminated.
 - (ii) Except for "complete discontinuance" issues, profit-sharing plans (even top-heavy plans) can skip contributions entirely for a year. Remember that under the top-heavy minimum-contribution requirement, no contributions have to be made for non-key employees if no employer contributions are made on behalf of key employees.

¹³

As a result of the amendment to I.R.C. §457(c) by the Economic Growth and Tax Relief Reconciliation Act of 2001, an employee is able to exceed such an elective deferral limitation if a §457 plan is combined with another plan that permits elective deferrals, such as a §401(k) plan.

4. Section 401(k) plans

Note:

Employees have often wanted to be able to add to their retirement by making contributions to qualified retirement plans. In the past, this was done through thrift plans by which the employee made contributions to an employer-sponsored plan. The disadvantage of such arrangements was that the contributions from the employee were after-tax. In other words, the employee had federal income and employment taxes withheld from their salary in respect of such contributions. While the employees enjoyed tax-deferred accumulation of earnings in the thrift plan, they did not enjoy the tax leverage on their contributions as the employer did on its deductible contributions.

Section 401(k) permits contributions to come not only from bonuses and other additions to normal salary, but also from the normal salary itself by the affirmative election by the employee to reduce that salary by the amount the employee wanted contributed to the plan on the employee's behalf. This suits employers quite well, as in many cases it eliminates the need for the employer to come up with additional funds above the normal salary levels.

In order to reduce salary without the employee being in constructive receipt, it is necessary for the employee to sign a salary-reduction agreement, in advance of earning that salary, by which the employee's normal salary is reduced in the payroll system to reflect the amounts that are put in the plan. The employee has a choice between current cash and deferred payments, and this system is referred to as a cash or deferred arrangement (CODA).

While the qualified salary reduction agreement is sufficient to eliminate the amount from wages for income-tax purposes -- it is not reported as such on the employee's W-2 -- the amounts remain wages for employment-tax purposes and are reported as such on the employee's W-2. This is an exception to the rules discussed earlier for profit-sharing and other qualified plans. However, such reductions to a self-employed person's draw are **not reflected in earnings from self-employment** and thus do not escape employment tax.

Because of the inclusion of elective deferrals in wages for Social Security tax purposes, it would appear that one cannot avoid the .9 percent tax on excess earnings in 2021 and later years by salary reduction.

Only a profit-sharing, stock bonus, pre-ERISA money purchase pension, or rural cooperative plan can include a cash or deferred arrangement (§401(k) arrangement) and be a qualified plan. A cash or deferred arrangement is part of a plan for these purposes if any contributions to the plan, or accruals or other benefits under the plan, are made or provided pursuant to the cash or deferred arrangement.¹⁴

A cash or deferred election can only be made with respect to an amount that is **not currently available** to the employee on the date of the election. Further, a cash or deferred election can only be made with respect to amounts that would (but for the cash or deferred election) become currently available after the later of the date on which the employer adopts the cash or deferred arrangement or the date on which the arrangement first becomes effective.¹⁵

In general, elective contributions under a qualified cash or deferred arrangement (including designated Roth contributions) are treated as employer contributions. Thus, for example, elective contributions under such an arrangement are treated as employer contributions for purposes of §401(a) (qualification requirements), §401(k) (special requirements), §402 (contributions), §404 (deductions), §411 (minimum

¹⁴ Treas. Regs. §1.401(k)-1(a)(1).

¹⁵ Treas. Regs. §1.401(k)-1(a)(3)(iii)(A).

vesting), §415 (limitations on contributions and benefits), §416 (top-heavy rules), and §417 (minimum survivor benefits).¹⁶

Note:

Such a characterization would suggest that the elective contributions made to the plan would be treated as employer contributions to a defined contribution retirement plan that would be subject to the limitation on tax benefits, if enacted.

Generally, a partnership or sole proprietorship is permitted to maintain a cash or deferred arrangement, and individual partners or owners are permitted to make cash or deferred elections with respect to compensation attributable to services rendered to the entity, under the same rules that apply to other cash or deferred arrangements. For example, any contributions made on behalf of an individual partner or owner pursuant to a cash or deferred arrangement of a partnership or sole proprietorship are elective contributions unless they are designated or treated as after-tax employee contributions. In the case of a partnership, a cash or deferred arrangement includes any arrangement that directly or indirectly permits individual partners to vary the amount of contributions made on their behalf.

In the most common type of CODA, a **salary-reduction arrangement**, the participant is given the option of having wages reduced in return for having an employer contribution made to the plan.¹⁷

Elective deferrals increase to the applicable amount.

