2021 Federal Tax Guide Updates and Changes

21. IRS Forms And Schedules For Claiming/Reporting Credits

Code section	Credit	Individual (credit not from pass-through entity)	C Corp	Partnership/ S Corp	Trust/ Estate[1], [2]	Taxpayer with credit from pass-through entity[3] only	Cooperative[4]	Taxpayer with credit from cooperative only
		IRS Form/Schedule	IRS Form/Schedule	IRS Form/Schedule	IRS Form/Schedule	IRS Form/Schedule	IRS Form/Schedule	IRS Form/Schedule
6428B	2021 Recovery Rebate Credit	1040 (Line 30)	n/a	n/a	n/a	n/a	n/a	n/a
Pub. L. No. 117-2, §9642; Pub. L. No. 116-127, Div. G, §7002	Temporary Credit for Sick Leave for Self-Employed Individuals	7202/1040 (Sch. 3)	n/a	n/a	n/a	n/a	n/a	n/a
Pub. L. No. 117-2, §9643; Pub. L. No. 116-127, Div. G, §7004	Temporary Credit for Family Leave for Self-Employed Individuals	7202/1040 (Sch. 3)	n/a	n/a	n/a	n/a	n/a	n/a
Pub. L. No. 116-260, Div. EE, Title III, §303(a)	2020 Qualified Disaster Employee Retention Credit	n/a	3800	5884-A, (Line 1b)	5884-A, (Line 1b)	3800	5884-A, (Line 1b)	3800

S&T 22. Inflation-Adjusted Amounts

Code Section	Description	2020 Amount	2021 Amount	Sources
24(d)(1)(A)	Child Tax Credit (Refundable Portion)	$1,400	Fully refundable (except for $500 other dependent credit) **	Rev. Proc. 2019-44; §24(i)(1)
25A(d)(2)	Lifetime Learning Credit Phaseout	Phaseout: Single/HOH* $59,000 — $69,000 MFJ $118,000 — $138,000	Phaseout: Single/HOH* $80,000 — $90,000 MFJ $160,000 — $180,000	Rev. Proc. 2019-44; Pub. L. No. 116-260, Div. EE, Title II, §104 * No longer inflation-adjusted after 2020

August 2, 2021

32(i)(1)	Earned Income Credit Excessive Income Amount	$3,650	$10,000	Rev. Proc. 2019-44; §32(j)(1)
42(h)(3)(C)(ii)	Low-Income Housing Credit	Greater of: (1) $2.8125 × state population or (2) $3,217,500	Lesser of: (1) $3.50 × state population or (2) 65% of the State housing credit ceiling for calendar year 2020	Rev. Proc. 2019-44; Pub. L. No. 116-260, Div. EE, Title II, §305

** If taxpayer has a principal place of abode in the United States for more than half of the tax year or is a bona fide resident of Puerto Rico for the tax year.

Chapter 100. Gross Income

100.C. Compensation

100.C.4. Fringe Benefits

100.C.4.D. Valuation Of Personal Use Of Employer-Provided Vehicles

Vehicle Cents-Per-Mile Valuation Method. Under the vehicle cents-per-mile valuation method, the value of the personal use of an employer-provided vehicle is determined by multiplying the standard mileage rate (57.5 cents per mile for 2020, 56 cents per mile for 2021) by the number of miles the employee drives the vehicle for personal purposes during the year. This method generally may be used if the vehicle is reasonably expected to be used regularly in the employer's business, is used primarily by an employee, and is actually driven at least 10,000 miles during the calendar year. However, this method may not be used if the fair market value of the vehicle on the date it is made available to the employee exceeds an applicable dollar amount. For vehicles first made available to employees for personal use in 2020, the applicable dollar amount is $50,400 for passenger automobiles (including trucks and vans), $51,100 for 2021 [Reg. §1.61-21(e); Reg. §1.61-21(e)(5)(vi) (transition rule); Notice 2021-2].

Automobile Lease Valuation Rule. Under the automobile lease valuation rule, the value of the personal use of an employer-provided vehicle generally is determined by multiplying the Annual Lease Value of the vehicle by the percentage of the total mileage that the vehicle is used for personal purposes during the year. The Annual Lease Value of the vehicle is determined using the Annual Lease Value Table (see Schedules & Tables 11.) and is based on the fair market value of the vehicle as of the first date on which the vehicle is made available to any employee for personal use [Reg. §1.61-21(d)(2)]. The following safe harbor rules apply in determining the fair market value of an employer-provided vehicle for this purpose [Reg. §1.61-21(d)(5)]:

• If the vehicle is owned by the employer, the safe harbor value of the vehicle is the employer's cost of purchasing the vehicle (including sales tax, title, etc.) in an arm's-length transaction.

• If the vehicle is leased (or revalued) by the employer, the safe harbor value is the retail value of the vehicle as reported in a nationally recognized publication that regularly reports new or used vehicle retail values.

• In a case in which an employer has a fleet of 20 or more vehicles, the fleet-average value (the average of the fair market values of all vehicles in the fleet) may be used for purposes of determining the annual lease values for all vehicles in the fleet. However, the fleet-average value may not be used for any vehicle unless the employer reasonably expects that the vehicle will regularly be used in the employer's trade or business and the fair market value of the vehicle is less than or equal to the maximum value. For vehicles first made available to employees for personal use in 2020, the maximum value is $50,400 for passenger automobiles (including trucks and vans), $51,100 for 2021 [Reg. §1.61-21(d)(5)(v), Reg. §1.61-21(d)(5)(v)(G) (transition rule); Notice 2021-2].

100.J. Unemployment Compensation

Gross income includes unemployment compensation received by an individual taxpayer [§85(a)]. Unemployment compensation generally includes any amount received under an unemployment compensation law of the United States or a state, including benefits paid by a state or the District of Columbia from the Federal Unemployment Trust Fund, state unemployment insurance benefits, railroad unemployment compensation benefits, and disability payments from a government program paid as a substitute for unemployment compensation. However, unemployment compensation does not include benefits received from an employer-financed fund or benefits received from a private fund to which the taxpayer voluntarily contributes (unless the taxpayer receives more than the amount contributed). Taxpayers who receive unemployment compensation should receive Form 1099-G, Certain Government Payments, reporting the total amount of unemployment compensation received during the year.

Up to $10,200 of unemployment compensation received in tax year 2020 is excluded from the gross income of a taxpayer whose adjusted gross income (determined after application of §86, §135, §137, §219, §221, former §222 (expired December 31, 2020), and §469 without regard to §85) is less than $150,000 [§85(c)]. For taxpayers who already filed a 2020 return, the IRS will recalculate the taxable amount of unemployment compensation. Taxpayers do not need to file amended returns unless the recalculation makes the taxpayer eligible for credits or deductions that were not included on the original return [IRS News Release IR-2021-71 (Mar. 31, 2021)].

If a taxpayer repays any amount of unemployment compensation in the same year it was received, only the excess of the amount received over the amount repaid is included in gross income. If a taxpayer repays any amount of unemployment compensation that was included in his or her gross income in an earlier year, the taxpayer can take a deduction for the amount repaid on his or her return for the year of repayment.

100.K. Social Security Benefits

A portion of Social Security benefits received by an individual taxpayer must be included in his or her gross income if certain requirements are met [§86(a)]. Social Security benefits include (i) monthly retirement, survivor, and disability benefits received under Title II of the Social Security Act (reported to taxpayers on Form SSA-1099, Social Security Benefit Statement), and (ii) the Social Security equivalent benefit (SSEB) portion of tier 1 railroad retirement benefits received under the Railroad Retirement Act

of 1974 (reported to taxpayers on Form RRB-1099, Payments by the Railroad Retirement Board). Social Security benefits do not include supplemental security income (SSI) payments. Social Security benefits are included in the gross income of the person who has the legal right to receive them.

A taxpayer is taxable on a portion of Social Security benefits received if his or her provisional income exceeds a base amount. Provisional income is equal to the sum of (i) one-half of the Social Security benefits received, plus (ii) modified adjusted gross income [§86(b)(1)]. The base amount is $32,000 for married taxpayers filing jointly, $0 for married taxpayers who live with their spouses and file separately, and $25,000 for all other taxpayers [§86(c)(1)].

In determining provisional income, modified adjusted gross income is equal to: (i) tax-exempt interest received, plus (ii) adjusted gross income (determined without regard to Social Security benefits, the §85(c) exclusion of a limited amount of unemployment compensation received in tax year 2020, the §135 exclusion of savings bonds interest, the §137 exclusion of employer-paid adoption expenses, the §221 educational loan interest deduction, the former §222 qualified tuition deduction (applicable in tax years beginning in 2020 and earlier), the §911 foreign income and housing costs exclusion, the §931 exclusion of income from U.S. possessions, and the §933 exclusion of income from Puerto Rico) [§86(b)(2)].

Example: Sarah is a retired single taxpayer who receives $10,000 of Social Security benefits during the year. Her adjusted gross income, not counting Social Security benefits, is $15,000 and she receives tax-exempt interest of $2,000. Sarah is not a “taxable individual” and she does not need to include any portion of her Social Security benefits in gross income because the sum of one-half of her Social Security benefits plus her modified adjusted gross income is $22,000 (($10,000 × 50%) + ($15,000 + $2,000)), and that amount is less than her base amount of $25,000.

The determination of the amount of a taxpayer's Social Security benefits includible in gross income depends on whether the taxpayer's provisional income is more or less than an adjusted base amount. The adjusted base amount is $44,000 for married taxpayers filing jointly, $0 for married taxpayers who live with their spouses and file separately, and $34,000 for all other taxpayers [§86(c)(2)].

If a taxpayer's provisional income does not exceed the adjusted base amount, the amount of Social Security benefits included in gross income is the lesser of [§86(a)(1)]:

1. 50% of the Social Security benefits received; or

2. 50% of the excess of the provisional income over the base amount.

