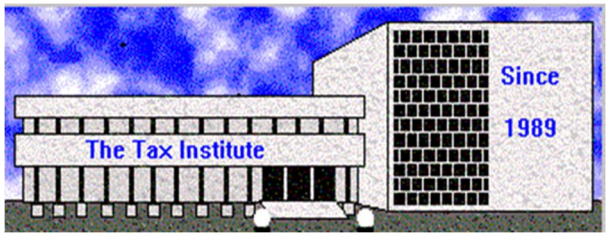

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RETIREMENT INCOME

With the different features and benefits that apply to the various types of retirement plans, choosing the one that is most suitable for taxpayers can be hard and time consuming. In some cases, the process is easier because choices can be narrowed down by eliminating the plans for which an individual is not eligible.

Qualified and non-qualified plans. To achieve the tax savings of the retirement plan, it must satisfies some Internal Revenue rules, in which case, they are referred to as qualified retirement plans. Qualified retirement plans cannot discriminate in favor of owners or highly compensated employees and the amount that can be contributed annually is restricted, depending on the type of plan. The withdrawal of money from a retirement account is referred to as a distribution.

Some retirement plans are available for taxpayers who are employees or owners of a business but not available to individuals without retirement at work. The retirement plan option available will depend then on the following categories in which taxpayers may fall. The retirement plan can vary depending on whether taxpayer is one of the following:

1. Individual.
2. Employee.
3. Sole-proprietors.
4. Teachers, public employees or member of a nonprofit organization.
5. Military member.
6. Member of corporation.

The retirement plan available for each one is described below.

TYPES OF RETIREMENT BASED ON TAXPAYER.

1. Individuals.

If the employer does not offer a retirement plan, taxpayers can start saving on their own. For these taxpayers the following two options exist:

- Tradition IRA
- Roth IRA

If an individual is offered a retirement plan at work, s/he can combine the previous two options with the retirement plan offered at work. Sometimes these two options are offered at work but they do not constitute a benefit from the employer because the employer is not able to contribute into the employeesô plan. These two retirement plans are actually available to all taxpayers who fall under the following categories.

2. Employees.

Employees will have the option to contribute to their retirement plan through their job. The following options will be available for employees:

- Traditional 401(k)
- Roth 401(k)

These plans are offered by employers because they allow them to match the employeeôs contributions to a certain point, usually six percent or less.

Employees can also have a retirement plan outside their job. They can combine their jobôs retirement plan with any of the two options available for individuals.

A 401(k) is a feature of a qualified profit-sharing plan that allows employees to contribute a portion of their wages to individual accounts.

- Elective salary deferrals are excluded from the employeeôs taxable income (except for designated Roth deferrals).
- Employers can contribute to employeesô accounts.
- Distributions, including earnings, are includible in taxable income at retirement (except for qualified distributions of designated Roth accounts).

3. Sole-proprietors.

There are different plans available business owners. The retirement plan will depend on the size of the business, how it is structured and how much money can be contributed. Self-employed individuals can take advantage of the fact that theyôre considered both employer and employee.

Keogh plan. Retirement plans for self-employed people were formerly referred to as 'Keogh plans" after the law that first allowed unincorporated businesses to sponsor retirement plans. Since the law no longer distinguishes between corporate and other plan sponsors, the term is seldom used.

Keogh plans are qualified plans intended for self-employed persons and owner-employees of unincorporated businesses or professional practices who file Schedule C, such as doctors or lawyers. Taxpayers must be operating as a sole proprietorship, a partnership, or a limited liability company (LLC) to participate in a Keogh. In addition, the participant must actually perform personal services for the business in order to be eligible.

The different defined contribution plans available are:

- Simple IRA (Savings Incentive Match Plan for Employees)
- Simple 401(k) (Savings Incentive Match Plan for Employees)
- SEP IRA (Simplified Employee Pension IRA, SEP IRA)
- Self-employed 401(k) aka Solo 401(k)

The individual retirement options are still available for self-employed taxpayers with the proper contribution limits discussed later.

4. Teachers, public employees and nonprofit.

The public sector receives their retirement plan options through the federal, state and local levels of government. They are available to most, but not all, public sector employees. These employer contributions to these plans typically vest after some period of time.

In many states, public employee pension plans are known as Public Employee Retirement Systems (PERS).

Federal employees were offered their retirement plans through the Civil Service Retirement System (CSRS), formed in 1920. CSRS provided retirement, disability and survivor benefits for most civilian employees in the federal government, until the creation of the new federal agency, the Federal Employees Retirement System (FERS), in 1987.

Retirement plans for public employees, teachers and nonprofit members will typically have access to the following plans:

- 403(b). It was originally created for teachers and nurses at public school or hospitals who were not covered by pension plans. Also called Tax Sheltered Arrangements (TSA), they are generally available to workers for any non-profit institution.
- 457(b). This is for employees working for a state or local government.
- A Defined Benefit retirement plan.

The retirement plan options are available for employees of the public and nonprofit sector. The 457(b) plan will have more restriction than the 403(b)

5. Military.

The military retirement system changed on Jan. 1, 2018. The retirement options for military come under two flavors:

- New Blended Retirement System (BRS). The Legacy Plan, which is the regular retirement option for military serving for 20 years, plus the TSP.
- Thrift Saving Plan (TSP). This is a federal version of a 401(k). Options inside the TSP are C, S, I Funds. Where C is the S&P500, the S is the aggressive growth fund and the I is the international. Some say the C Fund is the best option for performance.

Members of the military can also select the retirement plan options available for individuals.

6. Members of corporations.

Corporations will normally offer a pension plan as a vehicle for retirement. A corporate pension plan is a formal arrangement between a company and its employees. Note that it is also known as

pension and not only as retirement plan. The retirement plan is created inside the corporation. This pool of funds can be financed in several ways and will eventually be used to make periodic payments to retired employees. The money is property of the corporation meanwhile. In most cases, both employer and employees make regular contributions to the plan. In the past, employers were wholly responsible for contributing to the plan based on an employee's work, length of employment and position held.

There are two options for corporations, qualified and non-qualified retirement plans. The qualification for the qualified retirement plan comes from the IRS under Revenue Code Section 401(a). The Employee Retirement Income Security Act (ERISA), enacted in 1974, creates and defines the qualified and non-qualified plans for the private sector.

Qualified Pension Plans

Two of the most common corporate qualified pension plans are:

- The defined-benefit plan. This plan promises to pay employees a steady income stream at some point in the future. It is complicated and professional assistant from an actuary is required to create this plan. The benefit is calculated in advance, using a formula based on age, earnings, and years of service. In the United States, the maximum retirement benefit permitted under a defined benefit plan as of October, 2017, is $220,000. Defined benefit pension plans in the U.S. currently do not have contribution limits. The liability of a defined-benefit pension lies with the employer, who is responsible for making all decisions regarding the fund.

- The defined-contribution plans. Defined-contribution plans, on the other hand, don't guarantee a certain benefit. Fixed contributions are paid into an individual account by employers and employees.

Types of defined contribution plans include:

a) Profit sharing plans and
b) Money purchase plans.

Qualified plans are designed to offer individuals added tax benefits on top of their regular retirement plans, such as IRAs. Employers deduct an allowable portion of pretax wages from the employees, and the contributions and the earnings then grow tax-deferred until withdrawal. This is the benefit of being qualified from the IRS. When participating in a defined-benefit pension plan, an employer promises to pay employees a specific benefit for life beginning at retirement. The benefit is calculated in advance, using a formula based on age, earnings, and years of service. Interest, dividends or capital gains are taxed as ordinary income when the employee withdraws money from the plan.

Non-Qualified Pension Plans.

There are four major types of non-qualified plans:

- Deferred-compensation plans,
- Executive bonus plans,
- Group carve-out plans and
- Split-dollar life insurance plans.

The contributions made to these plans are usually nondeductible to the employer and taxable to the employee. However, they allow employees to defer taxes until retirement -- when they are presumably in a lower tax bracket. Non-qualified plans are often used to provide specialized forms of compensation to key executives or employees in lieu of making them partners or part owners in the company or corporation.

Non-qualified plans are those that are not eligible for tax-deferral benefits. Consequently, deducted contributions for non-qualified plans are taxed when income is recognized. This generally refers to when employees must pay income taxes on benefits associated with their employment.

Member of a corporation can also use the retirement plans available for business.

Vesting Provision for Corporation retirement plans. Employer contributions and earnings are available to employees once he/she is vested. Vesting, or the employeeôs right to benefits for which the *employer* has made contributions, depends on the plan provisions. There is not a set period for vesting but it must be a reasonable period.

ERISA AND NON-ERISA PLANS.

To be ERISA-qualified, a retirement plan must be set up and maintained by the employer (and/or a separate employee organization), and it must comply with federal rules regarding reports to plan participants, funding and vesting. Common types of ERISA accounts include 401(k) plans, deferred-compensation plans and profit-sharing plans.

Non-ERISA retirement plans. Common types of non-ERISA retirement accounts include IRAs (traditional and Roth), simplified employee pension plans (SEPs), SIMPLE IRAs, Keogh Plans, 403(b) plans, government plans, church plans and plans that donôt benefit employees (employer-only plans).

Employee Welfare Benefit Plans are protected under ERISA. In addition to pension plans, ERISA may also cover employee welfare benefit plans. What this means is that if taxpayersô plan is not a qualified ERISA retirement plan, but is ñcovered byò ERISA as a qualified employee welfare benefit plan, then that plan is also protected from attachment the same way as the ERISA retirement plan. A ñwelfare benefit planò provides medical care benefits, monetary payments in the event of illness, disability, accident, death or unemployment, and payment of benefits related to retirement, vacation, child care, education, prepaid legal services or similar benefits to the employee.

Examples of employee welfare benefit plans include:

- Group health and life insurance plans
- Dental and vision plans
- Day care
- Accidental death or disability benefits
- Health Reimbursement Arrangements (HRA)
- Health Savings Accounts (HSA)
- Wellness programs (including drug, alcohol and tobacco addiction), and
- Employee assistance programs.

Protection Against Creditors. Except for IRAs, qualified retirement plans, or ERISA plans, are also protected from the claims of creditors. Although IRAs are not ERISA-qualified, the funds are protected under a separate law ï the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ï but only if taxpayers file for bankruptcy. Depending on the state they live in, their IRA and other non-ERISA plans may ï or may not ï be protected from creditors. Some states shield IRAs in nearly all instances, for example, while others offer only limited protection.

Exceptions to the ERISA protection. ERISA-qualified plans may be at risk under certain circumstances and can be seized by:

- Taxpayerôs ex-spouse. The ex-spouse can get access to the fund under a Qualified Domestic Relations Order (QDRO), to the extent of the ex-spouseôs interest in the benefits as a marital asset or as part of a child support order.
- The IRS, for federal income tax debts
- The federal government, for criminal fines and penalties
- Civil or criminal judgments, in cases of your own wrongdoing against the plan

Individual Retirement Accounts are protected for bankruptcy only. Individual retirement accounts, non-employer-sponsored plans, are not covered by ERISA; except under certain conditions. If taxpayers file for bankruptcy, federal law protects up to $1 million in IRA funds as long as they directly contributed to the plan. Or, if they rolled the money into an IRA from a company plan, the entire amount is protected. That's yet another reason why keeping good records is important.

Some States limits the access of creditors to IRAs also. Taxpayers that do not use the bankruptcy option to protect their IRAs can sometimes be protected by the state. State law governs whether IRA funds are protected from creditors. While some other states follow different guidelines, states like New York, protect the assets as long they remain in the account. If taxpayers retire, rolling over assets from a 401(k) into an IRA may create estate planning benefits, but if they move to a state where their IRA is not protected by the state from creditors, they might be better off leaving those funds in the company plan so they stay protected.

LIMITS ON CONTRIBUTIONS TO RETIREMENT PLANS.

A contribution is the amount that the individual, the employer, the employee and the self-employed individual pay into their respective retirement plan. The contributions are limited to

each plan based on age, income and year. The plan must specifically state that contributions cannot exceed certain limits. Any contribution above the limit is penalized by the IRS.

The contributions must come from earned income. The contributions to a retirement plan must come from earned income, which is compensation for active work ð the source of contributions cannot be from investments.

For Individuals. The contribution limit set for individuals will be based on the limits imposed on the traditional IRAs and Roth IRAs. The contributions can be:

- Roth contributions or after-tax contributions. Contributions are limited based on income also. Deduction is not available.
- Traditional IRA contributions or before-tax contributions. Contributions are limited by income. A deduction may be available.

Some plans allow the catch up contributions for taxpayers above age 50.

The contribution income is always subject to FICA taxes. Taxpayersô contributions to a retirement plan are not subject to ordinary income taxes, but are subject to employment taxes in a before-tax plan. The after-tax plan will pay ordinary and FICA taxes.

Distributions from tax-deferred accounts are taxable as ordinary income in the year of the distribution. The income will not be subject to FICA taxes if they were paid already.

Distributions from retirement accounts funded with after-tax dollars, such as the Roth IRA, are completely tax-free.

Credit reduce the FICA tax pain for low income taxpayers. Because contributions to retirement accounts do not save on FICA taxes, there is not much tax savings for low income workers. To encourage low income workers to save for retirement, the federal government offers the retirement savings contribution credit ð often referred to as the saver's credit ð that matches up to $1000 of contributions for qualified taxpayers who contribute to their IRAs or 401(k)s.

Excess on Traditional IRAs and Roth IRAs. If taxpayers contributed to a Roth and traditional IRA in the same tax year and their total contribution went over the allowable IRA amount, IRS regulations require taxpayers to remove the excess from the Roth IRA first. The usual prescription for excess contributions is for the IRS to assess a 6% tax on the excess amount per year for as long as that excess stays in the account.

Excess on Traditional IRAS. The excess contribution must be removed from the IRA to which the amount was contributed. Therefore, an individual with multiple IRAs cannot cherry-pick the IRA from which the correction will occur.

Do not include in taxpayerôs gross income an excess contribution that was withdrawn from a traditional IRA before the tax return is due if both of the following conditions are met.

- No deduction was allowed for the excess contribution.
- Taxpayers withdraw the interest or other income earned on the excess contribution.

Taxpayers can take into account any loss on the contribution while it was in the IRA when calculating the amount that must be withdrawn. If there was a loss, the net income that must be withdrawn may be a negative amount. In most cases, the net income that must be transferred will be determined by the IRA trustee or custodian.

If the excess is discovered after the original income tax return has been filed, taxpayer can do one of the following:

- Remove the excess within 6 months and file an amended return by **October 15**. Write the following at the top of the amended return: ñFiled pursuant to section 301.9100-2ò.
- Reduce next year's contributions by the amount of the excess. For example, if the taxpayerôs limit is $5,500 and he/she exceeded it by $1,500 in the current year, they can offset the excess by limiting their contributions to $4,000 the following year.

Tax on excess contributions earnings. Taxpayers must include in their gross income the interest or other income that was earned on the excess contribution. Report it on the return for the year in which the excess contribution was made. This withdrawal of interest or other income earned may be subject to the additional 10% tax on early distributions if taxpayer was under age 59½. More about this is in Pub. 590-B.

*Form 1099-R***.** Taxpayers will receive Form 1099-R indicating the amount of the withdrawal. If the excess contribution was made in a previous tax year, the form will indicate the year in which the earnings are taxable.

Excess on Roth IRAs. Excess contributions on Roth IRAs that are removed after the deadline are treated as regular Roth IRA distributions, which means that the amount is tax-free and is not subject to the 10% early distribution penalty. However, the 6% excise tax will apply for the contribution that remains as an excess contribution in the Roth IRA.

Excess contributions to a Roth IRAs will be those made for the year that equal the total of:

1. Amounts contributed for the tax year to taxpayerôs Roth IRAs (other than amounts properly and timely rolled over) that are more than the contribution limit for the year, plus
2. Any excess contributions for the preceding year, reduced by the total of:
    a. Any distributions out of taxpayerôs Roth IRAs for the year, plus
    b. Taxpayerôs contribution limit for the year minus the contributions to all the taxpayerôs IRAs for the year.

If contributions to taxpayersô Roth IRA for a year were more than the limit, they can apply the excess contribution in one year to a later year if the contributions for that later year are less than the maximum allowed for that year.

Recharacterization of the excess contribution. If taxpayers have a Roth IRA, another way to avoid penalties is to transfer the excess amount and any earnings into a traditional IRA or vice versa. The IRS calls this move a ñrecharacterization.ò

To recharacterize a regular IRA contribution, taxpayers will tell the trustee of the financial institution holding the IRA to transfer the amount of the contribution plus earnings to a different type of IRA (either a Roth or traditional) in a trustee-to-trustee transfer or to a different type of IRA with the same trustee. If this is done by the due date for filing the tax return (including extensions), taxpayers can treat the contribution as made to the second IRA for that year (effectively ignoring the contribution to the first IRA).

For businesses and employees. For all the other retirement plans, there will be contribution limits set on the employee and the employer. The contributions can be separated as follows:

- Elective deferral contributions for employees. Also called salary reduction contributions, these are the most common types of contributions to retirement plans. Taxpayers elect to have their money deducted each pay period for their retirement account. Pre-tax dollars are contributed in this case. These contributions are not included in income.

- Matching contributions for employers. In most retirement plans, the employer can make contributions, or elective deferrals, to the employeeôs account. In some plans, employer contributions are mandatory; in other plans, they are discretionary (optional). The employer matches a certain amount per dollar contributed by the employee. Matching employer contributions are not taxable income (though the amount may be shown on Form W-2).

- Discretionary contributions for employers. Discretionary, or non-elective, employer contributions are allowed by some retirement plans. These are contributions made in addition to matching contributions, at the employer's discretion. Such a contribution must be made equally to every employee covered by the plan; it cannot be made only to certain individuals. Discretionary contributions by employers are generally nontaxable income for the employees.

<u>Excess contributions</u>. If deferrals are over the contribution limit, they are called excess deferrals. The IRC Section 402(g) limits apply to elective deferrals made into various arrangements, including 401(k) plans, 403(b) arrangements, Salary Reduction Simplified Employee Pension Plans (SAR-SEPs) and Savings Incentive Match Plans for Employees (SIMPLE-IRAs). Elective deferrals include both pre-tax salary reduction contributions and designated Roth contributions, which are contributed on an after-tax basis. A participant must aggregate all elective deferrals contributed to all of the plans in which he or she participates to determine if the IRC Section 402(g) limit has been exceeded.

Excess deferrals should be reported to the employer or plan administrator. Taxpayers may request that the excess amount plus earnings be reimbursed before the income tax due date for that year and pay ordinary income tax.

If the excess is discovered after the original income tax return has been filed, taxpayer can do one of the following:

- Remove the excess within 6 months and file an amended return by **October 15**.
- Reduce next year's contributions by the amount of the excess. For example, if the taxpayerôs limit is $5,500 and he/she exceeded it by $1,500 in the current year, they can offset the excess by limiting their contributions to $4,000 the following year.

Be aware that when taxpayers "carry forward" an excess to a future year, they'll have to pay a 6% penalty to the IRS until the excess is absorbed or corrected.

For example, if taxpayer contributed $1,000 more than allowed, he/she'd owe $60 each year until he/she corrects the mistake.

Form 5329 for not corrected excess. If taxpayer did not remove the excess contribution, the amount over the limit should be reported on form 5329 unlit removed. Part III to IX are used to report excess contributions to a variety of plans. Each year the issue remains the form is required.

Part III	**Additional Tax on Excess Contributions to Traditional IRAs.** Complete this part if you contributed more to your traditional IRAs for 2017 than is allowable or you had an amount on line 17 of your 2016 Form 5329.						
9	Enter your excess contributions from line 16 of your 2016 Form 5329 (see instructions). If zero, go to line 15				9		
10	If your traditional IRA contributions for 2017 are less than your maximum allowable contribution, see instructions. Otherwise, enter -0-	10					
11	2017 traditional IRA distributions included in income (see instructions) .	11					
12	2017 distributions of prior year excess contributions (see instructions) .	12					
13	Add lines 10, 11, and 12				13		
14	Prior year excess contributions. Subtract line 13 from line 9. If zero or less, enter -0-				14		
15	Excess contributions for 2017 (see instructions)				15		
16	Total excess contributions. Add lines 14 and 15				16		
17	**Additional tax.** Enter 6% (0.06) of the **smaller** of line 16 **or** the value of your traditional IRAs on December 31, 2017 (including 2017 contributions made in 2018). Include this amount on Form 1040, line 59, or Form 1040NR, line 57 .				17		
Part IV	**Additional Tax on Excess Contributions to Roth IRAs.** Complete this part if you contributed more to your Roth IRAs for 2017 than is allowable or you had an amount on line 25 of your 2016 Form 5329.						

Employer matching limit. The employer must annually choose one of the contribution methods below. The employer must tell employees during the election period which method will be used for the following year:

- *2% nonelective contribution* - 2% of each eligible employeeôs compensation regardless of whether or how much the employee deferred, or

- *3% matching contribution* - match of employeeôs elective deferrals on a dollar-for-dollar basis up to 3% of the employee's compensation.
    - May reduce the 3% limit to a lower percentage, but in any event, not lower than 1%. May not lower the 3% limit for more than 2 calendar years out of the 5-year period ending with the calendar year the reduction is effective.

- The employer cannot make any other contributions to a SIMPLE IRA plan.

Excess contributions also apply to employers. The employersô contribution limits do not affect the employeesô contributions to the plan; in other words they have two different limits and they

are not combined. The total of employer contributions, employee contributions and forfeitures allocated to a participantôs account cannot exceed the limits under Internal Revenue Code Section (IRC) 415(c).

Employers are required to know the matching limits set on their retirement plans. Prior to November 2, the beginning of the 60-day election period, employers must notify the employees of which contribution will be made in the following calendar year as employer.

Once again, employers need to review the plan document language for the employerôs contributions. Based on those provisions and compensation data, calculate the employer contribution for all employees. Compare the calculation with the amounts that were actually contributed for the employees. If the amounts differ, then itôs possible that the employer isnôt following the plan terms.

Correcting if the employer contributed less than was required. If the employer miscalculated the contributions and contributed less than required by the SIMPLE IRA plan document and annual notice, the employer must contribute make-up amounts, adjusted for earnings through the date of correction.

If the employer didnôt make the contribution timely, he/she can make an additional contribution of the earnings that the contributions wouldôve accrued if they were timely contributed.

If it isnôt feasible to determine what the actual investment results wouldôve been, the employer may use a reasonable rate of interest, such as the interest rate used by the Department of Laborôs Voluntary Fiduciary Correction Program.

Correcting if the employer contributed more than was required. If the employer contributed more than the amount required by the terms of the plan, then the employer should correct by using either the:

- *Distribution Method* - effect distribution for the excess amount, as adjusted for earnings (see Revenue Procedure 2016-51 section 6.11(5)(a)). The earnings adjustment will be based on the actual rates of return of the participantôs SMPLE IRA account from the date(s) that the excess deferrals were made through the date of correction.
    - When the excess amount is because of:
        1. Elective deferrals - distribute and report on Form 1099-R as taxable for the year the distribution is made.
        2. Employer contributions - distribute to the plan sponsor rather than to the participants and report on a Form 1099-R issued to the participant, with a taxable amount of zero.
- *Retention Method* ï retain excess amounts in the SIMPLE IRA. The plan sponsor must pay an amount to the IRS that is at least 10% of the excess amount. This is in addition to the Voluntary Correction Program user fee.

- *Small excess amounts*. If the total excess amount is $100 or less, the employer isnôt required to distribute the excess and isnôt subject to the special additional fee.

Self-Correction Program for Employer. If the employer miscalculate the contributions by not following the SIMPLE IRA plan document terms and annual notice, but meet the other Self-Correction Program (SCP) eligibility requirements, he/she might be able to use SCP to correct the mistake (if no excess monies are allowed to remain in the affected participantsô IRAs). The employer would have to determine whether:

- Appropriate practices and procedures were originally in place to facilitate compliance with requirements for calculating and paying the elective deferrals and employer contributions.
- The failure is insignificant.

Voluntary Correction Program for Employers (VCP). Under VCP, correction is described under ñCorrective action,ò above. If the plan isn't under audit, the employer may make a VCP submission using the model documents in Form 14568, Model VCP Compliance Statement, including Form 14568-D, Model VCP Compliance Statement - Schedule 4: SIMPLE IRAs. Include Forms 8950 and 8951. The employer must use VCP if he/she wishes to allow excess amounts to remain in the affected participantsô IRAs and the employer will have to pay an additional amount to the IRS equal to 10% of the excess amounts. Beginning in 2018, the user fee for VCP submissions is generally based upon the current value of all IRAs that are associated with the SIMPLE IRA plan. For example, if the value is between $0 and $500,000, the user fee is $1,500. If the value of all IRAs exceeds $500,000, the user fee will be higher.

Depositing Employees' Elective Deferrals. Employers must deposit employee contributions to the retirement planôs trust or individual accounts as soon as they can reasonably be segregated from the employerôs general assets. Department of Labor rules require that the employer deposit deferrals to the trust as soon as the employer can; however, in no event can the deposit be later than the 15th business day of the following month. Remember that the rules about the 15th business day isn't a safe harbor for depositing deferrals; rather, that these rules set the maximum deadline.

The Department of Labor provides a 7-business-day safe harbor rule for employee contributions to plans with fewer than 100 participants.

<u>Correcting error under IRS Employee Plans Compliance Resolution System (EPCRS)</u>. If the employer doesn't make the deposits timely, the failure may constitute both an operational mistake, giving rise to plan disqualification; if the plan specifies a date by which the employer must deposit elective deferrals and a prohibited transaction. Although an employer can correct an operational mistake under EPCRS, a prohibited transaction can't be corrected under EPCRS.

There are three ways to correct mistakes under EPCRS:

1. Self-Correction Program (SCP) - permits a plan sponsor to correct certain plan failures without contacting the IRS or paying any fee.

2. Voluntary Correction Program (VCP) - permits a plan sponsor to, any time before audit, pay a fee and receive IRS approval for correction of plan failures.

Audit Closing Agreement Program (Audit CAP) - permits a plan sponsor to pay a sanction and correct a plan failure while the plan is under audit.

Limits on Contributions to Each Retirement Plan.

Limits on Traditional IRA and Roth IRA contribution for Individuals**.**

For 2018, the cap on IRA and Roth IRA contribution limit is $5,500 for individuals under age 50 and $6,500 for those over 50. The contributions and limits apply to each individual. Unlike traditional IRAs, Roth IRAs have no age limit on contributions. Each taxpayer can contribute up to the limit each year.

Comparing traditional and Roth IRAs.		
Feature	**Traditional IRA**	**Roth IRA**
Who can make contributions?	Wage-earners under age 70½ at end of calendar year.	Wage-earners of any age with restrictions based on tax-filing status and annual modified adjusted gross income AGI.
Are contributions deductible?	Yes, but with restrictions based on tax-filing status, annual modified AGI, and access to a workplace retirement plan.	No.
Annual contribution limit	$5,500 ($6,500 if 50 or older); limited to lesser of earned income or contribution limit.	Same as traditional IRA.
Offers tax-free compounded income?	No.	Yes.
Taxes on withdrawals of contributions and earnings	Withdrawals are taxed; tax liability based on deductibility of original contributions.	Withdrawals of contributions arenôt taxed; earnings generally are taxed if taken before age 59½ and if they donôt meet the five-year holding period requirement.
Early withdrawal penalty	10% on most withdrawals before age 59½.	Withdrawals of contributions are not penalized; 10% penalty on withdrawal of earnings 1.) before age 59½ or 2.) not meeting tax-year holding period requirements.
Required minimum distributions (RMDs) at age 70½	Yes.	No; exceptions possible upon death of account owner.

Review Questions Section 1

Read and answer the following review questions. The correct answers are found on the next page with an explanation to strengthen up your knowledge. Note: This is not part of your Final Test.

1. What percentage do employers usually contribute to their employeeôs traditional 401(k) or Roth 401(k)?
   a) 50%
   b) 6%
   c) 10%
   d) Employers donôt contribute

2. This retirement plan was originally created for nurses and teachers working in public facilities who were not covered by pension plans.
   a) Social Security
   b) Keogh Plan
   c) 401(k)
   d) 403(b)

3. Generally, ERISA plans are protected against creditors; however, there are some exceptions to the protection. Which of the following can seize an ERISA-qualified plan?
   a) The IRS
   b) The federal government
   c) Taxpayerôs ex-spouse
   d) All of the above

4. Contributions to retirement plans must come from:
   a) Investments
   b) Earned income
   c) Inheritance
   d) Any source of income

5. Which of the following statements is true regarding excess contributions on Roth IRAs?
   a) If contributions to taxpayersô Roth IRA for a year were more than the limit, they can no longer apply it to a later year.
   b) Taxpayer must remove the excess within 6 months and file a return by April 15.
   c) After the deadline excess contributions are tax-free and are not subject to the 10% early distribution penalty since they are treated as regular Roth IRA contributions.
   d) All of the above are correct.

6. This form must be used when taxpayer does not remove the excess contributions made to a retirement plan.
   a) Form 8950
   b) Form 5329
   c) Form 5239
   d) Form 590

7. Voluntary Correction Program, Self-Correction Program, and the Audit Closing Agreement Program are examples of?
   a) Programs available for employers to correct amounts made to retirement plans.
   b) Programs for employees and employers to correct ERISA plans.
   c) Ways to correct errors under Employee Plans Compliance Resolution System.
   d) Ways for employers to correct an incorrect pension plan.

Questions Section 1 – Answers and Discussion

1. **Answer b.** Traditional 401(k)s and Roth 401(k)s are offered by employers because they allow them to match the employeeôs contributions to a certain point, usually six percent or less.

2. **Answer d**. 403(b) was originally created for teachers and nurses at public school or hospitals who were not covered by pension plans. Also called Tax Sheltered Arrangements (TSA), they are generally available to workers for any non-profit institution.

3. **Answer d.** ERISA-qualified plans may be at risk under certain circumstances and can be seized by:

- Taxpayerôs ex-spouse. The ex-spouse can get access to the fund under a Qualified Domestic Relations Order (QDRO), to the extent of the ex-spouseôs interest in the benefits as a marital asset or as part of a child support order.
- The IRS, for federal income tax debts
- The federal government, for criminal fines and penalties
- Civil or criminal judgments, in cases of your own wrongdoing against the plan

4. **Answer b.** The contributions to a retirement plan must come from earned income, which is reward for active work; therefore the source of contributions cannot be from investments.

5. **Answer a.** Excess contributions on Roth IRAs that are removed after the deadline are treated as regular Roth IRA distributions, which means that the amount is tax-free and is not subject to the 10% early distribution penalty. However, the 6% excise tax will apply for the contribution that remains as an excess contribution in the Roth IRA.

6. **Answer b.** <u>Form 5329 for not corrected excess</u>. If taxpayer did not remove the excess contribution, the amount over the limit should be reported on form 5329 unlit removed. Part III to IX are used to report excess contributions to a variety of plans. Each year the issue remains the form is required.

7. **Answer c.** The three ways to correct mistakes under EPCRS are:

- Self-Correction Program (SCP) - permits a plan sponsor to correct certain plan failures without contacting the IRS or paying any fee.
- Voluntary Correction Program (VCP) - permits a plan sponsor to, any time before audit, pay a fee and receive IRS approval for correction of plan failures.
- Audit Closing Agreement Program (Audit CAP) - permits a plan sponsor to pay a sanction and correct a plan failure while the plan is under audit.

Taxpayers may be eligible to make a full or partial IRA or Roth IRA contribution. Their total contributions to Roth and Traditional IRAs cannot exceed the dollar limits above, meaning they can contribute to both, such as $2,000 to a Traditional IRA and $3,500 to a Roth, but the total of both contributions cannot exceed the maximum contribution amount.

Rollovers do not count for the contribution limit. Rollover contributions do not have an annual limit. Taxpayers can rollover literally as much as they like from a qualified retirement plan (QRP) or IRA into another IRA. In addition, there is no requirement to have had earned income for the year when making a rollover.
A rollover generally refers to "existing" retirement account funds being transferred while a contribution generally refers to "new" funds being deposited. From a more technical standpoint, itôs a ñrolloverò when funds are transferred from a retirement plan (401k, 403b, so on) to an IRA. Moving funds between similar plans (old 401k to new 401k, old IRA to new IRA) is a "transfer." But the term "rollover" has come to be loosely used for almost any movement of funds between retirement plans/accounts.

Rollovers have no impact on taxpayersô annual contribution amounts and vice versa. They can rollover any amount without having to worry about annual limits, and then they can make regular annual IRA contributions up to the limits mentioned above.

If taxpayers have money in other qualified retirement accounts, such as a traditional IRA, 401(k), 403(b) or even another Roth IRA, they are allowed to move the money to a Roth IRA. These rollovers do not count as contributions, so they do not reduce the amount that taxpayers can contribute each year. For example, if they roll over $15,000 from another qualified retirement plan to a Roth IRA, they can still make their annual Roth IRA contribution up to the limit.

Recharacterizations can affect contribution limits. The amount recharacterized from one IRA to another must include related earnings or be reduced by any loss. The contribution limit for the year can be affected by a recharacterization. The contribution limit can decrease or increase accordingly.
Example: Assume John contributes $1,000 to his traditional IRA for 2017. Before the deadline for filing his 2017 federal income tax return, John decides to recharacterize his contribution (plus the $50 in earnings allocable to it) to a Roth IRA. Through a trustee-to-trustee transfer, $1,050 is switched to his Roth IRA. If John is otherwise eligible, he can contribute an additional $4,500 ($5,500 if he is age 50 or older by the end of the tax year) to his Roth IRA for 2017. The $50 of earnings is treated as having been earned in the Roth IRA.

Recharacterization time limit under the new Tax Cut Jobs Act (TCJA). Taxpayers were generally able to recharacterize their rollover or conversion by October 15 of the following year, regardless of whether they requested an extension to file their tax returns. For example, for taxpayersô conversion to a Roth IRA in 2016, they have until October 15, 2017, to recharacterize. This deadline applied even if:

- they did not request an extension to file your 2016 tax return, and
- they file their return on or before April 15, 2017.

Under the new TCJA law, for tax years beginning after December 31, 2017, the extra time to recharacterize a Roth conversion is eliminated. December 31 of each year may be "the do it or lose it date" for recharacterizations of conversions made in the previous year.

Under the new law, recharacterization cannot be used to unwind a Roth conversion. However, recharacterization is still permitted with respect to other contributions. For example, an individual may make a contribution for a year to a Roth IRA and, before the due date for the individualôs income tax return for that year, recharacterize it as a contribution to a traditional IRA.

In addition, an individual may still make a contribution to a traditional IRA and convert the traditional IRA to a Roth IRA, but the provision precludes the individual from later unwinding the conversion through a recharacterization.

Limits on Qualified and non-qualified plans.

401(k), 403(b), 457 and TSP contribution limits.

Qualified plans are subject to annual contribution limits set by the IRS each year. The contribution limit for employees who participate in 401(k), 403(b), most 457 plans, and the federal governmentôs Thrift Savings Plan is $18,500 in 2018. If taxpayer is age 50 or older they can contribute $6,000 more. Contributions in excess of these amounts are not deductible and may subject the employee to excise taxes.

For highly compensated employee the limit is set to $120,000.

SIMPLE IRA Contribution Limits		
Contribution Limits	2017	2018
Elective Deferral Limit	$12,500	$12,500
Catch-up limit for individuals age 50 and older	$3,000	$3,000
Maximum employers match ($1 for $1 match on the first 3% of employee compensation deferred).	$12,500	$12,500
Maximum employer non-elective contribution (2% of employeeôs compensation, up to $270K in 2017 and $275K in 2018)	$5,400	$5,500
Catch-up deferral is also matched by employer if individual is age 50 or older.	$3,000	$3,000

SEP IRA contribution limits. SEP IRA contributions are limited in 2018 to $55,000.

Profit Sharing, 401(k) and Money Purchase Pension defined contribution limit. For 2018 the defined contribution limit to a profit sharing account, 401(K), Money Purchase Pension is limited to $55,000.

The employee contribution limit to any of these accounts is limited to $275,000.

For top-heavy plan key employees the limit is $175,000.

2018 Retirement Contribution Limits Table			
Retirement Account	**2018 Limit**	**2017 Limit**	**Change**
401(k), 403(b), or 457 plans	$18,500	$18,000	Increase
50+ catch-up limits for above	$6,000	$6,000	None
Traditional IRA plans	$5,500	$5,500	None
Roth IRA plans	$5,500	$5,500	None
50+ catch-up limit for IRAs	$1,000	$1,000	None
SIMPLE IRA	$12,500	$12,500	None
50+ catch-up limit for SIMPLE IRA	$3,000	$3,000	None
SEP IRA	$55,000	$54,000	Increase
Solo 401(k)	$55,000	$54,000	Increase
50+ catch-up limit for Solo 401(k)	$6,000	$6,000	None

Key employeesô limit. There are also some income limits for contributing to certain retirement plans, which vary according to the type of plan and by the year of contribution. Moreover, there are special rules regarding highly compensated and key employees, who are defined as employees with at least the following inflation-adjusted minimum incomes:

- **control employee**:
  - 2018: $110,000
  - 2017: $105,000

- **highly compensated employee** [§414(q)]:
  - 2015 - 2018: $120,000
  - 2012 - 2014: $115,000
  - 2011: $110,000

- **key employee** [§416(i)(1)]:
  - 2017 - 2018: $175,000
  - 2014 - 2016: $170,000
  - 2012-2013: $165,000
  - 2011: $160,000

INVESTING OPTIONS INSIDE THE RETIREMENT PLANS. GOING ABOVE THE INFLATION RATE.

Essentially, the retirement plan indicates the tax treatment for the investment inside the retirement. It indicates if an upfront tax deduction with a tax deferred investment option is available or a tax-free plan with no tax benefit upfront is selected. The investment available inside the retirement plans will vary from safety to more risky and from increased growth to a safety-no-growth investment. The investment is sometimes based on the inflation rate; the investments that offer a return well above the inflation rate are offered to taxpayers but are not the standard.

There are two main options available for investment inside a retirement plan:

- Mutual funds. A mutual fund is a professionally managed investment fund that pools money from many investors to purchase securities. These are divided among many categories depending on companies, the type of growth and the objective. The most common funds include: growth, growth and income, aggressive growth and international. These managed funds main objective is to create a rate of return that outperforms the S&P500 index.
- Single stocks. They consist on stocks of a single company. They carry the complete risk and rate of return associated with that single company. They can be preferred, common, cumulative, etc. Keeping track of multiple single companies is a very complex job and risky.

Standard Rate of Return based on SP500 Index. There are lots of investment options to choose from, and making sense of them all is not easy. To make an investment easy, investment advisors take a standard rate of return based in the S&P500 index. The standard rate of return for investments is marked by the Standard & Poorôs 500, often abbreviated as the S&P 500, or just the S&P, is an American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.

The S&P can be the base return for a simple investment and some investments can go above or below depending on safety and cost. Mutual funds are considered to outperform the S&P but they come with an extra cost. Other options are single stocks that may outperform the S&P in one period but can also loss more in a single day. Single stocks have a higher risk due to the fact that is in one single company. Mutual funds are, on the other hand, invested in a pull of companies.

These two options are available for retirement plans and sometimes are used by other companies, like insurances companies that sell annuities or pensions to taxpayers. These companies sometimes use mutual funds to grow the money and give part of it to the taxpayers who purchase those products.

There is another investment option, similar to mutual funds except that they invest in real estate. This option is known as: REITs, Real Estate Investment Trust.

REITs are companies that own or finance real estate. Similar to mutual funds, REITs sell shares to investors who are then entitled to a portion of the income produced from the companyôs real estate investments. The income comes after all the expenses have been paid for the real estate properties. They have performed similar or sometimes better than the S&P but come with other risks.

To sell these types of investments, an individual must carry an investment license and must be registered with FINRA and with the proper state.

Low to Zero Rate of Return Options. There are other places considered safe but with low-to-zero return available inside the retirement plans, they sometimes offer a return below the inflation rate:

- Certificate of Deposits (CDs).
- Bonds of any kind. T-bills included.
- Money market account.
- Savings account.

Prohibited Investment Options Inside Some Retirement Accounts. The tax code prohibits retirement funds held in an IRA type of account ï traditional and Roth IRAs, SEPs, and SIMPLE IRAs ð to be invested in life insurance or collectibles, such as:

- Alcoholic beverages
- Antiques
- Artwork
- Coins
- Gems
- Metals
- Rugs
- Stamps
- Certain other tangible personal property.

Any amount invested in such assets will be considered distributed in the year of the investment, which may incur a 10% additional tax penalty on early distributions. There are specific exceptions for certain types of bullion and coins. Refined bullion can be owned directly if it is physically held by a bank or an IRS-approved non-bank trustee or if it is held indirectly by an IRA-owned limited liability company.

While the tax code does allow an IRA to invest in real estate, trustees are not required to offer that option. Also, investments in closely held companies or real estate will more likely lead to violating rules against self-dealing, thus disqualifying the IRA account as a qualified retirement account under the tax code, subjecting the amount in the account to taxes.

CONTRIBUTIONS TO NON-QUALIFIED RETIREMENT PLANS.
Taxpayers who have maxed out their 401(k) or 403(b) workplace savings plan may want to consider a nonqualified deferred compensation (NQDC) plan. NQDC plans allow executives to

defer a much larger portion of their compensation, and to defer taxes on the money until the deferral is paid. These plans are commonly known as deferred compensation plans or salary reduction plan.

NQDC plans arenôt for everyone; NQDC plans have the potential for tax-deferred growth, but they also come with substantial risks. The greatest risks for taxpayers include the complete loss of the assets in the NQDC plan because the assets are invested with only one company.

An NQDC plan is an agreement between employee and employer to defer a portion of the employeeôs annual income until a specific date in the future. Depending on the plan the set date could be in five years, 10 years, or at retirement.

Main types of NQDC. There are two general types of NQDC plans: top-hat plans and deferred savings plans. Top-hat plans are generally paid by employers, while deferred savings plans are based on the amount of compensation deferred by each employee. Under these general categories are several subtypes:

- Salary reduction arrangements,
- Bonus deferral plans,
- Supplemental executive retirement plans (SERPs), and
- Excess benefit plans.

Excess benefit plans are designed to provide benefits that exceed the limits defined in IRC §415. Phantom stock plans are also a type of NQDC plan.

Salary reduction plans and supplemental executive retirement plans (SERPs). With the salary reduction plan, the employer takes some of compensation that would otherwise be paid to the participant and defers it into the nonqualified plan. Unlike qualified retirement plans, there is no limit on the deferrals. On the other hand, a SERP is additional income beyond gross salary. Salary deferral plans are defined contribution (DC) plans, because they are funded with defined contributions, while SERPs are like defined benefit plans.

No contribution limits on Non-qualified deferred compensation. Taxpayers can decide how much to defer each year from their salary, bonuses, or other forms of compensation. Deferring this income provides one tax advantage: taxpayers donôt pay income tax on that portion of their compensation in the year deferred. Taxpayers do pay Social Security and Medicare taxes, so it has the potential to grow tax deferred until the retirement is received.

Most companies provide NQDC plans as an executive retirement benefit, because 401(k) plans often are inadequate for high earners. Take an executive earning $500,000 a year: The $18,500 limit on annual 401(k) contributions represents only 3.6% of his or her annual income. At that rate, the executive could never save enough (pretax) to make up the typical 70%ï 90% replacement income goal for retirement. By contrast, the executive could choose to set aside a much larger percentage of his or her salary into an NQDC plan each year, creating an appropriate retirement cushion. Of course, executives have after-tax savings opportunities as well, such as a taxable account and/or a tax-deferred annuity.

Employees do not control the investment options inside the NQDC. Control of the NQDC assets by the employee are limited by IRS rules and by the NQDC plan itself. With unfunded NQDC amounts, the investment selections are actually notional, what the employer promises to pay based on the selection, such as a fixed rate of interest, or the returns of a mutual fund or a stock index.

However, the returns must be reasonable. If a NQDC plan credits the deferral with excessive interest, or pays benefits based on unreasonable actuarial assumptions, additional FICA taxes may be due on the excessive or unreasonable amounts credited to the participant's account.

No loans and rollovers allowed. There are downsides to NQDC plans. For example, unlike 401(k) plans, taxpayers canôt take loans from NQDC plans, and they canôt roll the money over into an IRA or other retirement account when the compensation is paid to them. The money in this plan is not eligible to be rolled over into qualified retirement plans such as 403(b) plans or IRAs.

Not an asset of taxpayer until vested. Unlike a qualified plan, where benefits are segregated from the employer's general assets, the deferred compensation to the NQDC remains the employer's general assets and is subject to potential loss. The plan essentially represents a promise by the company to pay the employee back. At most, the company may set aside money in a trust, called a rabbi trust, to pay future benefits when they become payable. The funds in this trust are still part of the companyôs general assets, and would be subject to creditorsô claims in a corporate bankruptcy.

Funded by employee or employer; elective or non-elective. NQDC plans may require the employee to make contributions or the employer may pay the contributions. With an elective NQDC, an employee chooses to pay the contribution by receiving less current salary and bonus compensation. Non-elective NQDCs are plans in which the employer funds the benefit without reducing current compensation.

Taxable to taxpayers under the Economic Benefit Rule or the Constructive Receipt Rule. There are 2 main rules that determine whether deferred income is currently taxable to the employee:

- The economic benefit rule and
- The constructive receipt rule.

The Economic Benefit Rule, no forfeiture risk. The economic benefit rule (IRC §83) states that income will be taxable to the employee when there is no substantial risk of forfeiture or when it becomes transferable. The employer may maintain a substantial risk of forfeiture by using longer vesting schedules, performance thresholds, or conditions where the employee does not receive the compensation, such as if the employee leaves within a certain time or goes to work for a competitor.

Additionally, income is only taxable if the current value of the NQDC account is ascertainable. If the exact amount is known and there is no risk of forfeiture to the employee, then the employer can deduct the compensation from its taxes and the employee must pay taxes on the income in

the year received. So even if the money is transferred to a trust, where the distributions can only be paid to the employee, then the income is taxable to the employee since it has ascertainable economic benefit and there is no substantial risk of forfeiture.

The Constructive Receipt Rule. The constructive receipt rule [IRC §451(a)] states that income is taxable to an employee when the employee constructively receives it, meaning that the money is available to the employee, whether the employee actually receives it or not. The constructive receipt rule prevents an employee from choosing to receive compensation now or later. So if an executive can choose the timing of his bonus, then the bonus will become taxable at the earliest time that the executive can receive it. If the taxpayer does not pay taxes on income that was constructively received, then they will not only have to pay regular taxes on the income, but also a 20% penalty.

To defer taxation of compensation under the constructive receipt rule, an employee must choose to defer compensation that will be earned in a future year. If the deferral choice is made in the calendar year before earning the income, then the constructive receipt rule will not apply. It also will not apply if the compensation is received within 2½ months after the year when the participant becomes vested in the compensation. Additionally, the employee cannot have any right to receive payment before it is due under the terms of the NQDC plan.

Payroll taxes apply when money from NQDC is received. FICA (Federal Insurance Contributions Act) and Federal Unemployment Tax Act (FUTA) taxes must be paid when the income is earned or when there is no possibility of forfeiture of the income. Other state taxes will also apply. Additionally, these taxes are subject to tax withholding rules, where the taxes must be withheld before paying the compensation to the employee.

The employer's compensation deduction is governed by IRC §§ 83(h) and 404(a)(5). Generally, compensation cannot be deducted by the employer until it is includible in the income of the employee, which, as already stated, occurs when the employee actually or constructively receives the compensation or enjoys an economic benefit from it. Employers are required to withhold income taxes from NQDC amounts at the time the amounts are actually or constructively received by the employee.

No payroll taxes on earnings if reasonable; the non-duplication rule. The non-duplication rule in Treas. Reg. §31.3121(v)(2)-1(a)(2)(iii) excludes from wages, interest or earnings credited to amounts deferred under a NQDC plan. However, Treas. Reg. §31.3121(v)(2)-1(d)(2) limits the scope of the non-duplication rule to an amount that reflects a reasonable rate of return or is based on reasonable actuarial assumptions. Otherwise, earnings on NQDC plans may be subject to FICA taxes.

Vesting and forfeiture practices seen in nonqualified plans. Forfeiture provisions are necessary for some plans to defer the taxation of the income to the employee at a later time. SERP's are more likely to have forfeiture provisions, of which there are 4 types:

- vesting schedules
- performance conditions
- post-retirement consulting requirements, and

- noncompete agreements.

Forfeiture provisions are less common in salary reduction plans. The vesting schedule for deferred compensation plans is much more flexible than for retirement plans governed by ERISA. Hence, there is no limit to the duration of the vesting schedule. Generally, non-compete clauses will not be legally enforceable unless they are restricted to a reasonable time period and to a specific geographic region.

Vesting requirements under ERISA for qualified plans. According to the Department of Labor, in a defined benefit plan, an employer can require that employees have 5 years of service in order to become 100 percent vested in the employer funded benefits. Employers also can choose a graduated vesting schedule, which requires an employee to work 7 years in order to be 100 percent vested, but provides at least 20 percent vesting after 3 years, 40 percent after 4 years, 60 percent after 5 years, and 80 percent after 6 years of service. Plans may provide a different schedule as long as it is more generous than these vesting schedules.

Taxpayers are only entitled to the vested portion of their pension at the time they leave their employer.

Pension Options When Taxpayers Leave a Job. Typically, when taxpayers leave a job with a defined benefit pension in which they are vested, they have a few options. They can choose to take the money as a lump sum when leaving, or take the promise of regular payments in the future, also known as an annuity. Remember annuities make the return designed by employer not the return chosen by the employee.

Distributions from NQDC. Unlike tax-deferred qualified plans, NQDC plans have neither required minimum distributions nor a minimum age requirement for starting distributions. Distributions from NQDC plans are subject to taxes of the state where the participant resides, which may be different from the state where the compensation was earned.

Distributions can be scheduled for different dates, depending on requirements, using the class-year approach. Different dates can be scheduled for different accounts and different investment portfolios. Thus, a distribution from one account can be used to pay for a child's education, and another set of distributions can be scheduled for retirement.

Distributions under major events. Distributions depend on the triggering event specified in the plan, which is usually retirement, but may also include death, disability, some specified type of emergency, or when the business changes ownership. Nonqualified deferred compensation plans will also have provisions for preretirement death or disability, where the money would be paid to the participant or his heirs.
Deferred compensation schemes may also have a hardship withdrawal provision, where a certain amount may be withdrawn, equal to the amount needed for the emergency. The IRC defines a hardship as financial stress caused by accident or illness to the participant, his spouse, or dependent. The hardship withdrawal amount is taxed to the employee in the year received, so the employer can deduct the amount in the same year.

Early retirement or longer retirement provisions; the golden handshake or golden handcuffs. NQDC plans may also have special provisions for distributions. The golden handshake pays the participant a certain amount as an inducement to take early retirement. Golden handcuffs, on the other hand, usually have a long vesting schedule or a consultant stipulation, where the participant is paid only if he consults with the employer for a certain duration after retirement.

THE DIFFERENCE BETWEEN 401(K) AND NQDC PLANS, AT A GLANCE.		
Feature	**401(k)**	**NQDC**
Yearly limit on amount participant can defer from income	Yes, Internal Revenue Code (IRC) limits apply	No IRC limits, but plan limits are possible
Must start taking out money at age 70½	Yes, by IRC mandate, unless still working at company where the 401(k) plan is, subject to 5% owner rule	No IRC requirements, but plan rules are possible
Can receive distributions of any amount and at any time for financial hardship, and, from age 59½ on, without a penalty tax	Yes, whether employed or not	No, but job separation and other events can trigger distributions before that age
Ability to take early withdrawal at any time, paying taxes and a penalty on the withdrawal amount	Yes, but only upon separation from service; a 10% additional tax may apply if under age 59½. Plan may permit in-service withdrawals without penalty after age 59½	No, with the possible exception of amounts deferred and vested before 2005
Funds protected from creditors in bankruptcy	Yes	No
Must get distribution upon job loss	No. If balance is under $5,000, the plan sponsor may cash out the balance but is not required to do so. Also, participants may keep balances in plan well after normal retirement age	No; Sometimes a job loss will trigger a lump-sum distribution, but this is not a general rule
Upon job loss, the participant can roll money over to an IRA or transfer to a new employer's qualified plan	If the termination is a distributable event under the terms of the plan	No
Flexibility in when and how the participant can withdraw money in retirement	Usually, but not required	Limited by up-front elections, plan provisions, and redeferral rules
The participant can take loans from the plan	Yes, if plan allows	No
Tax deduction for the participant's company	At time of deferral	At time of distribution or when the participant recognizes it as taxable income

Golden parachute provision. Another possible provision is a golden parachute, which pays an additional deferred compensation when the company is sold or merged. Golden parachutes help to reduce the risk that the participant will not receive the deferred compensation if the company

is bought out. Hence, golden parachute provisions generally allow additional benefits, full vesting, and immediate payout when the business changes ownership.

NQDC are not only for retirement. NQDC plans arenôt just for retirement savings. Many plans allow taxpayers to schedule distributions during the course of their career, not just when they retire. They can defer part of their compensation to cover shorter-term goals like paying a childôs college tuition. Under this option, taxpayers can change their deferral amount from year to year.

INCOME LIMITS FOR CONTRIBUTIONS TO RETIREMENT PLANS AND TAX DEDUCTIONS.

The contributions to some retirement plans will depend on taxpayersô filing status and their modified adjusted gross income (MAGI).

The contribution can be reduced or "phased out" as the MAGI approaches the upper limits of the applicable phase-out ranges.

Both traditional and Roth IRAs impose restrictions in certain circumstances:

- *Roth IRA contribution limits:* The amount that taxpayers can contribute is reduced ð and eventually eliminated ð at higher incomes

- *Traditional IRA deduction limits*: Taxpayers can always contribute the full amount, but their ability to deduct contributions may be reduced or eliminated if taxpayer and spouse have a 401(k) or other retirement plan at work and contributions were made for the plan during the year, this includes the employer contributions.

Roth IRA Income and Contribution limits for 2018		
Filing status	**Modified AGI**	**Maximum contribution**
Married filing jointly or qualifying widow(er)	Less than $189,000	$5,500 ($6,500 if 50 or older)
	$189,000 to $198,999	Contribution is reduced
	$199,000 or more	Not eligible
Single, head of household or married filing separately if taxpayer did not live with spouse)	Less than $120,000	$5,500 ($6,500 if 50 or older)
	$120,000 to $134,999	Contribution is reduced
	$135,000 or more	Not eligible
Married filing separately (if taxpayer lived with the spouse at any time during year)	Less than $10,000	Contribution is reduced
	$10,000 or more	Not eligible

If taxpayersô income does not qualify them, they can open "backdoor" Roth IRA.

Back door Roth IRA. A backdoor Roth IRA allows taxpayers to get around the income limits by converting a Traditional IRA into a Roth IRA.
Contributing directly to a Roth IRA is restricted if the income is beyond the above limits, but there are no income limits for conversions.

This is not a tax dodge. Taxpayers will need to pay taxes on any money in the Traditional IRA that has not already been taxed. The funds converted to a Roth IRA will most likely count as income, which could kick taxpayers into a higher tax bracket in the year they do the conversion. On the other hand, if taxpayersô income is low for the year, they could take advantage of that situation by making the Roth conversion in that year.

Example. If taxpayers convert a Traditional IRA—money on which they have already received an income tax deduction—to a Roth IRA, they will owe taxes on the entire amount converted. If they contribute $5,500 to a Traditional IRA and then convert the money to a Roth IRA, they will owe taxes on the $5,500, plus on whatever money it earns between the contribution time to the conversion time. If they have saved $500,000 in a Traditional IRA, and convert the entire $500,000 to a Roth, they will owe taxes on the $500,000.

Taxpayers can do a backdoor Roth IRA in one of two ways. The first method is to contribute money to an existing Traditional IRA and then roll over that portion only to a Roth IRA account. Or, taxpayers can convert an entire Traditional IRA account to a Roth IRA account. The Traditional IRA does not have to be new. Taxpayers can roll over existing Traditional IRA moneyð or an old Traditional IRA accountð into a Roth.

Limit on Income for Traditional IRA. The amount that taxpayers can contribute to a Traditional IRA are the same as they have been for the past few years; however, the income limits are important because they indicate if taxpayers can deduct all or some of the contributions made on their income tax return.

Traditional IRA deduction income limits for 2018			
Filing status	**Full deduction if modified AGI is...**	**Partial deduction if modified AGI is...**	**No deduction if modified AGI is...**
Married filing jointly and taxpayer is covered by retirement plan at work	$101,000 or less	$101,000 but less than $121,000	$121,000 or more
Married filing jointly and the spouse is covered by a retirement plan at work	$189,000 or less	More than $189,000 but less than $199,000	$199,000 or more
Single or head of household	$63,000 or less	More than $63,000 but less than $73,000	$73,000 or more
Married filing separately and taxpayer and the spouse are covered by a retirement plan at work	Not available	Less than $10,000	More than $10,000

- Note that these limits apply if the taxpayer is eligible for an employer plan, even if the taxpayer chooses not to participate in the plan.

- Likewise, a nonparticipating spouse must be ineligible for the other spouse's employer's plan for these limits to apply.

Note that if only 1 spouse participates in an employer plan, then that spouse is limited by the joint filing status, but the nonparticipating spouse can still contribute to an IRA if the joint income is less than the MAGI limits for a joint filing with 1 nonparticipating spouse. So if, in 2018, Jim and Amy report $150,000 on their joint return, while Jim participates in a plan but Amy does not, then Jim can make no contributions, while Amy's contribution is limited only by the statutory limit, even if Amy makes $125,000 and Jim made only $25,000.

Non-Deductible IRA Contributions. Even if the IRA contribution is not deductible, taxpayers can still make a contribution. It is called a non-deductible IRA contribution and the funds in the account will grow tax-deferred until retirement age.

*Nondeductible Contributions and Form 8606***.** Although the taxpayerôs deductible IRA contribution may be limited, they may still choose to make the full amount of allowable contribution. The difference between the total allowable contribution and their total deductible contribution is considered to be a nondeductible contribution.

When they taxpayer has a nondeductible IRA contribution, Form 8606 must be filed. Form 8606 must be filed even if the taxpayer is not required to file a tax return for the year. If the taxpayer does not report their nondeductible contributions, all of their contributions to the traditional IRA will be treated as deductible and all distributions from the IRA will be taxed unless the taxpayer can show that nondeductible contributions were made.

Exception to contribution limits for traditional IRAs for Spousal IRA.

Taxpayers cannot contribute more than what they earned during the year. If their taxable compensation for the year was $4,000, that is also their IRA contribution limit for the year.

For taxpayers whose spouse is not working, they can have whatôs called a spousal IRA. If the working taxpayer earns enough to cover the contribution, he/she can contribute to both accounts. That means if both taxpayers want to contribute the maximum to an IRA, and both are under 50, the working spouse will need to earn at least $11,000 (to cover the $5,500 annual maximum for each one). The limit also doesnôt apply to transfers from other retirement accounts, like a 401(k) rollover.

OTHER RETIREMENT OPTIONS.

Social Security. The benefit amount is based on the earnings averaged over most of taxpayersô working career. Taxpayers do not have an account created under their name. The average earnings for Social Security retirement benefits will replace only about 40 percent of taxpayersô income. The percentage is lower for people in the upper income brackets and higher for people with low incomes. The Social Security Administration recommends a supplemental retirement plan.

The money paid in taxes is not held in a personal account for taxpayerôs use when they get their benefits. The SSA uses all taxpayersô taxes to pay for people who are getting benefits right now. Any unused money goes to the Social Security trust funds, not a personal account with taxpayerôs name on it.

Rail Road Retirement program. Railroad workers are entitled to participate in a federal retirement and disability program similar to Social Security. The railroad retirement program offers different and somewhat expanded benefits from Social Security, however. Additionally, the program is administered by the Railroad Retirement Board (RRB) and not by Social Security Administration (SSA). Like the SSA, the RRB is a federal agency.

Railroad benefits are divided into two tiers. Tier 1 is more like traditional Social Security, whereas Tier 2 is more like a private pension plan. This retirement is available for taxpayers who are age 62 or over.

Retirement Plan for Military. The new plan as discussed before is called the blended retirement plan. The options previously were the active duty retirement plan.

Pre-blended military retirement plan:

- Members receive 50% of base pay after 20 years of service, plus 2.5% for each additional year served.
- Members can participate in the Thrift Savings Plan, but there is no military-match on TSP contributions.
- Military retirement pay begins the month after the member retires.

New blended retirement plan:

- Members receive 40% of base pay at 20 years of service, plus 2.0% for each additional year served.
- Members can participate in the Thrift Savings Plan and will receive military-matching contributions from the military after reaching two years of service. (Note: this may change; there is legislation that may push this to 4 years of service before they will receive matching contributions).
- Members are eligible to receive a career status bonus upon reenlisting for 4 years at their 12-year mark. This would equal 2.5x their monthly base pay. (This would not replace any possible **reenlistment bonuses** that might be in effect at the time of reenlistment).
- Military retirement pay begins the month after the member retires. However, there is language that would allow members to receive some or all of their retirement pay in a lump sum in exchange for lower monthly payments.

Review Questions Section 1

Read and answer the following review questions. The correct answers are found on the next page with an explanation to strengthen up your knowledge. Note: This is not part of your Final Test.

8. Before taxpayers were able to re-characterize their rollover by October 15th of the following year. Under the new Tax Cut Jobs Act (TCJA), what is the new date?
   a) There is no change; the due date remains the same.
   b) July 1st, it must be six months and a day.
   c) December 30th of each year.
   d) The extra time is eliminated.

9. (Fill in the blank) _____ is a professionally managed investment fund that pools money from many investors to purchase securities.
   a) SP500
   b) Mutual fund
   c) Real Investment Trust
   d) Single Fund

10. What is the difference between Top-Hat plans and Deferred Savings Plans?
   a) Top-Hat plans are generally paid by employers. Deferred Savings Plans are based on the amount of compensation deferred by each employee.
   b) Top-Hat plans are generally paid by employees. Deferred Savings Plans are based on the amount of compensation deferred by each employee.
   c) Top-Hat plans are generally paid by employers. Deferred Savings Plans are based on the amount of compensation deferred by each employer.
   d) None of the above

11. Why would taxpayers want to consider a Nonqualified Deferred Compensation (NQDC) plan?
   a) Because NQDC plans are for everyone.
   b) There are no loss risks for taxpayers.
   c) Taxpayers can withdraw money whenever they need.
   d) For taxpayers who have maxed out their 401(k) or 403(b) workplace savings plan.

12. What are the downsides of NQDC plans?
   a) There are no downsides to NQDC plans.
   b) When money is paid to taxpayers, they canôt roll it over into an IRA or other retirement accounts.
   c) Taxpayers canôt take loans from NQDC plans.
   d) All of the above

13. (Fill in the blank) The _____ pays the participant a certain amount as an inducement to take early retirement. On the other hand _____ usually have a consultant stipulation, where the participant is paid only if he consults with the employer for a certain duration after retirement.
a) Vesting; Forfeiture
b) Golden parachute; Golden jet
c) Golden handshake; Golden handcuffs
d) Federal Insurance Contributions (FICA); Federal Unemployment Tax Act (FUTA)

14. Which of the following statements is true regarding ñbackdoorò Roth IRAs?
a) Taxpayer can convert an entire Traditional IRA account to a Roth IRA account.
b) Taxpayers canôt roll over existing Traditional IRA money into a Roth IRA.
c) ñBackdoorò Roth IRA is considered a tax dodge.
d) The funds converted to a Roth IRA will not count as income.

Questions Section 2 – Answers and Discussion

8. **Answer d.** Under the new TCJA law, for tax years beginning after December 31, 2017, the extra time to re-characterize a Roth conversion is eliminated. December 31 of each year may be "the do it or lose it date" for re-characterizations of conversions made in the previous year.

9. **Answer b.** A mutual fund is a professionally managed investment fund that pools money from many investors to purchase securities. These are divided among many categories depending on companies, the type of growth and the objective. The most common funds include: growth, growth and income, aggressive growth and international.

10. **Answer a.** Two general types of NQDC plans: top-hat plans and deferred savings plans. Top-hat plans are generally paid by employers, while deferred savings plans are based on the amount of compensation deferred by each employee.

11. **Answer d.** Taxpayers who have maxed out their 401(k) or 403(b) workplace savings plan may want to consider a NQDC plan. These plans allow executives to defer a much larger portion of their compensation, and to defer taxes on the money until the deferral is paid. These plans are commonly known as deferred compensation plans or salary reduction plan.

12. **Answer d.** No loans and rollovers are allowed to NQDC plans. For example, unlike 401(k) plans, taxpayers canôt take loans from NQDC plans, and they canôt roll the money

over into an IRA or other retirement account when the compensation is paid to them. The money in this plan is not eligible to be rolled over into qualified retirement plans such as 403(b) plans or IRAs.

13. **Answer c.** The golden handshake pays the participant a certain amount as an inducement to take early retirement. Golden handcuffs, on the other hand, usually have a long vesting schedule or a consultant stipulation, where the participant is paid only if he consults with the employer for a certain duration after retirement.

14. **Answer a.** Taxpayers can do a ñbackdoorò Roth IRA in one of two ways. The first method is to contribute money to an existing Traditional IRA and then roll over that portion only to a Roth IRA account. Or, taxpayers can convert an entire Traditional IRA account to a Roth IRA account. The Traditional IRA does not have to be new. Taxpayers can roll over existing Traditional IRA moneyð or an old Traditional IRA accountð into a Roth.

Paid off Real Estate. Rental property is another retirement option for individuals who are able to pay for the property in cash. Old time real estate investors will all agree that in the real estate business, the money is made at the buy. In other words, the purchase sounds more like a steal. The tax treatment of a real estate will differ from a traditional retirement plan but may bring deductions available for real estate. Buying and selling properties is more complicated that rental properties and represents more risk for average income earners. Schedule E will be required for rental properties. Schedule D or Form 4797 is used when there is capital gain or losses for investments properties.

Paid off Principal Home and Debt Free. No income tax consequences**.**

OTHER PRODUCTS THAT ARE PRESENTED LIKE RETIREMENT OPTIONS.

Annuities.

Another retirement option includes annuities. This is a common option for taxpayers who are near retirement or are already retired. The income in the annuity is not available for taxpayer before age 59 ½. This is one negative aspect of an annuity; taxpayers cannot get to their money during the growth period without incurring taxes and penalties. Any annuity, either qualified or non-qualifies, is not accessible for taxpayer until they are age 59 ½.

For federal tax purposes, annuities are classified as

Qualified plan. Tax deduction for contributions and income tax deferred on the complete contribution.
Non-qualified plan. There is no tax deduction on the after-tax contributions and only the gains will be taxed.

A qualified annuity is purchased as part of, or in conjunction with, an employer provided retirement plan or an individual retirement arrangement (such as an Individual Retirement Annuity or a Simplified Employee Pension Plan). If certain requirements are satisfied, contributions made to qualified annuities may be wholly or partially deductible from the taxable income of the individual or employer making the contributions. In this case, the plan allows for a tax deduction on the income tax return and the growth is tax-deferred.

A non-qualified annuity is not part of an employer provided retirement program and may be purchased by any individual or entity. Contributions to non-qualified annuities are made with after-tax dollars and are not deductible from gross income for income tax purposes. Taxpayers will be taxed only on the earnings. Payments into the account, therefore, comprise the cost basis and are not taxed or penalized when distributed at retirement. There are four ways to distribute money from an annuity: lump sum distribution, death, random withdrawals, and annuitization. In any event, only the earnings are taxed. Any taxes due are based on ordinary income tax rates, never capital gains rates.

Random withdrawals are taxed using last in, first out (LIFO) accounting. Accumulation and earnings are distributed first and taxed as ordinary income, plus a penalty if the annuitant is not yet 59 ½. The penalty is waived in the event of death or annuitization. Once all earnings have been distributed, the remaining cost basis is distributed income tax free.

Typically, during the first 7ð 10 years of an annuity, if withdrawals take place, earnings will be subject to taxes (plus a 10% penalty if under age 591/2), but in addition, the insurance company may levy a surrender charge on the distribution. Similar to a contingent deferred sales charge, the surrender charge is reduced the longer the policy is owned until it completely disappears.

When annuitizing an annuity, the policy owner enters into a contractual obligation for the systematic distribution of the asset. When annuitized, taxes are calculated using an exclusion ratio. The amount of each payment considered a return of cost basis is determined by dividing the annuity owner's cost basis by her expected return (based on life expectancy).

When it comes to taxes, the most important piece of information about the annuity is whether it is held in a qualified or non-qualified account.

Taxation of Annuities.		
	Qualified Annuity	**Non-Qualified Annuity**
Funded	Untaxed Money	After-tax funds
Payments	Full distribution is taxable as ordinary income.	Taxation determined by exclusion ratio.

Insurance Products. Not for Retirement Investing, Not for an Investment, and Not a Savings Option.

These insurance products are sometimes presented like retirement options but in reality they are an insurance product with a savings or investment option inside; these extra feature make the product more expensive. They are not available inside any retirement plan, this means that a retirement plan cannot invest on insurance products. All investment options purchased through an insurance company cost more because their fees must cover the accounts created inside the insurance to manage the investment or savings. The following products fall into this category:

- Cash Value Life Insurance, also known as permanent life insurance, permanent portfolio, etc.
- Whole Life Insurance.
- Index Universal Life Insurance.
- Variable Universal Life Insurance.

Beneficiaries of any life insurance will not be taxed on any distribution due to death. Sometimes the beneficiary receives the proceeds one year later, if there are interests gained in the midterm they will be taxed as interest income. In case the death benefit is paid to an estate, the beneficiaries of the estate will pay estate taxes on it. This last option can occur if the insurance did not have a beneficiary named.

There is a securities licensing requirement for some insurance to be sold. The savings inside an insurance product will start on later years once the insurance company has covered many other account fees. For this option, there is hardly ever any tax; the basis normally is less than the contributions. In case taxpayers have a gain it will be taxed as ordinary income. Form 1099-R is provided in these cases.

Life Insurance can become a Modified Endowment Contract MEC.

If the premiums paid into the insurance product are more than the allowed, the IRS will convert the insurance into a Modified Endowment Contract. Once the insurance is converted into MEC, the policy will be taxed in the following way:

- 10% penalty apply for any withdrawals made before age 59 ½
- Taxes are paid first for any withdrawal under the LIFO rule, Last In First Out. The gain is recovered firs and ordinary income tax applies.

This applies to insurance products purchased after 1988.

The maximum amount of money allowed into an insurance product is set by the Internal Revenue Code and it follows the ñ7-payò test. The 7-pay test must be passed every year. Once the test is failed, modified endowment treatment applies for the remaining life of the contract. Reformation of the policy is not possible. The 7-pay test is as follows:

- 7-year test is used, whereby an algorithm determines the appropriate ratio between the policy's face amount and premium. The cumulative sum of premiums paid into the policy over the first 7 years, and the sum of premiums required for the policy to be paid up in a 7-year window are the two factors to check. If the total amount of premiums paid surpasses the amount required to be paid up, the policy is a MEC. At this point, the IRS doesn't consider the policy to be *bona fide* life insurance anymore.

7-test year example.			
Policy Year	**Cumulative Modified Endowment Limit**	**Actual Annual Premium Paid**	**Cumulative Actual Annual Premium Paid.**
1	$41,016	$25,000	$25,000
2	$82,032	$25,000	$50,000
3	$123,048	$25,000	$75,000
4	$164,064	$50,000	$125,000
5	$205,080	$50,000	$175,000
6	$246,096	$50,000	$225,000
7	$287,112	$50,000	$275,000

In general, life insurance companies will allow taxpayers to withdraw the excess premium if this amount is exceeded, as long as it is done before the next policy anniversary. Otherwise a policy will be considered a MEC.

Tax Treatment of Life Insurance with savings or investment options inside.

During the life of the policy, net investment income (from dividends and interest paid to the separate account) and capital gains (both realized and unrealized) are not taxable to the policyholder. There is also no tax liability when a loan is taken against the cash value because a loan is not considered constructive receipt of income.

If the policy is surrendered, policy proceeds equal to the amount of premiums paid are tax free. The premiums paid are considered the cost basis of the policy. Any earnings over the cost basis are taxed as ordinary income to the policyholder; earnings over the cost basis are not subject to capital gains taxes. There is hardly ever any gain since the fees and premiums will override the basis.

A death benefit that is paid to the beneficiary of a life insurance policy is exempt from federal taxation as income. However, the full amount of the policy's death benefit can be included in the estate of the deceased policy owner for federal estate tax purposes.

1035 Provision

A 1035 exchange is a tax-free exchange between like contracts. The IRS allows annuity and life policyholders to exchange their policies without tax liability. For example, if a life policyholder wanted to exchange his policy to that of another company, he could transfer all values from the old policy into the new policy without recognizing any tax consequences. This 1035 exchange

provision applies to transfers from annuity to annuity, life to life and life to annuity. It cannot be used for transfers from an annuity to a life insurance policy.

This provision is only to avoid federal income taxes but it does not avoid any surrender charges imposed by the insurance company itself.

INCOME TAX TREATMENT OF RETIREMENT PLANS.

When analyzing different types of plans for retirement, we frequently use the terms pre-tax, after-tax, tax-deferred, and tax-free. These terms may be used to describe different events in the present and in the future. They can be combined as follows:

- Pre-tax and tax-deferred.
- After-tax and tax-free.

Pre-tax and tax-deferred Option.

Pre-tax money means income received by taxpayer that has not being taxed yet. It is not shown on gross income in Form W2 Box 1 but is taxed for Social Security and Medicare. This income and any growth will be taxed in the future.

When we use the term tax-deferred, it simply means that the earnings on the money invested is not taxed until some later date. The earnings will be taxed when money is withdrawn from the account.

Tax-deferred or pre-tax plans are registered with the government that is why they can provide a deferral of the income tax. They are called qualified plans.

After-tax and tax-free.

After-tax contributions are made once taxpayers have already paid the proper income taxes. Money earned with after-tax contributions will not be taxable until taxpayers take the money out of the plan. With a tax-free account, taxpayers will not pay taxes when the funds are taken out during retirement.

TAX OPTIONS FOR RETIREMENT PLANS	
Tax-deferred	Tax-free
IRA	Roth IRA
SEP IRA	Roth 401(k)
SIMPLE IRA	Roth 403(b)
401(k) & Profit sharing	Roth 457
403(b)	529 Plan
457 plan	Coverdell ESA
Qualified annuity	Health Savings Account
Non-qualified annuity	

Qualified Plan Tax Treatment.

Employer contributions to a qualified plan may be deducted immediately. The employee may also defer taxes on the salary he contributes to a qualified plan. Interest, dividends or capital gains are taxed as ordinary income when the employee withdraws money from the plan.

Tax Credit for Contributions made by Taxpayers, the saver's credit.

In addition to reducing the taxable income, by contributing to an eligible retirement account taxpayers may also be able to reduce their actual tax liability. In 2018, eligible retirement savers can reduce their tax liability by up to $1,000 ($2,000 if filing jointly) through the Retirement Savings Contributions Credit, more commonly known as the Tax Saverôs Credit.

The tax credit amount is 50 percent, 20 percent or 10 percent of the retirement plan or IRA contributions and the adjusted gross income (AGI).

For the 2018 tax year, the adjusted gross income must be $31,500 or less to qualify for the credit if taxpayer is filing as single or married filing separately.

The tax credit applies for those filing as head of household with AGIs below $47,250. Married couples filing jointly with AGIs of $63,000 or less in 2018 will also qualify for the Saver's Credit.

2018 Retirement Savings Contributions Credit			
Credit Rate	**Married Filing Jointly**	**Head of Household**	**All Other Filers***
50 percent of contributions	AGI not more than $38,000	AGI not more than $28,500	AGI not more than $19,000
20 percent of contributions	$38,001 - $41,000	$28,501 - $30,750	$19,001 - $20,500
10 percent of contributions	$41,001 - $63,000	$30,751 - $47,250	$20,501 - $31,500
0 percent of contributions	more than $63,000	more than $47,250	more than $31,500

Contributions for the Previous Tax Year. As tax filing deadlines approach saving for retirement in an IRA is a potential last minute strategy to help increase the retirement savings and potentially reduce taxpayersô taxes. IRA contributions for the 2018 tax year may be made up until the April 15, 2019 deadline. If you are self-employed SEP IRA contributions can be made until the extended due date.

Retirement Accounts Eligible for the Tax Credit. The Retirement Savings Contributions Credit can be used when taxpayers make contributions to following types of retirement accounts.

- Traditional or Roth IRA

- 401(k) plan
- 403(b) plan
- 457(b) plan
- Thrift Savings Plan (TSP)
- SIMPLE IRA
- Simplified Employee Pension (SEP) plan
- Section 501(c)(18) plans
- *my*RA (starter savings account from the U.S. Department of the Treasury)

Rollovers are not eligible for the credit.