In the case of taxable years beginning after December 31, 2006, the \$15,000 applicable dollar amount is indexed for inflation based on July 1, 2005 indexes, rounded to the next lower multiple of \$500 (currently \$19,500).

A qualified plan may now allow additional elective deferrals to be made to the plan by a participant who attains the age of 50 before the end of the plan year.

The additional elective deferrals are not taken into account under the ADP or other limitations on such contributions. The applicable dollar amount increases in the cost-of-living at the same time and in the same manner as adjustments for annual benefits and additions, except that the base period taken into account is the calendar quarter beginning July 1, 2005, and any increase that is not a multiple of \$500 is rounded to the next lower multiple of \$500. It is currently \$6,500.

The limitation on the total contributions to a §401(k) account for an individual is at \$58,000, so employer contributions can be used to enhance the contribution above the limitation on elective deferrals noted above. However, such employer contributions are subject to different nondiscrimination rules; there is no ADP test to give leeway from a compensation proportionate contribution standard.

Note:

The problem areas in §401(k) plans are two-fold. First, a cash or deferred arrangement satisfies the coverage and nondiscrimination requirement for a plan year only if: (i) the group of eligible employees under the cash or deferred arrangement satisfies the requirements of §410(b) (including the average benefit percentage test, if applicable);¹⁸ and (ii) the cash or deferred

¹⁶ Treas. Regs. §1.401(k)-1(a)(4)(ii).

¹⁷ Treas. Regs. §1.401(k)-1(a)(3)(i).

¹⁸ Treas. Regs. §1.401(k)-1(b)(1)(i).

arrangement satisfies either the ADP test, the ADP safe harbor, or the SIMPLE §401(k) provision.¹⁹ These provisions deal with (i) coverage and (ii) nondiscrimination in funding. Coverage simply means that an adequate number of employees, regardless of the level of contributions made, are participants -- i.e., contributing something -- to the plan. The nondiscrimination in funding requirement compares the level of elective contributions as a percentage of compensation by the class of non-highly compensated employees with that of the highly-compensated to make sure that the latter does not vary greatly from the former. Strict equality is not required, but this is certainly an area where employers have had trouble because (a) employees have not participated, or (b) their participation is at such low levels that higher-compensated individuals have an elective deferral limitation that is less, often much less, than what they may have wanted. Alternatives include (a) automatically entering employees into the plan at a specified level of salary reduction unless the employee affirmatively opts out, and (b) sweetening the pot with employer matching contributions, which may defeat the employer's purpose of limiting cash outlays (other than those that otherwise would have paid any way in salary).

5. Solo §401(k) plans

Because §401(k) plans are generally profit-sharing plans, the same objections raised against the profit-sharing plan in favor of a SEP generally apply. However, in the case of a true sole proprietor (or one whose only employee is a spouse), the low-cost, flexible SEP may have to give way in favor of a **solo §401(k) plan** at certain levels of Schedule C income.

Note:

A §401(k) plan can be designed primarily to allow for employee pre-tax salary deferrals. The plan can then allow for discretionary profit-sharing contributions or even discretionary employer-matching contributions. A discretionary match may not encourage employee salary deferrals, which is the normal reason to have the match. One caution, however: an employer will be required to contribute 3 percent of compensation for non-key employees if the plan is top-heavy and any key employee makes a 3-percent-of-compensation salary deferral.

- a. One advantage of the SEP was generally the low installation costs and nondiscrimination rules that are minimal in cases where there are several employees. But in a solo operation, nondiscrimination is not an issue, as there are no other employees against which to measure disparities of treatment.
- b. The proprietor with other employees in a §401(k) plan must bridle any instinct to make the maximum elective deferral of \$19,500, since ADP testing might preclude this and limit the amount of the elective deferral in accordance with the rules discussed. Again, this is not a concern in a case where there is a single participant in the plan.
- c. Yet, for one major reason solo §401(k) plans have gained traction in the last couple of years, the availability of elective deferrals in such plans, a feature not now generally available in a SEP, and only available in a SIMPLE to a much lesser extent. This presents an opportunity for the proprietor who wants to maximize his contributions advantageously for some Schedule C proprietors.
 - (i) In either case, the maximum annual addition to the participant's account in the plan is \$58,000. But how the owner gets there is very different.
 - (ii) The SEP is a straight profit-sharing plan that limits employer contributions to 25 percent of the proprietor's earned income (20 percent of self-employment income before taking into account the contribution itself).

¹⁹ Treas. Regs. §1.401(k)-1(b)(1)(ii).