If a taxpayer's provisional income exceeds the adjusted base amount, the amount of Social Security benefits included in gross income is the lesser of [§86(a)(2)]:

1. 85% of the Social Security benefits received; or

2. the sum of (i) 85% of the excess of the provisional income over the adjusted base amount, plus (ii) the lesser of (a) 50% of the difference between the base amount and the adjusted base amount, or (b) the amount that would be included in gross income if the taxpayer's provisional income was treated as not exceeding the adjusted base amount (as discussed above).

Example: Bill and Beth, married taxpayers who file a joint return, receive $5,000 of Social Security benefits during the year. They have $31,000 of modified adjusted gross income for the year. Bill and Beth are "taxable individuals" who must include a portion of the Social Security benefits in gross income because their provisional income of $33,500 (($5,000 × 50%) + $31,000) exceeds their base amount of $32,000. Because their provisional income does not exceed their adjusted base amount of $44,000, the amount of Social Security benefits included in gross income is only $750, which is equal to the lesser of 50% of the Social Security benefits received ($5,000 × 50% = $2,500) or 50% of the excess of their provisional income over their base amount (($33,500 − $32,000) × 50% = $750).

Example: Assume the same facts as in the previous example, except that Bill and Beth have $45,000 of modified adjusted gross income (instead of $31,000). Because provisional income of $47,500 (($5,000 × 50%) + $45,000) exceeds their adjusted base amount of $44,000, the amount of Social Security benefits includible in gross income is equal to the lesser of 85% of the Social Security benefits received or the following amount: the sum of (i) 85% of the excess of the provisional income over the adjusted base amount (($47,500 − $44,000) × 85% = $2,975), plus (ii) the lesser of (a) 50% of the difference between the base amount and the adjusted base amount (($44,000 − $32,000) × 50% = $6,000), or (b) the amount that would be included in gross income if the taxpayer's provisional income was treated as not exceeding the adjusted base amount, which is the lesser of 50% of the Social Security benefits received ($5,000 × 50% = $2,500) or 50% of the excess of the provisional income over the base amount (($47,500 − $32,000) × 50% = $7,750). Bill and Beth must include $4,250 of their Social Security benefits in gross income because 85% of the Social Security benefits received ($5,000 × 85% = $4,250) is less than $5,475 ($2,975 + $2,500).

The following special rules apply in determining the amount of Social Security benefits received during a tax year:

1. The amount of Social Security benefits received by a taxpayer during a tax year is reduced by any Social Security benefits the taxpayer repaid during that year, whether the repayment was for benefits received during that year or during a previous year [§86(d)(2)]. If the benefits repaid are more than the benefits received and a taxpayer's SSA-1099 or RRB-1099 shows net negative Social Security benefits received for the year, the benefits received in that year are not taxable and the taxpayer may claim an itemized deduction for the portion of the negative amount that represents benefits that were included in gross income in an earlier year.

2. A disabled taxpayer who receives workers' compensation generally receives a reduced amount of Social Security benefits that takes into account the amount of workers' compensation received. For federal tax purposes, the amount of Social Security benefits received must be increased by the workers' compensation received (i.e., the workers' compensation is treated as Social Security benefits for federal tax purposes) [§86(d)(3)].

3. A lump-sum payment of Social Security retirement benefits is generally included in gross income in the year received. However, if a lump-sum payment is attributable to earlier years, a taxpayer may elect to spread the payment back to the earlier years. When such an election is made, the amount included in gross income in the current year for the portion of the payment attributable to the earlier years is limited to the sum of the increases in gross income that would have occurred in the earlier years if the payment had actually been received in those years. This adjustment affects only the current year and no amended returns are filed for the earlier years [§86(e)].

Taxpayers can generally use the Social Security Benefits Worksheet (Source: 2020 Form 1040 Draft Instructions) to determine if any of their benefits are taxable.

100.L. Discharge of Indebtedness Income

Generally, income from the discharge of indebtedness (DOI) is included in gross income. For example, where a taxpayer and his or her bank modify a mortgage loan to reduce the principal balance of the loan, or where a credit card company settles a debt for less than the full amount the taxpayer owed, the taxpayer will typically realize income in an amount equal to the difference between the original amount owed and the modified amount owed after the discharge. However, certain DOI amounts are excluded from gross income, including amounts from (i) discharges occurring in a bankruptcy case under title 11, (ii) discharges occurring when the taxpayer is insolvent (but only to the extent of the insolvency), (iii) discharges of qualified farm indebtedness, (iv) for certain taxpayers, discharges of qualified real property business indebtedness, and (v) qualified principal residence indebtedness which is discharged before January 1, 2026, or subject to an arrangement that is entered into and evidenced in writing before January 1, 2026 [§108(a)(1)(A)–§108(a)(1)(E)]. Additionally, the discharge of certain student loans may also qualify for exclusion from income [§108(f)]. See 200.A. for further discussion of DOI amounts that are excluded from gross income. If a taxpayer is eligible to exclude DOI from income, he or she should file Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment).

A taxpayer does not realize income if the payment of the debt would have given rise to a deduction (i.e., interest forgiven by a lender on a business or home mortgage loan) [§108(e)(2)].

Sales of property, and in particular, real estate, frequently involve the cancellation or release of liabilities of the seller. In this situation, the nature of the liability is important. A disposition of property encumbered by a nonrecourse liability discharges the transferor from indebtedness, and the amount of the liability discharged is included in the transferor's amount realized, including instances where the amount of the nonrecourse debt exceeds the property's fair market value. The transferor realizes gain or loss from the disposition of the property depending on whether the indebtedness exceeds the transferor's basis in the property. No DOI income is realized, and therefore, none of the exclusions applicable to discharges of income are available [Reg. §1.1001-2(a)].

A disposition of property subject to a recourse liability is treated differently. As with nonrecourse debts, the amount of the recourse liability the transferee assumes is included in the transferor's amount realized. However, when the debt is discharged as part of the disposition, some of the income may be characterized as DOI income, rather than gain or loss from the sale or exchange of property. To the extent the fair market value of the property exceeds the transferor's basis, the transferor realizes gain. To the extent the recourse debt that is discharged exceeds the fair market value of the property, the transferor realizes DOI income, which may qualify for exclusion from income [Reg. §1.1001-2(a)].

Example: Andy owns property with a basis of $1,000 and a fair market value of $2,000. The property is subject to a nonrecourse mortgage in the amount of $3,000. Andy transfers the property to the lender and realizes $2,000 of gain ($3,000 amount realized − $1,000 basis). He does not realize any DOI income.

Example: Olivia owns land with a basis of $1,000 and a fair market value of $2,000. The property is subject to a recourse liability of $3,000. Olivia transfers the property to the creditor, who agrees that

Olivia will have no further liability to repay the debt. Olivia realizes $1,000 of gain on the disposition ($2,000 fair market value − $1,000 basis), and $1,000 of DOI income ($3,000 liability − $2,000 fair market value). If eligible, all or a portion of Olivia's DOI income may be excluded from gross income.

An individual taxpayer should receive a Form 1099-C, Cancellation of Debt, from a lender if the lender has discharged a debt the taxpayer owes to it, or if an identifiable event has occurred that is, or is deemed to be, a discharge of a debt of $600 or more. A taxpayer generally must report DOI income for the year to which Form 1099-C applies. However, if an identifiable event has occurred but the debt has not actually been discharged, the taxpayer is not required to report the DOI income until the year the debt is actually discharged.

The manner in which an individual taxpayer reports DOI income on his or her return depends on the nature of the debt. If the debt is a nonbusiness debt, the discharged amount is reported as “other income” on Form 1040 or Form 1040-SR. If the debt is a business debt, the discharged amount is reported on Schedule C (Form 1040). If the debt is a farming debt, the discharged amount is reported on Schedule F (Form 1040).

If a taxpayer includes DOI income in gross income in one tax year and repays the discharged amount in a later tax year, he or she may file Form 1040-X, Amended U.S. Individual Income Tax Return, to claim a refund for the tax year in which the DOI income was included in gross income (subject to the three-year statute of limitations).

Chapter 200. Exclusions from Gross Income

200.A. Discharge of Indebtedness

200.A.6. Qualified Principal Residence Indebtedness Exclusion

Qualified principal residence indebtedness discharged before January 1, 2021 (or discharged subject to an arrangement that was entered into and evidenced in writing before January 1, 2026) is excluded from gross income, regardless of the taxpayer's solvency [§108(a)(1)(E)].

The term “qualified principal residence indebtedness” means acquisition indebtedness (see 700.F.1.c.) with respect to the taxpayer's principal residence (see 300.E.3.a.). The amount of debt eligible for the exclusion for discharges before January 1, 2021 is $2 million ($1 million for married individuals filing separately). The amount of debt eligible for the exclusion for discharges after December 31, 2020 is $750,000 ($375,000 for married individuals filing separately). The amount excluded reduces the taxpayer's basis in the residence [§108(h)(1), §108(h)(2)].

The exclusion does not apply if the loan is discharged on account of services performed for the lender or any other factor not directly related to a decline in the value of the residence or the financial condition of the taxpayer. If only a portion of a loan is considered qualified principal residence indebtedness, the exclusion applies only to the amount discharged that exceeds the amount of the loan (as determined immediately before such discharge) that is not qualified principal residence indebtedness [§108(h)].

Example: Pam bought her principal residence for $880,000, paying $80,000 in cash and financing the rest with a recourse mortgage of $800,000. When the principal balance of the original mortgage loan

was $740,000 and the fair market value of the property was $1 million, Pam refinanced the debt for $850,000. She used the $110,000 she obtained from the refinancing ($850,000 minus $740,000) to pay off credit cards and to buy a new car. In 2020, Pam lost her job and was unable to pay the mortgage. Her home declined in value to between $700,000 and $750,000. The mortgage lender agreed to allow a short sale of the property for $725,000 and to cancel the remaining $125,000 of the $850,000 debt. Pam can exclude only $15,000 of the canceled debt from her income under the exclusion for canceled qualified principal residence indebtedness ($125,000 canceled debt minus the $110,000 amount of the debt that was not qualified principal residence indebtedness). Pam must include the remaining $110,000 of canceled debt in income (unless another exclusion, e.g., the insolvency exclusion (see 200.A.3.), applies).