Claiming the Saver's Credit. To take advantage of the Saver's Credit taxpayers must file IRS Form 8880, "Credit for Qualified Retirement Savings Contributions." Taxpayers must be age 18 or older and they cannot be a full-time student or be claimed as a dependent on someone else's tax return. The retirement contribution must have been made during the tax year for which the income tax is being filed. And taxpayers must meet the income requirements.

Because the saver's credit is limited to ordinary income tax liability, not employment tax liability, and because other credits come before the saver's credit on Form 1040, those credits listed prior to the retirement savings contribution credit, such as the child tax credit, dependent care credit, American opportunity credit, and the lifetime learning credit, will limit the credit available. As a result, the average credit is less than $250.

Employer matches and the tax benefit to employees.

One of the tax benefits to the employees for the employerôs matches to the retirement plan is that the contribution does not count towards the employeeôs limit. The employer contribution to employeeôs plan does not count towards the annual limit contributions of $18,500 for 2018. Employees can reduce their taxable income by up to $18,500 ($24,500 if age 50 and over). In 2018, the total combined employee and employer contribution is the lesser of 100% of an employeeôs compensation or $55,000 ($61,000 if age 50 and over).

Employees can defer all applicable income taxes on employer contributions until retirement age when the employees are more likely to be in a lower tax bracket.

Tax benefits to employers for their matches to employees' retirement plan.

Most employers can deduct, subject to limits, the contributions that they make to a retirement plan, including those made for their own retirement. The contributions, the earnings, and gains on them are generally tax free until distributed by the plan. This helps the employer contributions reduce their business tax bill.

In addition, small businesses may be eligible for the Retirement Plans Startup Costs Tax Credit. This tax credit allows eligible employers to claim 50% of their ordinary and necessary startup costs up to $500 per year. Expenses to educate employees about the plan are also eligible. Eligible employers can claim the credit for each of the first three years of the plan and may

choose to start claiming the credit in the tax year before the tax year in which the plan becomes effective. As part of the general business credit, a small business owner may carry this tax credit back or forward to other tax years when she canôt use the credit

Credit for Small Business when starting a retirement plan, Form 8881. Small businesses can get a tax credit to offset some of the costs of setting up a retirement plan. Smaller qualifying businesses can cut their taxes by up to $500 by claiming the Credit for Small Employer Pension Plan Startup Costs. A business claims this credit by filing IRS Form 8881 with their tax return. The requirements are:

-
- They had no more than 100 employees who were paid at least $5,000 in the year before it set up the plan. Employees who were paid less than $5,000 donôt count toward the total.
- A business did not previously have a retirement plan in place in the prior 3 years covering substantially the same employees as the plan being set up.

Small employer for this credit may differ from definitions used elsewhere in the tax code, such as with the Affordable Care Act, where the cutoff is 50 full-time employees. So a business that is considered a ñlargeò employer under the ACA or other provisions may still qualify for this credit under the two mentioned requirements.

AVOIDING THE EARLY WITHDRAWAL 10% TAX PENALTY.

Putting money into retirement accounts limits the availability of funds because they are generally subject to the Sec. 72(t) 10% addition to tax on distributions taken before reaching age 59½ (as well as being included in taxable income). Taxpayers may want to take their money out of these accounts early and see if they can avoid paying the 10% tax. There are some exceptions to the tax on early distributions and they will depend on whether the money is withdrawn from a qualified plan or not.

Distribution of Basis is not subject to the Penalty for Roth IRAs. The 10% tax does not apply to distributions of basis in after tax accounts. For example, nonqualifying distributions from Roth IRAs come from basis and then from earnings. Thus, early distributions from Roth IRAs are generally completely tax-free and penalty-free unless they exceed the basis in the Roth IRAs. The earnings are subject to the penalty in early withdrawals but are not taxed if taxpayer is actually at retirement age. For Roth IRAs, the basis in the account can be withdrawn at any time without any penalty.

Form 8606 Part III for Basis of Roth IRA distributions.

Part III **Distributions From Roth IRAs**

Complete this part only if you took a distribution from a Roth IRA in 2015. For this purpose, a distribution does not include a rollover, one-time distribution to fund an HSA, recharacterization, or return of certain contributions (see instructions).

19	Enter your total nonqualified distributions from Roth IRAs in 2015, including any qualified first-time homebuyer distributions (see instructions)	19		
20	Qualified first-time homebuyer expenses (see instructions). **Do not** enter more than $10,000	20		
21	Subtract line 20 from line 19. If zero or less, enter -0-	21		
22	Enter your basis in Roth IRA contributions (see instructions). If line 21 is zero, **stop here**	22		
23	Subtract line 22 from line 21. If zero or less, enter -0- and skip lines 24 and 25. If more than zero, you may be subject to an additional tax (see instructions)	23		
24	Enter your basis in conversions from traditional, SEP, and SIMPLE IRAs and rollovers from qualified retirement plans to a Roth IRA (see instructions)	24		
25	**Taxable amount.** Subtract line 24 from line 23. If more than zero, also include this amount on Form 1040, line 15b; Form 1040A, line 11b; or Form 1040NR, line 16b	25		

Form 8606 Part III is used to report the basis and the distributions of basis of a Roth IRA. Line 22 indicates the basis on the account and the amount free of tax. Keeping a record of the basis can be done with a report from the company holding the account. Taxpayers are required to report any conversion made to a Roth IRA using Form 8606 Part II; this conversion reporting is important otherwise the IRS will impose a tax on this conversions.

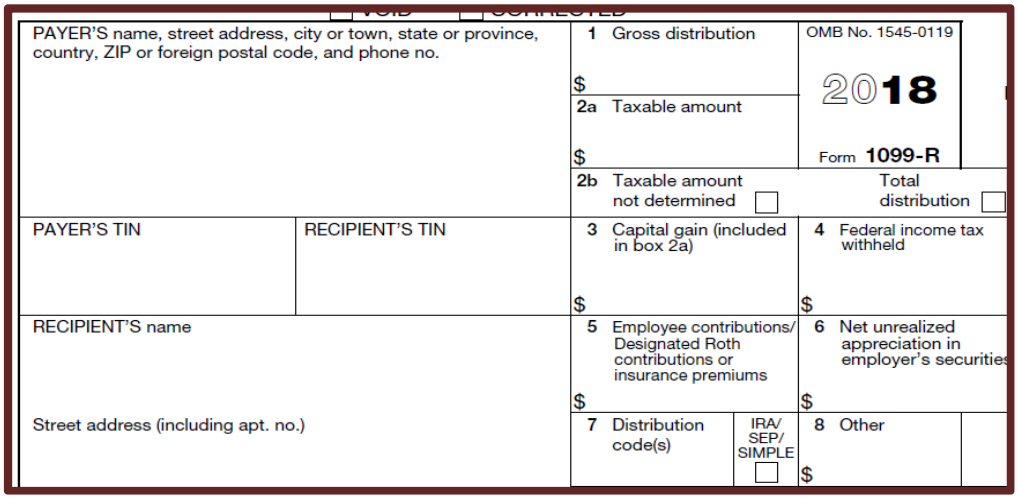
Exceptions to the Penalty for Qualified Plans and IRAs

Death or disability of the taxpayer

When a taxpayer dies, his or her retirement assets generally are transferred to one or more beneficiaries. The beneficiary must recognize income when he or she receives distributions from the inherited retirement assets. These distributions are not subject to the 10% tax. Beneficiaries are often required to begin withdrawing funds shortly after inheriting the retirement assets.

A taxpayer who is permanently and totally disabled can also take distributions without being subject to the 10% tax. Disabled taxpayers must furnish proof that they are unable to engage in any substantial gainful activity due to physical or mental impairment that is either terminal or expected to be long-term and indefinite. For these purposes, substantial gainful activity refers to the activity in which the individual customarily engaged before the disability arose or before retiring if the individual was retired at the time the disability arose. Regs. Sec. 1.72-17A(f) provides examples of conditions that ordinarily are considered in determining disability, including:

- Loss of two limbs;
- Progressive diseases that result in the loss or atrophy of a limb;
- Diseases that result in a major loss of heart or lung reserve;
- Inoperable and progressive cancer;
- Brain damage;
- Mental disease requiring constant supervision; and
- Loss of vision, speech, or hearing.


PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and phone no.
1 Gross distribution $
2a Taxable amount $
OMB No. 1545-0119
2018
Form 1099-R
2b Taxable amount not determined ☐
Total distribution ☐
PAYER'S TIN
RECIPIENT'S TIN
3 Capital gain (included in box 2a) $
4 Federal income tax withheld $
RECIPIENT'S name
5 Employee contributions/ Designated Roth contributions or insurance premiums $
6 Net unrealized appreciation in employer's securities $
Street address (including apt. no.)
7 Distribution code(s)
IRA/ SEP/ SIMPLE ☐
8 Other $

These conditions do not guarantee that an individual will be considered disabled but will be used to determine whether he or she can continue to be employed in his or her customary substantial gainful activity or a comparable activity.

Taxpayers should work with the custodian of the retirement plan to ensure the Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, reports distribution code 3 in box 7, indicating a distribution was disability-related. The custodian may specify the type of documentation it requires to prove the existence of the disability before it authorizes the early distribution. In addition, taxpayers should always keep that proof with their tax information in case of an IRS audit.

The type of proof necessary depends on the taxpayer's facts and circumstances. According to Sec. 72(m)(7), "an individual shall not be considered to be disabled unless he furnishes proof of the existence thereof in such form and manner as the Secretary may require"; however, the IRS has not specifically defined acceptable proof. Reasonable evidence could be a letter or affidavit from the taxpayer's physician that states the taxpayer has a permanent or indefinite disability that keeps him or her from gainful activity and that cannot be remedied by medication or other acts by the taxpayer. In addition, taxpayers could show treatment plans completed and/or Social Security disability payments received. Even with a physician's statement, the IRS and courts may deny the disability exemption if the taxpayer has continued to be employed, could remedy the disability through his or her own actions, or is expected to fully recover and therefore is not permanently disabled.

Substantially equal periodic payments

Substantially equal periodic payments (SEPPs) received over the taxpayer's expected life are not subject to the 10% tax if the payments continue for the longer of five years or until the taxpayer reaches age 59½. The IRS provides several safe-harbor methods for calculating the allowable payment. SEPPs taken from a Roth IRA gaining before age 59½ are not qualified distributions under this rule and are included in taxable income but will not be subject to the 10% tax.

- Three safe-harbor methods are available for calculating the annual withdrawal amount: (1) the required minimum distribution method, (2) the fixed amortization method, and (3) the fixed annuitization method. Each method produces a different annual withdrawal amount.

- Modification or termination of the SEPP before the end of the required time period results in a retroactive application of the 10% penalty to all previous withdrawals and interest charges from the date each withdrawal was received until the modification or termination occurred.

Medical expenses

A taxpayer's allowable medical expenses on Form 1040, *U.S. Individual Income Tax Return*, Schedule A, *Itemized Deductions*, reduce the amount of distributions subject to the 10% tax. Allowable medical expenses are those that exceed 10% of the taxpayer's adjusted gross income

(AGI), even if the taxpayer claims the standard deduction. The taxpayer needs to establish only that he or she incurred qualified medical expenses in the tax year in which the distribution from the retirement plan occurred and does not need to prove that he or she used the funds from the distribution to pay the medical expenses.

IRS levy

The IRS has the authority under Sec. 6331 to seize taxpayer assets, including retirement accounts, to recover unpaid taxes and penalties. This type of distribution is especially painful for a taxpayer because the amount the IRS seizes is also taxable income (except for basis), but the seized funds are not subject to the 10% tax.

Qualified reservists

Qualified reservists are those called to active duty after Sept. 11, 2001, for a period greater than 179 days or an indefinite period. For these withdrawals to be classified as qualified distributions, the qualified reservist must take the distributions during his or her active duty period. While these distributions are taxable income, they are not subject to the 10% tax. Qualified reservists can repay the distributions to an individual retirement plan within two years of the end of their active duty without regard to the usual limitations on contributions. Since the repayment contributions aren't deductible and instead create basis, it may be advisable for taxpayers to maximize their regular retirement contributions before repaying these amounts.

Exceptions Available to Corporation Qualified Plans Only

Early retirement

Distributions to former employees are not subject to the 10% tax if the employee is at least 55 years old before separating from service to the employer. Distributions can be from defined benefit or defined contribution plans. Distributions continue to be excluded from the penalty even if the former employee returns to work, as long as the separation was indefinite. This exception does not apply to an IRA, even if the IRA consists entirely of funds rolled over from a qualified employer plan.

The minimum separation age is reduced to 50 if the former employee is a qualified public safety employee and the distribution is from a defined benefit governmental plan. Qualified public safety employees are police, firefighters, and emergency medical providers who are employees of a state or political subdivision of a state.

Qualified domestic relations order

Distributions made to a person other than the account owner under a qualified domestic relations order (QDRO) are taxable to the person receiving the distribution (unless the money is rolled over into a retirement plan) but are not subject to the 10% tax. QDROs are common in divorce property settlements.

Dividends from an ESOP

Sec. 404(k) provides a C corporation a tax deduction for "applicable dividends" paid to participants on securities held by an employee stock ownership plan (ESOP). If the corporation qualifies for this deduction, then the dividends are not subject to the 10% tax, even if the employee receives them in cash. However, if the dividends are reinvested in qualifying employer securities at the employee's election, they are not eligible for this exception.

Federal phased retirement program

Certain federal civil service employees are eligible for a phased retirement annuity while continuing to work part time and a composite annuity upon full retirement. Payments under either of these plans are not subject to the 10% tax.

Exceptions Available for IRAs Only

Health insurance for the unemployed

Distributions to individuals who received unemployment benefits from a state or federal program may be exempt from the 10% tax to the extent the money was used to pay health insurance premiums for the individual and his or her family. To be eligible for this exception, distributions must occur in a tax year during which the individual has received unemployment compensation for 12 consecutive weeks or in the succeeding year. Distributions are not eligible if they are made after the individual has been reemployed for 60 days.

Example 1: *M was laid off from her employer in 2017 and started receiving unemployment benefits on Nov. 1, 2017. If she continues to receive unemployment through the week of Jan. 17, 2018, she is considered unemployed for purposes of the exception to the 10% tax since she has received unemployment benefits for 12 consecutive weeks. If M remains unemployed, any distributions made during 2017, 2018, and 2019 that are not in excess of the health insurance premiums paid during those years will not be subject to the 10% tax. However, if M gets her job back or gets another job, distributions made subsequent to 60 days from her reemployment date will be subject to the tax. So if M becomes employed on March 1, 2018, she can no longer take distributions under this exception after April 29, 2018.*

Self-employed individuals are generally not eligible for unemployment benefits. Nevertheless, IRA distributions used to pay health insurance premiums are exempt from the 10% tax under the same rules as for employees. To qualify for the exception, the self-employed individual must have been eligible for unemployment benefits except for the fact that he or she was self-employed. For instance, a taxpayer who is unemployed because his or her sole proprietorship went out of business may be eligible for this exception.

Higher education expenses

IRA distributions are not subject to the tax to the extent they do not exceed the taxpayer's qualified educational expenses. The qualified educational expenses can be for the taxpayer or the taxpayer's spouse, children, or grandchildren. Qualified expenses include tuition, fees, books, supplies, and equipment, as well as room and board for students who are enrolled at least half time. Qualified expenses are reduced by any financial assistance or a payment for an individual's educational expenses (other than a gift, bequest, devise, or inheritance) that is excluded from gross income. For example, scholarships, grants, and tax-free employer tuition assistance reduce the amount of qualified educational expenses.

Example 2: *P is a full-time student at a university. His total qualified expenses for 2017 are $20,000, which includes room and board and tuition. He receives a tax-free scholarship for $5,000 that is used to pay tuition included in the $20,000 of expenses. In this case, $15,000 can be withdrawn from IRAs without incurring a 10% tax. The IRA withdrawal can be made by P's parents or grandparents, as well as by P (but the cumulative withdrawals cannot exceed $15,000). The exclusion from the 10% tax does not limit the parents' or grandparents' ability to claim other educational tax benefits, such as education credits or a tuition deduction.*

First-time homebuyer

Distributions made to a qualified first-time homebuyer are not subject to the 10% tax. The maximum that a taxpayer can exclude is $10,000, and the taxpayer must use the distribution within 120 days to purchase or construct a principal residence for the taxpayer, spouse, child, grandchild, or ancestor of either the taxpayer or the spouse. The $10,000 is a lifetime limit that applies to the individual receiving the distribution. Thus, a taxpayer and spouse could each receive $10,000 from his or her own IRA to apply toward the purchase of the same primary residence. A first-time homebuyer is an individual who has not owned a home (or whose spouse has not owned a home) during the two-year period ending on the date of acquisition of the new home. If the acquisition date is delayed or canceled after the money is distributed, the taxpayer can roll over the money into an IRA within 120 days of the distribution. In this case, the taxpayer excludes the distribution from income in the same manner as with any other qualified rollover.

Example 3: *L and M, who are both under age 59½, purchase their first home in 2017 for $100,000. They can each withdraw $10,000 from their own IRAs free of the 10% tax to apply toward the purchase. However, if M withdraws $20,000 from his IRA and L withdraws none, then $10,000 of M's withdrawal will be subject to the 10% tax since the $10,000 limit applies to each individual taxpayer. Because the $10,000 is a lifetime limit, if L and M each withdraw $10,000 from his or her own IRA in 2017, they will not be able to take additional penalty-free distributions in the future to apply toward the purchase of a home for their children or grandchildren. If L and M take a qualified distribution to apply toward their first home on June 1, 2017, but the sale falls through, they have 120 days from the date of distribution (Sept. 29) to recontribute the funds into the IRAs without incurring a 10% tax or including the amount in income.*

PERIOD TO REPAY A RETIREMENT LOAN IS EXTENDED UNDER THE NEW TCJA.

Under pre-Act rules, for 401(k) and similar defined contribution plans, participants with a plan loan outstanding must repay the loan within 60 days of their departure. Those who fail to do so are considered to have defaulted on the loan and must pay income tax on the loan's balance. Borrowers younger than 50½ also must pay a 10 percent penalty.

Borrowers may avoid having their loan become a taxable withdrawal by contributing to an IRA or to another qualified employer plan in an amount equal to the defaulted loan. The contribution is then treated as a rollover that offsets an outstanding loan amount after separation from employment and, under current law, must be made within 60 days of the employee's departure.

The new TCJA extends this deadline to the latest date on which the participant can file his or her tax return for the year of the loan default. This means that taxpayers have until October of the following year to repay the loan. This date takes into consideration the extension for individuals to file their personal income tax return.

The new law applies to loans taken after January 1, 2018 so they can put back the money into their 401(k), IRA or 401(k) at a new employer.

Under pre-Act law, a plan may also provide that, in certain circumstances (for example, if an employee terminates employment), an employeeôs obligation to repay a loan is accelerated and, if the loan is not repaid, the loan is cancelled and the amount in the employeeôs account balance is offset by the amount of the unpaid loan balance, referred to as a ñloan offset.ò A loan offset is treated as an actual distribution from the plan equal to the unpaid loan balance (rather than a deemed distribution), and (unlike a deemed distribution) the amount of the distribution is eligible for tax-free rollover to another eligible retirement plan within 60 days. However, the plan is not required to offer a direct rollover with respect to a plan loan offset amount that is an eligible rollover distribution, and the plan loan offset amount is generally not subject to 20% income tax withholding.

INVESTMENT OPTIONS OUTSIDE OF RETIREMENT PLANS.

The investment options inside the retirement account are also available for taxpayers outside of their retirement plans. Taxpayers can use those investment options to put money aside and use it before retirement age. These mutual funds and stocks are also available for taxpayers who want use them for other non-retirement options. If they decide to invest outside of their retirement plan, the tax treatment will be different. These accounts outside of retirement are sometimes called bridge accounts; they provide income in case taxpayers are not at retirement age but want to have income in case they decide to retire early.

In case taxpayers use mutual funds outside of retirement to grow their money, the tax treatment will be based on distributions of the funds. Even if taxpayers receive a distribution and reinvest it, they will be required to pay taxes on it. The distribution reinvested becomes the taxpayersô basis and no other tax will be paid in the future.

If taxpayers hold shares in a taxable account, they are required to pay taxes on mutual fund distributions, whether the distributions are paid out in cash or reinvested in additional shares. The funds report distributions to shareholders on IRS Form 1099-DIV after the end of each calendar year.

Taxpayers who bought or sold shares in a mutual fund must report the transaction on their tax return and pay tax on any gains and dividends. Additionally, as an owner of the shares in the fund, they must report and potentially pay taxes on transactions conducted by the fund, that is, whenever the fund sells securities. There could be a capital gain or loss.

Review Questions Section 3

Read and answer the following review questions. The correct answers are found on the next page with an explanation to strengthen up your knowledge. Note: This is not part of your Final Test.

15. Which of the following statements is correct regarding Non-qualified annuities?
    a) The four ways to distribute money from an annuity are: lump sum distribution, death, annuitization, and random withdrawals.
    b) Only earnings get taxed.
    c) It may be purchased by any individual or entity.
    d) All of the above are correct.

16. The earnings on the money invested are not taxed until some later date is the definition of?
    a) After-tax
    b) Tax-deferred
    c) Tax Treatment
    d) Modified taxes

17. Which credits limit the saverôs credit?
    a) Lifetime learning credit
    b) Child tax credit
    c) Dependent care credit
    d) All of the above

18. Why would employers want to contribute to an employeeôs retirement plan?
    a) Employers can receive a tax credit of $500 for each employee they help.
    b) Contributing helps the employer reduce their business tax bill.
    c) The business owner will be given a credit that can only be used in future years, to reduce taxes owed.
    d) There is no positive or negative if employers decide to contribute to an employeeôs retirement plan.

19. Can a taxpayer who is permanently and totally disabled take distributions without being subject to the 10% tax?
    a) Yes, but the disabled taxpayer must provide specific proof as requested by the IRS.
    b) Anyone with physical or mental impairment is automatically exempt from the 10% tax.
    c) Yes, however, the disabled taxpayer must provide proof that they are unable to engage in any substantial gainful activity due to long-term and indefinite physical or mental impairment.
    d) No, everyone is subject to the 10% tax.

Questions Section 3 – Answers and Discussion

15. **Answer d.** A non-qualified annuity is not part of an employer provided retirement program and may be purchased by any individual or entity. Contributions to non-qualified annuities are made with after-tax dollars and are not deductible from gross income for income tax purposes. Taxpayers will be taxed only on the earnings. There are four ways to distribute money from an annuity: lump sum distribution, death, random withdrawals, and annuitization.

16. **Answer b.** The term tax-deferred, simply means the earnings on the money invested is not taxed until some later date. The earnings will be taxed once money is withdrawn from the account.

17. **Answer d.** Because the saver's credit is limited to ordinary income tax liability, not employment tax liability, and because other credits come before the saver's credit on Form 1040, those credits listed prior to the retirement savings contribution credit, such as the child tax credit, dependent care credit, American opportunity credit, and the lifetime learning credit, will limit the credit available. As a result, the average credit is less than $250.

18. **Answer b.** Most employers can deduct, subject to limits, the contributions that they make to a retirement plan, including those made for their own retirement. The contributions, the earnings, and gains on them are generally tax free until distributed by the plan. This helps the employer contributions reduce their business tax bill.

19. **Answer c.** A taxpayer who is permanently and totally disabled can also take distributions without being subject to the 10% tax. Disabled taxpayers must furnish proof that they are unable to engage in any substantial gainful activity due to physical or mental impairment that is either terminal or expected to be long-term and indefinite.

The chart below illustrates how each type of mutual fund income is taxed.

Tax Treatment of Investment outside of Retirement.		
Type of distribution	**Definition**	**Federal income tax treatment**
Long-term capital gains	Net gains from the sale of shares held for more than one year; may include some distributions received from investments held by the fund	Subject to the capital gains rates, usually lower than the ordinary income tax rates
Short-term capital gains	Net gains from the sale of shares held for one year or less	May be treated as ordinary dividends, thus taxable at ordinary income tax rates
Qualified dividends	Dividends from common stock of domestic corporations and qualifying foreign corporations	Normally taxed as long-term capital gains (subject to certain holding period and hedging restrictions)
Ordinary or non-qualified dividends	Investment income earned by the fund from interest and non-qualified dividends minus expenses; often used as a blanket term that includes all taxable income except long-term capital gains.	Taxable at ordinary income tax rates
Tax-exempt interest	Some or all interest on certain bonds, usually state or local municipal bonds, designated as tax-exempt	Not taxable for federal tax purposes; may be subject to state and/or local taxes, depending on your resident state and the type of bonds purchased
Taxable interest	Interest on fixed-income securities	Taxable at ordinary income tax rates
Federal interest	Interest on federal debt instruments	Taxable at ordinary federal income tax rates, but exempt from state income tax
Required distributions	Non-investment income required to be distributed by the fund (such as foreign currency gains that are taxed as ordinary income when distributed)	Taxed as ordinary income
Return of capital	A portion of your invested principal returned to you	Not taxable

Taxpayers who move between mutual funds at the same company must treat the transactions as sale or purchase, and pay the taxes on any gain.

Different than retirement plans, this investment option is taxed as-you-go. They do not receive a tax benefit when invested and are not tax deferred.

Outside investment options can work as a bridge account. These retirement options outside of retirement can be accessed easier than those inside of retirement. This means that penalties based on age will not apply.

IRA DISTRIBUTIONS.

A distribution is a transfer of money or property from an Individual Retirement Account (IRA) account to the taxpayer. The distribution rules for tax-deferred accounts are complex, but the same rules apply to the 3 different types of IRA accounts that defer taxes on contributions: traditional IRAs, SIMPLE IRAs, and SEP-IRAs. Different rules apply to Roth IRAs, since contributions have already been taxed, so distributions from Roth IRAs are tax-free. The rules for tax-deferred IRA accounts are easier to understand if the objectives of the rules are understood:

- Distributions are taxable when received;
- The government receives it share of the money, there are required minimum distributions after reaching age 70½;
- To enforce the main objective of retirement accounts, which is to provide for retirement, there are tax penalties for early distributions;
- If the taxpayer dies before receiving all distributions from all his IRA accounts, then the remaining value in those accounts is passed to beneficiaries, who are also subject to special rules for distributions.

Although distributions are a transfer of money or property from the account to the account holder, there are some transactions that are also considered distributions. A conversion of a traditional IRA to a Roth IRA is considered a distribution, so the taxpayer must include the distribution as income in the year of the distribution. Pledging the account as collateral for a loan is treated as a taxable distribution. When an IRA account is garnished, such as when child support obligations are enforced, the garnishment is considered a distribution that the taxpayer must include in income. If the distribution is not a qualified distribution, then the 10% tax penalty also applies. Garnishment is treated as a distribution because it was used to discharge an indebtedness of the taxpayer.

Distributions from traditional IRAs are taxable and are reported on Form 1099-R, Distributions from Pensions, Annuities, Retirement or Profit Sharing Plans, IRAs, Insurance Contracts, etc.. The custodian may withhold federal tax, but the taxpayer can direct the custodian not to withhold federal taxes by using Form W-4P.

IRA REQUIRED MINIMUM DISTRIBUTIONS (RDM).

Since contributions to a traditional IRA are tax deductible, and the earnings grow tax-free, the federal government wants to tax the money eventually, so the taxpayer must start receiving required minimum distributions (RMDs) by age 70½. The 1st distribution must be received by April 1 of the year following the year when the taxpayer reaches 70½. However, it is generally more prudent for the taxpayer to take this distribution when she reaches age 70½ since waiting

until the following year will result in 2 distributions for that year, for which a higher applicable marginal tax rate may apply. Thereafter, annual distributions must be received by year-end.

Penalty for not taking a RMD on time. If the distribution is less than the RMD, then a 50% tax penalty will be assessed on the difference unless there was a reasonable cause for the shortfall. So if you are required to take a $3000 distribution for the year, but instead, only took $2000, then a $500 (= $1000 × 50%) penalty will applied to the shortfall. Both the calculation of the penalty or a request of a waiver of the penalty must be made on Form 5329, which is attached to the taxpayer's tax return.

The RMD is based on the Uniform Lifetime Table published by the IRS, which lists the life expectancy for taxpayers by age. The trustee or custodian of the traditional IRA must report to the taxpayer the amount of the RMD by January 31 of the year of the required distribution.

In certain cases, the taxpayer will have to calculate the RMD. To figure the RMD, the RMD for each traditional IRA must be calculated separately, then totaled. Once the total has been determined, then the taxpayer can receive the RMD from just one of the accounts.

The IRA account balance at the end of the previous year in which the taxpayer reaches 70½ must be used, even if the taxpayer chooses to receive the distribution in the following year. In calculating the balances, any rollovers within 60 days of the year-end must be taken into account, even if the contribution was made in the next year.

The next step is to divide the account balance by the applicable life expectancy. The Uniform Lifetime Table, which can be found in Appendix C of Publication 590, provides 3 tables:

1. Table I is for beneficiaries.
2. Table II is for married owners whose spouse is at least 10 years younger.
3. Table III is for unmarried owners, married owners with a spouse who is no more than 10 years younger, or for married owners whose spouses are not the sole beneficiaries of the IRA.

Table III is a joint life expectancy for the taxpayer and a deemed beneficiary who is exactly 10 years younger, regardless of the beneficiary's actual age or even if the IRA owner has not named a beneficiary or if the taxpayer changes the beneficiary. When looking up the life expectancy from the table, the taxpayer should use the age that she will be on her birthday in that year. The RMD must be recalculated every year based on the life expectancy for the increased age.

The Uniform Lifetime Table is based on the assumption that the beneficiary of the IRA is 10 years younger than the taxpayer. A taxpayer with a spouse who is more than 10 years younger should use the Joint Life and Last Survivor Expectancy Table, which will yield a lower RMD, since the payouts will usually occur over a longer time. However, the spouse must be the sole beneficiary of the entire interest in the IRA during the entire calendar year for which the RMD is being figured; otherwise, the Uniform Lifetime Table must be used. If the taxpayer was married at the beginning of the year, but subsequently divorces or the spouse dies, then the taxpayer can

still use the joint table when calculating RMD for that year. When looking at the values in the table, the spouses' age is the age attained on their birthdays in that year.

INHERITED TRADITIONAL IRAs.

Distributions to beneficiaries are generally taxable and are not subject to the 10% tax penalty. As with distributions to IRA account holders, any portion of a distribution that is allocable to nondeductible contributions is nontaxable.

Rules for spouses inheriting an IRA. If a surviving spouse is the sole beneficiary of a deceased spouse's IRA, then the surviving spouse may treat the account as her own IRA or roll it over to her own IRA, which will then be treated under the regular rules.

Rules for non-spouse beneficiaries. If the decedent's estate is named as a beneficiary, then distribution requirements depend on when the decedent died. If before the date of required distributions, then the entire amount must be distributed by the 5th year after the year of death; otherwise, the distributions must be at least equal to the RMD based on the life expectancy of the beneficiary in the year of death.

Although a non-spouse beneficiary can transfer an IRA account to another financial institution, the account must, nonetheless, be maintained in the name of the deceased IRA owner, but for the benefit of the beneficiary. Although the financial institution will record the beneficiary's Social Security number on the account for tax purposes, the name on the account must remain that of the deceased IRA owner; otherwise, if the name is changed to that of the beneficiary, then the IRS will treat it as if the entire amount has been distributed to the beneficiary.

Required RDM for non-spouse beneficiaries. A beneficiary must receive an RMD for every year after the year of the decedent's death until the account is depleted. The RMD is calculated similarly to how it is calculated for account owners. The 50% tax penalty on any amount less than the RMD also applies to beneficiaries.

Surviving spouse getting the spouse's IRA. A surviving spouse who is a sole beneficiary with unlimited withdrawal rights of an IRA may change the name on the account to her own, thus subjecting the IRA account to the same rules as if it were her own account. If the surviving spouse does not receive an RMD within the 1st year after the death or contributes to the inherited IRA, then the account is deemed to be the surviving spouse's thereafter.

If a surviving spouse receives a distribution from the decedent spouse's IRA, then any amounts exceeding the RMD can be rolled over into her own IRA, but the RMD must be reported as income in the year in which it is received.

Surviving spouse getting a Roth IRA. If a Roth IRA owner dies, then the amounts in the Roth IRA accounts must be distributed to beneficiaries. If distributed as a lump sum, then it must be distributed before the end of the 5th calendar year postmortem. If paid as an annuity, then the amount of each distribution cannot be less than the amount that would be necessary to pay the beneficiary over his expected lifetime, as determined in IRS tables, in which case, distributions

must begin before the end of the calendar year after the year of death. However, if the beneficiary is a surviving spouse, then the spouse can elect to receive distributions when the decedent spouse would have reached 70½ or the surviving spouse can simply treat the IRA account as her own.

Failure to take the required minimum distribution (RMD) may result in a 50% excise tax on the amount that was not distributed.

Distributions to beneficiaries that are not qualified distributions, because the Roth IRA owner died before satisfying the five-year rule for qualified distributions, must include allocated earnings from the distributions as taxable income. Generally, basis, earnings, and any portions allocated to a rollover or conversion are divided proportionately among beneficiaries.

Other Retirement Accounts. The mandatory distribution rules that apply to regular IRAs ð where an account owner aged 70½ must begin receiving required minimum distributions based on his life expectancy by April 1 of the following year ð also apply to SIMPLE IRAs.

Distribution from a 401(k). A distribution from a 401(k) plan is not allowed until at least one of the following occurs:

- The employee retires or severs employment, becomes disabled, or dies;
- The plan ends and no other defined contribution plan is established or continued;
- If the plan is part of a profit-sharing plan, then distributions can be made if the employee reaches 59½ or suffers financial hardship; or
- The distribution is a qualified reservist distribution to a military reservist or member of the National Guard called to active duty for either at least 180 days or an indefinite period.

Plan withdrawals before age 59½ are subject to special tax rules. If the withdrawals are not qualified, then a 10% tax penalty may apply to the amount withdrawn, in addition to other taxes that would otherwise be due on the withdrawals. There is a mandatory withholding rate of 20% for lump sums and other distributions that are eligible for rollover if the distribution was paid directly to the taxpayer instead of being rolled directly over to another qualified retirement account. Taxpayers born before January 2, 1936 can use averaging for any lump-sum distributions.

A plan may also allow in-service distributions that are made while the plan is still active, but, besides being restricted by tax rules, such as being at least, the plan may also only allow in-service distributions after a certain numbers of years of being a participant or the distributions may be limited in frequency or to certain situations, such as paying for college.

SOCIAL SECURITY AND EQUIVALENT RAILROAD RETIREMENT BENEFITS.

As a taxpayer has worked through the years, they have made contributions to social security and Medicare. When they retire, they can apply to receive the following benefits social security benefits:

- Social security benefits,
- Monthly survivor, and
- Disability benefits.

They do not include supplemental security income (SSI) payments, which are not taxable.

22222	a Employee's social security number	OMB No. 1545-0008	
b Employer identification number (EIN)		1 Wages, tips, other compensation	2 Federal income tax withheld
c Employer's name, address, and ZIP code		3 Social security wages	4 Social security tax withheld
		5 Medicare wages and tips	6 Medicare tax withheld
		7 Social security tips	8 Allocated tips

Railroad Retirement. Equivalent tier 1 railroad retirement benefits are the part of tier 1 benefits that a railroad employee or beneficiary would have been entitled to receive under the social security system. They are often called the social security equivalent benefits (SSEB).

The Social Security Administration (SSA) reports social security benefits on Form SSA-1099 and Form SSA-1042S. The Railroad Retirement Board (RRB) issues Form RRB-1099 and Form RRB-1042S.

Payer's Name, Street Address, City, State, and ZIP Code United States Railroad Retirement Board 844 N Rush St Chicago IL 60611-1275 Payer's Federal Identifying No.		2017 Statement for Nonresident Alien Recipients of Payments by the Railroad Retirement Board	Copy B For Recipient's Records This information is being furnished to the Internal Revenue Service
Unique Form Identifier	1. Income Code	5. Claim Number and Payee Code	6. Recipient's U.S. Taxpayer Identification Number

FORM SSA-1099 – SOCIAL SECURITY BENEFIT STATEMENT

20XX. • PART OF YOUR SOCIAL SECURITY BENEFITS SHOWN IN BOX 5 MAY BE TAXABLE INCOME.
• SEE THE REVERSE FOR MORE INFORMATION.

Box 1. Name	Box 2. Beneficiary's Social Security Number	
Nicole S. Sterling	252-XX-XXXX	
Box 3. Benefits Paid in 20XX $34,545.00	Box 4. Benefits Repaid to SSA in 20XX $0.00	Box 5. Net Benefits for 20XX *(Box 3 minus Box 4)* $34,545.00
DESCRIPTION OF AMOUNT IN BOX 3	DESCRIPTION OF AMOUNT IN BOX 4	

Retirement Age. Social Security's full-benefit retirement age is increasing gradually because of legislation passed by Congress in 1983. Traditionally, the full benefit age was 65, and early retirement benefits were first available at age 62, with a permanent reduction to 80 percent of the full benefit amount. For those who turn 62 in 2018, full retirement age is 66 and four months. But for those who turn 62 in 2019, the full retirement age will increase to 66 and six months. Full retirement age is set to increase by two months each year until it hits 67. So, for anyone born in

1960 or later, full retirement age will be 67. Early retirement benefits will continue to be available at age 62, but they will be reduced more. When the full-benefit age reaches 67, benefits taken at age 62 will be reduced to 70 percent of the full benefit and benefits first taken at age 65 will be reduced to 86.7 percent of the full benefit

How to Determine When Social Security Benefits (or RRB) Are Taxable. To determine if any of the taxpayerôs social security benefits are taxable, the following information is needed:

- The taxpayerôs filing status
- One-half of the social security benefits (plus one-half of the spouseôs benefits, if filing a joint return)
- The total of the taxpayerôs other income (wages, self-employment, interest, dividends, etc.) including any tax exempt interest (plus the spouseôs other income, if filing a joint return).

If the sum of the one-half of the social security benefits plus the total of the other income exceeds the base amount (shown below) for the taxpayerôs filing status, some of the social security benefits will be taxable.

Base Amounts. The base amount for each filing status is shown below:
- Single, head of household or qualifying widow(er) - $25,000
- Married filing separately and lived apart from spouse all year - $25,000
- Married filing a joint return - $32,000
- Married filing separately and lived with spouse any time during the year - $0

How much of the benefits are taxable depends on the total amount of the taxpayerôs benefits and other income. Generally, the higher the total amount of income, the greater the taxable amount of benefits. Usually up to 50% of the taxpayerôs benefits will be taxable. However if either of the following situations applies, up to 85% of the benefits can be taxable:

- The total of one-half of the benefits and all of the taxpayerôs other income is greater than $34,000 ($44,000 if married filing jointly); or
- The taxpayer is married filing separate and lived with their spouse any time during the year.

Taxable SS Benefits.			
Filing Status	Base Amount (Benefit not Taxable)	50% of SS Benefit is Taxable	85% of Benefit is Taxable
Single, Head of Household, Qualifying Wodow(er), Married Filing Separate.	Less than $25,000	Between $25,001 and $34,000	Greater than $34,000
Married Filing Jointly	Less than $32,000	Between $32,000 and $44,000	Greater than $44,000

Taxes on the person receiving the benefits. The person who has the legal right to receive the benefits must determine whether the benefits are taxable.

For example, if a parent and child receive benefits, but the check is made out in the taxpayerôs name, the taxpayer should use only his/her part of the benefits to determine whether any benefits are taxable. One-half of the childôs portion of the benefits should be added to the childôs other income to determine whether any of these benefits are taxable to the child.

Taxpayers that receive their childôs Form SSA-1099 with their own name on it will not include their childôs Social Security benefits on their tax return; instead the benefits are calculated on the childôs own tax return if any.

Lump-sum Distribution of Benefits. Generally the taxpayer should use their 2018 income to determine the taxability of benefits received in 2018. However if the taxpayer receives a distribution in 2018 for benefits from an earlier year, they may be able to figure the taxable part of the payment for a previous year using the income from the earlier year. For additional information, see IRS Publication 915, Social Security and Equivalent Railroad Retirement Benefits.

Tips to consider before getting SSA benefits. Taxpayers that retired out of work and are fortunate enough to have other resources that you could live on ð such as a 401(k) account, an individual retirement account (IRA), or the proceeds from selling a house ð may want to consider spending down part of those resources while waiting to take Social Security.

How are the Social Security and Medicare taxes handled. The money paid for Social Security and Medicare taxes is not held in a personal account for taxpayers; instead the taxes are used to pay taxes to people who are getting benefits right now. Any unused money goes to the Social Security trust funds, not to a personal account with taxpayersôname on it.

How to Report Social Security Benefits. Net social security benefits (from Box 5, Form SSA-1099) are reported on line 5a of Form 1040. The taxable portion of any benefits received is included on line 5b, Form 1040. If the taxpayer is married filing separately and lived apart from their spouse for all of 2018, also enter ñDò to the right of the word ñbenefitsò on line 20a. If none of the benefits are taxable, do not report any of them on the tax return.

Repayment of Benefits. If the taxpayer repaid benefits in 2018, the amount of benefits repaid must be subtracted from the gross benefits they received in 2018, even if the repayment was for benefits received in a prior year.

Paying taxes ahead for taxable Social Security benefits Taxpayers that have to pay taxes on their Social Security benefits can make quarterly estimated tax payments or choose to have federal taxes withheld from their benefits.

Taxpayers can request the SSA to withhold federal taxes from their Social Security once they are applying for benefits.

Form 1040 (2018) Page 2

Attach Form(s) W-2. Also attach Form(s) W-2G and 1099-R if tax was withheld.

1	Wages, salaries, tips, etc. Attach Form(s) W-2				1		
2a	Tax-exempt interest	2a		b Taxable interest	2b		
3a	Qualified dividends	3a		b Ordinary dividends	3b		
4a	IRAs, pensions, and annuities	4a		b Taxable amount	4b		
5a	Social security benefits	5a		b Taxable amount	5b		
6	Total income. Add lines 1 through 5. Add any amount from Schedule 1, line 22				6		
7	Adjusted gross income. If you have no adjustments to income, enter the amount from line 6; otherwise, subtract Schedule 1, line 36, from line 6				7		
8	**Standard deduction or itemized deductions** (from Schedule A)				8		
9	Qualified business income deduction (see instructions)				9		
10	Taxable income. Subtract lines 8 and 9 from line 7. If zero or less, enter -0-				10		
11	a Tax (see inst) _____ (check if any from: 1 ☐ Form(s) 8814 2 ☐ Form 4972 3 ☐ _____)						
	b **Add** any amount from Schedule 2 and check here ► ☐				11		

Standard Deduction for—
- Single or married filing separately, $12,000
- Married filing jointly or Qualifying widow(er), $24,000

Taxpayers who are receiving benefits or are paying taxes through withholding will need a form W-4V from the Internal Revenue Service (IRS) to change or request taxes to be retained from their benefits.

Form **W-4V** (Rev. August 2014) Department of the Treasury Internal Revenue Service

Voluntary Withholding Request

(For unemployment compensation and certain federal government and other payments.)

► Give this form to your payer. Do not send it to the IRS.

OMB No. 1545-0074

1 Your first name and middle initial | Last name | 2 Your social security number

3 Home address (number and street or rural route) | City or town | State | ZIP code

4 Claim or identification number (if any) you use with your payer

5 ☐ I want federal income tax withheld from my unemployment compensation at a rate of 10% of each payment.

6 I want federal income tax withheld from (a) my social security benefits, (b) my social security equivalent Tier 1 railroad retirement benefits, (c) my Commodity Credit Corporation loans, (d) certain crop disaster payments under the Agricultural Act of 1949 or under Title II of the Disaster Assistance Act of 1988, or (e) dividends and other distributions from Alaska Native Corporations to its shareholders, at the rate of (check one):

7% ☐ **10%** ☐ **15%** ☐ **25%** ☐

7 ☐ I want you to stop withholding federal income tax from my payment(s).

Your signature ► **Date ►**

For Privacy Act and Paperwork Reduction Act Notice, see page 2. Cat. No. 22891V Form **W-4V** (Rev. 08-2014)

The withholding amount should be expressed on the following percentages:

- 7%, 10%, 15% or 25%

Only these percentages can be withheld. Flat dollar amounts are not accepted.

Supplemental Security Income. Supplemental Security Income (SSI) is a Federal income supplement program funded by general tax revenues (*not* Social Security taxes):

- It is designed to help aged, blind, and disabled people, who have little or no income; and
- It provides cash to meet basic needs for food, clothing, and shelter.

Eligibility for SSI - Individuals that fall into one of the following categories can apply for SSI:

- Aged (age 65 or older);
- Blind; or
- Disabled.

And, who:

- Has limited income; and
- Has limited resources; and
- Is a U.S. citizen or national, or in one of certain categories of aliens

As mentioned before SSI benefits are not taxable.

Reduction in Social Security retirement Benefits while working. Taxpayers can get Social Security retirement benefits and work at the same time. However, if they are younger than full retirement age and make more than the yearly earnings limit, the SSA will reduce their benefits.

Reduction in benefits at age 62. Taxpayers that are under full retirement age for the entire year will receive $1 less from their benefit payments for every $2 they earn above the annual limit.

- For 2018 that limit is **$17,040.**

Example. Let's suppose that taxpayers earned $20,000 from work during 2018, then their income would be $2,960 over the threshold, and they'd forfeit half of that, or $1,480.

Deduction in benefits months before the full retirement age. Taxpayers that reach the full retirement age will receive $1 less in benefits for every $3 they earn above a different limit. For this purpose the Social Security will use taxpayersô earnings before the month in which they reach the full retirement age.

- Taxpayers that reach full retirement age in 2018, the limit on the earnings for the months before full retirement age is **$45,360**.

No deductions at full retirement age. Starting with the month that taxpayers reach full retirement age, they can get their benefits with no limit on their earnings.

Deductions and taxes on SSA benefits after full retirement age. Taxpayers that are still working after full retirement age will have to remember that part of their benefits might be subject to taxation. The figures shown before indicates how much of the Social Security benefits will be taxable for each taxpayer according to their filing status and income threshold.

Credits toward Social Security benefits. Taxpayers get credits toward Social Security benefits every working year. The number of credits needed to be eligible for Social Security benefits depends on taxpayersô age and the type of benefit for which they will apply. Taxpayers can earn a maximum of four credits each year. Most people need mandatory 40 credits (10 years of work with full credits) to qualify for retirement benefits.

Credits for Social Security benefits. Maximum 4 per year.	
2017 employee and self-employed	2018 employee and self-employed
$1,300 earns one credit	$1320 earns one credit

How much benefits can be received? The Social Security Administration (SSA) will take into consideration the benefit payments to taxpayers on how much they earned during their working career. Higher lifetime earnings result in higher benefits. If there were some years not worked or with low earnings, the benefits may be lower than if taxpayer had worked steadily.

The age at which taxpayers decide to retire also affects their benefit. If they retire at age 62, the earliest possible Social Security retirement age, their benefits will be lower than if they retire at age 66 and months.

Limits on Social Security benefits. While the mentioned before implies that there is no limit to the size of taxpayersô benefits, the Social Security Administration has in fact imposed one. In 2018, the most taxpayers can collect in Social Security benefits is $3,698, regardless of their age. For each year there is a limit on the maximum amount of benefits received:

- For 2018 the maximum monthly retirement benefit for someone who retires at age 62 is $2,158.
- Taxpayers that retire at age 65 in 2018 will have a maximum benefit of $2,589.
- Taxpayers that retire at age 70 in 2018 will have a maximum benefit of $3,698.

Pensions and Annuity Withholding.

Generally, pension and annuity payments are subject to Federal income tax withholding unless taxpayer elect otherwise. The withholding rules apply to the taxable part of payments from an employer pension annuity, profit-sharing, stock bonus, or other deferred compensation plan. The rules also apply to payments from an individual retirement arrangement (IRA), an annuity, endowment, or life insurance contract issued by a life insurance company. There is no withholding on any part of a distribution that is not expected to be includible in the recipient's gross income.

Form W-4P and Withholding on Periodic Payments. Generally, periodic payments are pension or annuity payments made for more than 1 year that are not eligible rollover distributions. Periodic payments include substantially equal payments made at least once a year over the life of the employee and/or beneficiaries or for 10 years or more. For wage withholding purposes, these payments are treated as if they are wages. In this case taxpayers should use Form W-4P, Withholding Certificate for Pension or Annuity Payments.

Nonperiodic Payments. The withholding rate for a non-periodic distribution that is not an eligible for rollover is 10% of the distribution. Any loan treated as a distribution is also subject to withholding under this rule.

Mandatory Withholding on Payments Delivered Outside the United States. The election to be exempt from income tax withholding does not apply to any periodic or nonperiodic payment delivered outside the United States or its possessions to a U.S. citizen or resident alien. Refer to Form W-4P for more information.

Review Questions Section 4

Read and answer the following review questions. The correct answers are found on the next page with an explanation to strengthen up your knowledge.

20. The part of a distribution from a pension that is attributed to the taxpayerôs contributions is_____.
    a) Taxable
    b) Nontaxable
    c) Recovered first
    d) Reported as wages on the tax return

21. The two methods for determining the taxable portion of a pension distribution are:
    a) The Simple and Not-So-Simple Methods.
    b) The Simplified Method and the 10-year Rule.
    c) The Simplified Method and the General Rule.
    d) The General Rule and the 10-year Rule.

22. A disability pension received by a taxpayer before minimum retirement age is reported on:
    a) Line 7, Form 1040, until taxpayer reaches minimum retirement age.
    b) Line 16, Form 1040, until taxpayer reaches maximum retirement age.
    c) Line 21, Form 1040, for the remaining period.
    d) It is not reported on the tax return

23. For the purposes of rollovers, a qualified retirement plan includes all of the following, except:
    a) A qualified employer plan
    b) A tax-sheltered annuity plan
    c) An eligible state or local government section 457 plan
    d) All of the above are considered to be qualified retirement plans

24. Taxpayers are allowed to rollover their IRA retirement _____ without penalties.
    a) As long as they want.
    b) Twice a year.
    c) Once a month
    d) Once a year.

25. If the taxpayer receives a distribution from a retirement plan or IRA before reaching age 59 ½, there may be a _____ imposed on the taxable portion of the distribution.
    a) Interest
    b) Tax deduction.
    c) 10% penalty
    d) Penalty varies depending on the filing status of the taxpayer

Questions Section 1 – Answers and Discussion

20. **Answer b**. The part of the distribution that is treated as a recovery of the taxpayerôs contribution is tax free. The first step in determining how much of a distribution is taxable is to determine the amount of the taxpayerôs investment in the pension or annuity.

21. **Answer c**. There are two methods generally used to determine the taxable portion of a distribution:

- The General Rule or the Simplified Method; and
- The General Rule.

22. **Answer a**. A taxpayer who has retired on disability must generally include in their income any amount received under a plan that is paid for by their employer. Instead of reporting their disability pension on line 16, Form 1040, taxable amounts are reported on Line 7 of Form 1040 until the taxpayer reaches minimum retirement age.

23. **Answer d**. Any amount rolled over is not included in income until it is distributed from the new plan without being rolled over. For the purposes of rollovers, a qualified retirement plan includes:

- A qualified employer plan
- A qualified employee annuity
- A tax-sheltered annuity plan (403(b) plan)
- An eligible state or local government section 457 deferred compensation plan

24. **Answer d**. Starting in 2015, taxpayers can make only one rollover from an IRA to another or the same IRA in any 12-month period, regardless of the number of IRAs they own.

25. **Answer c**. If the taxpayer receives a distribution from a retirement plan or IRA, and they are under age 59½, a 10% penalty is generally imposed on the taxable portion of the distribution. The 10% additional tax applies to the part of the distribution that taxpayers have to include in gross income.

HEALTH BENEFITS NOT AFFECTED BY THE TAX CUTS AND JOBS ACT (TCJA).

A health savings account usually supplements one's current insurance coverage, although with some HSAs taxpayers don't have to have insurance coverage. These types of health savings accounts pay for medical expenses that their health insurance coverage typically does not pay for. Depending on the plan they choose, the money in an HSA is deposited either by the taxpayer or an employer before it is taxed so it's like paying for out of pocket medical costs tax-free. In addition, with some plans, taxpayers can earn interest on the money while it is sitting there waiting to be used.

These are the health savings accounts and other employeesô benefits that were not affected by the TCJA and are still available for taxpayers:

1. **Health Savings Accounts (HSAs):** The Bill makes no changes to the tax treatment of Health Savings Accounts.

2. **Health Reimbursement Account (HRA) with focus on QSEHRA.** No change was made to this program under the TCJA.

3. **Healthcare flexible spending accounts (FSAs):** The Bill makes no changes to the tax treatment of Healthcare FSAs. They continue to be tax-free.

4. **Employer provided healthcare:** The Bill makes no changes to the tax treatment of employer-provided healthcare benefits. They continue to be tax-free.

5. **Dependent care and adoption assistance programs:** The Bill makes no changes to the tax treatment of Dependent Care FSAs or Adoption Assistance Accounts or programs. It also keeps in place the adoption tax credit.

6. **Educational assistance programs:** The Bill makes no changes to the tax treatment of employer-provided educational assistance programs.

THE HEALTH SAVINGS ACCOUNTS (HSAs) AND HOW THEY WORK.

Contributing to an HSA. Taxpayers and/or the employer put money into the HSA account (the account can be set-up through the employer as a benefit or taxpayers can also set up the account through a private company.) The contributions are 100% tax deductible from gross income.

The contributions belong to the participant. All of the money in the HSA (including any contributions deposited by the employer) belongs to taxpayer even if he/she:

- Leave the job, leave the qualifying health plan, the taxpayer retires.

In other words, an HSA is not a "use-it-or-lose-it" type of account. This is one reason why an HSA can help with retirement savings.

High Deductible Health Insurance Plan (HDHP) Required to open an HSA Account. First of all, not just anyone can contribute to a health savings account ï taxpayers must first have a qualifying high deductible health insurance plan if a health plan is not offered at work. ñHigh deductibleò is defined as having a deductible of:

High Deductible Limits		
Size	**Minimum Deductible**	**Maximum Out-of-Pocket**
Single	$1,350	$6,650
Family	$2,700	$13,300

The high deductible for 2018 is $1,350 for an individual, or $2,700 for a family. Once taxpayers select a plan with that limit, they are eligible to contribute to an HSA. When taxpayers open their HSA, they can contribute up to the individual or family limit each year.

Once taxpayers have a qualifying health care plan, they can star shopping around for different banks or investment accounts that offer HSAs.

Triple-tax benefit of HSAs. HSAs have triple-tax advantages (as long as the accountholder follows the rules set up by the IRS) that other programs donôt have. The triple-tax advantages are:

1. Tax-free contributions into an HAS. Some savings accounts, such as a Roth 401(k) or IRA, are taxed before someone puts funds in. However, the funds are not taxed when money is spent from the account. When someone contributes money to their HSA, the funds are not taxed. This is similar to a traditional 401(k) or IRA.

Because of the significant tax advantages of an HAS, the IRS has put a limit on how much someone can contribute to an HAS each year. For the upcoming tax year of 2019, the maximum contribution limit is $3,500 for an individual and $7,000 for a family. Those accountholders 55 and older can contribute an additional $1,000 annually.

California will tax contributions to an HSA. Contributions Federal law allows taxpayers a deduction for contributions to an HSA account. Contributions made on behalf of an eligible individual by an employer are excluded from W-2 wages. California does not conform to this provision.

Taxpayers will make the adjustment using Schedule CA to include the exclusion as income in California. Distributions that are not used for qualified medical expenses are includible in federal gross income. The amount taxable under federal law, less interest and dividend income previously taxed by California, is not taxable by California.

2. Tax-free growth in an HAS. Accountholders can also grow the funds in their account through interest and, potentially, through investing. And, unlike other growth options, the increase in funds is not subject to taxes. There is also no expiration date on an HSA and no required

minimum distribution (like from a 401(k) or IRA. This means that accountholders can potentially spend years growing the funds in their HSA ð all tax free.

3. Tax-free distributions from an HAS. Traditional IRA and 401(k) programs are not taxed when the accountholder puts money in the account, but the money is taxed when it is taken out of the account. This leads to the third tax advantage of HSAs: Funds spent from an HSA are not taxed as long as they are spent on qualified medical expenses. In other words, accountholders canôt use their HSA funds to pay for a vacation or buy a new big-screen TV, but they can fund their visits to the doctor, their dental and vision care, etc. Spending HSA funds on non-qualified medical expenses results in taxes and an additional 20 percent penalty

That said, anyone 65 years and older can use their HSA funds for any reason; the money will be taxed, but they will not be subject to the 20 percent tax penalty. If a retiree uses the funds for qualified medical expenses, it will still be totally tax-free.

Inheriting an HSA.

Spouse Beneficiary. If a deceased HSA ownerôs spouse is the death beneficiary, the inherited HSA becomes the spouseôs own HSA as of the account ownerôs date of death, whether the spouse is covered under a high deductible health plan (a requirement to make HSA regular contributions) or not. From a procedural standpoint, a common approach taken by some HSA custodians and trustees when moving assets from a decedentôs name and social security number to a surviving spouseôs name and social security number, is to establish an HSA for the surviving spouse and transfer the balance of the decedentôs HSA to that of the surviving spouse.

Nonspouse Beneficiary. If a nonspouse is the death beneficiary of an HSA the account is no longer an HSA as of the account ownerôs date of death, essentially resulting in an immediate taxable distribution from a tax standpoint. The beneficiary must include the HSAôs date-of-death fair market value (FMV) as taxable income in the year of the account ownerôs death. However, because the distribution is due to death, the 20 percent penalty tax, which applies to nonqualified distributions, does not apply. Additionally, any portion of an inherited HSA balance used to pay outstanding medical expenses of the account owner within one year of the account ownerôs death will not be taxable to the beneficiary.

Estate as Beneficiary. If an HSA ownerôs estate is the death beneficiary, the HSA is no longer an HSA as of the date of death. The FMV of the HSA as of the account ownerôs date of death is included in the HSA ownerôs year of death gross income.

Qualifying through work or as individual. Taxpayers can check with their employer to see if they have an employer-sponsored health care plan. If not, then they may be able to purchase a qualifying HDHP on the ACA exchanges, or find one through a health insurance company. Once taxpayers have a qualifying health care plan, they can shop around for different banks or investment accounts that offer HSAs.

Tax benefits of the contributions. Taxpayersô money sits in the account like it would do in a

bank account, except that the money contributed is not taxed and can be invested to create some income.

Tax benefits for employers who contribute to employees' HSAs. Generally, contributions made by an employer to the health savings account (HSA) of an eligible employee are excludable from an employee's income and are not subject to federal income tax, Social Security or Medicare taxes. In addition, employer contributions are deductible as a business expense to the company. An employee's HSA may be funded by contributions from the employer, from the employee or both. Employers may choose to contribute a set amount or make "matching" contributions.

If an HSA is funded by contributions from both the employer and the employee, it will be important to ensure that the total contributions remain within the annual IRS limits. Contributions made in excess of these annual limits may become taxable income to the employee.

While employer contributions to an HSA may be excluded from the employee's income, all employer contributions, including those made by the employee through a cafeteria plan, must be reported in box 12 of the employee's W-2.

HSAs can be opened outside the job. HSAs are available from a wide variety of banks, credit unions, or other broker. The contributions can be invested in the stock market if a broker is selected. If the funds are with a bank or credit union, they will probably offer just some interests.

HSAs Accounts have the investment benefits of IRAs and Roth IRAs. Health Savings Accounts combine the best of the Traditional IRA and Roth IRA. Contributions are tax-deductible in the year they are made (like a Traditional IRA), and the earnings and withdrawals are tax-free if used for a qualifying medical expense (like a Roth IRA, when used for retirement). There are no age limits when using your HSA funds for a qualifying medical expense. So taxpayers can let their money ride until needed. Or just let it grow and pay for medical expenses out of pocket.

Funding the HSA Account with retirement funds. Taxpayers may be able to fund their HSA with a tax-free rollover from their traditional or Roth IRA. The distribution must be made directly by the trustee of the IRA to the trustee of the HSA and is only allowed once in their lifetime. The size of the rollover is limited to the annual HSA contribution limit minus any money that taxpayers have already contributed for the year.

If taxpayers have a 401(k) from a former employer, they may be able to make the move in two steps: Roll it over into an IRA first, and then make a tax-free direct transfer from the IRA into the HSA. 457 plans do not qualify for a rollover to an HSA.

Reporting contributions on the income tax return using Form 8889. Report all contributions to the HSA using Form 8889 when filing the income tax return. Taxpayers can include the contributions made from January 1, 2019 through April 17, 2019 that are designated for 2018. The form can also show the contributions made by the employer.

Form 5498-SA from Custodian. Taxpayers should receive Form 5498-SA, HSA, Archer MSA, or Medicare Advantage MSA Information, from the trustee showing the amount contributed to the HSA during the year. The employer's contributions will also be included in box 12 of Form W-2, Wage and Tax Statement, with code W.

Using funds from the HSA. When taxpayers need to use their money for medical expenses, they will normally use a debit card associated with the account. Sometimes, taxpayer will pay for the medical expenses out of their pocket and then forward the bill to the plan administrator who will reimburse the expense into taxpayersô health account.

Keep records for medical expenses. Taxpayers will need to save sufficient documentation to prove that the HSA withdrawals were used for medical expenses. If the IRS audits the return, taxpayers may have to produce things like doctor's bills and health insurance explanation of benefits forms.

Penalty for using it for non-medical expenses. When taxpayers take money out of their HSA account and donôt use it for medical expenses, theyôll have to pay income taxes on it plus a 10 percent penalty. Just as taxpayers would with a retirement account.

No penalty for non-medical withdrawals after age 65. Once taxpayers reach age 65, the current tax rules allow them to make non-qualifying withdrawals from their HSA with the same tax rules as a Traditional IRA. They would pay taxes on the withdrawals, but they would not pay any penalties.

Requirements to start and contribute to an HSA Account. Taxpayers are eligible to start and contribute to an HSA if they meet all of these requirements:

1. Theyôre covered by a qualified HDHP (this means a high deductible health plan that meets the deductible and out-of-pocket requirements established by the IRS for HSA-qualified plans, and that doesn't cover anything besides preventive care before the deductible is met ð ie, theyôll pay the full cost of office visits, rather than just a copay, until they've met their deductible).
2. Taxpayers donôt have additional, more traditional, health insurance coverage.
3. They arenôt on Medicare.
4. Nobody else can claim them as dependents on their tax return.
5. They don't have a general purpose

Yearly HSA Contribution Limits	2017	2018
Self-only coverage under age 55	$3,400	$3,450
Family coverage under age 55	$6,750	$6,900
Self-only coverage age 55+	$ 4,400	$ 4,450
Family coverage age 55+	$ 7,750	$ 7,900

Tax on excess contributions. Contributing more to the health savings account (HSA) will create an excise tax. Going above the IRS limit for the tax year is called an excess contribution. All excess contributions are subject to income tax and a 6% excise tax each year until corrected.

Taxpayers can avoid paying the excise tax by:

1. Withdrawing the excess contribution(s) by the tax filing deadline of the year the contribution was made, and
2. Withdrawing any income earned on the excess contribution(s) and including it on your tax return for that year

HSAs Tax Benefit Planned for the future. The Trump administration is trying to bring more benefits to the HSAs account. One of the increased benefits would include higher contribution limits. Future reform would allow loosening the eligibility guidelines in terms of who can make contributions, and tax credits to help people fund HSAs. Nothing has changed about HSA rules for now, but those are proposals that could still be considered in the future.

THE HEALTH REIMBURSEMENT ACCOUNT (HRA), AN EMPLOYER PLAN FOR THE EMPLOYEES. NOW WITH A DIFFERENT NAME AND ARRANGEMENT.

A Health Reimbursement Account is an employer-sponsored account that reimburses the employees for medical expenses. Unlike an HSA, no HDHP is required. Unlike an FSA, any unused portion typically can be carried forward to the next year.

Thereôs no government-set limit on HRA contributions. But only your employer can contribute to an HRA; employees arenôt allowed to contribute.

Applicable Large Entities (ALE) can offer HRA along with a medical plan. An HRA may not be maintained by a large company that does not also maintain a group health plan for its employees. Violations can result in the imposition of an excise tax under Sec. 4980D of $100 per day ($36,500 per year) per employee.

Relief for Small companies with the updated Qualified Small Employer Health Reimbursement Arrangement (QSEHRA). Small business employers can now help cover the cost of their employeesô individual health plans via a Qualified Small Employer Health Reimbursement Arrangement (QSEHRA).

Under the Affordable Care Act (ACA), employers could only provide HRAs when they were integrated with ACA compliant group health plans. As result, employers who were using HRAs to reimburse employees for premiums on individual market policies faced penalties.

Section 18001 of the 21st Century Cures Act, changes this. Qualifying small employer HRAs are no longer subject to this restriction, and may be used by employers to reimburse individuals, effective January 1st, 2017.

A QSEHRA allows a small employer to reimburse employees for at least a portion of their individual market health insurance premiums. And those employees may also be eligible for premium subsidies in the exchange.

Keeping comply with QSEHRA requirements. If the QSEHRA arrangement fails to satisfy all of the requirements for treatment as a qualified small employer HRA, it will be treated as a regular HRA, which will trigger the Sec. 4980D excise tax of up to $36,500 per year per employee (i.e., $100 per day per employee).

Requirements to establish a QSEHRA. To be eligible to provide a qualified small employer HRA, an employer must not be an "applicable large employer" (ALE), defined by Sec. 4980H(c)(2) as an employer "who employed an average of at least 50 full-time employees on business days during the preceding calendar year." A full-time employee is defined as an employee who works on average 30 or more hours per week. Sec. 4980H(c)(2)(E) requires full-time-equivalent (FTE) employees also to be taken into account in determining whether an employer is an ALE.

Small employers are not allowed to offer health coverage for QSEHRA. In addition, to be eligible to provide a qualified small employer HRA, an employer must not offer a group health plan to any of its employees. Examples of group health plans that would disqualify an employer include an HRA other than a qualified small employer HRA, and a health flexible spending arrangement. However, employer contributions to an employee's health savings account (HSA) do not constitute a group health plan. Employees must obtain the health insurance through another source, such as a health insurance exchange established under PPACA.

The employee must substantiate any medical expense for which payment from the arrangement is made. Notice 2017-67 provides details of what constitutes proof of coverage and substantiation of a medical expense. If a qualified small employer HRA mistakenly makes a payment to an employee when he or she does not have insurance coverage, the payment is taxable to the employee.

Contributions limit for QSEHRA. In 2018, a small business can contribute up to $5,050 to an employee-only QSEHRA, and up to $10,250 if the employee has family members who also have minimum essential coverage. That is also the maximum reimbursement amount. The amount is prorated monthly if the employee doesn't have coverage under the QSEHRA for the full year. In 2018, the monthly limit is $420.83 for a single employee and $854.16 for an employee with covered family members.

Employers aren't required to contribute the larger amount for employees with families. They can if they choose to, but it's also permissible for the employer to give everyone the same amount, based on self-only coverage. It's also permissible for the employer to set a lower QSEHRA limit, as long as it's done consistently across all eligible employeesð for example, contributing 80 percent of the annual limit, instead of 100 percent.

QSEHRA reimbursements are tax-free if they follow the requirements. The QSEHRA was created as a formal, tax-free benefit. In practice, that means that reimbursements issued through the QSEHRA are always free of payroll tax for small businesses and their employees.

Reporting of QSEHRA benefits on Form W-2. Small businesses offering a QSEHRA must report the benefit on every eligible employeeôs W-2.

Box 12, code FF is reserved specifically for the QSEHRA benefit. Businesses should report the total amount of allowances the employee was entitled to receive during that calendar year, without regard to the amount of payments or reimbursements the employee actually received.

The permitted benefit amount should include only newly available QSEHRA funds. Any carryover amounts from previous years should not be included.

If the business uses a noncalendar-year QSEHRA, it should report a prorated amount of the permitted benefit for the calendar year. For example, if the employer offers $200 a month and the QSEHRA plan year begins on June 1, 2018, the employer would report $1,400 on the employeeôs 2018 Form W-2 ($200 x seven months of permitted benefit in 2018).

Similarly, if an employeeôs eligibility or allowance changes during the year, the company should prorate the amount reported on their W-2 to reflect the change. For example, if an employee is eligible for $200 a month as a self-only employee from January 1, 2018, to May 31, 2018, and $400 as a married/family employee from June 1, 2018, to December 31, 2018, the business should report $3,800 on the employeeôs 2018 Form W-2 ($200 x five months of permitted self-only-status benefit + $400 x seven months of permitted family-status benefit).

Reporting taxable reimbursements on Form W-2. Employees who donôt have minimum essential coverage can still receive reimbursements through the QSEHRA, but those reimbursements are subject to income tax. Businesses should track employeesô coverage status throughout the year and report as taxable income on their W-2 any reimbursements made while the employee didnôt have MEC.

Specifically, any taxable reimbursements should be included as other compensation in box 1, Wages, tips, and other compensation.

If the business discovers an employee lacks MEC after filing their W-2, it should provide the employee with a Form W-2c, Corrected Wage and Tax Statement, and file the form with the Social Security Administration (SSA).

These payments wonôt affect the amount reported in box 12, code FF.

Some businesses provide for taxable reimbursements through their QSEHRA of over-the-counter drugs purchased without a doctorôs note or premiums paid on a pretax basis for an employeeôs spouseôs group health policy. If this is the case, the business should report the amounts paid to employees that year as wages subject to tax withholding in box 1. This does not affect box 12.

Premium Tax Credit benefit or the QSEHRA benefit; sometimes is one or the other. Employers and employees need to understand that if the QSEHRA is set up so that family members can also have their benefits reimbursed, nobody in the family will be eligible for premium subsidies, even if they only end up getting a small portion of their premiums reimbursed via the QSEHRA. In some cases, this could result in a family losing out on a

significant amount of premium subsidies in the exchange, making the QSEHRA a net negative for them.

Expenses covered under a QSEHRA. Qualified small employer HRAs enable an eligible employer to reimburse employees for medical expenses, such as health insurance premiums, as defined under Sec. 213(d). Qualified small employer HRAs are solely employer-funded; employees cannot contribute to them.

The employer may only reimburse eligible employees for medical care expenses after the employees have provided proof of minimum essential coverage.

Tax treatment of payments received under a QSEHRA. Payments from a qualified small employer HRA to an employee are not includible in the employee's income, as long as the employee has obtained qualifying health insurance.

Filing requirements for business with QSEHRA. Form 720. Because the QSEHRA is a self-insured health plan, itôs subject to the Patient-Centered Outcomes Research Initiative (PCORI) fee. Businesses offering a QSEHRA must report this fee annually on IRS Form 720. The fee is based on the number of eligible employees included in the benefit for that tax year.

For 2018, the PCORI fee and the completed Form 720 are due by July 31, 2018. The fee is $2.39 per plan enrollee.

HEALTHCARE FLEXIBLE SPENDING ACCOUNT (FSAs).

Health Savings Accounts and Flexible Spending Accounts help you lower your income taxes while saving money to use for medical expenses. However, the similarities stop there.

A Flexible Spending Account (also known as a flexible spending arrangement) is a special account in which employees put money that can be used to pay for certain out-of-pocket health care costs.

The employees donôt pay taxes on this money. This means they will save taxes on the amount they set aside for health care expenses. The employer also saves payroll taxes on the money set aside.

Employers may make contributions to the employeesô FSAs, but they arenôt required to.

FSA eligibility requirements. Typically, anyone whose employer offers an FSA can participate; including employees not covered under the employerôs health plan. Employers may exclude certain types of employees, such as part-time, seasonal or temporary.

FSA contribution limits for 2018. Contributions to an FSA are limited by the IRS to $2,650 per year. If an employee is married, each spouse may contribute up to $2,650 to his or her own FSA, even if both participate in the same FSA sponsored by the same employer. An employerôs plan may further limit the contributions into an FSA.

FSA funds are not rolled over year to year. FSAs are generally structured as a use it or lose it plan. This means that amounts in the FSA at the end of the plan year generally cannot be carried over to the next year. Additionally, if an accountholder leaves an employer or retires, unused funds are forfeited. However, the plan can provide for either a grace period or a carryover.

FSAs with limited carryover. Employers may allow up to $500 of unused FSA funds remaining at the end of a plan year to be carried over to the next year.

FSAs with a grace period. A grace period is an extension beyond the plan year, during which employees may still incur eligible FSA expenses and use the funds remaining in their accounts to cover those expenses.

Types of FSAs. The FSAs come in a few different varieties that will allow taxpayers to pay for different things. Employers decide what spending accounts to offer. The employer will inform the employees what type of FSAs is available. Here are some of the types of flexible spending accounts that they can choose from:

Medical Expense. One of the most common types of flexible spending account is the medical expense account. With this type of account, taxpayers can combine it with a health insurance plan to pay for most of the medical expenses incurred during the year. This account can be used to pay for things that medical insurance does not cover. For example, taxpayers can use the money in this account to pay for co-payments, or their deductible. This type of account can also be used to pay for prescriptions and other treatments. Participants can even use it to pay for services like dental work, vision care and chiropractic care.

Dependent Care. This type of account can be used to pay for a dependentôs health care expenses. Participants can contribute as much as $5000 per year towards their dependentôs account. In most cases, this type of account is used to pay for daycare expenses for children living in the same household under age 13. This type of account can be used to pay for dependent care of elderly adults that living with participant.

Health Premiums. Another option that can be available is a flexible spending account that is designed to reimburse employees for healthcare insurance premiums. If a company does not offer a healthcare plan to its employees, they can offer this as an alternative. For example, a married couple may have a family insurance plan covered under one spouse, so the other spouse can have their insurance costs defrayed and put into a flexible spending account, or FSA.

Adoption Assistance. In some cases, companies will also offer a flexible spending account that will allow individuals to use the funds for adoption assistance. The process of adoption can be very expensive and many people do not have the necessary resources. With this type of account, taxpayers can set aside pre-tax money and use it to complete the adoption process. This can help pay for any expenses that are incurred during the act of adopting a child. The legal fees of an adoption process can be very expensive and without a FSA account, an adoption may not be possible.

An FSA is Employer-Owned. An FSA is owned and run by the employer. There is no option for an employee to get an FSA on their own in the marketplace (unlike an HSA that an employee could secure outside of the workplace). So if an employee leaves the job for any reason, the FSA balance returns to the employer. Employees who quit or are terminated lose all of their unused contributions.

Also, any unused non-rolled over FSA funds return to the employer, at year-end. Thatôs because the employer is the owner of the FSA account.

Health spending account comparison	HSA	HRA	FSA
Taxpayer owns the account.	Yes	No	No
The employer owns the account.	No	Yes	Yes
Taxpayers must have a high-deductible health plan.	Yes	No	No
Only the employer can put money in.	No	Yes	No
Taxpayer and the employer can put money in.	Yes	No	Yes
Taxpayers can invest the money in the account.	Yes	No	No
Must report account when taxpayers file their taxes.	Yes	No	No

INVESTING FOR EDUCATION.

COVERDELL EDUCATION SAVINGS ACCOUNTS. THE INCOME TAX TREATMENT.

Income and Contribution limits. The Internal Revenue Service (IRS) limits who may contribute to a Coverdell ESA. The eligibility is based on taxpayersô modified adjusted gross income (MAGI) and their tax filing status.

A Coverdell ESA is meant to be used for qualified education expenses. Failing to stick to the IRS guidelines for distributions could trigger a tax penalty. Here are some scenarios that could result in a taxable event.

Contributions rules for Coverdell ESA. As far as the contributions themselves are concerned, there are three requirements the IRS expects you to meet:

1. Contributions must be in cash. In other words, taxpayers canôt use stocks or other investments to fund the account.
2. Contributions canôt be made after the beneficiary turns 18, unless they have special needs.
3. Contributions must be made by the due date of the contributing individualôs tax return. For most people, that would be the annual April filing deadline, even if taxpayers filed an extension.

Income limits for contributions. Something else to note regarding contributions are the restrictions for individuals at the higher end of the MAGI scale. If theyôre a single filer with an

MAGI between $95,000 and $110,000, or a married couple whose MAGI falls between $190,000 and $220,000, the $2,000 limit is gradually reduced.

For example, a single person whose MAGI is $96,500 would be limited to contributing $1,800 to a Coverdell ESA for the year, based on the IRS formula for calculating contributions. A married couple filing jointly with an MAGI of $205,000 would be able to contribute $1,000 for the year.

Excess contributions penalty. Exceeding the annual contribution limit can result in a tax penalty. The IRS requires ESA beneficiaries to pay a 6% excise tax each year on excess contributions that are still in their account at the end of the year.

The only exception to the penalty is for excess contributions that are distributed before the first day of the sixth month of the following tax year. But, any earnings included in the distribution would still be subject to regular income tax.