- (iii) By contrast, the proprietor in a §401(k) plan may first make an “employee” contribution by an elective deferral of up to \$19,500. At low levels of self-employment income this could generate a high ADP. But because there are no other employees, this will not be a problem. Thus, the proprietor now only has to fund \$38,500 by an employer contribution, and it is only the employer contribution that is limited by the 25 percent of earned income rule applicable to defined contribution plans.
- (iv) At some point, the additional cost of having a document prepared for a §401(k) plan and making annual reports may outweigh the additional available contribution.
- d. The solo §401(k) also works well when the proprietor has the spouse as the sole common-law employee. The spouse is treated as a highly-compensated employee regardless of the level of compensation actually paid by reason of the relationship to the proprietor as a highly compensated employee.

Note:

The economics tilt toward the solo §401(k) because of the availability of an up-front contribution that is largely independent of self-employment income or compensation paid.²⁰ This gives the plan a head start on contributions compared to the simpler and less expensive SEP.

6. Money-purchase pension plan

A money-purchase pension plan must specify a fixed annual contribution by the employer. The contribution must be definitely determinable and cannot be ambiguous in any way.²¹ Any contribution formula must meet the nondiscrimination rules. These rules provide design safe harbors and several general tests, whereby the plan can demonstrate nondiscrimination by performing an annual mathematical test. Note that compensation must be capped, for purposes of determining the applicable contribution, to \$290,000 (as indexed in 2021). The most common contribution formula is a level percentage (up to 25 percent) of compensation for all participants. This formula satisfies a design safe harbor (meaning that no nondiscrimination testing must be performed) if: (i) the plan has a single uniform formula for all participants; and (ii) the plan has a uniform normal retirement age and vesting schedule applicable to all employees.²²

For the sole proprietor, the money-purchase plan had been used as a supplement; because today's annual additions and deduction limitations are the same, its major use is not a tax one; the required contributions to the money-purchase plan may provide greater certainty to employees than a profit-sharing plan. The maximum contribution is \$58,000. For the self-employed individual with no employees, it produces the same bottom line result as a profit-sharing plan, but because of the obligation to make a fixed level of contribution, lacks the degree of flexibility of a profit-sharing plan.

7. Defined-benefit plan

In a defined-benefit plan, the employer promises to provide a benefit, which is generally expressed as an amount payable as a **single life annuity** beginning at a stated **normal retirement age**. In order to fulfill this obligation, the employer must not only make sufficient contributions to fully fund all obligations under the plan, as determined by an actuary, but also make payments in the future. The actuary will adjust the

²⁰ The elective deferral cannot exceed the self-employment income or compensation.

²¹ Rev. Rul. 73-379, 1973-3 C.B. 124.

²² Treas. Regs. §1.401(a)(4)-2.

contribution levels in accordance with the mix of life expectancies and remaining time to retirement with respect to each obligation as well as the actual investment experience of the fund. **Each year**, the actuary must take a new plan census and determine the projected benefit at retirement for each participant based on the participant's current and projected salary, and the time left to complete funding, i.e., at the projected retirement. In determining the amount the employer must contribute each year, the actuary takes into account the actual investment and mortality experience of the fund in light of its obligations.

Note:

The employer's annual contribution to the plan is the amount that is actuarially estimated to be required to fund expected plan benefit liabilities. ERISA generally requires that a defined benefit plan's assets be valued at least annually, and that at that time, there be a new determination of the plan's experience gains and losses and, hence, of the plan's total liability. This illustrates the greatest impediment to these plans: significant overhead in plan administration and the necessity of a trained professional actuary to determine the status of the plan's funding each year.

In a defined-benefit plan, the promise to make contributions is not to any one participant's account (there are none), but to actuarially create a separate fund that will be sufficient to pay fixed benefits at retirement of each participant. This requires an actuary to determine, based on mortality and presumed investment assumptions, the amount required to be set aside to meet the particular benefits of the plan's particular participants.

The employer is liable for the payment of the promised benefit without regard to the investment experience of the fund. This has two corollaries:

- a. If the fund has investment experience less favorable than the initial assumptions, the amount of future contributions will have to be increased over any original projected contribution scales; and
- b. If the fund has investment experience more favorable than the initial assumptions, the amount of future contributions will have to be decreased over any original projected contribution scales.

Planning point:

The contribution level may fluctuate each year based on the performance of the plan's assets, a factor that is somewhat outside of the control of the plan sponsor. Since the sponsor is required to make contributions to satisfy the minimum-funding requirements, only the most stable plan sponsors will be able to sponsor defined-benefit plans. Cash flow is not predictable because it depends on investment performance as well as mortality of the employee group, both of which can vary wildly from the actuarial assumptions used in the plan.