A discharge of indebtedness that would have qualified but for the expiration of the qualified principal residence indebtedness exclusion in §108(a)(1)(E) may qualify for another exclusion, such as the insolvency exclusion under §108(a)(1)(B) or the deductible debt exclusion under §108(e)(2).

200.A.9. Student Loan Exclusion

Certain student loans provide that all or a portion of the debt incurred to attend a qualified educational institution (as defined in §170(b)(1)(A)(ii)) will be discharged if the recipient of the loan works for a certain period of time in certain professions for any of a broad class of employers. DOI income from the discharge of these student loans is excluded from gross income. The loan must have been made by one of the following entities [§108(f)(2); Reg. §1.170A-9(c)(1)]:

• the federal government, a state or local government, or an instrumentality, agency, or subdivision thereof;

• a tax-exempt public benefit corporation that has assumed control of a state, county, or municipal hospital, and whose employees have been deemed public employees under state law; or

• an educational institution (a) receiving funds from an entity described in one of the previous two bullets for the purpose of making the loan, or (b) as part of an institutional program designed to encourage students to serve in occupations or areas with unmet needs and under which the services provided are for or under the direction of a governmental unit or a tax-exempt §501(c)(3) organization.

A loan made to refinance a qualified student loan also qualifies if made by an educational institution or tax-exempt §501(a) organization under a program designed as described in part (b) of the third bullet, above.

Example: Stephanie attended law school and has student loan debt. The loans and the underlying loan documents did not address whether any of the debt would be forgiven if Stephanie worked in a particular profession for a specified period of time. Her law school offers a loan repayment assistance program (LRAP) to help reduce the student loan debt of graduates that engage in public service. The LRAP program is designed to encourage graduates to enter public service in occupations or areas with unmet needs. Under the LRAP program, the law school makes loans that refinance the graduates' original student loans. After the graduate works for a required period in a qualifying law-related public service position, the law school will forgive all or a part of the graduate's debt. After Stephanie

graduates law school, she signs an LRAP promissory note and accepts the terms and conditions of the law school's LRAP loan. Stephanie's LRAP loan is a qualified student loan for purposes of the exclusion.

Taxpayers are not required to reduce any tax attributes as a result of the exclusion of discharged student loans from gross income.

Gross income does not include certain student loan amounts discharged in 2021 through 2025. To qualify for exclusion, the loan must be (1) provided expressly for postsecondary educational expenses and made, insured, or guaranteed by the U.S. government or an eligible educational institution; (2) a private education loan; (3) made by an educational organization pursuant to either (a) an agreement with the U.S. government, an eligible educational institution, or private educational lender, or (b) a program designed to encourage students to serve in occupations or areas with unmet needs and under which the services are for (or led by) a governmental unit or tax-exempt organization; or (4) made by an educational or tax-exempt organization to refinance an individual's loan in order to help them attend an educational organization, if such refinancing loan is pursuant to a program described above. The income exclusion does not apply to loan discharges made by organizations described in (3), above, or by private educational lenders if the discharge is due to services performed for the organization or lender [§108(f)(5)].

For discharges of student loan indebtedness in 2018 through 2020, gross income did not include certain discharges on account of the death or total and permanent disability of a student. Loans eligible for the exclusion were loans made by (1) the United States (or an instrumentality or agency thereof), (2) a state or political subdivision, (3) certain tax-exempt public benefit corporations that control a state, county, or municipal hospital and whose employees have been deemed to be public employees under state law, or (4) an educational organization that originally received the funds from which the loan was made from the United States, a state, or a tax-exempt public benefit corporation. Private education loans (as defined in §140(7) of the Consumer Credit Protection Act) are also covered by the exclusion [Former §108(f)(5)].

Taxpayers who took out federal student loans that are discharged under settlement discharge actions, the Department of Education's Closed School discharge process, or the Defense to Repayment discharge process do not have to recognize gross income from discharge of indebtedness [Rev. Proc. 2015-57, modified by Rev. Proc. 2017-24, amplified by Rev. Proc. 2018-39, amplified by Rev. Proc. 2020-11 (safe harbor procedures)].

200.D. Sickness, Injury, And Death Benefits

200.D.1. Accident, Health, And Disability Insurance

200.D.1.D. COBRA Continuation Coverage Premium Assistance

The temporary premium assistance for eligible individuals who elect COBRA continuation coverage is excluded from gross income. The premium assistance period begins on April 1, 2021, and ends on September 30, 2021 [§139I; Pub. L. No. 117-2, §9501].

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200.J. U.S. Savings Bond Redemptions Used For Higher Education Tuition

Amounts realized from an individual's redemption of a qualified U.S. savings bond during a tax year in which the individual pays qualified higher education expenses are not included in that individual's gross income. The exclusion is not available for married individuals filing a separate return [§135(a)].

A qualified U.S. savings bond is any U.S. savings bond that is issued after 1989 to an individual at least 24 years old at the time of issuance, and that is issued at a discount under 31 U.S.C. §3105. Qualified higher education expenses are tuition or fees required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or any dependent for whom the taxpayer is allowed a personal exemption deduction, at an accredited university, college, junior college, nursing school, or vocational school [§135(c)]. Qualified education expenses also include contributions to a qualified tuition program on behalf of a designated beneficiary, or to a Coverdell education savings account on behalf of an account beneficiary who is the taxpayer, the taxpayer's spouse, or any dependent for whom the taxpayer would be allowed a personal exemption deduction (see 200.L.). Qualified higher education expenses do not include expenses for any course involving sports, games, or hobbies that are not part of a degree program.

Additionally, qualified higher education expenses must be reduced by the sum of the following amounts:

• the tax-free portion of a qualified scholarship or fellowship (see 200.H.);

• expenses used to figure the tax-free portion of distributions from a Coverdell education savings account or a qualified tuition program (529 plan) (see 200.L.);

• any tax-free payments (other than gifts, bequests, devises, or inheritances) received as educational assistance; and

• any expenses used in figuring the American Opportunity and Lifetime Learning credits (see 900.B.5.).

Where the aggregate proceeds (principal and interest) of all the taxpayer's redeemed U.S. savings bonds exceed the taxpayer's qualified education expenses for the tax year, the amount of interest that may be excluded is reduced pro rata by multiplying the amount that would otherwise be excluded by a fraction, the numerator of which is qualified educational expenses, and the denominator of which is the aggregate proceeds of qualified U.S. savings bonds redeemed.

Example: Randy redeems his qualified U.S. savings bonds and receives $15,000, of which $10,000 is principal and $5,000 is interest. Randy's son has qualified educational expenses of $20,000. Randy may exclude the entire $5,000 of interest from his income.

Example: Veronica redeems her qualified U.S. savings bonds and receives $20,000, of which $12,000 is principal and $8,000 is interest. Veronica's daughter has qualified educational expenses of $15,000. Veronica may exclude $6,000 (($15,000 expenses ÷ $20,000 proceeds), multiplied by $8,000 of otherwise excludible interest) of interest from her income.

Phaseout of Exclusion. The exclusion is subject to a phaseout of the excludible amount based on the taxpayer's modified adjusted gross income (MAGI). The phaseout begins for taxpayers with MAGI of $82,350 ($123,550 for joint returns) in 2020 ($83,200 and $124,800, respectively, for 2021). For

taxpayers with MAGI above this threshold, the excludible amount is reduced by the same ratio to which the amount of MAGI exceeding the threshold bears to $15,000 ($30,000 for joint returns). Thus, the exclusion is completely phased out for taxpayers with MAGI of $97,350 ($153,550 for joint returns) in 2020 ($98,200 and $154,800, respectively, for 2021) [Rev. Proc. 2019-44, Rev. Proc. 2020-45].

MAGI, for this purpose, is the taxpayer's adjusted gross income for the tax year after applying (i) the partial exclusion for Social Security and tier 1 railroad retirement benefits, (ii) the adjustments for limitations on passive activity losses and credits, and (iii) the deduction for certain retirement savings, and without regard to the following [§135(c)(4)]:

• excludible higher education savings bond interest;

• excludible unemployment compensation (2020 only);

• excludible adoption assistance payments;

• the deduction for interest on certain qualifying education loans;

• the former deduction for qualified tuition and related expenses (repealed for tax years beginning after 2020);

• excludible foreign earned income or housing amounts;

• excludible income from U.S. possessions; and

• excludible income from Puerto Rican sources available to bona fide residents of Puerto Rico.

Example: In 2020, Bob and Florence redeem qualified U.S. savings bonds and receive $10,000, of which $6,000 is principal and $4,000 is interest. They file a joint return and their MAGI is $123,950. The excess of their MAGI over the threshold is $400 ($123,950 − $123,550). Thus, their excludible interest is limited to $3,947 ($4,000 otherwise excludible interest − $53 ($4,000 otherwise excludible interest multiplied by .0133 ($400 ÷ $30,000))).

Reporting. Excluded interest from the redemption of qualified U.S. savings bonds for taxpayers with qualified education expenses is reported on Form 8815, Exclusion of Interest from Series EE and I U.S. Savings Bonds Issued After 1989.

200.K. Certain Cost-Sharing Payments

A taxpayer may exclude from income all or part of a government payment received under certain cost-sharing conservation, reclamation, and restoration programs. A payment, for this purpose, is any economic benefit conferred upon the taxpayer as a result of an improvement. The exclusion applies only to the portion of a payment that meets all of the following tests [§126(b); Reg. §16A.126-1(a)]:

• The payment must be for a capital expense, as no payment that is properly associated with an amount allowable as a deduction for the tax year the amount is paid or incurred may be excluded.