Withdrawals for Expenses Other Than Education. Form 1099-Q is used. The IRS is very clear about what an ESA can be used for. Qualified education expenses for higher education include:

- Tuition and fees
- Books, supplies and equipment
- Expenses for special-needs services required by a special-needs beneficiary
- Room and board for students who are enrolled at least half-time
- Computer equipment, software, internet access or related services if used primarily by the beneficiary while theyôre enrolled

Qualified expenses for elementary and secondary education include:

- Tuition and fees
- Books, supplies and equipment
- Academic tutoring
- Special-needs services for a special needs beneficiary
- Room and board if attending a boarding school
- Uniforms
- Transportation
- Supplementary items and services, including extended day programs
- Computer technology, equipment and internet access

All qualified expenses must be paid to an eligible school. That includes colleges and universities that are eligible to participate in federal financial aid programs, and elementary and high schools that meet state standards.

Tax penalties for non-qualified expenses. If funds in a Coverdell ESA are used for anything that doesnôt fit into either of these categories, a 10% tax penalty applies and any earnings on the distribution are subject to regular income tax. This would be like borrowing money at least 22%.

The IRS does allow for some exceptions allowing you to avoid the 10% penalty on taxable distributions. The penalty can be avoided if:

- Distributions are made to a beneficiary or the estate of the designated beneficiary on or after the death of the designated beneficiary
- Distributions are made because the designated beneficiary becomes disabled
- The designated beneficiary is attending a U.S. military academy
- Distributions are included in income because the beneficiary received a tax-free scholarship or fellowship grant, veteransô educational assistance, employer-provided educational assistance, or any other tax-free payments (excluding gifts or inheritances) to pay for education expenses
- Distributions are included in income because the qualified education expenses were considered in determining the American Opportunity or Lifetime Learning Credit

Tax Penalties for Distributions Beyond Age 30. The money contributed to a Coverdell ESA canôt remain there indefinitely. Once the beneficiary reaches age 30, any leftover funds must be distributed within 30 days. After this point, the distribution earnings would become fully taxable and the 10% penalty would apply. Taxpayers can, however, avoid the penalty by rolling the balance over to another Coverdell ESA for a different beneficiary.

So just how high could the penalty climb*?* Let's say Julie accumulates $2,000 in deposits per year until her 18th birthday. She has $36,000 of pre-profit or interest earnings. She earned $18,000 from this investment and has $52,000 in the bank at age 18.

Julie wins a full-ride scholarship and ends up using the money in her ESA for textbooks only. She uses a total of $2,000 of her contributions and her investments earn another $30,000 by the time she turns 30. With $48,000 in earnings and $34,000 in contributions, sheôd be taxed on the earnings and 10% early distribution penalty as well which would amount to $4,800. While this seems like a lot of money, she still has $77,200, less any income tax owed on the earnings. She could transfer her ESA to a beneficiary, a younger sibling or spouse, to avoid taxes. However, she would no longer have the money.

Coverdell ESA Rollovers That Avoid Penalties. If taxpayers donôt think all the money in a Coverdell account will be used up and they want to avoid the penalty, they can roll those funds over to someone else within the family. Rollovers must be completed within 60 days after the funds are distributed; otherwise, the entire amount is subject to taxes and penalties.

The rollover must be to another person who qualifies as an eligible beneficiary under age 18 who is a family member. That includes:

- a child, stepchild, foster child, adopted child or any of their descendants
- a sibling or stepsibling
- a parent or stepparent
- a spouse or in-law
- a first cousin

Taxpayers can only make one rollover from a Coverdell ESA to another Coverdell account in any 12-month period. But, they can make unlimited transfers from ESA trustee directly to another ESA trustee, since these arenôt considered distributions or rollovers. If taxpayers are rolling over to a new account, remember to follow the same rules for comparing accounts as they did when initially opening the Coverdell ESA. If the beneficiary is over 18, he or she will need to sign off on the rollover paperwork consenting to the move.

INVESTING FOR EDUCATION USING A 529 PLAN.

A 529 plan provides tax advantages when saving and paying for higher education. There are two major types:

- Prepaid tuition plans, and
- Savings plans.

Prepaid tuition plans allow the plan holder to pay for the beneficiary's tuition and fees at designated institutions in advance. Savings plans are tax-advantaged investment vehicles, similar to IRAs.

529 Plan General Requirement. A 529 plan can be created for the taxpayer or any other beneficiary. The beneficiary could be a child, grandchild, spouse, or even non-relatives. There is no limit on the number of 529 plans an individual can set up, but contributions should not exceed the cost of education nor the limit as set by the state. So if a plan has more than one contributor, these contributors should inform each other of their contributions to ensure they don't exceed the limits.

Holder of the plan is the owner not the beneficiary, unless taxpayer is also the beneficiary. The assets of a plan belong to the plan holder, not the beneficiary (although these can be the same person). The beneficiary has no claim on the assets, which can be withdrawn by the holder for any reason at any time, with penalties. A plan can be transferred to a member of the beneficiary's family, or excess funds can be rolled over into a family member's plan. Neither action triggers a penalty or taxes. Although the beneficiary does not control the plan's assets, they may affect his or her financial aid eligibility to a significant degree. The plan's assets are generally not counted as part of the plan holder's estate, so 529 plans confer estate tax benefits.

<u>Parent owned</u> ï If the 529 plan account is owned by the parent, then it is considered a parental asset for financial aid purposes. (5.64% of the value of the account is annually considered to be counted towards the Expected family contribution (EFC) and is considered on the FAFSA (Free Application for Federal Student Aid). Although qualified tax free distributions are not counted as income for the EFC calculation.

<u>Student owned</u> ï In this scenario, the student is considered the account owner and beneficiary. As long as the student is a dependent of the parent, the account is also considered to be an asset of the parent and would have the same EFC impact on the FAFSA. Qualified, tax free distributions are not counted as income for the EFC calculation.

Grandparent owned ï Many have resulted to opening 529 plans that are owned and controlled by the grandparent. This is done as a 529 plan account that is owned by the grandparent, is not considered an asset of the student. The balance of the account does not require an EFC calculation, although qualified, tax free distributions are considered income. This would be the recommended option for a situation that involves a younger child who has many years until college. Here, the contributions grow tax deferred and the grandparent is able to reduce their taxable estate through gifts. If possible, funds from the grandparent owned 529 plan should be accessed and used the last two years of college. (Due to the ñprior prior ruleò).

Education covered under 529 Plan. New feature under the new TCJA. Tax reform included a provision that will allow owners of 529 Plan account to take tax-free distributions from the plan for K-12 expenses for the beneficiary named on the account. This is new for 529 accounts. Prior to this provision, 529 accounts could only be used for college expenses. Now 529 account holders can distribute up to $10,000 per student per year for K-12 qualified expenses. Another important note, this is not limited to expenses associated with private schools. K-12 qualified expense will be allowed for:

- Private School, Public School, Religious Schools, Homeschooling

529 Savings Plan, mutual funds can be selected. Under the savings plans, taxpayers will have the option to select the mutual funds in which the plan should be invested and the rate of return desired. There are other plans in which the investment is targeted to the date the beneficiary is expected to start their education. This last option reduces the risk as the date approaches by reducing the rate of return, but the return will not necessary outpace the inflation. Since the investor bears the risks of the investments, the amount that is eventually available for eligible education expenses will be affected by the rate of return on the investments.

529 Prepaid Tuition Plan, money managed by the state. Prepaid tuition plans are offered by states and higher education institutions. In a way, they're analogous to futures contracts, as they allow the plan holder to prepay for one or more semesters at designated colleges or universities at current prices. This shields them from inflation in tuition costs.

Under a prepaid tuition program, eligible expenses for a fixed period of time or a fixed number of credits are prepaid at an eligible educational institution. For example, an individual may make prepayments for two future semesters of college at today's cost. The prepayment guarantees the beneficiary two semesters, regardless of the cost in the future. This means that the program manager bears the risks of the investments. Contributions are limited to amounts necessary to pay the beneficiary's qualified education expenses.

There are two major problems with prepaid college tuition. Number one, several of these states have managed these funds so poorly that now they're not even going to be able to honor the prepaid portion.

The other downside is that the rate of return will not outpace the inflation rate as some mutual funds would do.

Tax Treatment of 529 Plans and Tax Penalty for non-qualified expenses. Earnings from a 529 plan are exempt from federal income taxes, providing withdrawals are used for qualified educational expenses. Distributions that are not used to pay for qualified educational expenses are subject to taxes and a 10% fee and any earnings on the distribution are subject to regular income tax.

No tax deduction for contributions. Contributions to a 529 plan do not reduce taxpayersô federal taxable income. However, more than 30 states provide tax deductions or credits for contributions in a 529 plan. 529 plans can offer certain other federal tax benefits.

For example, while a gift over $14,000 would typically trigger a gift tax, there is a special exception for 529 plans. A contribution of up to $70,000 per person can be treated as if it were made over a five-calendar-year period, thus avoiding the tax if no further gifts are made to that child from the individual. If the gift is made early in the child's life, the money has a long time to grow before it's needed for college.

Withdrawals Options for 529 Plans to avoid penalties and Form 1099-Q. As mentioned, withdrawals from a 529 plan are tax free if the money is used for qualified higher education expenses at an eligible institution. When it comes time to start distributing cash, there are three options available:

Sending a Check to the School. It may seem like having the funds sent directly to the school would be the easiest option, but it could be problematic if the withdrawal is supplementing a financial aid package. The school may opt to adjust the studentôs financial aid award based on the amount of the 529 plan distribution. If the aid package is trimmed down too much, taxpayers may have to pull additional funds out of the plan or cover the gap out of own pocket.

Sending a Check to Yourself. Having the check sent to yourself can sidestep that issue, but it puts you on the hook for making sure that your studentôs expenses get paid. You also must report the distribution on your tax return, requiring you to file Form 1099-Q. This might trigger taxes and penalties on the distribution, even when the funds have been used for qualified education expenses.

Sending a Check to Your Beneficiary. This option poses the least amount of hassle, allowing taxpayers to bypass the issues of potentially diminishing a financial-aid package or causing a hiccup with your tax filing. Assuming the student is responsible about using the funds to pay for education expenses, the distribution would be considered tax free and wouldn't cause any snafus at tax time as long as the beneficiary files his or her own return.

And if such a distribution ended up being a taxable event, the earnings would be taxed at the beneficiaryôs tax rate, not the plan holder's tax rate.

Example, Taxpayer has the plan to send the student a $20,000 check to cover expenses for the upcoming school year, after which he or she suddenly receives an unexpected $5,000 scholarship. The amount of the scholarship that isn't used for education expenses would be

taxable income; however, the Internal Revenue Service wouldn't tack on the additional 10% penalty that usually applies when an excess distribution is made from a 529 plan.

Example, suppose that the qualified education expenses are $10,000,the student receives a $2,000 Pell grant and boxes 1 and 2 of form 1099-Q report a gross distribution of $8,000 and earnings of $1,000. The adjusted expenses are $8,000—which means taxpayer doesn't have to report any education program distributions on your tax return.

Keeping records of expenses to reconcile with Form 1099-Q for ESAs and 529 plans. If the Distribution doesnôt exceed the amount of the student's qualifying expenses, then the distribution is not taxable and the recipient will not report any of the distribution shown on Form 1099-Q. The IRS does not request any additional information to substantiate whether or not the distribution exceeded the actual qualified expenses. Nevertheless it would be wise to keep a good record of these expenses just in case the tax return gets picked up for examination.

No additional education credit is allowed. If the distribution exceeds the school expenses, then the recipient must report the earnings on the excess as "other income" on his/her tax return. Additionally when a studentôs school expenses are paid with these funds, the recipient cannot claim a tuition deduction or either of the educational tax credits for the same expense.

Sometimes Form 1099-Q is sent to holder of the plan. One other issue that can come up with Coverdell and 529 Plans is when the account owner instead of the beneficiary receives the 1099-Q. If the box on the 1099-Q that states "*Check if the recipient is not designated beneficiary*" is checked sometimes the IRS' computers calculate a deficiency and automatically assess penalties and interest. This is easily solved with proper communication of the situation with the IRS but nevertheless it does take time. The best way to avoid this situation is to have the distribution paid directly to the school or to the beneficiary. This will create a 1099-Q in the name of the beneficiary instead of the account owner and keep the IRS away.

Coverdell ESA and 529 Plan Comparison Chart		
Item	ESA	529 plan
Tax-free withdrawals	Qualified expenses for kindergarten through college	Qualified expenses for college; up to $10,000 for primary or secondary school tuition*
Investment options	Many	Limited
Income eligibility limit for contributors	Annual contributions are capped at $2,000 for joint filers with a modified adjusted gross income (MAGI) up to $190,000, and are gradually reduced for MAGI between $190,000 and $220,000. Incomes above $220,000 are ineligible.À	Noneÿ

Coverdell Advantages Vs. 529's. If taxpayers are choosing between the two, Coverdellôs have two major advantages over 529 plans:

1. *Self-directed when taxpayers do not want to manage the funds*: Coverdellôs are self-directed, whereas 529 plans are limited to the stateôs selected investment options (much like an employer has limited investment options in a 401K). Coverdellôs are like IRAôs ï you invest in whatever you want to. For amateur investors this might be intimidating, but if you are a cost-conscious investor (i.e. **commission-free ETF's** or low-cost index funds), Coverdellôs might make more sense.

2. *Primary school expenses*: Coverdellôs can be used to cover expenses at primary and secondary schools (basically anything before college), as well as post-secondary, whereas 529ôs can only be used towards post-secondary. This is a big benefit for those with children that generate significant expenses in their pre-college years. Expenses could include tuition, uniform, tutoring, books, supplies, and even technology (i.e. computers).

529 Advantages over Coverdell's. 529ôs have a few key advantages over Coverdellôs:

1. *Contribution limit:* The $2,000 annual maximum is much lower than 529ôs, which often donôt set limits (varies by state). The money you put in a 529 account is considered a gift and, as such, qualifies for the annual $15,000 (2018) gift tax exclusion. That is, taxpayers can contribute up to $15,000 annually, per beneficiary, without incurring any gift tax. Taxpayers can contribute more, but they would incur into the gift tax. For more on this topic, check out **IRS publication 559**.

2. *Income limit:* In order to contribute, Coverdellôs have an income limit for the contributor, while 529ôs donôt.

3. *Tax credits and deductions:* Some states offer an income tax or credit deduction for contributions to its 529 plan.

4. *Age limit:* Coverdell balances must be spent by age 30 or taxes and penalties could apply. They can, however, be transferred to another beneficiary or rolled in to a 529 plan. 529ôs have no age limits.

Review Questions Section 1

Read and answer the following review questions. The correct answers are found on the next page with an explanation to strengthen up your knowledge. Note: This is not part of your Final Test.

26.) What is one great benefit from Health Savings Accounts (HSA), depending on the plan chosen?

a) When the taxpayer retires the HSA amount will double.
b) Everyone in the family can use this account to pay for medical bills, even before the owner of the HSA retires.
c) Since the money in an HSA is deposited before it is taxed, itôs like paying for out of pocket medical costs tax-free.
d) None of the above are correct.

27.) In general, when a non-spouse inherits an HSA from a deceased partner the account is no longer an HSA and will be considered taxable, unless?
   a) It will not be taxable to the beneficiary if the balance is used to pay outstanding medical expenses of the account owner within one year of the ownerôs death.
   b) The beneficiary closes the HSA account before the tax year ends.
   c) The beneficiary decides to keep the HSA and they must transfer the decedentôs HSA to their own HSA account as soon as possible or else subject to 20% penalty tax.
   d) If the beneficiary is a non-spouse the account is no longer an HSA and there is no tax break. It must be reported as taxable income in the year of the account ownerôs death.

28.) Which of the following statements is correct regarding QSEHRAôs?
   a) QSEHRA stands for Qualified Small Employee Health Reimbursement Arrangement.
   b) A family set up with a QSEHRA may lose out on a significant amount of premium subsidies.
   c) Reimbursements to employees who donôt have minimum essential coverage are not subject to income tax.
   d) An employer can offer a group health plan to any of his employees.

29.) Since the money in a Coverdell ESA canôt remain in the beneficiaryôs account beyond age 30, what must they do in order to avoid the 10% penalty?
   a) That is incorrect; the money can remain in the Coverdell ESA indefinitely.
   b) Transfer the funds in the ESA to their personal bank account.
   c) The balance can be rolled over to another Coverdell ESA beneficiary.
   d) If the beneficiary did not use up all the money in the ESA before graduating the penalty canôt be avoided.

30.) Which of the following statements is correct regarding form 1099-Q?
   a) The only time the recipient will not report distributions on Form 1099-Q is if the distribution doesnôt exceed the amount of the studentôs qualifying expense, since the distribution is not taxable.
   b) In some cases the account owner will receive form 1099-Q instead of the beneficiary.
   c) This form is used to report distributions on the tax return when you distribute money to yourself from a 529 plan to cover for qualifying education expenses.
   d) All of the above are correct.

31.) What is one advantage Coverdell has over 529 plans?

a) Coverdellôs donôt have an income limit for contributions, while 529ôs do.
b) 529ôs balances must be spent by age 30 or else taxpayer is subject to taxes and penalties. Under Coverdell there is no age limit.
c) Coverdellôs can be used to cover expenses at primary and secondary schools as well as post-secondary, whereas 529 plans can only be used towards primary and secondary schools.
d) Coverdellôs are similar to IRAôs in the sense that you can invest in whatever you want. 529 plans are limited to the stateôs selected investment options.

Questions Section – Answers and Discussion 1

26. **Answer c.** These types of health savings accounts pay for medical expenses that their health insurance coverage typically does not pay for. Depending on the plan they choose, the money in an HSA is deposited either by the taxpayer or an employer before it is taxed so it's like paying for out of pocket medical costs tax-free. In addition, with some plans, taxpayers can earn interest on the money while it is sitting there waiting to be used.

27. **Answer a.** If a non-spouse is the death beneficiary of an HSA the account is no longer an HSA as of the account ownerôs date of death, essentially resulting in an immediate taxable distribution from a tax standpoint. The beneficiary must include the HSAôs date-of-death fair market value (FMV) as taxable income in the year of the account ownerôs death. Any portion of an inherited HSA balance used to pay outstanding medical expenses of the account owner within one year of the account ownerôs death will not be taxable to the beneficiary.

28. **Answer b.** Employers and employees need to understand that if the QSEHRA is set up so that family members can also have their benefits reimbursed, nobody in the family will be eligible for premium subsidies, even if they only end up getting a small portion of their premiums reimbursed via the QSEHRA. In some cases, this could result in a family losing out on a significant amount of premium subsidies in the exchange, making the QSEHRA a net negative for them.

29. **Answer c.** The money contributed to a Coverdell ESA canôt remain there indefinitely. Once the beneficiary reaches age 30, any leftover funds must be distributed within 30 days. After this point, the distribution earnings would become fully taxable and the 10% penalty would apply. Taxpayers can, however, avoid the penalty by rolling the balance over to another Coverdell ESA for a different beneficiary.

30. **Answer d.** If the Distribution doesnôt exceed the amount of the student's qualifying expenses, then the distribution is not taxable and the recipient will not report any of the distribution shown on Form 1099-Q.

An issue that can come up with Coverdell and 529 Plans is when the account owner instead of the beneficiary receives the 1099-Q. This is easily solved with proper communication of the situation with the IRS but nevertheless it does take time. The best way to avoid this situation is to have the distribution paid directly to the school or to the beneficiary. This will create a 1099-Q in the name of the beneficiary instead of the account owner and keep the IRS away.
Having the check sent to yourself can sidestep tax penalties, if the money is used for qualified higher education expenses at an eligible institution, but it puts you on the hook for making sure that your studentôs expenses get paid. You also must report the distribution on your tax return, requiring you to file Form 1099-Q. This might trigger taxes and penalties on the distribution, even when the funds have been used for qualified education expenses.

31. **Answer d.** Coverdellôs are self-directed, whereas 529 plans are limited to the stateôs selected investment options (much like an employer has limited investment options in a 401K). Coverdellôs are like IRAôs, you invest in whatever you want to. If you are a cost-conscious investor Coverdellôs might make more sense.

RENTAL INCOME AND CHANGES UNDER THE TCJA.

If the taxpayer (TP) rents property to others, generally they must include in gross income all amounts received as rent. Rental income is any payment received for the use of, or occupation of property. As well as including rental income, taxpayers can deduct expenses of renting property. In this section, we will study the Schedule E of Form 1040.

A not-for-profit activity will not be reported on Schedule E. There are also other rental situations in which forms other than Schedule E would be used.

Normally rental income and expenses are reported in Schedule E, Part I; when taxpayers rents buildings, rooms, or apartments, and provides only heat, electricity, trash collection, etc.,.

If taxpayers have more than three rental or royalty properties, complete and attach as many Schedules E as are needed to list the properties. Complete lines 1 and 2 for each property. However, fill in the ñTotalsò column on only one Schedule E. The figures in the ñTotalsò column on that Schedule E should be the combined totals of all Schedules E.

Possible Deduction for Pass-Through Entities under the Tax Cuts Jobs Act (TCJA). For 2018 and beyond, the TCJA establishes a new deduction based on a non-corporate ownerôs qualified business income (QBI) from a pass-through business entity ð meaning a sole proprietorship, a limited liability company (LLC) treated as a sole proprietorship for tax purposes, a partnership, an LLC treated as a partnership for tax purposes, or an S corporation. The deduction generally equals 20% of QBI, subject to restrictions that can apply at higher income levels.

The new QBI deduction is available to offset net income from a profitable rental real estate activity that taxpayers own through a pass-through entity. This includes the vast majority of residential landlords who own their rental property as sole proprietors (who individually own their properties), limited liability companies (LLCs), and partnerships. With these entities, any profit earned from the rental activity is ñpassed throughò to the owner or ownersô individual tax returns and they pay tax on it at their individual income tax rates.

20% deduction under the TCJA for Rental Income.
Starting in 2018, taxpayers with qualified business income (including rental income), may be eligible to take a tax deduction up to 20% of their QBI. Determining whether or not taxpayers will be eligible to capture the full 20% deduction on their rental income will be based on their total taxable income for year. The taxable income thresholds are as follows:

Single filers: $157,500
Married filing joint: $315,000

ñTotal taxable incomeò is not the AGI (adjusted gross income) and itôs not just income from their real estate business or self-employment activities. Itôs their total taxable income less some deductions. The IRS has yet to provide with full guidance on the definition of ñtotal taxable incomeò.

Below The Income Threshold

If the total taxable income is below the income thresholds listed above, the calculation is very easy. Take the total QBI and multiply it by 20% and thatôs the tax deduction.

Above The Income Threshold

If your total taxable income is above the thresholds, the calculation gets more complex. If you exceed the income thresholds, your deduction is the LESSER of:

1. 20% of QBI

2. The GREATER OF:

- 50% of W-2 wages paid to employees
- 25% of W-2 wages paid to employees PLUS 2.5% of the unadjusted asset basis

The best way to explain the calculation is by using an example. Assume the following:

- John bought a commercial building 3 years ago for $1,000,000
- John have already captured $100,000 in depreciation on the building
- After expenses, John nets $150,000 in income each year
- The LLC that owns the property has no employees
- John is married
- John owns a separate small business that makes $400,000 in income

Since John is over the $315,000 total taxable income threshold for a married couple filing joint, John will calculate his deduction as follows:

The LESSER of:

1. 20% of QBI = $30,000 ($150,000 x 20%)

2. The GREATER of:

- 50% of W-2 wage paid to employees = $0 (no employees)
- 25% of W-2 wages page to employees plus 2.5% of unadjusted basis

(25% of wages = $0) + (2.5% of unadjusted basis = $25,000) = $25K

In this example, Johnôs deduction would be limited to $25,000. Here are a few special notes about the calculation listed above. In the 11th hour, Congress added the ñ2.5% of unadjusted basisò to the calculation. Without it, it would have left most landlords with a $0 deduction. Why? Real estate owners typically do not have W-2 employees, so 50% of W-2 wages would equal $0. Some larger real estate investors have ñproperty management companiesò but they are usually setup as a separate entity. In which case, the W-2 income of the property management company would not be included in the calculation for the QBI deduction.

The 2.5% is based on unadjusted basis and itôs not reduced by depreciation. However, the tangible property has to be subject to depreciation on the last day of the year to be eligible for the deduction. Meaning, even though the 2.5% is not reduced for the amount of depreciation already taken on the property, the property must still be in the ñdepreciation periodò on the last day of the year to be eligible for the QBI deduction.

- The depreciable period starts on the date the property is places in service and ends on the LATER of:

    - 10 years, or
    - The last day of the last full year in the assetôs ñregularò (not ADS) depreciation period

Meaning, if taxpayers purchase a non-residential rental building that is depreciated over 39 years, the owner can continue to capture the depreciation on the building but that will not impact the 2.5% unadjusted basis number for the full 39 years of the depreciation period.

- Any asset that was fully depreciated prior to 2018, unless it was placed in service after 2008, will not count toward the basis.

- Shareholders or partners may only take into consideration for purposes of applying the limitation 2.5% his or her allocable share of the basis of the property. So if the total basis of commercial property is $1,000,000 and taxpayers are a 20% owner, their basis limitation is $1,000,000 x 20% x 2.5% = $5,000

Schedule C or Form 1065 for rental income? Generally, Schedule C is used when TP materially participates in residential rental activity.

If TP is a real estate dealer, who receives income from renting real property, or an owner of a hotel, motel, etc., who provides substantial services (maid services, etc.) for guests, report the rental income and expenses on Schedule C or C-EZ.

Schedule E for other than Real Estate Dealer. If TP is not a real estate dealer or the kind of owner described above, then report the rental income and expenses on Schedule E.

Substantial services do not include the furnishing of heat and electricity, cleaning of public areas, trash collection, or other similar services.

Use Form 1065, U.S. Return of Partnership Income, if TPôs rental activity is a partnership (including a partnership with your spouse unless it is a qualified joint venture).

Report Rental Income on Schedule E

SCHEDULE E (Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Supplemental Income and Loss
(From rental real estate, royalties, partnerships, S corporations, estates, trusts, REMICs, etc.)
► Attach to Form 1040, 1040NR, or Form 1041.
► Go to *www.irs.gov/ScheduleE* for instructions and the latest information.

OMB No. 1545-0074
2017
Attachment Sequence No. 13

Name(s) shown on return | Your social security number

Part I **Income or Loss From Rental Real Estate and Royalties** **Note:** If you are in the business of renting personal property, use **Schedule C** or **C-EZ** (see instructions). If you are an individual, report farm rental income or loss from **Form 4835** on page 2, line 40.

A Did you make any payments in 2017 that would require you to file Form(s) 1099? (see instructions) . . . . . ☐ Yes ☐ No
B If "Yes," did you or will you file required Forms 1099? . . . . . ☐ Yes ☐ No

1a	Physical address of each property (street, city, state, ZIP code)
A	
B	
C	

1b	Type of Property (from list below)	2 For each rental real estate property listed above, report the number of fair rental and personal use days. Check the **QJV** box only if you meet the requirements to file as a qualified joint venture. See instructions.		Fair Rental Days	Personal Use Days	QJV
A			A			☐
B			B			☐
C			C			☐

Type of Property:
1 Single Family Residence 3 Vacation/Short-Term Rental 5 Land 7 Self-Rental
2 Multi-Family Residence 4 Commercial 6 Royalties 8 Other (describe)

Income:	Properties:		A		B		C	
3 Rents received		3						
4 Royalties received		4						
Expenses:								
5 Advertising		5						

Page 1 of Schedule E. Attach this Schedule to Form 1040 when reporting rental income

When to report Rental Income? Generally, report rental income on TPôs tax return in the year received. When to report the income will also depend on whether the accounting method used is a cash basis, or the accrual method.

<u>Cash method.</u> TP is using a cash basis accounting method if he reports income on his return in the year he actually or constructively receives it, regardless of when it was earned. TP constructively receives income when it is made available; for example, by being credited into TPôs bank account.

Accrual method. If taxpayer is using accrual basis accounting method, generally report income when it is earned, rather than when it is received. Furthermore, deduct expenses when TP incurs them, rather than when TP pays them.

Types of Rental Income The following are some forms in which payments from rental property are received:

- Advance rent. Advance rent is any amount of payment TP received before the period that it covers. This advance rent is included in rental income in the year received, regardless of the period covered.

- Security deposits. The Security deposits are considered income if part or all of it is kept, because the tenant did not live up to the terms of the lease. Include the amount of security deposit kept in TPôs income for that year. Do not include a security deposit in TPôs income when you receive it, if TP is planning to return it to the tenants at the end of the lease. If an amount called a security deposit is to be used as a final payment of rent, it is considered an advance rent, include it in TPôs income on the tax year received.

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

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

- Part interest. If TP owns a partial interest in rental property, report TPôs percentage of the rental income from the property, taxpayer should also include the percentage of expenses.

- Rental of property also used as a home. If TP rents property that is also used as a personal home and rents it fewer than 15 days during the tax year, do not include the rent received in TPôs income, and do not deduct rental expenses. However, they can deduct on Schedule A (Form 1040), Itemized Deductions, interest, taxes, casualty and theft losses that are allowed for nonrental property.

No self-employed taxes provision kept for rental income under the TCJA. As already known, people who own their own businesses are required to pay Social Security and Medicare taxes on their net business income, as well as income taxes. These taxes are commonly referred to as self-employment taxes. One of the nice things about owning rental property is that rental income is ordinarily not subject to self-employment tax, only income tax. However, there is one exception for landlords who provide substantial personal services to their tenants and are effectively running a bed and breakfast business or hotel, not a normal rental operation.

The House version of the TCJA contained a provision that removed the rental income exemption from self-employment taxation. However, as many tax experts expected, this was dropped from the final version of the bill. Thus, landlords who do not provide substantial personal services to their tenants remain exempt from having to pay Social Security and Medicare tax on their rental income.

No Deductions for Not-For-Profit Rental Activities. The vast majority of rental activities qualify as businesses or investment activities. However, rentals that are not profit-motivated must be classified as not-for-profit activities, also called hobbies. Under prior law, expenses from a hobby could be deducted as a personal itemized deduction on IRS Schedule A to the extent the exceeded 2% of the taxpayers adjusted gross income. However, such deductible hobby expenses could not exceed hobby income. The TCJA completely removes the personal deduction for hobby expenses. This means that while the income from a rental activity classified as a hobby must be reported and tax paid, no expenses may be deducted.

RENTAL EXPENSES.

Generally, the expenses of renting property, such as maintenance, insurance, taxes, and interest, can be deducted from rental income.

When tenants pay any of TPôs expenses, the payments are rental income. Taxpayers must include this kind of payments as income. They can deduct the expenses if they are deductible rental expenses listed in the following table.

If the rental property is used sometimes for personal purposes, the expenses must be divided between rental and personal use. If TP owns part of the rental property, they can deduct expenses paid according to the percentage of ownership.

Generally rental expenses will be deducted in the year incurred. However, this applies only if cash method is used. Under the accrual method, the expenses are deducted when incurred rather than when they are paid.

Following is a list of the most common rental expenses:

◆ Advertising. ◆ Cleaning and maintenance. ◆ Commissions. ◆ Depreciation. ◆ Insurance. ◆ Interest (other). ◆ Legal fees. ◆ Management fees.	◆ Mortgage interest. ◆ Rental payments. ◆ Repairs. ◆ Tax return preparation fees. ◆ Taxes. ◆ Travel expenses. ◆ Utilities.

Advertising. "Reasonable" expenses for advertising would be printing of business cards, Yellow Pages ads, newspaper advertisements, TV and Radio ads costs (including production costs), and costs for setting up business website. Costs for temporary signs are considered advertising. Costs for permanent signs (that last more than a year) are not advertising, but signs may be depreciated

as long-term assets. Costs for help-wanted ads are a deductible business expense, but they are not considered 'advertising.'

Auto and travel. Taxpayers can deduct ordinary and necessary transportation expenses if they are incurred to collect rental income, or to manage, conserve, and maintain rental property.

If a personal car is used, like a pickup truck or light van for rental activities, TP can deduct the expenses using one of two methods: actual expenses or the standard mileage rate.

Travel expenses also can be deducted from rental income. These travel deductions have to be ordinary and necessary expenses of traveling away from home for the primary purpose of collecting rental income or to manage, conserve, and maintain rental property. You must properly allocate the TPôs expenses between rental and nonrental activities. You cannot deduct the cost of traveling away from TPôs home if the primary purpose of the trip is to improve the property. The cost of improvements is recovered by taking depreciation.

Cleaning & Maintenance. Cleaning and maintenance expenses that keep your property in good working condition can be deducted. Common expenses are lawn maintenance, carpet cleaning, and other janitorial services. Cleaning and maintenance expenses may also include the cost of cleaning out a property for a new tenant, or cleaning a property after an old tenant.

Commissions. Rental agencies and property managers usually charge commissions for collecting rent, making repairs, finding and managing tenants. Taxpayers are allowed to deduct the cost of commissions paid as a rental expense, since ordinary and necessary expenses related to the management of TPôs investments are deductible.

Depreciation. Depreciation is the mechanism for recovering the cost in an income producing property and must be taken over the expected life of the property. The depreciation of the rental property can be taken once the property is ready and available for rent.

Even if the property is not rented, because of a temporary repair or improvement, taxpayaers can continue to claim a deduction for depreciation.

Taxpayers must stop depreciating property when the total of yearly depreciation deductions equals cost or other basis of TPs property. For this purpose, the yearly depreciation deductions include any depreciation that TP is allowed to claim, even if it was not claimed.

Property Depreciation must be stopped when TP retires it from service, even if TP has not fully recovered its cost or other basis. TP retires property from service when it is permanently withdrawn from use in a trade or business, or from use in the production of income, because of any of the following events.

- Selling or exchange the property.
- Converting the property to personal use.
- Abandoning the property.
- The property is destroyed.

The depreciation method generally used is the Modified Accelerated Cost Recovery System (MACRS). MACRS method depreciates residential rental property placed in service after 1986.

If rental property was placed in service before 1987, the methods that should be used are:

ACRS (Accelerated Cost Recovery System) for property placed in service after 1980, but before 1987. Straight line or declining balance method over the useful life of property placed in service before 1981.

Taxpayers must complete and attach Form 4562 for rental activities only if they are claiming:

- Depreciation, including the special depreciation allowance, on property placed in service during 2018;
- Depreciation on listed property (such as a car), regardless of when it was placed in service; or
- Any other car expenses, including the standard mileage rate, or lease expenses.

Otherwise, figure the depreciation on taxpayersô own worksheet. They do not have to attach these computations to their return, but they should keep them in their records for future reference.

Changes to Section 179 Deduction under TCJA. Section 179 deduction was changed under the Tax Cuts and Jobs Act (TCJA). The provision enables rental business owners to deduct in one year the cost of personal property used in a rental business, such as furniture and appliances. During 2017, the maximum amount that can be deducted under Section 179 is $500,000. Starting in 2018, the Section 179 maximum is increased to $1 million. The $1,000,000 amount is reduced (but not below zero) by the amount by which the cost of property placed in service during the year exceeds $2,500,000.

One significant limitation on Section 179 is that is has never been available for rental property owners to use to deduct the cost of personal property used in residential rental units. In a major victory for landlords, the TCJA eliminates this restriction starting in 2018.

100% Bonus Depreciation through 2022 under TCJA. Currently, business owners may deduct in a single year up to 50% of the cost of personal property they purchase for their business. The TCJA increases this amount to 100% for property acquired and placed into service from September 27, 2017 through December 31, 2022. Moreover, 100% bonus depreciation would apply for the first time to both new and used property, instead of new property only. The bonus depreciation amount will be phased down in 2023 and later years as follows:

- 80% for property placed in service during 2023
- 60% for property placed in service after during 2024
- 40% for property placed in service during 2025
- 20% for property placed in service during 2026
- 0% for 2027 and later.

Bonus Depreciation or Repair Provision. Bonus depreciation may not be used for real property, except for real property improvements such as landscaping or grading, and other components that have a depreciation period of 20 years or less. Thus, landlords may not use it to deduct the cost of their rental buildings or major building components. However, landlords can use bonus depreciation to fully deduct in one year the cost of personal property they use in their rental activity, such as appliances, laundry equipment, gardening equipment, and furniture. But landlords can often do this already under existing provisions in the tax lawð for example, the de minimis safe harbor under the repair provision enables landlords to fully deduct in one year any personal property that costs $2,500 or less. Section 179 can also now be used.

Listed property must be used over 50% of the time for business to qualify for bonus depreciation. Listed property includes cars, and entertainment property like televisions and cameras. Computers were classified as listed property as well, but the TCJA removes them from this classification starting in 2018. Thus, bonus depreciation may be used to deduct computers used less than 50% of the time for a rental business.

Repair and depreciation under Section 1.263(a)-1, -2, and -3 completely revamped in 2014 the way a taxpayer must evaluate certain expenditures in order to determine whether the costs represent immediately deductible repair expenses or capital improvements that must be depreciated over time.

Section 162 of the Internal Revenue Code (IRC) allows taxpayers to deduct all the ordinary and necessary expenses incurred during the taxable year in carrying on their trade or business, including the costs of certain materials, supplies, repairs, and maintenance. However, section 263(a) of the IRC requires them to capitalize the costs of acquiring, producing, and improving tangible property, regardless of the size or the cost incurred.

The tangible property regulations are intended to provide guidance to taxpayers on whether certain expenditures should be capitalized or deductible as a business expense and to provide them with more objective measurements.

The final tangibles regulations under Section 1.263(a) apply to anyone who pays or incurs amounts to acquire, produce, or improve tangible real or personal property. These regulations apply to corporations, S corporations, partnerships, LLCs, and individuals filing a Form 1040 with Schedule C, E, or F.

Under the new regulation, taxpayers are required to formally adopt a new method of accounting using Form 3115.

Safe-harbors. Effective for taxable years beginning on or after January 1, 2016, the Internal Revenue Service increased the de minimis safe harbor threshold from $500 to $2500 per invoice or item for taxpayers without applicable financial statements. In addition, the IRS will provide audit protection to eligible businesses by not challenging the use of the $2,500 threshold for tax years ending before January 1, 2016 if the taxpayer otherwise satisfies the requirements of Treasury Regulation § 1.263(a)-1(f)(1)(ii).

Insurance premiums paid in advance. If TP paid an insurance premium for more than one year in advance, for each year of coverage you can deduct the part of the premium payment that will apply to that year. You cannot deduct the total premium in the year TP paid it.

No changes to Mortgage Interest Deductions under the TCJA. Consistent with prior law, you can still deduct mortgage interest and state and local real estate taxes on rental properties. While the TCJA imposes new limitations on deducting personal residence mortgage interest and state and local taxes (including property taxes on personal residences), those limitations do *not* apply to rental properties, unless you also use the property for personal purposes. In that case, the new limitations could apply to mortgage interest and real estate taxes that are allocable to your personal use.

In addition, you can still write off all the other standard operating expenses for rental properties. Examples include depreciation, utilities, insurance, repairs and maintenance, yard care and association fees.

You can deduct mortgage interest paid on rental property. Certain expenses that were paid to obtain a mortgage on rental property cannot be deducted as interest. These expenses, which include mortgage commissions, abstract fees, and recording fees, are capital expenses. You can only amortize them over the life of the mortgage.

Interests reported on Form 1098, Mortgage Interest Statement, are deductible. If TP and at least one other person (other than TPôs spouse if you file a joint return) were liable for, and paid interest on the mortgage as well as receiving the Form 1098, report TPôs share of the interest on Schedule E (Form 1040), line 13. Attach a statement to the return showing the name and address of the other person. In the left margin of Schedule E, next to line 13, enter ñSee attached.ò

Repairs. Deducting the cost of repairs of rental property is permitted, but you cannot deduct the cost of improvements. The cost of improvements is recovered by taking depreciation; however, there is a difference in repairing the rental property and improving it. A repair keeps the property in good operating condition. Repairs do not materially add value to the property or substantially prolong its life: Repainting your property inside or out, fixing gutters or floors, fixing leaks, plastering, and replacing broken windows are examples of repairs.

If TP makes repairs as part of an extensive remodeling or restoration of property, the whole job is considered an improvement. An improvement adds value to the property, prolongs its useful life, or adapts it to new uses. If TP makes an improvement to property, the cost of the improvement must be capitalized. The capitalized cost can generally be depreciated as if the improvement were a separate property.

IMPROVEMENTS TO RENTAL HOUSE		
Additions Bedroom Bathroom Deck Garage Porch Patio	**Miscellaneous** Storm windows, doors New roof Central vacuum Wiring upgrades Satellite dish Security system	**Plumbing** Septic system Water heater Soft water system Filtration system
Lawn & Grounds Landscaping Driveway Walkway Fence Retaining wall Sprinkler system Swimming pool	**Heating & Air Conditioning** Heating system Central air conditioning Furnace Duct work Central humidifier Filtration system	**Interior Improvements** Built-in appliances Kitchen modernization Flooring Wall-to-wall carpeting **Insulation** Attic Walls, floor Pipes, duct work

Taxes. Generally, you cannot deduct charges for local benefits taxes that increase the value of the property, such as charges for putting in streets, sidewalks, or water and sewer systems. These charges are nondepreciable capital expenditures, and must be added to the basis of property. However, you can deduct local benefit taxes that are for maintaining, repairing, or paying interest charges for the benefits.

Utilities. You can deduct the cost of electricity heat, sewer, and water that were paid for the rental house. If tenant pays for those services that payment is considered income and you have to include it as rental income.

Other expenses. Pre-rental expenses. You can deduct your ordinary and necessary expenses for managing, conserving, or maintaining rental property from the time it becomes available for rent.

Rental of equipment: You can deduct rent paid for equipment that was used for rental property repairs; for example, renting of machinery to repair a broken pipe. However, in some cases lease contracts are actually purchase contracts; if so, you cannot deduct these payments. You can recover the cost of purchased equipment through depreciation.

Tax return preparation fees: You can deduct, as a rental expense, the part of tax return preparation fees paid to prepare Schedule E, Part I. For example, on the 2018 Schedule E you can deduct fees paid in 2019 to prepare Part I of the 2018 Schedule E. You can also deduct, as a rental expense, any expense (other than federal taxes and penalties) that were paid to resolve a tax underpayment related to TPôs rental activities.

Uncollected rent: If the TP is in a cash basis method, do not deduct uncollected rent. Because TP has not included it in rental income, it is not deductible.

If TP uses an accrual method, then report income when earned. In case you are unable to collect the rent, you may be able to deduct it as a business bad debt.

Vacant rental property: If TP holds property for rental purposes, you may be able to deduct ordinary and necessary expenses (including depreciation) for managing, conserving, or maintaining the property while the property is vacant. However, you cannot deduct any loss of rental income for the period the property is vacant.

Vacant while listed for sale. If TP sells property held for rental purposes, you can deduct the ordinary and necessary expenses for managing, conserving, or maintaining the property until it is sold.

RENTING PART OF PROPERTY

If the taxpayer rents only part of their property and uses part for personal use, they must divide up certain expenses incurred. Expenses directly related to the rental portion of the property are deductible in full. For example, the expense for painting or wallpapering a room used strictly for rental purposes is deductible in full. However those expenses paid for the entire property may need to be divided up between rental and personal use. The taxpayer can use any reasonable method for dividing the expenses. It may be easiest to divide certain expenses based on the number of people involved (such as certain utility items). The two most common methods for dividing expenses are one based on the number of rooms in the property and one based on the square footage of the property.

RENTAL OF VACATION HOMES OR OTHER PERSONAL USE DWELLINGS

If a vacation home or other dwelling unit is used by the taxpayer for personal use part of the time and also rented at fair rental value for 15 days or more during the year, the expenses must be prorated. A dwelling unit includes a house, apartment, mobile home, boat, apartment or other similar property.

The taxpayer uses a dwelling unit as a home during the tax year if they use it for personal purposes more than the greater of:

- 14 days; or
- 10% of the total days it is rented to others at a fair rental price.

Personal use by the taxpayer includes any day that the unit is used by any of the following:

- The taxpayer or any other person who has an interest in the property, unless it is rented to the other owner as his main home under a shared equity financing agreement.
- A member of the taxpayerôs family (or family member of another owner) unless that person uses the dwelling as their main home and pays a fair rental price. For the purposes of this discussion, family includes brothers, sisters, half-brothers, half-sisters, spouses, ancestors (parents, grandparents) and lineal descendants (children, grandchildren)
- Anyone under an arrangement that lets the taxpayer use another dwelling unit; or
- Anyone that pays the taxpayer less than a fair rental price for the dwelling unit

If the taxpayer uses a dwelling unit as a home and rents it fewer than 15 days during the year, they are not required to include that rental income on their tax return. However they cannot deduct any expenses as rental expenses.

If the dwelling is used as a residence and also rented for 15 days or more, then some expenses are deductible in full; some expenses are deductible only to the extent of the income reported. Any expenses that cannot be deducted in the current year because of the rental income limit can be carried over to the following year.

Expenses are deductible in the following order:

1. The rental portion of interest, taxes and casualty losses. The rental portion is deductible on Schedule E. The personal portion will be deductible on Schedule A if the taxpayer itemizes deductions.
2. Rental expenses not directly related to the dwelling unit, such as advertising, related travel, commissions, fees, office supplies, etc. These items are fully deductible.
3. Expenses directly related to the dwelling unit such as repairs, maintenance, trash pickup, lawn care, etc.
4. Depreciation

If items (1) and (2) exceed the gross rent, a loss may be claimed on the vacation home. If operating expenses (3) exceed gross rent minus items (1) and (2), they must be carried forward to the next year.

RENTAL LOSS

Rules Before the TCJA. Under pre-TCJA law, taxpayerôs business losses could usually be fully deducted in the tax year when they arose *unless*:

- The passive activity loss (PAL) rules or some other provision of tax law limited that favorable outcome, or
- The business loss was so large that it exceeded taxable income from other sources, creating a net operating loss (NOL).

New Loss Disallowance Rule Under the TCJA. If the rental property generates a tax loss ð and most properties do, at least during the early years ð things get complicated. The passive activity loss (PAL) rules will usually apply.

In general, the PAL rules only allow taxpayers to deduct passive losses to the extent they have passive income from other sources, such as positive income from other rental properties or gains from selling them. Passive losses in excess of passive income are suspended until taxpayers:

1) Have sufficient passive income or gains, or
2) Sell the property or properties that produced the losses.

To complicate matters further, the TCJA establishes another hurdle for taxpayers to pass beyond the PAL rules: For tax years beginning in 2018 through 2025, taxpayers canôt deduct an excess business loss in the current year. An excess business loss is the excess of their aggregate business deductions for the tax year over the sum of:

1. The aggregate business income and gains for the tax year, plus
2. $250,000 or $500,000 if they are a married joint-filer.

Finally, under the TCJA carryforwards can be carried indefinitely; they are no longer limited to 20 years. These losses can be deducted under the rules for net operating loss (NOL) carryforwards.

Important: This new loss deduction rule applies *after* applying the PAL rules. So, if the PAL rules disallow the rental real estate loss, taxpayers donôt get to the new loss limitation rule.

The idea behind this new loss limitation rule is to further restrict the ability of individual taxpayers to use current-year business losses (including losses from rental real estate) to offset income from other sources (such as salary, self-employment income, interest, dividends and capital gains). The practical result is that the taxpayerôs allowable current-year business losses (after considering the PAL rules) canôt offset more than $250,000 of income from such other sources or more than $500,000 for a married joint-filing couple.

Passive Activity Loss (PAL) Rules: IRS Limits on Deducting Passive Losses. There are special rule limitations, which may need to be applied if taxpayers have a net loss on Schedule E. Those rules are:

1) The limitation based on the amount of investment they have at risk in their rental activity, and
2) The special limits imposed on passive activities.

Taxpayers may also have a loss (or gain) related to their rental property from a casualty or theft. This is considered separately from the income and expense information on Schedule E.

Generally a loss from rental real estate activities is not deductible unless the taxpayer has income from other passive activities. However, if the taxpayer ñactivelyò or ñmateriallyò participates in the rental activity, they may be able to deduct some of the losses.

Review Questions Section 5

Read and answer the following review questions. The correct answers are found on the next page with an explanation to strengthen up your knowledge. Note: This is not part of your Final Test.

32. If a cash basis taxpayer receives advance rent for a period of time in the next tax year, they should:
    a) Wait until the next tax year to report the income
    b) Report the income in both the current and the next tax year
    c) Report the income in the current tax year only
    d) Not report the income at all

33. If a taxpayer receives a security deposit from a tenant and they plan to return it to the tenant at the end of the lease, _____.
    a) It should be reported as income when received.
    b) It should be considered first and last month of rent.
    c) It should not be included in income unless the landlord makes a decision to keep all or part of the funds.
    d) A security deposit should not be received if it is planned to be returned to tenant.

34. If a tenant pays any expenses of the landlord, the payments are considered to be_____.
    a) Rental income for the landlord
    b) A deduction for the landlord if it is an allowable expense
    c) An incidental benefit to the landlord, thus not includible in income
    d) Both (a) and (b)

35. Under Section 1.263(a) taxpayers will be required to pay attention to the following when file their business income tax return.
    a) They are required to depreciate their assets using the correct method of depreciation.
    b) They are required to determine if an expense represents immediately repair expense or a capital improvement that must be depreciated.
    c) They are required to determine if an expense is for business use or personal use.
    d) They are required to carry over any unused depreciation by making the proper election on Form 3115.

36. In general, Section 162 and Section 263(a) of the Internal Revenue Code (IRS) differ to each other. All the following are the differences between these IRS sections, except:
    a) Section 162 allows taxpayer to deduct the materials expenses in the current year; Section 263 (a) requires taxpayers to capitalize the expenses for improving tangible property.
    b) Section 263(a) requires taxpayers to capitalize the expenses for producing tangible property; Section 162 allows taxpayers to deduct all the ordinary supplies for the business.
    c) Section 162 allows deductions in the current year while Section 263(a) requires taxpayers to capitalize the cost related to tangible property.
    d) All of the above are valid differences.

37. What is the requirement for taxpayers when filing their business income tax return for taxable years 2014 and after?
    a) They are required to file Form 3115 to increase their depreciation amount.
    b) They are required to File Form 3115 to adopt the new regulations and the new method of accounting.
    c) They are required to complete Form 3115 in case they want to treat all the materials and supplies as repair expenses.
    d) Form 3115 will be required in order for taxpayer to depreciate any asset in the future.

38. Safe harbor exists to the existing process that helps distinguish correctly between repairs or amortization expenses, the safe harbor is:
    a) The Small building safe harbor for building costing less than $1 million.
    b) The $5,000/$2,500 de minimis safe harbor.
    c) The routing maintenance to building safe harbor.
    d) All of the above.

39. In order to take a deduction for the repair or depreciate the expense, taxpayers will be required to know all the following, except:
    a) Taxpayers need to know if the expense if for a betterment of the unit of property.
    b) Taxpayers are required to know if the expense is to restore the unit of property.
    c) Taxpayers are required to know if the item will be sold in the near future.
    d) Taxpayers need to know if the expense is to adapt the unit of property to a new or different use.

Questions Section – Answers and Discussion 1

32. **Answer c**. If a taxpayer receives advanced rent (rent for a period of time in the future), they must report the income when received no matter if they are a cash basis or accrual basis taxpayer.

33. **Answer c**. If a taxpayer receives any amount of money as a security deposit, and they plan to return it to their tenant at the end of the lease, it should not be included in income. If a landlord makes a decision to keep all or a portion of a security deposit because their tenant has not lived up to the terms of their lease, it should be included in income at that time. A security deposit is different from money received as first and last months of rent (which is includible in income).

34. **Answer d**. If the tenants pay any of the expenses to fix the rental property, the payments are rental income. Taxpayers must include them in their rental income.

35. **Answer b**. The IRS issued final regulations under Section 1.263(a)-1, -2, and -3 that completely revamp the way a taxpayer must evaluate certain expenditures in order to determine whether the costs represent immediately deductible repair expenses or capital improvements that must be depreciated over time.

36. **Answer d.** Section 162 of the Internal Revenue Code (IRC) allows taxpayers to deduct all the ordinary and necessary expenses incurred during the taxable year in carrying on

their trade or business, including the costs of certain materials, supplies, repairs, and maintenance. However, section 263(a) of the IRC requires them to capitalize the costs of acquiring, producing, and improving tangible property, regardless of the size or the cost incurred. The tangible property regulations are intended to provide guidance to taxpayers on whether certain expenditures should be capitalized or deductible as a business expense and to provide them with more objective measurements.

37. **Answer b**. With the new regulations effective for tax years beginning on or after Jan. 1, 2014, almost every federal tax return for businesses that own tangible property should have at least one Form 3115 or an election statement that the taxpayers will need to file to adopt the rules under the final regulations. For example, taxpayers will need to file a Form 3115 to adopt the materials-and-supplies provision or file an election statement to use the de minimis rules. Failure to include the Form 3115 or election statement may indicate either an unauthorized accounting method change or the taxpayerôs noncompliance with the final regulations.

38. **Answer c**. Under the final regulations, every repair cost must be evaluated through a series of steps that, if done correctly, will yield the proper treatment of the cost: capitalize or deduct. The series of steps are the following:
    - For a betterment to the unit of property; or
    - To restore the unit of property; or
    - To adapt the unit of property to a new or different use.
    - Expenses done for the above will be proper capitalized and depreciated.

39. **Answer d**. Taxpayers can see if they can benefit from one of the following safe-harbors that exist under the final regulations to avoid the facts and circumstances analysis:
    - The $5,000/$2,500 de minimis safe harbor;
    - The small building safe harbor for buildings that cost $1 million or less.
    - The routine maintenance to buildings safe harbor;
    - A new annual election to capitalize repair costs that are capitalized on a taxpayerôs books and records; and
    - The refinement of the criteria for defining betterments and restorations to tangible property.

Active Participation. A taxpayer actively participates in a rental real estate activity if they owned at least 10% of the rental property and made significant management decisions. Management decisions include approving new tenants, deciding on rental terms, approving expenditures, etc.

Material Participation. A taxpayer materially participates in an activity if they were involved in its operations on a regular, continuous and substantial basis during the year.

If the taxpayer actively participated in the rental activity and their rental losses are less than $25,000, generally they are allowed to deduct the full amount of the loss. However If the taxpayerôs modified adjusted gross income is more than $100,000 ($50,000 MFS), they will not be able to deduct the full amount of the $25,000. If their modified adjusted gross income is $150,000 or more ($75,000 MFS) they generally cannot deduct a loss at all.

If the taxpayer is married filing a separate return, and lived apart from their spouse all year, their special allowance cannot be more than $12,500. If they are filing a separate return and lived with their spouse for any part of the year, they cannot use the special allowance to reduce their non-passive income or tax on non-passive income.

Rental Real Estate Professionals. Rental activities in which the taxpayer materially participates are not passive activities if, for that year, the taxpayer was a real estate professional.

A taxpayer qualifies as a real estate professional for the year if they meet both of the following requirements:

1. More than half of the personal services they performed in all trades or businesses during the year were performed in real property trades or businesses in which the taxpayer materially participated
2. They performed more than 750 hours of services during the tax year in real property trades or businesses in which they materially participated.

Other items on Schedule E

Page 1 of Schedule E is used to report income/loss from royalties received from sources such as oil and gas wells, or other natural resources. Page 2 of Schedule E is used to report income or loss from partnerships, S corporations, estates, trusts, and real estate mortgage investment conduits.

Like-Kind Exchanges under the TCJA. The TCJA still allows real estate owners to sell appreciated properties while deferring the federal income hit indefinitely by making like-kind exchanges under Section 1031. With a like-kind exchange, taxpayers swap the property they want to unload for another property (the replacement property). They are allowed to put off paying taxes until they sell the replacement property ð or they can arrange yet another like-kind exchange and continue deferring taxes.

Important: For 2018 and beyond, the TCJA eliminates tax-deferred like-kind exchange treatment for exchanges of *personal* property. However, prior-law rules that allow like-kind exchanges of personal property still apply if one leg of a personal property exchange was completed as of December 31, 2017, but one leg remained open on that date.

The old provision (pre-TCJA) included the following:

- Real property is like-kind with all real property.
- U.S. real property is not like-kind with non-U.S. real property.
- Personal property is like-kind with personal property, so long as both are in the same asset class for depreciation purposes.

The TCJA removes personal property from the least of property eligible for like-kind exchanges under Section 1031. After Dec. 31, 2017, like-kind exchanges are limited to real property held for productive use in a trade or business or for investment, in other words, not held for personal use or primarily for sale or exchange.

FOREIGN PERSONS RECEIVING RENTAL INCOME FROM U.S. REAL PROPERTY

U.S. real estate professionals and rental agents/property managers are encountering an increasing number of situations that involve foreign persons' acquiring U.S. real estate as a part-time residence, for investment or in some cases to conduct a U.S. business. The U.S. tax rules that apply to ownership and dispositions of U.S. real estate by foreign persons are different in some important respects from the rules that apply to U.S. persons.

U.S. real estate professionals must know how to properly deal with foreign investors in U.S. real estate in order to be in compliance with the federal tax laws affecting real estate transactions. They must be familiar with the rules that determine whether an individual or entity is to be treated as a U.S. person or a foreign person. In addition, they must also be familiar with the fundamentals of U.S. federal income taxation of foreign investors with U.S. rental income. Under U.S. tax law, a taxpayer can depreciate the property. There are different depreciation rates for residential and commercial properties. This annual depreciation is deducted from income as an expense on an income tax return. However, it may be recaptured if the property is sold.

Rental income from real property located in the United States and the gain from its sale will always be U.S. source income subject to tax in the United States regardless of the foreign investor's personal tax status and regardless of whether the United States has an income treaty with the foreign investor's home country.

The method by which rental income will be taxed depends on whether or not the foreign person who owns the property is considered "engaged in a U.S. trade or business." Ownership of real property is not considered a U.S. trade or business if it consists of merely passive activity such as a net lease in which the lessee pays rent, as well as all taxes, operating expenses, repairs, and interest in principal on existing mortgages and insurance in connection with the property. Such passive rental income is subject to a flat 30 percent withholding tax (unless reduced by an

applicable income tax treaty) applied to the gross income rather than the "net rent" received. Thus, the real estate taxes, operating expenses, ground rent, repairs, interest and principal on any existing mortgages, and insurance premiums paid by the lessee on behalf of the foreign owner-lessor, must be included in gross income subject to the 30 percent withholding tax. The gross income and withheld taxes must be reported on Form 1042-S, Foreign Persons U.S. Source Income Subject to Withholding to the IRS and the payee by March 15 of the following calendar year. The payer must also submit Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons, by March 15.

If, on the other hand, the foreign investor is engaged in a U.S. trade or business such as the developing, managing and operating a major shopping center, the rental income will not be subject to withholding and will be taxed at ordinary progressive rates. Expenses such as mortgage interest, real property taxes, maintenance, repairs and depreciation (accelerated cost recovery) may then be deducted in determining net taxable income. The nonresident must make estimated tax payments for the tax due on the net rental income, if any. The only way these expenses can be deducted, however, is if an income tax return Form 1040NR for nonresident alien individuals and Form 1120-F for foreign corporations is timely filed by the foreign investor.

Foreign individuals and foreign corporations may elect to have their passive rental income taxed as if it were effectively connected with the U.S. trade or business. Once such an election is made by attaching a declaration to a timely filed income tax return, there is no obligation to withhold even in a net-lease situation. Once made, the election may not be revoked without the consent of the IRS. Unless the foreign investor has properly informed the property manager that the rental income is to be treated as "effectively connected income" by submitting to the property manager with a fully completed Forms W-8ECI, Certificate of Foreign Personôs Claim for Exemption From Withholding on Income Effectively Connected With the Conduct of a Trade or Business in the United States, the property manager should withhold thirty percent (30 percent) of the gross rental receipts so as to avoid personal liability.

A fully completed Form W-8ECI must include a valid U.S. tax identification number for the foreign landlord (in other words, the rental agent must withhold and remit the 30 percent tax to the IRS until this requirement is satisfied).

Form W-8ECI

Form **W-8ECI**
(Rev. February 2006)
Department of the Treasury
Internal Revenue Service

Certificate of Foreign Person's Claim That Income Is Effectively Connected With the Conduct of a Trade or Business in the United States

► Section references are to the Internal Revenue Code. ► See separate instructions.
► Give this form to the withholding agent or payer. Do not send to the IRS.

OMB No. 1545-1621

Note: *Persons submitting this form must file an annual U.S. income tax return to report income claimed to be effectively connected with a U.S. trade or business (see instructions).*

Do not use this form for:	**Instead, use Form:**
• A beneficial owner solely claiming foreign status or treaty benefits	W-8BEN
• A foreign government, international organization, foreign central bank of issue, foreign tax-exempt organization, foreign private foundation, or government of a U.S. possession claiming the applicability of section(s) 115(2), 501(c), 892, 895, or 1443(b)	W-8EXP
Note: *These entities should use Form W-8ECI if they received effectively connected income (e.g., income from commercial activities).*	
• A foreign partnership or a foreign trust (unless claiming an exemption from U.S. withholding on income effectively connected with the conduct of a trade or business in the United States)	W-8BEN or W-8IMY
• A person acting as an intermediary	W-8IMY
Note: *See instructions for additional exceptions.*	

Part I **Identification of Beneficial Owner** (See instructions.)

1 Name of individual or organization that is the beneficial owner

2 Country of incorporation or organization

3 Type of entity (check the appropriate box): ☐ Individual ☐ Partnership ☐ Government ☐ Private foundation ☐ Simple trust ☐ Grantor trust ☐ International organization ☐ Corporation ☐ Complex trust ☐ Central bank of issue ☐ Disregarded entity ☐ Estate ☐ Tax-exempt organization

4 Permanent residence address (street, apt. or suite no., or rural route). **Do not use a P.O. box.**

City or town, state or province. Include postal code where appropriate.

Country (do not abbreviate)

5 Business address in the United States (street, apt. or suite no., or rural route). **Do not use a P.O. box.**

City or town, state, and ZIP code

6 U.S. taxpayer identification number (required—see instructions) ☐ SSN or ITIN ☐ EIN

7 Foreign tax identifying number, if any (optional)

8 Reference number(s) (see instructions)

9 Specify each item of income that is, or is expected to be, received from the payer that is effectively connected with the conduct of a trade or business in the United States (attach statement if necessary)

A real property manager who collects rent on behalf of a foreign owner of real property is considered a withholding agent and is personally and primarily liable for any tax that must be withheld. The liability of the withholding agent includes amounts that should have been paid plus interest, penalties, and where applicable, criminal sanctions. Property managers who do not comply with these rules will be held liable (either individually or through their company) for 30 percent of gross rents, plus penalties and interest. Also, property managers need to report annual rents collected on behalf of foreign landlords on Forms 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons, and 1042-S, Foreign Personôs U.S. Source Income Subject to Withholding. These are the equivalent of Forms 1096 and 1099-MISC but are for foreign owners.

To enforce the system of withholding, the Internal Revenue Code defines a "withholding agent" to be any person in whatever capacity (including lessees and managers of U.S. real property) having the control, receipt, custody, disposal or payment of income that is subject to withholding. Thus, a real property manager who collects rent on behalf of a foreign owner of real property is clearly considered a withholding agent. A withholding agent is personally and primarily liable for any tax that must be withheld. The liability of the withholding agent includes amounts that should have been paid plus interest, penalties and, where applicable, criminal sanctions. The statute of limitations does not start until a withholding return is filed by the withholding agent. Once the return has been filed, the statute of limitations begins to run at the later of two dates: the date of actual filing of the correct return or April 15 of the calendar year in which the return should have been filed. The withholding agent will remain liable if he actually

knows that the foreign owner's statements are false. The withholding agent's duty of inquiry seems to be a "reasonably prudent test," measured by all facts and circumstances.

Use Form 1042 to report annual rents collected on behalf of foreign landlords.

Form **1042**
Department of the Treasury
Internal Revenue Service

Annual Withholding Tax Return for U.S. Source Income of Foreign Persons
▶ Go to *www.irs.gov/Form1042* for instructions and the latest information.

OMB No. 1545-0096
2017

If this is an amended return, check here ▶ ☐

Name of withholding agent | Employer identification number

Ch. 3 Status Code | Ch. 4 Status Code

Number, street, and room or suite no. (if a P.O. box, see instructions)

City or town, state or province, country, and ZIP or foreign postal code

For IRS Use Only	
CC	FD
RD	FF
CAF	FP
CR	I
EDC	SIC

If you do not expect to file this return in the future, check here ▶ ☐ Enter date final income paid ▶

Section 1 **Record of Federal Tax Liability** (Do not show federal tax deposits here)

Line No.	Period ending		Tax liability for period (including any taxes assumed on Form(s) 1000)	Line No.	Period ending		Tax liability for period (including any taxes assumed on Form(s) 1000)	Line No.	Period ending		Tax liability for period (including any taxes assumed on Form(s) 1000)
1	Jan.	7		21	May	7		41	Sept.	7	
2		15		22		15		42		15	
3		22		23		22		43		22	
4		31		24		31		44		30	
5	Jan. total			25	May total			45	Sept. total		

A nonresident who fails to submit a timely filed income tax return loses the ability to claim deductions against the rental income, causing the gross rents to be subject to the 30 percent tax. Generally, the nonresident will need to retroactively file at least six years of delinquent income tax returns, or all prior year tax returns, if they have held the rental property for less than six years. However, the ability to elect to treat the rental income as effectively connected with a U.S. trade or business will be lost after 16 months from the original due date of the return, and the remaining back years may be subject to tax under the gross income method. Rental income from real property located in the United States and the gain from its sale will always be U.S. source income subject to tax in the United States regardless of the foreign investor's status and regardless of whether the United States has an income treaty with the foreign investor's home country.

Determining Alien Tax Status. If taxpayer is an alien (not a U.S. citizen) he/she is considered a nonresident alien unless one of the following two tests is met. Taxpayers are a resident alien of the United States for tax purposes if they meet either the green card test or the substantial presence test for the calendar year (January 1-December 31).

Certain rules exist for determining the Residency Starting and Ending Dates for aliens.

In some cases aliens are allowed to make elections which override the green card test and the substantial presence test, as follows:

- Nonresident Spouse Treated as a Resident
- Closer Connection To a Foreign Country

- Effect of Tax Treaties

Taxpayers can be both a nonresident alien and a resident alien during the same tax year. This usually occurs in the year they arrive or depart from the United States. If so, they may elect to be treated as a Dual Status Alien for this taxable year and a Resident Alien for the next taxable year if they meet certain tests. For more information regarding "Dual-Status Aliens" ï "First Year Choice" see Publication 519, U.S. Tax Guide for Aliens.

A resident alien who is required to establish his/her U.S. residency for the purpose of claiming a tax treaty benefit with a foreign country should refer to Certification of U.S. Residency for Tax Treaty Purposes.

Substantial Presence Test. Taxpayers will be considered a U.S. resident for tax purposes if they meet the substantial presence test for the calendar year. To meet this test, they must be physically present in the United States on at least:

1. 31 days during the current year, and
2. 183 days during the 3-year period that includes the current year and the 2 years immediately before that, counting:

    - All the days you were present in the current year, and
    - 1/3 of the days you were present in the first year before the current year, and
    - 1/6 of the days you were present in the second year before the current year.

Example. John was physically present in the United States on 120 days in each of the years 2017, 2018, and 2019. To determine if he meets the substantial presence test for 2019, count the full 120 days of presence in 2019, 40 days in 2018 (1/3 of 120), and 20 days in 2017 (1/6 of 120). Since the total for the 3-year period is 180 days, John is not considered a resident under the substantial presence test for 2019.

Days of Presence in the United States. Taxpayers are treated as present in the United States on any day they are physically present in the country, at any time during the day. However, there are exceptions to this rule. Do not count the following as days of presence in the United States for the substantial presence test.

- Days you commute to work in the United States from a residence in Canada or Mexico, if you regularly commute from Canada or Mexico.
- Days you are in the United States for less than 24 hours, when you are in transit between two places outside the United States.
- Days you are in the United States as a crew member of a foreign vessel.
- Days you are unable to leave the United States because of a medical condition that develops while you are in the United States.
- Days you are an exempt individual.

For details on days excluded from the substantial presence test for other than exempt individuals, refer to Publication 519, U.S. Tax Guide for Aliens.

Exempt Individual. Do not count days for which you are an exempt individual. The term "exempt individual" does not refer to someone exempt from U.S. tax, but to anyone in the following categories who is exempt from counting days of presence in the U.S.:

- An individual temporarily present in the United States as a foreign government-related individual
- A teacher or trainee temporarily present in the United States under a "J " or "Q " visa, who substantially complies with the requirements of the visa
- A student temporarily present in the United States under an "F, " "J, " "M, " or "Q " visa, who substantially complies with the requirements of the visa
- A professional athlete temporarily in the United States to compete in a charitable sports event

If you exclude days of presence in the United States because you fall into a special category, you must file a fully-completed Form 8843, Statement for Exempt Individuals and Individuals with a Medical Condition.

Closer Connection Exception to the Substantial Presence Test. Even if you passed the substantial presence test you can still be treated as a nonresident alien if you qualify for one of the following exceptions;

1. The closer connection exception available to all aliens.
2. The closer connection exception available only to students.

Dispositions of United States Real Property Interests. The disposition of a U.S. real property interest by a foreign person (the transferor) is subject to the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) income tax withholding.

FIRPTA authorized the United States to tax foreign persons on dispositions of U.S. real property interests. A disposition means ñdispositionò for any purpose of the Internal Revenue Code. This includes but is not limited to a sale or exchange, liquidation, redemption, gift, transfers, etc.

Persons purchasing U.S. real property interests (transferees) from foreign persons, certain purchasers' agents, and settlement officers are required to withhold 10 percent of the amount realized on the disposition, special rules for foreign corporations. In most cases, the transferee/buyer is the withholding agent. If you are the transferee/buyer you must find out if the transferor is a foreign person. If the transferor is a foreign person and you fail to withhold, you may be held liable for the tax. For cases in which a U.S. business entity such as a corporation or partnership disposes of a U.S. real property interest, the business entity itself is the withholding agent.

U.S. Real Property Interest. A U.S. real property interest is any interest, other than solely as a creditor, in real property (including an interest in a mine, well, or other natural deposit) located in the United States or the U.S. Virgin Islands, as well as certain personal property that is associated with the use of real property (such as farming machinery or hotel furniture). It also

means any interest, other than solely as a creditor, in any domestic corporation unless it is established that the corporation was at no time a U.S. real property holding corporation during the shorter of the period during which the interest was held, or the 5-year period ending on the date of disposition. If on the date of disposition, the corporation did not hold any U.S. real property interests, and all the interests held at any time during the shorter of the applicable periods were disposed of in transactions in which the full amount of any gain was recognized, then FIRPTA withholding would not apply.

Rates of Withholding. The transferee must deduct and withhold a tax equal to 10% (or other amount) of the total amount realized by the foreign person on the disposition. The amount realized is the sum of:

1. The cash paid, or to be paid (principal only)
2. The fair market value of other property transferred, or to be transferred, and
3. The amount of any liability assumed by the transferee or to which the property is subject immediately before and after the transfer. The amount realized is generally the amount paid for the property. If the property transferred was owned jointly by U.S. and foreign persons, the amount realized is allocated between the transferors based on the capital contribution of each transferor.

A foreign corporation that distributes a U.S. real property interest must withhold a tax equal to 35% of the gain it recognizes on the distribution to its shareholders.

A domestic corporation must withhold a tax equal to 10% of the fair market value of the property distributed to a foreign shareholder if:

1. The shareholder's interest in the corporation is a U.S. real property interest, and
2. The property distributed is either in redemption of stock or in liquidation of the corporation.

Exceptions from FIRPTA Withholding. Generally you do not have to withhold in the following situations; however, notification requirements must be met:

1. You (the transferee) acquire the property for use as a home and the amount realized (generally sales price) is not more than $300,000. You or a member of your family must have definite plans to reside at the property for at least 50% of the number of days the property is used by any person during each of the first two 12-month periods following the date of transfer. When counting the number of days the property is used, do not count the days the property will be vacant.
2. The property disposed of (other than certain dispositions of nonpublicly traded interests) is an interest in a domestic corporation if any class of stock of the corporation is regularly traded on an established securities market. However, if the class of stock had been held by a foreign person who beneficially owned more than 5% of the fair market value of that class at any time during the previous 5-year period, then that interest is a U.S. real property interest if the corporation qualifies as a United States Real Property Holding Corporation (USRPHC), and you must withhold on any disposition.

3. The disposition is of an interest in a domestic corporation and that corporation furnishes you a certification stating, under penalties of perjury, that the interest is not a U.S. real property interest. Generally, the corporation can make this certification only if the corporation was not a USRPHC during the previous 5 years (or, if shorter, the period the interest was held by its present owner), or as of the date of disposition, the interest in the corporation is not a U.S. real property interest by reason of section 897(c)(1)(B) of the Internal Revenue Code. The certification must be dated not more than 30 days before the date of transfer.
4. The transferor gives you a certification stating, under penalties of perjury, that the transferor is not a foreign person and containing the transferor's name, U.S. taxpayer identification number, and home address (or office address, in the case of an entity).
5. You receive a withholding certificate from the Internal Revenue Service that excuses withholding.
6. The transferor gives you written notice that no recognition of any gain or loss on the transfer is required because of a non-recognition provision in the Internal Revenue Code or a provision in a U.S. tax treaty. You must file a copy of the notice by the 20th day after the date of transfer with the:
7. Internal Revenue Service Center
   P.O. Box 409101
   Ogden, UT 84409.
8. The amount the transferor realizes on the transfer of a U.S. real property interest is zero.
9. The property is acquired by the United States, a U.S. state or possession, a political subdivision thereof, or the District of Columbia.
10. The grantor realizes an amount on the grant or lapse of an option to acquire a U.S. real property interest. However, you must withhold on the sale, exchange, or exercise of that option.
11. The disposition (other than certain dispositions of nonpublicly traded interests) is of publicly traded partnerships or trusts. However, if an interest in a publicly traded partnership or trust was owned by a foreign person with a greater than 5% interest at any time during the previous 5-year period, then that interest is a U.S. real property interest if the partnership or trust would otherwise qualify as a USRPHC if it were a corporation, and you must withhold on it.

Certifications. The certifications in items (3) and (4) are not effective if you have actual knowledge, or receive a notice from an agent, that they are false. If you are required by regulations to furnish a copy of the certification to the IRS and you fail to do so in the time and manner prescribed, the certifications are not effective.

Liability of Agents. If you receive either of the certifications discussed in item (3) or (4) and the transferor's agent or your agent (the transferee's agent) has actual knowledge that the certification is false, or in the case of (3), that the corporation is a foreign corporation, the agent must notify you, or the agent will be held liable for the tax. The agent's liability is limited to the amount of pay the agent gets from the transaction.

An agent is any person who represents the transferor or transferee in any negotiation with another person (or another person's agent) relating to the transaction, or in settling the

transaction. A person is not treated as an agent if the person only performs one or more of the following acts related to the transaction:

- Receipt and disbursement of any part of the consideration,
- Recording of any document,
- Typing, copying, and other clerical tasks,
- Obtaining title Insurance reports and reports concerning the condition of the property, or
- Transmitting documents between the parties.

A Withholding Agent is personally liable for the full amount of FIRPTA withholding tax required to be withheld, plus penalties and interest. A Withholding Agent is any person having the control, receipt, custody, disposal or payment of income that is subject to withholding. Generally, the person who pays an amount to the foreign person subject to withholding must do FIRPTA withholding.

Reporting and Paying Tax on U.S. Real Property Interests. Two forms are generally used for reporting and paying the tax to the IRS regarding the acquisition of U.S. real property interests.

- Form 8288, U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests (IRC Section 1445)
- Form 8288-A, Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests (IRC Section 1445)

Transferees must use Forms 8288 and 8288-A to report and pay to the IRS any tax withheld on the acquisition of U.S. real property interests. These forms must also be used by corporations, partnerships, estates, and trusts that must withhold tax on distributions and other transactions involving U.S. real property interests. You must include the U.S. TIN of both the transferor and transferee on the forms.

For publicly traded trusts and real estate investment trusts, you must use Forms 1042 and 1042-S procedures for reporting and paying over tax withheld on distributions from dispositions of U.S. real property interests. Use Income Codes 24, 25, and 26 on Form 1042-S for transactions involving these entities.

Form 8288. The tax withheld on the acquisition of a U.S. real property interest from a foreign person is reported and paid using Form 8288. Form 8288 also serves as the transmittal form for copies A and B of Form 8288-A, Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests. Generally, you must file Form 8288 by the 20th day after the date of the transfer.

If an application for a withholding certificate is submitted on Form 8288-B, Application for Withholding Certificate for Dispositions by Foreign Persons of U.S. Real Property Interests to the IRS before or on the date of a transfer and the application is still pending with the IRS on the date of transfer, the correct withholding tax must be withheld, but does not have to be reported and paid immediately. The amount withheld (or lesser amount as determined by the IRS) must be

reported and paid within 20 days following the day on which a copy of the withholding certificate or notice of denial is mailed by the IRS.