Defined-benefit plans have been disappearing over the past 15 years from most small businesses because of the high overhead in maintaining them and the difficulty in communicating its features to employees. Costs cannot be projected and controlled without the aid of the arcane ways of the actuary. This may be particularly important to employers with cash-flow concerns.

- a. Another difficulty lies in the mandatory nature of pension contributions because the contributions cannot be easily determined and can change rapidly depending on changes in current market rates. Employers with **steady, dependable cash flow** are the only ones who should venture into this area. Contributions to a defined-benefit plan must be made, without regard to the employer's financial condition, subject to obtaining a funding waiver from the government.

- b. In a defined-benefit plan, the employee benefits from the certainty of a specified benefit. The employer is responsible to make contributions necessary to fund promised benefits. If the plan's investment experience exceeds the actuarial assumptions, the employer's required contributions will be lowered. Similarly, if investment experience is inferior, contributions will increase.

Planning point:

Assuming the small business has at least two employees, a defined-benefit plan can generally maximize income for older owner-employees and provide maximum tax shelter for the employer as discussed below in connection with the deduction available. They are unique in being able to take into consideration service that predates the adoption of the plan.

A defined-benefit plan could turn into a tax shelter if limitations are not placed on the amount of benefit that can be defined at retirement. This limit applies to the annual benefit payable beginning at the Social Security retirement age. A defined-benefit plan may not provide an annual benefit greater than the lesser of 100 percent of the average of the employee's compensation in the employee's three highest-paid years (the "percentage limit") or \$230,000 in 2021 (the "dollar limit").

- a. The highest three years is the period specified in the plan of consecutive calendar years (not in excess of three) during which the employee was both a participant and had the greatest aggregate compensation.²³
- b. The dollar limit must be actuarially increased for participants who work beyond the normal retirement age, since benefits continue to accrue.²⁴

Planning point:

Funding levels to the extent attributable to individual participants are functions of age/mortality, years to normal retirement age, and interest (return) rate assumptions. In all cases, an older person at a given salary level will require more annual funding than a younger employee at the same compensation. An individual at a given age with high compensation will require more funding than another employee at the same age, but with a lower salary. Together, an older employee with a high wage will require considerably more funding than a younger employee with a lower compensation base. Thus, in many defined benefit plans, the cost for older employees may be very small compared to that of the principal of the company, and certainly the percentage of annual contributions to the plan for a lower-salaried employee would be far less than that based on compensation.

For maximum reduction in income (given a tax rate rise), reduction in AGI (given the 3.8 percent tax), reduction in wages subject to Social Security (given the .9 percent tax on excess earnings), and its apparent favored status as a deduction (given the potential application of tax savings limitations on certain deductions and some exclusions), the defined benefit plan is hard to beat. However, taxpayers could also consider the **cross-tested profit-sharing** plan discussed above which also can create a disproportionality of contribution level (but apparently without the benefit of not being subject to the limitation on tax benefits).

There is no rule prohibiting a self-employed person from establishing a defined-benefit plan. In some ways, the self-employed person is a good candidate because there will be no benefit costs for other employees. However, due to the additional administrative expense, few self-employed persons have been interested in a defined-benefit plan.

²³ I.R.C. §415(e)(3).

²⁴ I.R.C. §415(b)(2)(D).

Note:

The greatest impediment to the defined benefit plan is the loss of flexibility with respect to contributions and its counter-intuitive requirement that as the performance of the investments in the plan declines, the level of required contributions goes up. At a time when the lower investment prices may show a problem in the economy -- when a business might want to be most protective of its flexibility with respect to cash -- the mandatory contribution rules may prove a major problem.

The reasons to consider a defined-benefit plan is if the self-employed person is either looking for a deductible contribution in excess of \$58,000 or a contribution in excess of 25 percent of compensation. A consultation with an actuary is needed to determine if it is possible to meet one of these objectives. It is more likely that this goal can be met for an individual over age 45. Given the additional tax that applies either to excess earnings or investment income when AGI exceeds \$250,000, the most dramatic way of reducing AGI -- assuming it does not conflict with the client's economic needs and lifestyle -- is to shift income from current earnings to deferred compensation. Given the current interest rate environment, the discount factors will be so small that substantial contributions will be actuarially required annually in order to fully fund a maximum benefit of an individual in his or her 50s; advisors need to determine from an actuary these current levels.