• The payment must not increase the taxpayer's annual income from the property for which the payment is made by more than the greater of:

— 10% of the average annual income derived from the affected property before receiving the improvement; or

— $2.50, multiplied by the number of affected acres.

• The Secretary of Agriculture must certify that the payment was made primarily for the purpose of conserving soil and water resources, protecting or restoring the environment, improving forests, or providing a habitat for wildlife.

The excludible portion of a payment is the present fair market value of the right to receive annual income from the affected acreage of the greater of either [Reg. §16A.126-1(b)(5)]:

• 10% of the prior average annual income from the affected acreage (i.e., the average of the gross receipts from the affected acreage for the last three tax years before the tax year in which the taxpayer begins to install the improvement); or

• $2.50, multiplied by the number of affected acres.

Example: Walter owns a farm. One hundred acres of his land were reclaimed under a rural abandoned mine program contract with the USDA. The total cost of the improvement is $500,000, of which the USDA paid $490,000 and Walter paid $10,000. The value of the cost-sharing improvement is $15,000. The present fair market value of the right to receive the annual income from the property of 10% of the prior average annual income of the affected acreage is $1,380. The present fair market value of the right to receive $250 ($2.50, multiplied by 100 acres) is $1,550. Walter may exclude $1,550 (the greater of $1,380 and $1,550) from income.

The amount of the exclusion is reported on Schedule F (Form 1040). A taxpayer may elect not to have these rules apply to all or part of any excludible portion [§126(c)].

200.N. Miscellaneous Items Of Exclusion

200.N.16. 2020 Unemployment Compensation

For any tax year beginning in 2020, up to $10,200 of unemployment compensation received by a taxpayer is excluded from gross income to the extent that the taxpayer's adjusted gross income (AGI) for the year is less than $150,000. AGI is determined without regard to unemployment compensation, and after application of the social security benefits inclusion, the higher education savings bond exclusion, the adoption assistance exclusion, the retirement savings deduction, the education loan interest deduction, the former qualified tuition deduction, and the passive activity loss and credit limitation [§85(c)].

For taxpayers who already filed a 2020 return, the IRS will recalculate the taxable amount of unemployment compensation. Taxpayers do not need to file amended returns unless the recalculation

makes the taxpayer eligible for credits or deductions that were not included on the original return [IRS News Release IR-2021-71 (Mar. 31, 2021)].

200.N.17. COVID-19-Related Financial Assistance

The following types of COVID-19-related financial assistance are excluded from gross income:

- forgiveness of Paycheck Protection Program loans and certain other loans;
- qualified emergency financial aid grants;
- emergency economic injury disaster loan (EIDL) grants and targeted EIDL advances;
- subsidies for certain loan payments;
- shuttered venue operator grants; and
- restaurant revitalization grants

[Pub. L. No. 117-2, §9672, §9673; Pub. L. No. 116-260, Div. N, Title II, Subtitle B, §276, §277, §278].

Chapter 300. Property Transactions

300.B. Capital Gains and Losses

300.B.3. Holding Periods for Capital Assets

The length of time a taxpayer held a capital asset that is sold or exchanged determines whether the gain or loss realized on the disposition is short-term or long-term gain or loss. In general, the holding period of property begins the day after the property is acquired and ends with the day the property is disposed of. Only whole days are taken into account. The sale or exchange of property held for one year or less produces short-term gain or loss, while the sale or exchange of property held for more than one year produces long-term gain or loss [§1222].

Example: Jimmy purchases property at 8:00 a.m. on January 1, Year 1. He sells the property at a gain at 11:00 p.m. on January 1, Year 2. The holding period begins on January 2, Year 1, the day after the acquisition, and it ends on January 1, Year 2, the day of the disposition. Fractions of days are not counted. Therefore, Jimmy is treated as having held the property for exactly one year.

For tax years beginning after 2017, a three-year holding period applies to certain service-based partnership interests ("carried interest"), notwithstanding the rules of §83 or any election in effect under §83(b) to achieve long-term capital gain status [§1061; Reg. §1.1061-1–§1.1061-6].

300.E. Nonrecognition/Deferrals

300.E.6. Miscellaneous Nonrecognition Transactions

300.E.6.g. Gain on Rollover Of Empowerment Zone Investments

A taxpayer may elect not to recognize capital gain on the sale of any qualified empowerment zone asset (QEZA) held for more than one year if the sales proceeds were used to purchase any QEZA (for the same zone as the asset sold) within 60 days after the sale [§1397B]. Rollover gain nonrecognition treatment is not permitted from the sale of Qualified Empowerment Zone assets after December 31, 2020 [§1397B(c)].

The taxpayer's basis in the replacement QEZA is the cost of the replacement QEZA, reduced by the amount of gain not recognized by reason of the election [§1397B(b)(4)].

Chapter 400. Trade or Business Expenses

400.A. Common Trade or Business Deductions

400.A.2. Compensation Paid

Payment of Compensation Resulting in Forgiveness of a Paycheck Protection Program Loan. Although compensation paid from the proceeds of a forgiven Paycheck Protection Program loan (PPP loan) would otherwise be denied a deduction under §265(a)(1) and Reg. §1.265-1, Congress passed legislation stating that no deduction will be denied because of the exclusion of PPP loan forgiveness from gross income. [COVID-related Tax Relief Act of 2020, Pub. L. No. 116-260, Div. N, Title II, Subtitle B, §276 (amending §7A(i) of the Small Business Act), applicable to tax years ending after March 27, 2020; Rev. Rul. 2021-2].

400.A.8. Rent and Royalty Expenses

Rent or royalty payments for the use of property are generally deductible in the year paid or accrued, if paid in connection with a taxpayer's trade or business [§162(a)(3); Reg. §1.162-11].

Taxes and Other Operating Expenses. If the terms of a lease require the lessee to pay as additional rent a pro rata share of real estate taxes levied on the property and some or all of the property's operating expenses (e.g., insurance, maintenance, trash hauling, and security), the lessee may deduct these expenses as additional rent [Reg. §1.162-11(a), §1.61-8(c)].

Advance Rents and Bonuses. If a lessee pays for the use of property in advance of the year in which the property actually will be used, the lessee must capitalize the payment and amortize it proportionately over the base term of the lease (regardless of the lessee's method of accounting). Thus, for any tax year, the lessee may deduct only the amount that applies to his or her use of the rented property during that tax year. Bonus payments paid by a lessee to induce the lessor to enter into the lease are treated similarly. In each case, though, the lessor must include the payment in income in the year of receipt [Reg. §1.162-11(a), §1.61-8(b)].

Cancellation or Termination of Lease. Amounts a lessee pays to cancel a business lease generally may be deducted as a rent payment. However, a lessee must capitalize a lease termination payment if he or she incurs the payment in connection with the acquisition of another lease, because the payment permits the lessee to obtain a benefit (i.e., the acquisition of the second lease) that extends beyond the end of the year [Reg. §1.263(a)-4(d)(6)].

Unreasonable Rent Between Related Parties. A lessee may not take a deduction for the payment of unreasonable rent. If rental payments between related parties are excessive in amount, the parties' relationship may create the presumption that the dealings were not arm's-length. Generally, rent paid to a related lessor is reasonable if it is the same amount the lessee would pay to an unrelated lessor for use of the same property.

Improvements Made by Lessee. Gross income generally does not include the income (other than rent) a lessor of real property derives upon the termination of a lease that represents the value of such property attributable to buildings erected or other improvements made by the lessee [§109] (see 200.N.4.).

Leases vs. Sales. The characterization of a transaction as a lease or a sale may significantly impact a taxpayer. For instance, in a lease transaction, a lessee may generally deduct rental payments. However, if the property is purchased, the buyer may be able to deduct depreciation or interest if the purchase of the property is financed. A lessor who receives rental payments has ordinary income that may be offset by depreciation and interest deductions. However, a seller may realize capital gain upon the sale. Different taxpayers in different tax positions will find it advantageous to structure a transaction either as a sale or as a lease.

Whether a transaction is a sale or a lease is a question of the intent of the parties, as evidenced by the facts and circumstances surrounding the transaction and the agreement. Generally, the IRS considers a transaction to be a sale if any of the following conditions are present [Rev. Rul. 55-540]:

• portions of the periodic payments are made specifically applicable to an equity to be acquired by the lessee;

• the lessee acquires title to the property upon payment of a stated amount of "rentals" that he or she is required to make under the terms of the contract;

• the total amount that the lessee is required to pay for a relatively short period of use constitutes an inordinately large proportion of the total sum required to be paid to secure the transfer of title;

• the agreed "rental" payments materially exceed the current fair rental value (this may indicate that the payments include an element other than compensation for the use of property);

• as determined at the time of entering into the original agreement, the property may be acquired under a purchase option at a price that is nominal in relation to the value of the property at the time when the option may be exercised, or that is a relatively small amount when compared with the total payments that are required to be made; or

• some portion of the periodic payments are specifically designated as interest or are otherwise readily recognizable as the equivalent of interest.

If the transfer involves real property, the essential question is whether the property will be used by another for a limited period of time and then returned to the owner (a lease), or whether the ultimate ownership passes to the other party and that party has full use of the property during the period before passage of title (a sale).

Example: Carl enters into an agreement with Will to allow Will full occupancy of Carl's current residence for a 10-year period. The agreement provides that Will must pay $1,000 per month, plus 8% interest on the unpaid balance, for the full term of the agreement, and title to the property will pass to Will upon payment of the entire $120,000 ($1,000 × 12 months × 10 years). Will is required to pay all taxes and insurance, and he is entitled to prepay the entire remaining outstanding amount without penalty. If Will fails to make a payment, Carl is permitted to reoccupy the home. The agreement between Carl and Will is a sale, rather than a lease, because the only possibility of reversion to Carl is upon default in Will's payments, there is a prepayment privilege consistent with a sale, and title passes upon completion of the agreement if all of the terms are satisfied.