If the principal purpose of applying for a withholding certificate is to delay paying over the withheld tax to the IRS, the transferee will be subject to interest and penalties. The interest and penalties will be assessed beginning on the 21st day after the date of transfer and ending on the day the payment is made.

Form 8288-A. The withholding agent must prepare a Form 8288ï A for each person from whom tax has been withheld. Attach copies A and B of Form 8288ï A to Form 8288. Keep Copy C for your records.

IRS will stamp Copy B and send it to the person subject to withholding. That person must file a U.S. income tax return and attach the stamped Form 8288ï A to receive credit for any tax withheld.

A stamped copy of Form 8288ï A will not be provided to the transferor if the transferor's TIN is not included on that form. In this case, to get credit for the withheld amount, the transferor must attach to its U.S. income tax return substantial evidence of withholding (for example, closing documents) and a statement that contains all the required information shown on Forms 8288 and 8288ï A including the transferor's TIN.

Form 8288-A

Withholding agent's name, street address, city, state, and ZIP code		1 Date of transfer 2 Federal income tax withheld	**Statement of Withholding on Dispositions by Foreign Persons of U.S. Real Property Interests** OMB No. 1545-0902	
Withholding agent's Federal identification number	Identification number of foreign person subject to withholding (see instructions)	3 Amount realized	4 Gain recognized by foreign corporation	**Copy A For Internal Revenue Service Center**
Name of person subject to withholding		5 Description of property transferred		
Foreign address (number, street, and apt. or suite no.)		6 Person subject to withholding is: An individual ☐ A corporation ☐ Other (specify) ►		For Privacy Act and Paperwork Reduction Act Notice, see the Instructions for Form 8288.
City, province or state, postal code, and country (not U.S.)	7 Country code	Mailing address of person subject to withholding (if different)		
Form **8288-A** (Rev. 6-2011) Cat. No. 62261L	**Attach Copies A and B to Form 8288**	Department of the Treasury - Internal Revenue Service		

Application for Reduced Rate of Withholding. A reduced rate of withholding may be allowed upon the submission and acceptance of Form 8288-B.

Requirement for Taxpayer Identification Numbers (TIN's). Treasury Decision 9082 requires all transferees (buyers) and foreign transferors (sellers) of U.S. real property interests to provide their TINôs, names and addresses on withholding tax returns, applications for withholding

certificates, notice of non-recognition, or elections under sections IRC 897(i) when disposing of a U.S. real property interest.

If the transferor sends Forms 8288 and 8288-A to the IRS for processing but does not list a TIN on the forms and does not attach a Form W-7 ITIN application, the IRS will process the forms, but will not date stamp Form 8288-A "Copy B Mailed" or forward it to the foreign transferor. Instead, the IRS will mail Letter 3794 SC/CG to the foreign transferor, instructing the transferor to apply for an ITIN by filing Form W-7.

Tax Obligations. Generally, if you are a foreign person that disposes of real property located in the United States as seller or transferor, you must file a U.S. tax return.

A foreign person can file Form 1040NR, 1041, 1065, 1065-B, or 1120-F to report the sale or other disposition as effectively connected with the conduct of a trade or business in the United States.

To receive credit for any federal income tax withheld shown in box 2, attach Form 8288-A to your tax return, unless you make a request for early refund. Foreign partnerships, other than publicly traded partnerships, should report the withholding on Form 8804, Annual Return for Partnership Withholding Tax (Section 1446), and attach Form 8288-A. Publicly traded partnerships, and nominees of such partnerships, should use Forms 1042 and 1042-S to report the withholding.

If the amount shown in box 2 is greater than your maximum tax liability, you may apply for an early refund. However, you must still file your tax return when due. To apply for an early refund, you must first get a withholding certificate. No particular form is required for an application for early refund, but it must include the following information in separate paragraphs numbered as shown below:

1. Your name, address, and U.S. taxpayer identification number,
2. The amount required to be withheld as stated in the withholding certificate issued by the IRS,
3. The amount withheld shown in box 2 (attach a copy of this Form 8288-A), and
4. The amount to be refunded.

Send your application for a withholding certificate and/or application for early refund to Ogden Service Center, P.O. Box 409101, Ogden, UT 84409

Form 1040NR. Gain or loss on the disposition of a U.S. real property interest is taxed as if the gain or loss were effectively connected with the conduct of a U.S. trade or business.

Report gains and losses on the disposition of U.S. real property interests on Schedule D (Form 1040) and Form 1040NR, line 14. Also, net gains may be subject to the alternative minimum tax.

Income You Can Elect To Treat as Effectively Connected With a U.S. Trade or Business

You can elect to treat some items of income as effectively connected with a U.S. trade or business. The election applies to all income from real property located in the United States and held for the production of income and to all income from any interest in such property. This includes:

- Gains from the sale or exchange of such property or an interest therein,
- Gains on the disposal of timber, coal, or iron ore with a retained economic interest,
- Rents from real estate, or
- Rents and royalties from mines, oil or gas wells, or other natural resources.

The election does not apply to dispositions of U.S. real property interests.

To make the election, attach a statement to your return for the year of the election. Include the following items in your statement.

1. That you are making the election.
2. A complete list of all of your real property, or any interest in real property, located in the United States (including location). Give the legal identification of U.S. timber, coal, or iron ore in which you have an interest.
3. The extent of your ownership in the real property.
4. A description of any substantial improvements to the property.
5. Your income from the property.
6. The dates you owned the property.
7. Whether the election is under section 871(d) or a tax treaty.
8. Details of any previous elections and revocations of the real property election.

Form 1099-S, Proceeds From Real Estate Transactions. Generally, the real estate broker or other person responsible for closing the transaction must report the sale of the property to the IRS using Form 1099-S.

Form 1099-S

☐ CORRECTED (if checked)

FILER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone number	1 Date of closing	OMB No. 1545-0997	Proceeds From Real Estate Transactions
	2 Gross proceeds $	2018 Form 1099-S	
FILER'S TIN / TRANSFEROR'S TIN	3 Address (including city, state, and ZIP code) or legal description		Copy B For Transferor
TRANSFEROR'S name			This is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this item is required to be reported and the IRS determines that it has not been reported.
Street address (including apt. no.)	4 Transferor received or will receive property or services as part of the consideration (if checked) ▶ ☐		
City or town, state or province, country, and ZIP or foreign postal code	5 If checked, transferor is a foreign person (nonresident alien, foreign partnership, foreign estate, or foreign trust) ▶ ☐		
Account number (see instructions)	6 Buyer's part of real estate tax $		

Form 1099-S (keep for your records) www.irs.gov/Form1099S Department of the Treasury - Internal Revenue Service

Form 1099-S is used to report sales or exchanges of real estate. Although most people only get a Form 1099-S when they sell their home, you may also get the form when you sell any of the following.

- Improved or unimproved land, including air space.
- Inherently permanent structures, including any residential, commercial or industrial building.
- A condominium unit and its appurtenant fixtures and common elements, including land.
- Stock in a cooperative housing corporation.

Mobile homes that are not permanently fixed to a foundation are not included in the reporting requirements for Form 1099-S. You should receive this form by February 1, of the current year.

1099-S Tax Effects. The IRS considers the profit you make from selling a house as a taxable gain. However, it allows a significant exclusion or reduction if you meet several requirements. The house you sold must have been owned by you and have been your primary residence. You must have resided in the home for at least two of the five years preceding the sale. If you meet these requirements, federal tax laws allow you to exclude a fixed amount from your taxable gain. If you are a single filer, you may exclude $250,000. If you are married and file your taxes jointly with your spouse, you may exclude $500,000. You must pay taxes on the amount of your taxable gain from the sale that exceeds the amount of your exclusion.

Review Questions Section 6

Read and answer the following review questions. The correct answers are found on the next page with an explanation to strengthen up your knowledge. Note: This is not part of your Final Test

32. If an amount called a security deposit is to be used as a final payment of rent, then you should _____.
    a. Report it as a rental income when the tenant leaves.
    b. Report half of it at the beginning and the rest at the end.
    c. Report it as a rental income when you receive it.
    d. All of the above are valid.

33. Which of the following apply to property or service in lieu of rent
    a. The fair market value of a service given instead of money for the rent should be included as rental income.
    b. The fair market value of a property given instead of money for the rent should be included as rental income.
    c. The fair market value of a service or property is the agreed upon or specified price.
    d. All of the above.

34. If you rent property, that you also use as your home and you rent it fewer than _____ days during the tax year you do not have to include the rent received.
    a. 10 days
    b. 15 days
    c. 5 days
    d. None of the above

35. If your tenant pays for a reparation in the rental house, you should treat this as_____:
    a. Obligation of your tenant
    b. Expense and deduct it from your income
    c. Income and deduct it as a rental expense
    d. Income and nondeductible expense

36. Auto and travel expenses can be deducted when they are _____.
    a. Necessary to collect rents or to manage, conserve or maintain your rental property
    b. Necessary to make improvements to the rental property
    c. Necessary to buy a sofa for personal use
    d. Necessary to go and pay the property taxes

37. When do you stop depreciating the rental property?
    a. When the total of the depreciation equal the cost or basis of the rental property.
    b. When you retire it from service, even if you have not fully recovered its cost.
    c. When you withdraw it from use in trade or business because you abandon it.
    d. All of the above.

38. Which of the following is not an improvement to rental house?
    a. Replacing broken windows
    b. Adding a new bedroom
    c. Putting a new roof
    d. Installing a new fence

39. Which of the following pre-rental expenses can be deducted?
    a. Necessary expenses for conserving the rental house available for rent.
    b. Necessary expenses for managing the rental house from the time available for rent.
    c. Expenses for maintaining rental property available for rent.
    d. All of the above.

40. A dwelling unit includes _____.
    a. A mobile home
    b. An apartment
    c. A boat
    d. All of the above

41. If a taxpayer does not rent their property to make a profit, _____.
    a. They should complete Schedule E.
    b. They should complete Schedule C.
    c. They should report their income on line 21, Form 1040.
    d. The income is not considered to be taxable.

Review Questions – Answers and Discussion

Question 32 correct answer is C. If an amount called a security deposit is to be used as a final payment of rent, it is advance rent. Include it in your income when you receive it. The Security deposits are considered income if you keep part or all of it because your tenant did not live up to the terms of the lease. Include the amount that you keep in your income in that year. Do not include a security deposit in your income when you receive it if you plan to return it to your tenant at the end of the lease.

Question 33 correct answer is D. If you receive property or services, instead of money, as rent, include the fair market value of the property or services in your rental income. If the services are provided at an agreed upon or specified price, that price is the fair market value unless there is evidence to the contrary.

Question 34 answer B is correct. If you rent property that you also use as your home and you rent it fewer than 15 days during the tax year, do not include the rent you receive in your income and do not deduct rental expenses. However, you can deduct on Schedule A (Form 1040), Itemized Deductions, interest, taxes, casualty and theft losses that are allowed for nonrental property.

Question 35 answer C is correct. Generally, the expenses of renting your property, such as maintenance, insurance, taxes, and interest, can be deducted from your rental income. When your tenant pays any of your expenses, the payments are rental income. You must include them in your income. You can deduct the expenses if they are deductible rental expenses.

Question 36 answer A is correct. You can deduct your ordinary and necessary transportation expenses if you incur them to collect rental income or to manage, conserve, or maintain your rental property. You cannot deduct the cost of traveling away from home if the primary purpose of the trip is to improve the property. The cost of improvements is recovered by taking depreciation.

Question 37 answer D is correct. You must stop depreciating property when the total of your yearly depreciation deductions equals your cost or other basis of your property. For this purpose, your yearly depreciation deductions include any depreciation that you were allowed to claim, even if you did not claim it

Question 38 answer A is correct. An improvement adds to the value of property, prolongs its useful life, or adapts it to new uses. If you make an improvement to property, the cost of the improvement must be capitalized. The capitalized cost can generally be depreciated as if the improvement were separate property. Repainting your property inside or out, fixing gutters or floors, fixing leaks, plastering, and replacing broken windows are examples of repairs.

Question 39 answer D is correct. You can deduct your ordinary and necessary expenses for managing, conserving, or maintaining rental property from the time you make it available for rent.

Question 40 answer D is correct. A dwelling unit includes a house, apartment, mobile home, boat, apartment or other similar property.

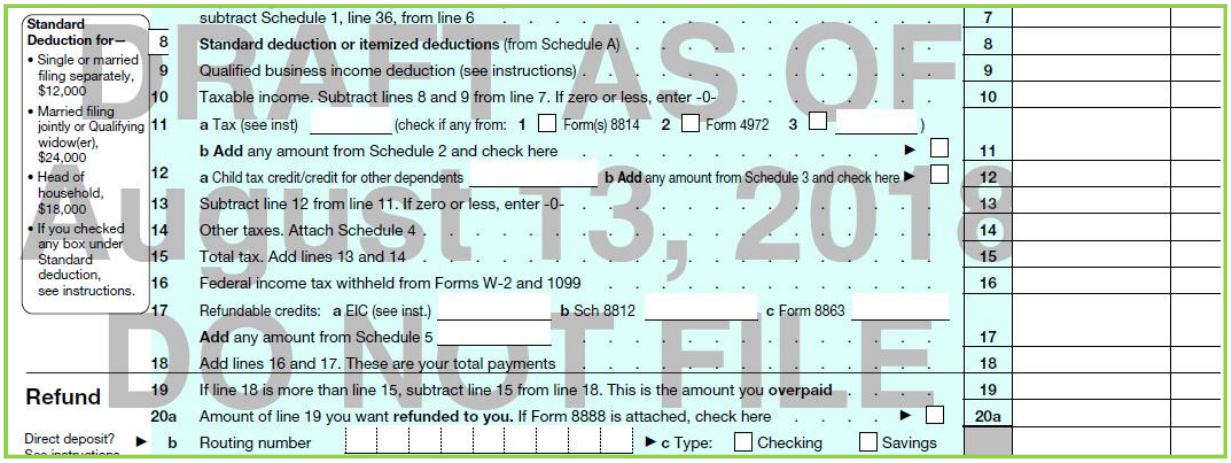
If the taxpayer uses a dwelling unit as a home and rents it fewer than 15 days during the year, they are not required to include that rental income on their tax return. However they cannot deduct any expenses as rental expenses.

Question 41 answer C is correct. If the taxpayer does not rent their property to make a profit, they can deduct their expenses only up to the amount of their rental income. The amount of rental expenses greater than rental income should not be included. In this case, do not complete and file Schedule E. Instead report the income on line 21, Form 1040.

PERSONAL TAX CREDITS UNDER THE TCJA.

After the tax liability, or Alternative Minimum Tax, if any, has been determined taxpayers may be able to reduce their tax liability by claiming one or more individual tax credits. These credits can be divided into refundable credits and non-refundable credits. Refundable credits are those treated as a payment and thus can be refunded to the taxpayer by the Internal Revenue Service. Refundable tax credits are applied towards a person's tax obligations, and any over-payments are refunded back to the taxpayer. Nonrefundable tax credits are those credits that can reduce the federal income tax liability to zero, but taxpayer will not receive any remaining credit.

Tax and Credits Section of Form 1040



Non-refundable tax credits. New Form 1040.

REFUNDABLE AND NONREFUNDABLE TAX CREDITS	
Refundable	**Non-refundable**
◆ Earned Income Credit ◆ Adoption Credit. ◆ Excess Social Security Credit ◆ Additional Child Tax Credit, Form 8812 ◆ American Opportunity Credit - partly refundable ◆ Refundable Credit for Prior Year Minimum Tax ◆ Naturally, withholdings for federal income taxes and estimated taxes are also refundable tax credits	◆ Child and Dependent Care Credit ◆ Education credits. ◆ Credit for the Elderly or Disabled ◆ Child Tax Credit ◆ Family Care Credit ◆ Foreign Income Tax Credit ◆ Retirement Savings Contribution Credit

There are eligibility rules and credit limitations for many of these personal tax credits. Some of the non-refundable and refundable tax credits are going to be explained in this book.

CHILD TAX CREDIT AND REFUNDABLE CHILD TAX CREDIT.

The Child Tax Credit is a nonrefundable tax credit for people who have a qualifying child. The credit is limited to $2,000 per qualifying child.

This credit, as well as any other non-refundable tax credit, is used to reduce tax. If the tax on Form 1040 is zero, taxpayer does not need to figure the child tax credit because there is no tax to reduce. However, taxpayer may qualify for the additional child tax credit on Schedule 8812.

Under the Tax Cuts and Jobs Act (TCJA) the following new child tax credit rules will take place in 2018:

- The Child Tax Credit under the new TCJA is worth up to $2,000 per qualifying child. The age cut-off remains at 17 (the child must be under 17 at the end of the year for taxpayers to claim the credit).
- The refundable portion of the credit is limited to $1,400. This amount will be adjusted for inflation after 2018.
- The earned income threshold for the refundable credit is lowered to $2,500, which means that a family must only earn $2,500 or more to claim the credit.
- The beginning credit phase-out for the child tax credit increases in 2018 to $200,000 ($400,000 for joint filers). The phase-out also applies to the new $500 credit for other dependents.
- The child must have a valid SSN to qualify for the $2,000 Child Tax Credit.

Dependent Requirements for the CTC. Prior to the TCJA, the taxpayer who was eligible to claim the childôs dependent exemption could also be eligible to claim the Child Tax Credit (CTC). In turn, the taxpayer and child had to meet several ñtestsò for the one to be considered the dependent of the other.

The TCJA eliminates the dependent exemption itself, but retains the *definition* of dependent to claim the new child tax credit and other child or dependent-related tax benefits. For Child Tax Credit reform purposes, this will usually mean that the child must be related to the taxpayer in one of several ways (son, daughter, grandchild, etc.), must live in the taxpayerôs home more than half the year, and must not provide more than half of his or her own support. Special rules apply if the parents are divorced or legally separated.

In order for an individual to be eligible for the Child Tax Credit, the following six tests must be met:

1. **Age Test:** The child you claim must be under the age of 17 at the last day of the tax year (December 31).
2. **Relationship Test**: A child must be related to taxpayers as their daughter, son, stepdaughter, stepson, sister, brother, half-sister, half-brother, stepsister, stepbrother or a descendant of any of these, such as a granddaughter or nephew. Two exceptions to the relationship test are 1) an adopted child, who is always considered taxpayersô child as long as the child was placed with them through a legal adoption, and 2) a foster child, who taxpayer can legally claim as their dependent as long as the child was placed with them by a court order or an authorized agency. Examples of authorized agencies include state and local governments, tax-exempt agencies that are licensed by state and local governments and Indian tribal governments.
3. **Support Test:** The child must not have provided over half of his/her own financial support for the tax year.
4. **Dependent Test:** The child must be claimed as a dependent on taxpayersô tax return.
5. **Citizenship Test with SSN:** The child must be a US Citizen, U.S. national, or U.S. resident alien. SSN is required.
6. **Residence Test:** The child must have lived with you for more than half of the tax year for which you claim the credit. Some exceptions exist if taxpayer or the child had temporary absences due to school, medical care, military service, etc.

Exemption Amount Exists for the Child Tax Credit. Under 26 U.S. Code §152(d)(1)(B), a qualifying relative includes an individual ñwhose gross income for the calendar year in which such taxable year begins is less than the exemption amount."

There is no personal exemption amount anymore, and itôs pretty impossible to have income less than zero. As a result, the proposed regulations will make it clear that the reduction of the personal exemption amount (to zero) will not be taken into account to figure dependency for purposes of the $500 credit.

Similarly, the reduction of the personal exemption amount (to zero) will not be taken into account to figure dependency as it relates to head of household status.

Instead, the exemption amount for the application of these provisions will be treated as $4,150, as adjusted for inflation, for years in which the exemption amount is zero (2018 through 2025).

According to the IRS, this interpretation is consistent with 26 U.S. Code §151(d)(5), which states that ñ[f]or purposes of any other provision of this title, the reduction of the exemption amount to zero under subparagraph (A) shall not be taken into account in determining whether a deduction is allowed or allowable, or whether a taxpayer is entitled to a deduction, under this section.ò

CTC Rules for Divorced or Separated Parents. Special "tiebreaker" rules apply to divorced and separated parents. The credit will go to the parent with whom the child lived most during the tax year. The parent with the highest adjusted gross income (AGI) gets the credit if the child lived with both parents the same amount of time.

Earned Income Requirement for Taxpayers. To claim the credit, taxpayers earned income can only be taxable earned income and nontaxable combat pay. Earned income generally includes salaries, wages, tips, net earnings from self-employment and other employee pay that is taxable.

Income thresholds were increased. In previous tax years, the credit has only been available for low- to middle-income households. For instance, the credit began to disappear in 2017 for married couples who earned more than $110,000 and for single filers with AGI above $75,000.

In 2018, the credit will be available to far more households, due to raise in the phaseout thresholds. Here's a quick guide to the Child Tax Credit phaseout thresholds for 2018.

Tax Filing Status	Maximum AGI for Full Credit	AGI Where Credit Disappears
Single	$200,000	Over $240,000
Married filing jointly	$400,000	Over $440,000
Head of household	$200,000	Over $240,000
Married filing separately	$200,000	Over $240,000

If taxpayersô income falls between the two income thresholds for their filing status, they can still claim a partial credit. Each Child Tax Credit they qualify for will be reduced by $50 for every $1,000 their modified adjusted gross income (MAGI) exceeds the lower threshold.

Refundable portion of the Child Tax Credit, Form 8812.Starting in 2018, the child tax credit is partly refundableð that is, taxpayers may collect it even if they owe no taxes for the year. The maximum refundable amount is $1,400 per child. However, the actual refundable amount they can collect if they owe no tax for the year depends on their earned income (generally, wages, salary, tips, or net earnings from self-employment). The refundable amount is equal to 15% of the earned income over $2,500, up to the maximum $1,400 credit. For example, if taxpayerôs earned income is $10,000, his/her refundable credit would be 15% x ($10,000 - $2,500) = $1,125.

The $1,400 figure is indexed for inflation, so it can be expected to increase periodically. If 15% works out to $1,500, taxpayers would still only be refunded $1,400.

Claiming three or more qualifying children. If taxpayers have three or more qualifying children, they can use an alternative formula to determine the refundable portion. Under the alternative formula, the refundable portion is equal to the amount by which their Social Security taxes (those taken out of their wages or paid out as self-employment taxes) exceed their earned income tax credit (sometimes called EIC or EITC).

The credit is limited if their modified adjusted gross income (MAGI) exceeds the phaseout amount for their filing status.

Tax Filing Status	Maximum AGI for Full Credit	AGI Where Credit Disappears
Single	$200,000	Over $240,000
Married filing jointly	$400,000	Over $440,000
Head of household	$200,000	Over $240,000
Married filing separately	$200,000	Over $240,000

Phase-outs means that the credit is reduced as the income increases. In this case, the reduction is $50 for each $1,000 by which their MAGI exceeds the threshold amount.

Claiming the refundable and non-refundable credit. But beginning with the 2019 tax year, taxpayers will be able to use only one 1040 form instead of having to choose between three possibilities. The IRS is combining the current 1040, 1040A and 1040EZ forms into one comprehensive form for simplicity. Attach Form 8812 to the return to claim the refundable portion of the credit.

FAMILY CREDIT OR OTHER DEPENDENT CREDIT UNDER TCJA.

The tax reform bill also includes a nonrefundable $500 "family credit" for other dependents. Examples might include an aging parent who depends on taxpayer for care or a child whose support the taxpayer provides, but is 17 years old or older. This new credit, referred to as a ñfamily credit,ò is designed to compensate for the eliminated personal exemption and is subject to the same phaseout as the child tax credit

Requirements for the $500 non-refundable credit. The new credit is qualifying dependents other than children who can be claimed for the child tax credit. The qualifying dependent must be a U.S. citizen, U.S. national, or U.S. resident alien. The credit is calculated with the child tax credit in the form instructions. The total of both credits is subject to a single phase out when adjusted gross income exceeds $200,000, or $400,000 if married filing jointly. The new credit allows taxpayers the credit for certain dependents age 17 or older, adult dependents, and dependents who have an ITIN living in the U.S.

Taxpayers may be able to claim this credit if they have children age 17 or over, including college students, children with ITINs, or other older relatives in their household.

If their child doesnôt have a valid SSN, the child may still qualify for the Credit for Other Dependents. If the dependent child lived with taxpayers in the United States and has an ITIN, but

not an SSN, issued by the due date of the 2018 return (including extensions), taxpayers may be able to claim the new Credit for Other Dependents for that child.

The Exemption Amount Still Applies for this Credit. Under 26 U.S. Code §152(d)(1)(B), a qualifying relative includes an individual ñwhose gross income for the calendar year in which such taxable year begins is less than the exemption amount."

There is no personal exemption amount anymore, and itôs pretty impossible to have income less than zero. As a result, the proposed regulations will make it clear that the reduction of the personal exemption amount (to zero) will not be taken into account to figure dependency for purposes of the $500 credit.

Similarly, the reduction of the personal exemption amount (to zero) will not be taken into account to figure dependency as it relates to head of household status.

Instead, the exemption amount for the application of these provisions will be treated as $4,150, as adjusted for inflation, for years in which the exemption amount is zero (2018 through 2025).

According to the IRS, this interpretation is consistent with 26 U.S. Code §151(d)(5), which states that ñ[f]or purposes of any other provision of this title, the reduction of the exemption amount to zero under subparagraph (A) shall not be taken into account in determining whether a deduction is allowed or allowable, or whether a taxpayer is entitled to a deduction, under this section.ò

THE HEAD OF HOUSEHOLD STATUS UNDER THE TCJA.

The TCJA eliminates the value of the personal and dependent exemptions that were so familiar in years past. As a result, claiming a Head of Household (HOH) status can make a measurable difference for a newly single parent. To claim it, the taxpayer needs to be unmarried, pay for more than 50% of the household expenses and have a dependent who has lived in the household for more than 50% of the time. If there is one child, only one parent can claim to be HOH for this family.

For divorcing couples, the incremental savings for being Head of Household instead of Single mean that this is likely to be a significant point of discussion in divorce negotiations.

Head of Household only when claiming the qualifying dependent. The parent who is Head of Household can also claim the expanded $2,000 Child Tax Credit for each qualifying child, including the $1,400 that is refundable (i.e., you need to owe income tax to benefit). Tax credits are much more valuable than exemptions. Whereas exemptions reduce taxable income, tax credits directly reduce the amount of tax itself.

In the past, parents could alternate taking children as exemptions using IRS form 8332. Of course, these exemptions helped reduce taxable income. As a result, exemptions have been an important clause in separation agreements. However, under the new tax law, exemptions no longer result in a reduction in taxable income.

With TCJA, it is not clear that the Child Tax Credit will be tradeable. Effectively, it would require the IRS to publish a regulation that allows trading of the Child Tax Credit between parents and a form that makes it possible. So far, the IRS has not released that regulation. This is sure to frustrate some parents, as they try to arrange their finances for their post-divorce reality. Their best bet is to negotiate as if the Child Tax Credit will not be tradeable, but write in the agreement that it may be traded if allowed by laws and regulations. Parents could then work on dividing the economic benefits of the credit instead.

The Child Tax Credit and the HOH status provide a measurable boost to the after-tax income of the beneficiary. Thus, they will become an essential consideration of any divorce negotiation involving children.

Due Diligence requirement for Head of Household Status. The IRS expanded the long-standing paid preparer due diligence requirement to include individual income tax returns claiming the head of household filing status.

The final regulations, available in the Federal Register, implement a provision included in the Tax Cuts and Jobs Act (TCJA). The additional requirement will apply starting with 2018 returns, prepared on or after November 7, 2018.

The due diligence requirement was originally designed to reduce errors on returns claiming the Earned Income Tax Credit. Legislation in 2015 expanded the due diligence requirements to include the Child Tax Credit, Additional Child Tax Credit, and American Opportunity Tax Credit. Under the TCJA, the due diligence requirement now also applies to individual income tax returns claiming the head of household filing status.

Paid preparers must submit Form 8867, Paid Preparerôs Earned Income Credit Checklist, with every tax return claiming any of the covered tax benefits. The form is designed as a checklist to help paid preparers meet the requirement by obtaining eligibility information from their clients. Paid preparers are required to keep copies of the form or comparable documentation for their records, which is also subject to review by the IRS.

Paid preparers are subject to a penalty, indexed to inflation, for each failure to comply with the requirement. For tax year 2018, the penalty will be $520.

The Exemption Amount Counts for the HH status. Under 26 U.S. Code §152(d)(1)(B), a qualifying relative includes an individual ñwhose gross income for the calendar year in which such taxable year begins is less than the exemption amount."

There is no personal exemption amount anymore, and itôs pretty impossible to have income less than zero. As a result, the proposed regulations will make it clear that the reduction of the personal exemption amount (to zero) will not be taken into account to figure dependency for purposes of the $500 credit.

Similarly, the reduction of the personal exemption amount (to zero) will not be taken into account to figure dependency as it relates to head of household status. Instead, the exemption amount for the application of these provisions will be treated as $4,150, as adjusted for inflation, for years in which the exemption amount is zero (2018 through 2025).

According to the IRS, this interpretation is consistent with 26 U.S. Code §151(d)(5), which states that ñ[f]or purposes of any other provision of this title, the reduction of the exemption amount to zero under subparagraph (A) shall not be taken into account in determining whether a deduction is allowed or allowable, or whether a taxpayer is entitled to a deduction, under this section.ò

EARNED INCOME TAX CREDIT (EITC)

The Earned Income Tax Credit (EITC) or Earned Income Credit (EIC) is a refundable tax credit that reduces or eliminates the tax owed by low-income workers. Greater tax credit is given to those who also have qualifying children. When the tax credit exceeds the amount of taxes owed, it results in a tax refund to those who claim and qualify for the credit. This tax credit is provided, in part, to offset the burden of social security taxes and to provide an incentive to work.

The Earned Income Credit was increased for working families with three or more dependents. Previously the earned income credit maxed out at two dependents.

Requirements to claim the Earned Income Tax Credit. There are some requirements to claim the Earn Income Credit. The first one is that taxpayer must be at least age 25, but under age 65. At the same time, taxpayer cannot be a dependent or a qualifying child of another person. If filing a married filing separate return then the Earn Income Credit cannot be claimed. Here is a list of the other requirements.

EARN INCOME CREDIT FOR 2018
The maximum amount of credit for Tax Year 2018 is: • $6,431 with three or more qualifying children • $5,716 with two qualifying children • $3,461 with one qualifying child • $519 with no qualifying children

Social Security Number Requirement. To claim the EITC, taxpayers and qualifying child must have a valid Social Security Number issued by the Social Security Administration (SSA). If any Social Security Number is missing or incorrect, the credit will be denied.

The EITC cannot be claimed with a social security card saying ñNot valid for employmentò. This is true also for a SSN issued only to get federal funded benefits like Medicaid.

If the immigration status has changed and taxpayer is now a U.S citizen or permanent resident, he or she can ask to get a new SSN without the legend ñNot Valid for Employmentò.

If the social security card reads ñValid for work only with INS authorization,ò or ñValid for work only with DHS authorization,ò the SSN is valid to claim the credit.

The credit cannot be claimed with an Individual Taxpayer Identification Number (ITIN). ITINs are issued by the Internal Revenue Service to noncitizens that cannot get a SSN.

Filing Status Requirement. The Filing Status to claim the credit cannot be Married Filing Separately. If taxpayer is married and the spouse did not live in taxpayerôs home at any time during the last 6 months of the year, then taxpayer may be able to file as head of household, instead of married filing separately. In that case, taxpayer may be able to claim the EIC. However, there are some requirements to file as a head of household.

Earn income Requirement. This credit is called the ñearned incomeò credit because, to qualify, taxpayer must work and have earned income. In the case of a married couple filing a joint return, this requirement can be fulfilled even if just one spouse works and has earned income. If taxpayer is an employee, earned income includes all the taxable income received from employer. If taxpayer is self-employed or a statutory employee, then the earn income will be figured on EIC Worksheet B in the instructions for Form 1040.

Taxpayer cannot get the Earn Income Credit with foreign earned income. This is true even if taxpayer excluded it from gross income using Form 2555 or 2555-EZ

If taxpayer is retired on disability, taxable benefits received under the employer's disability retirement plan are considered earned income until taxpayer reaches minimum retirement age. Minimum retirement age generally is the earliest age at which taxpayer could have received a pension or annuity if he or she were not disabled. Taxable disability payments should be reported on Form 1040.

Earned Income could be: Wages, Salaries, Tips, Other taxable employee compensation, net earnings from self-employment, Disability pay reported as wages, Parsonage allowances, Meals and lodging furnished for the convenience of the employer, Voluntary salary deferrals, Military pay earned in a combat zone, strike pay paid by a union and statutory employee wages.

Beginning on the day after taxpayer reaches minimum retirement age; payments received are taxable as a pension and are not considered earned income.

Investment Income Limits Requirement. To claim the earn income tax credit, taxpayerôs investment income for 2018 must be less than $3,500. Investment income is the total of the following amounts:

- Taxable interest, tax-exempt interest, dividend income, capital gain net income.

NOT EARNED INCOME
The following items are considered not earned income: • Interest and dividends • Pensions and annuities • Social security and railroad retirement benefits • Alimony and child support • Welfare benefits • Workers' compensation benefits • Unemployment compensation (insurance) • Nontaxable foster care payments • Veterans' benefits, including VA rehabilitation payments. • Amounts received for work performed while an inmate in a penal institution are not earned income when figuring the earned income credit. • Nontaxable workfare payments do not qualify for the EIC. • If you are married, but qualify to file as head of household under special rules for married taxpayers living apart and live in a state that has community property laws, your earned income for the EIC does not include any amount earned by your spouse that is treated as belonging to you under those laws. That amount is not earned income for the EIC, even though you must include it in your gross income on your income tax return. Your earned income includes the entire amount you earned, even if part of it is treated as belonging to your spouse under your state's community property laws. • Conservation Reserve Program (CRP) • Nontaxable pay for members of the Armed Forces. • Disability insurance payments received from a disability insurance policy for which taxpayer paid the premiums for.

Adjusted Gross Income Limits Requirement. The adjusted gross income is important when calculating the Earn Income Tax Credit. Each filing status has a limit. It will also be important to know how many qualifying children taxpayer has. The following are the limits on adjusted gross income limits with up to three qualifying children.

The United States Treasury will compute the adjustments to these amounts based on the Chained Consumer Price Index for All Urban Consumers (C-CPI-U). The Tax Cuts and Jobs Act established this method for determining adjustments for the Earned Income Tax Credit and other tax provisions starting with tax year 2018.

ADJUSTED GROSS INCOME LIMITS FOR EACH FILING STATUS TO CLAIM THE EARN INCOME TAX CREDIT IN 2018		
Filing Status	**Number of qualifying Children**	**Adjusted Gross Income Limits**
• **Single** • **Head of household** • **Qualifying widow(er)**	Three or more qualifying children	The credit is eliminated when earned income reaches $49,194.
	Two qualifying children	The credit is eliminated when earned income reaches $45,802.
	One qualifying child	The credit is eliminated when earned income reaches $40,320
	No qualifying children	The credit is eliminated when earned income reaches $15,270
• **Married filing jointly**	Three or more qualifying children	The credit is eliminated when earned income reaches $54,884
	Two qualifying children	The credit is eliminated when earned income reaches $51,492
	One qualifying child	The credit is eliminated when earned income reaches $46,010
	No qualifying children	The credit is eliminated when earned income reaches $20,950

Qualifying Child Requirement. To claim the Earn Income Credit the child must have a valid Social Security Number (SSN). The child must be younger than taxpayer (except when child is permanently and total disable). There are other rules in order to claim a child to get the EIC. The rules for qualifying children for purpose of claiming the earned income credit are slightly different from the rules for dependents. Thus, it may be possible that a child qualifies as taxpayerôs dependent, but not for EIC; or might qualify taxpayer for EIC even though the non-custodial parent claims the dependent. Here are the qualifying children rules for the earned income credit:

- Relationship test,
- Age test,
- Residency test, and
- Joint return test.

Relationship Test: The child must be related to taxpayer by birth, marriage, adoption, or foster arrangement. The child can be the son, daughter, grandchild, niece, nephew, brother, sister, or eligible foster child of taxpayer. Adopted children are treated the same as children by birth. Foster children must be placed in care of taxpayer by an authorized placement agency.

Age Test: The child must be under age 19 at the end of 2018, or the child must be under age 24 and a full-time student. If taxpayer cares for a person who is totally and permanently disabled, the person can be claimed for the Earned Income Credit regardless of age.

Residency Test: The child must live with taxpayer for more than half the year in the United States. More than half a year means six months and a day. A child is considered to have lived with taxpayer if the child was born or died in the current tax year and lived with taxpayer the entire time he or she was alive. Temporary absences, including school, vacation, medical care, military service, or detention in a juvenile facility, can count as time lived with taxpayer. The residency test means that two people are not able to claim the same child for the Earned Income Credit.

The Tie-Breaker Rule. If the child is claimed by two or more persons in a calendar year, then the child will be the qualifying child of the parents first, and then the taxpayer with the highest adjusted gross income (AGI). If both of the child's parents claim the credit, the parent with whom the child resides the longest may claim the credit. If the child resides with both parents an equal amount of time, the parent with the highest AGI will claim the child for EIC.

The qualifying child cannot be used by more than one person to claim the EIC. If more than one person has the same qualifying child, they must decide who will take *all* of the following benefits associated with that qualifying child:

ÅThe childôs exemption
ÅThe child tax credit
ÅHead of household filing status
ÅThe credit for child and dependent care expense, and
ÅThe earned income credit.

They cannot ñmix and matchò individual benefits of claiming the child. For example, one person cannot claim the exemption for the child and the other claim the child tax credit.

Joint return test: The child claimed for the earned income credit cannot file a joint return with his or her spouse. One exception is if their joint return is solely a claim for refund and the couple does not take any deductions or credits on their jointly-filed tax return.

How to Figure the EIC In order to claim the Earn Income Credit, complete the Worksheet in the instructions for the forms 1040, A or EZ. If taxpayer has a qualifying child, complete Schedule EIC and attach it to the return.

- EIC Worksheet A. Use this Worksheet if taxpayer was not self-employed at any time in 2011 and is not a member of the clergy, a church employee who files Schedule SE, or a statutory employee filing Schedule C or C-EZ.

- EIC Worksheet B. This Worksheet is used for self-employed people or members of the clergy, church employees who files Schedule SE, or statutory employees filing Schedule C or C-EZ **Information of qualifying children is given to the IRS on Schedule EIC.**

To claim the Earn Income Credit use Schedule EIC and attached it to the income tax return (Form 1040 or 1040A)

SCHEDULE EIC
(Form 1040A or 1040)

Department of the Treasury
Internal Revenue Service (99)

Earned Income Credit
Qualifying Child Information

▶ Complete and attach to Form 1040A or 1040 only if you have a qualifying child.
▶ Go to *www.irs.gov/ScheduleEIC* for the latest information.

1040A 1040 EIC

OMB No. 1545-0074
2017
Attachment Sequence No. **43**

Name(s) shown on return | Your social security number

Before you begin:

- See the instructions for Form 1040A, lines 42a and 42b, or Form 1040, lines 66a and 66b, to make sure that (**a**) you can take the EIC, and (**b**) you have a qualifying child.
- Be sure the child's name on line 1 and social security number (SSN) on line 2 agree with the child's social security card. Otherwise, at the time we process your return, we may reduce or disallow your EIC. If the name or SSN on the child's social security card is not correct, call the Social Security Administration at 1-800-772-1213.

CAUTION

- *You can't claim the EIC for a child who didn't live with you for more than half of the year.*
- *If you take the EIC even though you are not eligible, you may not be allowed to take the credit for up to 10 years. See the instructions for details.*
- *It will take us longer to process your return and issue your refund if you do not fill in all lines that apply for each qualifying child.*

Qualifying Child Information	Child 1	Child 2	Child 3
1 **Child's name** If you have more than three qualifying children, you have to list only three to get the maximum credit.	First name Last name	First name Last name	First name Last name
2 **Child's SSN** The child must have an SSN as defined in			

Disallowance of EIC. Disallowance of EIC is usually due to math or clerical errors, reckless or intentional disregard of EIC rules, and fraud. If taxpayer has been disallowed for any reason other than a math or clerical error, then taxpayer must file Form 8862 before claiming EIC again.

If the IRS disallowed the EIC because of a math or a clerical error for any year after 1996, it is not necessary to file Form 8862 with the tax return.

If the IRS disallows the EIC due to reckless or intentional disregard of EIC rules, then the EIC cannot be claimed for two years after the disallowance. If the EIC has not been reduced or disallowed again for any reason other than math or clerical errors, and taxpayer has previously filed Form 8862 since disallowance, then it is not necessary to file Form 8862 again.

If taxpayer has been disallowed due to fraud, then the EIC cannot be claimed for 10 years after final determination that the EIC claim was due to fraud.

A person or couple will be disallowed EIC for two years if they claim EIC when not eligible and the IRS determines the "error is due to reckless or intentional disregard of the EIC rules." A

person or couple will be disallowed for ten years if they make a fraudulent claim. Form 8862 is required after this time period in order to be reinstated. However, this form is not required if EIC was reduced solely because of math or clerical error

EIC and Certain Welfare Benefits. Earned income credit has no effect on certain welfare benefits. Any refund received because of the EIC and any advance EIC payments received will not be considered income when determining whether the taxpayer is eligible for the following benefit programs, or how much they can receive from these programs. However, if the amounts received are not spent within a certain period of time, they may count as an asset (or resource) and affect their eligibility.

- Medicaid and supplemental security income (SSI).
- Food stamps.
- Low-income housing

EITC Due Diligence Requirements for Paid Preparers.

Paid practitioners filing returns or claiming refund involving the Earned Income Credit must meet due diligence requirements in determining if the taxpayer is eligible for, and the amount of, the EIC. Failure to do so could result in a penalty of $520 per failure.

Form 8867.

Form 8867, Paid Preparerôs Earned Income Credit Checklist, was designed to ensure that the paid preparer considered all the requirements necessary when preparing an EIC return. It contains 19 questions that paid preparers are expected to ask their clients when preparing their tax return. Paid tax preparers need to answer the questions covering EITC eligibility on the Form 8867 using clientôs information. The recommendation is to ask each question in language your client understands and ask probing questions of your client instead of question with a yes or no answer. For example, the question, ñIs the taxpayerôs filing status married filing separately?ò Do not let the client tell you his or her filing status. Paid tax preparers need to determine the client filing status and ask questions that get you to the correct answer.

There are four parts to the Form 8867:
Part I covers EITC eligibility requirements for all taxpayers.
Part II covers EITC eligibility requirements for taxpayers with a qualifying child.
Part III covers EITC eligibility requirements for taxpayers without a qualifying child.
Part IV covers the paid preparerôs due diligence requirements.

Review Questions Section 7

Read and answer the following review questions. The correct answers are found on the next page with an explanation to strengthen up your knowledge. Note: This is not part of your Final Test.

42. Which of the following statements is NOT true regarding the Child Tax Credit under the new Tax Cuts and Jobs Act?

a) The age for dependents who qualify for the Child Tax Credit was not modified.
b) The new Child Tax Credit amount under the new tax Act is applied retroactively for tax years prior to 2018; taxpayers who qualify for the extra amount should file an amended return.
c) The Child Tax Credit contains both a refundable portion and a nonrefundable portion as every year.
d) Taxpayers will continue to use the same Schedule 8812 to claim the refundable and nonrefundable portion of the Child Tax Credit.

43. Under the Tax Cuts and Jobs Act, taxpayers who want to claim the child tax credit must comply with one of the following requirements to claim the credit:

a) The child must be related to the taxpayer as son, daughter or grandchild.
b) The dependent can reside anywhere as long as taxpayer is providing economic support.
c) The dependent must have earned income.
d) None of the above.
e)

44. Under the new tax Act, taxpayers who have public assistant or unemployment benefits as their only source of income will be able to receive the following Child Tax Credit amount:

a) Only $1,000 since this is not earned income.
b) The complete $1,400 refund since they will not have income tax due.
c) They cannot receive any Child Tax Credit with unearned income.
d) They can qualify for up to $500 refundable Child Tax Credit.

45. Which of the following taxpayersô earned income amount will not be counted towards the refundable portion of the Child Tax Credit?

a) The refundable portion of the Child Tax Credit is based on the taxpayerôs complete earned income amount.
b) The refundable portion of the credit does not take into consideration the first $1,000 of earned income.
c) The refundable portion of the credit does not take into consideration the first $1,400 of earned income.
d) The refundable portion of the credit does not take into consideration the first $2,500 of earned income.

46. Daniel is a single taxpayer who will file his income tax claiming 3-year-old son as depended. Danielôs earned income for 2017 was $12,000. Letôs suppose he does not owe any income tax; he will qualify for the following amount of the Additional Child Tax Credit:

a) He will get $1,000 of the Additional Child Tax Credit as every year.
b) He will get $2,000 of Additional Child Tax Credit.
c) He will get $1,400 of Additional Child Tax Credit.
d) He does not qualify for any portion of the Child Tax Credit because he is single and the income is not enough.

47. Taxpayers with dependents age 17 or older will be able to get one of the following credits under the new tax Act:

a) They can claim the exemption deduction for dependents who do not qualify for the Child Tax Credit.
b) Taxpayers can claim a $500 refundable credit for dependents age 17 or older.
c) Taxpayers cannot claim any other credit besides the Child Tax Credit starting in 2018
d) Taxpayers can claim a non-refundable credit of $500 for dependents who are age 17 or older.

Questions Section – Answers and Discussion 1

42. **Answer B.** Beginning in 2018, up to $1,400 of the $2,000 Child Tax Credit can be refundable. If any part of the credit is left over after eliminating taxpayersô tax debt, the IRS will send a refund of up to $1,400 to taxpayers.

43. **Answer A.** The TCJA eliminates the dependent exemption itself, but retains the definition of dependent to claim the CTC and other child- or dependent-related tax benefits. For Child Tax Credit reform purposes, this will usually mean that the child must be related to the taxpayer in one of several ways (son, daughter, grandchild, etc.), must live in the taxpayerôs home more than half the year, and must not provide more than half of his or her own support. Special rules apply if the parents are divorced or legally separated.

44. **Answer C**. Taxpayers must have earned income, such as from a job or self-employment, to qualify for the refundable portion. Investment income will not count towards the credit. Other unearned income that will not qualify includes: unemployment benefits, public assistance, and workerôs compensation benefits.

45. **Answer D**. The TCJA says the refundable portion of the credit is *up to* $1,400. The credit is actually equal to 15 percent of taxpayersô earned income over $2,500. The first $2,500 does not count for the credit.

46. **Answer C**. A taxpayer would need earned income of approximately $12,000 a year to qualify for and receive the full $1,400 refund

47. **Answer D**. Taxpayers with qualifying dependents other than a child dependent who qualifies for the Child Tax Credit can get a nonrefundable $500. This credit is also known as the Family Credit.

IRS Regulation Concerning Form 8867.

The IRS requires any tax paid preparer to file a due diligence checklist, Form 8867, with any federal return claiming the Earned Income Tax Credit.

The IRS and Paid Preparers.

The IRS actually considers paid preparers to be partners in helping families claim the correct amount of EIC. The number of families that claim EIC is high, and the number of erroneous claims is also high. The IRS estimates an error rate of 23 to 28 percent, or $11 to $13 billion paid out in error.

In December 2008, new tax regulations were issued to provide additional guidance for the EICT due diligence ñknowledgeò requirement, setting a standard for its application and adding a documentation requirement. There are two specific changes:

1. A tax return preparer must make reasonable inquiries if a reasonable and well-informed tax return preparer, knowledgeable in the law would conclude that the information given to the return preparer appears to be incorrect, inconsistent or incomplete.
2. The tax return preparer must also document in their files the additional inquiries made as a result and their clientôs responses to these inquiries.

These changes require tax return preparers to:

- Evaluate the information received from the client
- Apply a consistency and reasonableness standard to the information received
- Ask additional questions when applicable
- Make reasonable inquiries if the information appears to be incorrect, inconstant or incomplete
- Document additional inquiries and the clientôs response

The IRS has cited the following examples of when additional questions may be necessary.

Example 1.

A 22 year-old taxpayer wants to claim two sons, ages 10 and 11, as qualifying children for purposes of the EIC. Preparer A must make additional reasonable inquiries regarding the relationship between the taxpayer and the children as the age of the taxpayer appears inconsistent with the ages of the children claimed as sons.

Example 2.

An 18 year-old female taxpayer with an infant has $3,000 in earned income and states that she lives with her parents. Taxpayer wants to claim the infant as a qualifying child for the EIC. This information appears incomplete and inconsistent because the taxpayer lives with her parents and earns very little income. Preparer B must make additional reasonable inquires to determine if the taxpayer is the qualifying child of her parents and, therefore, ineligible to claim the EIC.

Example 3.

Taxpayer asks Preparer C to prepare his tax return and wants to claim his niece and nephew as qualifying children for the EIC. Preparer C should make reasonable inquiries to determine whether the children meet EIC qualifying child requirements and ensure possible duplicate claim situations involving the parents or other relatives are properly considered.

Example 4.

Taxpayer asks Preparer D to prepare her tax return and tells D that she has a Schedule C business, that she has two qualifying children and that she wants to claim the EIC. Taxpayer indicates that she earned $10,000 from her Schedule C business, but that she has no expenses. This information appears incomplete because it is very unlikely that someone who is self-employed has no business expenses. D must make additional reasonable inquiries regarding taxpayerôs business to determine whether the information regarding both income and expenses is correct.

Common IRS Notices Regarding Earned Income Tax Credit

The notice number prints on the top right-hand side of each page of all the IRS notices and on the lower right-hand side of the tear-off stub included with most of them. That number identifies the message delivered in every notice. While the contents may vary somewhat, every notice with the same number has the same basic purpose.

- **CP09 Notice.** The IRS sends this notice because their records indicate that taxpayer may be eligible for the Earned Income Credit (EIC), but taxpayer did not claim it on the filed tax return.

- **CP10A Notice.** This notice indicates that the IRS has made a change(s) to your return because they believe there is a miscalculation involving your Earned Income Credit.

- **CP11A Notice.** The IRS sends this notice to inform you of the changes they have made to your return because they believe there is a miscalculation involving your Earned Income Credit. This notice normally indicates that as a result of the change you owe money on your taxes.

- **CP12A Notice.** The IRS has made changes to correct the Earned Income Credit (EIC) claimed on your tax return.

- **CP13A Notice.** This notice indicates that the IRS has made changes to your return because they found an error involving your Earned Income Credit. You are not due a refund nor do you owe an additional amount because of our changes. Your account balance is zero.

- **CP75 Notice.** This is an Audit Notice. The IRS is auditing your tax return. This notice requests the documentation to verify the Earned Income Credit (EIC) that you claimed. The Earned Income Credit and/or the Additional Child Tax Credit (ACTC) portion(s) of your refund is being held pending the results of the audit. You have to read the notice and the enclosed forms carefully. They explain the information you must send to the IRS. You have to provide copies of the documentation they request to verify the items being audited. Complete the response form by indicating which items your supporting documentation addresses and return the form with the documents you are submitting.

- **CP75A Notice.** The IRS is auditing your tax return and need documentation to verify the Earned Income Credit (EIC), dependent exemption(s) and filing status you claimed.

- **CP75C Notice.** You were banned from claiming the Earned Income Credit (EIC) in a prior tax year due to your intentional disregard of the rules or a fraudulent claim. Since your ban is still in effect, the IRS disallowed the EIC for your current tax year.

- **CP75D Notice.** The IRS is auditing your tax return and they need documentation to verify the income and withholding you reported on the tax return. This may affect your eligibility for the Earned Income Credit (EIC), dependent exemption(s) and other refundable credits that you claimed. The IRS will hold your refund pending the results of the audit.

Every year the Internal Revenue Service sends millions of letters and notices to taxpayers, but that does not mean you need to worry. Here are eight things every taxpayer should know about IRS notices.

1. Do not panic. Many of these letters can be dealt with simply actions and painlessly.
2. There are number of reasons the IRS sends notices to taxpayers. The notice may request payment of taxes, notify you of a change to your account or request additional information. The notice you receive normally covers a very specific issue about your account or tax return.
3. Each letter and notice offers specific instructions on what you need to do to satisfy the inquiry.
4. If you receive a correction notice, you should review the correspondence and compare it with the information on your return.
5. If you agree with the correction to your account, usually no reply is necessary unless a payment is due.
6. If you do not agree with the correction the IRS made, it is important that you respond as requested. Write to explain why you disagree. Include any documents and information you wish the IRS to consider, along with the bottom tear-off portion of the notice. Mail

the information to the IRS address shown in the lower left part of the notice. Allow at least 30 days for a response.

7. Most correspondence can be handled without calling or visiting an IRS office. However, if you have questions, call the telephone number in the upper right corner of the notice. Have a copy of your tax return and the correspondence available when you call.
8. Itôs important that you keep copies of any correspondence with your records.

CHILD & DISABLED DEPENDENT CARE CREDIT.

The Tax Cuts and Jobs Act did not make changes to this credit. If the taxpayer paid someone to care for a child under age 13 or a qualifying spouse or dependent so they could work or look for work, they may be able to reduce their tax by claiming the Child and Dependent Care Credit on their federal income tax return. To qualify, their spouse, children age 13 or older, and other dependents must be physically or mentally incapable of self-care. The credit is non-refundable and it is a percentage of the amount of work-related child and dependent care expenses the taxpayer paid to a care provider.

The credit varies from 35 to 20 percent of qualifying expenses, depending upon the taxpayerôs income. In addition, employer dependent care assistance programs allow employees to exclude from income certain payments expended for child and dependent care. Tax return reporting is done on Form 2441, Child and Dependent Care Expenses.

Earned Income Limit ï The expenses allowable in computing the credit are limited to earned income. Generally, only taxable compensation is included in earned income. A taxpayer can elect to include nontaxable combat pay in earned income for dependent care credit purposes even if he chooses not to include it in earned income for purposes of the earned income credit or the exclusion or deduction for dependent care benefits.

Computation and Credit Limits - The maximum expense limit is:
For one qualified person $3,000
For two OR MORE qualified people $6,000

Limitation May Be in Unequal Proportions - The total amount of employment-related expenses that do not exceed the annual dollar limitation may be taken into account although the amount of employment-related expenses attributable to one qualifying individual exceeds 50 percent of the limitation. For example, a taxpayer with expenses of $4,000 for one qualifying individual and $1,500 for a second qualifying individual may take into account the full $5,500. *(Reg. 1.21-2(a)(3))*

Limit reduced by employer-provided dependent care assistance plans - The limit must be reduced by the amount a taxpayer excludes from gross income under an employer-provided dependent care assistance plan. For taxpayers who file joint returns, the expense is limited to the EARNED INCOME of the lower paid spouse. Self-employed taxpayers use NET EARNINGS

on Schedule C as earned income, even if the net is less than $400. Self-employee individuals who choose the optional method to figure self-employment tax may use the imputed income figured for the optional method as the amount of earned income.

Tax year of credit - Regardless of the taxpayer's method of accounting, the credit is allowable only in the tax year the services are provided or the tax year the expenses are paid, whichever is later.

Credit Percentage ï The amount of Child and Dependent Care Credit that taxpayers can get is a percentage of their work-related child and dependent care expenses. The percentage depends on the adjusted gross income, and ranges from 35% to 20% of their costs, on a sliding scale. As income increases, the percentage decreases.

Child and Dependent Care Credit based in AGI and Care Cost	
Adjusted Gross Income	**Percentage of Costs**
0 - $15,000	35%
$15,001 - $43,000	34% - 21% (sliding scale)
over $43,000	20%

The person providing the care cannot be:

- The taxpayerôs spouse.
- The parent of the qualifying child under age 13.
- A person that the taxpayer can claim as a dependent.

If taxpayerôs child provides the care, he or she:

- Must be age 19 or older by the end of 2015.
- Cannot be the dependent of the taxpayer paying for the care.

Requirements for the Credit.

- **Principal Place of Abode** - A qualifying individual must have the same principal place of abode as the taxpayer for more than half of the tax year.

- **Qualifying Individual** - A ñqualifying individualò can be any of the following:

1. A qualifying child who is the taxpayerôs ***dependent and who is under age 13*** when care is provided;
2. The taxpayerôs spouse who was physically or mentally not able to care for himself or herself and lived with the taxpayer for more than half the year;
3. A person who was physically or mentally not able to care for himself or herself, lived with the taxpayer for more than half the year, and either:

a. Was the taxpayerôs dependent, or

b. Would have been the taxpayerôs dependent except that:

   i. He or she received gross income of $5000 or more,
   ii. He or she filed a joint return, or
   iii. The taxpayer, or the taxpayerôs spouse if filing jointly, could be claimed as a dependent on someone elseôs return.

4. The qualifying individualôs name and social security number are required to be shown on Form 2441.

Definition of marital status - The credit is not allowed for taxpayers who are married unless they file a joint return. Taxpayers who are separated under a decree of divorce or separate maintenance are not married for purposes of the child care credit.

Child of divorced or separated parents or parents living apart. Even if taxpayer cannot claim the child as a dependent, he or she is treated as the taxpayerôs qualifying person if:

- The child was under age 13 or was not physically or mentally able to care for himself or herself,
- The child received over half of his or her support during the calendar year from one or both parents who are divorced or legally separated under a decree of divorce or separate maintenance, are separated under a written separation agreement, or lived apart at all times during the last 6 months of the calendar year,
- The child was in the custody of one or both parents for more than half the year, and
- Taxpayer was the child's custodial parent.

The custodial parent is the parent with whom the child lived for the greater number of nights in the year. If the child was with each parent for an equal number of nights, the custodial parent is the parent with the higher adjusted gross income.

Qualifying Expenses - Expenses are employment-related only if they are incurred to enable the taxpayer to be gainfully employed, or actively searching for gainful employment, and the expenses are for household services or for the care of a qualifying individual.

- **School Expenses** ï Only school expenses for a child **below the level of kindergarten** are for the care of a qualifying individual, and may be employment-related.

- **Day Camp** - Expenses for day camp may be for the care of a qualifying individual, even if the camp specializes in a particular activity. Additionally, the cost of transportation provided by a dependent care provider may be an employment-related expense.

- **Part-Time Employment** - Taxpayers who work part-time must allocate expenses between days worked and days not worked. However, if a taxpayer who works part-time is required to pay for dependent care on a periodic basis that includes days worked and days not worked, the taxpayer is not required to allocate the expenses.

- **Payments to related individuals** - *A* credit is not allowed for any amount paid by the taxpayer to the taxpayer's spouse or the parent of the taxpayer's child who is a qualifying individual.

- **Agency and Application Fees** - The regulations clarify that indirect expenses such as application and agency fees may be employment-related expenses if the taxpayer is required to pay the expenses to obtain the care. Forfeited deposits do not qualify. *(Reg. Sec. 1.21-1(d)(11))*

Special Situations

- **Summer School, Day Camp**

  - Costs of summer school and tutoring programs are not qualifying employment-related expenses because they are educational in nature.
  - The rule that a dependent care center must comply with applicable state and local laws also applies to a day camp where more than six persons are cared for in return for a fee.
  - A day camp or similar program may constitute a qualifying employment related expense, even though the camp specializes in a particular activity, such as soccer or computers.
  - The full amount paid for an education day camp that focuses on reading, math, writing, and study skills may be a qualifying expense.
  - No portion of the cost of an overnight camp is an employment related expense.

- **Care Centers for Sick Children –** The IRS declined, in final regulations, to specify to be determined on a case-by-case basis as whether the expenses would be that payments to sick care centers were a qualifying expense. Instead, the matter is employment qualifying or a medical expense.

- **Absence from Work -** Generally, a taxpayer must allocate the cost of care on a daily basis if expenses are paid during a period in which a taxpayer is not employed or in active search of employment, but there is an exception for short, temporary absences. The final regulations eliminate the requirement that the temporary absence exception only applies to taxpayers who pay for care on a weekly, monthly, or annual basis.

  - Only those costs that a taxpayer is required to pay during the absence (e.g., while ill or on vacation) qualify for the exception.
  - A safe harbor for a short temporary absence is an absence of no more than two consecutive calendar weeks.
  - Cost of care while a taxpayer is on short- or long-term disability leave under the Family Medical Leave Act, paid medical leave, or paid maternity leave are not employment-related expenses.

- **Shift Workers** - Costs of overnight care and day care for parents who work at night and sleep during the day may be qualifying expenses.

- **Kindergarten Expenses -** Kindergarten is considered a non-qualifying educational cost regardless of whether a child attends part-time or full-time. Similarly, qualifying expenses do not include the cost of sending a child to a private school even though the taxpayer lives overseas in a place where public education is unavailable.

- **Live-In Caregivers –** The increase in the cost of utilities attributable to providing room and board to a caregiver may constitute a qualifying expense.

- **Care Outside the Home** - Costs for care outside the taxpayer's household of a qualifying individual who is a dependent or spouse incapable of self-care who regularly spends at least eight hours each day in the taxpayer's household may qualify for the credit.

- **Disabled Or Full-Time Spouse -** There are special ñearned incomeò allowances for months when the taxpayer or spouse is disabled or a full-time student (See table below). For each month or part of a month that the spouse was a student or was disabled, he or she is considered to have worked and earned income. His or her earned income for each month is considered to be at least $250 ($500 if more than one qualifying person was cared for). If taxpayerôs spouse also worked during that month, use the higher of $250 (or $500) or his or her actual earned income for that month. If, in the same month, both taxpayer and spouse were either students or disabled, only one of them can be treated as having earned income in that month.

"Earned Income" for Disabled or Full-time student spouse when claiming the Child and Dependent Credit		
Qualifying persons	One	Two
Imputed Income	$250	$500

- **Students at On-Line Institutions** ï In the case of a married taxpayer student the cost of child care while studying on-line at home is NOT a qualified expense for purposes of the deemed income rule. The statute requires that the educational organization have students in attendance at the place where its educational activities are regularly carried on. However, an individual who takes online courses at a school that has traditional classroom instruction as well as on-line course may be a student for purposes of the deemed earned income rule.

Provider Information - Taxpayers claiming this credit must provide the name, address, and identification number of the childcare provider unless the provider is a tax exempt organization (e.g., a church). If the latter, the notation ñtax-exemptò is made on the return instead of the ID number. The IRS may deny the credit when this information is not included on a return. ***Failure of a childcare provider to furnish an ID number to a taxpayer without reasonable cause is subject to a $50 penalty. (Code Section 6109(a))***

Failure to provide the required information on a return can be excused if the taxpayer showed ñdue diligence.ò Due diligence is shown by keeping on file a copy of a providerôs social security card, driverôs license, providerôs letterhead or invoice, IRS Form W-10 (Dependent Care Providerôs Identification and Certification), Form W-4 (if provider is a household employee), or a statement of employerôs dependent care assistance program.

Dependent Care Benefits:

Employer Programs **-** Dependent care assistance programs are those that employers establish by a written plan to provide dependent care assistance for the exclusive benefit of employees. The payments received under the plan and used by employees to pay dependent care expenses are excludable from employeesô income up to the lower of:

1. The employeeôs earned income (for married employees, this is the earned income of the lower paid spouse), or
2. $5,000 ($2,500 for married separate).

Dependent care assistance which exceeds the limits must be included in an employeeôs income in the year the dependent care is provided even though it is not paid to the employee until later.

Dependent care benefits include paid leaves for dependent care, child and dependent care tax credits and dependent care flexible spending accounts. For dependent care benefits to be available to an individual, the dependent must be a natural or adopted child and the parent pay more than fifty percent of his expenses. This is also applicable to a child of which a person has legal guardianship.

Other Rules:

1. Compute the earned income limitation of a spouse who is incapacitated or a full-time student in the same manner as is done under the childcare credit rules.
2. When dependent care is provided in-kind on the employerôs premises at a facility maintained by the employer, employees using the facility exclude from income the value of the services provided.
3. There is no dependent care assistance exclusion where the care provider is the employeeôs dependent and/or child under age 19.

Who Is An Employee **-** For purposes of the exclusion, the term employee includes self-employed individuals (as defined in Code Section 401(c)(1)).

Self-employed individuals as "employees" eligible for the dependent care assistance exclusion - An ñemployee,ò for purposes of the dependent care assistance exclusion, includes a self-employed individual who can be covered under a self-employed retirement plan under Code Sec. 401(c)(1).

***W-2 Reporting of Dependent Care Exclusion Amounts* -** Form W-2, Box 10 shows the amount of dependent care benefits paid by the employer. The amount should not be included in Box 1 (Wages).

Mortgage Interest Credit. Taxpayers can qualify for the mortgage interest credit. This credit is separate from the mortgage interest paid reported on Form 1098 and deducted on Schedule A. The mortgage interest credit is taken by taxpayers using Form 8396. In order to take this credit,

taxpayers must have a Qualified Mortgage Credit Certificates (MCC) issued by state or local governmental units or agencies. The certificate credit rate is shown on the certificate.

Taxpayers can claim the mortgage interest credit if both of these are true:

- They have a qualified mortgage credit certificate (MCC).
- The certificate was issued by the state or local government or agency under a qualified MCC program.

To figure the corresponding credit, use Form 8396: Mortgage Interest Credit. To avoid double benefits, taxpayers must subtract the amount of this credit from their mortgage interest deduction if both of the following apply:

- Taxpayers claim the Mortgage Interest Credit.
- The same taxpayers itemize their deductions using their Form 1098 Mortgage Interest.

The home that the Certificate is issued for must be in the same jurisdiction as the issuing agency, and must also be the taxpayersô main residence.

Some mortgage credit certificates, mostly those issued by the federal government or federal agencies, may not qualify for the Mortgage Interest Credit. If a mortgage is refinanced then the MCC must be reissued, and homeowners who sell their residence within nine years may have to repay some of the credit issued.

Review Questions Section 7

Read and answer the following review questions. The correct answers are found on the next page with an explanation to strengthen up your knowledge.

42. If the taxpayer had their earned income credit denied for a reason other than a math or clerical error, they_____.
    a) Can claim the credit as usual if they are eligible
    b) Cannot claim the credit for the next two tax years
    c) Cannot claim the credit for the next ten tax years
    d) Must attach a completed Form 8862 to their tax return to claim the credit

43. Which of the following is false regarding Preparer Due Diligence & the EITC?
    a) A preparer may be fined $500 for each failure to use due diligence.
    b) A preparer must complete Form 8867 with the information collected from taxpayer.
    c) A preparer can prepare a return based solely on the clientôs information, even if he/she has reason to believe the information is incorrect.
    d) The preparer must retain records for 3 years after the June 30th following the date the return or claim was presented for signature.

44. When claiming the Earned Income Tax Credit for a self-employed individual, one of the following is required in order to comply with the due diligence requirements:
   a) Tax professionals must determine that the net self-employment income is correct.
   b) Tax professionals must determine that the net self-employment income is complete.
   c) Tax professionals must make additional inquiries and the taxpayerôs responses must be documented.
   d) All of the above.

45. What of the following are the common issues found on self-employed taxpayers claiming the Earned Income Tax Credit:
   a) The income on Schedule C is in round numbers.
   b) The expenses expected for the business are not included.
   c) Schedule C with income that gives taxpayers the maximum EITC
   d) All of the above

46. The adoption and adoption assistant program is an amount that:
   a) Is given as a tax refund.
   b) Is given as a nonrefundable tax credit.
   c) Is always included in income.
   d) Is taxable for taxpayer.

47. The child and dependent care credit is given to:
   a) All taxpayers with qualifying child.
   b) All taxpayers that did not get the Child Tax Credit.
   c) Taxpayers that work and paid someone to take care of their child.
   d) Taxpayers that paid to someone to take care of their child while they rest.

48. The mortgage interest credit has one of the following tax benefits:
   a) The credit is the same as the mortgage interest paid and reported on Form 1098.
   b) The credit is taken on Schedule A.
   c) The credit is a refundable tax credit.
   d) The credit is taken on Form 8396 and reduces any other mortgage interest deduction taken on Schedule A.

Questions Section 7 – Answers and Discussion

42. **Answer d**. Disallowance of EIC is usually due to math or clerical errors, reckless or intentional disregard of EIC rules, and fraud. If taxpayer has been disallowed for any reason other than a math or clerical error, then taxpayer must file Form 8862 before claiming EIC again.

43. **Answer c**. If the IRS examines the EITC claims received by a tax preparer and find that he/she did not meet all four due diligence requirements, the tax preparer can get a $500 penalty for each failure to comply with EITC due diligence requirements. Tax preparers must complete Form 8867, *Paid Preparer's Earned Income Credit Checklist*, with the

information provided by taxpayer to make sure all the EITC eligibility criteria is considered for each claim prepared. Tax preparer must keep these records for 3 years.

44. **Answer d**. Tax return preparers should always demonstrate due diligence when preparing returns. Paid tax return preparers generally can rely on the taxpayers' representations, but EITC due diligence requires the paid preparer to take additional steps to determine that the net self-employment income used to calculate the amount of or eligibility for EITC is correct and complete.

45. **Answer d**. *Some issues about Schedule C***.** Tax preparers may find the following issues when claiming the EITC for a Self-employed taxpayer:

- Schedule C income in round numbers, Schedule C cash businesses as the only income on a return claiming EITC, Schedule C with little or no expenses when expenses would be expected.

46. **Answer b**. The taxpayer may be able to take a nonrefundable tax credit for qualifying expenses paid to adopt an eligible child (including a child with special needs). Taxpayers can also benefit from the exclusion of an employer-provided adoption assistant. The adoption credit is an amount subtracted from their tax liability.

47. **Answer c**. If the taxpayer paid someone to care for a child under age 13 or a qualifying spouse or dependent so they could work or look for work, they may be able to reduce their tax by claiming the Child and Dependent Care Credit on their federal income tax return.

48. **Answer d**. Taxpayers can qualify for the mortgage interest credit. This credit is separate from the mortgage interest paid reported on Form 1098 and deducted on Schedule A. The mortgage interest credit is taken by taxpayers using Form 8396.

TAX BENEFITS FOR EDUCATION

There is a variety of tax credits, deductions and savings plans available to taxpayers to assist with the expense of higher education. Most of these benefits apply only to higher educational expenses. The types of tax benefits available include the following (not all will be discussed in this chapter):

- The American opportunity credit.
- The Hope credit and the lifetime learning credit.
- The deduction for student loan interest paid.
- The deduction for tuition and fees paid.
- The Coverdell education savings account (ESA).
- A qualified tuition program (QTP).
- An exception to the penalty on early withdrawal from an IRA for educational expenses.
- Tax-free treatment of a canceled student loan.
- Tax-free student loan repayment assistance.
- Tax-free interest from savings bonds.
- Tax-free employer paid educational expenses.
- Miscellaneous itemized deduction for work-related educational expenses.

Scholarships and fellowships. A candidate for a degree can exclude amounts received as a qualified scholarship or fellowship. A qualified scholarship or fellowship is any amount received for:

- Tuition and fees; or
- Fees, books, supplies and equipment required for courses at the school.

Amounts received for room and board are generally not conceded to be excludible from income.

Grants, scholarships and fellowships. There is very little difference in practice, and the terms are sometimes used interchangeably. There are a few minor technical distinctions. Grants are the most inclusive, representing any grant of money in exchange for a prescribed purpose. Scholarships usually refer to grants in support of undergraduate education, and fellowships usually refer to grants in support of post-baccalaureate projects, or to pre-baccalaureate projects pursued outside the normal curriculum. All scholarships and fellowships are grants. Grants, scholarships, and fellowships do not need to be repaid.

A scholarship or fellowship grant is tax free only to the extent:

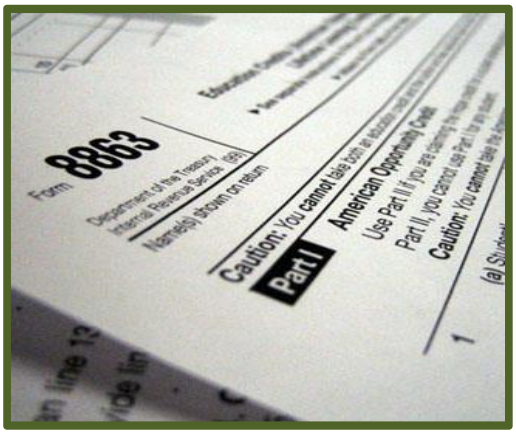
- It does not exceed the qualifying student qualified education expenses;
- It is not designated or earmarked for other purposes (such as room and board), and does not require (by its terms) that it cannot be used for qualified education expenses; and

- It does not represent payment for teaching, research, or other services required as a condition for receiving the scholarship.

Taxpayers will be considered a candidate for a degree if:

1. They attend a primary or secondary school or are pursuing a degree at a college or university, or
2. Attend an educational institution that:
    a. Provides a program that is acceptable for full credit toward a bachelor's or higher degree, or offers a program of training to prepare students for gainful employment in a recognized occupation; and
    b. Is authorized under federal or state law to provide such a program and is accredited by a nationally recognized accreditation agency.

Overview of Tax Benefits for Education.



Two federal tax credits may help taxpayers offset the costs of higher education for themselves, their dependents or spouse. These tax education credits are:

- The American Opportunity Credit, and
- The Lifetime Learning Credit.

Requirements. To qualify for either credit, taxpayers must pay postsecondary tuition and fees for themselves, dependents or spouse. The credit may be claimed by either the parent or the student, but not both. If the student was claimed as a dependent, the student cannot file to take the credit.

Credits available. For each student, taxpayers may claim only one of the existing credits in a single tax year. Taxpayers cannot claim the American Opportunity Credit to pay for part of their dependentôs tuition and then claim the Lifetime Learning Credit.

However, if taxpayers pay college expenses for two or more students in the same year, they can choose to take credits on a per-student, per-year basis. Taxpayers can claim the American Opportunity Credit for the sophomore dependent and the Lifetime Learning Credit for the graduated student.

Alternatives. Taxpayers that do not qualify for these education credits may qualify for the tuition and fees deduction, which can reduce the amount of their income subject to tax by up to $4,000. However, taxpayers cannot claim the tuition and fees tax deduction in the same year that they claim the American Opportunity Tax Credit or the Lifetime Learning Credit. Taxpayers must choose to either take the credit or the deduction and should consider which is more beneficial for them.

Form **8863**

Department of the Treasury
Internal Revenue Service (99)

Education Credits
(American Opportunity and Lifetime Learning Credits)

▶ Attach to Form 1040.
▶ Go to *www.irs.gov/Form8863* for instructions and the latest information.

OMB No. 1545-0074

2018

Attachment Sequence No. 50

Name(s) shown on return | Your social security number

CAUTION *Complete a separate Part III on page 2 for each student for whom you're claiming either credit before you complete Parts I and II.*

Part I **Refundable American Opportunity Credit**

1 After completing Part III for each student, enter the total of all amounts from all Parts III, line 30 . . . 1

2 Enter: $180,000 if married filing jointly; $90,000 if single, head of household, or qualifying widow(er) . . . 2

3 Enter the amount from Form 1040, line 7. If you're filing Form 2555, 2555

SCHEDULE 3
(Form 1040)

Department of the Treasury
Internal Revenue Service

Nonrefundable Credits

▶ Attach to Form 1040.
▶ Go to *www.irs.gov/Form1040* for instructions and the latest information.

OMB No. 1545-0074

2018

Attachment Sequence No. 03

Name(s) shown on Form 1040 | Your social security number

Nonrefundable Credits	48	Foreign tax credit. Attach Form 1116 if required	48	
	49	Credit for child and dependent care expenses. Attach Form 2441	49	
	50	Education credits from Form 8863, line 19	50	
	51	Retirement savings contributions credit. Attach Form 8880	51	
	52	Reserved	52	
	53	Residential energy credit. Attach Form 5695	53	
	54	Other credits from Form a ☐ 3800 b ☐ 8801 c ☐	54	
	55	Add the amounts in the far right column. Enter here and include on Form 1040, line 12	55	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71480G Schedule 3 (Form 1040) 2018

EDUCATION CREDITS

Remember that these credits reduce the tax itself dollar for dollar as opposed to a deduction, which reduces taxable income. There are two education credits available:

- The lifetime learning credit, and
- The American opportunity tax credit.

These credits apply only to expenses paid for higher educational expenses. The lifetime credit is nonrefundable; the American opportunity credit may be partially refundable.

Previous to the American Opportunity was the Hope Credit.

The Hope credit generally applies to 2008 and earlier tax years. It helps parents and students pay for post-secondary education. The Hope credit was a nonrefundable credit. This means that it can reduce your tax to zero, but if the credit is more than your tax the excess was not refundable. The Hope credit was limited by taxpayersô income.

The Hope credit was for payments of the first two years of tuition and related expenses (i.e. student activity fees, course-related books, course-related supplies and equipment) for an eligible student for whom the taxpayer claims an exemption on the tax return.

The Hope credit targeted the first two years of post-secondary education, and an eligible student must be enrolled at least half time. The Hope credit was modified to create the American Opportunity Credit.