Certain leveraged lease transactions involving equipment may be considered sales, rather than leases.

Royalties. Royalties are compensation paid for the use of intangible personal property or in exchange for rights to exploit natural resources. In both cases, the amount of the royalty is typically measured as a percentage of the income derived from the sale of a unit of the property. Royalties are generally deductible as business expenses under much the same conditions that rent paid for business purposes is deductible.

Rent Payment Resulting in Forgiveness of a Paycheck Protection Loan. A deduction is allowed for rent that qualifies as payment on a covered rent obligation under §1106(a)(4) of the CARES Act even if payment of the rent results in forgiveness of a covered loan under the Paycheck Protection Program (PPP loan) and the income associated with the loan forgiveness is excluded from gross income [Rev. Rul. 2021-2].

400.A.9.A. Qualified Business Income Component

The determination of the first component of the combined qualified business income amount depends on whether the taxpayer's taxable income is above or below a threshold amount. The threshold amounts for 2020 are $326,600 ($329,800 for 2021) for joint filers, $163,300 ($164,900 for 2021) for single or head of household filers, and $163,300 ($164,925 for 2021) for married taxpayers filing separately [§199A(e)(2); Reg. §1.199A-1(b)(12); Rev. Proc. 2019-44, Rev. Proc. 2020-45].

If a taxpayer's taxable income does not exceed the threshold amount, the taxpayer's first component is equal to 20% of the net total QBI from all of the taxpayer's trades or businesses. This calculation includes the taxpayer's share of QBI from trades or businesses conducted by RPEs, and it also includes the taxpayer's QBI from "specified service trades or businesses" (SSTBs) [Reg. §1.199A-1(c)].

If a taxpayer's taxable income exceeds the threshold amount, the taxpayer's first component is determined by calculating the lesser of 20% of the taxpayer's QBI or the taxpayer's wage-basis limitation

for each of its trades or businesses (including aggregated trades or businesses) and then calculating the total of those amounts. This calculation includes the taxpayer's share of QBI, W-2 wages, and unadjusted basis immediately after acquisition (UBIA) of qualified property from trades or businesses conducted by RPEs; however, QBI from SSTBs is fully or partially excluded from this calculation. Before making this calculation, a taxpayer must (i) apply the SSTB exclusion, (ii) aggregate trades or businesses (if so desired), and (iii) net and/or carryover any QBI losses [Reg. §1.199A-1(d)].

Qualified Business Income (QBI). For purposes of the deduction, qualified business income (QBI) is the net amount of qualified items of income, gain, deduction, and loss from a trade or business (or aggregated trade or business). Qualified items are items that are (i) included or allowed in determining taxable income, and (ii) effectively connected with the conduct of a trade or business within the United States. Qualified items do not include qualified REIT dividends or qualified PTP income (as discussed above, these items are instead treated as part of the second component of the combined qualified business income amount). Qualified items also generally do not include (i) capital gains and losses, (ii) dividends, (iii) interest income, (iv) gains or losses from certain commodities transactions and foreign currency transactions, (v) certain income from notional principal contracts, (vi) amounts received from annuities, and (vii) any amount of loss or deduction properly allocable to an amount in one of the six preceding categories. Finally, qualified items do not include (i) guaranteed payments received by partners from a partnership, (ii) payments received by partners from a partnership for services performed in a capacity other than as a partner, and (iii) reasonable compensation received by S corporation shareholders from an S corporation [§199A(c); Reg. §1.199A-3(b)].

For a taxpayer with more than one trade or business (including an aggregated trade or business), net negative QBI from any trade or business must be offset against net positive QBI from other trades or businesses in proportion to the relative amounts of net positive QBI. If a taxpayer's combined QBI from all of its trades or businesses (including aggregated trades or businesses) for the tax year is a negative amount, that amount is carried over and treated as net negative QBI from a separate trade or business in the following tax year. It is used to offset the taxpayer's net positive QBI in that year. It is not used to offset any amount from the second component of the deduction (the qualified REIT dividend/qualified PTP income component) [§199A(c)(2); Reg. §1.199A-1(c)(2)(i), §1.199A-1(d)(2)(iii)].

Trade or Business. The deduction is only available for taxpayers with income from a trade or business (or aggregated trade or business). The final regulations provide that, for this purpose, a trade or business is any trade or business under §162 other than the trade or business of performing services as an employee (see 400.A. for a discussion of trades or businesses under §162). Under an exception to this general rule, rental activity that does not normally rise to the level of a §162 trade or business will be treated as a trade or business for this purpose if the property is rented or licensed to an individual or RPE that is commonly controlled. In addition, the IRS has issued a proposed revenue procedure providing a safe harbor under which individuals and RPEs may treat certain rental real estate enterprises as a trade or business even if they don't otherwise qualify under the general rule or the exception. The IRS ordinarily will not rule on whether a taxpayer or relevant passthrough entity is engaged in a specified service trade or business [§199A(d)(1); Reg. §1.199A-1(b)(14); Notice 2019-7; Rev. Proc. 2021-3].

Aggregation Rules. In some cases, it may be beneficial for taxpayers to aggregate multiple trades or businesses in order to maximize the extent to which W-2 wages and UBIA of qualified property can be taken into account for purposes of the wage-basis limitation. The final regulations allow individuals and RPEs to aggregate trades or businesses if they meet the following requirements: (i) the same person or

group of persons own, directly or indirectly, 50% or more of each trade or business to be aggregated for the majority of the tax year, (ii) all of the items attributable to each trade or business are reported on returns with the same tax year, (iii) none of the trades or businesses are SSTBs, and (iv) the trades or businesses satisfy at least two of three relationship requirements (they provide products, property, or services that are the same or customarily offered together; they share facilities or significant centralized business elements; or they are operated in coordination with, or reliance upon, one or more of the businesses in the aggregated group).

An individual taxpayer may aggregate trades or businesses operated directly (i.e., through sole proprietorships), and may also aggregate trades or businesses operated through an RPE (i.e., through a partnership or S corporation) to the extent the aggregation is not inconsistent with the RPE's aggregation. An RPE may aggregate trades or businesses operated directly, and may also aggregate trades or businesses operated through a lower-tier RPE to the extent the aggregation is not inconsistent with that RPE's aggregation. If an RPE does not aggregate its trades or businesses, an individual owner of the RPE may choose to aggregate the RPE's trades or businesses. If an RPE does aggregate its trades or businesses, an individual owner of the RPE may not subtract from the RPE's aggregation, but may aggregate additional trades or businesses of the RPE. Once an individual or RPE aggregates trades or businesses, it must consistently aggregate those same trades or businesses in later years (although new trades or businesses may be added to an existing aggregation) [Reg. §1.199A-4].

Wage-Basis Limitation. The wage-basis limitation for a trade or business is equal to the greater of: (i) 50% of the W-2 wages paid by the trade or business (or aggregated trade or business), or (ii) 25% of the W-2 wages paid by the trade or business (or aggregated trade or business), plus 2.5% of the UBIA of all qualified property of the trade or business (or aggregated trade or business) [§199A(b)(2)(B); Reg. §1.199A-1(d)(2)(iv)(A)].

W-2 wages generally include the total wages subject to wage withholding, elective deferrals, deferred compensation, and designated Roth contributions. To constitute W-2 wages, such amounts must be properly included in a return filed with the Social Security Administration. The IRS has provided guidance on methods of calculating W-2 wages for this purpose [§199A(b)(4); Reg. §1.199A-2(b); Rev. Proc. 2019-11].

Qualified property is tangible property of a character subject to depreciation that is held by the trade or business (or aggregated trade or business) at the end of the year, used in the production of QBI during the year, and for which the depreciable period has not ended before the end of the year. The unadjusted basis immediately after acquisition (UBIA) of qualified property is the basis of the qualified property on the placed in service date and before certain adjustments, such as adjustments made under §1016 [§199A(b)(6); Reg. §1.199A-2(c)].

As discussed above, for 2020 the wage-basis limitation does not apply for joint filers with taxable income of $326.600 or less and for other taxpayers with taxable income of $163,300 or less. The wage-basis limitation is phased-in for joint filers with taxable income within a phase-in range of $326,600 to $426,600 and for other taxpayers with taxable income within a phase-in range of $163,300 to $213,300. The amount of the phased-in wage-basis limitation is equal to 20% of the taxpayer's QBI minus a "reduction amount." The reduction amount is equal to the "excess amount" (the excess of 20% of QBI over the full amount of the wage-basis limitation) multiplied by the ratio of (i) taxable income in excess of the threshold amount, to (ii) $100,000 for joint filers or $50,000 for other taxpayers [§199A(b)(3);

Reg. §1.199A-1(d)(2)(iv)(B), §1.199A-1(b)(9)]. For taxpayers with taxable income above the phase-in range, the full wage-basis limitation applies.

Example: In 2020, Ted operates a QTB that generates $250,000 of QBI and pays $80,000 of W-2 wages. Ted has $300,000 of taxable income for the year and he files a joint return. Because Ted's taxable income does not exceed the $326,600 threshold amount, the wage-basis limitation does not apply and he can take the full 20% QBI deduction of $50,000 ($250,000 × 20%).

Example: Assume the same facts as in the previous example, except that Ted's taxable income for the year is $430,000. Because Ted's taxable income is more than $426,600, the full wage-basis limitation applies to limit his QBI deduction. Ted's QBI deduction is limited to the wage-basis limitation of $40,000 ($80,000 × 50%).