The American Opportunity Credit (AOC).

The American opportunity credit originally modified the existing Hope. The American Opportunity Credit was created on 2009 making the benefits available to a broader range of taxpayers, including many taxpayers with higher incomes and those who owe no tax.

The also adds required course materials to the list of qualifying expenses and allows the credit to be claimed for four post-secondary education. Where the Hope credit only applied to the first two years of post-secondary education, the American Opportunity credit is available for four years of college, and the maximum credit per student increases to $2,500. The American Opportunity credit equals 100% of the first $2,000 of qualified post-secondary education expenses plus 25% of the next $2,000 (assuming the phase-out rule doesnôt affect taxpayer). So the maximum annual credit is $2,500.

Benefits of the AOC. Generally, taxpayers can claim the American opportunity credit if all four of the following requirements are met.

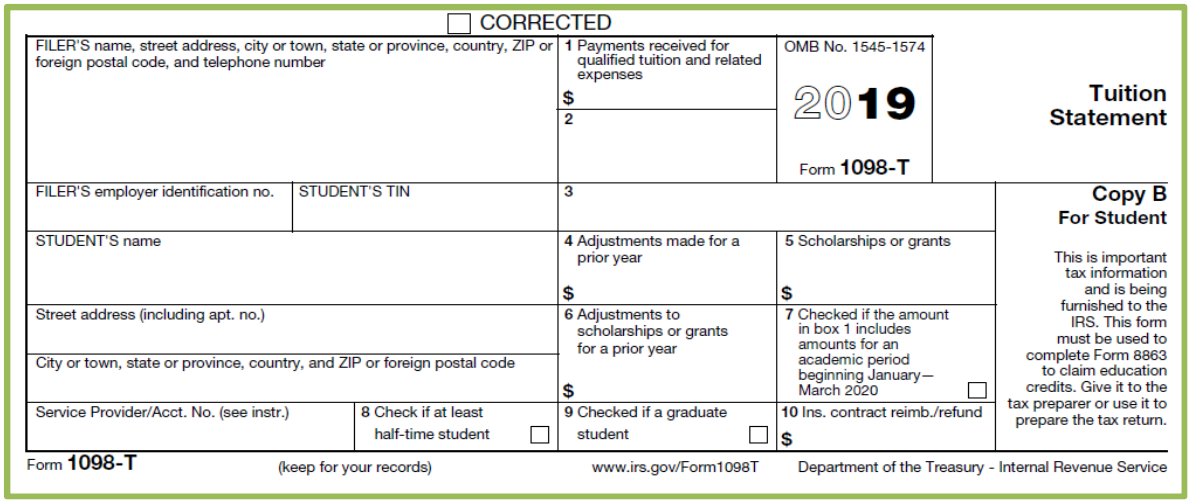
- Taxpayers pay qualified education expenses of higher education.
- Taxpayers pay the education expenses for an eligible student.
- Taxpayers can claim the exemption for the person who is taking the credit. It could be taxpayers themselves, dependents or spouse.

Qualified Expenses. Qualified expenses for the education tax credits include tuition and required fees for the enrollment or attendance at an eligible post-secondary educational institution. To be creditable, the expenses paid during a taxable year must relate to

1. An academic period that begins in the same taxable year; or
2. An academic period that begins in the first three months of the following taxable year.

For the American opportunity tax credit, qualified expenses have been expanded to include expenditures for course materials, as well as tuition and required fees. For this purpose, the term "course materials" means books, supplies and equipment needed for a course of study whether or not the materials are purchased from the educational institution as a condition of enrollment or attendance. Some or all of these expenses will be recorded on Form 1098-T, Tuition Statement. The student should receive a Form 1098-T from the educational institution that the student attended. If the student does not receive a Form 1098-T, the student should contact the educational institution and request the form.

Form 1098-T. Educational institutions are required to file a Form 1098-T, Tuition Statement, to the IRS and give a copy to the enrolled students. A reportable transaction includes payments received, amounts billed or refunds made for tuition and related expenses.


☐ CORRECTED

FILER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone number		1 Payments received for qualified tuition and related expenses $	OMB No. 1545-1574 2019 Form 1098-T Tuition Statement
		2	
FILER'S employer identification no.	STUDENT'S TIN	3	Copy B For Student
STUDENT'S name		4 Adjustments made for a prior year $	5 Scholarships or grants $
Street address (including apt. no.)		6 Adjustments to scholarships or grants for a prior year $	7 Checked if the amount in box 1 includes amounts for an academic period beginning January—March 2020 ☐
City or town, state or province, country, and ZIP or foreign postal code			
Service Provider/Acct. No. (see instr.)	8 Check if at least half-time student ☐	9 Checked if a graduate student ☐	10 Ins. contract reimb./refund $

This is important tax information and is being furnished to the IRS. This form must be used to complete Form 8863 to claim education credits. Give it to the tax preparer or use it to prepare the tax return.

Form 1098-T (keep for your records) www.irs.gov/Form1098T Department of the Treasury - Internal Revenue Service

Form 1098-T will be accurately prepared if the educational institution addressed boxes 8 and 9. Note that box 8 will be checked if the student was enrolled at least half-time and box 9 will be checked if the student was enrolled as a graduate student. There are some exceptions where an educational institution is not required to file and provide the Form 1098-T. These exceptions include:

- Courses for which no academic credit is offered, even if the student is otherwise enrolled in a degree program.
- Nonresident alien students, unless the student requests the institution to file Form 1098-T.
- Students whose tuition and related expenses are waived entirely or paid entirely with scholarships or grants.
- Students whose tuition and related expenses are covered by a formal billing arrangement with the studentôs employer or a government agency such as the Department of Veterans Affairs or the Department of Defense.

Student qualifications. Generally, an eligible student can be the taxpayer and spouse and their dependents that are enrolled at an eligible educational institution for at least one academic period (semester, trimester, quarter) during the year. The dependent is any person for whom the taxpayer claims a dependency exemption. It generally includes the taxpayerôs qualified child who is under age 19 or who is a full-time student under age 24. The student must also meet ***all*** of the following requirements.

- The student had not completed the first 4 years of postsecondary education before the tax year of the credit (generally, the freshman through senior years of college), as determined by the eligible educational institution. For this purpose, do not include academic credit awarded solely because of the student's performance on proficiency examinations.

- For at least one ***academic period*** beginning in the tax year of the credit, was ***enrolled at least half-time*** in a program leading to a degree, certificate, or other recognized educational credential.
- An eligible student is one that has no felony drug conviction. Having no felony drug conviction means the student has not been convicted of a Federal or state felony offense for possession or distribution of a controlled substance as of the end of the taxable year for which the credit is claimed

Allowance Period. The American Opportunity credit is allowed with respect to qualified tuition and related (QT&R) expenses paid for **the first four years of the student's post-secondary education** in a degree or certificate program, if the student has not completed the first four years of post-secondary education before the beginning of the fourth tax year. And, for each eligible student, the American Opportunity credit may be claimed for four tax years (Code Sec 25A(i)(2)). This is true even if a taxpayer had claimed the Hope credit in prior years.

Dependent expenses. If there are qualified education expenses for the dependents during a tax year, either taxpayers or the dependent, but not both, can claim the American opportunity credit.

Taxpayers that want to claim the American Opportunity Credit for their dependents, they must also claim an exemption for their dependent.

Who can claim your Dependent expenses	
If this applies	**Then…**
If taxpayers claim an exemption on their tax return for a dependent who is an eligible student	They can claim the American opportunity credit based on that dependent's expenses. The dependent cannot claim the credit.
If taxpayers do **not** claim an exemption on their tax return for a dependent who is an eligible student (even if entitled to the exemption)	The dependent can claim the American opportunity credit. Taxpayers cannot claim the credit based on this dependent's expenses.

Expenses paid by dependent. If taxpayers claim an exemption on their tax return for an eligible student who is also their dependent, treat any expenses paid (or deemed paid) by the dependent as if taxpayers had paid them. Include these expenses when figuring the amount of the American opportunity credit.

Expenses that do not qualify for the AOC. The following expenses do not qualify for the American Opportunity Credit:

- Room and board.
- Transportation.
- Insurance.
- Medical expenses.
- Student fees unless required as a condition of enrollment or attendance.

- Same expenses paid with tax-free educational assistance.
- Same expenses used for any other tax deduction, credit or educational benefit.

Taxpayers that paid for qualified educational expenses with certain tax-free funds, such as a tax-free scholarship, Pell grant, VA education assistance, employer provided educational assistance, etc., cannot claim the American Opportunity credit using those assisted payments. The educational expenses must be reduced by any of the above assistance payments before calculating the credit. However, if taxpayers pay with funds received as a tax-free gift, loan or inheritance, the expenses will still qualify for the credit.

Who cannot take the credit? Taxpayers cannot claim the American opportunity credit if any of the following applies:

- Taxpayers filing status is married filing separately.
- Taxpayers are listed as a dependent on another person's tax return (such as their parents').
- Taxpayers (or your spouse) were a nonresident alien for any part of the year and the nonresident alien did not elect to be treated as a resident alien for tax purposes.
- Taxpayers claim the lifetime learning credit or a tuition and fees deduction for the same student in the same year.

Benefits of the American Opportunity Credit
The credit can be up to $2,500 per eligible student. It is available for the first four years of postsecondary education.
Forty percent of the credit is refundable, which means that taxpayers may be able to receive up to $1,000, even if they owe no taxes.
Taxpayers can claim the education tax credit by completing Form 8863, Education Credits, and attaching it to Form 1040 or 1040A.

Rules for taxpayers under age 24. If taxpayers were under age 24 at the end of the tax year in question and the conditions listed below apply to them, they cannot claim any part of the American opportunity credit as a refundable credit on their tax return. Instead, their allowed credit will be used to reduce their tax as a nonrefundable credit only.

Taxpayers do not qualify for a refund if all of the following apply to them:

1. Taxpayers are:
   a) Under age 18 at the end of the tax year that will be claimed, or
   b) Age 18 at the end of the tax year in question and their earned income was less than one-half of their own support, or
   c) Over age 18 and under age 24 at the end of the tax year in question and a full time student and their earned income was less than one-half of your support.
2. At least one of the parents was alive at the end of the year.
3. They are not filing a joint return.

Earned Income for the AOC credit**.** Examples of earned income include wages, salaries, tips, and other taxable employee pay; net earnings from self-employment; and gross income received as a statutory employee. Statutory employees include full-time life insurance agents, certain agent or commission drivers and traveling salespersons, and certain homeworkers.

Full-time student for the AOC credit. The student will be considered a full-time student for the year if during any part of any 5 calendar months during the year they were enrolled as a full-time student at an eligible educational institution, or took a full-time, on-farm training course given by an institution or by a state, county, or local government agency.

Eligible Educational Institutions**.** An eligible educational institution is generally any accredited public, nonprofit, or proprietary (private) college, university, vocational school, or other postsecondary institution. In addition, the institution must be eligible to participate in a student aid program administered by the Department of Education. Virtually all accredited postsecondary institutions meet this definition.

Determining the Amount of the American Opportunity Credit. Allowed on a per-eligible-student basis, the American Opportunity Credit equals the sum of:

a) 100% of the first $2,000 of each eligible studentôs qualified tuition and related (QT&R) expenses **plus**
b) 25% of the next $2,000, of that studentôs QT&R expenses.

The maximum amount of the credit that the taxpayer can claim is $2,500 times the number of eligible students.

Example. Juan and Sabrina are married and file a joint tax return. For 2018, they claim an exemption for their dependent daughter on their tax return. Their MAGI is $70,000. Their daughter is in her junior (third) year of studies at the local university. Juan and Sabrina paid qualified education expenses of $4,300 in 2018.

Since all of them meet all of the requirements for the American opportunity credit. Juan and Sabrina can claim a $2,500 American opportunity credit in 2018. This is 100% of the first $2,000 of qualified education expenses, plus 25% of the next $2,000.

Credit Phase-Out Provisions. For higher-income taxpayers, this credit begins to phase out for modified AGI (MAGI) in excess of $80,000 ($160,000 for married couples filing jointly. The phase-out amounts are not inflation-indexed. MAGI is the taxpayerôs regular AGI increased by: Foreign earned income and housing exclusion and housing deduction (§911), amounts excluded by taxpayer from sources in American Samoa (§931), and amounts excluded by taxpayer from sources in Puerto Rico (§933).

American Opportunity Credit Phase-Out 2018 compared with 2019				
	2018 Phase-Out Begins	**2018 Phase-Out Complete**	**2019 Phase-Out Begins**	**2019 Phase-Out Complete**
Married filing jointly	$160,000	$180,000	$160,000	$180,000
Single	$80,000	$90,000	$80,000	$90,000
Head of household	$80,000	$90,000	$80,000	$90,000
Married filing separately	N/A	N/A	N/A	N/A

Portion of the Credit is Refundable. 40% of the credit (after application of the phase-out limitation) is refundable (Code Sec 25A(i)(5)).

Example – Refundable Portion of AOTC*: Faith is eligible for a $2,500 AOTC and his MAGI is below the phase-out threshold. Her maximum refundable portion of AOTC is $1,000 ($2,500 x .4). Her tax liability is $1,900. After first using the credit to offset her tax liability, she has $600 of credit remaining ($2,500 – 1,900). She is entitled to a refundable credit of $600, the lesser of the maximum portion of the credit that could be refunded ($1,000) or the balance of the credit left after reducing his regular tax to zero. If Faith's tax had been $1,300, she would have $1,200 of credit left after offsetting his tax ($2,500 – 1,300). But she could only claim a refund of $1,000 of the remaining credit.*

Example – Refundable Portion of AOTC*: Brandon and Cara are married and file a joint return. They are eligible for a $2,500 AOTC, and their modified AGI is $170,000, which exceeds the phase-out threshold, so they must reduce their AOTC by 50% ((170,000 - $160,000)/$20,000) to $1,250. Therefore, the maximum refundable portion of their AOTC would be $500 ($1,250 x .4).*

Claiming the AOC on Form 8863. To claim the credit, Parts I and III of Form 8863, *Education Credits (American Opportunity and Lifetime Learning Credits)* must be completed and include the form with the tax return.

If taxpayers receive a refund of the qualified expenses before filing their tax return for that year, they must reduce the amount of qualified expenses by the amount refunded. However, if taxpayers receive a refund of qualified fees paid after filing their tax return for the year, they may have to recapture or pay back some of the credit claimed. For more information, get IRS Publication 970, Tax Benefits of Higher Education.

THE LIFETIME LEARNING CREDIT

The lifetime learning credit helps parents and students pay for post-secondary education. Taxpayers can claim the lifetime learning credit of up to $2,000 for qualified education expenses paid for all students enrolled in eligible educational institutions. There is no limit on the number of years that the lifetime learning credit can be claimed for each student. However, a taxpayer cannot claim both the American opportunity credit and lifetime learning credits for the same student in one year. Thus, the lifetime learning credit may be particularly helpful to graduate students, students who are only taking one course and those who are not pursuing a degree.

Amount of Credit. The amount of the credit is 20% of the total qualified expenses for all eligible students on the tax return. The maximum amount of expenses allowed per tax return is $10,000; the maximum amount of the credit is $2,000 per return. The Lifetime Learning Credit is a nonrefundable tax credit. This means that it can reduce the tax to zero, but the exceeding credit will not be refundable.

Who can claim the lifetime learning credit? Generally, taxpayers can claim the lifetime learning credit if all three of the following requirements are met:

- They pay qualified education expenses of higher education.
- They pay the education expenses for an eligible student.
- The eligible student is the taxpayerôs dependent, spouse or him/herself.

If taxpayers are eligible to claim the lifetime learning credit and also the American opportunity credit for the same student in the same year, they can choose to claim either credit, but not both.

If taxpayers pay qualified education expenses for more than one student in the same year, they can choose to take credits on a per-student, per-year basis. This means that, for example, they can claim the Hope or American opportunity credit for one student and the lifetime learning credit for another student in the same year.

Alternatives to the Lifetime Learning Credit. Taxpayers that do not qualify for these education credits may qualify for the tuition and fees deduction, which can reduce the amount of their income subject to tax by up to $4,000. However, taxpayers cannot claim the tuition and fees tax deduction in the same year that they claim the American Opportunity Tax Credit or the Lifetime Learning Credit. They must choose to either take the credit or the deduction and should consider which is more beneficial for them.

Allowance Period. The Lifetime credit may be claimed for an unlimited number of tax years.

Review Questions Section 8

Read and answer the following review questions. The correct answers are found on the next page with an explanation to strengthen up your knowledge.

49. A candidate for a degree receiving scholarships or fellowships will fall into the following tax situation:
    a) They will be required to report as income the scholarships and fellowships received.
    b) They can take an extra deduction for the scholarships and fellowships received.
    c) They can exclude from income the scholarships and fellowships received.
    d) None of the above.

50. One of the following qualifies as tax free fellowship:
    a) Fellowship not exceeding the studentôs qualified education expenses.
    b) Fellowships not designated for other school expenses like rented apartment.
    c) Fellowships that do not represent a payment for teaching.
    d) All of the above.

51. Education credits exist for qualifying students, regarding the Hope credit and the American Opportunity credit one of the following is true:
    a) The Hope credit and the American Opportunity credit are nonrefundable.
    b) The Hope credit offers more benefits than the American Opportunity; taxpayers must choose between those two credits.
    c) The American opportunity credit is the only available and modifies the Hope credit.
    d) The Hope credit is the only one available and modifies the American Opportunity credit

52. Qualifying expenses under the American Opportunity credit include:
    a) Expenses for books.
    b) Expenses for supplies for the school.
    c) Expenses for equipment needed for a course.
    d) All of the above.

53. The American Opportunity credit can be claimed for:
    a) As long as the student is studying.
    b) 1 year.
    c) 4 years
    d) Two academic periods.

54. One of the following taxpayers will not be able to take the American Opportunity credit:
    a) Taxpayers filing their income tax as married filing separately.
    b) Taxpayers that are listed as dependents on their parentsô income tax return.
    c) Taxpayers claiming the tuition and fees deduction for the same student in the same year.
    d) All of the above.

55. The lifetime learning credit has one of the following tax benefits:
    a) Refundable credit of $1,000.
    b) Nonrefundable credit of $1,500
    c) Nonrefundable credit $2,000
    d) Nonrefundable credit $2,500 and the credit not used can be carried over.

Questions Section 8 – Answers and Discussion

49. **Answer c**. A candidate for a degree can exclude amounts received as a qualified scholarship or fellowship.

50. **Answer d**. A scholarship or fellowship grant is tax free only to the extent:

- It does not exceed the qualifying student qualified education expenses;
- It is not designated or earmarked for other purposes (such as room and board), and does not require (by its terms) that it cannot be used for qualified education expenses; and
- It does not represent payment for teaching, research, or other services required as a condition for receiving the scholarship.

51. **Answer c**. The American opportunity credit originally modified the existing Hope. The American Opportunity Credit was created on 2009 and extended through 2017 making the benefits available to a broader range of taxpayers, including many taxpayers with higher incomes and those who owe no tax.

52. **Answer d**. For the American opportunity tax credit, qualified expenses have been expanded to include expenditures for course materials, as well as tuition and required fees. For this purpose, the term "course materials" means books, supplies and equipment needed for a course of study whether or not the materials are purchased from the educational institution as a condition of enrollment or attendance.

53. **Answer c**. The American Opportunity credit is allowed with respect to qualified tuition and related expenses paid for **the first four years of the student's post-secondary education** in a degree or certificate program, if the student has not completed the first four years of post-secondary education before the beginning of the fourth tax year.

54. **Answer d**. Taxpayers cannot claim the American opportunity credit include the following:

- Taxpayers filing status is married filing separately.
- Taxpayers are listed as a dependent on another person's tax return (such as their parents').
- Taxpayers claim the lifetime learning credit or a tuition and fees deduction for the same student in the same year.

55. **Answer c**. The amount of the credit is 20% of the total qualified expenses for all eligible students on the tax return. The maximum amount of expenses allowed per tax return is $10,000; the maximum amount of the credit is $2,000 per return. The Lifetime Learning Credit is a nonrefundable tax credit. This means that it can reduce the tax to zero, but the exceeding credit will not be refundable.

The Lifetime Learning Credit
The credit can be up to $2,000.
It is available for all years of postsecondary education and for courses to acquire or improve job skills.
The maximum credited is limited to the amount of tax paid on the return.
The student does not need to be pursuing a degree or other recognized education credential.
Qualified expenses include tuition and fees, course related books, supplies and equipment. Felony drug convictions are permitted

Eligible student. To claim the lifetime learning credit, the qualified educational expenses must have been paid for an eligible student. To be an eligible student, the individual must be enrolled in one or more courses at an eligible educational institution. There is no requirement for the student to attend courses on at least a half-time basis. For example, a businessperson may claim

the credit for courses to improve his job skills taken at an eligible educational institution, even if he takes only one course.

Who Cannot Claim the lifetime learning Credit? Taxpayers cannot claim the lifetime learning credit if any of the following applies.

- Their filing status is married filing separately.
- They are listed as a dependent on another person's tax return (such as parents' return).
- Taxpayer (or spouse) was a nonresident alien for any part of the year and the nonresident alien did not elect to be treated as a resident alien for tax purposes.
- Taxpayers claim the American opportunity credit or a tuition and fees deduction for the same student in the same tax year.

What Expenses Qualify. The lifetime learning credit is based on qualified education expenses paid for each qualifying dependent claimed on the return. Generally, the credit is allowed for qualified education expenses paid during the year in question or in the first 3 months following the claimed year. For example if taxpayer is filing 2018 income tax they would consider the first 3 months of 2019. The course must be either part of a postsecondary degree program or taken by the student to acquire or improve job skills.

Qualified education expenses include only amounts for books, supplies, and equipment required to be paid to the institution as a condition of enrollment

Expenses Paid for a Dependent. Qualified education expenses paid for a dependent during the tax year, are deductible by taxpayer or dependent, but not both.

If taxpayer claims the lifetime learning credit, the qualifying student must be claimed on taxpayerôs tax returns. The expenses paid by the eligible student are used by the taxpayer who is claiming the credit and the dependentôs exemption.

IF taxpayers...	**THEN they...**
Claim an exemption on their tax return for a dependent who is an eligible student.	They can claim the lifetime learning credit based on that dependent's expenses. The dependent cannot claim the credit.
Do **not** claim an exemption on their tax return for a dependent who is an eligible student (even if entitled to the exemption).	The dependent can claim the lifetime learning credit. Taxpayers cannot claim the credit based on this dependent's expenses.

What expenses that do not qualify. Qualified education expenses do not include amounts paid for:

- Room and board, insurance, medical expenses (including student health fees), transportation, or other similar personal, living, or family expenses.
- Any course or other education involving sports, games, or hobbies, or any noncredit course, unless such course or other education is part of the student's degree program or (for the lifetime learning credit only) helps the student acquire or improve job skills.
- Nonacademic fees, such as student activity fees, athletic fees, insurance expenses, or other expenses unrelated to the academic course of instruction.

No Double Benefit Allowed. Taxpayers cannot do any of the following:

- Deduct higher education expenses on their income tax return (as, for example, a business expense) and also claim a lifetime learning credit based on those same expenses.
- Claim a lifetime learning credit in the same year that they are claiming a tuition and fees deduction for the same student.
- Claim a lifetime learning credit and an American opportunity credit based on the same qualified education expenses.
- Claim a lifetime learning credit based on the same expenses used to figure the tax-free portion of a distribution from a Coverdell education savings account (ESA) or qualified tuition program (QTP).
- Claim a credit based on qualified education expenses paid with tax-free educational assistance, such as a scholarship, grant, or assistance provided by an employer.

Eligible educational institution. An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the U.S. Department of Education. It includes virtually all accredited public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions. The educational institution should be able to tell you if it is an eligible educational institution.
Certain educational institutions located outside the United States also participate in the U.S. Department of Education's Federal Student Aid (FSA) programs.

Academic period. An academic period includes a semester, trimester, quarter, or other period of study (such as a summer school session) as reasonably determined by an educational institution. In the case of an educational institution that uses credit hours or clock hours and does not have academic terms, each payment period can be treated as an academic period.

Determining the Amount of the Lifetime Learning Credit. The amount of the credit (for each eligible student) is 20% of the first $10,000 of qualified education expenses paid for all eligible students The maximum amount of the credit that the taxpayer can claim for the year is $2,000, regardless of the number of students for whom they are claiming the credit.

Taking the credit. Taxpayers can claim the lifetime learning credit by completing Parts II and IV of Form 8863 and submitting it with Form 1040.

Modified AGI Phase Out. For purpose of the Lifetime earning credit, modified AGI is the taxpayerôs regular AGI increased by: Foreign earned income and housing exclusion and housing deduction (§911), amounts excluded by taxpayer from sources in American Samoa (§931), and amounts excluded by taxpayer from sources in Puerto Rico (§933). The phase-out thresholds are indexed for inflation.

Lifetime Credit Phase-Out		
	2018 Phase-Out Begins	**2018 Phase-Out Complete**
Married filing jointly	$114,000	$134,000
Single	$57,000	$67,000
Head of household	$57,000	$67,000
Married filing separately	N/A	N/A

Treatment of a Comprehensive or Bundled Fee. If a student is required to pay a fee (such as a comprehensive or a bundled fee) to an eligible educational institution that combines charges for qualified tuition and related expenses with charges for personal expenses, the portion of the fee that is allocable to personal expenses is not included in qualified tuition and related expenses. The determination of what portion of the fee relates to qualified tuition and related expenses and what portion relates to personal expenses must be made by the institution using a reasonable method of allocation. *(Reg. § 1.25A-2(d)(4))*

Example – Bundled Fees *– BC College requires all students to live on campus. It charges a single comprehensive fee to cover tuition, required fees, and room and board. Based on the college's reasonable allocation, sixty percent of the comprehensive fee is allocable to tuition and*

Education Credits Comparison		
	American opportunity Credit	**Lifetime Learning Credit**
Maximum Credit	Up to $2,500 credit per eligible student	Up to $2,000 credit per return
Refundable or nonrefundable	40% of credit may be refundable; the rest is nonrefundable	Nonrefundable - credit limited to the amount of taxes paid.
Numbers of years of postsecondary education	Available ONLY for the first 4 years of postsecondary education	Available for all years of postsecondary education and for courses to acquire or improve job skills.
Number of tax year credit available	Available ONLY for 4 tax years per eligible student.	Available for an unlimited number of years
Type of degree required	Student must be pursuing an undergraduate degree or other recognized education credential	Student does not need to be pursuing a degree or other recognized education credential
Number of courses	Student must be enrolled at least half time for at least one academic period beginning during the year	Available for one or more courses
Felony drug conviction	As of the end of the year, the student had not been convicted of a felony for possessing or distributing a controlled substance	Felony drug convictions are permitted
Qualified expenses	Tuition and required enrollment fees. and course materials that the student needs for a course of study whether or not the materials are bought at the educational institution as a condition of enrollment or attendance.	Tuition and required enrollment fees (including amounts required to be paid to the institution for course-related books, supplies, and equipment).

other required fees not allocable to personal expenses, and the remaining forty percent of the comprehensive fee is allocable to charges for room and board and other personal expenses. Therefore, only sixty percent of the college's comprehensive fee is a qualified tuition and related expense.

Payments within Academic Period. If qualified tuition and related **expenses** are paid by the taxpayer during one tax year for an **academic period** that begins during the **first three months** after that tax year, that **academic** period is treated as beginning during the tax year in which the payment is made. In other words, if qualified tuition and related **expenses** are paid during one tax year for an **academic period** that begins during the first three months of the taxpayer's next tax year (i.e., in January, February, or March of the next tax year for calendar year taxpayers), an education credit is allowed with respect to the qualified tuition and related expenses only in the tax year in which the expenses are paid. Reg § 1.25A-5(e)(2)(i)

Hobby Courses. Qualified tuition and related expenses do not include expenses that relate to any course of instruction or other education that involves sports, games, hobbies, or any noncredit course, unless the course or other education is part of the student's degree program, or in the case of the Lifetime Learning Credit, the student takes the course to acquire or improve job skills. (Reg. § 1.25A- 2(d)(5))

Example – Hobby Courses *- As a degree student at Porterville College, Sarah is required to take a certain number of courses outside of her chosen major in Economics. To fulfill this requirement, she enrolls in a square dancing class offered by the Physical Education Department. Because she receives credit toward her degree program for the square dancing class, the tuition for the square dancing class is included in qualified tuition and related expenses.*

Recapture of Education Credits (AOC, Lifetime Learning, and Tuition and Fee Deductions). If, after filing their tax return, taxpayers receive tax-free educational assistance or a refund of an expense used to figure an education credit on their return, they may have to repay all or part of the credit. They must figure their education credit for the year as if the assistance or refund was received in the same year and not later. Subtract the amount of the refigured credit from the amount of the original credit. The result is the amount the taxpayer must repay. The taxpayer should add the repayment (recapture) to their tax liability for the year in which they receive the assistance or refund. Their original tax return filed does not have to be changed.

Example. Sandra receive an education credit in 2017 using the expenses not covered by the government assistance, the following year she receives a refund to cover the expenses used to claim the credit. In this case she pays back the extra credit using her 2018 income tax return. She will be required to write "ECR" and the amount owed back on Form 1040. Please note that the original 2017 income tax return does not change.

The original education credit amount received will be located on Form 8863 for the year in question.

Example of the recapture amount for the American Opportunity Credit. Mary paid $7,000 in tuition and fees in August 2017 for her child. The child began college in September 2017. She filed her 2017 tax return on February 17, 2018, and claimed an American opportunity credit of $2,500. After she filed the return, she received a refund of $4,000 for the expenses used to figure the credit. Mary must refigure her 2017 American opportunity credit using $3,000 of qualified education expenses instead of $7,000. The refigured credit is $2,250. The increase to her tax liability is $250. She has to include the difference of $250 as additional tax on her 2018 tax return.

STUDENT LOAN INTEREST DEDUCTION

Generally, personal interest paid is not deductible on a tax return. However, the taxpayer may take an adjustment to income for certain student loan interest expenses paid. The taxpayer can take a deduction of up to $2,500 even if they do not itemize their deductions. This credit was not modified by the TCJA.

Qualified Student Loan. A qualified student loan is a loan taken out solely to pay qualified educational expenses that were:

- Paid for the taxpayer, spouse or a person who was the taxpayerôs dependent when they took out the loan
- Paid or incurred with a reasonable period of time before or after the taxpayer took out the loan; and
- Paid for education provided during an academic period for an eligible student.

Loans from a related person or from a qualified employer plan do not qualify for the student loan interest deduction.

Eligible Student. An eligible student for the purposes of the student loan interest deduction is a degree candidate carrying at least a half-time course load. The student may be the taxpayer, the taxpayerôs spouse, or someone claimed as the taxpayerôs dependent in the year the education was furnished.

Also, for the purposes of the student loan interest deduction, there exist the following exceptions to the general rules for dependents:

- The person would be the taxpayerôs dependent, however the taxpayer is a dependent of another;
- The person would be the taxpayerôs dependent, however the individual files a joint return with their spouse;
- The person would be the taxpayerôs dependent, however the individual has gross income that was equal to or greater to $4,150 for 2018 (the exemption amount is zero if used against income tax).

Qualified Education Expenses. For the purposes of the student loan interest deduction, qualified education expenses include the total costs of attending an eligible institution, including

graduate school. They include tuition and fees, room and board, books and supplies and other necessary expenses such as transportation.

The room and board qualifies to the extent that the larger of the allowance for room and board, determined by the educational institution, or the actual amount charged.

Amounts Includible as Interest. In addition to the simple interest on the loan, the following can be deductible as well (as long as all of the other requirements have been met):

- Loan origination fee for the use of money, accrued over the time of the loan
- Unpaid interest on a student loan that is added by the lender to the outstanding principal balance of the loan
- Interest on revolving lines of credit (including credit cards) if the borrower uses the like of credit only to pay qualified education expenses
- Interest on refinanced student loans. If the taxpayer refinanced the loan for a greater amount than the original loan and the taxpayer used the additional amount for anything other than qualified education expenses, they cannot deduct any interest paid on the refinanced loan

Amounts Not Includible as Interest. Amounts that cannot be deducted as student loan interest include:

- Interest paid on a loan that the taxpayer is not legally obligated to repay
- Loan origination fees that are payments for property or services, such as a processing fee
- Interest paid to the extent that the payments were made through the taxpayerôs participation in the National Health Service Corps (NHSC) Loan Repayment Program or certain other state loan repayment programs.
- Interest paid on a loan given by a related person.

Who Can Claim The Deduction? Generally a taxpayer may claim a deduction for student loan interest if the following requirements are met:

- They use any filing status except Married Filing Separately;
- No one else is claiming an exemption for the taxpayer; and
- The taxpayer paid qualified student loan interest;

In addition, the taxpayer may deduct interest paid on a student loan for their dependent in the following circumstances:

- The taxpayer is legally obligated to make the interest payments;
- The taxpayer actually made the payments during the tax year; and
- The taxpayer claims an exemption for the dependent on their tax return.

Determining the Amount of the Deduction. The taxpayerôs deduction for student loan interest for the year is generally the smaller of $2,500 or the amount actually paid. However, the actual

amount of the deduction may be reduced if the taxpayerôs Modified Adjusted Gross Income (MAGI) exceeds a phase out amount based on their filing status.

Student Loan Interest Deduction Phase Out Amounts for 2014		
Filing Status	Modified Adjusted Gross Income (MAGI)	Deduction is
Single, Head of household, or Qalifying widow(er)	Not more than $65,000	Not affected.
	More than $65,000 but less than $80,000	Reduced.
	$80,000 or more	Eliminated.
Married filing joint return	Not more than $130,000	Not affected.
	More than $130,000 but less than $160,000	Reduced.
	$160,000 or more	Eliminated.

Calculating the Phase Out. To figure the phase out, multiply the interest deduction (before the phase out, but not more than $2,500) by a fraction. The numerator is taxpayersô MAGI minus $65,000 ($130,000 in the case of a joint return). The denominator is $15,000 ($30,000 in the case of a joint return). Subtract the result from taxpayersô deduction (before the phase out) to give them the amount they can deduct.

The process is represented by the following fraction:

$$\frac{\text{MAGI - \$65,000 (\$130,000 MFJ)}}{\text{\$15,000 (\$30,000 MFJ)}}$$

Subtract the result from the amount of interest paid to arrive at the allowed deduction.

Example: A single taxpayer paid $3,000 in qualified student loan interest in 2018. His MAGI is $65,000. The allowed deduction is calculated as follows:

$$\frac{\textit{\$2500 (the maximum amount allowed) X (\$65,000 - \$55,000)}}{\textit{\$15,000}} = \textit{\$833}$$

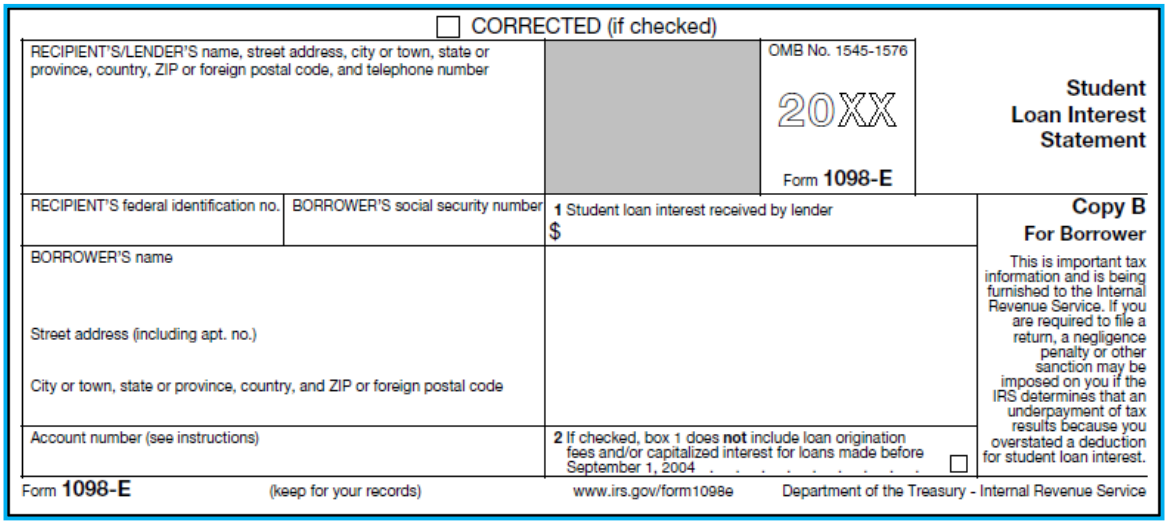
$2500 - $833 = $1667 -- the allowed deduction amount

Form 1098-E. To help figuring the student loan interest deduction, taxpayers should receive Form 1098-E. Generally, an institution (such as a bank or governmental agency) that received interest payments of $600 or more during 2018 on one or more qualified student loans must send Form 1098-E (or acceptable substitute) to each borrower by January 31, 2019.

For qualified student loans taken out before September 1, 2004, the institution is required to include on Form 1098-E only payments of stated interest. Other interest payments, such as certain loan origination fees and capitalized interest, may not appear on the form. However, if

there is other qualifying interest paid and not included on Form 1098-E, taxpayers can also deduct those amounts.

The lender may ask for a completed Form W-9S, or similar statement to obtain the borrower's name, address, and taxpayer identification number. The form may also be used by the borrower to certify that the student loan was incurred solely to pay for qualified education expenses.



☐ CORRECTED (if checked)

RECIPIENT'S/LENDER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone number		OMB No. 1545-1576 20XX Form **1098-E**	**Student Loan Interest Statement**
RECIPIENT'S federal identification no.	BORROWER'S social security number	**1** Student loan interest received by lender $	**Copy B** **For Borrower**
BORROWER'S name Street address (including apt. no.) City or town, state or province, country, and ZIP or foreign postal code			This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if the IRS determines that an underpayment of tax results because you overstated a deduction for student loan interest.
Account number (see instructions)		**2** If checked, box 1 does **not** include loan origination fees and/or capitalized interest for loans made before September 1, 2004 ☐	

Form **1098-E** (keep for your records) www.irs.gov/form1098e Department of the Treasury - Internal Revenue Service

TUITION AND FEES DEDUCTION

The tuition and fees deduction can reduce the amount of the taxpayerôs taxable income by up to $4,000. Like the student loan interest deduction, the tuition and fees deduction is taken as an adjustment to income, meaning that the taxpayer can benefit even if they do not itemize deductions and only if they owe taxes.

Who Can Take The Deduction? Generally the taxpayer may claim the tuition and fees deduction if all of the following requirements are met:

- The taxpayer paid qualified higher education expenses;
- The expenses were paid for an eligible student; and
- The eligible student is the taxpayer, the taxpayerôs spouse or a dependent for whom the taxpayer claims an exemption on their tax return.

The taxpayer cannot take a deduction for tuition and fees if they are using the married filing separate filing status or if they are claimed as a dependent on the tax return of another

Who Cannot Claim the Deduction? Taxpayers cannot take the tuition and fees deduction if any of the following applies:

- Their filing status is married filing separately.
- Another person can claim an exemption for the qualifying student on his or her tax return.
- Their modified adjusted gross income (MAGI) is more than $80,000 ($160,000 if filing a joint return).
- Taxpayers (or spouse) were a nonresident alien for any part of 2018 and the nonresident alien did not elect to be treated as a resident alien for tax purposes. More information on nonresident aliens can be found in Publication 519.

Eligible Student, Defined. For the purposes of the tuition and fees deduction, an eligible student must be enrolled in one or more courses at an eligible educational institution (as defined in the discussions on the education credits). The student must have either a high school diploma or a General Educational Development (GED) credential.

Expenses Paid For A Dependent. In order to claim the tuition and fees deduction for a dependent, the taxpayer must:

- Have paid the expenses; and
- Claim an exemption for the dependent.

Determining the Amount of the Deduction. The maximum amount of the tuition and fees deduction for 2018 is $4,000, $2,000 or $0, depending on the amount of the taxpayerôs MAGI.

Tuition and Fees Deduction Phase Out Amounts for 2018	
Filing Status	Taxpayers Cannot Take the Credit if their MAGI is above.
Married Filing Jointly.	$160,000
Single Head of household Qualifying widow(er).	$80,000

Maximum Amounts for the Tuition and Fees Deduction		
Filing status	MAGI is	Maximum tuition deduction is
Single Head of household Qualifying widow.	Not more than $65,000	$4,000
	More than $65,000 but not more than $80,000	$2,000
	More than $80,000	$0
Married filing jointly	Not more than $130,000	$4,000
	More than $130,000 but not more than $160,000	$2,000
	More than $160,000	$0

Claiming the Deduction. Form 8917 is required to claim the tuition and fee deduction. The form is submitted with Form 1040.

Review Questions Section 9

Read and answer the following review questions. The correct answers are found on the next page with an explanation to strengthen up your knowledge. Note: This is not part of your Final Test.

56. Which of the following is false regarding eligibility for the lifetime learning credit?
a) The student cannot have a felony drug conviction
b) The student can be enrolled in at least one course in a degree program
c) The student can be in their junior year in a state university
d) The student can be taking a course to increase their job skills

57. For the Lifetime Learning Credit, taxpayers that are not claiming the qualifying student as a dependent can:
a) Claim the lifetime learning credit in full.
b) Claim 50% of the lifetime learning credit.
c) Transfer the credit to the dependent.
d) Nobody can take the credit.

58. In order to claim the education credits the taxpayer must:
a) Send the studentôs transcript with the tax return.
b) Send a schoolôs letter to the IRS.
c) Complete Form 8863.
d) Complete Form 1040 only.

59. Taxpayers that receive a refund of expenses used to calculate the education credit will be required to:
a) Wait until the IRS makes the correction.
b) File an amended income tax return.
c) Figure the excess amount received and add it to the tax liability on the year received.
d) Include the full amount on income.

60. The taxpayer that paid student loan interest can take one of the following tax benefits:
a) They can claim an education credit with the student loan interest paid.
b) They can receive a tax refund.
c) They can reduce their taxable income.
d) None of the above.

61. All of the following are includible as student loan interest, except:
a) Loan origination fees accrued over the time of the loan
b) Interest on a credit card if the taxpayer used it only for qualified educational expenses
c) Interest on a credit card if the taxpayer used it only for qualified educational expenses plus a trip to Jamaica
d) Interest on a refinanced student loan if the new loan was the same amount as the old loan

62. All of the following requirements must be met for the taxpayer to claim a deduction for student loan interest, except:
a) The use any filing status except married filing separately.
b) No one else is claiming an exemption for the taxpayer.

c) The taxpayer paid the student loan interest.
d) All of the above are requirements that must be met.

63. In which of the following situations is the taxpayerôs student loan interest deduction phased out completely?
a) The taxpayer is single with a MAGI of $47,000
b) The taxpayer is married filing a joint return with a MAGI of $110,000
c) The taxpayer is filing as head of household with a MAGI of $85,000
d) The taxpayer is single with a MAGI of $60,000

Questions Section 9 – Answers and Discussion

56. **Answer a**. The Lifetime Learning Credit can be taken even if the student was convicted for felony drug.

57. **Answer c**. If taxpayers do **not** claim an exemption on their tax return for a dependent who is an eligible student (even if entitled to the exemption), they can transfer the credit to the dependent. Taxpayers cannot claim the credit based on this dependent's expenses.

58. **Answer c**. Taxpayers can claim the education credits by completing Form 8863 and submitting it with Form 1040 or 1040A.

59. **Answer c**. If, after filing their tax return, taxpayers receive tax-free educational assistance or a refund of an expense used to figure an education credit on their return, they may have to repay all or part of the credit. They must figure their education credit for the year as if the assistance or refund was received in the same year and not later. Subtract the amount of the refigured credit from the amount of the original credit. The result is the amount the taxpayer must repay. The taxpayer should add the repayment (recapture) to their tax liability for the year in which they receive the assistance or refund. Their original tax return filed does not have to be changed.

60. **Answer c**. Taxpayers may take an adjustment to income for certain student loan interest expenses paid. The taxpayer can take a deduction of up to $2,500 even if they do not itemize their deductions.

61. **Answer c**. Interest on revolving lines of credit (including credit cards) if the borrower uses the like of credit only to pay qualified education expenses; this does not include expenses for personal use.

62. **Answer d**. Generally a taxpayer may claim a deduction for student loan interest if the following requirements are met:

- They use any filing status except Married Filing Separately;
- No one else is claiming an exemption for the taxpayer; and
- The taxpayer paid qualified student loan interest.

63. **Answer c**. Taxpayers that file their income tax a s head of household will completely lose their student loan interest deduction if their Modified Adjusted Gross Income is above $80,000.

TAX

UPDATES

THE WAYFAIR DECISION. ONLINE SALES TAX, NO BUSINESS OFFICE IS REQUIRED.

In a five-to-four decision, the Supreme Court has ruled that states can make online businesses collect sales taxes ð even if they donôt have a physical presence in that state.

This new ruling overturns a decision from the Court in 1992 that paved the way for the explosion of online retail in the United States. At issue was the Quill Corp. v. North Dakota decision, which ruled that companies need to have at least some physical connection with a state for that state to require that company to pay taxes.

Background of the physical presence test. The property or employees rule, or physical presence rule, dates to 1967ôs Bellas Hess case, where the Supreme Court held that Illinois could not require an out-of-state catalog company to collect sales tax. The idea was that sales tax is so complex to collect that forcing out-of-state sellers to do so put impermissible burdens on interstate commerce. That ruling was reaffirmed by the Court in 1992ôs Quill case, with some misgivings over whether it was the correct rule.

Physical presence test proven to be inadequate by states. Between 1992 and 2018, several factors undermined the physical presence rule. E-commerce emerged and grew sharply, resulting in some online sellers not collecting sales tax despite widespread directed sales and activity in a state. Technological advances reduced the cost of collecting sales taxes, including platforms created by some of the e-commerce websites. Finally, the physical presence rule proved to be an ineffective restraint on state tax power. Even before the Wayfair ruling, 31 states required tax collection in minimal cases of physical presence in a state, such as with airport stopovers by employees, contracts with in-state advertisers or placing website cookies on computers within the state. It is noteworthy that none of the nine justices in Wayfair, nor either of the parties in the case, asserted that the physical presence rule is the correct rule.

Decision to charge sales tax to online sales rest on each state. While the ruling opens the door for states to collect taxes from online businesses, there are some significant outstanding questions now that the court has made its decision.

First, the court did not rule out the possibility that states may not collect taxes on all online purchases, given the negligible size of some transactions. And the court didnôt say whether states could retroactively seek sales taxes.

Thatôs a big issue, considering that e-commerce sales in the U.S. were $435.5 billion in 2016, versus $180 billion in mail-order sales in 1992 when the court issued its first ruling on interstate sales and taxes.

For most large online retailers (including Amazon ð the countryôs largest), the decision will have little impact, since theyôve been voluntarily paying state sales taxes for years. Instead, the burden will be on earlier-stage companies that do not have the same sort of scale and which will be facing more operational costs as a result.

Some states may adopt laws that emulate South Dakotaôs in every respect. Other states may adopt laws that adopt only some of the features, and that would likely be subject to further litigation. Some states may not act until their next regular legislative session, while others may never act.

Congress may act to establish a minimum standard for states that wish to collect sales tax on interstate sales. A federal standard would create certainty for sellers and consumers and ensure that every state meets certain simplification guidelines.

Use tax was in effect. Consumers normally owe use tax to their resident state on the purchases where the sales tax was not charged. The use tax is then the sales tax on purchases made outside one's state of residence for taxable items that will be used, stored or consumed in one's state of residence and on which no tax was collected in the state of purchase.

Another question will be whether Congress acts. Congress has pending bills (Remote Transactions Parity Act, or RTPA, and Marketplace Fairness Act, or MFA) that would specify what simplifications a state must make to be able to require online sellers to collect taxes. Such a law would be compatible with the Courtôs ruling, providing more protections for sellers and consumers. But some have opposed the passage of those bills, claiming it would tax the internet.

State actions under this court's decision. Some states will move quickly to enact laws resembling South Dakotaôs to collect sales tax on internet purchases. Other states would need to make significant changes to their sales tax system to be able to collect, particularly large states that have resisted joining other states in adopting more uniform, simplified sales tax laws. Some states, such as New Hampshire, will likely never pass a sales tax.

A valid concern, however, is the ability of small e-commerce sellers to collect sales taxes in a simple way. The Court praised South Dakotaôs provision of compliance software and simplified state rules. For instance, South Dakota gives immunity from audit to sellers who encounter errors made by sales tax software programs. It is likely that large e-commerce platforms will provide sales tax compliance services for their sellers. Congress could also pass RTPA, which provides additional protections such as limiting interstate audits, requiring states to pay for integrating sales tax collection software within sellersô systems, and setting a sales threshold exempting smaller businesses from having to comply with too many rules.

Safe-harbors for the Waifair decision. The Court carefully evaluated South Dakotaôs law, noting six features showing it was ñdesigned to prevent discrimination against or undue burdens upon interstate commerce.ò These six features are:

1. a safe harbor excluding those who sell only limited amounts in South Dakota;
2. no retroactive tax collection;
3. single, state-level administration of sales taxes;
4. a simplified tax rate structure;
5. uniform definitions and other rules; and
6. access to software provided by the state, with immunity for those who rely on it.

A state that attempts to collect sales taxes on e-commerce without these provisions will almost certainly face a legal challenge, with challengers of such laws able to point to the rationale in the Wayfair ruling as guidance of whatôs permissible.

Benefit for local stores with physical presence. Vendors with physical storefronts indicated that this is a huge win because their online counterparts had an advantage because they didnôt have to charge customers local sales tax. Local governments may also see a windfall as a result of the ruling, as the government estimates that between $9 billion and $13 billion in potential tax revenue is left on the table, thanks to earlier Supreme Court decisions on the taxation of online purchases.

Internet Tax Freedom Act (ITFA). Congress prohibited the states from taxing internet access in a law known as the Internet Tax Freedom Act (ITFA). That law is not changed by this decision and is not directly related to whether states can tax e-commerce. ITFA only applies to what you pay to connect to the internet. So long as states pass e-commerce laws that apply equally to other forms of commerce, they would not conflict with ITFA.

No big change on the e-comerce for big companies. If states simplify their tax systems as set out by Wayfair, there will likely be only small changes in the e-commerce landscape. Sellers may need to monitor their new compliance requirements and seek a new software solution, but these costs can be minimized if states provide the necessary simplifications and protections. However, if some states ignore the features of the South Dakota law in crafting their own laws, and put crushing burdens on interstate sellers, there will be more litigation and a higher potential for action by Congress.

THE DYNAMEX DECISION. A CALIFORNIA DECISION OVER EMPLOYEE OR INDEPENDENT CONTRACTOR CLASSIFICATION THAT MANY STATES ARE FACING.

The California Supreme Court issued a landmark decision in the matter of Dynamex Operations West, Inc. v. Superior Court of Los Angeles. The California Supreme Court reinterpreted and ultimately rejected the Borello test for determining whether workers should be classified as either employees or independent contractors for the purposes of the wage orders adopted by Californiaôs Industrial Welfare Commission (ñIWCò) in favor of a worker-friendly standard that may upend the existing independent contractor labor market.

The court's opinion in Dynamex v. Superior Court of Los Angeles County has a lot of trucking companies in panic mode, scrambling to figure out how the ruling will affect their operations. The ruling could also have a profound impact on many tech companies like Uber, Lyft, Instacart, and others that provide on-demand services, like the barbershops in any California Neighborhood.

All workers are employees. In particular, the Court embraced a standard *presuming* that all workers are employees instead of contractors, and placed the burden on any entity classifying an individual as an independent contractor of establishing that such classification is proper under the newly adopted ñABC testò.

The ABC Test. The Dynamex court rejected the Borello test and replaced it with the so-called ABC test that several states have adopted. Under the ABC test, a worker will be deemed to have been ñsuffered or permitted to work,ò and thus, an employee for wage order purposes, unless the putative employer proves:

A. that the worker is free from the control and direction of the hiring entity in connection with the performance of the work, both under the contract for the performance of the work and in fact;
B. that the worker performs work that is outside the usual course of the hiring entityôs 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.

Note that each of these requirements need to be met in order for the presumption that a worker is an employee to be rebutted, and for a court to recognize that a worker has been properly classified as an independent contractor.

The court noted that in many states a common element of the ABC test ñprovide[s] that a hiring entity may satisfy part B by establishing either (1) that the work provided is outside the usual course of the business for which the work is performed, or (2) that the work performed is outside all the places of business of the hiring entity.ò (emphasis added)

However, the court deliberately removed the latter element from part B of its new standard, which will make it difficult to classify an individual as an independent contractor unless that person has essentially no connection to the employerôs business. In other words, employers in California that rely on independent contractors are about to discover that the California supreme court may have just put their business model in jeopardy.

The Origin of the Decision. Dynamex is a nationwide same-day courier and delivery service that offers on-demand, same-day pickup and delivery services to businesses and the public. Prior to 2004, Dynamex classified its California drivers as employees. Starting in 2004, however, Dynamex converted all of its drivers to independent contractors as a cost savings measure.

In January 2005, Plaintiff Charles Lee entered into a written independent contractor agreement with Dynamex to provide delivery services for the company. Just three months after leaving his work at Dynamex, Lee filed this lawsuit on his own behalf and on behalf of similarly situated Dynamex drivers, alleging that Dynamexôs alleged misclassification of its drivers as independent contractors led to Dynamexôs violation of the provisions of IWC wage order No. 9, the applicable state wage order governing the transportation industry, as well as various sections of the Labor Code, and, as a result, that Dynamex had engaged in unfair and unlawful business practices under Business and Professions Code section 17200.

The Supreme Court's Decision. As a threshold matter, the Court framed its decision by broadly characterizing the misclassification of independent contractors as harmful and unfair to workers, honest competitors, and the public as a whole. The Court provided a long, detailed, and nuanced

analysis of the relevant case lineage, carefully analyzing Borello, Martinez, and Ayala v. Antelope Valley Newspapers, Inc., 59 Cal.4th 522, 527 (2014). In doing so, the Court read each of these cases and their respective holdings in a decidedly worker-friendly fashion.

The Borello Test and the new Dynamex Decision. In Borello, the Supreme Court held that the ñright to controlò the means and manner in which work is performed by a worker is the most important of several factors to be considered when evaluating a classification analysis, including secondary factors such as ownership of equipment, opportunity for profit and loss, and the belief of the parties. This test is more flexible because it balances the different factors to arrive at a classification based on individual circumstances of each case. Prior to Dynamex, many cases (including the Courtôs own recent decisions) referred to the multi-factor Borello test as the traditional ñcommon lawò classification analysis.

The Court of Appeal rejected Dynamexôs argument, and concluded that Martinez is not limited to the joint employer context but also applies to the classification analysis. The Court of Appeal also rejected the contention that the multifactor test set forth in Borello is controlling in cases arising under an obligation imposed by an IWC wage order.

Consequently, the California Supreme Court granted review to clarify the appropriate standard for determining employee or contractor status in the wage order context.

Previously, California used the ñBorello testòð which strongly favors a conclusion that workers are employees.

Factors under the Borello Test. Courts in California generally used the common law standard until 1989, when the state supreme court issued a decision in S. G. Borello & Sons, Inc. v Dept. of Industrial Relations in which it established an eleven-factor test for determining employment status.

The test examines the total circumstances of the relationship between the business and the person performing the work, in light of the following 11 factors:

1. Whether the person performing work is engaged in an occupation or business that is distinct from that of the company;
2. Whether the work is part of the companyôs regular business;
3. Whether the company or the worker supplies the equipment, tools, and the place for the person doing the work;
4. The workerôs financial investment in the equipment or materials required to perform the work;
5. The skill required in the particular occupation;
6. The kind of occupation, with reference to whether, in the locality, the work is usually done under the companyôs direction or by a specialist without supervision;
7. The workerôs opportunity for profit or loss depending on his or her own managerial skill (a potential for profit does not include bonuses);
8. How long the services are to be performed;
9. The degree of permanence of the working relationship;

10. The payment method, whether by time or by the job; *and*
11. Whether the parties believe they are creating an employer/employee relationship.

Although no single factor in the Borello test is determinative, the first oneð whether the individualôs work is the service or product that is the companyôs primary businessð is given the most weight.

What Does the Dynamex Decision Mean for Businesses? The question of whether an individual worker should be classified as an employee or independent contractor has considerable significance for workers, businesses, and the public generally. If a worker is classified as an employee, the employer bears the responsibility of paying Social Security and payroll taxes, unemployment insurance taxes and state employment taxes, providing workerôs compensation insurance, and of course, complying with the endless labyrinth of state and federal statutes governing the wages, hours, and working conditions of employees.

Indeed, many businesses, particularly those operating in the ñgig economy,ò are fundamentally premised on the use of independent contractors. In light of this case, any businesses operating in California that treat workers as independent contractors should confer with their legal counsel to review the relationship under the ñABC testò and determine whether any or all such workers should be reclassified.

For example, prong B of the ABC test is particularly troublesome for any businesses that use independent contractors to deliver or provide their core product or service. In applying the ABC test to Dynamex, the Court noted that a class of delivery drivers could be certified under prong B because the question of whether the delivery drivers were performing outside the usual course of Dynamexôs business could clearly be resolved on a classwide basis. Indeed, delivery servicesð which are provided by the delivery driversð are the very core of Dynamexôs business.

Lastly, it is not yet clear whether the ABC test applies to wage claims that do not arise from a wage order. For example, a claim for reimbursement for business expenses such as fuel and tolls that are not governed by a wage order and are obtainable only under section 2802 of the Labor Code may still be controlled by the Borello test. Indeed, this was the holding of the Court of Appeal in Dynamex, and the Supreme Court stated that it was not reaching the issue. Also left open by the Supreme Courtôs decision is whether the ñexercises control over the wages, hours or working conditionsò prong of the wage ordersô definition of ñemployò is applicable to classification questions outside the joint employment context.

Examples of uncertainty regarding the Dynamex Decision. The initial impact of this case focused on how the decision would impact the ógig economyôï ride hailing apps, as a start. As commentators and others evaluated the scope of the case, its potential application to more types of independent contractor relationships, including franchises, became clear. *Dynamex* did not involve a franchise relationship and there is no discussion of the franchise business model, leaving open how it might be applied to such relationships. In many franchises, it is the franchisorôs expertise in the licensed businessð whether running a pizzeria or frying chickenð that attracted the franchisee in the first place. Many franchisors sell pizzas or fried chicken, just as their franchisees do. Does that mean that the óBô factor is negated, turning all franchisees and

their employees into the employees of the franchisor? The answer is pending and will require more time to see how these type of business deal with the issue.

Review Questions Section 1

Read and answer the following review questions. The correct answers are found on the next page with an explanation to strengthen up your knowledge. Note: This is not part of your Final Test.

1. What was the Wayfair decision?
a) The introduction to the Internet Tax Freedom Act (ITFA).
b) The Supreme Court ruling to make online businesses collect sales tax.
c) More revenue for local storefronts.
d) Passing of a new tax bill by Congress.

2. What is the Internet Tax Freedom Act?

a) An act that would specify simplifications a state must make to Require online sellers to collect sales taxes.
b) The ability of small e-commerce sellers to collect sales taxes in a simple way.
c) A new ruling that overturned the Courtôs decision in 1992
d) The prohibition by congress that did not allow states to tax internet access

3. How much was the sale in e-commerce in the U.S in 2016?

a) 180 billion
b) 100 hundred
c) 435.5 billion
d) 453.5 billion

4. What is the Dynamex Decision?

a) Small changes to Wayfair decision
b) Single state level administration of sales taxes
c) A simplified tax rate structure
d) A decision by the supreme court to consider workers as employees following the Dynamex company incident.

5. What is the letter A from the ABC test?

a) The worker is customarily engaged in an independently established occupation or business.
b) The Supreme Court rule that companies are required to have some physical representation with a state in order to pay taxes.
c) The worker is free from control and direction of the hiring entity in connection with the performance of work.
d) All of the above.

6. What responsibility does an employer have over his employees?

a) Paying social security and payroll taxes, providing working conditions for employees and paying their workers compensation insurance.
b) He has to worry about employees claiming the EIC.
c) Paying state taxes for the employee before April 15.
d) Offering Health coverage and retirement plans no matter how many employees they actually have.

Questions Section – Answers and Discussion 1

1. **Correct answer: B.** The Supreme Court has ruled that states can now make online businesses collect sales taxes, even if they donôt have any physical presence, they can still collect taxes form them.

2. **Correct answer: D.** Congress approved the Internet Tax Freedom Act to prohibit the taxation of internet access to any state in the United States.

3. **Correct answer: C.** E-commerce sales in the U.S were 435.5 billion dollars in 2016, it is a great sale compared to the 1992 sales which were 180 billion dollars.

4. **Correct answer: C.** The Dynamex decision was very important for certain companies, it defined that workers are not contractors and therefore as employees must have workers compensation insurance covered by the employer following a lawsuit that was brought to the attention by the Supreme Court.

5. **Correct answer: C:** The worker has to be free from the control of the hiring person in connection with the performance of the work that is outside the usual course of the business.

6. **Correct answer A:** The employer has the responsibility to provide a safe work environment for the employee, payment of wages timely, payment of payroll taxes which conform the Social Security and Medicare, the payroll state taxes and insurance coverage via workers compensation.

REMINDER. ITINs AND SSNs ASSIGNED AFTER APRIL 15 ARE NOT VALID FOR ANY PREVIOUS YEAR.

Under Protecting Americans from Tax Hikes (PATH), taxpayers were required to have their identification number assigned before the due date of the original income tax return. Under the TCJA, the same principle will apply with the only difference that a SSN is required for dependents claiming the Child or Additional Child Tax Credit.

The provision denies to any taxpayer the EITC, the Child Tax Credit, the Additional Child Tax Credit and the American opportunity tax credit, with respect to any taxable year for which such taxpayer has a taxpayer identification number that has been issued after the due date for filing the return for such taxable year. In other words, taxpayers who got their identification number after April 15 will not qualify for those credits for any previous year. If taxpayer is filing the original income tax return for 2017 with an ITIN application in May of 2018, the IRS will deny any credit mentioned before because taxpayer did not have an identification number assigned before the due date. The same principle applies to amended returns.

Example. Luis is filing his original income tax return for 2017 in May of 2018; he did not have ITIN in 2017. Luis is filing his tax return with the Form W7, Application for IRS Individual Taxpayer Identification Number. The income tax includes two children who are U.S citizens; one of them is age 6 and the other age 8. The IRS will deny the Child Tax Credit because Luis did not have his ITIN or SSN assigned before April 15, 2018.

Similarly, a qualifying child (in the case of the EITC and child credit) or a student (in the case of the American opportunity credit) is not taken into account with respect to any taxable year for which such child or student is associated with a taxpayer identification number that has been issued after the due date for filing the return for such taxable year.

REMINDER. UNDER NEW TCJA, THE SSN IS REQUIRED FOR ALL QUALIFYING CHILDREN CLAIMING CTC AND ACTC. TAXPAYERS ARE NOT REQUIRED TO HAVE SSN, YET.

In order to claim the credit Child Tax Credit or the Additional Child Tax Credit, each childôs SSN is now required under the TCJA. Other forms of taxpayer identification, such as an ITIN or ATIN, no longer suffice. SSNs are only available to U.S. citizens, aliens who are lawfully admitted into the U.S. for permanent residence or work, and other aliens who can lawfully work in the U.S. Although there is no express requirement that a taxpayer claiming the credit himself or herself be a U.S. citizen or resident, as a practical matter, taxpayers with questionable citizenship or residency status will likely be hesitant to claim the credit. This does not mean that they cannot file and get the credit.

EXEMPTION CREDIT TAKEN INTO CONSIDERATION FOR PREMIUM TAX CREDIT.

Section 36B allows a premium tax credit to eligible individuals who enroll themselves, their spouse, or any dependent (as defined in section 152) in a qualified health plan through an Exchange, and section 6011 provides general rules related to income tax return filing requirements.

The regulations under section 36B and 6011 include rules that apply based on whether a taxpayer claims or claimed a personal exemption deduction under section 151 for an individual. These rules affect eligibility for the premium tax credit, computation of the premium tax credit, reconciliation of advance payments of the premium tax credit, and income tax return filing requirements related to the premium tax credit. Specifically, references such as ñclaim a personal exemption deduction,ò ñclaims a personal exemption deduction,ò or ñclaimed as a personal exemption deduction,ò are included in several parts of these sections of the tax code.

The Treasury Department and the IRS intend to amend the regulations under section 36B and 6011 to clarify the meaning of claiming a personal exemption deduction for the taxable years for which the exemption amount is reduced to zero.

Section 5000A provides that if a taxpayer, or dependent of the taxpayer who is an applicable individual for whom the taxpayer is liable, is without minimum essential coverage or a coverage exemption for one or more months in a taxable year, the taxpayer must include an individual shared responsibility payment when filing his or her federal income tax return. The regulations under § 5000A include rules that apply based on whether a taxpayer claims or claimed a personal exemption deduction under section 151 for an individual. Specifically, section 1.5000Aï 1(d)(4) refers to a taxpayer who ñclaims a deduction for a personal exemption,ò and § 1.5000A-3(e)(3)(ii)(B) refers to ñan individual for whom a personal exemption deduction is claimed.ò Section 11081 of the Act reduced the amount of the shared responsibility payment to zero for 2019 taxable year.

Because the Act decreases the exemption amount to zero, taxpayers will no longer claim a personal exemption deduction on their individual income tax returns by listing an individualôs name and social security number, multiplying the number of allowed exemptions by the exemption amount, and entering that amount on their tax return. Consequently, taxpayers may have questions about what it means to claim a personal exemption deduction for purposes of the premium tax credit and the individual shared responsibility provision. Until further guidance is issued, the following rules apply for purposes of the regulations under sections 36B and 5000A:

- A taxpayer is considered to have claimed a personal exemption deduction for himself or herself for a taxable year if the taxpayer files an income tax return for the year and does not qualify as a dependent of another taxpayer under section 152 for the year;

- A taxpayer is considered to have claimed a personal exemption deduction for an individual other than the taxpayer if the taxpayer is allowed a personal exemption deduction for the individual (taking into account section 151(d)(5)(B)) and lists the

individualôs name and TIN on the Form 1040, U.S. Individual Income Tax Return, or Form 1040NR, U.S. Nonresident Alien Income Tax Return, the taxpayer files for the year.

TAX REFORM 2.0. MORE CHANGES TO THE TCJA.

Tax Preparers are thinking that we are done with tax reform? The Tax Cuts and Jobs Act (TCJA) was passed in December of 2017, with many of the provisions taking effect in 2018. Now, Congress is pushing for more, which they are calling ñTax Reform 2.0.ò
(Details regarding whatôs being touted as a ñsecond roundò of tax reform are scarce, but House Ways and Means Committee Chairman Kevin Brady (R-TX) has released a ñlistening session frameworkò for the plan. Thatôs a term the House clearly likes: The draft documents of the original tax reform were likewise called a framework. According to Brady, the framework is the starting point for the ñlistening sessionsò that lawmakers will have with their constituents back home. So far, the framework includes:

Permanent tax cuts. The language in the framework kicks off by suggested that there will be a push to make tax rate cuts for individuals (including that pass-through deduction meant to add small businesses) permanent. Specifically, the framework says that a second round of tax reform ñis about locking in these tax cuts for middle-class families and small businesses.ò
Currently, tax cuts for corporations are permanent, while those for individuals will expire - a plan which was introduced in the Senate version of the bill. You can find the updated tax rates, which are effective now, here.

New Retirement Savings Plans. The framework will reportedly include a ñrange of proposalsò tied to retirement savings. However, there are no details - nope, not even a hint.

New Family Savings Plan. If there is anything that Congress loves more than shiny things, itôs an acronym. Here, they have both: Under the proposal, there would be a new Universal Savings Account ñto offer a fully flexible savings tool for families.ò It is not entirely new, the idea (or at least the acronym) - was first introduced in 2015. A similar bill was introduced by Representative Dave Brat (R-VA) in 2017. Neither version went very far. At its base, it's a Roth-type account, meaning you will fund, growth would be tax-deferred, and you would not be taxed on withdrawals. Where it differs from a Roth (or, at least as it stands in the 2017 version) is that distributions would not be limited to retirement and could be made at any time. No additional details about the plan, nor confirmation that the Brat USA proposal is intended to apply "as is," were outlined in the framework.

Expanded 529 Education Savings Accounts. Itôs not a surprise to see this push again. Under the original House tax reform proposal, parents could have set up 529 plans for unborn children and used up to $10,000 per year of plan funds for private elementary and secondary school expenses. In the final version of the TCJA, up to $10,000 of 529 savings plans are allowed per student for public, private and religious elementary and secondary schools, but a Senate provision which applied to homeschool students was not included. The new framework would reinstate homeschooling as a permitted use while also adding apprenticeship fees to the list. Most surprising? The proposal would allow you to use accounts to ñhelp pay off student debt.ò

Retirement Plans for Babies. The House is not really suggesting retirement plans for new babies. What the framework proposes is to allow families to access retirement accounts penalty-free for new baby expenses. It's unclear whether those expenses would be restricted to medical expenses, or whether they would include cribs, clothing, etc. The proposal would also allow families to replenish those accounts in the future presumably, some sort of catch-up provision might apply.

Growing Brand-New Entrepreneurs. The framework suggests initial and expanded expensing for brand-new businesses, as well as vague language to ñremove barriers to growth.ò Of all of the proposals, allowing expensing and expanded startup costs for new businesses is likely to garner the most support from the House and Senate.

- The Protecting Family and Small Business Tax Cuts Act of 2018 would make the individual tax changes that were passed in late 2017 permanent. Currently, the lower marginal tax rates, higher Child Tax Credit, and most of the other tax changes that affect individual taxpayers are set to expire after 2025. This bill also would extend the more generous medical deduction threshold of 7.5% of AGI, which is currently set to expire after the 2018 tax year, for another two years.

- The Family Savings Act of 2018 would make several changes affecting retirement, education, and general savings in the United States. It would remove the age limit of 70 1/2 for making traditional IRA contributions and also exempt Americans with less than $50,000 in their retirement accounts from required minimum distributions, or RMDs. The bill also would help families by allowing up to $7,500 in penalty-free withdrawals from retirement accounts for expenses related to a new child. Additionally, it would create a new type of savings account, known as a Universal Savings Account, which would have a similar tax structure to a Roth IRA but would allow $2,500 to be set aside on a tax-advantaged basis for any purpose, not just retirement. Finally, the bill would make some small tweaks to allowable expenses for 529 accounts and make it easier for smaller companies to join together to offer 401(k) plans.

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- Finally, the American Innovation Act is the shortest bill of the three and is designed to encourage Americans to start their own businesses. It would do this by allowing qualified new businesses to deduct as much as $20,000 in start-up costs in the year they are incurred.

HEALTH CARE COVERAGE REQUIRED FOR 2018 TAX RETURNS AND CHANGES FOR 2019 TAXABLE YEAR.

For the tax year 2018, the IRS will not accept electronically filed tax returns where the taxpayer does not address the health coverage requirements of the Affordable Care Act. The IRS will not accept the electronic tax return until the taxpayer indicates whether they had coverage, had an exemption or will make a shared responsibility payment. In addition, returns filed on paper where taxpayers do not address the health coverage requirements may not be processed until the information is provided.

The requirement will cover also the 2016 through 2018 tax returns that will be filed in 2019 or later. In 2019, the Tax Cuts and Jobs Act will reduce the penalty to zero and it will not be required to report the health coverage.

The treasury department is sending letters to Taxpayers when the income tax returns are sent without the 1095-A form information and the form 8962 properly filled, but they were covered over the market place (Obamacare system), the letter LTR 12C or similar asks for more information to process the return accurately and is giving 20 days to send the reply. The reply should consist in Form 8962, Premium Tax Credit to reconcile the advance credit payments with the amount of the premium tax credit allowed for the year; also the 1095-A received should be attached. The reply can be done by mail or by fax. Preparer have to be careful to include all the information requested and attached a cover letter following the letter instructions.

Taxpreparers should be aware to always ask if the taxpayer was covered under the Obamacare, marketplace, California covered, or whatever name is familiar in the area to define the Obamacare coverage; some taxpayers seem to ignore the name of the type of coverage they were or even in present time are using, therefore is always proper to ask in different ways for applicable tax years before 2019.

PREMIUM TAX CREDIT AND OTHER OBAMACARE'S PROVISIONS UNDER THE TCJA

The ACA individual mandate, the penalty for individuals who do not have health insurance was eliminated under the Tax Cuts and Jobs Act. This mandate requires taxpayers without coverage by a qualifying health plan to pay a penalty. The elimination of the individual mandate is effective for months beginning after December 31, 2018. So, the individual mandate is in effect for 2017 and 2018.

Additionally, the employer mandate for providing health coverage has been retained. This shared responsibility for the employer imposes a penalty on large companies if it they do not offer minimum essential health insurance coverage or if one or more of its full-time employees obtains a premium tax credit to help purchase health coverage. The employer mandate applies to for-profit companies, not-for-profit organizations and government entities.

Marketplaces and employer health Insurance offering requirement will still be in place. The Tax Cuts and Jobs Act (TCJA) is not repealing the Obamacare entirely. The only provision of Obamacare that will be repealed is the individual mandate and that occurs in 2019. All other provisions of Obamacare remain in place. This includes the employer mandate that requires businesses with more than 50 full-time employees provide health coverage for their employees or face stiff penalties. The health care exchanges through which individuals may obtain health care coverage will also remain in place.

TJCA effects on Obamacare. Obtaining health coverage under the TCJA will be purely voluntary for individuals starting in 2019. Analysis on the impact that the TCJA will have on the Obamacare indicate that millions of people will not obtain health coverage or will drop off their current one. This is more likely to be true for young, healthy people who do not need health services as much as other groups. The Congressional Budget Office estimates that the number of uninsured Americans will increase by 13 million over the next 10 years. In addition, those individuals who do obtain Obamacare coverage will have their health more compromised and therefore more expensive to insure. As a result, the Budget Office estimates that the cost of Obamacare coverage will rise by 10% in most years over the next decade. Individuals who qualify for Obamacare tax credits may be largely protected from these cost increases. But those who do not qualify for the credits because their income is higher than the baselines may get priced out of the market.

Another impact of the Tax Cuts and Jobs Act law on the Obamacare is that people who are not getting insurance will not require premium tax credits and this will save the government funds. According to the Congressional Budget Office (CBO), eliminating the individual mandate will save the federal government approximately $338 billion over the next 10 years. This is because as mentioned before, fewer people will obtain government subsidized health coverage. This savings enabled Congress to implement many of the tax cuts contained in the TCJA.

Overall, this could translate to an additional 13 million or more Americans going without health insurance, including 5 million who previously purchased insurance under the Affordable Care Act.

NEW SCHEDULES TO FORM 1040

The 2018 draft form, which has not yet been officially posted on the IRS website, uses the first page to gather information about the taxpayer and any dependents and for the taxpayerôs signature and jurat. The second page gathers information on the taxpayerôs income, deductions (including a new line for the Sec. 199A qualified business income deduction), credits, and taxes paid. Many of the items reported on the 1040 will be calculated on various new schedules, which have also not yet been officially posted. These schedules include:

- Schedule 1, *Additional Income and Adjustments to Income*, includes items from lines 10 through 37 of the 2017 Form 1040, such as business income, alimony received, capital gains or losses, and adjustments including educator expenses and student loan interest expense.

- Schedule 2, *Tax*, includes items from lines 44 through 47 of the 2017 Form 1040, such as the tax on a childôs unearned income (commonly called the kiddie tax), the alternative minimum tax, and any excess premium tax credit that must be repaid.

- Schedule 3, *Nonrefundable Credits*, includes items from lines 48 through 55 of the 2017 Form 1040, such as the foreign tax credit, the credit for child and dependent child care, the education credit, and the residential energy credit.

- Schedule 4, *Other Taxes*, includes items from 57 through 63 of the 2017 Form 1040, such as household employment taxes, the health care individual responsibility payment (the individual mandate), the net investment income tax, and the additional Medicare tax. It also includes a new line for reporting the Sec. 965 net tax liability installment from Form 965-A ð a form that does not yet exist.

- Schedule 5, *Other Payments and Refundable Credits*, includes items from lines 65 through 74 of the 2017 Form 1040, such as estimated tax payments, the net premium tax credit, and amounts paid with an extension request.

- Schedule 6, *Foreign Address and Third Party Designee*, provides taxpayers who have a foreign address a place to list their country, province, and postal code (formerly these appeared on page 1 of the 1040) and provides all taxpayers with a place to list information for a third-party designee who can discuss the return with the IRS.

The new Form 1040 and the new schedules also refer to various existing schedules, which presumably will continue to exist in updated form. These include Schedule A, *Itemized Deductions* which already have suffered a considerable modifications mentioned later, Schedule C, *Profit or Loss From Business*, Schedule D, *Capital Gains and Losses*, Schedule E, *Supplemental Income and Loss*, Schedule F, *Profit or Loss From Farming*, Schedule H, *Household Employment Taxes*, Schedule SE, *Self-Employment Tax*, and Schedule 8812, *Child Tax Credit*.