Example: Assume the same facts as in the previous examples, except that Ted's taxable income for the year is $366,600. Because Ted's taxable income falls within the phase-in range, he must apply a phased-in wage-basis limitation. The phased-in wage basis limitation is equal to 20% of QBI ($250,000 x 20%) minus the reduction amount (($50,000 – $40,000) × (($366,600 – $326,600)/$100,000))). Thus, Ted's phased-in wage-basis limitation is $46,000 ($50,000 – $4,000) and his QBI deduction is limited to that amount.

Specified Service Trade or Business Exclusion. As discussed above, the QBI from a specified service trade or business (SSTB) may be fully or partially excluded from the calculation of the deduction if the taxpayer's taxable income exceeds the threshold amount. An SSTB includes a trade or business that performs services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services. It also includes any trade or business for which the principal asset is the reputation or skill of one or more employees or owners. The final regulations provide that this category of SSTB is generally limited to a trade or business in which employees or owners receive (i) endorsement fees, (ii) appearance fees, or (iii) fees for the use of an individual's name, signature, vice, image, likeness, trademark, or other symbols associated with the individual's identity. Finally, an SSTB includes a trade or business that performs services consisting of (i) investing and investment management, or (ii) trading or dealing in securities, partnership interests, or commodities. The final regulations provide a de minimis rule under which a trade or business is not treated as an SSTB if less than 10% of its gross receipts (5% in the case of a trade or business with gross receipts of more than $25 million) are attributable to the performance of services in one of these fields [§199A(d)(2); Reg. §1.199A-5(b), §1.199A-5(c)].

For 2020, the SSTB exclusion does not apply for joint filers with taxable income of $326,600 or less and other taxpayers with taxable income of $163,300 or less. The SSTB exclusion is phased-in for joint filers with taxable income within a phase-in range of $326,600 to $426,600 and for other taxpayers with taxable income within a phase-in range of $163,300 to $213,300. Such taxpayers can take a partial deduction for their QBI from an SSTB (for taxpayers with taxable income above the phase-in range, no deduction is allowed). The amount of the SSTB's qualified items, W-2 wages, and UBIA of qualified property taken into account as a result of the phase-in of the SSTB exclusion is determined by multiplying those amounts by an "applicable percentage." The applicable percentage is equal to 100% reduced by a percentage equal to the ratio of (i) taxable income in excess of the threshold amount, to (ii) $100,000 for joint filers or $50,000 for other taxpayers. If the SSTB exclusion and the wage-basis

limitation both apply, the phase-in of the SSTB exclusion is determined before the phase-in of the wage-basis limitation [§199A(d)(3); Reg. §1.199A-1(d)(2)(i), §1.199A-1(b)(2)].

Example: In 2020, Ted operates an SSTB that generates $250,000 of QBI and pays $80,000 of W-2 wages. Ted has $300,000 of taxable income for the year and he files a joint return. Because Ted's taxable income does not exceed the $326,600 threshold amount, the SSTB exclusion does not apply (note that the wage-basis limitation also does not apply). Ted can take the full 20% QBI deduction of $50,000 ($250,000 x 20%).

Example: Assume the same facts as in the previous example, except that Ted's taxable income for the year is $430,000. Because Ted's taxable income is more than $426,600, his QBI from the SSTB does not qualify for the QBI deduction.

Example: Assume the same facts as in the previous examples, except that Ted's taxable income for the year is $366,600. Because Ted's taxable income falls within the phase-in range, he is allowed a deduction for a phased-in portion of his QBI from the SSTB, subject to the phase-in of the wage-basis limitation. The phase-in of the SSTB exclusion must be applied before the phase-in of the wage-basis limitation. Thus, Ted must first determine the amount of QBI and W-2 wages taken into account as a result of the phase-in of the SSTB exclusion. Ted's applicable percentage is 60% (100% − (($366,,600 − $326,600)/$100,000)) and, for purposes of determining his QBI deduction, he can take into account QBI of $150,000 ($250,000 60%) and W-2 wages of $48,000 ($80,000 × 60%). Ted must then determine the phased-in wage-basis limitation based on those amounts. The phased-in wage-basis limitation is equal to 20% of QBI ($150,000 × 20%) minus the reduction amount (($30,000 − $24,000) × ($361,400 − $321,400)/$100,000))). Thus, after phase-in of both the SSTB exclusion and the wage-basis limitation, Ted's QBI deduction is limited to $27,600 ($30,000 − $2,400).

Special Rules for Partnerships and S Corporations. Although the QBI deduction is allowed for the QBI of partnerships and S corporations, the deduction is taken at the partner or shareholder level. Each partner or shareholder takes into account its allocable share of QBI, W-2 wages, UBIA of qualified property, qualified REIT dividends, and qualified PTP income. Note that the deduction has no effect on a partner's or shareholder's adjusted basis in its ownership interest or on a shareholder's accumulated adjustment account [§199A(f)(1)(A); Reg. §1.199A-1(e)(1)].

Special reporting rules apply to partnerships and S corporations (i.e., RPEs). RPEs are required to report to each owner on Schedule K-1 the owner's allocable share of QBI, W-2 wages, and UBIA of qualified property for each trade or business the RPE engages in directly, and whether any such trade or business is an SSTB. In addition, the RPE must report to each owner the owner's allocable share of items reported to the RPE by other RPEs in which the RPE has a direct or indirect interest, including not only the items discussed above but also qualified REIT dividends and qualified PTP income [Reg. §1.199A-6(b)]. For 2020, an RPE reports this information to owners in the “Other Information” section of Schedule K-1 (line 20 for Schedule K-1 (Form 1065) and line 17 for Schedule K-1 (Form 1120S)).

Special Rules for Trusts and Estates. Trusts and estates are generally eligible for the QBI deduction. A trust or estate is treated as an RPE to the extent that it allocates QBI and other items to its beneficiaries, and is treated as an individual to the extent it retains such items. For grantor trusts, a person treated as owning all or part of the trust computes the QBI deduction as though that person directly conducted the activities conducted by the trust. For non-grantor trusts and estates, the QBI deduction is computed at

the entity level, and QBI and other items are allocated to each beneficiary and the trust or estate based on the relative proportion of the trust's or estate's distributable net income (DNI) that is distributed (or required to be distributed) to the beneficiary or retained by the trust or estate [Reg. §1.199A-6(d)].

400.A.11. Travel And Transportation Expenses

400.A.11.C. Business And Personal Use Of Automobiles

400.A.11.C.(2) Standard Mileage Rate

Rather than keeping track of actual expenses, a taxpayer may use the standard mileage rate set by the IRS. The standard mileage rate for all miles of business use is 57.5 cents per mile for 2020, and 56 cents per mile in 2021 [Notice 2021-2].

The deduction computed using the standard mileage rate for business miles is in lieu of deducting operating and fixed costs (e.g., depreciation, maintenance and repairs, tires, gas, oil, insurance, and registration fees) of the automobile. Not included in the standard mileage rate, and thus deductible as a separate item, are parking fees, tolls, interest relating to the purchase of the automobile, and state and local taxes to the extent they are allowable deductions [Rev. Proc. 2019-46]. Because depreciation is considered a component of the standard mileage rate, the taxpayer's basis in the automobile must be reduced by the depreciation allowed. The portion of the standard mileage rate treated as depreciation is 27 cents per mile for 2020, and 26 cents per mile for 2021 [Notice 2021-2].

To use the standard mileage rate, the taxpayer must choose to use it in the first year the automobile is placed in service in the taxpayer's business. For later years, the taxpayer may choose to use either the standard mileage rate or actual expenses. However, the standard mileage rate may not be used to compute deductible expenses if the taxpayer [Rev. Proc. 2019-46]:

• uses five or more cars at the same time (e.g., in fleet operations);

• claimed a depreciation deduction for the car using any method other than straight-line;

• claimed a deduction under §179 for the election to expense certain depreciable business assets (see 500.D.);

• claimed the bonus depreciation allowance under §168(k); or

• used the Accelerated Cost Recovery System (ACRS) or the Modified Accelerated Cost Recovery System (MACRS);

• claimed actual car expenses after 1997 for a car the taxpayer leased; or

• is a rural mail carrier who received a qualified reimbursement [§162(o)].

While the business standard mileage rate may be used during the suspension period (see 400.A.11.c.) in computing adjusted gross income under §62, the business standard mileage rate cannot be used to

claim a miscellaneous itemized deduction subject to the two-percent floor under §67 for unreimbursed travel expenses pad or incurred during the suspension period [Rev. Proc. 2019-46].

400.A.11.C.(4) Fixed And Variable Rate (FAVR) Allowances

A fixed and variable rate allowance (FAVR allowance) is a mileage allowance that includes a combination of payments covering (i) periodic fixed payments of projected fixed costs of operating a standard automobile (e.g., depreciation, insurance, property taxes, and registration and license fees), and (ii) periodic variable payments of projected operating costs of using a standard automobile (e.g., gas, oil, tires, and routine maintenance and repairs) [Rev. Proc. 2019-46].

Limitations on Use of FAVR Allowances. The allowance may be paid only for an automobile that meets all of the following requirements [Rev. Proc. 2019-46]:

1. It is owned or leased by the employee receiving the payment.

2. It costs (when new) at least 90% of the standard automobile cost taken into account for purposes of determining the FAVR allowance for the first calendar year the employee receives the allowance for the automobile.

3. Its model year does not differ from the current calendar year by more than the number of years in the retention period.

A FAVR allowance may not be paid for any automobile for which the employee has claimed one of the following:

• depreciation using a method other than straight-line for its estimated useful life;

• bonus depreciation (see 500.C.);

• a §179 deduction (see 500.D.);

• depreciation using the Accelerated Cost Recovery System (ACRS) (see 500.B.5.) or the Modified Accelerated Cost Recovery System (MACRS) (see 500.B.4.); or

• actual automobile expenses for an automobile the taxpayer leased.

The deduction computed using a FAVR allowance is in lieu of deducting operating and fixed costs (e.g., depreciation, maintenance and repairs, tires, gas, oil, insurance, and registration fees) of the automobile. Not included in the FAVR allowance, and thus deductible as a separate item, are parking fees, tolls, and interest payments relating to the purchase of the automobile to the extent otherwise deductible. During the suspension period (see 400.A.11.c.), an employee may not claim a miscellaneous itemized deduction for parking fees and tolls attributable to the employee driving the automobile in performing services as an employee [Rev. Proc. 2019-46].

FAVR Allowance Amounts. For purposes of computing the allowance under a FAVR plan, for passenger automobiles (including trucks and vans) placed in service in 2020 and 2021, the maximum standard automobile cost may not exceed $50,400 and $51,100, respectively [Notice 2021-2].

400.A.12. Meal And Entertainment Expenses

400.A.12.e. Exceptions to The Entertainment Disallowance Rules

Restaurant Food and Beverages for 2021 and 2022. An employer's cost of otherwise deductible food or beverages provided by a restaurant, and paid or incurred before January 1, 2023 is not subject to the 50% limitation [§274(n)(2)(D), Pub. L. No. 116-260, Div. EE, Title II, §210].

Food and Beverages for Employees. An employer's cost of running a company cafeteria or employee dining room on the employer's premises, including the cost of the meals served, is excepted from the entertainment disallowance rules until December 31, 2025, when such expenses become nondeductible. This exception applies even if guests are occasionally served in the cafeteria or dining room. When deductible, food and beverage expenses under this exception are subject to the 50% limit (see 400.A.12.a.) [§274(e)(1), §274(n)(1), §274(o); Reg. §1.274-2(f)(2)(ii), §1.274-12].

Entertainment Expenses Treated as Compensation. An employer who furnishes noncash benefits to an employee generally is not subject to the entertainment disallowance rules to the extent that the employer treats the cost of the benefit as compensation to the employee and withholds taxes accordingly [§274(e)(2); Reg. §1.274-2(f)(2)(iii)]. In the case of certain specified employees (described in §274(e)(2)(B)(ii)), the exception applies only to the extent of the amount of expenses treated as compensation or includible in income. The taxpayer's cost of food and beverages under this rule is not subject to the 50% deduction limitation [§274(n)(2)(A); §1.274-12(c)(2)(i)].

Reimbursed Expenses. An employee or independent contractor who incurs business entertainment costs for which he or she is reimbursed by his or her employer or client is not subject to the entertainment disallowance rules so long as the employer or client is subject to the entertainment disallowance rules. This rule is the corollary to the employer exception for entertainment expenses treated as compensation, and it ensures that the entertainment disallowance rules apply at only one level. The exception applies to an employee if the employer does not treat the entertainment expense as compensation [§274(e)(3); Reg. §1.274-2(f)(2)(iv), §1.274-12(c)(2)(ii)]. The taxpayer's cost of food and beverages under this rule is not subject to the 50% deduction limitation [§274(n)(2)(A)]. However, for practical purposes, this exception is now available only to independent contractors because employees are unable to deduct their employee business expenses (see 400.A.3.) [§67(g)].

Recreational Activities for Employees. The cost to an employer of recreational activities or facilities primarily for the benefit of his or her employees is not subject to the entertainment disallowance rules [§274(e)(4); Reg. §1.274-2(f)(2)(v)]. The exception typically applies to the cost of holiday parties, annual picnics, and company swimming pools, baseball diamonds, bowling alleys, and golf courses. The exception does not apply if the recreational activities are provided in circumstances that discriminate in favor of highly compensated employees (as defined in §414(q)). The taxpayer's cost of food and beverages under this rule is not subject to the 50% deduction limitation [§274(n)(2)(A); §1.274-12(c)(2)(iii)].

Business Meetings. Entertainment costs incurred by a taxpayer that are directly related to business meetings of his or her employees, stockholders, agents, or directors are not subject to the entertainment disallowance rules. The exception does not apply if there are so many distractions that there is little possibility of engaging in the active conduct of business [§274(e)(5); Reg. §1.274-2(f)(2)(vi)]. The taxpayer's cost of food and beverages at these meetings is still subject to the 50% deduction limitation [§274(n)(1); §1.274-12(a)(3), Ex. 4].

Meetings of Business Leagues. Expenses directly related to and necessary for attendance at a business meeting held by one of a variety of business leagues (e.g., chambers of commerce, real estate boards, boards of trade, certain professional associations, and trade associations) are not subject to the entertainment disallowance rules [§274(e)(6); Reg. §1.274-2(f)(2)(vii)]. The taxpayer's cost of food and beverages at these meetings is still subject to the 50% deduction limitation [§274(n)(1)].

Items Available to the Public. The cost to the taxpayer of goods, services, and facilities made available to the general public is not subject to the entertainment disallowance rules. The cost of sponsoring a television or radio entertainment program falls within this exception. Similarly, the cost of maintaining private recreational facilities (e.g., parks and golf courses) falls within this exception to the extent the facility is made available to the general public [§274(e)(7); Reg. §1.274-2(f)(2)(viii)]. The taxpayer's cost of food and beverages under this rule is not subject to the 50% deduction limitation [§274(n)(2)(A); §1.274-12(c)(2)(iv)].

Entertainment Sold to Customers. The taxpayer's expenses for entertainment sold to customers for fair value are not subject to the entertainment disallowance rules. This exception ensures that a taxpayer in the business of selling entertainment can deduct the costs of producing that entertainment [§274(e)(8); Reg. §1.274-2(f)(2)(ix)]. The taxpayer's cost of food and beverages under this rule is not subject to the 50% deduction limitation [§274(n)(2)(A); §1.274-12(c)(2)(v)].

Expenses Includible in the Income of Non-Employees. Business entertainment costs for a non-employee that a taxpayer includes in the recipient's income as compensation or as a prize or award are not subject to the entertainment disallowance rules. The taxpayer must report the expense on an information return for the non-employee [§274(e)(9)]. While the taxpayer who qualifies for this exception is not subject to the entertainment disallowance rule, the non-employee is subject to the entertainment disallowance rule. The taxpayer's cost of food and beverages under this rule is not subject to the 50% deduction limitation [§274(n)(2)(A); §1.274-12(c)(2)(i)(B)].

400.A.13. Interest

All taxpayers generally can deduct business interest expense. However, the deduction for business interest expense is limited to the sum of (i) business interest income, (ii) 50% (for tax years beginning in 2020) or 30% (for tax years beginning in 2021) of adjusted taxable income (ATI), and (iii) floor plan financing interest [§163(j)]. Business interest is any interest paid or accrued on debt properly allocable to a trade or business (it does not include investment interest). Business interest income is the amount of interest includible in the taxpayer's gross income that is properly allocable to a trade or business (it does not include investment income). Adjusted taxable income is “tentative taxable income” (i.e., taxable income computed without regard to the §163(j) limitation and without regard to any disallowed business interest expense carryforwards) computed without regard to (i) any item of income, gain, deduction, or loss not properly allocable to a trade or business, (ii) any business interest expense (other

than disallowed business interest expense carryforwards) or business interest income that was included in the computation of the taxpayer's tentative taxable income, (iii) the amount of any net operating loss, (iv) the amount of the §199A deduction, (v) any depreciation (including bonus depreciation), amortization, or depletion (including any depreciation, amortization, or depletion that is capitalized into inventory under §263A); (vi) any deduction for a capital loss carryback or carryover; (vii) any floor plan financing interest expense for the tax year that was included in the computation of the taxpayer's tentative taxable income; (viii) the sum of any Subpart F, GILTI and §78 income inclusions that were included in the computation of tentative taxable income, reduced by the portion of the deduction for GILTI and FDII allowed under §250(a) by reason of these inclusions. Floor plan financing interest is interest paid or accrued on debt used to finance the acquisition of motor vehicles held for sale or lease to retail customers and secured by the inventory so acquired. For purposes of these rules, a trade or business does not include (i) the trade or business of performing services as an employee, (ii) certain regulated utilities, (iii) a real property trade or business that elects out ("electing real property trade or business"), and (iv) a farming business that elects out ("electing farming business").

The §163(j) limitation effectively operates to limit the deduction for net business interest expense (less any floor plan financing interest) to 50% of ATI (for tax years beginning in 2020) or 30% of ATI (for tax years beginning in 2021). The limitation generally applies to the business interest of all taxpayers. However, the limitation does not apply to taxpayers with average annual gross receipts of $26 million (inflation-adjusted amount for 2020 and 2021) or less for the three preceding tax years [Rev. Proc. 2019-44, Rev. Proc. 2020-45]. Generally, all interest paid or received by a C corporation will be treated as business interest expense or business interest income, solely for purposes of computing the business interest expense limitation [Reg. §1.163(j)-4(b)(1)]. Moreover, the investment interest expense of a partnership that is allocated to a C corporation partner generally will be treated as business interest expense, solely for purposes of computing the business interest expense limitation. [Reg. §1.163(j)-4(b)(3)(i)]. Taxpayers compute the business interest limitation on Form 8990, Limitation on Business Interest Expense Under Section 163(j). The amount of business interest not allowed as a deduction for any tax year can be carried forward indefinitely for use in later tax years. Taxpayers with interest that was disallowed under pre-2018 §163(j) for their last tax year beginning before 2018 generally may carry forward such interest as business interest under current §163(j) for their first tax year beginning after 2017.

Note: For tax years beginning in 2019 and 2020 (2020 only for partnerships), the deduction for business interest expense is limited to the sum of (i) business interest income, (ii) 50% of ATI, and (iii) floor plan financing interest expense. Taxpayers may elect not to use the increased limitation and may elect to substitute 2019 ATI for 2020 ATI. Special rules apply for short tax years. In the case of partnerships, the increase to the ATI portion of the limitation applies only to tax years beginning in 2020. Any election not to use the increased limitation must be made at the partnership level. Like other taxpayers, partnerships may elect to substitute 2019 ATI for 2020 ATI. A special rule allows partners to treat 50% of any excess business interest expense allocated to the partner in a tax year beginning in 2019 as paid or accrued in the partner's first tax year beginning in 2020, with the remaining 50% subject to the §163(j)(4)(B)(ii) limitation based on allocated excess taxable income (or allocated excess business interest income) under Reg. §1.163(j)-6(g)(2)(i). Partners may elect out of this provision [§163(j)(10); Reg. § 1.163(j)-2(b); Rev. Proc. 2020-22].