On the other hand, Schedule B, *Interest and Ordinary Dividends*, Schedule J, *Income Averaging for Farmers and Fishermen*, and Schedule R, *Credit for the Elderly or the Disabled*, are not mentioned on the new form and schedules. A line exists for reporting the earned income tax credit, although Schedule EIC itself is not mentioned.

Review Questions Section 2

Read and answer the following review questions. The correct answers are found on the next page with an explanation to strengthen up your knowledge. Note: This is not part of your Final Test.

7. What is the only difference between the PATH and the TCJA with respect to the tax payer identification number?

a) The PATH requires for tax payers to have an identification number assigned before their deadline for their original income tax return.
b) SSN is required for dependents claiming the Additional Child Tax Credit.
c) The new law qualifies dependents with ITIN for the Additional Child Tax Credit.
d) All of the above.

8. What does section 36B allow?

a) Amends previous regulations.
b) Allows premium tax credit to eligible people who enroll themselves and their families in a qualified health plan.
c) A degree of requirements to qualify for the premium tax credit.
d) It states the amounts of premiums and credit allowable.

9. What is the Tax Reform 2.0?

a) The basis and foundation of the Tax Cuts and Jobs Act.
b) New Tax Brackets applying soon.
standard for determining a employee from a contractor.
c) A mix of new additions to the TCJA such as permanent tax cuts, new retirement savings plans, new family savings plans, etc.
d) All of the above.

10. What is the family savings plan?
a) A variant of an HSA
b) Permanent tax cuts
c) Itôs a Roth type account, a new plan where TP funds, and would not be tax on withdrawals, the growth would be tax deferred.
d) A completely new idea of savings and investment.

11. What is schedule 3 of the new 1040 form?

a) Additional income and adjustments to income
b) Tax includes items from lines 44 to 47 of the 2017 form.
c) Foreign address and 3rd party designee
d) Nonrefundable credits

12. What are the requirements the IRS made in order to accept electronically filed tax returns?

a) Individuals have to send their birth certificate in order to be accepted for a tax return.
b) The tax payer has to provide evidence of healthcare coverage by the Affordable Care Act.
c) They have to present the medical bills paid.
b) Every tax payer has to show the Market Place application submitted.

13. What consists of the reply to the treasury department?

a) Form 1040 completely with all the schedules attached.
b) Form 1095-A filled out with income tax.
c) Form 8962 completely filled out Attaching also the 195-A form.
d) Form 8962 completely filled out Attaching also the 195-A form and copy of tax return.

Questions Section 2 – Answers and Discussion

7. Correct answer: B. Under the PATH act, taxpayers are required to have an ID number assigned prior to the due date of the original income tax return, but the TCJA requires the social security number to be able to claim the credit.

8. **Correct answer B.** Section 36B allows a premium tax credit to eligible individuals who enroll themselves, their spouse or any dependent in a qualified health plan.

9. Correct answer: The TCJA is a new act approved by congress to add new extensions to the old tax cut and nearly doubled the deductions, here are some additions to the old tax cut: Permanent tax cuts, new retirement savings plans, new family savings plans, etc.

10. Correct answer: C. Congress generated a Universal Savings Account in order to offer a fully flexible savings tool for families, what it means it is that you pay in at the funding and not be taxed on withdrawals.

11. Correct answer: D. There are many schedules to the time consuming 1040 form. But schedule 3 consists of nonrefundable credits and includes items 48 through 57 of the 2017 form 1040.

12. **Correct answer: B.** For the 2018 tax year, the IRS will not accept but rather decline electronically filed tax returns where the tax payer does not address whether they are covered for health insurance requirements of the Affordable Care Act.

13. **Correct answer:** C. A reply to the U.S department of treasury must include form 8962 completely filled out and the form 1095-A form attached. The reply can be faxed for a faster IRS response or mailed to the address in the letter.

SOME OF THE TAX IMPLICATIONS FOR IMPLEMENTATION OF THE CONSOLIDATED APPROPRIATIONS ACT OF 2018

The Consolidated Appropriations Act, 2018 to fund the government through the remainder of the fiscal year contains several tax provisions, including tax technical corrections for bills other than the Tax Cuts and Jobs Act (TCJA) and a fix for the Section 199A cooperative issue.

What will be the Excise Tax on High Cost Employer-Sponsored Health Coverage or Cadillac Tax?

A 40 percent excise tax In an Employer sponsored health plan whose value exceeds the legally specified thresholds, this means a very expensive plan. These plans will be subject to this Cadillac tax, starting in 2022. The mentioned Cadillac tax will be imposed on insurance companies, but the cost will likely fall on workers. The tax will effectively limit the tax preference for employer sponsored health insurance. Under prior law, for tax years beginning after December 31, 2019, a 40% excise tax was scheduled to apply to any ñexcess benefitò provided to any employee whoôs covered under any ñapplicable employer-sponsored coverage.ò

The recent government funding law further delays the Cadillac tax for an additional two years. It is now scheduled to apply for tax years 2022 and later.

The Cadillac tax was originally scheduled to take effect in 2018 but has been delayed twice by legislation, most recently by the Extension of Continuing Appropriations Act of January 2018. This ñCadillac taxò will equal 40 percent of the value of health benefits exceeding thresholds projected to be $11,200 for single coverage and $30,150 for family coverage in 2022. The thresholds will be indexed to growth in the consumer price index in subsequent years. Thresholds will be higher for plans with more-expensive-than-average demographics, retirees ages 55 to 64, and workers in high-risk professions. The Cadillac tax will apply not only to employersô and employeesô contributions to health insurance premiums, but also to contributions to health saving accounts, health reimbursement arrangements, and medical flexible spending accounts.

Employees will pay the Price. The tax will be collected on insurance companies, but the final price will likely be passed on to workers in the form of lower salaries. Some employers will avoid the tax by switching to less expensive health insurance; this will translate into higher wages but also higher income and payroll taxes. In fact, the Joint Committee on Taxation and the Congressional Budget Office predict that 70 percent of the revenue raised by the Cadillac tax will be through the indirect channel of higher income and payroll taxes, rather than through excise taxes collected from insurers. Projections suggest the excise tax will have the largest relative impact on after tax income for families in the middle income range.

Limits the Employer Sponsored Health Insurance Exclusion. Employer provided health benefits are excluded from taxable income, reducing income and payroll tax revenue by an estimated $280 billion in 2018. Even if one ignores the revenue losses, there are other undesirable aspects of the exclusion. The exclusion for employer-sponsored health insurance

(ESI) is poorly targeted, as it is worth more to taxpayers in higher brackets who would be more likely to purchase insurance in the first place. Additionally, the ESI exclusionsô open ended nature may contribute to faster health care cost growth. For these reasons, tax analysts have often suggested limiting the ESI exclusion by including the value of health benefits beyond a certain threshold in taxable income.

While the Cadillac tax plan is not a direct limit, it effectively reduces the ESI exclusion. If employers avoid the excise tax by shifting compensation from health benefits to taxable wages, the ultimate impact will be identical to an exclusion limit. In both cases, health benefits that exceeded thresholds before introduction of the Cadillac tax would become subject to income and payroll taxes. If employers continue to offer high-cost health plans, the impact will be similar to an exclusion limitð though less progressive. Excess benefits would be taxed at 40 percent rather than at an individual workerôs marginal tax rate. After accounting for income and payroll tax offsets, the effective excise tax rate is ultimately lower than 40% and, in fact, declines with income.

Medical Device Tax . The January 22, 2018 government funding law further delays the medical device tax for an additional two years. Itôs now scheduled to apply to sales after taxable year 2019.

Under prior law, for tax years beginning after December 31, 2017, a 2.3%-of-sales-price excise tax was to be imposed on the sale of any taxable medical device by the deviceôs manufacturer, producer or importer. Originally, the medical device tax was scheduled to apply for sales after December 31, 2012. But it has been suspended, most recently by the 2015 Protecting Americans from Tax Hikes (PATH) Act.

The medical device excise tax applies to manufacturers and importers and generally does not apply to individual consumers directly but prices for the final consumer definitely will be affected.

Annual Fee on Health Insurance Providers. There is currently a suspension of the Health Insurance Providers Fee for 2019; the fee is scheduled to restart also with the filing requirement of the form 8963 Report of the Health Insurance Provider Information.

Effective for calendar years beginning after December 31, 2013, U.S. health insurance providers generally were supposed to face an annual flat fee. The fee is a fixed amount allocated among all providers based on their relative market share as determined by each entityôs net premiums written for the data year (the year immediately preceding the year in which the fee is paid).

The annual fee on health insurance providers was suspended for 2017 by the 2016 Consolidated Appropriations Act. Now itôs been further suspended by the recent government funding law; the annual fee on health insurance providers is now scheduled to apply in tax years beginning after December 31, 2019. The suspension does not affect the filing requirements and payment of the fees for 2018 and 2020.

UPDATES ON THE IRS IDENTITY VERIFICATION PROCESS

Identity theft places a burden on its victims and presents a challenge to businesses, organizations and government agencies, including the IRS. For individuals, tax-related identity theft occurs when someone uses taxpayerôs stolen social security number to file a tax return claiming a fraudulent refund.

The IRS combats tax-related identity theft with an aggressive strategy of prevention, detection and victim assistance.

New IRS Identity Theft Letters

If your return triggers an ID verification process, you will receive one of the following four letters from the IRS:

Letter 4883C. Taxpayers must call to resolve this case. When calling, taxpayers should have the letter, a prior-year tax return, the return for the year that the letter is for, and all supporting documents for those returns like W2s, W2Gs, 1099s, schedules A, C, E, etc.

Letter 5071C. Taxpayers may receive a letter when the IRS stops suspicious tax returns that have indications of being identity theft but contains a real taxpayerôs name and/or Social Security number. Only those taxpayers receiving Letter 5071C should access the new online tool to confirm their identity, this letter can be also solved by calling the number in the letter.

New Letter 5447C: Can be solved by phone or writing to resolve the case. If Taxpayer calls, they should have the letter, a prior-year tax return, the most recent return, and all supporting documents. If the response is by mail, copies of all requested information should be attached.

New Letter 5747C: Taxpayers can only resolve the case by making an in-person appointment at a Taxpayer Assistance Center (TAC). You must bring the documents mentioned in the letter, no other options to solve the case are allowed.

Tax preparers can represent clients to try to solve the case, but it is highly recommended to be with the taxpayer either by phone or in person due to the use of personal financial and work related questions used by the IRS agents.

Online Tool for Taxpayers to Verify their Identity

Taxpayers who received requests from the IRS to verify their identities can do it using the Identity Verification Service website: idverify.irs.gov or https://www.irs.gov/identity-theft-fraud-scams/identity-verification (most recent).

An account has to be created and the website will ask a series of questions that only the real taxpayer can answer.

Once the identity is verified, the taxpayers can confirm whether or not they filed the return in question. If they did not file the return, the IRS can take steps at that time to assist them. If they did file the return, it will take approximately six weeks to process it and issue a refund.

Letter 5071C is mailed through the U.S. Postal Service to the address on the return. It asks taxpayers to verify their identities in order for the IRS to complete processing of the returns if the taxpayers did file it or reject the returns if the taxpayers did not file it. The IRS does not request such information via email, nor will the IRS call a taxpayer directly to ask this information without receiving a letter first. The letter number can be found in the upper corner of the page.

The letter gives taxpayers two options to contact the IRS and confirm whether or not they filed the return. Taxpayers may use the idverify.irs.gov site or call a toll-free number on the letter. Because of the high-volume on the toll-free numbers, the IRS-sponsored website, idverify.irs.gov, is the safest, fastest option for taxpayers with web access.

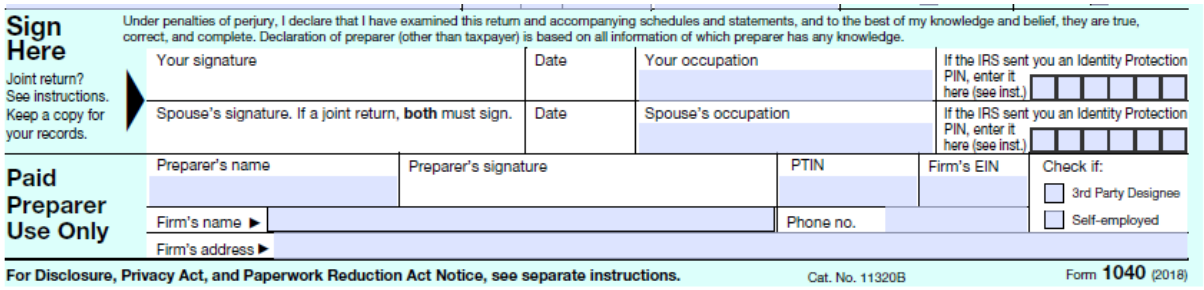
Taxpayers should have available their prior year tax return and their current year tax return, if they filed one, including supporting documents, such as Forms W-2 and 1099 and Schedules A and C.

THE IDENTITY PROTECTION PIN (IP PIN)

Taxpayers that were victims of identity theft will receive every year an Identity Protection Pin. This PIN is assigned once taxpayers have informed the IRS about the issue using Form 14039, Identity Theft Affidavit.

An IP PIN is a 6-digit number assigned to eligible taxpayers to help prevent the misuse of their Social Security number on fraudulent federal income tax returns. Once they receive an IP PIN, they must use it to confirm their identity on the tax return for the current year or any delinquent returns filed during the calendar year. The IRS will send a new IP PIN each December by postal mail.

New for 2018 taxable year forms have been modified to fit two PINs for Taxpayer and Spouse in case both of them have compromised their identity.



Sign Here

Joint return? See instructions. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature	Date	Your occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.)
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.)

Paid Preparer Use Only

Preparer's name	Preparer's signature	PTIN	Firm's EIN	Check if:
Firm's name ▶		Phone no.		3rd Party Designee
Firm's address ▶				Self-employed

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2018)

What does an IP PIN do?

An IP PIN helps the IRS verify a taxpayerôs identity and accept their electronic or paper tax return. When taxpayers have an IP PIN, it prevents someone else from filing a tax return with their SSN as the primary or secondary taxpayer (spouse).

IP PIN helps Preventing Identity Theft.

If a return is e-filed with taxpayerôs SSN and an incorrect or missing IP PIN, the IRS system will reject it until the correct IP PIN is submitted or taxpayers file on paper. If the same conditions occur on a paper filed return, the IRS will delay its processing and any refund that may be due for the protection of taxpayers. The IRS will determine if the paper filed return belongs to the taxpayer.

Who is eligible for an IP PIN?

The following taxpayers will be eligible for an IP PIN:

- Taxpayers that are victims of identity theft and the IRS resolved their cases already. The IRS will put an identity theft indicator on the affected taxpayerôs account. The IRS will send every year in December a CP01A Notice containing the IP PIN for the current tax year, or

- Taxpayers that filed their federal tax return last year as residents of Florida, Georgia or the District of Columbia, or

- Taxpayers that received a CP01F Notice or another IRS letter inviting them to voluntarily 'opt in' to get an IP PIN.

Online Tool to get an IP PIN

Taxpayers living in Florida, Georgia, or the District of Columbia as well as recipients of a CP01F notice or other letter, can require an IP PIN if they do not have it already. These taxpayers will need to verify their identity to receive an IP PIN through the IRS online system: *http://www.irs.gov/Individuals/Get-An-Identity-Protection-PIN.*

Reminders about the IP PIN

- Taxpayers that receive a CP01A Notice will find their PIN in the left column, third paragraph of the notice, The PIN will state: ñ**Your assigned 2018 IP PIN is: _____.**”

- If taxpayers lost their IP PIN or did not receive a new one, they can login through the IRS website*: http://www.irs.gov/Individuals/Get-An-Identity-Protection-PIN.*

- Taxpayers cannot use their IP PIN on another taxable year income tax return.

- Taxpayers cannot use their IP PIN on a state income tax return.

WHAT TAX PREPARERS MUST KNOW ABOUT IDENTITY THEFT

Tax preparers play a critical role in assisting clients, both individuals and businesses, who are victims of tax-related identity theft. The IRS is working hard to prevent and detect identity theft as well as reduce the time it takes to resolve these cases.

Signs of Identity Theft

Taxpayers may be victims of identity theft if the one of the following signs appear when filing their income tax return:

- More than one tax return was filed already with the clientôs SSN,
- Taxpayer has a balance due, refund offset or a collection action taken for a year in which he or she did not file a tax return,
- IRS records indicate that taxpayer received wages from an unknown employer,
- A business client may receive an IRS letter about an amended tax return, fictitious employees or about a defunct, closed or dormant business.
- A refund check from the United States Treasury that was not expected or the refund is higher than the amount stated on original tax return.

How to Fight Identity Theft

If someone steals and uses taxpayersô personal information, they can take these three steps as soon as possible:

1. Place a fraud alert with the credit reporting bureaus.
2. Get a free credit report or better yet consider monitoring your credit continuously.
3. Create an Identity Theft Report by filing a complaint with the Federal Trade Commission and the local police department.
4. Report the issue to the IRS using Form 14039, Identity Theft Affidavit. This form can be used if none of the above steps have been taken.
5. Close accounts opened without your permission immediately.

Review Questions Section 3

Read and answer the following review questions. The correct answers are found on the next page with an explanation to strengthen up your knowledge. Note: This is not part of your Final Test.

14. Which part of Obama care is being overridden by the TCJA?

a) The Affordable Care Act was eliminated by the TCJA
b) It limits the need for the 1095-A form
c) The ACA Individual mandate which penalize tax payers for not having coverage for health coverage.
d) The emission of the12C letters.

15. What Impact will the Cadillac tax cause to insurance companies and workers in 2022?

a) Taxpayers who are not under health insurance will not be impacted.
b) It will be imposed on insurance companies with the cost likely falling on the workers.
c) It will almost make no impact at all.
d) It was started in 2018.

16. What effect will the High Cost Employer-Sponsored Health Coverage or also called Cadillac Tax have on employees?

a) It will have lower salaries for the employees and have higher payroll taxes for the employer.
b) It will have no effect on the employees; it will just be the employers who will be affected.
c) On the contrary the employees will have a higher salary with better benefits.
d) all of the above

17. What is the Medical Device Tax?

a) Has to be paid by manufacturers and importers in 2018.
b) A limit to the ACA individual mandate.
c) It has been suspended for years before 2018.
d) It is an excise tax that applies to manufacturers and importers and sometimes does not apply to individual consumers but increase prices for the final consumer.

18. What is one of the reasons a taxpayer gets an IP PIN issued?

a) Tax Payers are getting E-mail from the IRS asking to get one.
b) Someone stole your tax return in a burglary.
c) An IRS agent calls to TP saying that he must get an IP PIN at a certain website.
d) Tax payers who have been victim of identity theft and the tax payer have filed an identity affidavit form 14039.

19. Are taxpreparers able to represent the clients in an identity theft case?

a) No, the tax payer has to make an in person appointment with the IRS.
b) No, taxpayer receives Letter 4883C then he must call to resolve the matter.
c) Yes, but it is recommended and almost required that the client be present either physically or through a cell phone during the call before and IRS agent.
d) Yes, but the tax preparer and the client must testify in court in order to solve the case.

20. Which of the following is a sign of identity theft?
a) An IRS letter states income not recognized by the taxpayer
b) The tax return gets rejected with a code indicating that a tax return was already filed with that Social security number.
c) A refund check from the United States treasury that is larger than the one expected.
d) All of the above.

Questions Section 3 – Answers and Discussion

14. **Correct answer: C.** The ACA individual mandate, the penalty for individuals who do not have health insurance was eliminated under the Tax Cuts and Jobs Act, it was part of Obama Care; it is now eliminated now no longer in effect.

15. **Correct answer: B.** The High Cost Employer-Sponsored Health Coverage or better known as the Cadillac tax will be imposing a 40% excise tax on the excess benefits in every Employer sponsored health coverage plan starting in 2022.

16. **Correct answer: A.** The Cadillac tax will greatly affect employeesô salaries and will be causing higher payroll taxes for the employers which will have to pass on the cost to workers.

17. **Correct answer: D.** The medical device tax applies to manufacturers and importers and generally does not apply to individual consumers and importers.

18. **Correct answer: D**. The following are common reasons for taxpayers to receive and IP PIN:

- Taxpayers who fell victim to identity theft and filed an affidavit of identity theft before the IRS.
- Taxpayers who filled out a tax return in the states of Florida, Georgia, or the District of Colombia.
- Taxpayers that have received a letter inviting them voluntarily to get an IP PIN.

19. **Correct answer: C.** It is strongly recommended that Tax Preparers have their clients either physically present or on the phone to give answers to personal and financial related questions used by IRS agents to solve the identity theft problem.

20. **Correct answer: D.** Here are some of the most common signs of identity theft:

- Tax payer has a balance due, but the refund offset or the collection action was taken for a year in which no one filed a tax return.
- IRS records state that the tax payer received wages from an unknown employer.
- More than one tax return was filed already with the clientôs SSN.
- A refund check from the United States Treasury that was not expected or the refund is higher than the amount stated on original tax return.

Tax Cuts and Jobs Act's Impact on Individual Taxation

Congress passed the first major tax reform legislation in 30 years at the end of 2017, known as the Tax Cuts and Jobs Act of 2017 (TCJA). The changes relating to the Actôs provisions affecting individual taxpayers are temporary in nature and generally apply beginning in 2018 and ending on December 31, 2025. Accordingly, most of the provisions of the Act applicable to individual taxpayers expire for years beginning in 2026.

Because of the major tax reforms being implemented as a result of passage of the Tax Cuts and Jobs Act, it is important for tax preparers to watch for additional IRS guidance relative to the Act and to research appropriately as issues affected by the Act are emerging.

Individual and Capital Gains Tax Rates for 2018

The Act maintains the current seven individual tax brackets but generally reduces the applicable tax rates. The Tax brackets effective for 2018 income under the Act shows the following:

2018 Income Tax Brackets				
Income in Excess of:				
Tax Bracket	Unmarried	MFJ	HOH	MFS
10%	$0.00	$0.00	$0.00	$0.00
12%	$9,525.00	$19,050.00	$13,600.00	$9,525.00
22%	$38,700.00	$77,400.00	$51,800.00	$38,700.00
24%	$82,500.00	$165,000.00	$82,500.00	$82,500.00
32%	$157,500.00	$315,000.00	$157,500.00	$157,500.00
35%	$200,000.00	$400,000.00	$200,000.00	$200,000.00
37%	$500,000.00	$600,000.00	$500,000.00	$300,000.00

The TCJA generally keeps the maximum tax rate imposed on net capital gain and qualified dividends. Accordingly, net long term capital gain and qualified dividends are generally taxed at 0%, 15% or 20% depending on taxable income and filing status as follows:

Capital Gains & Qualified Dividend Tax Rate based on Taxable Income and Filing Status for 2018				
Maximum Rate	MFJ	HOH	MFS	Single
0%	<$77,200	<$51700	<$38,600	<$38,600
15%	$77,200.00	$51,700.00	$38,600.00	$38,600.00
20%	$479,000.00	$452,400.00	$239,500.00	$425,800.00

Standard Deduction Increased and Filing Requirements Changed

The Act has increased the standard deduction for 2018. Under the new law, standard deductions are:

- $24,000 for married couples whose filing status is married filing jointly and surviving spouses
- $12,000 for singles and married couples whose filing status is married filing separately
- $18,000 for taxpayers whose filing status is head of household

Standard Deduction for Dependents

A taxpayer who can be claimed as a dependent is generally limited to a smaller standard deduction, regardless of whether the individual is actually claimed as a dependent. For 2018 returns, the standard deduction for a dependent is the greater of:

- $1,050; or
- The dependentôs earned income from work for the year plus $350 (but not more than the standard deduction amount, generally $12,000).

Standard Deduction for Blind and Senior Taxpayers

Elderly and/or blind taxpayers receive an additional standard deduction amount added to the basic standard deduction. The additional standard deduction for a blind taxpayerð a taxpayer whose vision is less than 20/200ð and for a taxpayer who is age 65 or older at the end of the year is:

- $1,300 for married individuals; and
- $1,600 for singles and heads of household

The additional standard deduction for taxpayers who are both age 65 or older at year-end and blind is double the additional amount for a taxpayer who is blind (but not age 65 or older) or age 65 (but not blind). For example, a 65-year-old single blind taxpayer would add $3,200 to his or her usual standard deduction: $1,600 for being age 65 plus $1,600 for being blind. ($1,600 x 2 = $3,200). Thus, his or her standard deduction would normally be $15,200. ($12,000 + $3,200 = $15,200)

Standard Deduction Eligibility

The general rule with respect to deductions is that a taxpayer may choose to take a standard deduction or itemize his or her deductions. Although that general rule applies in the case of most taxpayers, certain taxpayers are ineligible to take the standard deduction and must itemize.
Taxpayers who are ineligible to take the standard deduction are the following:

- Taxpayers whose filing status is ñmarried filing separatelyò and whose spouse itemizes
- deductions;
- Taxpayers who are filing a tax return for a short tax year due to a change in their annual
- accounting period; and
- Taxpayers who were nonresident aliens or dual-status aliens during the year

Personal Exemption Temporarily Reduced to Zero

Personal exemptions are temporarily reduced to zero under TCJA for taxable years beginning after December 31, 2017, and before January 1, 2026.

Income & Adjustments to Income

Alimony. Under the tax law, alimony is deductible by the payer and included in the income of the recipient for tax purposes. That tax treatment continues for alimony payments made pursuant to a divorce or separation agreement entered into on or before December 31, 2018. Thus, alimony payments made in 2018 are deductible to the payer and includible in the recipientôs income.
However, under The Tax Cuts and Jobs Act, alimony payments will no longer be tax-deductible to the payer or includible in the income of the recipient if made under:

1). A divorce or separation agreement entered into after December 31, 2018; or

2). A divorce or separation agreement entered into on or before December 31, 2018 but modified after that date if the modified agreement specifically provides that the provisions of the Tax Cuts and Jobs Act of 2017 will apply.

Alimony payments made under a divorce or separation agreement entered into on or before December 31, 2018 but paid after that dateð with the exception of such payments made under a modified agreement described in 2) aboveð will continue to be tax-deductible to the payer and includible in the income of the recipient.

Moving Expense Deduction & Reimbursement
Many taxpayers change their residence each year, and a substantial percentage of those taxpayer relocations involve new jobs. Prior tax law permitted a taxpayer to deduct moving expenses provided the new job location was at least 50 miles farther from the taxpayerôs former home than the former main job location or, if the taxpayer had no former principal place of work, the new job location was at least 50 miles from the taxpayerôs former home. However, under the TCJA, both the taxpayerôs moving expense deduction and the exclusion of an employerôs

reimbursement or payment of the taxpayerôs moving expenses have been suspended except for military relocation. Accordingly, any non-military moving expense reimbursement made by an employer is taxable as income to the employee.

Moving Expenses in Military Relocations

In the case of a military relocation, the taxpayerôs move must be pursuant to a military order and involve a permanent change of station. In such a case, any paid or incurred moving and storage expenses:

- Furnished in kind, or
- For which reimbursement or allowance is provided to the service member, spouse or dependents are not includible in gross income nor reported.

In addition, if the moving expenses paid or incurred in connection with a military relocation are furnished or reimbursed (or an allowance is provided) to the service memberôs spouse and dependents to move:

- To a location other than the one to which the service member moves, or
- From a location other than the one from which the service member moves such expenses are likewise neither includible in gross income nor reported.

Roth IRAs Recharacterization

Taxpayers may rollover funds in a traditional IRA to a Roth IRA in a rollover contribution usually referred to as a ñconversion.ò Making such a conversion requires the taxpayer to recognize any converted traditional IRA contributions that were deducted and any income earned in the traditional IRA. However, no premature distribution penalty for an early distribution from the traditional IRA would apply.

Sometimes taxpayers who converted their IRAs changed their minds and wished to reverse the conversion. Prior tax law permitted a taxpayer to unwind a Roth conversion in a subsequent transaction referred to as a ñrecharacterizationò provided the unwinding was done by the due date of the taxpayerôs income tax return for the year in which the conversion was made, including extensions. The TCJA has eliminated recharacterization of Roth conversions for any Roth conversion made after December 31, 2017. Note, however, that Roth conversions made on or before December 31, 2017 may still be recharacterized in 2018 until the date for filing the taxpayerôs 2017 income tax return, including extensions.

Schedule A and it's Itemized Deductions

The TCJA has affected various Schedule A itemized deductions. The affected Schedule A deductions are those for:

- Medical expenses;
- State and local taxes;
- Home mortgage interest;
- Charitable contributions;
- Casualty and theft losses; and
- Miscellaneous itemized deductions subject to 2% of AGI.

In addition, the Tax Cuts and Jobs Act law has affected the overall limitation on itemized deductions. We will consider some of them.

Medical Expense AGI Threshold

The medical and dental expense deduction is subject to an AGI threshold, and only unreimbursed medical and dental expenses that exceed the threshold may be deducted. In 2013, the AGI threshold applicable to deductible medical and dental expenses was increased from 7.5% of AGIð a level at which it had been since 1986ð to 10% of AGI. The increase in the AGI threshold from 7.5% to 10% was waived for taxpayers age 65 or older until January 1, 2017. Effective January 1, 2017, the 10% AGI threshold applicable to unreimbursed medical and dental expenses was scheduled to apply to all taxpayers.

The TCJA reduced the applicable threshold for the deduction of unreimbursed medical and dental expenses to 7.5% of AGI for the years 2017 and 2018. Beginning in 2019, the applicable AGI thresholdð above which a taxpayer may deduct unreimbursed medical and dental expensesð will be 10% for all taxpayers regardless of age.

State and Local Tax Deductions

State and local taxes paid by an itemizing taxpayer have generally been a deductible item on the taxpayerôs federal income tax return without limit. The TCJA limits the federal income tax deduction for state and local taxes to $10,000 ($5,000 for married taxpayers filing separately) beginning in 2018.

Home Mortgage Interest Deduction. Under prior tax law, the home mortgage interest deduction was limited to home mortgage interest paid on mortgage debt falling into three categories:

1) Mortgages taken out before October 13, 1987, called ñgrandfathered debtò;

2) Mortgages taken out by the taxpayer (or spouse if married filing a joint return) after October 13, 1987 to buy, build or improve the taxpayerôs home, i.e. ñacquisition debt,ò but only if the total of such mortgages plus any grandfathered debt was $1 million or less ($500,000 or less if married filing separately) throughout the year; and

3) Mortgages taken out by the taxpayer (or spouse if married filing a joint return) after October 13,1987 that were home equity debt, i.e. any indebtedness (other than acquisition indebtedness) secured by a qualified residence, but only if the total of such mortgages was $100,000 or less ($50,000 or less if married filing separately) and totaled no more than the fair market value of the taxpayerôs home reduced by 1 and 2 above.

The dollar limits for mortgages in the second and third categories apply to the combined mortgages on the taxpayerôs main home and any second home. The TCJA made the following changes to the existing home mortgage interest deduction for taxable years 2018 through 2025:

- Interest paid on home equity indebtednessð home equity loans and lines of credit, in other
- wordsð incurred after December 15, 2017 is not tax-deductible unless used to buy, build or

- substantially improve the taxpayerôs home that secures the loan;
- Interest paid on acquisition debt incurred after December 15, 2017, less any acquisition debt
- incurred on or before December 15, 2017, is limited to interest paid on total acquisition
- indebtedness but only if the total of such mortgages is $750,000 or less ($375,000 or less if
- married filing separately); and
- Interest paid on acquisition debt incurred on or before December 15, 2017 is limited to interest paid on acquisition indebtedness of $1,000,000 or less ($500,000 or less if married filing separately).

Exception for Binding Contracts
A taxpayer could enter into a ***written binding contract*** to buy a principal residence before December 15, 2017 to close on the property before January 1, 2018 but not purchase the residence until after December 31, 2017. In such a case, if the taxpayer purchases the residence before April 1, 2018, the acquisition debtð for purposes of the mortgage interest deductionð will be deemed to have been incurred before December 15, 2017. Accordingly, the maximum tax deduction would be limited to interest paid on acquisition indebtedness of $1,000,000 or less ($500,000 or less if married filing separately) rather than the reduced amounts under the TCJA.

Indebtedness Refinancing
The tax treatment of refinanced existing mortgage debt is treated, for purposes of the applicable dollar limits, as incurred on the date the original indebtedness was incurred but only to the extent the amount of the indebtedness resulting from the refinancing does not exceed the amount of the refinanced indebtedness.

Charitable Contributions
Charitable contributions are contributions made in cash or property to, or for the use of, churches and governments and to other organizations that have applied to the IRS and been approved to become qualified organizations. A contribution made to an individual, regardless of how needy the individual, is not a charitable contribution for which a tax deduction may be taken. The maximum amount of charitable contribution a taxpayer is permitted to deduct in any year may be limited by the taxpayerôs contribution base, in most cases the contribution base is an amount equal to the taxpayerôs adjusted gross income and further limited depending on the type of property contributed. However, any charitable contribution exceeding the applicable tax deduction limit may be carried over to the following five years.

The tax code generally applies three limits applicable to the permitted tax deduction of charitable contributions. Those limits are:
1) *A **50% limit*** that normally applies to most qualified organizations, such as:
- churches,
- educational organizations with a regular faculty and curriculum,
- organizations whose principal purpose is providing medical or hospital care, medical
- education or medical research, such as hospitals or medical research organizations, and
- the United States or any state, the District of Columbia, a U.S. possession, a political
- subdivision of a state or U.S. possession, or an Indian tribal government;

2) *A **30% limit*** that applies to contributions:

- for the ***use*** of any qualified organization;
- of capital gain property contributed to 50% limit organizations if the deduction is figured
- on the fair market value without reduction for appreciation, and
- to all qualified organizations other than 50% limit organizations, such as:
  - veterans organizations,
  - fraternal societies,
  - nonprofit cemeteries, and
  - certain private nonoperating foundations; and

3) *A **20%*** limit that applies to all contributions of capital gain property to or for the use of qualified organizations that are not 50% limit organizations.

AGI Limit for Cash Contributions. The TCJA increases the limit on a taxpayerôs deductible charitable cash contributions from 50% under prior tax law to 60% of the taxpayerôs contribution base for qualified organizations to which the 50% limit normally applies. The increased limitation for cash contributions applies to contributions made in any taxable year beginning in January 1, 2018 and before January 1, 2026.

80% of the payment as a charitable contribution. The TCJA has changed the deduction by eliminating that provision. Under the TCJA, no deduction is permitted for a payment made after December 31, 2017 to an institution of higher education that entitles the donor to receive the right to purchase tickets for seating at an athletic event at the institutionôs athletic stadium. However, if a portion of a payment is for the purchase of such tickets, the part of the payment that is for the tickets and the remainder of the payment should be treated as separate amounts: a portion not tax-deductible and a portion possibly tax-deductible.

Exception to Contemporaneous Written Acknowledgement. Donors making charitable gifts of $250 or more are required to obtain a contemporaneous written acknowledgment of the gift from the charitable organization in order to substantiate the gift for tax purposes. Under prior law, an alternative form of charitable gift substantiation permitted the charitable organization to file a document with the IRS that contained detailed information concerning the donor and the donorôs gift rather than requiring the donor to obtain a contemporaneous written acknowledgement of the gift.

The TCJA eliminates the exception to a contemporaneous written acknowledgment of a donorôs gift, effective for gifts made after December 31, 2016**.** (Note: The effective date of the elimination of the exception to a contemporaneous written acknowledgment is retroactive to gifts made on and after 2016.)

Content and Timing of Contemporaneous Written Acknowledgement
In order to meet the requirements of the TCJA with respect to a contemporaneous written acknowledgment of a charitable gift, the acknowledgment should contain the following information:

— The amount of cash and a description of any property other than cash contributed;

— Whether the organization receiving the gift provided any goods or services in return for the gift; and
— A description and a good-faith estimate of the value of any goods or services given by the donor or, if the goods and services consist solely of intangible religious benefits, a statement to that effect.

A written acknowledgment of a charitable gift is considered ñcontemporaneousò only if it is obtained by the donor on or before the *earlier of*:

— The date the taxpayer files a tax return for the taxable year in which the contribution was made, or
— The due date, including extensions, for filing the tax return for the taxable year in which the contribution was made.

Casualty and Theft Loss Deduction. Taxpayers normally have been able to deduct some or all of the losses they incur as a result of various casualtiesð fires, storms, shipwrecks, etc.ð and thefts. Under prior tax law, the tax deduction for a personal casualty or theft loss was limited to such losses but only to the extent that:

- The amount of each separate casualty or theft loss was more than $100, and
- The total amount of all losses during the year, reduced by $100, was more than 10% of the taxpayerôs adjusted gross income.

The tax treatment of personal casualty losses and thefts is changed under the TCJA. Pursuant to the TCJA, the itemized deduction for personal casualty and theft losses is temporarily limited in tax years 2018 through 2025 solely to losses attributable to federally-declared disasters.

In addition, casualty loss rules are revised for net disaster losses occurring in 2016 and 2017. Under the revision, the limitation applicable to each casualty is increased from the previous $100 to $500 for an individual who has a net disaster loss for tax years beginning in 2016 or 2017. However, the 10% AGI limitation for such taxpayers is waived.

A federally-declared disaster means any disaster that is subsequently determined by the president of the United States to warrant assistance by the federal government under the Robert T Stafford Disaster Relief and Emergency Assistance Act**.**

Miscellaneous Itemized Deductions Subject to 2% of AGI Threshold

Taxpayers who itemize their deductions normally have been able to deduct certain expenses as miscellaneous itemized deductions on schedule A (Form 1040) to the extent that, in the aggregate, they exceed 2% of the taxpayerôs AGI. Such taxpayer expenses include:

- Unreimbursed employee expenses;
- Tax preparation fees; and
- Certain other expenses.

Under the TCJA, these miscellaneous itemized deductions subject to the 2% of AGI floor are suspended for expenses incurred after December 31, 2017 through 2025, this have brought such a burden on regular employees having unreimbursed expenses, laborers, day laborers and agricultural workers either migrant or not.

Itemized Deductions Phase-Out Amounts. Prior tax law provides for an overall limitation on certain itemized deductions applicable to higher income individuals whose adjusted gross

income (AGI) exceeds specified limits based on the taxpayerôs filing status. The specified limits are subject to annual adjustment for inflation.
The TCJA suspended the overall limitation on itemized deductions for tax years beginning after December 31, 2017 through December 31, 2025. Accordingly, itemized deductions are not reduced for higher-income taxpayers.

Unearned Income of Minor Children. The ñKiddie taxò is an area that has been revamped under the recently enacted Tax Cuts and Jobs Act (TCJA). The kiddie tax will still apply to unearned income for children under the age of 19 and college students under the age of 24. Unearned income is income from sources other than wages and salary ï i.e. investment income.
Under the TCJA, kiddie tax rules were simplified. Beginning in the 2018 tax year, the net unearned income of a child subject to the rules will be taxed at the capital gain and ordinary income rates that apply to trusts and estates. Thus, the childôs tax is unaffected by the parentôs tax situation or the unearned income of any siblings. Trusts and estates reach the highest tax bracket of 37% after only $12,500 (for 2019 tax season) of income, significantly faster than the individual rate. High-income individuals who were already in the maximum tax bracket will not see a significant difference under the new rules, however lower and middle income individuals subject to the new kiddie tax laws might see more of an impact. A childôs earned income will still be taxed at their own individual brackets and rates under the TCJA.

2018 Alternative Minimum Tax Exemption for a Child Subject to the "Kiddie Tax." For taxable years beginning in 2018, for a child to whom the ñkiddie tax" applies, the exemption amount for purposes of the alternative minimum tax may not exceed the sum of:

1) the child's earned income for the taxable year, plus;
2) $7,650.

Capital Gains and Qualified Dividend Tax Rates. For tax years 2018 and 2019, long term capital gains and qualified dividends will remain the same. However the percentile rates will change due to the new tax brackets set by the TCJA, which includes a new 20% threshold amount.

- 0% if you fall into the 10% or 12% tax bracket
- 15% if you fall into the 22%, 24%, 32%, or 35%

For 2018 the 20% threshold applies to those earning over $500,000 ($510,301 for 2019) and married couples earning over $600,000 ($612,351 for 2020).

Net Investment Income Tax (NIIT). A relatively new tax that was devised to help fund the Affordable Care Act, the NIIT applies at a rate of 3.8% to certain net investment income of individuals, estates and trusts that have income above the statutory threshold amounts. Single or Head of Household filer with modified adjusted gross income (MAGI) over $200,000, married filing joint couple or qualifying window(er) filer with MAGI over $250,000, or married filing separate filer with MAGI over $125,000, will owe NIIT. This makes the top rate on long-term gains effectively 23.8% combined.

Modified adjusted gross income (MAGI) for the purpose of the net investment income tax is adjusted gross income for the year with the foreign earned income exclusion added back in, less

any deductions that were disallowed under the rules for the foreign earned income exclusion. Taxpayers who invest in controlled foreign corporations and passive foreign investment companies may need to make further modifications to adjusted gross income.

Taxpayers should be aware that these threshold amounts are not indexed for inflation. If you are an individual who is exempt from Medicare taxes, you still may be subject to the Net Investment Income Tax if you have Net Investment Income and also have modified adjusted gross income over the applicable thresholds.

For tax year 2018 no changes were made to short-term capital gains. They are still taxed as normal income, at rates from 10% to 37% depending on your tax bracket.

Social Security and Medicare Taxes. Social Security is financed by a 12.4 percent tax on wages up to the annual threshold, with half (6.2 percent) paid by workers and the other half paid by employers. This taxable wage base usually goes up each yearð in 2018 it rose from $127,200 in 2017 to $128,700. In 2019 it is planned to rise to $132,900. Earnings above this amount are not subject to the Social Security portion of the payroll tax or used to calculate retirement payouts.

Medicare taxes are assessed on all income. The Medicare tax rate is 1.45 percent of all income. The employee and employer both pay 1.45 percent.

Self-employed : the Social Security tax rate is 12.4 percent on income under $132,900 through the end of 2018. The Medicare tax rate is 2.9 percent on all income.

Additional Medicare Tax: Also, beginning in 2013 and continuing in 2019 you must pay an additional 0.9 percent more in Medicare taxes on earned individual income of more than $200,000 ($250,000 for married couples filing jointly; $125,000 Married Filing Separately). The Additional Medicare tax applies when a taxpayer's wages from all jobs exceeds the threshold amount. For married couples filing jointly, the additional Medicare tax applies on the couple's combined wages from their jobs. (Additional medicare tax has been extended until 2023).

Income from United States Savings Bonds for Taxpayers Who Pay Qualified Higher Education Expenses. For taxable years beginning in 2019, the exclusion under IRC§ 135, regarding income from United States savings bonds for taxpayers who pay qualified higher education expenses with this income, begins to phase out for modified adjusted gross income above $121,600 (up from $119,550 in 2018) for joint returns and $81,100 (up from $79,700 in 2018) for all other returns. The exclusion is completely phased out for modified adjusted gross income of $151,600 (up from $149,550 in 2018) or more for joint returns and $96,100 (up from $94,700) or more for all other returns.

Qualified Transportation Fringe Benefit. For taxable years beginning in 2019, the monthly limitation regarding the aggregate fringe benefit exclusion amount for transportation in a commuter highway vehicle and any transit pass is $265 (Up from $260 in 2018). The monthly limitation regarding the fringe benefit exclusion amount for qualified parking is $265.

Estates. Under the Tax Cuts and Jobs Act the exemption amount for estate tax has been doubled to $11,200,000 or $22,400,000 for couples. In 2019 it has been adjusted for inflation and will rise to $11,400,000 for individuals and $22,800,000 for couples. This is a major increase from a total of $5,490,000 for estates of decedents who died in 2017.

Annual Exclusion for Gifts. For calendar years 2018-2019, the first $15,000 of gifts to any person (other than gifts of future interests in property) are not included in the total amount of taxable gifts under IRC§ 2503 made during that year. This dollar amount has been raised for the first time since 2013.
For calendar year 2019, the first $155,000 (up from $152,000 in 2018) of gifts to a spouse who is not a citizen of the United States (other than gifts of future interests in property) are not included in the total amount of taxable gifts under IRC§ 2503 and 2523(i)(2) made during that year. For taxable years beginning in 2019, IRC§ 6039F authorizes the Treasury Department and the Internal Revenue Service to require recipients of gifts from certain foreign persons to report these gifts if the aggregate value of gifts received in the taxable year exceeds $16,388.

Foreign Earned Income Exclusion. For tax year 2019, the foreign earned income exclusion is $105,900, up from $104,100 for tax year 2018.

Some Changes and Updates on Business Taxes for 2018

Corporation Tax. One of the major changes introduced in the Tax Cuts and Jobs Act is the large decrease in the corporate tax rate. The corporate tax rate will take effect right away in the current tax year of 2018. The tax rate has been lowered from 35% to 21%.

Tax Rates for Self-Employment (SE) Tax. The 15.3% self-employment tax is composed of a Social Security tax of 12.4% on the first $132,900 of net self-employment income (for 2019), and a Medicare tax of 2.9% on all net self-employment income. The $132,900 amount is called the Social Security wage base, and represents the maximum amount income from wages and net self-employment income subject to the Social Security tax. There is no maximum limit on earnings subject to the Medicare part.

Standard Business Mileage Rate. For 2019 the standard mileage rate for the cost of operating your car, van, pickup, or panel truck for each mile of business use is 58 cents per mile. For 2018, the standard mileage rate for the cost of operating your car, van, pickup, or panel truck for each mile of business use is 54.5 cents per mile.

Entertainment and Meal Expenses. Prior to the Tax Cuts and Job Act, taxpayers generally could deduct 50% of expenses for business-related meals and entertainment. Meals provided to an employee for the convenience of the employer on the employerôs business premises were 100% deductible by the employer and tax-free to the recipient employee. Various other employer-provided fringe benefits were also deductible by the employer and tax-free to the recipient employee.

Under the new law, for amounts paid or incurred after December 31, 2017, deductions for business-related entertainment expenses are disallowed. Meal expenses incurred while traveling

on business are still 50% deductible, but the 50% disallowance rule will now also apply to meals provided via an on-premises cafeteria or otherwise on the employerôs premises for the convenience of the employer. After 2025, the cost of meals provided through an on-premises cafeteria or otherwise on the employerôs premises will be nondeductible.

The one major category that was still under confusion at the time the bill was released was when a meal expense is incurred when meeting with a client or partner to discuss business matters. The argument is that when the entertainment expense was completely repealed under the TCJA, by default it grabbed the meals expense under its umbrella. On October 3rd, 2018 the IRS released a statement clarifying this by stating that taxpayers may continue to deduct 50 percent of the cost of business meals if the taxpayer (or an employee of the taxpayer) is present and the food or beverages are not considered lavish or extravagant. The meals may be provided to a current or potential business customer, client, consultant or similar business contact. Food and beverages that are provided during entertainment events will not be considered entertainment if purchased separately from the event.

TCJA Changes to Net Operating Loss. The TCJA revamps the rules for net operating losses (NOLs) that a business may encounter. Essentially, NOLs can no longer be carried back for two years, but can now be carried forward indefinitely (instead of for 20 years), not to exceed 80% of taxable income in any one year.

Section 179 Expense Limits. Section 179 of the IRS Tax Code allows a business to deduct, for the current tax year, the full purchase price of financed or leased equipment and off-the-shelf software that qualifies for the deduction. The equipment purchased, financed or leased must be within the specified dollar limits of Section 179, and the equipment must be placed into service in the same tax year that the deduction is being taken (for tax year 2018, this means the equipment must be put into service between 01/01/2018 and 12/31/2018).

The December 2015 Federal Budget Bill passed by Congress and signed by the President made permanent the Section 179 expense deduction at the $500,000 level. This had been in doubt for most of 2015. Businesses exceeding a total of $2 million of purchases in qualifying equipment will have the Section 179 deduction phase-out dollar-for-dollar and completely eliminated above $2.5 million. Another change - the Section 179 cap will be indexed to inflation in $10,000 increments in future years, starting in 2016. In 2017 the cap was raised to $510,000. However, under the Tax Cuts and Jobs Act in 2017 the deduction will be increased to $1,000,000 for the 2019 tax season and $1,020,000 for the 2020 tax season.

TCJA Changes to Section 179 and Bonus Depreciation

A provision of the tax code called Section 179 enables rental business owners to deduct in one year the cost of personal property used in a rental business, such as furniture and appliances. During 2017, the maximum amount that can be deducted under Section 179 is $500,000. Starting in 2018, the Section 179 maximum is increased to $1 million. The $1,000,000 amount is reduced (but not below zero) by the amount by which the cost of property placed in service during the year exceeds $2,500,000. In 2019 these values increase to $1,020,000 and $2,550,000 respectively.

One significant limitation on Section 179 is that is has never been available for rental property owners to use to deduct the cost of personal property used in residential rental units. In a major victory for landlords, the TCJA eliminates this restriction starting in 2018. Section 179 now allows expensing of assets for real commercial property (commercial use buildings such-as shopping centers and warehouses). For the first time, Section 179 property includes items such-as roofs, HVACs, fire protection and alarm systems, and security systems.

100% Bonus Depreciation through 2022. Currently, business owners may deduct in a single year up to 50% of the cost of personal property they purchase for their business. The TCJA increases this amount to 100% for property acquired and placed into service from September 27, 2017 through December 31, 2022. Moreover, 100% bonus depreciation would apply for the first time to both new and used property, instead of new property only. The bonus depreciation amount will be phased down in 2023 and later years as follows: 80% for property placed in service during 2023; 60% for property placed in service after during 2024; 40% for property placed in service during 2025; 20% for property placed in service during 2026; 0% for 2027 and later.

Bonus depreciation may not be used for real property, except for real property improvements such as landscaping or grading, and other components that have a depreciation period of 20 years or less. Thus, landlords may not use it to deduct the cost of their rental buildings or major building components. However, landlords can use bonus depreciation to fully deduct in one year the cost of personal property they use in their rental activity, such as appliances, laundry equipment, gardening equipment, and furniture. But landlords can often do this already under existing provisions in the tax lawð for example, the de minimis safe harbor enables landlords to fully deduct in one year any personal property that costs $2,500 or less. Section 179 can also now be used.

Listed property must be used over 50% of the time for business to qualify for bonus depreciation. Listed property includes cars, and entertainment property like televisions and cameras. Computers were classified as listed property as well, but the TCJA removes them from this classification starting in 2018. Thus, bonus depreciation may be used to deduct computers used less than 50% of the time for a rental business.

Listed Property. Common examples of listed property are automobiles and computers. (Note that cell phones are no longer considered ñlistedò property). Listed property is a special classification for assets that lend themselves to both personal and business use. The designation is for tax purposes only and has no meaning for financial reporting. While there are limitations on the allowable depreciation amounts and methods for certain listed property, the primary objective of the IRS is to ensure you only depreciate the business and investment-use portion of these assets and not the personal-use portion. To do this, the IRS has established record keeping requirements for the use of such property.
The IRS defines listed property as: Passenger automobiles; any other transportation property; property of a type generally used for entertainment, recreation or amusement purposes, but not used exclusively at a regular place of business; any computer or peripheral equipment not used exclusively at a regular place of business and owned or leased by the person operating the business.

Listed Property. Under the TCJA, computers and peripheral equipment placed in service after 2017 are no longer treated as ñlisted propertyò whether or not they are used in a business establishment (including a home office) or whether or not an employeeôs use is for the convenience of an employer. This means that the use doesnôt have to pass a more-than-50% qualified business use test in order to be eligible for Section 179 expense and avoids mandatory application of the ADS.

Luxury car deductions. The annual depreciation limits for ñluxury carsò kick in at surprisingly modest levels. Now TCJA hikes the limits for business drivers for cars placed in service in 2018 and thereafter. For example, not even counting bonus depreciation, the first-year deduction jumps from a maximum of $3,160 to $10,000. Of course, actual deductions must be based on percentage of business use.

Rental Income and changes due to the TCJA Law changes. The main provisions of the TCJA affecting business owners and rental property owners (landlords) are described below. Most of these following provisions take effect on January 1, 2018.

New Pass-Through Tax Deduction. For landlords, the most significant change created by the TCJA is a new tax deduction for owners of pass-through businesses. This includes the vast majority of residential landlords who own their rental property as sole proprietors (who individually own their properties), limited liability companies (LLCs), and partnerships. The rental income from properties ñpasses throughò to line 17 of Form 1040, thus the origin of the term. The TCJA creates a brand new tax deduction for individuals who earn income through pass-through entities. If your rental activity qualifies as a business for tax purposes, as most do, you may be eligible to deduct an amount equal to 20% of your net rental income. This is in addition to all your other rental-related deductions. This deduction is being referred to as the Section 199A deduction (referring to the specific tax code for this deduction) or the Qualified Business Income Deduction.

If the taxpayer qualify for this deduction, he will effectively be taxed on only 80% of your rental income. Thus, the effective rate for taxpayers in the top 37% tax bracket is 29.5%. This extremely complex deduction goes into effect in 2018 and is scheduled to end on January 1, 2026. All the details of the deduction have yet to be made clear by the IRS as there are various complexities that have still not been clarified; nevertheless, it basically works as follows:

Taxable Income below $315,000 ($157,500 for singles) for 2018 and $321,400 ($160,725 for singles) in 2019, TP will qualify for an income tax deduction equal to 20% of your rental income if:

- He operates his rental business as a sole proprietor, LLC owner, partner in a partnership, or S corporation shareholder, and
- his total taxable income for the year from all sources after deductions is below $315,000 ($321,400 for 2019) if TP is married filing jointly, or $157,500 ($160,725 in 2019) if he is single.

This deduction is phased out the income exceeds the $315,000/$157,500 ($321,400/$160,725) limits. It disappears entirely for marrieds filing jointly whose income exceeds $415,000 ($421,400 for 2019) and for singles whose income exceeds $207,500 ($210,700 for 2019). This is a personal deduction you can take on your return whether or not you itemize. However, it is not an ñabove the lineò deduction that reduces your adjusted gross income (AGI).

Income above $415,000 ($421,400 for 2019) and $207,500 for Singles ($210,700 for 2019). If the annual taxable income is over $415,000 if Taxpayer is filing married filing jointly, or $207,500 if single, he is still entitled to a pass-through deduction of up to 20% of his rental activity income. However, the deduction cannot exceed:

- 50% of Taxpayer applicable share of the W-2 employee wages paid by your rental business, or
- 25% of Taxpayer share of the W-2 wages paid by your business, PLUS 2.5% of the original purchase price of the depreciable long-term property used in the production of incomeð for example, the real property you rent. Since most residential landlords have no employees, the 25% plus 2.5% deduction will be of most benefit to them.

The 2.5% deduction can be taken during the entire depreciation period for the property, which is 27.5 years for residential property. However, it can be no shorter than 10 years.

De minimis safe harbor election. The IRS requires you to capitalize (and therefore depreciate) the costs of acquiring, producing, and improving tangible property, regardless of the size or the cost incurred. The tax law has long required you to determine whether expenditures related to tangible property are currently deductible business expenses or non-deductible capital expenditures. Effective for taxable years beginning on or after January 1, 2016, the Internal Revenue Service in Notice 2015-82 increased the *de minimis safe harbor* threshold from $500 to $2,500 per invoice or item for taxpayers without applicable financial statements (AFSs). In addition, the IRS will provide audit protection to eligible businesses by not challenging the use of the $2,500 threshold for tax years ending before January 1, 2016.

For taxpayers with AFSs, the limit is $5,000, which the IRS justifies as warranted because those taxpayers are more likely to follow accounting GAAP rules. Prior to this new IRS Notice, neither the Internal Revenue Code nor prior regulations included a de minimis safe harbor exception to capitalization; you were required to determine whether each expenditure for tangible property, regardless of amount, was required to be capitalized. If you were audited and the IRS disagreed with your determination, then adjustments would be made reflecting the difference between expensing the cost immediately or capitalizing the cost. The de minimis safe harbor election eliminates the burden of determining whether every small dollar expenditure for the acquisition or production of property is properly deductible or ñcapitalizableò.

If you elect to use the de minimis safe harbor, you don't have to capitalize the cost of qualifying de minimis acquisitions or improvements. However, de minimis amounts you pay for tangible property may be subject to capitalization under if the amounts include the direct or allocable

indirect costs of other property you produced or acquired for resale. For example, you must capitalize all the direct and allocable indirect costs of constructing a new building.

If a purchase does not qualify under the de minimis safe harbor, you should treat the amount under the normal rules that apply, for example currently deducting expenses for incidental materials and supplies or for repair and maintenance. This treatment is proper regardless of whether the amount exceeds the applicable de minimis safe harbor limitation. The de minimis safe harbor is simply an administrative convenience that generally allows you to elect to deduct small-dollar expenditures for the acquisition or production of property that otherwise must be capitalized under the general rules.

Review Questions Section 4

Read and answer the following review questions. The correct answers are found on the next page with an explanation to strengthen up your knowledge. Note: This is not part of your Final Test.

21. The following is true about alimony?
a) It is not deductible if your separation agreement is during 2018 tax year.
b) It should not be included on income by the recipient.
c) Alimony is deductible by the payer and included in the income of the recipient for tax purposes.
d) Alimony paid after December 31, 2018 will not be deductible.

22. What is the additional Standard deduction for senior tax payers?
a) 1500 and 1800.
b) Elderly or blind tax payers are going to receive and additional standard deduction equal to 1,300.
c) $12,000.
d) None of the above.

23. How does the TCJA affect State and local taxes beginning in 2018?
a) The new law limits the federal income tax deduction to $10,000.
b) Limits the deduction to $5,000 for married filing separately.
c) They have been deductible items without limitation but not in 2018.
d) All of the above.

24. How did the TCJA change casualty and theft loss deduction?
a) The deduction is limited to more than $100.
b) The treatment of personal casualty losses and theft has not changed with the TCJA.
c) The itemized the deduction for personal casualty and theft losses temporarily limits to losses attributable to federally declared disasters.
d) all of the above.

Questions Section 4 – Answers and Discussion

21. **Correct answer: C.** Under tax law the Alimony is a deductible by payer and Will no longer be a tax deductible to the payer. It was eliminated by the Tax Cuts and Jobs act IF made under a divorce agreement after December 31, 2018 and a divorce agreement entered on or before December 31, 2018.1

22. **Correct answer: B.** Elderly or blind tax payers receive an additional deduction along with the standard deduction. Therefore the additional standard deduction is 1,300 for married seniors and 1,600 dollars for heads of house hold and singles.

23. **Correct answer: A.** State and local taxes were originally been a deductible item on the taxpayers federal income tax return with no limit, but after the TCJA was in effect, it was limited to 10,000 dollars annually.

24. **Correct answer: C.** Under the TCJA, the itemized deduction for personal casualty have been temporarily limited in tax years 2018 through 2025 solely to losses attributable to federally declared disasters.

ETHICS

AVOID CIRCULAR 230 DISCLAIMERS ON EMAILS OR LETTERS

The IRS Office of Professional Responsibility (OPR) will send letters asking practitioners to stop using Circular 230 disclaimers saying the disclaimer is required. Many practitioners are using the following legend at the end of their written communication: óThe Internal Revenue Service requires that I tell you,ô or óunder Circular 230 I am obliged to say.ô

According to the OPR this legend is taken from section 10.37 of Circular 230 and is a misstatement. The form or wording of the alternative disclaimer will be up to practitioners and they should not blame the IRS or OPR for their own comments. According to the OPR the government and practitioners have widely conceded that the former disclaimer had been rendered devoid of meaning after being used in all e-mailed communications, even in the context of arranging social meetings or other non-legal related matters.

Replacing the old provision, and now of much more importance for practitioners, is the new Circular 230 Section 10.37 on due diligence governing written advice. The government deliberately structured it as a ñprinciples-based regulationò. Practitioners are required to make reasonable factual and legal assumptions on their comments. The OPR has mentioned that practitioners need to put reasonable amounts of effort into ascertaining what the relevant facts and circumstances are with respect to what practitioner knows or should know.

Not all written material will be considered relevant to the provisions of Section 10.37. For example, documents prepared for educational distribution or comments submitted to the government will not be targeted under the mentioned Circular 230 Section 10.37. On the other hand, the OPR indicates, ñIf it's some of the stuff when folks went out and spoke to large conventions of dentists and doctors and sold them tax shelters in the process, those written materials would constitute written advice under 10.37.ò

PRACTICE BEFORE THE INTERNAL REVENUE SERVICE

Practice before the Internal Revenue Service (IRS) comprehends all matters connected with a presentation to the Internal Revenue Service or any of its officers or employees relating to a taxpayerôs rights, privileges, or liabilities under laws or regulations administered by the Internal Revenue Service. Such presentations include, but are not limited to, preparing and filing documents, corresponding and communicating with the Internal Revenue Service, rendering written advice with respect to any entity, transaction, plan or arrangement, or other plan or arrangement having a potential for tax avoidance or evasion, and representing a client at conferences, hearings and meetings including tax audits.

The following individuals may practice before the IRS:

- Individuals representing oneself
- Attorneys in good standing with the IRS
- Enrolled Retirement Plan Agents

- Enrolled Agents (EAs)
- Enrolled Actuaries
- Certified Public Accountants (CPAs)
- And certain federal government officers and employees
- Registered Tax Return Preparers (RTRP)

What is a RTRP? A Registered Tax Return Preparer is a category of federal tax return preparers created by the Internal Revenue Service in 2012. In January 2013, however, the Internal Revenue Service announced that it was suspending the program because of a ruling on January 18, 2013, by the United States District Court for the District of Columbia (Loving v. IRS). As a result of a lawsuit, the Court issued an order prohibiting the Internal Revenue Service from enforcing the regulatory requirements for registered tax return preparers. In accordance with this order, tax return preparers covered by this program are not currently required to register with the IRS. The IRS announced that because of the Court's ruling, tax return preparers are not required to complete the competency testing or to secure the continuing education that had been required. However, individuals that successfully met the requirements for an RTRP and registered as such with the IRS, continue to be recognized as RTRPs by the IRS as long as they maintain annual CE requirements.

RTRPs may practice before the Internal Revenue Service. Practice as a *Registered Tax Return Preparer* is limited to preparing and signing tax returns and claims for refund, and other documents for submission to the Internal Revenue Service. A registered tax return preparer may prepare all or substantially all of a tax return or claim for refund of tax. A registered tax return preparer may represent taxpayers before revenue agents, customer service representatives, or similar officers and employees of the Internal Revenue Service (including the Taxpayer Advocate Service) during an examination if the registered tax return preparer signed the tax return or claim for refund for the taxable year or period under examination. A RTRP may not represent a taxpayer before appeals officers, revenue officers, Counsel or similar officers or employees of the Internal Revenue Service or the Treasury Department. A registered tax return preparerôs authorization to practice before the IRS also does not include the authority to provide tax advice to a client or another person except as necessary to prepare a tax return, claim for refund, or other document intended to be submitted to the Internal Revenue Service.

Limited representation rights for non-credentialed preparers. Effective for tax returns and claims for refunds prepared and signed after Dec. 31, 2015, the limited right to represent clients before the IRS held by *non-credentialed* preparers (all preparers other than the ones listed above, including RTRPs) will be accorded only to those preparers participating in the *IRS Annual Filing Season Program*, a voluntary IRS sponsored continuing education (CE) program. The changes in the limited representation rules have no impact on returns prepared and signed by non-credentialed preparers on or before Dec. 31, 2015. Non-credentialed tax return preparers who participate in the Annual Filing Season Program will continue to have limited rights to represent clients. This enables them to represent taxpayers whose returns they prepared and signed, but only before revenue agents, customer service representatives and similar IRS employees, including the Taxpayer Advocate Service.

The tax return preparer must participate in the Annual Filing Season Program for both the year of return preparation and the year of representation to represent their client. There are no changes to representation rules for enrolled agents, certified public accountants and attorneys. These tax professionals continue to have unlimited practice rights and can represent any taxpayer before any IRS office, including collection and appeals, regardless of whether they prepared the tax return in question. To participate in the Annual Filing Season Program, non-credentialed tax return preparers must complete either 15 or 18 hours of continuing education from IRS-approved CE providers.

The CE must be completed by Dec. 31 of every year, in order to receive a Annual Filing Season Program Record of Completion for the coming tax season. Platinum Professional Services offers the IRS AFSP 18 Hour Courses including AFTRC for tax preparers in states other than California, Oregon and Maryland. California, Oregon and Maryland tax courses offered by Platinum Professional Services includes 15 hour of IRS-approved CE which is the requirement that these tax preparers need to fulfill. The individual tax preparer will then need to register in the Annual Filing Season Program.

GUIDELINES RELATED TO PRACTICE BEFORE THE INTERNAL REVENUE SERVICE

Subject to section 500 of title 5, the Secretary of the Treasury may ð

(1) Regulate the practice of representatives of persons before the Department of the Treasury; and

(2) Before admitting a representative to practice, require that the representative demonstrate ð

(A) Good character;

(B) Good reputation;

(C) Necessary qualifications to enable the representative to provide to persons valuable service; and

(D) Competency to advise and assist persons in presenting their cases.

(E) After notice and opportunity for a proceeding, the Secretary may suspend or disbar from practice before the Department, or censure, a representative who ð

- Is incompetent;
- Is disreputable;
- Violates regulations prescribed under this section; or
- With intent to defraud, willfully and knowingly misleads or threatens the person being represented or a prospective person to be represented.

The Secretary may impose a monetary penalty on any representative described above. If the representative was acting on behalf of an employer or any firm or other entity in connection with the conduct giving rise to such penalty, the Secretary may impose a monetary penalty on such employer, firm, or entity if it knew, or reasonably should have known, of such conduct. Such penalty shall not exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty and may be in addition to, or in lieu of, any suspension, disbarment, or censure of the representative.

BEST PRACTICES FOR TAX PRACTITIONERS

Tax practitioners should provide clients with the highest quality representation concerning Federal tax issues by adhering to best practices in providing advice and in preparing or assisting in the preparation of a submission to the Internal Revenue Service. Best practices include the following:

Communicating - A practitioner should insure clear communication with the client regarding the terms of the engagement. For example, the advisor should determine the clientôs expected purpose for and use of the advice given and should have a clear understanding with the client regarding the form and scope of the advice or assistance to be rendered.

Establishing facts - A practitioner should determine which facts are relevant, evaluate the reasonableness of any assumptions or representations, and relate the applicable law (including potentially applicable judicial doctrines) to the relevant facts, and arrive at a conclusion supported by the law and the facts.

Giving Advise - A practitioner should advise the client regarding the import of the conclusions reached, including, for example, whether a taxpayer may avoid accuracy-related penalties under the Internal Revenue Code if a taxpayer acts in reliance on the advice.

Practice before the IRS - A practitioner should always act fairly and with integrity in practice before the Internal Revenue Service.

Tax advisors with responsibility for overseeing a firmôs practice of providing advice concerning Federal tax issues or of preparing or assisting in the preparation of submissions to the Internal Revenue Service should take reasonable steps to ensure that the firmôs procedures for all members, associates, and employees are consistent with the best practices set forth above.

PERFORMING DUE DILIGENCE AS A TAX PREPARER

As a professional tax return preparer, you have a responsibility to provide quality service and to abide by certain ethical standards. When you obtain your Annual Filing Season Certificate from the IRS or prepare taxes as a credentialed professional (CPA, EA, etc.), there are ethical standards that you must be familiar with and abide by. You are required to maintain a certain level of due diligence to help insure that the tax returns that you are submitting to the IRS and state agencies are accurate and correct. Ethical standards that you must abide by include the following:

- Never knowingly prepare false returns
- Never engage in criminal, infamous, dishonest, notoriously disgraceful conduct, or any other conduct deemed to have a negative effect on the IRS
- Treat all taxpayers in a professional, courteous, and respectful manner
- Obtain training to obtain the knowledge necessary to complete accurate tax returns and keep up to date on tax law changes
- Complete the proper steps when electronically filing tax returns
- Safeguard the personal information acquired so as to maintain the privacy and confidentiality of all individuals whose information you obtain and only use that information for purposes of filing tax returns.

Taxpreparers due diligence. Due diligence means doing your part as a taxpreparer to ensure tax returns are correct, including verifying the identity and social security numbers of all individuals included on a tax return. As an IRS registered tax preparer, you are ensuring that the information on the return you are preparing or reviewing is correct and complete.

Doing your part includes:

ÅConfirming a taxpayerôs (and spouse if applicable) identity including complete legal names and Social Security Numbers

Å Providing top-quality service by helping taxpayers understand and meet their tax responsibilities

ÅMaking sure the facts presented by the taxpayer ñmake senseò to you and ñpaintò a reasonable picture of the facts being presented (example below)

Generally you can rely on good faith for taxpayer information without requiring documentation as verification. However, exercise caution when taxpayers want to claim a refundable credit such as the Earned Income Credit or education credits, especially if these credits are maximized.

Please note: When you have doubts about an individualôs identity, it is within your rights as a tax preparer to ask from proof of an individualôs identity. Proof can be in the form of a state driverôs license, passport, or other official state or federal issued I.D. When an electronically filed tax return rejects because of an issue with a social security number, you should ask to see the original social security card so that you can verify the number.

Top Four Things to Remember About Due Diligence

1. Do your part to ensure a tax return is correct.

2. Question any unusual, inconsistent, or incomplete items.

3. If you are unsure about a deduction or credit, research the answer, or ask another experienced tax preparer (including an IRS Enrolled Agent or Certified Public Accountant)

4. Remind taxpayers that when they sign their tax returns, they are stating under penalty of perjury that the return is accurate to the best of their knowledge.

Follow due diligence guidelines and take reasonable steps to ensure the tax return is correct by abiding by the following:

ÅAsk enough questions to determine if allowable expenses were incurred and that income reported is correct.

ÅAdd all taxable income to the tax return, even if the taxpayer does not agree with you.

ÅIf the item is questionable and/or unallowable, do not claim the deduction or credit on the tax return.

Å If you are uncomfortable with the information and/or documentation provided by a taxpayer, **do not prepare the tax return**.

ÅIf the taxpayer does not agree with your advice, you should **not prepare the return**.

Tax return integrity means that you must take reasonable steps to ensure the tax return is correct, which includes:

Å Verifying that all social security numbers presented by the taxpayer match the social security numbers listed on the tax return.

ÅNot preparing returns that you are unfamiliar with (for example, preparing a corporate form 1120 tax return when you have had no prior training for this type of return).

ÅExplaining to the taxpayer why the deduction or credit can or cannot be included on their return. Use IRS reference materials used to support your statements.

Å Not making changes or corrections to the tax return after the taxpayer leaves your office/location without first notifying the taxpayer.

As a tax preparer, you have the responsibility to perform adequate due diligence on EVERY return.

It is a good practice for a tax preparer to establish a relationship with other local well reputable tax practitioner, Enrolled Agent or CPA with tax experience. When you as a tax preparer are faced with a situation or question that you are unfamiliar with, having a trusted local expert to call on, can be extremely helpful. When faced with a tax return that is too complex for you to handle, having a reputable individual that you can refer the taxpayer to can also have a positive impact on your reputation.

For illustration purposes, here is one way that being observant and questioning if "things make sense" can stop you from filing, what may turn out to be, a fraudulent tax return.

Sue Lee has been a tax preparer for five years and obtains her business primarily from referrals and individuals that live in her community and see her office as they drive by her location. On April 14th, one day before the due date for personal 1040 tax returns, a new customer walked into her office. She noticed the customer drove up in a brand new "S" Class Mercedes Benz that Sue guessed must have cost at least $80,000 (Sue does not know for certain, because she cannot afford anything close to that make and model of vehicle). As she starts to interview the new customer, she finds that the individual lives and works in a city ten miles from her office location. When Sue asks why he chose her and her office to file the tax return, the customer states that a "friend" referred him but that he "cannot remember which friend". The customer produces a W-2, showing total income of $28,000 for the year. He states that he had no other sources of income. He also states that he is married, wants to file a joint return and also has three dependent children, all under the age of 10. He produces all of the names and social security numbers for his wife and dependents (written on a piece of paper) and asks if he will qualify for the "earned income program" that his friend told him about.

As he takes a call on the latest model iPhone, you start to think that this does not make sense. Why did he choose your office, when he lives 10 miles away? If he was referred by a "friend" and drove the 10 miles to your office because of the referral, why can he not remember the friend's name that referred him? How can he afford an expensive new car and support a wife and three children on $28,000 a year?

At this point, as a tax preparer, you should feel very uncomfortable with this situation. You can refuse to prepare a tax return if you are not comfortable with a situation. What do you say to this particular individual? You can start by letting him know that since he is a new client and it looks like he will indeed be eligible for the Earned Income Credit, you will need to verify all Social Security Numbers by reviewing the original Social Security Cards. Also, his wife will need to come in to verify her information and sign the return in your presence, since you will be filing a joint tax return for them. Be professional but firm this will be necessary before you can proceed. As he walks out the door wave good bye, for the first and last time, because you will not see him again.

CONFLICT OF INTEREST WHEN REPRESENTING A CLIENT

Per Circular 230, Section 1: Except as provided by Section 2 of this section, a practitioner shall not represent a client before the Internal Revenue Service if the representation involves a conflict of interest. A conflict of interest exists if:

(1) The representation of one client will be directly adverse to another client; or

(2) There is a significant risk that the representation of one or more clients will be materially limited by the practitionerôs responsibilities to another client, a former client or a third person, or by a personal interest of the practitioner.

Section 2: Notwithstanding the existence of a conflict of interest under Section 1 of this section, the practitioner may represent a client if:

(1) The practitioner reasonably believes that the practitioner will be able to provide competent and diligent representation to each affected client;

(2) The representation is not prohibited by law; and

(3) Each affected client waives the conflict of interest and gives informed consent, confirmed in writing by each affected client, at the time the existence of the conflict of interest is known by the practitioner. The confirmation may be made within a reasonable period of time after the informed consent, but in no event later than 30 days.

Copies of the written consents must be retained by the practitioner for at least 3 years from the date of the conclusion of the representation of the affected clients, and the written consents must be provided to any officer or employee of the Internal Revenue Service on request.

Frivolous Positions Taken by a Tax Practitioner

If a tax practitioner takes a frivolous position on a tax return that cannot be defended under any circumstances, the possible repercussions are serious. The matter can be referred to the Office of Professional Responsibility (OPR). After all procedural requirements have been met; the OPR can file a complaint against the tax practitioner. A complaint must name the respondent, provide a clear and concise description of the facts and law that constitute the basis for the proceeding, and be signed by an authorized representative of the Internal Revenue Service.

The respondent must be notified in the complaint or in a separate paper attached to the complaint of the time for answering the complaint, which may not be less than 30 days from the date of service of the complaint, the name and address of the Administrative Law Judge with whom the answer must be filed, the name and address of the person representing the Internal Revenue Service to whom a copy of the answer must be served, and that a decision by default may be rendered against the respondent in the event an answer is not filed as required. In response to a complaint from the OPR, a tax practitioner must specifically admit or deny each allegation set forth in the complaint, except she/he may state she/he is without sufficient information to admit or deny a specific allegation if that is true.

The respondent may not deny a material allegation in the complaint that the respondent knows to be true, or state that the respondent is without sufficient information to form a belief, when the respondent possesses the required information.

If a tax practitioner determines that there is reasonable basis for a taxpayerôs position on a tax matter, but she or he does not believe there is a realistic possibility of success based on the merits of the position, the tax practitioner can file a tax return or other related tax document if the position is not frivolous and is adequately disclosed on the return..

If a complaint is received by a tax practitioner, it is a serious matter and must be promptly and properly handled by the tax practitioner.

If a taxpayer ends up in tax court, The IRS has the burden of proof for any factual issue in a court proceeding if the taxpayer has done all of the following: Provided credible evidence relating to the issue in a court proceeding; Complied with all substantiation requirements and maintained all required records; Cooperated with all reasonable requests by the IRS for information regarding the preparation and related tax treatment of any item reported on the return.

The Tax Evasion is the illegal practice of not paying taxes, by not reporting income, reporting expenses not legally allowed, or by not paying taxes owed. Tax evasion is always illegal and is most commonly thought of in relation to income taxes, but tax evasion can be practiced by businesses and individuals on all different types of taxes including state sales taxes and employment taxes. Tax Avoidance is when businesses and individuals avoid taxes by taking all legitimate deductions and by sheltering income from taxes by doing things such-as setting up employee retirement plans and by other means, all legal and under the Internal Revenue Code or state tax codes.

A Tax Shelter helps reduce how much tax you pay the federal government by reducing your taxable income. There are many legitimate tax shelters. The IRS considers the abuse of tax shelters a form of tax evasion, which is illegal. Circular 230, section 10.35, addresses requirements for issuing covered opinions including tax shelter opinions. Section 10.35 applies to ñmore likely than notò covered opinions and ñmarketedò covered opinions. A ñmore likely than notò tax shelter opinion is an opinion that reaches the conclusion that the taxpayerôs position has a more than 50% chance to be resolved in his or her favor. A ñmarketedò tax shelter opinion will be used by someone other than the author (which can be a tax practitioner) in promoting, marketing, or recommending the tax shelter.

Review Questions Section 2

Read and answer the following review questions. The correct answers are found on the next page with an explanation to strengthen up your knowledge. Note: This is not part of your Final Test

1. Which of the following individuals may practice before the IRS?

   a) Individuals representing themselves
   b) Attorneys in good standing with the IRS
   c) Enrolled Agents (EAs) and Certified Public Accountants (CPAs)
   d) All of the above

2. Practice before the IRS comprehends all matters connected with a *presentation* to the IRS or any of its officers or employees relating to a taxpayerôs rights, privileges, or liabilities under laws or regulations administered by the IRS. Such presentations include, but are not limited to which of the following?

   a) Preparing and filing documents.
   b) Corresponding and communicating with the Internal Revenue Service.
   c) Representing a client at conferences, hearings and meetings including tax audits.
   d) All of the above represent presentations.

3. Which of the following statements regarding performing *due diligence* by a tax practitioner is **not** accurate?

   a) Confirming a taxpayerôs (and spouse if applicable) identity is not the tax practitioner's responsibility.
   b) A tax practitioner should make sure that facts presented by the taxpayer make sense and seem reasonable based on the facts being presented.
   c) A tax practitioner should help taxpayers with better understanding their tax responsibilities.
   d) All of the above statements are accurate.

4. A practitioner must exercise due diligence. Which of the following are examples of the due diligence that a practitioner must exercise?

   a) A practitioner must exercise due diligence in preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits.
   b) A practitioner must exercise due diligence in determining the correctness of oral or written representations made by the practitioner to clients with reference to any matter administered by the IRS.
   c) A practitioner must exercise due diligence in determining the correctness of oral or written representations made by the practitioner to the Department of the Treasury.
   d) All of the above are examples of due diligence that the practitioner must demonstrate.

5. A practitioner may publish the availability of a written schedule of fees and disseminate the following fee information ð Fixed fees for specific routine services, hourly rates, range of fees for particular services, and fee charged for an initial consultation. Which of the following statements is also true concerning fees a practitioner may charge?

   a) Fee information may not be communicated in professional lists, telephone directories or radio and television advertising.
   b) Any statement of fee information concerning matters in which costs may be incurred must include a statement disclosing whether clients will be responsible for such costs.
   c) Once a practitioner publishes charges, changes can be made to the published charges at any time and without any prior notice.
   d) All of the above are true statements regarding fees.

6. Generally, a practitioner may not charge a contingent fee for services rendered in connection with any matter before the Internal Revenue Service. However, there are circumstances where a contingent fee is allowed. Which of the following statements is correct?

   a) A practitioner may not charge a contingent fee for services rendered in connection with the IRS' examination of, or challenge to an original tax return.
   b) A practitioner may charge a contingent fee for services rendered in connection with an amended return or claim for refund or credit where the amended return or claim for refund or credit was filed within 120 days of the taxpayer receiving a written notice of the examination of, or a written challenge to the original tax return.
   c) A practitioner must charge a contingent fee for services rendered in connection with any judicial proceeding arising under the Internal Revenue Code.
   d) All of the above are correct statements regarding contingent fees.

7. Any statement of fee information provided to the customer, concerning matters involving costs that may be incurred for tax preparation services, must include:

   a) A statement disclosing whether clients will be responsible for such costs.
   b) The practitioner's refund policy.
   c) Any initial consultation fee charged.
   d) Disclosure of all possible contingent fees.

8. A practitioner shall not represent a client before the Internal Revenue Service if the representation involves a conflict of interest. A conflict of interest exists if _____.

   a) There is even a minimal probability of risk that the representation will cause issues for the tax preparer.
   b) The representation of one client will be directly adverse to another client.
   c) The practitioner is a blood relative of the client that is being represented.
   d) All of the above, given no additional information, are examples of where a conflict of interest definitely exists.

9. Notwithstanding the existence of a conflict of interest the tax practitioner may represent a client if:

    a) At least one affected client waives the conflict of interest and gives informed consent.
    b) The practitioner reasonably believes that the practitioner will be able to provide competent and diligent representation to each affected client.
    c) The representation may be prohibited by state law but is not prohibited by federal law.
    d) All of the above are correct.

10. Generally, a practitioner will be presumed to have exercised *due diligence* when relying on the work product of another person (such-as an employee of the practitioner's firm) if the practitioner _____.

    a) Used reasonable care in engaging, supervising, training, and evaluating the person.
    b) Used reasonable care in hiring the person.
    c) Insured that the person completed their required continuing education.
    d) Any of the above will satisfy due diligence requirements.

Review Questions 2 – Answers and Discussion

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1. **Answer d.** This is the best answer; all of the above have representation rights with the IRS. The following also have representation rights to practice before the IRS: Enrolled Retirement Plan Agents, Enrolled Actuaries, **Certified Public Accountants (CPAs),** and certain federal government officers and employees.

2. **Answer d.** An additional practice is rendering written advice with respect to any entity, transaction, plan or arrangement, or other plan or arrangement having a potential for tax avoidance or evasion As of the latest version of Circular 230, practice as a registered tax return preparer is limited to preparing and signing tax returns and claims for refund, and other documents for submission to the Internal Revenue Service. A registered tax return preparer may prepare all or substantially all of a tax return or claim for refund of tax. A registered tax return preparer may represent taxpayers before revenue agents, customer service representatives, or similar officers and employees of the Internal Revenue Service (including the Taxpayer Advocate Service) during an *examination if the registered tax return preparer signed the tax return or claim for refund for the taxable year or period under examination.* A RTRP may not represent a taxpayer before appeals officers, revenue officers, Counsel or similar officers or employees of the Internal Revenue Service or the Treasury Department.

3. **Answer a.** For a tax practitioner, due diligence means doing your part to ensure tax returns are correct, including verifying the identity and social security numbers of all individuals included on a tax return. As an IRS certified tax preparer, you ensure the information on the return you are preparing or reviewing is correct and complete.

4. **Answer d.** Generally, a practitioner will be presumed to have exercised due diligence for purposes of this section if the practitioner relies on the work product of another person and the practitioner used reasonable care in engaging, supervising, training, and evaluating the person, taking proper account of the nature of the relationship between the practitioner and the person.

5. **Answer b.** The correct answer is B. This answer is incorrect because there is a 30 day period that you must honor published prices. Regarding ñAò above, Fee information **may be** communicated in professional lists, telephone directories, print media, mailings, and electronic mail, facsimile, hand delivered flyers, radio, television, and any other method available. Regarding ñCò above, A practitioner may charge no more than the rate(s) published for at least 30 calendar days after the last date on which the schedule of fees was last published. With regards to solicitation and advertising, please note that a practitioner may not persist in attempting to contact a prospective client if the prospective client has made it known to the practitioner that he or she does not desire to be solicited. In the case of radio and television broadcasting, the broadcast must be recorded and the practitioner must retain a recording of the actual transmission. In the case of direct mail and e-commerce communications, the practitioner must retain a copy of the actual communication, along with a list or other description of persons to whom the communication was mailed or otherwise distributed. The copy must be retained by the practitioner for a period of at least 36 months from the date of the last transmission or use.
6.
7. **Answer b.** A practitioner may charge a contingent fee for services rendered in connection with a claim for credit or refund filed solely in connection with the determination of statutory interest or penalties assessed by the Internal Revenue Service.

8. **Answer a.** A practitioner **may** publish the availability of a written schedule of fees and disseminate the following fee information: Fixed fees for specific routine services, hourly rates, range of fees for particular services, and fee charged for an initial consultation.

9. **Answer b.** The representation of one client will be directly adverse to another client.

10. **Answer b.** All involved clients need to give consent. The requirements are as follows: The practitioner reasonably believes that the practitioner will be able to provide competent and diligent representation to each affected client; The representation is **not prohibited by law**;

and **each affected client waives the conflict of interest and gives informed consent**, confirmed in writing by each affected client, at the time the existence of the conflict of interest is known by the practitioner.

11. **Answer a.** Generally, a practitioner will be presumed to have exercised due diligence if the practitioner relies on the work product of another person and the practitioner used reasonable care in engaging, supervising, training, and evaluating the person, taking proper account of the nature of the relationship between the practitioner and the person. Some practitioners rely too much on assuming that a person is completely competent because they have met the required education requirements - this is not enough.

INCOMPETENT AND DISREPUTABLE CONDUCT

The following is a summary of the rules of conduct involved with being a tax practitioner. A complete discussion is located in Section 10.51 of Circular 230.

Incompetence and disreputable conduct. Incompetence and disreputable conduct for which a practitioner may be sanctioned under Section10.50 of Circular 230 includes, but is not limited to

1. Conviction of any criminal offense under the Federal tax laws.
2. Conviction of any criminal offense involving dishonesty or breach of trust.
3. Conviction of any felony under Federal or State law for which the conduct involved renders the practitioner unfit to practice before the Internal Revenue Service.
4. Giving false or misleading information, or participating in any way in the giving of false or misleading information to various government officials.
5. Solicitation of employment as prohibited under §10.30, the use of false or misleading representations with intent to deceive a client or prospective client in order to procure employment, or intimating that the practitioner is able improperly to obtain special consideration or action from the Internal Revenue Service or any officer or employee thereof.
6. Willfully failing to make a Federal tax return in violation of the Federal tax laws, or willfully evading, attempting to evade, or participating in any way in evading or attempting to evade any assessment or payment of any Federal tax.
7. Willfully assisting, counseling, encouraging a client or prospective client in violating, or suggesting to a client or prospective client to violate, any Federal tax law, or knowingly counseling or suggesting to a client or prospective client an illegal plan to evade Federal taxes or payment thereof.
8. Misappropriation of, or failure properly or promptly to remit, funds received from a client for the purpose of payment of taxes or other obligations due the United States.
9. Directly or indirectly attempting to influence, or offering or agreeing to attempt to influence, the official action of any officer or employee of the Internal Revenue Service by the use of threats, false accusations, duress or coercion, by the offer of any special

inducement or promise of an advantage or by the bestowing of any gift, favor or thing of value.

10. Disbarment or suspension from practice as an attorney, certified public accountant, public accountant, or actuary by any duly constituted authority of any State, territory, or possession of the United States, including a Commonwealth, or the District of Columbia, any Federal court of record or any Federal agency, body or board.
11. Knowingly aiding and abetting another person to practice before the Internal Revenue Service during a period of suspension, disbarment or ineligibility of such other person.
12. Contemptuous conduct in connection with practice before the Internal Revenue Service, including the use of abusive language, making false accusations or statements, knowing them to be false, or circulating or publishing malicious or libelous matter.
13. Giving a false opinion, knowingly, recklessly, or through gross incompetence, including an opinion which is intentionally or recklessly misleading or engaging in a pattern of providing incompetent opinions on questions arising under the Federal tax laws includes conduct that reflects gross indifference, preparation which is grossly inadequate under the circumstances, and a consistent failure to perform obligations to the client.
14. Willfully failing to sign a tax return prepared by the practitioner when the practitionerôs signature is required by Federal tax laws unless the failure is due to reasonable cause and not due to willful neglect.
15. Willfully disclosing or otherwise using a tax return or tax return information in a manner not authorized by the Internal Revenue Code, contrary to the order of a court of competent jurisdiction, or contrary to the order of an administrative law judge in a proceeding instituted under §10.60.
16. Willfully failing to file on magnetic or other electronic media a tax return prepared by the practitioner when the practitioner is required to do so by the Federal tax laws unless the failure is due to reasonable cause and not due to willful neglect.
17. Willfully preparing all or substantially all of, or signing, a tax return or claim for refund when the practitioner does not possess a current or otherwise valid preparer tax identification number or other prescribed identifying number.
18. Willfully representing a taxpayer before an officer or employee of the Internal Revenue Service unless the practitioner is authorized to do so pursuant to this part.
19. A practitioner who, having been retained by a client with respect to a matter administered by the IRS, knows that the client has not complied with the revenue laws of the United States or has made an error in or omission from any return, document, affidavit, or other paper which the client submitted or executed under the revenue laws of the United States, must advise the client promptly (as soon as reasonably possible) of the fact of such noncompliance, error, or omission. The practitioner must advise the client of the consequence.
20. When a complaint is issued against a practitioner the complaint must name the respondent, provide a clear and concise description of the facts and law that constitute the basis for the proceeding, and be signed by the Director of the OPR or a person representing the Director of the OPR. The time frame given for responding to the complaint cannot be less than 30 days and the respondent must be notified of the time frame.

Sanctions for the Disreputable and Incompetent Conduct of a Tax Practitioner

The Secretary of the Treasury, or delegate, after notice and an opportunity for a proceeding, may penalize by censure, suspend, or disbar any practitioner from practice before the Internal Revenue Service if the practitioner is shown to be incompetent or disreputable including intent to defraud, and willfully and knowingly mislead or threaten a client or prospective client. Censure is a public reprimand.

If the practitioner was acting on behalf of an employer or any firm or other entity in connection with the conduct giving rise to a penalty, the Secretary of the Treasury, or delegate, may impose a monetary penalty on the employer, firm, or entity if it knew, or reasonably should have known of such conduct.

The Director of the Office of Professional Responsibility may confer with a practitioner, employer, firm or other entity, concerning allegations of misconduct, irrespective of whether a proceeding has been instituted. In lieu of a proceeding being instituted or continued a practitioner may offer consent to be sanctioned.

The amount of the penalty shall not exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty. Any monetary penalty imposed on a practitioner may be in addition to or in lieu of any suspension, disbarment or censure and may be in addition to a penalty imposed on an employer, firm or other entity.

A practitioner who is disbarred by the Office of Professional Responsibility (OPR) may seek reinstatement after 5 years following such disbarment or disqualification. Reinstatement will not be granted unless the Internal Revenue Service is satisfied that the petitioner is not likely to conduct himself, thereafter, contrary to the regulations in this part, and that granting such reinstatement would not be contrary to the public interest.

THE FEES.

A practitioner may publish the availability of a written schedule of fees and disseminate the following fee information:

Fixed fees for specific routine services, hourly rates, range of fees for particular services, and fee charged for an initial consultation. Any statement of fee information concerning matters in which costs may be incurred must include a statement disclosing whether clients will be responsible for such costs. Fee information may be communicated in professional lists, telephone directories, print media, mailings, and electronic mail, facsimile, hand delivered flyers, radio, television, and any other method available.

A practitioner may charge no more than the rate(s) published for at least 30 calendar days after the last date on which the schedule of fees was last published. With regards to solicitation and advertising.

The tax practitioner may not persist in attempting to contact a prospective client if the prospective client has made it known to the practitioner that he or she does not desire to be solicited.

In the case of radio and television broadcasting, the broadcast must be recorded and the practitioner must retain a recording of the actual transmission. In the case of direct mail and e-commerce communications, the practitioner must retain a copy of the actual communication, along with a list or other description of persons to whom the communication was mailed or otherwise distributed. The copy must be retained by the practitioner for a period of at least 36 months from the date of the last transmission or use.

A practitioner may not charge an unconscionable fee in connection with any matter before the Internal Revenue Service. Contingent fees generally, a practitioner may not charge a contingent fee for services rendered in connection with any matter before the Internal Revenue Service.

A practitioner may charge a contingent fee for services rendered in connection with the Serviceôs examination of, or challenge to ð

(i) An original tax return;

(ii) An amended return or claim for refund or credit where the amended return or claim for refund or credit was filed within 120 days of the taxpayer receiving a written notice of the examination of, or a written challenge to the original tax return.

A practitioner may charge a contingent fee for services rendered in connection with a claim for credit or refund filed solely in connection with the determination of statutory interest or penalties assessed by the Internal Revenue Service. A practitioner may charge a contingent fee for services rendered in connection with any judicial proceeding arising under the Internal Revenue Code.

Tax Client Records

In general, a practitioner must, at the request of a client, promptly return any and all records of the client that are necessary for the client to comply with his or her Federal tax obligations. The practitioner may retain copies of the records returned to a client.

The existence of a dispute over fees generally does not relieve the practitioner of his or her responsibility under this section. Nevertheless, if applicable state law allows or permits the retention of a clientôs records by a practitioner in the case of a dispute over fees for services rendered, the practitioner need only return those records that must be attached to the taxpayerôs return. The practitioner, however, must provide the client with reasonable access to review and copy any additional records of the client retained by the practitioner under state law that are necessary for the client to comply with his or her Federal tax obligations.

Records of the client include all documents or written or electronic materials provided to the practitioner, or obtained by the practitioner in the course of the practitionerôs representation of the client, that pre-existed the retention of the practitioner by the client. The term also includes

materials that were prepared by the client or a third party (not including an employee or agent of the practitioner) at any time and provided to the practitioner with respect to the subject matter of the representation. The term also includes any return, claim for refund, schedule, affidavit, appraisal or any other document prepared by the practitioner, or his or her employee or agent, that was presented to the client with respect to a prior representation if such document is necessary for the taxpayer to comply with his or her current Federal tax obligations. The term does not include any return, claim for refund, schedule, affidavit, appraisal or any other document prepared by the practitioner or the practitionerôs firm, employees or agents if the practitioner is withholding such document pending the clientôs performance of its contractual obligation to pay fees with respect to such document.

When requested tax records or information are not in the possession of, or subject to the control of, the practitioner or the practitionerôs client, the practitioner must promptly notify the requesting Internal Revenue Service officer or employee the following:

Provide any information that the practitioner has regarding the identity of any person who the practitioner believes may have possession or control of the requested records or information.

The practitioner is required to make reasonable inquiry of his or her client regarding the identity of any person who may have possession or control of the requested records or information but the practitioner is **not** required to make inquiry of any other person or independently verify any information provided by the practitionerôs client regarding the identity of such persons.

When a proper and lawful request is made by the Director of the Office of Professional Responsibility (OPR), a practitioner must provide the Director of the OPR with any information the practitioner has concerning an inquiry by the Director of the OPR into an alleged violation of the regulations in this part by any person, and to testify regarding this information in any proceeding instituted under this part, unless the practitioner believes in good faith and on reasonable grounds that the information is privileged. With respect to any reasonable inquiry of a practitionerôs client regarding the identity of any person who may have possession or control of records or information requested by the IRS, the practitioner is **not** required to make inquiry of any other person or independently verify any information provided by the practitionerôs client regarding the identity of such persons.

Retention of Client Records

You must keep tax and related records as long as they may be needed for the administration of any provision of the Internal Revenue Code. Generally, this means you must keep records that support items shown on a tax return until the period of limitations for that return runs out. The period of limitations is the period of time in which you can amend a return to claim a credit or refund, or the Internal Revenue Service can assess additional tax. If no other provisions apply, the statute of limitations is 3 years after the return was filed. If more than 25% of gross income has been omitted from the tax return, the statute of limitations is 6 years after the return was filed, unless the omitted amount was disclosed in the return or in a statement attached to the return, in a manner adequate to apprise the Internal Revenue Service of the nature and amount of the omission. If a tax return is not filed at all, or a fraudulent or false return is filed, there is no

statute of limitations. Generally, there is a **3-year** statute of limitations for the IRS auditing a tax return and a **10-year** statute of limitations for the IRS collecting tax.

Power of Attorney (POA). A tax practitioner can obtain a Power of Attorney from a client to act in that clientôs behalf. Care must be taken though and a tax practitioner must understand that the power of attorney limits what the practitioner can and cannot do.

An example: *Maria, a Tax Practitioner, prepares Winston's income tax return. Winston gives Maria a power of attorney over his tax matters, including the authorization to receive his federal income tax refund check. Accordingly, the IRS sends Winston's $1,000 refund check to Maria's office. Winston still owes Maria $600 for tax services already provided. Even though Maria has a power of attorney, it does not afford her the right to negotiate checks payable to Winston. Maria's only option is to turn over the check to Winston. She will need to pursue other legal means available to her to collect what is owed to her.*

To revoke a power of attorney that has been previously executed, the taxpayer must send a copy of the previously executed power of attorney to the Internal Revenue Service (with an original signature) and write ñREVOKEò across the top of the power of attorney.

The IRS has a Power of Attorney form that is to be used when a taxpayer wants a tax practitioner to represent them before the IRS. A separate Form 2848 should be completed for each taxpayer. Form 2848 will not be honored for any purpose other than representation before the IRS. If not signed and dated by the taxpayer, the Power of Attorney will be returned to the taxpayer.

If a tax practitioner is to be granted authorization to obtain information about a taxpayer, from the IRS, then **Form 8821**, Tax Information Authorization [link] is completed and filed with the IRS. Form 8821 authorizes any individual, corporation, firm, organization, or partnership you designate to inspect and/or receive your confidential information in any office of the IRS for the type of tax and the years or periods you list on Form 8821. You may file your own tax information authorization without using Form 8821, but it must include all the information that is requested on Form 8821.

Offer in Compromise. An offer in compromise allows you to settle your tax debt for less than the full amount you owe. It may be a legitimate option if you can't pay your full tax liability, or doing so creates a financial hardship. An Offer in Compromise can include all tax related payments that are due including tax payments and related penalties and interest accrued. An EA can help a taxpayer with the necessary paperwork involved with filing an Offer in Compromise. Collection actions, such as levy, may be delayed and a rejected offer may be appealed.

Installment Agreements. You can make monthly payments through an installment agreement if you're not financially able to pay your tax debt immediately. However, you will reduce or eliminate the amount of penalties and interest you pay and avoid the fee associated with setting up an installment agreement if you pay your tax bill in full. Installment agreements generally require equal monthly payments. Before you apply:

- File all required tax returns;

- Consider other sources (loan or credit card) to pay your tax debt in full to save money;
- Determine the largest monthly payment you can make ($25 minimum); and pay a user fee if the entire tax due is not paid within 120 days, and
- Know that your future refunds will be applied to your tax debt until it is paid in full.

IRS E-File Program

Any tax return preparer who anticipates preparing and filing 11 or more Forms 1040, 1040A, 1040EZ and 1041 (covered returns) during a calendar year must use IRS e-file (unless the preparer or a particular return is administratively exempt from the e-file requirement). Even if you are an authorized e-file provider, clients for whom you prepare one of the returns identified above may choose to file on paper if the return is filed by a tax return preparer with an approved hardship waiver. A Hardship request for avoiding the e-filing a return or returns can be requested for a taxpayer or for a tax preparer. Specified tax return preparers may request an undue hardship waiver from the e-file requirement using **Form 8944**, [link] Preparer e-file Hardship Waiver Request. Form 8944 generally must be submitted to the IRS no later than February 15 of the year for which a waiver is being requested.

For an approved hardship waiver for a taxpayer, specified tax return preparers generally should attach **Form 8948**, [link] Preparer Explanation for Not Filing Electronically, to the client's paper return. A specified tax return preparer is a preparer of covered returns who reasonably expects to file 11 or more covered returns in a calendar year. The requirement does not apply to individuals who do not meet the definition of ñtax return preparerò under the Internal Revenue Code and related regulations, such as an individual who provides tax assistance under a Volunteer Income Tax Assistance (VITA) program, a person who merely prepares a return of the employer (or of an officer or employee of the employer) by whom the person is regularly and continuously employed, or a person who prepares a return as a fiduciary for any person.

If a tax practitioner cannot correct an error that has caused an e-filed return to be rejected by the IRS, he or she must take reasonable steps to inform the taxpayer of the rejection within **24 hours** and provide the taxpayer with the reject code(s) accompanied by an explanation. Because of the short time frames involved, it is critical that an e-filer closely monitor the status of e-filed returns and act immediately to correct any errors or take other, appropriate action.

It is recommended that all tax practitioners obtain a phone number from every client that the client can be reached at during business hours. This may not be a clientôs primary number but could be a work number or cell phone number. An email address should also be obtained as some individuals have easier access to an email than a phone call. Explain to the client that if this is not a primary number for them, it will only be used for emergency purposes, such-as a rejected tax return.

It is recommended also that Form 8633 be used whenever possible as many changes can only be updated by filing form 8633. These changes include Adding an additional principal of a firm, such as a partner or a corporate officer and making a change to the Responsible Official listed on the originally filed Form 8633.

Authorized electronic filing providers must notify the Internal Revenue Service of all changes to the information they originally submitted on Form 8633, Application to Participate in the Internal Revenue Service Electronic Filing Program. All revisions may be made using Form 8633, but you may update certain information by letter, using the firmôs official letterhead.

Violations May Result in a Variety of Sanctions

There are three levels of infractions and possible, related sanctions. They are as follows:

- **Level One Infractions** ð Level One Infractions are violations of IRS e-file rules and requirements that, in the opinion of the IRS, have little or no adverse impact on the quality of electronically filed returns or on IRS e-file. The Internal Revenue Service monitors and performs annual suitability checks on authorized Internal Revenue Service electronic filing providers for compliance with the revenue procedure and program requirements.

The IRS may issue a written reprimand for a Level One Infraction.

- **Level Two Infractions** ð Level Two Infractions are violations of IRS e-file rules and requirements that, in the opinion of the IRS, have an adverse impact upon the quality of electronically filed returns or on IRS e-file. Level Two Infractions include continued Level One Infractions after the IRS has brought the Level One Infraction to the attention of the Authorized IRS e-file Provider.

Depending on the infractions, the IRS may either restrict participation in IRS e-file or suspend the Authorized IRS e-file Provider from participation in IRS e-file for a period of one year beginning with the effective date of suspension.

- **Level Three Infractions** ð Level Three Infractions are violations of IRS e-file rules and requirements that, in the opinion of the IRS, have a significant adverse impact on the quality of electronically filed returns or on IRS e-file. Level Three Infractions include continued Level Two Infractions after the IRS has brought the Level Two Infraction to the attention of the Authorized IRS e-file Provider.

A Level Three Infraction may result in suspension from participation in IRS e-file for two years beginning with the effective date of the suspension year, or depending on the severity of the infraction, such as fraud or criminal conduct, it may result in expulsion without the opportunity for future participation. **The IRS reserves the right to suspend or expel an Authorized IRS e-file Provider prior to administrative review for Level Three Infractions.**

Direct Deposit of Refund Checks

Taxpayers often elect the direct deposit option because it is the fastest way of receiving refunds. An Electronic Return Originator (ERO) (actually, any tax practitioner) should advise the taxpayer of the option to receive his/her refund by direct deposit or paper check. The Electronic Return Originator should caution taxpayers that some financial institutions do not permit the

deposit of joint refunds into individual accounts**.** Direct Deposit of tax refunds is a free service offered by the IRS and state tax agencies. A tax preparer cannot charge an extra fee for using direct deposit. The IRS publishes a calendar of when they send out direct deposits and mail out paper checks. Check Publication 2043 to find out when a federal tax refund is likely to be deposited into an account (helpful resource). No refunds amounts has to be deposited on any account pertaining to a third person including the Electronic Return Originator (ERO) or taxpreparer account.

The Earned Income Tax Credit (EITC) and Ethics

A tax practitioner must be able to prove that he/she performed a certain level of due diligence when preparing a tax return that includes the Earned Income Tax Credit (EITC). This is very important. Please review the **EITC due diligence requirements** at the special IRS site for Tax Practitioners [link] and keep this information accessible for future reference. To meet due diligence requirements the tax practitioner needs to ask more questions of their clients if the claims they make about self-employment seem inconsistent, incorrect or incomplete when the tax return includes EITC. Paid tax practitioners will want to pay special attention to persons with disabilities or persons having children with disabilities as many qualify for the EITC.

IRC §6695(g) states: Any person who is a tax return preparer with respect to any return or claim for refund who fails to comply with due diligence requirements imposed by the Secretary by regulations with respect to determining eligibility for, or the amount of, the credit allowable by section 32 shall pay a penalty of $500 for each return where due diligence requirements are not met. Specifically, the following are the Four Due Diligence requirements related to EITC are: Complete and Submit the Eligibility Checklist, Compute the Credit, Be knowledgeable about your client, Keep Records for the Proper Time Periods. They are discussed in detail below and this information is taken directly from the IRS website.

Complete and Submit Eligibility Checklist *(***Form 8867**, link below)

- Complete Form 8867, Paid Preparer's Earned Income Credit Checklist, to make sure you consider all EITC eligibility criteria for each claim you prepare.
- Complete checklist based on information provided by your client(s).
- For EITC returns or claims for refund filed electronically, submit Form 8867 to the IRS electronically with the return.
- For EITC returns or claims for refund not filed electronically, attach the completed form to any paper return you prepare and send to the IRS.
- For EITC returns or claims for refund you prepare but do not submit directly to the IRS, provide the completed Form 8867 to your client to send with the filed tax return or claim for refund.

Compute the Credit

- Complete the EIC worksheet from the Form 1040 instructions, or Publication 596, Earned Income Credit, or a form with the same information. The worksheet shows what

is included in the computation, that is, self-employment income, total earned income, investment income and adjusted gross income. Most professional tax preparation software includes the computation worksheet.

Knowledge of Correct Taxpayer Information

- Not know or have reason to know any information used to determine your client's eligibility for, or the amount of EITC is incorrect, inconsistent or incomplete.
- Make additional inquiries if a reasonable and well-informed tax return preparer would know the information is incomplete, inconsistent or incorrect
- Know the law and use your knowledge of the law to ensure you are asking your client the right questions to get all relevant facts.
- Document any additional questions you ask and your client's answer at the time of the interview.

Keep Records

- Keep a copy of the **Form 8867 and the EIC worksheet**.
- Keep a record of all additional questions you asked your client to comply with your due diligence requirements and your client's answers to those questions.
- Keep copies of any documents your client gives you that you relied on to determine eligibility for, or the amount of the EITC.
- Verify the identity of the person giving you the return information and keep a record of who provided the information and when you got it.
- Keep your records in either paper or electronic format but make sure you can produce them if the IRS asks for them.
- Keep these records for 3 years from the latest date of the following that apply:
  - The original due date of the tax return (this does not include any extension of time for filing.), or
  - If you electronically file the return or claim for refund and sign it as the return preparer, the date the tax return or claim for refund is filed, or
  - If the return or claim for refund is not filed electronically and you sign it as the return preparer, the date you present the tax return or claim for refund to your client for signature, or
  - If you prepare part of the return or claim for refund and another preparer completes and signs the return or claim for refund; you must keep the part of the return you were responsible to complete for 3 years from the date you submit it to the signing tax return preparer.

TAX PRACTITIONERS WHO ARE ALSO NOTARIES

Many tax preparers are also commissioned as notary publics in their States, the following, from Circular 230, is summarized here.

A tax preparer may not take acknowledgments, administer oaths, certify papers, or perform any official act as a notary public with respect to any matter administered by the Internal Revenue Service and for which he or she is employed as counsel, attorney, or agent, or in which he or she may be in any way interested. In other words, a tax practitioner cannot notarize any documents for a tax client, if the documents are in any way related to matters concerning the IRS.

Tax Return Preparers and IRC 6694 and 6695

Tax return preparers need to be familiar with Internal Revenue Codes (IRC) 6694 and 6695. IRC 6694, *Understatement of Taxpayer's Liability by a Tax Return Preparer*, and IRC 6695, *Other Assessable Penalties with Respect to the Preparation of Tax Returns for Other Persons*.

Return preparer penalties are imposed against the person or business that prepared a return.

Return Preparer Penalties under IRC Section 6694

IRC 6694 penalties can only apply if there is an understatement of tax liability.

- **The IRC 6694(a)** penalty is the greater of **$1,000 or 50%** of the income derived (or to be derived) by the tax return preparer with respect to each return, amended return or claim for refund prepared if there is an understatement on the return or claim due to an unreasonable position taken on the return or claim that the preparer knew or reasonably should have known about. A position is unreasonable if:

    A. There was not substantial authority for the position and the position was not disclosed.

    B. The position was disclosed but there was not reasonable basis for the position.

    C. The position is with respect to a tax shelter or reportable transaction under IRC 6662A and it is not reasonable to believe the position will be more likely than not sustained on the merits.

- **The IRC 6694(b)** penalty is the greater of **$5,000 or 50%** of the income derived (or to be derived) by the tax return preparer with respect to returns, amended returns, and claims for refund prepared after May 25, 2007. The penalty may be imposed against a tax preparer if:

A. There is an understatement of liability, on a return or claim for refund prepared by the preparer, which is due to a willful attempt in any manner to understate the tax liability by the preparer, or

B. The preparer has recklessly or intentionally disregarded rules or regulations.

- Reduce the IRC 6694(b) penalty by the amount of the IRC 6694(a) penalty if both the IRC 6694(a) and (b) penalties are asserted against the preparer on the same return or claim.

Please be aware that because the IRC 6694(b) penalty involves willfulness (or a lack of discipline on the part of the tax preparer) there is no statutory period for assessment of this penalty. On tax return preparer penalties asserted under section 6694(a) and 6695, there is a three year statute of limitations for possible assessments that begins to run on the statutory due date of the return (usually the 15th of April for individual tax returns) or, if filed late, the filing date of the return. The statute of limitations on assessment for the section 6694(a) and 6695 penalties may be extended using a Form 872-D, Consent to Extend the Time on Assessment of Tax Return Preparer Penalty. IRC 6696(d) addresses periods of limitation.

Return Preparer Penalties under IRC Section 6695

- The return preparer penalties under IRC 6695 are assessed against preparers who:

A. Fail to provide the taxpayer with a copy of the return, $50 per failure, up to a maximum of $25,000 for each calendar year; per IRC 6695(a),

B. Fail to sign the return, $50 per failure, up to a maximum of $25,000 for each calendar year, per IRC 6695(b),

C. Fail to provide an identifying number, $50 per failure, up to a maximum of $25,000 for each calendar year; per IRC 6695(c),

D. Fail to retain a copy of the return or a list of returns prepared, $50 per failure, up to a maximum of $25,000 for each return period, per IRC 6695(d),

E. Fail to file a tax return preparer information return or set forth an item in the return as required under IRC 6060, $50 for each failure, up to a maximum of $25,000 for each return period, per IRC 6695(e),

F. Negotiate a refund check or misappropriate a refund via electronic means, $500 per failure per IRC 6695(f), or

G. Fail to be diligent in determining eligibility for the Earned Income Tax Credit, $500 per failure per IRC 6695(g).

These penalties are generally processed under the pre-assessment penalty procedures.

Please note that under Section 6695(f) tax return preparers are prohibited from endorsing or negotiating a refund check relating to a return for which he or she is a preparer. However, a tax return preparer is not prohibited from affixing the taxpayerôs name on a refund check (typically accomplished via a mechanical stamp) for the purpose of depositing the check into an account in the name of the taxpayer.

ADDITIONAL RETURN PREPARER PENALTIES UNDER IRC SECTION 6713

The penalty under IRC 6713 is assessed against preparers who:

- Receive compensation for preparing a tax return, or engage in the business of preparing or providing services in connection with the preparation of tax returns; and
- Disclose any information furnished to him or her in connection with the preparation of any return; or
- Use any information furnished to him or her for any purpose other than to prepare or assist in preparing the taxpayer's return. The same exceptions set forth in IRC 7216(b) apply to IRC 6713.

The penalty is $250 for each disclosure or use above, up to a maximum of $10,000 for each calendar year.

Tax Preparer Appeals Process

The Office of Professional Responsibility (OPR) has exclusive authority for all matters related to practitioner discipline, including disciplinary proceedings and sanctions. OPR is committed to processing referrals and conducting investigations in a timely and fair manner. The investigative process and disciplinary proceedings follow established due process guidelines designed to ensure that practitioners receive notice of the allegations against them and an opportunity to present their side of the story at multiple stages ï this is referred to as the ñappeals processò. During an OPR investigation, you may choose to be represented by someone authorized to practice before the IRS. If you choose to have a representative during an OPR investigation into issues relating to your own tax compliance, your representative must file a Form 2848, Power of Attorney and Declaration of Representative. If your investigation relates to a conduct matter, your representative must provide a representation letter at first contact with OPR.

The following summaries the Process:

- Field or Office Examination. Examiners must determine if potential penalties are applicable including preparer penalties.
- Client Examination Process. Examiners gather written evidence and oral testimony to make the initial return preparer penalty determination.
- After the Audit. Examiners will open a separate penalty investigation.
- Proposal, Assessment and Appeal Procedures

If the examiner determines a penalty applies then a detailed report is prepared and a copy of the report is provided to the tax return preparer. The preparer has 30 days to request an appeal before the penalty is assessed. Examination sends the preparer Letter 1125, which provides the preparer with information on appeals rights. If there is no response to the letter, the penalty is assessed.

Unenrolled return preparersô limited representation privileges may be suspended or revoked by Examination Area Directors.

Examinations under Small Business/Self Employed (SB/SE) Campus and Area, Large Business and International (LB&I) and Tax Exempt and Government Entities (TE/GE) Divisions are responsible for identifying tax returns to which return preparer penalties apply.

Some penalties are related to positions taken or items reported on underlying tax returns (the related tax return). In general, an un-agreed penalty case will not be sent to Appeals before the related tax return is submitted to Appeals. Examination will include in the preparer case file information on the current status and location of the related return. A preparer conduct penalty may not be submitted to Appeals if there is less than 180 days remaining on the statute of limitations.

Review Questions Section 2

Read and answer the following review questions. The correct answers are found on the next page with an explanation to strengthen up your knowledge. Note: This is not part of your Final Test

1. Which of the following are considered client records or documents?

   a) Materials that were prepared by the client or a third party.
   b) Tax returns prepared by the tax practitioner for the client.
   c) Electronic materials provided to the practitioner by the client.
   d) All of the above are considered client records.

2. Which of the following is a true statement regarding the possession of a clientôs records by a tax practitioner?

   a) At the request of a client, a practitioner must promptly return any and all records of the client that are necessary for the client to comply with his or her Federal tax obligations.
   b) Once records have been returned to a client, the practitioner cannot be in possession of any copies related to the returned records.
   c) If a dispute exists over fees owed to the practitioner by the client, then the practitioner is under no obligation whatsoever to return any tax records in his or her possession until the fee dispute has been reasonably resolved.
   d) All of the above statements are true.

3. When requested tax records or information are not in the possession of, or subject to the control of, the practitioner or the practitionerôs client, the practitioner must promptly notify the requesting Internal Revenue Service officer or employee. Which of the following accurately states the practitionerôs responsibilities?

   a) Provide any information that the practitioner has regarding the identity of any person who the practitioner believes may have possession or control of the requested records or information.
   b) The practitioner is not required to make reasonable inquiry of his or her client regarding the identity of any person who may have possession or control of the requested records or information. This is the sole responsibility of the IRS.
   c) The practitioner is required to make inquiry of any other person.
   d) All of the above accurately recap the practitionerôs responsibilities.

4. When a client waives the conflict of interest and gives informed consent, the confirmation of the waiver must be made in writing, within a reasonable period of time, but in no event later than _____.
   a. 30 days
   b. 90 days
   c. Three months
   d. 15 days

5. Regarding the instituting of sanctions against a practitioner, which of the following is a true statement?
   a) Regardless of whether or not the practitioner was acting on behalf of an employer or any firm or other entity in connection with the conduct giving rise to a penalty, the Secretary of the Treasury, or delegate, may not impose a monetary penalty on the employer or firm; only on the individual.
   b) The amount of the penalty can exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty.
   c) Any monetary penalty imposed on a practitioner may be in addition to or in lieu of any suspension, disbarment or censure and may be in addition to a penalty imposed on an employer, firm or other entity.
   d) None of the above are correct.

6. Incompetent and disreputable conduct by a tax practitioner can include:

   a) Failure to sign a tax return prepared by the practitioner when the practitionerôs signature is required, regardless of the reason.
   b) Giving written advice to a taxpayer on a matter that the practitioner is competent and considers all relevant facts. Tax advice cannot be put in writing by anyone but an official or employee of the IRS.

   c) Knowingly aiding and abetting another person to practice before the Internal Revenue Service during a period of suspension, disbarment or ineligibility of such other person.
   d) All of the above are examples of incompetence or disreputable conduct.

7. Which of the following constitute best practices that should be followed by a tax practitioner?

   a) A practitioner should insure clear communication with the client regarding the terms of the engagement.
   b) A practitioner should determine which facts are relevant, evaluate the reasonableness of any assumptions or representations, and relate the applicable law (including potentially applicable judicial doctrines) to the relevant facts, and arrive at a conclusion supported by the law and the facts.
   c) A practitioner should advise the client regarding the import of the conclusions reached, including, for example, whether a taxpayer may avoid accuracy-related penalties under the Internal Revenue Code if a taxpayer acts in reliance on the advice.
   d) All of the above are best practices that a practitioner should follow.

8. Which of the following statements correctly defines "*Tax Avoidance*"?

   a) Tax Avoidance is the illegal practice of not paying taxes, by not reporting income, reporting expenses not legally allowed, or by not paying taxes owed.
   b) Tax Avoidance is when businesses and individuals avoid taxes by taking all legitimate deductions and by sheltering income from taxes by doing things such-as setting up employee retirement plans and by other means, all legal and under the Internal Revenue Code or state tax codes.
   c) Tax Avoidance is always illegal and is most commonly thought of in relation to income taxes, but Tax Avoidance can be practiced by businesses and individuals on all different types of taxes including state sales taxes and employment taxes.
   d) Answers "A" and "C" are both correct.

9. In the case of radio and television broadcasting, the broadcast must be recorded and the practitioner must retain a recording of the actual transmission. In the case of direct mail and e-commerce communications, the practitioner must retain a copy of the actual communication, along with a list or other description of persons to whom the communication was mailed or otherwise distributed. The copy must be retained by the practitioner for a period of at least _____ from the date of the last transmission or use.

   a) 12 months
   b) 36 months
   c) 14 days
   d) One year

10. The IRS is requesting a sworn statement from a taxpayer, administered by a notary public, related to a tax matter that is being investigated. Which of the following statements is true regarding the notarized sworn statement?

    a) The tax practitioner that is representing the taxpayer before the IRS may not administer the oath but may notarize the statement (typically called an affidavit) as long as he or she is a commissioned notary public.
    b) The tax practitioner that is representing the taxpayer before the IRS may administer the oath and notarize the statement (typically called an affidavit) as long as he or she is a commissioned notary public.
    c) The tax practitioner that is representing the taxpayer before the IRS may not administer the oath and notarize the statement (typically called an affidavit) regardless of whether or not he or she is a commissioned notary public.
    d) The tax practitioner that is representing the taxpayer before the IRS may administer the oath but not notarize the statement (typically called an affidavit) regardless of whether or not he or she is a commissioned notary public.

Review Questions 2 – Answers and Discussion

1. **Answer d.** all of the possible answers represent client documents. When in doubt, assume that a document related in any way to a client, is a "client document". Client records and documents does **not** include any return, claim for refund, schedule, affidavit, appraisal or any other document prepared by the practitioner or the practitionerôs firm, employees or agents if the practitioner is withholding such document pending the clientôs performance of its contractual obligation to pay fees with respect to such document.

2. **Answer a.** Records should be returned as soon as the practitioner has access to them, without delay. The existence of a dispute over fees generally does not relieve the practitioner of his or her responsibilities to the client. Nevertheless, if applicable state law allows or permits the retention of a clientôs records by a practitioner in the case of a dispute over fees for services rendered, the practitioner need only return those records that must be attached to the taxpayerôs return.

3. **Answer a.** The practitioner is required to make every reasonable attempt to obtain information - in other words - do not ignore the request. In addition to ñAò above the practitioner is required to make reasonable inquiry of his or her client regarding the identity of any person who may have possession or control of the requested records or information but the practitioner is **not** required to make inquiry of any other person or independently verify any information provided by the practitionerôs client regarding the identity of such persons.

4. **Answer a.** Copies of the written consents must be retained by the practitioner for at least **36 months** from the date of the conclusion of the representation of the affected clients, and the written consents must be provided to any officer or employee of the Internal Revenue Service on request.

5. **Answer c.** If the practitioner was acting on behalf of an employer or any firm or other entity in connection with the conduct giving rise to a penalty, the Secretary of the Treasury, or delegate, **may** impose a monetary penalty on the employer, firm, or entity if it knew, or reasonably should have known of such conduct.

   The amount of the penalty **shall not** exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty. Any monetary penalty imposed on a practitioner may be in addition to or in lieu of any suspension, disbarment or censure and may be in addition to a penalty imposed on an employer, firm or other entity.

6. **Answer c.** Knowingly doing anything against an IRS ruling will definitely prove disreputable conduct to the IRS. For answer A, if failure to sign the return is due to reasonable cause and not due to willful neglect, then the practitioner is not acting in an incompetent manner. For answer B, a tax practitioner can give written advice within the guidelines of section 10.37 of Circular 230. There are other examples; the complete list is detailed in section 10.51 of Circular 230.

7. **Answer d.** In addition to practitioners following best practices, practitioners with responsibility for overseeing a firmôs practice of providing advice concerning Federal tax issues or of preparing or assisting in the preparation of submissions to the Internal Revenue Service should take reasonable steps to ensure that the firmôs procedures for all members, associates, and employees are consistent with the best practices set forth above.

8. **Answer b.** The correct answer is B, as this is the correct definition of *Tax Avoidance*. Answers "A" and "C" define *Tax Evasion* which is the illegal practice of not paying taxes, by not reporting income, reporting expenses not legally allowed, or by not paying taxes owed. Tax evasion is always illegal and is most commonly thought of in relation to income taxes, but tax evasion can be practiced by businesses and individuals on all different types of taxes including state sales taxes and employment taxes.

9. **Answer b.** A good practice is to retain any form of general client communication, including fee schedules, flyers promoting a discount and any brochures made available to clients for a period of at least 36 months (three years), even if you did not directly produce the materials.

10. **Answer c.** Many tax practitioners are also notaries, please remember the following: a tax practitioner cannot notarize any documents for a tax client, if the documents are in any way related to matters concerning the IRS.

CALIFORNIA

CALIFORNIA 2019

QUICK UPDATE REGARDING CALIFORNIA AND IRS AUDITS

When the Internal Revenue Service audits taxpayers return, they have to notify California Franchise Tax Board of the outcome. Once the IRS completes an examination of the tax return and issued a revenue agent report (RAR), taxpayers should notify (by amending the 540 return) to the FTB within six months of the final federal determination.

Notification requirements. The FTB requires notification if the IRS adjusts or corrects gross income or deductions. The notification should include any IRS assessed penalties, adjustments or corrections resulting from math errors, tax credit adjustments, other tax adjustments, or supplemental income even if the IRS did not examine these adjustments.

The final federal determination is the date each IRS examination adjustment or resolution is assessed as described in Internal Revenue Code Section 6203. If the FTB receives the federal changes within the six month period, they have two years from the date the report is received to apply the federal changes to the California tax return. Notification of a change or correction by the taxpayer or IRS must be sufficiently detailed to allow computation of the resulting California tax change.

If taxpayers or the IRS notifies the FTB more than six months after the date of the final federal determination, the FTB considers the notification untimely. In that case, the FTB has four years from the date they receive ñsufficiently-detailedò information to apply the federal changes to taxpayers California return. ñSufficiently-detailedò information is defined as enough information to allow FTB to compute the resulting California tax return change.

If taxpayers receive an assessment from the FTB because the IRS notified them of the federal adjustment, taxpayers may call the FTB to find out the date of notification for purposes of the two year or four year statute of limitations. For tax preparers the FTB has the practitioner hot line to call and find out about any modification.

If Notifications are Not Received. If the taxpayer or the IRS does not provide the FTB with a timely notification of the federal changes, the statute of limitations for assessment remains open, and therefore, the FTB may issue an assessment at any time. Interest accrues from the original tax year due date until the tax liabilities and penalties are paid in full.

When the FTB is properly notified, they may be able to resolve the case without the need to request more information. Notification also ensures prompt assessment of any additional tax, which may reduce the amount of interest we charge.

Increase in tax credits or decrease in the income. If federal changes decrease the income or increase tax credits and result in a California tax refund, if the overpayment requires a tax refund, taxpayers must file a claim for refund. They must file the claim within either:

- The normal statute of limitations.
- Two years after the final federal determination (whichever is later).

Amending the Tax Return. If filing a claim for refund on Form 540X, Amended Individual Income Tax Return, or Form 100X, Amended Corporation Franchise or Income Tax Return, for a tax year when litigation is pending or when a final determination by the IRS is pending, write ñPROTECTIVE CLAIMò in red ink at the top of the completed Form 540X or Form 100X. This will leave the statute of limitations open for a claim for refund.

Unexpected results. Unexpected results can occur if the FTB is not notified of a federal examination. This is particularly true in multiple year cases where one year results in an assessment (tax due) and another year results in an overpayment (tax refund). If all normal statutes of limitations expire, then the FTB can still assess the taxpayer based on the open-ended statute law. However, if a claim for refund is not filed within two years of the final federal determination, no open statute allows the overpayment. The taxpayer cannot offset overpayments against any amounts due and no refund can be issued.

For more information on methods of notification, as well as, where to submit the notification, see Publication 1008, Federal Tax Adjustments and Notification Responsibilities to California.

MOST COMMONT CALIFORNIA TAX AUDIT ISSUES

Some of the most common tax audit issues affecting personal income taxpayers include:

New Earned Income Credit Audits. Franchise Tax Board is sending letters called ñAdditional Documentation Required ï Refund Pendingò after the filing season 2019 for the 2018 taxable year, the document is asking for:

- Social Security Number: Copies of SSN Cards for the taxpayerôs, spouse, and for the qualified children.
- Self-Employed Amounts if any: Business bank statements or credit card statements with business income or expenses (Covering at least 2 months). Any certification, license, permit or registration required for the business. Any federal form 1099 or federal schedule K (Form 1065).
- Proof of relationship: A copy of each child birth certificate, if the taxpayer is not listed in the birth certificate, documentation showing the relationship should be attached, for divorced or separated parents (parents living apart) a decree of divorce or separate maintenance or written separation agreement, including custodial agreement.
- Proof of residence: Documentation showing where the child lived during the tax year in question, list all addresses and length of time the child lived at each address during the tax year in question, a letter or record from the childôs school or

physician showing their name, date of birth, address and name of the custodial parent. One example of acceptable proof would be the 1095B, 1095A or 1095C, health coverage, report card, student profile, medical records or medical insurance statement.

- Proof of fill-time student or disabled child: For the child, who is between 19 and 23 years old and is a full-time student, proof of full-time enrollment form the school. For a permanently and totally disabled child, an affidavit from their physician to verify that the patient was physically and/or mentally incapacitated such that the patient was incapable of caring for his or her needs.
- Sending the Documents: Taxpreparers can mail or fax the documents to the address and number instructed in the letter.

They still might request more information, is suggested to check on the IRS documents usually requested to claim EIC and the ones required at the time of a federal EIC audit, either by mail or in person; It is also suggested that as a part of the federal due diligence, taxpreparers should keep copies of at least the basic documentation related to every dependent that qualifies for the credit and also for taxpayerôs, especially for the head of household filing status. It is very important to reply to this document between the period of time given in the letter which is usually 30 days.

Like-Kind Exchange (IRC Section 1031). Audits related to IRC Section 1031 continue to find noncompliance in the following areas:

- Gain computation errors (taxable boot due to debt netting; non-exchange expense items included in the computation).
- Invalid identifications (failing the 3-property 200%:95% tests; not acquiring substantially the same property that was identified; identifying a partial interest and acquiring a higher percentage interest).
- Including the cost of property improvements made after the exchange closed in the exchange (boot) calculation.
- Withdrawing cash out of the proceeds from the relinquished property.

Other State Tax Credit (OSTC). The FTB uses third party data to verify tax payments were made to other states and to disallow credits claimed to those states which do not have a reciprocal agreement with California.

Head of Household (HOH) Filing Status. Common errors include:

- The qualifying individualôs income exceeds the gross income test of $3,700.
- Taxpayers who do not meet the requirements to be considered unmarried or considered not an RDP.

Expired Credits. Some of the expired credits disallowed include the Ridesharing, Recycling Equipment, Solar Energy, Political Contribution, Employer Ridesharing, and Water Conservation credits.

Employee Business Expenses. The FTB may ask taxpayers claiming unreimbursed employee business expenses to provide documentation to substantiate their employerôs reimbursement policy to determine if their expense is allowable.

Some of the most common tax audits issues affecting pass through entities and related flow through to owners include:

Partnership/LLC Property Dispositions. Issues involving property dispositions reported by partnerships and LLCôs include like-kind exchanges (IRC Section 1031), foreclosures of real estate, and cancellation of debt (COD) income.

Termination of Partnership/LLC. Issues include partnership and LLC liquidations reported by both partnerships and partners.

Transfer of Partnership Interest. Issues include disposition of partnership and LLC interests by the partners/members of partnerships and LLCs. The FTB continues to identify taxpayers who transfer partnership interests between related entities to create a higher basis.

Shareholder/Partner/Owner's Basis in a Pass-Through Entity. We verify shareholderôs basis to determine the correct flow-through income, losses, deductions, and credits. The FTB uses the correct basis to determine taxability of distributions, debt repayments, and dispositions.

S Corporation Liquidations. Common S corporation liquidation issues include:

- S corporation taxpayers that do not accelerate the recognition of installment gain for California purposes in the final year.
- S corporation shareholders that do not report the gain recognized under IRC Section 331(a).
- Nonresident shareholders that do not report their share of the gain that was recognized by the S corporation on the sale of intangible assets.

Charitable Deductions for Trusts. The FTB verifies that the amount donated is from the gross income of the trust and is paid pursuant to the terms of the governing instrument.

Charitable Remainder Trusts. The FTB verifies that the trust is operated pursuant to the terms of the governing instrument and that the trust meets statutory requirements. A charitable remainder trust that is not operated correctly may lose its tax-exempt status, and the previously untaxed income may be subject to income tax. In some cases, a disqualified charitable remainder trust will be treated as a grantor trust and the income of the trust will be reported on the grantorôs individual tax return.

Apportionment of Trust Income. A trust will be subject to taxation if the fiduciary is a California resident or a beneficiary whose interest in such trust is noncontingent is a California resident. When trust apportionment of income is within and without California, the FTB looks at how the income is sourced to California and the residency status of the trustee.

Some of the most common tax audit issues affecting corporations include:

Cost of Performance and Sourcing of Intangible Sales. For tax years beginning before January 1, 2011, sales from intangible sales and services are assigned based on the cost of performance. The complex rules of identifying income-producing activities and documentation necessary to do a cost-of-performance analysis may result in incorrect assignment of sales from intangibles and services. For tax years beginning on or after January 1, 2011, taxpayers who elect a single sales factor for apportioning business income to California will use market rules for assigning sales from intangibles and services instead of cost of performance rules.

Sales Factor and Gross Receipts. The FTB continues to see items in the sales factor denominator that do not meet the definition of "gross receipts" or that result in distortion.

Abusive Tax Shelters. The FTB is reviewing the high abusive tax shelters in a variety of situations to avoid state or federal tax. These types of transactions often involve the creation of entities or deductions without economic substance or a business purpose.

Credits. The FTB verifies that credits, such as Enterprise Zone and Research and Development Credits, are reported correctly. In addition, there is verification on the assignment of credits and a revision that it is properly reported by the assignor and the assignee.

FTB COMMON NOTICES

State of California
Franchise Tax Board

The FTB issues return information notices when they detect or correct a tax return mistake. The notices will contain the date of the tax returns that was corrected or revised. The following items are going to be included in any FTB notice:

- Payment coupon: If taxpayers have a balance due, they can mail the coupon with their payment.
- Tax Year Summary: Shows the revised tax return amounts. Compare them to the amounts on the tax return to see that they match.
- Explanation of Revisions: Explains why the FTB revised the tax return. There may be more than one revision.

The FTB may send a notice with codes that range from 01 ï 18 or A ï Y. These codes will provide more information about the revision. An explanation of every code will be included in the back of each notice.

Common notices and their meaning

Notice	What it means
Request for Tax Return Demand for Tax Return	The FTB has no record of taxpayersô California personal income tax return for the year specified.
Notice of Tax Change Return Information Notice	The FTB found and corrected one or more errors while processing the tax return.
Income Tax Due Notice	If there is a balance and is not paid or taxpayer does not contact the FTB within 30, the FTB can impose collection fees, contact third parties, file state tax liens, and take other collection actions.
Court-Ordered Debt (COD)	The FTB collects delinquent court-ordered debt for participating courts and agencies.
Vehicle Registration Debt	The FTB collects delinquent vehicle registration debt for the Department of Motor Vehicles.
Earnings Withholding Order	The FTB issues this order to the employer to withhold from wages the indicated debt.
Order to Withhold	The FTB issues this order taxpayersô financial institution to collect a debt.
Notice of Tax Lien	The FTB files a lien against taxpayerôs real or personal property to secure an amount owed.
Collection Referral	Taxpayers that do not pay the balance in full or contact the FTB may be referred to a private collection agency.
Collection notice from a private collection agency on behalf of Franchise Tax Board	Taxpayerôs account has been referred to a private collection agency. Contact the agency at the number on the notice.
Audit Contact Letter	The FTB is examining taxpayerôs tax return.
Notice of Proposed Assessment	The FTB made audit adjustments to taxpayerôs account for a specified tax year.
Intent to Offset Federal Payments	The FTB intends to submit taxpayerôs debt to the U.S. Treasury Offset Program if the balance is not paid in full. The FTB will intercept eligible federal tax payments (including IRS refunds) and may result in an additional offset fee.
Intercept Notice	The FTB intercepted taxpayerôs income tax refunds, lottery winnings, or unclaimed property payment (up to the amount owed) to state, local, or other government agencies.

REVISION OF FORM 593, REAL ESTATE WITHHOLDING

When real estate is sold in California, the state requires that income tax for that sale must be withheld and reported using Form 593-C.

Form 593-C. The seller is required to complete the State of California Real Estate Withholding Certificate, form number 593-C. The escrow company will provide this form to the seller, typically when the escrow instructions have been prepared and sent out for signatures.

Withholding amount. The standard amount of taxes to withhold is equal to 3 1/3% of the total sales price. If the seller is claiming an exemption by filling out the 593-E form, the percentages will be different on if it is reduced withholding. Those percentages are reflected on the form itself.

Entities That May Be Considered ñIndividualsò by the Franchise Tax Board.

Single Member LLC: If the seller is a single member disregarded LLC, the information of the single member must be provided

Grantor Trust: A grantor trust is created when the trust is formed by the grantor(s) and the grantor(s) are also the trustee(s) of the trust. A good example of a grantorôs trust is a Family Trust. The grantor trust is disregarded for tax purposes and the individual seller must report the sale and claim the withholding on his/her/their individual tax returns. If the trust was a grantor trust that became irrevocable upon the grantorôs death, the name of the trust and the trustôs federal employer identification number (FEIN) must be provided on Form 593-C.

Exceptions to Withholding. Certain real estate transactions are exempt to state income tax withholding. The exceptions are:

- The total sales price is $100,000.00 or less;
- The property is being foreclosed upon pursuant to a power of sale under a deed of trust, or sold by a deed in lieu of foreclosure;
- The transferor is a bank acting as a trustee other than a trustee of a deed of trust;
- The seller certifies to an *exemption*.

Exemptions to Withholding. The most common exemption is the sellerôs principal residence as set forth under Internal Revenue Code (IRC) Section 121. Generally speaking, the seller must have owned and lived in the property as their main home for at least two years during the five-year period ending on the sale of sale. Another exemption would be a loss or zero gain. Claiming this exemption will require form number 593-E to be filled out and signed by the seller.

If any of the first three exceptions are applicable, the seller checks the appropriate exception on the 593-C form. If the seller checks number 4 on the 593-C form, claiming an exemption, there is an additional form which will need to be filled out.

Issued found by the FTB. The FTB is trying to improve the system so the process and availability of real estate withholding credits are ready and available for taxpayers when the tax return is filed.

The FTB has found that 70 percent of the forms filed through the automated system were processed successfully. However, 30 percent of the forms were not processed successfully. The FTB found that the main issue was the inaccurate information or incomplete information shown in the forms.

The FTB is working in a short-term improvement and also in a long-term improvement. The following outlines a brief overview of what is happening behind the scenes at FTB:

The Short-Term Solutions

- Manually review the Form 593s that do not process successfully through the automated system. The FTB review each account, and work with the Real Estate Escrow Person (REEP) to make necessary corrections to a completed Form 593 and/or manually apply the credit before taxpayers file their tax return.
- Validate the accuracy of the Notice of Tax Change prior to mailing it to the taxpayer. This notice is generated when the credit claimed on the tax return does not match the credit available in the FTBôs system. The FTB reviews the records to determine if there is an unapplied credit or if the discrepancy is correct. In many cases, the FTB was able to resolve the discrepancy prior to issuing the Notice of Tax Change.

The Long-Term Solutions

- Educate the escrow community regarding Form 593 completion.
- Provide personal income tax real estate withholding credit information on MyFTB, so taxpayers can view their credits prior to filing their return. (Scheduled to launch in September 2015)
- Revise FTB Publication 1016, Real Estate Withholding Guidelines, based on input from the stakeholders to clarify the real estate withholding process and instructions.
- Revise Form 593 based on input from taxpayers and practitioners. The FTB wants to make this form as user-friendly as possible and stay consistent with the real estate withholding regulations.

CALIFORNIA COMPETES TAX CREDIT

The California Competes Tax Credit is an income or franchise tax credit available to businesses that come to California or stay and grow in California. Tax credit agreements will be negotiated by the Governor's Office of Business and Economic Development (GO-Biz) and approved by a statutorily created ñCalifornia Competes Tax Credit Committee.ò The committee consists of:

- Director of GO-Biz (Chair).
- State Treasurer.

- Director of the Department of Finance.
- One appointee each by the Speaker of the Assembly and Senate Committee on Rules.

To get information on how to qualify, obtain and apply for the credit, taxpayers can visit the Go-Biz California Competes Tax Credit at:

http://www.business.ca.gov/Programs/CaliforniaCompetesTaxCredit.aspx

The businesses applying will compromise to certain employment and/or project investment requirements, the books and records of the businesses applying might be reviewed by the state before the credit is granted; agreements between the state and the businesses might have to be signed also.

The credit is not refundable it just reduces the tax liability and has been available since 2014 taxable year and will be available to apply for until 2029. If the credit is not used on certain years, it can be carried forward for a period of 6 years. The form used to claim the credit is the FTB 3531 California Competes Tax Credit.

BUSINESS ENTITY E-FILE REQUIREMENT

The business entity e-file requirement law (Assembly Bill 2754) became effective January 1, 2015.

For taxable years beginning on or after January 1, 2014, any business entity that files an original or amended tax return prepared using tax preparation software is required to electronically file (e-file) their return, unless a waiver is granted.

The FTB may grant a waiver if the business entity is unable to comply with the requirements due to, but not limited to:

- Technology constraints ï The inability of the tax preparation software used by a taxpayer to electronically file the tax return due to software limitations or the complex nature of the tax return.
- Where compliance would result in undue financial burden.
- Circumstances that constitute reasonable cause and not willful neglect.

Taxpayers must complete waiver requests through an online form on our website. To access the waiver request, go to ftb.ca.gov and search for business e-file waiver.

Review Questions Section 1

Read and answer the following review questions. The correct answers are found on the next page with an explanation to strengthen up your knowledge. Note: This is not part of your Final Test

1. If the IRS completes an examination of the federal tax return and the FTB is not notified what will happened in California?
   a) The FTB will only have 1 year to make changes to the California return
   b) California can issue an assessment at any time and charge interest accrues from the original tax year due date.
   c) California will not have a right to issue any assessment.
   d) California will not be able to collect interest unless there is a formal notification

2. What of the following is a common audit tax issue regarding trust in California?

   a) The fiduciary is a California resident that pays taxes for all income in California.
   b) The trust is a beneficiary whose interest in the trust is noncontingent is a California resident paying taxes to California.
   c) The fiduciary is a California resident that is not paying taxes in California and is apportioning income.
   d) None of the above

3. Certain real estate transactions are exempt from the state income tax withholding if the transactions is one of the following:

   a) The sales price is more than 100,000.00
   b) The seller avoid certifying to an exemption
   c) The property is sold by a bank
   d) The property is being foreclosed.

True or False.

4. In general the California Competes tax credit will be available for businesses that come to California or stay and grow in California

   a) True
   b) False

5. Entities that file originals or amended tax returns prepared using tax preparation software are required to comply with the new e-file requirement. What of the following entities may grant a waiver from this requirement?
   a) An entity that has a complex nature on their tax returns
   b) An entity where compliance would not affect it financially
   c) An entity that completes the waiver request online after they forgive to e-file the income tax return on time.
   d) None of the above

Review Questions 1 – Answers and Discussion

1. **Answer b is correct.** If the taxpayer or the IRS does not provide the FTB with a timely notification of the federal changes, the statute of limitations for assessment remains open, and therefore, the FTB may issue an assessment at any time. Interest accrues from the original tax year due date until the tax liabilities and penalties are paid in full. When the FTB is properly notified, they may be able to resolve the case without the need to request more information. Notification also ensures prompt assessment of any additional tax, which may reduce the amount of interest charged.

2. **Answer c is correct.** A trust will be subject to taxation if the fiduciary is a California resident or a beneficiary whose interest in such trust is noncontingent is a California resident. When trust apportionment of income is within and without California, the FTB looks at how the income is sourced to California and the residency status of the trustee.

3. **Answer is d).** Certain real estate transactions are exceptions to state income tax withholding. The exceptions are:
   - The total sales price is $100,000.00 or less;
   - The property is being foreclosed upon pursuant to a power of sale under a deed of trust, or sold by a deed in lieu of foreclosure;
   - The transferor is a bank acting as a trustee other than a trustee of a deed of trust;
   - The seller certifies to an *exemption*.

4. **Answer is a.** The California Competes Tax Credit is an income or franchise tax credit available to businesses that come to California or stay and grow in California. Tax credit agreements will be negotiated by the Governor's Office of Business and Economic Development (GO-Biz) and approved by a statutorily created ñCalifornia Competes Tax Credit Committee.ò

5. **Correct answer is a.** For taxable years beginning on or after January 1, 2014, any business entity that files original or amended tax return prepared using tax preparation software is required to electronically file (e-file) their return, unless a waiver is granted. The FTB may grant a waiver if the business entity is unable to comply with the requirements due to, but not limited to:
   - Technology constraints ï The inability of the tax preparation software used by a taxpayer to electronically file the tax return due to software limitations or the complex nature of the tax return.
   - Where compliance would result in undue financial burden.
   - Circumstances that constitute reasonable cause and not willful neglect.

NEW COLLEGE ACCESS TAX CREDIT

The College Access Tax Credit (CATC) is a new state tax credit for taxpayers who make authorized contributions of money to the CATC Fund. Senate Bill 798 established the credit for both personal and corporate income taxes under California Revenue and Taxation (R&TC) Code Sections 17053.86 and 23686.

The CATC is available for taxable years 2014-2022. The total amount that The California Educational Facilities Authority (CEFA) can allocate for the CATC each year is $500 million. To claim the credit, a taxpayer must make a contribution to the CATC Fund administered by the California Educational Facilities Authority (CEFA). Taxpayers must receive a certificate from the CEFA documenting the amount of the contribution and the credit amount in order to claim the credit on their state income tax return. The amount of the credit allocated and certified by the CEFA for a taxpayer for each taxable year is:

- 60 percent of the amount contributed by the taxpayer for the 2014 taxable year.
- 55 percent of the amount contributed by the taxpayer for the 2015 taxable year.
- 50 percent of the amount contributed by the taxpayer for the 2016 through 2022 taxable year.

Taxpayers may claim the CATC on their California tax return. They may also be able to take a charitable deduction for the contribution to CATC Fund on their federal tax return. Any charitable deduction for contributions made to the CATC Fund claimed on a federal tax return must be added back as a state adjustment on the California tax return, as taxpayers are not allowed a deduction and a credit for the same contribution.

You may also be able to claim a charitable deduction on your federal tax return. If you do this, you must add back the amount of the charitable deduction taken on your federal return as a state adjustment on your California tax return. You cannot claim a deduction and a credit for the same contribution on your California tax return.

You are eligible to claim this tax credit for the taxable year you submitted the applications if all of the following is fulfilled:

- The California Educational Facilities Authority (CEFA) received a completed application by their deadline for that taxable year.
- CEFA sent to Taxpayer a Notice of Allocation Reservation.
- Taxpayer provided CEFA a Contribution Submittal Form and contribution by the due date required on the Notice of Allocation Reservation.
- CEFA provides the taxpayer with a signed College Access Tax Credit Certification.

You must receive a certificate from CEFA before you can claim the credit on your California income tax return.

This Tax Credit can be used to offset California tax liability, and it can reduce the tax below tentative minimum tax.

CEFA began accepting applications for an allocation of the credit since November 3, 2014. Additional information on making a CATC contribution is available on CEFAôs website.

SENIOR HEAD OF HOUSEHOLD CREDIT

State of California taxpayers have many credits available. For example, for tax year 2018, qualifying taxpayers who claimed the Senior Head of Household Credit (code 163) could receive a maximum credit of $1,300. The credit is not refundable and is applied against tax. Taxpayers may claim the Senior Head of Household credit if were over a certain age and had an Adjusted Gross Income (AGI) under certain limits. The purpose of this credit is to make it easier for a senior to take advantage of the lower tax liability afforded to the Head of Household filing status, without having to meet all of the Head of Household qualifications, therefore providing additional financial relief for certain seniors that still maintain a status as head of a household. If the head of household meets all of the below listed conditions then there is no need to qualify to use the head of household filing status in order to claim the credit:

- Was 65 years of age or older as of December 31 in the tax year which the credit is claimed. For example, to claim the credit in 2018, the taxpayer must be 65 or older as of December 31, 2018.
- Qualified as a Head of Household in one of the two previous tax years.
- Did not have AGI over $76,082 for 2018.
- Did not have AGI over $73,226 for 2017.

NOTE: The credit is equal to two percent of your California taxable income or the "maximum credit allowed" as shown in the chart above (for the tax year at issue), whichever amount is less.

While the credit is available to the individuals who meet the criteria above, research revealed that numerous taxpayers claiming the credit were not entitled to it. In these cases, the taxpayer did not meet the minimum age requirement, did not provide a household for a qualifying individual in one of the two previous tax years, and/or did not have an AGI under the required threshold. Taxpayers, who filed their 2016, 2017, and 2018 California income tax returns that claimed the Senior Head of Household Credit and who do not qualify, will receive a Notice of Proposed Assessment in the fall of 2019.

HEAD OF HOUSEHOLD GUIDELINES.

Some clients may inquire about claiming the head of household (HOH) filing status. This filing status provides a lower tax liability and a higher standard deduction than the single filing status. Although many clients may think of themselves as the head of their household, they may not qualify for this filing status under state and federal tax laws.

To qualify for this filing status the taxpayer must meet all of the following requirements:

- The taxpayer was unmarried and not a registered domestic partner (RDP), or if married, met the requirements to be "considered unmarried" or "considered not in a registered domestic partnership" as of the last day of the tax year.
- The taxpayer paid more than one-half the costs of keeping up his or her home for the year.
- The taxpayerôs home was the main home for the taxpayer and a qualifying person who lived with the taxpayer for more than one-half the year. For limited exceptions to this rule, see the discussions regarding for Parent/Stepparent (Father or Mother) and Temporary Absence in FTB Publication 1540, California Head of Household Filing Status.
- The qualifying person was related to the taxpayer and met the requirements to be a qualifying child or qualifying relative.
- Generally, the taxpayer was entitled to a Dependent Exemption Credit for his or her qualifying person. However, under limited circumstances, the taxpayer does not have to be entitled to a Dependent Exemption Credit for his or her qualifying child. See FTB Publication 1540 and the two law summaries:
    1) Head of Household Filing Status, Taxpayer Unmarried and Not in a Registered Domestic Partnership, Applicable to Tax Years 2007 and Thereafter.
    2) Head of Household Filing Status Taxpayer Married (Considered Unmarried) or A Registered Domestic Partner (Considered Not in A Registered Domestic Partnership) Applicable to Tax Years 2007 and Thereafter.
- The taxpayer was not a nonresident alien at any time during the year.

There are several resources available to assist taxpayers to determine if they qualify for the head of household filing status:

- The 2018 Personal Income Tax Instruction Booklets for Forms 540 and 540 2EZ contain the general rules for using the head of household filing status.

- FTB Publication 1540, California Head of Household Filing Status Provides detailed information on the filing status.
- For HOH in Spanish, see FTB Publication 1540SPAN, Estado Civil de Cabeza de Familia de California.
- The HOH Website.
- The HOH self-test available online at ftb.ca.gov and search HOH self test.
- The Practitioners Corner Webpage provides more information about the topics covered in our HOH Filing Status -Seminar.

By using these resources - to determine eligibility, taxpayers may avoid a denial of their head of household filing status and an assessment of additional tax plus interest.

Tip for taxpayers that file electronically: By filing FTB Form 4803e, HOH Schedule (Questionnaire), with the electronic return, most electronic filers can avoid receiving a HOH Audit Letter in the mail that requests information about their head of household filing status. However, they may receive a HOH Audit Letter if the Form 4803e information is incomplete or contains conflicting information; taxpreparers can get advantage and save time for a later audit letter if as a part of the e-file process the form 4803e is submitted with the tax return regular e-filing.

JOINT CUSTODY HEAD OF HOUSEHOLD CREDIT

If your child did not live in your home more than half of the taxable year, you may qualify for the Credit for Joint Custody Head of Household. To qualify for the credit you may not have used the married/RDP filing jointly, head of household, or qualifying widow(er) filing status. Some of the other qualifications include

- Taxpayer (TP) must be unmarried at the end of 2018
- TP furnished more than one-half of the household expenses for your home that also served as the main home of your child, step-child, or grandchild for at least 146 days but not more than 219 days of the taxable year.
- The custody arrangement for the child must be part of a decree of dissolution or legal separation or part of a written agreement between the parents where the proceedings have been initiated, but a decree of dissolution or legal separation has not yet been issued.
- If the child is married/or an RDP, you must be entitled to claim a dependent exemption credit for the child.
- TP must be unmarried at the end of 2018
- TP furnished more than one-half of the household expenses for your home that also served as the main home of your child, step-child, or grandchild for at least 146 days but not more than 219 days of the taxable year.
- The custody arrangement for the child must be part of a decree of dissolution or legal separation or part of a written agreement between the parents where the proceedings have been initiated, but a decree of dissolution or legal separation has not yet been issued.
- If the child is married/or an RDP, TP must be entitled to claim a dependent exemption credit for the child.

CLAIMING CREDITS IN CALIFORNIA

California has a variety of credits, many of which are not applicable on the taxpayerôs federal return. Listed below are the most common credits available. A code number identifies each credit (except the exemption credit). To claim only one or two credits, enter the credit name, code number, and amount of the credit on line 25 and line 26, Form 540. To claim more than two credits, use Schedule P (540), Part III.

Exemption Credits. Unlike the federal return where the taxpayer is allowed an additional exemption amount which is subtracted from income before calculating tax, California allows an exemption *credit*. Exemption credits reduce the taxpayerôs calculated tax. For 2018, the exemption amounts are $118 for the taxpayer (and spouse or RDP); an additional $118 if the taxpayer/spouse is blind or over 65. Each dependent on the return allows the taxpayer to subtract an additional $367 from their tax.

The credit can be reduced. If the taxpayerôs federal adjusted gross income (AGI) on line 13 is more than the amount shown below for their filing status, the credits will be limited. (For purposes of computing limitations based upon adjusted gross income (AGI), RDPs recalculate their AGI using a federal pro forma or RDP Worksheet, located in FTB Pub. 737, Tax Information for Registered Domestic Partners.) If federal AGI is more than the amount shown below for each filing status, the credits will be limited.

For higher-income taxpayers the exemption credit is reduced as follows:

Filing status	Reduce each credit by:	For each:	Federal AGI exceeds:
Single	$6	$2,500	$194,504
Married/RDP filing separately	$6	$1,250	$194,504
Head of household	$6	$2,500	$291,760
Married/RDP filing jointly	$12	$2,500	$389,013
Qualifying widow(er)	$12	$2,500	$389,013

When applying the phaseout amount, apply the $6/$12 amount to each exemption credit, but do not reduce the credit below zero. If a personal exemption credit is less than the phaseout amount, do not apply the excess against a dependent exemption credit.

Nonrefundable renterôs credit. If the taxpayer paid rent for at least six months on their principal residence located in California, they may be eligible for an additional tax credit. To be eligible for the credit, the taxpayer must meet the following criteria:

- They must have been a resident of California for at least six months (part-year residents should see the instructions for Form 540NR);
- Their California adjusted gross income for 2018 must be less than $41,641 (single or married/RDP filing separately) or $83,282 (married/RDP filing joint, head of household or qualifying widow);
- They must have paid rent for at least half the year on a home that was their principal residence;
- They cannot be claimed as a dependent by any other person;
- The property they rented cannot be exempt from property tax;
- The taxpayer or their spouse /RPD cannot have claimed the homeownerôs property tax exemption during 2018 (unless they maintained separate residences)

The amount of the nonrefundable credit is $60 if single, $120 if married/RDP filing jointly, head of household, or qualifying widow(er). If the taxpayer and their spouse/RDP file separate return, lived in the same rental property and both qualify for the credit, one spouse/RDP can claim the full amount of the credit ($120) or each may claim $60.

Sport league penalties. For taxable years beginning on or after January 1, 2014, an owner of all or part of a professional sports franchise will not be allowed a deduction for the amount of any fine or penalty paid or incurred, that was assessed or imposed by the professional sports league that includes that franchise. Additional information can be found in the instructions for California Schedule CA (540 and 540NR).

CALIFORNIA ITEMIZED DEDUCTIONS, IN GENERAL

California allows taxpayers to take either the standard deduction or itemized deductions. Obviously taking the larger of the two will result in the lowest tax liability. A taxpayer may choose to itemize deductions on their federal return and take the standard deduction on their California return, or vice versa. If a taxpayer does not itemize on their federal return but chooses to itemize on their California return, they must complete a federal Schedule A to come up with their base amounts for their itemized deductions. Write ñFor California Onlyò on the top of the form and attach the Schedule A to the California return.

Any adjustments to the federal amounts because of differences in tax law are made using either the worksheet for Form 540 or Part II of Schedule CA.

Medical expenses. In general, California conforms to all of the federal provisions regarding medical expenses. However in California, medical benefits (including health insurance premiums) paid on behalf of registered domestic partners are deductible. Include medical expenses for the taxpayer's registered domestic partner and their dependent(s) that occur on or after 1/1/02. A ñdomestic partnerò is defined in the California Family Code. The term is generally used to describe either two persons of the same sex, or if of the opposite sex, one or both of the partners must be over the age of 62.

Because the federal itemized deductions do not include this amount, the additional deductible benefits must be added in to arrive at California itemized deductions. The medical expenses are entered as a positive number on line 41 of Schedule CA.

Taxes paid to state, local or foreign authorities. California does not allow a deduction for state, local or foreign income taxes paid, including any amounts paid for State Disability Insurance (SDI) or Voluntary Plan Disability Insurance (VPDI). This includes any amounts paid through withholding, estimated taxes or prior year balance dues paid in the current year. The amount of state, local or foreign taxes included on the return must be adjusted for California purpose.

Because the federal itemized deductions include this amount, which is not deductible on the state return, these taxes must be subtracted from the federal Schedule A total to arrive at California itemized deductions. The appropriate amount should be included on Schedule CA, line 39.

If the taxpayer has elected to deduct the amount of their general sales tax, this amount should be subtracted on line 39, Schedule CA. California also does not allow deductions for the annual tax paid by a limited partnership, franchise taxes or income taxes paid under the Corporation Tax Law. Any of these taxes are subtracted on Schedule CA, line 39.

Personal property taxes. For California purposes, personal property taxes usually include part of the cost to register a car, motorcycle, boat or trailer. These taxes are known as Vehicle License Fees (VLF). The VLF was established by the Legislature in 1935 in lieu of a property tax on vehicles. The formula for VLF assessment established by the Legislature is based upon the purchase price of the vehicle or the value of the vehicle when acquired. The VLF decreases with each renewal for the first 11 years. The VLF is prorated if the assignment/reassignment of a registration year results in a registration year of less than 12 months.

The total fee paid to the DMV is not deductible. The total amount is comprised of a registration fee (usually $31), plus additional fees such as an air quality fee, a theft deterrent fee, an abandoned vehicle fee, plus a fee that helps defray expenses for emergency call boxes. These amounts are considered nondeductible and must be subtracted from the total amount to determine the deductible VLF fee. The deductible amount is included on the federal Schedule A, line 7. The DMV web site has a Vehicle Registration Fee Calculator that will calculate the VLF for tax purposes. The taxpayer will need to know their license number and the last five digits of their Vehicle Identification Number (VIN).

The DMV calculator is located at: https://mv.dmv.ca.gov/FeeCalculatorWeb/vlfForm.do

In addition the Vehicle License Fee is separately stated on the Vehicle Registration Renewal Notice sent out by the DMV.

Mortgage Interest paid. Generally mortgage interest that is deductible on the federal return is considered deductible on the California return as well. The only time an adjustment might be required is if the taxpayer has reduced their deductible mortgage interest by the amount of their

mortgage interest credit. California has no comparable credit, so any amount subtracted from the federal Schedule A amounts should be added back to arrive at California itemized deductions. Enter the amount of the federal Mortgage Interest Credit as a positive number on line 41, Schedule CA.

Investment Interest paid. If the taxpayerôs investment income is different for California purposes, for example due to U.S. savings bond interest, an adjustment may be needed for investment interest paid. A complete discussion of this topic is beyond the scope of this course. Get the instructions for Form 3526, *Investment Interest Expense Deduction* for more information.

Miscellaneous and itemized deductions. Generally, any miscellaneous itemized deductions allowed on the federal return were also deductible on the California return. However, the TCJA new law suspended for tax years 2018 through 2025 the job expenses and itemized miscellaneous expense deduction subject to 2% of AGI threshold (meaning expenses had to exceed 2% of AGI and then the excess could be deducted). Expenses in this category include expenses related to investments, hobby expenses (limited to hobby income), un-reimbursed employee business expenses and tax preparation expenses. Because California did not conform to this change, it is important for taxpayers with these expenses in excess of the 2% AGI threshold, continue to maintain records of these expenses as they will be needed for the California tax return.

Itemized deduction limitations**.** Like the federal return, California itemized deductions may be limited for higher income taxpayers. If the taxpayerôs federal AGI exceeds the following amounts:

- Single or married/RDP filing separately $176,413
- Head of household $264,623
- Married/RDP filing jointly or qualifying widow(er) $352,830

TURF REMOVAL INCENTIVE

For taxable years beginning on or after January 1, 2014, and before January 1, 2019, taxpayers can exclude from gross income any amount received as a rebate, voucher, or other financial incentive issued by a local water agency or supplier for participation in a turf removal water conservation program.

Program Overview

Turf grass is one of the most water-intensive plants in your landscape. Its high water use and frequent maintenance make it a time-consuming and expensive yard option. In fact, the average residential customer spends about 60% of their water on outdoor irrigation. In California there is a program to replace the turf with a friendly yard.

To help with turf removal projects, rebates are available for $2.00 or more per square foot of turf removed. This increased turf removal rebate is being provided in response to Governor Edmund G Brown Jr.ôs emergency drought declaration.

Review Questions Section 2

Read and answer the following review questions. The correct answers are found on the next page with an explanation to strengthen up your knowledge. Note: This is not part of your Final Test

6. Claiming the Head of Household filing status gives tax payers a lower tax liability and higher standard deductions. What of the following is recommended when filing a head of household return?
   a) Taxpayers should file as head of household if they paid for some expenses of a dependent that is living with grandparents.
   b) Taxpayer is married but he/she decides to file as head of household
   c) A nonresident alien should file for 4803e to claim the head of household filing status.
   d) Taxpayers should file electronically Form 4803e with the electronic return to avoid receiving a HOH audit letter.

7. In California, unlike the federal return, _____ are deductible.
   a) Medical expenses for nondependents.
   b) Medical expenses for registered domestic partners and their dependents.
   c) Medical expenses for pets living in the household.
   d) Medical expenses paid for elective plastic surgery.

8. The only time an adjustment for mortgage interest might be required is when the taxpayer has reduced their deductible mortgage interest by the amount of their _____.
   a) Seller paid points
   b) Buyer paid points
   c) Private mortgage insurance
   d) Mortgage interest credit

9. In California taxpayers can benefit from the turf removal incentive. Taxpayers can get a rebate by a local water agency or supplier for participation in a turf removal program but they have to report the voucher income to the state.

   a) True
   b) False

10. In California there is a program to replace the turf with a friendly yard in order to save water. The program has the following benefit.

    a) Taxpayers can receive a rebate for $2.00 or more that will report in their California income tax
    b) California taxpayers can exclude from gross income any amount received as a rebate, voucher or other financial incentive issued by a local water agency.
    c) California tax payers can exclude from gross income up to 60% of income received from a local water agency
    d) All of the above

Review Questions 2 – Answers and Discussion

6. **Answer is d.** By filing FTB Form 4803e, HOH Schedule (Questionnaire), with the electronic return, most electronic filers can avoid receiving a HOH Audit Letter in the mail that requests information about their head of household filing status. However, they may receive a HOH Audit Letter if the Form 4803e information is incomplete or contains conflicting information.

7. **Correct answer is b.** In general, California conforms to all of the federal provisions regarding medical expenses. However in California, medical benefits (including health insurance premiums) paid on behalf of registered domestic partners are deductible. Include medical expenses for the taxpayer's registered domestic partner and their dependent(s).

8. **Answer d is correct.** Generally mortgage interest that is deductible on the federal return is considered deductible on the California return as well. The only time an adjustment might be required is if the taxpayer has reduced their deductible mortgage interest by the amount of their mortgage interest credit. California has no comparable credit, so any amount subtracted from the federal Schedule A amounts should be added back to arrive at California itemized deductions.

9. **Answer is b.** For taxable years beginning on or after January 1, 2014, and before January 1, 2019, taxpayers can exclude from gross income any amount received as a rebate, voucher, or other financial incentive issued by a local water agency or supplier for participation in a turf removal water conservation program.

10. **Answer b is correct.** For taxable years beginning on or after January 1, 2014, and before January 1, 2019, taxpayers can exclude from gross income any amount received as a rebate, voucher, or other financial incentive issued by a local water agency or supplier for participation in a turf removal water conservation program.

CHILD AND DEPENDENT CARE EXPENSE CREDIT FORM 3506

The Child and Dependent Care Expenses Credit is a non-refundable tax credit. The credit is applied against the net tax liability. If the credit exceeds the net tax liability, the excess credit cannot be refunded. The credit is allowed for certain household and dependent care expenses incurred during the year that allowed taxpayers to seek or maintain gainful employment.

Taxpayers can take the credit if they meet all of the following for the tax year:

- Their Adjusted Gross Income is less than $100,000.00.
- They had at least as much earned income as they paid for child or dependent care.
- They have a qualifying individual.

A qualifying individual is one of the following:

- A dependent of the taxpayer who is under 13 years of age and for whom the taxpayer is entitled to a dependent exemption credit. A child who turned 13 during the tax year qualifies only for the part of the year when he or she was 12 years old.
- The spouse of the taxpayer, if he or she is physically or mentally unable to care for him or herself.
- A dependent of the taxpayer who is physically or mentally unable to care for him or herself and for whom the taxpayer was entitled to a dependent exemption credit without regard to the gross income limitation and either:
    1. Was a dependent
    2. Would have been a dependent except that: She received gross income of $4,050 or more, she filed a joint return, and the taxpayer, or his spouse/RDP if filing a joint return, could be claimed as a dependent on someone elseôs tax year return.

Taxpayers that paid someone to care for their child or another qualifying person in order to work or look for work in 2018 may be eligible to claim the credit. FTB Form 3506, Child and Dependent Care Expenses Credit, is used to figure the credit amount.

Taxpayers do not have to take the federal Child and Dependent Care Expense Credit to claim the California credit.

There are differences between California and Federal law regarding the Child and Dependent Care Expenses credit. The California credit is a percentage of the federal credit as modified by California law. While a taxpayer may be eligible to claim the federal credit, he may or may not be eligible to claim the California credit due to the following differences:

- California does not allow this credit for care that is provided outside the state of California.
- Nonresident taxpayers may not claim the credit, unless earned wages are from working in California or earned self-employment income is derived from California business activities.

- To qualify for the California credit, Federal adjusted gross income must be $100,000 or less.
- Same-sex married couples and RDPs must file a joint California return to claim this credit.

There is an exception to having to file jointly to claim the credit if the couple meets the tests to be considered unmarried or not an RDP. To be considered unmarried or not an RDP, the taxpayer and spouse/RDP must have lived apart for the entire last six months of the tax year. The taxpayerôs qualifying person(s) must have lived in the taxpayerôs home for greater than half the tax year, and the taxpayer must have paid for more than half the cost of keeping up the home. In addition, all other requirements for claiming the credit must be met
Taxpayers whose Federal AGI is $100,000 or less and qualify for the federal credit for child and dependent care on federal Form 2441 may also qualify for the California Child and Dependent Care Expenses Credit. This is a nonrefundable credit.

Since the California credit is a percentage of the Federal credit, the Federal amounts must be determined before the taxpayer can figure the California credit on Form FTB 3506 (the federal tax return must be completed first) The amount of California credit varies with the Federal AGI and is determined by multiplying the Federal Credit amount by the applicable percentage as per the chart below.

<u>Federal AGI / California Percentage of Federal Credit</u>
$40,000 or less / 50% or .50 of Fed Credit
Over $40,000 but not over $70,000 / 43% or .43 of Fed Credit
Over $70,000 but not over $100,000 / 34% or .34 of Fed Credit
Over $100,000 you do not qualify for the California credit

For purposes of claiming this credit, even if the service member is domiciled outside of California, active duty pay is considered earned income from California sources. However, Military personnel who are domiciled outside of California should use their federal AGI less their military pay to determine the percentage of federal credit on the above chart. FTB Publication 1032, Tax Information for Military Personnel, has more information about this topic.

Test for a Qualifying Child for the Child and Dependent Care Expenses Credit

- Relationship Test: The child must be a son, daughter, stepchild, adopted child, eligible foster child, brother, sister, half-brother, half-sister, stepbrother, stepsister, or a descendant of one of these. An adopted child includes a child who has been lawfully placed with the taxpayer for legal adoption even if the adoption is not yet final. An eligible foster child must be placed with the taxpayer by an authorized placement agency or by a court.
- Age Test ï For the purposes of qualifying for the Child and Dependent Care Expenses Credit, the child must be under 13.
- Residency Test ï The child must live with the taxpayer for more than half the year.

- Support Test ï The child must not have provided more than half of his or her own support.
- Joint Return Test ï The child or dependent must not have filed a joint federal or state income tax return with his or her spouse/RDP.
- Citizenship Test ï The child must be a citizen or national of the U.S. or a resident of the U.S., Canada, or Mexico.

Divorced, RDP Terminated, Separated, or Never-Married Parents. Special rules apply in determining if the taxpayerôs child meets the requirements to be his qualifying person, for divorced, RDP terminated, separated, or never-married parents, for the Child and Dependent Care Expenses credit. Only one parent qualifies to claim a child as a qualifying person when separate returns are filed by the parents.

In cases where both parents pay for child care for the same child, only one parent can qualify for the credit. Some custody agreements include a provision detailing which parent is entitled to the credit. However, that parent must meet all eight of the qualifications listed in the instructions for Form FTB 3506, to claim the credit.

CLEAN CARS AND TRUCKS REBATES

The Air Resources Board (ARB) Clean Vehicle Rebate Project (CVRP) is a program that is designed to promote the purchase of battery electric, plug-in hybrid electric, and fuel cell vehicles. The Board is giving rebates of up to $5,000 per light-duty vehicle. The rebates are available for individuals, nonprofits, government entities, and business owners who purchase or lease an eligible vehicle.

For Fiscal Year 2015-16, the California Energy Commission (Energy Commission) approved the transfer of $5 million to CVRP to augment funding freeway capable Zero Emissions Vehicles certified for four or more passengers.

To apply for a rebate taxpayers need to visit the Center of Sustainable Energy webpage at: https://cleanvehiclerebate.org/eng or call 866-984-2532.

For tax purposes the rebate in California is not taxable but taxpayer will pay sales tax in the full amount. CSE does not issue a 1099 for the rebate.

Truck and bus regulations. On December 12, 2008, the California Air Resources Board approved the Truck and Bus regulation to significantly reduce particulate matter, or PM, and oxides of nitrogen emissions from existing diesel vehicles operating in California.

The regulation requires diesel trucks and buses that operate in California to be upgraded to reduce emissions. Newer heavier trucks and buses must meet PM filter requirements beginning

January 1, 2012. Lighter and older heavier trucks must be replaced starting January 1, 2015. By January 1, 2023, nearly all trucks and buses will need to have 2010 model year engines or equivalent.

The regulation applies to nearly all privately and federally owned diesel fueled trucks and buses and to privately and publicly owned school buses with a gross vehicle weight rating (GVWR) greater than 14,000 pounds. The regulation provides a variety of flexibility options tailored to fleets operating low use vehicles, fleets operating in selected vocations like agricultural and construction, and small fleets of three or fewer trucks.

The ARB has a Fleet Calculator to assist fleet owners in evaluating various compliance strategies to comply with the Truck and Bus Rule.

Vehicles exempt:

- Curtain side vans;
- Military tactical vehicles;
- Solid waste vehicles;
- Authorized emergency vehicles;
- Container chassis;
- Drayage tractors and trailers that operate within a 100 mile radius of a port or intermodal rail yard; and,
- Drop frame vans.

California treatment of rebates and vouchers. Rebates or vouchers from a local water agency, energy agency, or energy supplier can be excluded from income. California law allows an income exclusion for rebates or vouchers from a local water agency, energy agency, or energy supplier for the purchase and installation of water conservation appliances and devices. Federal law has no similar exclusion.

Gains from rebates. Capital gain on cash for Clunkers rebates under the federal Car Allowance Rebate System (CARS) program are not taxable. Under federal law, Cash for Clunkers rebates are not taxable. For California, if the amount of the rebate is greater than the basis of the used vehicle relinquished there is a California capital gain. A taxpayer that used the rebate through their business in a like-kind exchange of vehicles should reduce the basis on the new vehicle acquired in the like-kind exchange and upon disposal of the new vehicle, recognize the rebate income at that time.

MANDATORY E-PAY LAW FOR 2018

On September 30, 2008, Assembly Bill 1389 was signed, adding Section 19011.5 to the California Revenue and Taxation Code. This new law requires individuals to remit all future payments electronically once they:

- Make an estimated tax or extension payment (by check or electronic method) over $20,000 for a taxable year beginning on or after January 1, 2009; OR

- File an original return with a tax liability over $80,000 for a taxable year beginning on or after January 1, 2009.

Fiduciaries, estates, and trusts are not required to make payments electronically, regardless of the amount owed.

Group nonresident/composite return filers may be required to make their payments electronically if they meet the mandatory e-pay requirements.

Once the taxpayer surpasses $20,000 for the first payment, the mandatory electronic payment requirement will be activated. All subsequent payments would then be required to be submitted electronically, without regard to:

- The amount of the payment
- The type of tax payment
- The tax year for which the payment has been made
- Taxpayers who fail to comply with the electronic payment requirement are subject to a penalty of 1% for noncompliance.
- A waiver of the mandatory electronic payment requirement may be requested for one of the following reasons:
    - Taxpayer have not made an estimated tax or extension payment in excess of $20,000 during the current or previous taxable year
    - Taxpayer total tax liability reported for the previous taxable year did not exceed $80,000.
    - The amount you paid is not representative of your total tax liability

Payments covered by the law. If taxpayers make a payment or file a return meeting the mandatory requirement, the FTB will send them an FTB 4106 MEO, *Mandatory e-pay Participation Notice,* advising them that all future payments must be remitted electronically.

If taxpayers do not receive notification from FTB, they are still required to remit payments electronically once you meet either of the above thresholds.

Some tax preparation software may also remind taxpayers to e-pay

Once taxpayers meet the mandatory e-pay threshold, they are required to make all subsequent payments electronically, regardless of the amount, type, or taxable year.

For example: taxpayers make their first quarter estimated tax payment of $25,000 on 4.15.18 by paper check. Any payment made after that (for example, a bill payment from a previous year or your second quarter estimated tax payment) must be made electronically.

Mandatory e-pay penalty. When taxpayers are required to make electronic payments but pay by other means, the FTB can assess a penalty equal to 1 percent of the amount paid, unless the taxpayersô failure to pay electronically was for reasonable cause and not willful neglect.

On January 1, 2011: FTB started assessing the penalty provision of the statute. Prior to this date they did not assess the penalty to allow taxpayers and their representative's time to implement processes and procedures to comply with the law.

Electronic payment methods

Taxpayers can e-pay using one of the following methods:

- Pay online with Web Pay.
- Request an Electronic Funds Withdrawal (EFW) on the e-filed return.
- Pay by credit card.
- Use the pay-by-phone option.

Some of these options are not available for a Group Nonresident/Composite Return Filers

What is Not an electronic payment. Making a payment using the bank's online bill payment system is not an electronic payment. The bank mails a paper check to FTB which does not meet the requirement to pay electronically.

e-file and e-pay. While taxpayers must make their tax payments electronically if they meet the e-pay criteria, they are not required to e-file their tax return. The FTB will continue encouraging to e-file their return but will not be required.

Waiving the mandatory e-pay requirement. Taxpayers can request a general or permanent waiver from mandatory e-pay requirement. To request the waiver individuals must complete and submit form FTB 4107, Mandatory e-pay Election to Discontinue or Waiver Request. The FTB will review the waiver request and notify individuals in writing when they we approve or deny the request.

Taxpayers can request a general waiver from mandatory e-pay if one or more of the following is true:

- Taxpayers have not made an estimated tax or extension payment in excess of $20,000 during the previous income year; or their tax liability reported for the previous income year did not exceed $80,000;
- The amount paid is not representative of taxpayersô tax liability.

If the FTB grants a waiver and taxpayers subsequently meet the mandatory e-pay requirements, they must resume making their payments using an electronic method.

Taxpayers can request a permanent waiver from mandatory e-pay if they have a permanent physical or mental impairment that prevents them from using a computer. Taxpayers must have their physician complete and sign PAGE 3 of FTB 4107. The signed affidavit must be attached to FTB 4107 when it is submitted.

When qualifying individuals file FTB 4107, to request a permanent impairment waiver they can check a box on the form and have the FTB reviews the account for possible waiver of a previously imposed mandatory e-pay penalty if **all** the following exist:

- Taxpayer received a mandatory e-pay penalty for payments made before receiving approval of the permanent physical or mental impairment request.
- The date on the physicianôs affidavit of permanent physical or mental impairment pre-dates the assessment of the penalty.
- The statute of limitations for filing a claim for refund is still open.

Advantages of electronic payment methods. Even if taxpayers are not required to make electronic payments, they can still take advantage of paying their personal income tax (estimated tax, bill, return, or extension) payments online.

- e-file and schedule the tax payment for April 15.
- Ensure that the FTB receives the payments on time.
- Subscribe to receive an email reminder to remit the quarterly estimate payments.
- Schedule the estimate payments for the entire year at one time.
- Save the cost of mailing the payments to the FTB.

CALIFORNIA AND IRS TAX PROVISIONS

On December 19, 2014, the President signed the Tax Increase Prevention Act of 2014 (Public Law 113-295), which extends most of the expiring provisions through December 31, 2014. This act retroactively extends 54 expired tax provisions thorough 2014.

Since the last time California conformed to the Internal Revenue Code (IRC) was when the Conformity Act of 2010 was enacted with a specified conformity date of January 1, 2009, this means that California continues to be out of conformity with a minor exception.

The exception is that California tax law automatically conforms to federal changes made to pension provisions, except for elective deferrals. As a result, this federal extension automatically applies under California law to the extent it applies to federal pension provisions; for example, California automatically conforms to the one-year extension (through 2014) of tax-free distributions from IRAs for charitable purposes

Examples of federal provisions to which California does not conform:

- $250 teachersô deduction for classroom supplies.
- Mortgage insurance premium deduction.
- Work Opportunity Credit.
- Above the line deduction for qualified tuition expenses.
- New energy-efficient home credit.
- 5-year Built-In-Gain period. Under California law, the recognition period for the built-in gains tax is 10 years.
- Exclusion of 100 percent of gain on sale of small business stock. For California, the Court of Appeal held that California Revenue and Taxation Code (R&TC) Sections 18152.5 and 18038.5 are unconstitutional, so these sections became invalid and unenforceable. Thus, there is no exclusion of gain on sale of small business stock for California tax purposes.
- Research Credit. California still modifies the general credit to be 15 percent of qualified expenses (instead of the federal rate of 20 percent of qualified expenses) and modifies the university ñbasic researchò credit to be 24 percent of qualified expenses (instead of the federal rate of 20 percent of qualified expenses). And, California does not conform to the federal repeal date, meaning the research credit is permanent for California purposes.

Many of the federal extensions involve depreciation. Recall that California Personal Income Tax Law generally conforms to the Modified Accelerated Cost Recovery System commonly known as MACRS as of January 1, 2009, but specifically does not conform to bonus depreciation.

Furthermore, California Corporation Tax Law does not adopt MACRS, and instead is generally in substantial conformity to the pre-1981 federal asset depreciation range (ADR) depreciation rules that generally allow property to be depreciated based on its ñuseful life.ò Lastly, California conforms to the federal election to deduct (or ñexpenseò) the cost of qualifying property under IRC Section 179, rather than to recover such costs through depreciation deductions (commonly referred to as ñsmall business expensingò), as of January 1, 2009, with significant modifications.

Medical and Dental Deduction ï The federal law changed in 2013 , as a result the medical and dental expense that can be an itemized deduction on Schedule A from amounts over 7.5% of the taxpayerôs adjusted gross income (AGI) to 10% of AGI. California did not adopt the change in the medical and dental expense threshold. This change was only applied to taxpayers under the age of 65, so for those taxpayers 65 and over, the 7.5% threshold still applied on the federal tax return.

California taxpayers continue to be able to itemize medical and dental expenses incurred that exceed 7.5% of AGI, so for tax years 2013 through 2016, an adjustment was required if medical and dental expenses were itemized and the tax payer was under the age of 65. The federal law reverted back to the 7.5% threshold for the 2017 and 2018 tax years, therefore for these tax years an adjustment is not required (California complies with federal). However, as it stands now, starting with the 2019 tax year, all taxpayers (including those 65 years and older) will see the threshold increase to 10%. At this moment whether or not California will comply with this change has yet to be determined.

Pension Annuities, SEPs, and Nonqualified Plans

The1040 tax return must be completed before starting the California tax return. After the federal return has been completed, the California amounts of the pension, annuity, or IRA income must be computed independently, based on California tax law. If the California amount differs from the federal amount, the taxpayer will need to make a California adjustment. Depending on the California form filed, report the California adjustment on whichever California form the taxpayer files: Schedule CA (540) for Form 540 filers or Schedule CA (540NR) for Long Form 540NR filers.

There are a few common instances where differences exist between California and federal law: The more common differences apply to early distributions, part-year and nonresident pension income, social security and railroad retirement benefits, and Health Savings Accounts (HSAs). A California adjustment is an addition to or subtraction from the federal AGI. The federal pension, annuity, or IRA income is included in the federal AGI figure that the taxpayer lists on his California return.

Normal Distributions. The California treatment of pensions, annuities, and IRAs is very similar to the federal treatment of that same income. Nevertheless, some differences do exist between California and federal law, which could cause the amount of taxable California distribution income to be different from the amount reported on the federal return.

Early Distributions of IRAôs are considered later in Retirement Benefits.

CALIFORNIA EMPLOYMENT TAXES

In California a business becomes an employer when it pays cumulative wages in excess of $100 in a calendar quarter to one or more employees. The first thing an employer is required by law to do is file a registration form with the Employment Development Department (EDD) within fifteen (15) calendar days after paying over $100 in wages for employment in a calendar quarter, or whenever a change in ownership occurs.

California Form DE-1 should be completed by the employer and filed with the EDD in one of the following ways:

- Register online from the EDDôs e-Services for Business at https://eddservices.edd.ca.gov.
- Mail the completed registration form to the EDD, Account Services Group (ASG) MIC 28, P.O. Box 826880, Sacramento, CA 94280-0001.
- Fax the completed registration form to the EDD at 916-654-9211.
- Call for telephone registration at 916-654-8706.

Note: Businesses that are already registered and have a change in form or ownership complete a Change of Employer Account Information (DE 24). There are industry specific registration forms ï agricultural, government, school, Indian tribe, household or nonprofit employers should check with EDD for the proper registration form to file.

Employers are responsible for reporting wages paid to their employees and paying Unemployment Insurance (UI) and Employment Training Tax (ETT) on those wages, as well as withholding and remitting State Disability Insurance (SDI) tax and California Personal Income Tax (PIT) due. Once subject, the employer must report wages for that year and the following year, regardless of the amount of wages paid.

Unemployment Insurance (UI). California Unemployment Insurance (UI) is an employer paid contribution. No amounts are withheld from the employeeôs wages. The UI tax rates are based on one of seven tax rate schedules (AA through F) established by law. The new employer UI tax rate is 3.4 percent (.034) of the first $7,000 in wages paid annually for the first three years. In the fourth year, the UI tax rate is calculated based on each employerôs previous experience. All UI taxes paid, taxable payroll reported, UI benefit charges, and prorated credits and charges to the UI reserve account are used to establish each employerôs individual UI tax rate. UI rates range from 1.5% to 6.2%. California UI can be used as a credit against IRS FUTA tax.

California State Disability Insurance (SDI). The purpose of California SDI is to provide temporary benefit payments to workers for non-work related disabilities.

CA SDI is a deduction from employeesô wages. Employers withhold a percentage of wages (1% for 2019) for SDI on the first $118,371 in wages paid to each employee in a calendar year for a maximum withholding amount of $939.40.

Paid Family Leave Insurance. For California workers covered by State Disability Insurance, Paid Family Leave insurance provides up to six weeks of benefits for individuals who must take time off to care for a *seriously ill* child, spouse, parent, or domestic partner, or to bond with a new minor child.

California Personal Income Tax (PIT). The California PIT is a tax levied by the Franchise Tax Board on the income of California residents and the income from California sources for nonresidents. The EDD administers the reporting, collection and enforcement of PIT withholding. The tax is administered by the Governor to provide resources needed for California public services such as schools, public parks, roads and health and human services.

California PIT is withheld from employeesô pay based on the employees withholding allowance certificate ï either federal Form W-4 or California Form DE 4. Wages subject to income tax consists of compensation for services performed by an employee including, but not limited to salaries, bonuses, commissions, fees and payments in forms other than checks for cash.

New Hire Reporting. Federal law requires all employers to report to EDD within 20 days of start of work all employees who are newly hired or rehired. This information is used to assist state and county agencies in locating parents who are delinquent in their child support obligations.

An individual is considered a new hire on the first day in which he/she performs services for wages. An individual is considered a rehire if the employer/employee relationship has ended and the returning individual is required to submit a W-4 form to the employer.

California Form DE 34 is used to report newly hired employees to EDD.

Withholding Deposits. Although employer UI and ETT taxes are due quarterly, SDI and California PIT withheld from employeesô wages may need to be deposited more often. California deposit due dates are generally the same as federal deposit due dates. Penalty and interest are charged on late deposits.

California Payroll Taxes Forms. Wages paid to employees must be reported to the Employment Development Department using the following forms:

- Quarterly Contribution Return and Report of Wages (DE 9) and
- Quarterly Contribution Return and Report of Wages (Continuation) (DE 9C)

Employers are required to file both a *Quarterly Contribution Return and Report of Wages* (DE 9) and the *Quarterly Contribution Return and Report of Wages (Continuation)*(DE 9C) each quarter.

Review Questions Section 3

Read and answer the following review questions. The correct answers are found on the next page with an explanation to strengthen up your knowledge. Note: This is not part of your Final Test

11. Taxpayers in California are entitled to take the Child Care Expense Credit if meet the following:
    a) Their Adjusted Gross Income is less than $100,000.00.
    b) They had at least as much earned income as they paid for child or dependent care.
    c) They have a qualifying individual.
    d) All of the above.

12. What is one of the conditions for Same-sex married couples and RDPs have to meet to be able to claim the credit?
    a) Claim also the credit in form 1040.
    b) They have to live out of the state of California.
    c) Federal AGI has to be $80,000 or less.
    d) They must file a joint California return to claim this credit.

13. To comply with the mandatory e-pay law taxpayer can use all the following methods, except:
    a) Pay online with web pay
    b) Pay by credit card
    c) Use the EFW on the e-filed return
    d) Pay by using the bankôs online payment

14. In California, if taxpayers make their tax payments electronically what is going to be the requirement for the tax return?

    a) If taxpayers make their payments electronically then they are required to e-file their tax return.
    b) Taxpayers that made their payments electronically will not be required to e-file their tax return
    c) The FTB will penalize taxpayers that do not e-file their tax return
    d) None of the above

15. One of the following statements is true regarding the Unemployment Insurance in California.

    a) The UI in California is going to be cheaper if employers and employees paid the same amount.
    b) The UI is an employerôs responsibility and the rate will not always be the same
    c) The UI rate is the same and is paid until employee reaches $115,000 in wages
    d) The UI rate is paid by employee and is paid only in the first $7000 in wages.

Review Questions 3 – Answers and Discussion

11. **Correct answer is d.** All 3 Conditions have to be meet for taxpayers claiming the Child and Dependent Care Credit in California.

12. **Answer is a.** Same-sex married couples and RDPs must file a joint California return to claim this credit.
13.
14. **Correct answer is d.** Making a payment using the bank's online bill payment system is not an electronic payment. The bank mails a paper check to FTB which does not meet the requirement to pay electronically.

15. **Answer is b.** While taxpayers must make their tax payments electronically if they meet the e-pay criteria, they are not required to e-file their tax return. The FTB will continue encouraging to e-file their return but will not be required.

16. **Correct answer is d.** California Unemployment Insurance (UI) is an employer paid contribution. No amounts are withheld from the employeeôs wages. The UI tax rates are based on one of seven tax rate schedules (AA through F) established by law. The new employer UI tax rate is 3.4 percent (.034) of the first $7,000 in wages paid annually for the first three years.

Employment Training Tax (ETT). The ETT provides funds to train employees in targeted industries to improve the competitiveness of California businesses. The ETT funds promote a healthy labor market by helping California businesses invest in a skilled and productive workforce, and develop the skills of workers who directly produce or deliver goods and services.

The ETT is an employer-paid tax. Employers subject to ETT pay one-tenth of one percent (.001) on the first $7,000 in wages paid to each employee in a calendar year.

Form DE 9. The DE 9 reconciles wages reported and taxes paid for each quarter. If form DE9 shows a tax payment due, it should be submitted with a DE 88/DE 88ALL coupon or pay electronically using the EFT system to avoid noncompliance penalty.

Form DE 9C. The DE 9C reports individual employee wages for each quarter. Employers with 250 or more employees must submit their wage reports electronically.

Employers may file both reports either electronically using e-Services for Business, or by mailing paper forms, or on approved alternate forms.

How to Report. Many EDD forms require employers to specify the quarter on the report and/or deposit. The date format used on forms for reporting and/or making deposits is the last 2 digits of the year and then one digit representing each quarter. Entering the incorrect format may cause delays, penalties, interest, and/or misapplication of funds.

For example:

- 1st quarter of 2019 is entered as 191, which is 19 for 2019 and 1 for the first quarter.
- Subsequent quarters would be 192, 193, and 194.

The DE 9 and DE 9C are due as follows:		
Report Covering	**Filing Due Dates**	**Delinquent if Not Filed By**
January, February, March	April 1	April 30, 2019
April, May, June	July 1	July 31, 2019
July, August, September	October 1	October 31, 2019
October, November, December	January 1	January 31, 2019

No payroll paid. Employers that paid no wages during a quarter are still required by law to sign and file the DE 9 and the DE 9C. Just check the ñNo Payrollò box in Item A, on the DE 9 and Item C on the DE 9C, then sign and mail both reports. If employer does not expect to pay wages within the next year they may notify EDD by writing or by checking the ñOut of Business/Final Reportò box in Item B on the DE 9 and Item D on the DE 9C. The EDD will send a letter confirming that the account has been inactivated.

Filing late or failing to file. If the DE 9C is not submitted on time, EDD will issue a written demand for the report. If the DE 9C is not submitted within 15 days of the demand date, a penalty of $20 ($10 for periods prior to 3rd quarter 2014) for each unreported employee, plus interest, will be charged unless there is good cause for the delay. A penalty of $20 ($10 for periods prior to 3rd quarter 2014) for each employee, plus interest, is also charged if an employer fails to report by magnetic media when required, unless good cause exists.

Prior forms. The Quarterly Wage and Withholding Report (DE 6) and the Annual Reconciliation Statement (DE 7) will remain available online for years 2010 and prior.

Payroll Tax Forms		
Form ID	**Tax Code**	**Form Name**
DE34	WH/UI	CA Report of New Hires
DE88	WH/UI/SDI	Payroll Tax Deposit Coupon
DE 9	WH/UI/SDI	Quarterly Contribution Return and Report of Wages
DE 9C	WH/UI	Quarterly Contribution Return and Report of Wages (Continuation)

Other California Payroll Items. In California the minimum wage in 2019 is $11.00 per hour if the company has 25 or less employees. For employers with 26 or more employees is $12. Each city may have a different minimum wage, since several cities have wage increases, including Los Angeles, which is before July 1, $13.25 on July 1, 2019 will be increased to $14.25.

California has paid sick leave, which becomes effective July 1, 2015; however, the new mandatory employee notification requirement is effective January 1, 2015.

Every person who engages in business within the City of Los Angeles is required to obtain the necessary Tax Registration Certificate(s) and to pay the business tax or to obtain an exemption. For other cities, please call us or contact your city government for registration and reporting requirements.

Additional Information Regarding AB1522 and mandatory sick leave. On September 10, the Governor of California approved State Assembly Bill 1522, also known as the ñHealthy Workplaces, Healthy Families Act of 2014.ò This bill mandates that ALL employers in the state of California must provide paid sick leave to their employees, regardless of the size of the business.

Here are the highlights of the bill:

1. To be eligible, the employee must work for a minimum of 30 days for said employer.
2. For every 30 hours worked, the employee accrues 1 hour of paid sick leave.
3. The employee may begin to accrue paid sick leave at the time of hire, but may not begin using that paid sick time until they have completed a 90-day probationary period.
4. The paid sick time accrued may carry over from year to year, but an employer can limit the amount of paid time used in one calendar year to three days or 24 hours.
5. Employers are not required to provide any paid sick time in addition to what is stipulated in this bill, even if they have a paid sick policy that is different.
6. Any accrued but unused paid sick leave time does NOT have to be paid out to the employee upon separation.
7. If an employee separates from an employer, but is then rehired by that employer within one year from the date of separation, any accrued but unused paid sick time shall be reinstated and there will be no waiting period before the employee can begin using the time.
8. The employer does not have to allow the sick time to accrue to a balance of greater than 48 hours, or 6 days.
9. The employee may decide how many sick hours to use at one time, not to be in increments of less than two hours.
10. When the accrued sick time is used, it must be paid out at the employeeôs regular rate of pay, and be paid no later than the next regular pay date after the sick leave was taken.
11. When sick leave must be taken, the employee must provide reasonable advance notification or notify the employer as soon as practical.
12. The employer cannot require, as a condition of using the paid sick leave, that the employee find a replacement worker to cover the days when the employee uses the paid sick leave.
13. This law went into effect as of July 1, 2015.

RESIDENCY

For tax purposes, a resident is any individual who meets any of the following conditions:

- Is in California for other than a temporary or transitory purpose;
- Domiciled in California, but outside California for a temporary or transitory purpose.

A nonresident is any individual who is not a resident. A **part-year resident** is any individual who is a California resident for part of a year and a nonresident for part of a year.

Essentially a person is considered to be a resident of the place where they have the closest connections with. The following list shows some of the factors that can be used to determine residency status. It is the strength of ties that is important and not just the number.

- Amount of time spent in California versus elsewhere
- Location of spouse/children
- Location of principal residence
- Where their driverôs license is issued
- Where their vehicles are registered
- Where a professional license is maintained
- Where the taxpayer is registered to vote
- Location of banks where the taxpayer maintains an account
- Location of doctors, dentists, accountants and attorneys
- Location of the church, temple or mosque, professional associations, or social and country clubs of which the taxpayer is a member
- Location of real property and investments
- Location of social ties
- Permanence of work assignments in California

A person is presumed to be a California resident for any taxable year in which they spend more than nine months in the state.

Residency is important because it determines how income is taxed by California.

Safe Harbor Rules. For taxable years beginning on or after January 1, 1994, a safe harbor is available for certain individuals leaving California under employment-related contracts. This safe harbor provides that an individual domiciled in California who is outside California under an employment-related contract for at least 546 consecutive days will be considered a nonresident unless any of the following is met:

The individual has intangible income of more than $200,000 in any year the employment contract is in effect; or the primary purpose of the absence from California is to avoid paying income tax.

Individuals not covered by this safe harbor determine their residency status based on facts and circumstances described above.

Income Taxable by California. Residents of California are taxed on all income, including income from sources outside California. Nonresidents of California are taxed only on income from Californian sources. Part-year residents are taxed on all income received while a resident and only on income from California sources while a nonresident.

For taxable years beginning in 2002 and later, nonresidents and part-year residents determine their California tax by multiplying their California taxable income by an effective tax rate. The effective tax rate is the California tax on all income as if they were a California resident for the

entire year and for all prior tax years for any carryover items, deferred income, suspended losses, or suspended deductions, divided by that income. The following formula can be used:

Prorated tax = California taxable income X (Tax on total taxable income/Total taxable income)

BUSINESS INCOME – CALIFORNIA ISSUES

In general, California conforms to the federal treatment of business income; however some differences do exist. Any adjustments that are needed are made on Schedule CA (540/540NR). There is no need to prepare a separate Schedule C for California.

Business Income. No adjustment is needed for business income as long as all income is attributable to California. If a taxpayer is a full-year resident, all income is attributable to California (even if earned in another state). If the person is a part-year resident and had self-employment income while a resident of another state, California taxes business profits (losses) from all businesses conducted while a California resident and all businesses conducted in California while a nonresident. Any income from a business not conducted in California while the taxpayer was a nonresident is non-taxable to California.

However, if a nonresident owns and operates a business that is a conducted partly inside and partly outside California, and there is a business relationship between them, the nonresidentôs California source business income is determined by apportionment. See the instructions for California Schedule R, Apportionment and Allocation of Income.

If California does not allow a deduction that has been claimed on the federal return, the amount of the deduction must be added back to arrive at California taxable income. The adjustment must be made on Schedule CA (540/540NR), line 12, column C. If the taxpayer has expenses that are allowed by California, but prohibited on the federal return, the amount of the expense is subtracted to decrease taxable California income. Enter the amount of the expense on Schedule CA (540/540NR), line 12, column B.

California **allows** the following deductions (not allowed on the federal return):

- Spouse travel. If a nonemployee spouse accompanies the taxpayer on a business trip **and performs services for the business**, a deduction is allowed on the California return if all other requirements are met.

- Lobbying expenses. Federal law prohibits a deduction paid or incurred in connection with influencing legislation. California does not conform.

The following is a Federal/State Comparison Chart for Typical Business Expenses and how are treated for California purposes.

Federal/State Comparison Business Chart	
ITEM	**Differences Between Federal and California Law**
Employer-provided adoption benefits exclusion	Federal law increased the maximum amount of employer-provided adoption benefits exclusion per child to $13,810. California only allows a 50% of qualified cost up to $2500 per child.
Startup expenses (IRC Section 195)	For tax years beginning on or after January 1, 2010, federal law increased the deduction for startup expenses under IRC Section 195 from $5,000 to $10,000 and the phase-out threshold from $50,000 to $60,000. California does not conform to federal increases. For both federal and California, start expenses not deducted are amortized ratably over a 180-month period.
Enterprise Zone (EZ), Local Agency Military Base Recovery Area (LAMBRA), or Targeted Tax Area (TTA) business expense deduction	Federal law has no comparable deduction. A California enterprise zone business may elect to immediately expense up to $40,000 of the cost of qualified property. A California LAMBRA business may elect to immediately expense up to $40,000 of the cost of qualified property. A California TTA business may elect to immediately expense up to $40,000 of the cost of qualified property. For California purposes, you may not take an IRC Section 179 deduction on any asset used to calculate the business expense deduction.
Cellular phones	For tax years beginning on or after January 1, 2010, federal law removed cellular phones (and similar telecommunications equipment) from the definition of listed property under IRC Section 280F. California does not conform to federal increases.
Credit for employer-paid child care center and services	The Employer Childcare Program Credit has expired. The credit was allowed from each taxable year beginning on January 1, 1994 and before January 1, 2012. The credit carryover is allowed until exhausted.
Employer wage expenses for Work Opportunity Credit and Welfare-To-Work Credit	Federal law allows a Work Opportunity Credit and a Welfare-To-Work Credit for employers that hire individuals from certain target groups and recipients of long-term family assistance. Employers that claim these credits must reduce their wage expense by the amount of the credits. California has no similar credits.
Business expense	California does not allow a deduction for business expenses incurred at a club that discriminates.

CALIFORNIA SALES TAX & EVASION BARRIERS

Businesses in California must obtain a seller's permit if they:

- Are engaged in business in California and
- Intend to sell or lease tangible personal property that would ordinarily be subject to sales tax if sold at retail.

The requirement to obtain a seller's permit applies to individuals as well as corporations, partnerships, and limited liability companies. Both wholesalers and retailers must apply for a permit.

Collecting sales tax. In general, retail sales of tangible personal property in California are subject to sales tax. Examples of tangible personal property include such items as furniture, giftware, toys, antiques, clothing, and so forth.

In addition, some service and labor costs are taxable if they result in the creation of tangible personal property. For example, if a business makes a ring for a specific customer, the business is creating tangible personal property. Therefore, the total amount charged for the ring (including the charge for labor) would be taxable. This would also be the case if the customer provided the materials for making the ring.

However, labor costs for making repairs (resetting a diamond, for example) are not taxable since they do not result in the creation of tangible personal property. The business is only repairing or reconditioning existing property.

Likewise, a charge for labor installing or applying property which has been sold is not ordinarily subject to sales tax (*note*: the labor charge should be stated separately on the bill).

Sales Tax Rates. Sales and use tax rates can change throughout the year due to city and county voters approving special district taxes. These special district taxes are added to the overall state rate, increasing the total tax rate for that city or county. When these changes occur, the Board of Equalization (BOE) will send out notices to all registered sellers in the counties and cities where the rate(s) is changing.

BOE focuses on tax evasion. The BOE is detecting and taking action against tax evasion. The investigation includes some businesses that use illegal sales suppression software, often called ñzappersò. The BOW has mentioned that this system is designed to evade paying tax by falsifying electronic records.

The BOE has identified that the software erases sales transactions, which enables users to avoid paying income tax, sales tax, and other point-of-sale (POS) fees collected on retail sales. Using such technology to deliberately falsify records for the purpose of evading taxes is a crime and punishable by law. It is also a crime for anyone to knowingly sell, purchase, install, transfer, or possess sales suppression software programs or other electronic devices used to hide or remove sales and to falsify records for commercial gain. Violators may be sentenced to up to three years in county jail, fined up to $10,000, and required to pay all illegally withheld taxes, plus interest and penalties.

The BOE is working collaboratively with other state and federal law enforcement agencies to exchange information and investigate underground operations. They are taking an assertive

approach to identifying and prosecuting all cases of tax evasion, including those based on falsified POS data. If a business is audited, they have the ability and technology to detect unlawful sales suppression. If an auditor detects the use of sales suppression software, the auditor may disregard reported sales amounts and establish the actual sales based on some or all of the following sources:

- Credit card sales
- Third-party electronic sales information
- On-site observation of sales

Reporting Suspicious Businesses. The BOE has established a website that allows California taxpayers to assist with identifying tax evasion by providing information on possible tax violations www.boe.ca.gov/trace. Employers can help their clients by ensuring they do not employ these devices or otherwise alter their recordkeeping systems and they accurately report their taxable sales.

Counterfeit goods are now taxable. A new law makes all sales of counterfeit goods taxable. If a person is convicted in trafficking counterfeit goods, then all of their sales and purchases of those counterfeit goods will be considered taxable. This applies whether they are a manufacturer, wholesaler, distributor, or a retailer of the counterfeit goods. A person may no longer claim a resale deduction for the sale of counterfeit goods, and any purchases made of counterfeit goods for subsequent resale will also be taxable. Counterfeit goods commonly refer to property with a counterfeit mark. In general terms, a counterfeit mark is a mark that is identical with or substantially indistinguishable from a mark registered with the United States Patent and Trademark Office.

The BOE may bill the convicted trafficker of counterfeit goods for unpaid sales or use tax within one year after the last day of the calendar month following the date of conviction. By billing convicted counterfeit goods traffickers, the BOE is discouraging the criminal sale of counterfeit goods and leveling the playing field for all businesses.

Sales tax reporting for mobile food trucks. The mobile nature of a mobile food truck makes it difficult to know and collect the correct rate of tax for each sales location at the time of sale.

As with all retailers, mobile food truck vendors are required to report and pay tax on sales of taxable items at the tax rate for the location in which the sales were made. For sales occurring prior to July 1, 2014 to be considered tax-included, the retailer was required to post a notice to customers (or include provisions in a sales agreement or receipt) stating that tax is included in the listed menu price. If such a notice was not posted, the listed menu prices were presumed to not include tax and the vendor was required to report and pay tax measured by the prices charged.

On July 1, 2014 and later, if taxpayer in restaurants and mobile trucks do not add a separate sales tax amount to the menu price, any taxable menu items sold are presumed to have the tax included in the sales price. This does not apply when you are making sales as a caterer (hired by a private party to provide food/drink on the customerôs premises or parties).

To help make calculating and reporting taxes for mobile food truck vendors easier, the BOE amended the regulations to presume that sales tax is included in the price of taxable items sold by mobile food vendors if the tax is not added separately. This change allows vendors to charge the same tax included price for each menu item no matter where they are (without additional signage), which will eliminate the need to recalculate sales tax at each stop where the tax rate changes. This presumption does not apply when mobile food vendors make sales as caterers hired by a private party to provide food and/or drinks on that partyôs premises (or premises provided by the private party). However, the mobile food truck vendor must still keep track of what sales were made at each location. When filing returns, mobile food truck vendors must calculate and report tax included sales using the proper tax rates of the various sales locations.

BOE visits. The BOE has a program to educate and revise sales tax compliance and issues through the state. The Statewide Compliance and Outreach Program (SCOP) focuses on educating businesses, as well as identifying and registering businesses who are actively selling or leasing tangible personal property in California without a seller's permit. SCOP also advises on other State tax and fee permits and licenses a business may need to obtain. In general, the purpose of SCOP is to:

- Educate business owners regarding their tax responsibilities,
- Advise business owners when they need a seller's permit,
- Explain to owners how to report and remit their taxes and fees due,
- Verify and update BOE account information,
- Review business operations compared to sales and use tax returns filed to provide guidance on proper reporting, and
- Provide business owners the opportunity to ask questions.

SCOP will monitor the ongoing compliance of newly registered businesses, reduce the number of businesses operating without a valid seller's permit, and enhance the awareness of businesses on the consequences of tax evasion.

SCOP teams located throughout the state will conduct door-to-door visits to all non-residential businesses based on zip code. At each visit, SCOP specialists will:

- Identify themselves and show identification,
- Verify the need for and existence of a seller's permit and other required fee permits and licenses,
- Review license/permit to verify that it is updated with the correct information,
- Determine if the business is reporting its sales and use taxes properly,
- Provide information and assistance to the business owner on sales and use tax reporting responsibilities, and
- Answer owner's questions.

If the SCOP specialists find that a business is reporting its taxes incorrectly, they will advise the business to file amended returns to correct any refund or underpayment. In some instances, the business may be referred for an audit.

The filing of an amended return does not prevent further BOE activity, such as an audit or refund, for the same period(s) in question.

RETIREMENT BENEFITS

California generally conforms to federal law regarding taxation of other pension and annuity income. No adjustment for other pension or annuity distributions would be necessary. However, see lump sum distributions, below.

Lump Sum Distributions. If the taxpayer received a qualified distribution in 2009, and they were born before January 2, 1936 they can choose to use Schedule G-1 to figure their tax. California law regarding the capital gain election and 20-year averaging is generally the same as federal law. Like the federal Form 4972, the tax calculated on Schedule G-1 is paid only once in the tax year that the distribution is received. This separate tax is added to the taxpayerôs regular tax calculated on their other income.

If the taxpayer qualifies to use federal Form 4972, they can also use the special tax methods on Schedule G-1.

Schedule G-1. Use Schedule G-1 along with Form 540 to:

- Choose the 5.5% capital gain method by completing Part II;
- Choose the 10-year averaging method by completing Part III; and
- Figure tax using the 10-year averaging method, which taxes the ordinary income part of the distribution as if it were received in equal parts over 10 years.

After 1986 the taxpayer can choose to use Schedule G-1 only once for each plan participant. If they receive more than one lump sum distributions for the same plan participant in one tax year, the taxpayer must treat all of the distributions in the same way.

To make the capital gain election, only the taxable amount of the distribution resulting from pre-1974 participation qualifies. That amount should be shown in Form 1099-R, box 3.

Early Distributions. Like the federal return Early distributions are amounts withdrawn before the age of 59 ½ , California also imposes an additional tax (penalty) on an early distribution from a qualified retirement plan, annuity or IRA. The rules for early distributions and their exceptions are the same as the federal. However, the additional tax rate for California is 2 ½ %, rather than 10%. FTB Form 3805P is used to calculate and report the additional tax. If both the taxpayer and spouse have early distributions, a separate FTB Form 3805P must be used for each taxpayer. For more information, see the instructions for FTB Form 3805P.

Rollovers. California conforms to the federal provisions regard rollovers of retirement benefits. No adjustment is needed on the California return if the taxpayer has chosen to roll over all or part of their retirement plan distribution.

California residents are taxed on all income, including pensions earned in another state but received in California. Part-year residents are also taxed on pensions received while a California resident. Non-residents are not required to pay tax on a pension earned in California but distributed after December 31, 1995.

Social Security & Equivalent Railroad Retirement Benefits. California does not tax social security benefits, Tier I Railroad Retirement benefits, Tier II Railroad Retirement benefits or sick pay received under the Railroad Unemployment Insurance Act.

If the taxpayer has social security benefits that are taxable on their federal return, an adjustment must be made to subtract them from California taxable income. To subtract social security benefits, the adjustment is made on Schedule CA, line 20, column B. Railroad Retirement benefits are subtracted on Schedule CA, line 16, column B.

Review Questions Section 4

Read and answer the following review questions. The correct answers are found on the next page with an explanation to strengthen up your knowledge. Note: This is not part of your Final Test

16. Employers are subject to continue paying ETT tax of .001 for one of the following employee.

    a) Employee whose income is $94385.
    b) Employee that is in California and has YTD income of $104,378
    c) Employee A that has $3450 in gross wages and employee B that has $6450 in gross wages.
    d) Employees that have $10,000 in YTD income.

17. What of the following forms should be used to file the payroll report to the Employment Development Department each calendar quarter in 2019?

    a) Form DE34 and DE88/DE 88ALL
    b) Form DE9 and DE 9C if there was not payroll during the quarter.
    c) Form DE6 and DE7 each quarter
    d) Form DE88/DE 88ALL if there is no payroll balance.

18. One of the following employees will not qualify for the new mandatory sick leave program in California.

    a) An employee that work a company at least 30 days in 2018
    b) An employee that completed a 90-day probationary period
    c) An employee that worked at least 30 hours starting July 1, 2018
    d) All of the above

19. The IRS allows an employer-provided adoption benefit exclusion of $13,190 per child, in California the tax law allows_____ per child.

    a) No deduction
    b) 100% deduction similar to the IRS
    c) 25% deduction
    d) Up to $2500

20. One of the following is NOT performed by a SCOP specialist that is sent by the Board of Equalization under the sales tax compliance program.

    a) Educate business owners regarding their tax responsibilities.
    b) Verify and update BOE account information
    c) Determine if the business is reporting its sales and use tax properly
    d) The SCOP specialist will not advice business to correct their sales tax report or refer the business for an audit.

Review Questions 4 – Answers and Discussion

16. **Correct answer is c.** The ETT is an employer-paid tax. Employers subject to ETT pay one-tenth of one percent (.001) on the first $7,000 in wages paid to each employee in a calendar year.

17. **Correct answer is b.** Wages paid to employees must be reported to the Employment Development Department using the following forms:

- Quarterly Contribution Return and Report of Wages (DE 9) and
- Quarterly Contribution Return and Report of Wages (Continuation) (DE 9C)

If no payroll was paid just check the ñNo Payrollò box in Item A, on the DE 9 and Item C on the DE 9C, then sign and mail both reports.

18. **Correct answer is b.** To be eligible, the employee must work for a minimum of 30 days for said employer. For every 30 hours worked, the employee accrues 1 hour of paid sick leave. The employee may begin to accrue paid sick leave at the time of hire, but may not begin using that paid sick time until they have completed a 90-day probationary period. This law goes into effect as of July 1, 2015.

19. **Answer is d.** Federal law increased the maximum amount of employer-provided adoption benefits exclusion per child to $13,190. California only allows a 50% of qualified cost up to $2500 per child.

20. **Correct answer is d.** The BOE has a program to educate and revise sales tax compliance and issues through the state. The Statewide Compliance and Outreach Program (SCOP) focuses on educating businesses, as well as identifying and registering businesses who

are actively selling or leasing tangible personal property in California without a seller's permit. If the SCOP specialists find that a business is reporting its taxes incorrectly, they will advise the business to file amended returns to correct any refund or underpayment. In some instances, the business may be referred for an audit.

INDIVIDUAL RETIREMENT ARRANGEMENTS

California conforms to the treatment of contributions to Individual Retirement Arrangements (IRAs) including those made to a Roth IRA or a Coverdell Education Savings Account. And California also conforms to the federal tax treatment regarding IRA distributions.

However, in the past there were differences regarding the amount of deduction allowed when a contribution was made to an IRA. Due to these differences, taxpayers may have a different basis in their IRA for federal and California purposes.

Remember that a taxpayer is not required to pay tax on a non-deductible contribution when it is distributed.

History of Federal/California Differences in Deductible IRA Contributions. Before 1987 there were differences in federal/California treatment of deductible IRA amounts. The following is a resume of the differences:

1975. Federal law allows an IRA deduction of up to $1,500. California does not allow a deduction for IRA contributions.

1976 ï 1981. California law is the same as federal law. An IRA deduction of the smaller of $1,500 or 15% of compensation is allowed.

1982 ï 1986. California law is different from federal law. The maximum federal deduction was $2,000. California continues to allow a deduction of the lesser of $1,500 or 15% of compensation, plus an additional deduction for a nonworking spouse for a total of up to $1,750.

Under federal law a deduction was allowed if the taxpayer was an active participant in a qualified or government retirement plans or to persons who made a contribution to a tax-sheltered annuity. California did not allow a deduction in those circumstances.

1987 ï present. California law and federal law regarding the deductibility of IRA contributions is the same.

If a taxpayer made a deductible IRA contribution during one of the periods when federal and California law was different, they will need to make an adjustment.

Also if the taxpayer changed residency status after they first began making contributions to their IRA, or made different contributions to an IRA because of federal and California self-employment income differences, they may need to make an adjustment. See FTB Publication 1005, *Pension and Annuity Guidelines* for more information on how to calculate the California basis.

CAPITAL GAINS AND LOSSES

California currently generally conforms to federal law regarding the treatment of capital gains. However, an adjustment to the amount of gain or loss on the sale of a capital asset may be necessary if the asset has a different basis for federal and California tax purposes.

Generally, the California basis of property will be the same as the federal basis. However differences most commonly occur when an asset was depreciated during the time when federal and California treatment of deprecation differed.

California Schedule D (540) is used when there is a difference between the California and federal capital gain amounts. This form should be filed only if there is a difference between the federal and state amounts.

The following assets may be different from the federal basis due to differences between California and federal laws.

- Gain on the sale of qualified small business stock, which qualifies for the gain exclusion under IRC Section 1202.
- Basis amounts resulting from differences between California and federal law in prior years.
- Gain or loss on stock and bond transactions.
- Installment sale gain reported on form FTB 3805E, Installment Sale Income.
- Gain on the sale of personal residence where depreciation was allowable.
- Flow-through gain or loss from partnerships, fiduciaries, S corporations, or LLCs.
- Capital loss carryover from the 2015 California Schedule D (540)
- Capital gain from children under age 19 or students under age 24 included on the parentôs or childôs federal tax return and reported on the California tax return by the opposite taxpayer. For more information, get form FTB 3803.

Qualified Assisted Housing Development. Gain on sale or disposition of a qualified assisted housing development to low-income residents or to specified entities who maintain housing for low-income residents.

Federal law does not allow special treatment on gains related to the sale of certain assisted housing. California law permits the deferral of such gain, under certain conditions, if the proceeds are reinvested in residential real property (other than a personal residence) within two years of the sale.

Gain on sale of personal residence. For sale or exchanges after May 6, 1997, federal law allows an exclusion of gain on the sale of a personal residence in the amount of $250,000 ($500,000 if married filing jointly). The taxpayer must have owned and occupied the residence as a principal residence for at least 2 of the 5 years before the sale. California conforms to this provision. However, California taxpayers who served in the Peace Corps during the 5-year period ending on the date of the sale may reduce the 2-year period by the period of service, not to exceed 18 months.

If there is a difference between the amounts excluded (or depreciated, if recapture applies) for federal and California, complete California Schedule D (540 or 540NR). Transfer the amount from California Schedule D, line 12a, to Schedule CA (540 or 540NR), line 13, column B (if gain is less than federal). Transfer the amount from California Schedule D, line 12b, to Schedule CA (540 or 540NR), line 13, column C (if gain is more than federal).

CALIFORNIA AMENDED RETURNS

Federal tax returns are changed or amended by completing and filing Form 1040X. Generally, if a taxpayer files a federal amendment, they will need to complete and file California Form 540X to inform the FTB of the changes. However, the taxpayer is not required to file an amended California return if the changes do not affect the California return.

If the original return shows a refund, Form 540X should not be filed until the refund has been received. Also, if the IRS examines or changes the taxpayerôs federal return, they will need to file an amended return with the State of California within six months after the final federal determination. If Form 540X is being filed as the result of an amended federal return, include a copy of the federal amendment with the state amendment. If the state return is being amended because of an IRS examination or letter, attach a copy of the federal correspondence with the amended California return. Form 540X is completed in the same manner as Form 1040X.

Starting January **2018**, the Franchise Tax Board (FTB) will star accepting e-file amended returns for individuals on tax year **2017** Forms 540, 540NR Long, 540NR Short, and 540 2EZ, as well as new Schedule X. For tax year **2016** and prior years, amended individual returns will need to continue to be paper filed using Form 540X. This new schedule X Subject was explained with more detail on our course last year.

CALIFORNIA TAX RELATED PENALTIES

Underpayment penalties. An underpayment penalty will be charged when taxes are not paid by the due date. The penalty is 5 percent of the unpaid tax as of the due date plus 1/2 of 1 percent each month, or part of a month the tax remains unpaid, not to exceed 40 months. The maximum penalty is 25 percent of the total unpaid tax.

Penalty on unpaid taxes. A delinquent penalty will be charged on unpaid taxes if a return is filed late. The penalty is 5 percent of the unpaid tax due for every month that the return is late, up to a maximum penalty of 25 percent of the unpaid tax. The minimum penalty is $135 for tax

years beginning on or after January 1, 2011, (before January 1, 2011 is $100) or 100 percent of the unpaid tax, whichever is less.

There are also other penalties that can be imposed such as for a check returned for insufficient funds, negligence, substantial understatement of tax and fraud.

Interests. Interest will be charged on any delinquent or late payment from the original due date of the return to the date paid. In addition, if other penalties are not paid within 15 days of the date of the notice, interest will be charged from the date of the billing notice until the date of payment. Interest compounds daily and the interest rate is adjusted twice a year.

The current rate on personal income tax underpayments and overpayments, corporation underpayments, and estimate penalties is 3%. The current rate on **corporation overpayments** is 0%.

Previous Interest Rates			
From	**To**	**Interest rate***	**Corporation Overpayment rate**
July 1, 2019	December 31, 2019	6%	2%
January 1, 2019	June 30, 2019	5%	2%
July 1, 2017	December 31, 2018	4%	1%
January 1, 2017	June 30, 2017	4%	0%
July 1, 2012	June 30, 2016	3%	0%
January 1, 2012	June 30, 2012	4%	0%
July 1, 2011	December 31, 2011	4%	0%
January 1, 2011	June 30, 2011	5%	0%
January 1, 2010	December 31, 2010	5%	2%
July 1, 2009	December 31, 2009	7%	3%
January 1, 2009	June 30, 2009	8%	5%
July 1, 2008	December 31, 2008	7%	4%
January 1, 2007	June 30, 2008	6%	3%
July 1, 2006	December 31, 2006	7%	4%
January 1, 2006	June 30, 2006	6%	3%

*Personal income tax underpayment and overpayment, corporation underpayment, and estimate penalty rate.

CTEC REGISTRATION INCREASED

CTEC Raised the registration fee to $33. Effective August 1, 2014, the California Tax Education Council (CTEC) will increase its annual registration fee for tax preparers from **$25 to $33**.

Why the Fee Increase? The purpose of CTEC is to ensure registered tax preparers are competent in their profession in order to protect California taxpayers. Quality tax education standards, tax preparer enforcement, and public awareness all play a role in this endeavor.

Recent audits proved that more attention is needed regarding the courses offered by CTEC-approved education providers. As a result, the board allocated more funds toward the oversight of its education providers to help ensure two goals are fulfilled:

- CTEC Registered Tax Preparers (CRTPs) receive quality tax education.
- California taxpayers receive quality tax preparation services from CRTPs.

The board discussed the fee increase at length during its May meeting. All committee budgets were scrutinized before a decision was made to increase the fee.

The additional $8 is the minimal amount needed to avoid a budget shortfall. This is the first registration fee increase CTEC implemented in its 17-year history.

Why Start in August? CTEC's renewal registration cycle begins August 1 of each year. A fee increase is needed to ensure CTEC funds its Curriculum Provider Committee, which approves courses offered by education providers.

Late Renewal Fee. CTEC Registered Tax Preparers (CRTPs) who did not meet the October 31, 2015 renewal deadline have until January 15, 2016 to pay the $55 late fee and renew late.

To renew online, CRTPs will need:

- 20 hours of completed continuing education (10 hours of federal tax law, 3 hours of federal tax law updates, 2 hours of ethics and 5 hours of state)
- A valid PTIN from the IRS
- Current $5,000 surety bond
- Visa or MasterCard to pay the $88 fee ($33 registration fee, plus $55 late fee)

CRTPs who fail to meet the late renewal deadline will be required to start over, retake the 60-hour qualifying education course and register as a new tax preparer. By law, CRTPs cannot prepare tax returns for a fee until their registration is current with CTEC.

CRTP GENERAL INFORMATION

What is CRTP? A CRTP is a CTEC Registered Tax Preparer. A taxpreparer that wants to become a CRTP must fulfill the following:

- *First* complete 60-hours (45 hours federal and 15 hours state) of qualifying tax education from a CTEC Approved Provider
- *Obtain* a PTIN (Preparer Tax Identification Number) from the IRS
- *Purchase* a $5,000 tax preparer bond (from any insurance company)
- *Register* with CTEC within 18 months from the completion date on the certificate of completion
- *Registration Fee* with CTEC

Tax practitioners that become CRTPs will need to renew their CTEC registration every year before October 31. To renew the following is required:

- *Complete* 20-hours (10 hours federal tax law, 3 hours federal tax update, 2 hours of Ethics and 5 hours for State) of continuing tax education each year
- *Maintain a valid PTIN (Preparer Tax Identification Number) from the IRS*
- *Maintain* a $5,000 tax preparer bond
- *Renew* the registration by October 31st of each year
- *Renewal Registration* with CTEC

Practitioners that are not registered. California law requires anyone who prepares tax returns for a fee within the State of California and is not an exempt preparer to register as a tax preparer with the California Tax Education Council (CTEC). Exempt preparers are California certified public accountants (CPAs), enrolled agents (EAs), and attorneys who are members of the State Bar of California.

As of January 1, 2005, the California Franchise Tax Board (FTB) has the authority to identify and penalize unregistered tax preparers.

"Failure to register as a tax preparer with the California Tax Education Council, as required by Section 22253 of the Business and Professions **Code**, unless it is shown that the failure was due t reasonable cause and not due to willful neglect.

(1) The amount of the penalty under this subdivision for the first failure to register is two thousand five hundred dollars ($2,500). This penalty shall be waived if proof of registration is provided to the Franchise Tax Board within 90 days from the date notice of the penalty is mailed to the tax preparer.

(2) The amount of the penalty under this subdivision for a failure to register, other than the first failure to register, is five thousand dollars ($5,000)."

Consumers can report unregistered tax preparers by filling out the Noncompliant Complaint Form through CTEC's website. All reports are kept confidential.

Who Must Register?

See the following table for more information:

If tax practitioners:	**And they:**	**Does the state of California require CTEC registration?**
Are an inactive CPA or are a non-California CPA	Prepare income tax returns for a fee in California	Yes, or you must resume/become an active California CPA
Work for an exempt tax preparer	Sign the income tax return	Yes
	Do not sign the income tax return (exempt tax preparer is the responsible party)	No
Work for a CTEC Registered Tax Preparer (CRTP)	Take income tax data from a client and enter it into a computer (whether in person or other contact)	Yes
	Have no contact with clients and perform the clerical function of inputting tax information into the computer for your employer	No
Are a nonexempt tax preparer	Take income tax data from a client and enter it into a computer and/or prepare the income tax return	Yes
Are a nonexempt tax preparer who prepares income tax returns that are bundled or included with other services	Receive a fee for the bundle of services which include the preparation of the income tax return	Yes
Are an employee of a business unrelated to income tax return preparation	Prepare (or assist with preparation of) the company's business income tax return	No
	Compile the company's business income tax information for submission to a paid tax preparer who will prepare the income tax return	No

CTEC CODE OF CONDUCT

Background: In 1996 the California Legislature passed the Tax Preparers Act, Business and Professions Code 22250-22259, which regulates tax preparers. Those sections of the statute pertaining to tax preparer ethics, professional conduct, conduct regarding bonding and penalties for breaking the law are listed below.

A tax preparer is defined as ña person who, for a fee, assists with or prepares tax returns for another person or who assumes final responsibility for completed work on a return on which preliminary work has been done by another person, or who holds himself or herself out as offering those services.ò

A tax return is defined as ña return, declaration, statement, refund claim, or other document required to be made or filed in connection with state or federal income taxes or state bank and corporation franchise taxes.ò

The statute exempts the following:

- An individual with a current valid license issued by the California Board of Accountancy (and his or her employees while functioning within the scope of his or her employment).
- An individual who is an active member of the State Bar of California (and his or her employees while functioning within the scope of his or her employment).
- Some employees of a trust company or business as defined in the statute, a financial institution and employees thereof who are regulated as defined in the statute.
- Enrolled Agents (and their employees while functioning within the scope of their employment).

Other CRTP important information:
Preparer Code of Conduct. CTEC Registered Tax Preparers (CRTPs):

- Must register as a tax preparer with the California Tax Education Council (CTEC).
- Must maintain a $5,000 Tax Preparer Bond issued by a surety company admitted to do business in California. A tax preparer shall provide to the surety company proof that he or she is at least 18 years of age before a bond can be issued.
- Must identify to the surety company all preparers employed or associated with the tax preparer securing the bond.
- Must file an amendment to the bond within 30-days of any change in the information provided in the bond.
- Must not conduct business without having a current surety bond in effect.

- Must cease doing business as a tax preparer upon cancellation or termination of bond until a new bond is obtained.
- Must furnish evidence of a current bond upon the request of any state or federal agency or law enforcement agency.
- Must, prior to rendering any tax preparation services, provide the customer, in writing, with the tax preparerôs name, address, telephone number, and evidence of compliance with the bonding requirement.
- Must not make fraudulent, untrue, or misleading statements or representations which are intended to induce a person to use their tax preparation services.
- Must not obtain the signature of a customer to a tax return or authorizing document, which contains blank spaces to be filled in after it has been signed.
- Must not fail or refuse to give a customer, for their own records, a copy of any document requiring the customerôs signature, within a reasonable time after the customer signs.
- Must not fail to maintain a copy of any tax return prepared for a customer for four years from the later of the due date of the return or the completion date of the return.
- Must not engage in advertising practices, which are fraudulent, untrue, or misleading, including assertions that the tax preparer bond in any way implies licensure or endorsement of a tax preparer by the State of California.
- Must not violate provisions of Sections 17530.5 or 7216 of Title 26 of the United States Code prohibiting tax preparers from disclosing any information obtained in the business of preparing federal or state income tax returns unless (1) consented to, in writing, by the taxpayer in a separate document; (2) expressly authorized by law; (3) necessary for the preparation of the return; and, (4) pursuant to court order.
- Must not fail to sign a customerôs tax return when payment for services rendered has been made.
- Must not fail to return, upon the demand by or on behalf of a customer, records or other data provided to the tax preparer by the customer.
- Must not give false or misleading bond information to a consumer or giving false or misleading information to a surety company in obtaining their tax preparer bond.
- Must apply for their Certificate of Completion within 18-months after completing their 60-hours of qualifying education from a CTEC approved provider.
- **Must** complete, on an annual basis, not less than 20 hours of continuing education from an approved curriculum provider (10 hours federal tax law, 2 hours ethics, 3 hours federal tax update and 5 hours California).

When a person prepares a tax return, for a fee, without the appropriate lawful designation, he or she could be cited and fined up to $5,000 for each illegally prepared tax return. According to California Business and Professions Code 22253.2, the Franchise Tax Board may notify the California Tax Education Council when it identifies an individual who has violated the law. The Franchise Tax Board pursuant to an agreement with the California Tax Education Council, may do any of the following: (1) Cite individuals preparing tax returns in violation of subdivision (a) Section 22253. (2) Levy a fine of up to five thousand dollars ($5,000) per violation. (3) Issue a cease and desist order, which shall remain in effect until the individual has come into compliance with the provisions of paragraph (1) of subdivision (a) of Section 22253.

Violators of other sections of the statute are guilty of a misdemeanor, which offense is punishable by a fine not exceeding $1,000, or by imprisonment in a county jail for not more than one year, or by both. If a CRTP fails to perform a duty specifically imposed upon him or her pursuant to this statute, any person may maintain an action for enforcement of those duties or to recover a civil penalty in the amount of $1,000, or for both enforcement and recovery.

The Superior Court in and for the county in which any person acts as a tax preparer in violation of the provisions of this statute, may, upon a petition by any person, issue an injunction or other appropriate order restraining the conduct.

Review Questions Section 5

Read and answer the following review questions. The correct answers are found on the next page with an explanation to strengthen up your knowledge. Note: This is not part of your Final Test

21. A taxpayer may have a different basis in their IRA for federal and state purposes because of_____.

    a) Differences in the amount of deduction allowed.
    b) Date of contribution,
    c) No difference exists between federal and California,
    d) Amounts contributed

22. Regarding the exclusion of gain on the sale of a personal residence, California taxpayers who _____ may reduce the two year occupancy period by the period of service, not to exceed 18 months.

    a) Serve in the military
    b) Live overseas
    c) Serve in the Peace Corps
    d) Serve in a monastery

23. If the IRS amended return leaves the refund from California the same then taxpayer will _____.

    a) File an amended California return to inform of the changes with the IRS.
    b) Leave the original California return as is.
    c) Send a copy of the IRS amended return to the FTB.
    d) All of the above.

True or False.

24. The renewal registration with CTEC will be just the usual fee only if tax practitioner does not renew by the due date.
    a) True
    b) False

25. A tax preparer that wants to become a CRTP must fulfill one of the following requirements:

    a) Complete a 60-hours qualifying tax education and register with CTEC
    b) Obtain a PTIN at the IRS webpage
    c) Purchase a $5,000 tax preparer bond
    d) All of the above

Review Questions 5 – Answers and Discussion

21. **Correct answer is a.** In the past there were differences regarding the amount of deduction allowed when a contribution was made to an IRA. Due to these differences, taxpayers may have a different basis in their IRA for federal and California purposes.

22. **Answer c is correct.** For sale or exchanges after May 6, 1997, federal law allows an exclusion of gain on the sale of a personal residence in the amount of $250,000 ($500,000 if married filing jointly). The taxpayer must have owned and occupied the residence as a principal residence for at least 2 of the 5 years before the sale. California conforms to this provision. However, California taxpayers who served in the Peace Corps during the 5-year period ending on the date of the sale may reduce the 2-year period by the period of service, not to exceed 18 months.

23. **Answer is b.** Federal tax returns are changed or amended by completing and filing Form 1040X. Generally, if a taxpayer files a federal amendment, they will need to complete and file California Form 540X to inform the FTB of the changes. However, the taxpayer is not required to file an amended California return if the changes do not affect the California return.

24. **Answer is b.** CTEC Raised the registration fee to $33. Effective August 1, 2014, the California Tax Education Council (CTEC) will increase its annual registration fee for tax preparers from **$**25 to $33. The additional $8 is the minimal amount needed to avoid a budget shortfall. This is the first registration fee increase CTEC implemented in its 17-year history.

25. **Answer is d.** A CRTP is a CTEC Registered Tax Preparer. A taxpreparer that wants to become a CRTP must fulfill the following:

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