I**nterest Payment Resulting in Forgiveness of a Paycheck Protection Loan.** A deduction is allowed for mortgage interest paid on a covered mortgage obligation under §1106(a)(2) of the CARES Act even if

payment of the mortgage interest results in forgiveness of a covered loan under the Paycheck Protection Program (PPP loan) and the income associated with the loan forgiveness is excluded from gross income [Rev. Rul. 2021-2].

400.A.16. Corporate Charitable Contributions

400.A.16.b. Percentage Limitations on Corporate Charitable Contributions

Except for certain donations by corporate farmers or ranchers and qualified hurricane and California wildfire contributions, a single percentage limitation applies to all gifts by corporations. The charitable contributions deduction for any tax year is limited to 10% of the corporation's taxable income [§170(b)(2)(A)]. For this purpose, taxable income is computed without regard to the following items [§170(b)(2)(D)]:

• the charitable contributions deduction;

• the dividends received deduction (see 1300.C.2.b.) and certain other deductions allowable only to corporations;

• any net operating loss carryback to the tax year (see 800.G.3.);

• the deduction for income attributable to domestic production activities of specified agricultural or horticultural cooperatives (see 400.A.10.); and

• any capital loss carryback to the tax year (see 300.B.5.).

Qualified conservation contributions by certain corporate farmers and ranchers are not subject to the general 10% limit but, instead, are allowed to the extent that the aggregate of such contributions does not exceed the corporation's taxable income over the charitable contributions otherwise allowed. The property must be used in (or be available for) agriculture or livestock production and must be subject to a restriction requiring that the property remain available for such production [§170(b)(2)(B)]. Contributions by certain Alaska Native Corporations relating to land conveyed under the Alaska Native Claims Settlement Act may qualify for the exception [§170(b)(2)(C)].

2020-2021 Modification under the CARES Act. Any “qualified contribution” is allowed as a deduction only to the extent that the aggregate of such contributions does not exceed the excess of 25% of the taxpayer's taxable income over the amount of all other charitable contributions allowed. A “qualified contribution” is defined as one that: (i) is paid in cash during calendar year 2020 or 2021 to an organization described in §170(b)(1)(A), and (ii) the taxpayer makes an election to apply the provision. In the case of an S corporation, the respective election must be made separately by each shareholder [Pub. L. No. 116-136, §2205; Pub. L. No. 116-260, Div. EE, Title II, §213].

Carryover of Excess Contributions. Charitable contributions that exceed the 10% (or 25% for qualified 2020 or 2021 contributions as stated above) limitation may be carried over to the succeeding five tax years (in order). Contributions actually made during any tax year are deductible before any carryovers to that year may be deducted, and carryovers from the earliest year are deducted first among carryover

amounts [§170(d)(2)(A); Pub. L. No. 116-136, §2205(a)(2)(B)(iii)]. The carryforward period is 15 years for qualified conservation contributions [§170(b)(2)(B)(ii) Pub. L. No. 116-260, Div. EE, Title II, §213].

An excess contribution is deductible in a carryover year to the extent of the lesser of [§170(d)(2)(A)]:

• the excess of the maximum amount deductible for the tax year under the 10% limitation over the sum of (i) contributions made during the year, and (ii) excess contributions made in tax years before the contribution year but that are deducible as carryovers for the year; or

• the portion of the excess not already deductible for a previous carryover year.

Carryovers of excess contributions may not be deducted to the extent it increases a net operating loss carryover [§170(d)(2)(B)].

400.D. Limitations on Trade or Business Deductions

400.D.2. Nondeductible Fines and Penalties

Taxpayers may not deduct fines, penalties, or any other amounts paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of a government or governmental entity for (i) the violation of any law, or (ii) the investigation or inquiry by the government or governmental entity into the potential violation of any law [§162(f)(1); Reg. §1.162-21(a)]. For this purpose, a "governmental entity" is defined to include nongovernmental entities that exercise certain self-regulatory powers [§162(f)(5); Reg. §1.162-21(e)]. Under an exception to the general rule of nondeductibility, a taxpayer may be able to deduct (i) an amount that constitutes restitution for damage or harm that was caused by the violation of a law or the potential violation of a law, or (ii) an amount paid to come into **compliance** with a law that was violated or a law that was potentially violated and is the subject of an investigation or inquiry [§162(f)(2)(A)(i); Reg. §1.162-21(b)(1)]. However, such a deduction may be taken only if the amount is identified in the court order or settlement as restitution or as an amount paid to come into compliance with such law [§162(f)(2)(A)(ii); Reg. §1.162-21(b)(2)]. If restitution is paid for the failure to pay a tax, a deduction is allowed only if such tax would have been deductible if timely paid [§162(f)(2)(A)(iii); Reg. §1.162-21(c)(2)]. Though, if penalties are imposed relating to such taxes, a deduction for such penalties and interest payments related to such penalties is disallowed [Reg. §1.162-21(c)(2)]. There are two other exceptions under which a deduction may also be allowed: (i) a deduction may be allowed for an amount paid or incurred by reason of any court order in a suit to which no government or governmental entity is a party, and (ii) a deduction may be allowed for any amount paid or incurred as taxes due [§162(f)(3), §162(f)(4); Reg. §1.162-21(c)(1), §1.162-21(c)(3)].

400.F. Exceptions To Capitalization

400.F.5. Other Exceptions to Capitalization

400.F.5.A. Energy-Efficient Commercial Buildings

Taxpayers may deduct a portion of the cost of energy efficient commercial building property. The deduction is limited to the square footage dollar amount (the square footage of the building multiplied

by $1.80, adjusted for inflation), minus the aggregate amount of §179D deductions allowed for the building for all prior tax years [§179D, Pub. L. No. 116-260, Div. EE, Title I, §102].

400.F.5.F. Certain Qualified Film, Television, and Theatrical Productions

Taxpayers generally can elect to deduct the cost of a qualified film or television productions and the cost of a qualified live theatrical productions. However, the election to take this deduction expires for productions commencing after 2025 [§181(g), Pub. L. No. 116-260, Div. EE, Title I, §116].

Film and Television Productions A taxpayer can elect to deduct the cost of any qualified film or television production, limited to $15 million per production ($20 million for productions in certain communities) [§181(a)]. A qualified production must be a motion picture film or video tape; however, the production must not be a sexually explicit production for which records must be maintained under 18 U.S.C. §2257. Seventy-five percent of the total compensation of the production must be qualified compensation. Any production that is part of a television series must be one of the first 44 episodes of the series; however, each episode is treated as a separate production for purposes of the $15 million production cost dollar limitation and the 75% compensation rule [§181(d)].

Theatrical Productions A taxpayer can elect to deduct the cost of any qualified live theatrical production, limited to $15 million per production ($20 million for productions in certain communities) [§181(a)]. A qualified live theatrical production is a live staged production of a play (with or without music) derived from a written book or script; however, the production must not be a sexually explicit production under 18 U.S.C. §2257(h)(1). Seventy-five percent of the total compensation of the production must be qualified compensation. The production must be produced or presented by a commercial entity in any venue subject to audience limitations. Each production in a group of multiple productions (e.g., a series of tours) is treated as a separate production [§181(e)].

For property acquired and placed in service after September 27, 2017, and before January 1, 2027, qualified film or television productions and qualified live theatrical productions are eligible for bonus depreciation [§168(k)(2)] (see 500.C.1.).

Chapter 500. Capitalization, Depreciation, And Amortization

500.A. Capital Expenditures

500.A.1. Tangible Property Costs Subject To Capitalization

500.A.1.A. Expenditures For The Acquisition Or Production Of Tangible Property

Taxpayers generally must capitalize amounts paid to acquire or produce a unit of real or personal property, including leasehold improvements, land and land improvements, buildings, machinery and equipment, and furniture and fixtures. Such amounts include the invoice price, transaction costs, and costs for work performed before the date the property is placed in service. In addition, taxpayers must capitalize amounts paid to acquire real or personal property for resale, as well as amounts paid to defend or perfect title to property [Reg. §1.263(a)-2(d)(1), §1.263(a)-2(e)(1)]. There are exceptions to the capitalization rules for materials and supplies, routine maintenance, certain small taxpayers, and de minimis expenditures (see 400.A.7.).

The uniform capitalization rules apply to property produced by the taxpayer or acquired by the taxpayer for resale [§263A] (see 1100.D.). In tax years 2020 and 2021, if a taxpayer (other than a tax shelter) has average annual gross receipts for the prior three tax years of $26 million or less, the taxpayer is exempt from the UNICAP rules, regardless of entity structure or industry [§263A(i), §448(c); Reg. §1.263A-1(j); Rev. Proc. 2019-44, Rev. Proc. 2020-45].

Facilitative Costs. Except as provided by the de minimis safe harbor, taxpayers must capitalize amounts paid to facilitate the acquisition of real or personal property. For this purpose, facilitative amounts include amounts paid for [Reg. §1.263(a)-2(f)]:

• transporting the property (for example, shipping fees and moving costs);

• securing an appraisal or determining the value or price of property;

• negotiating the terms or structure of the acquisition and obtaining tax advice on the acquisition;

• application fees, bidding costs, or similar expenses;

• preparation and review of documents effectuating the property's acquisition;

• examining and evaluating the property's title;

• conveying property between parties (including sales and transfer taxes, and title registration costs);

• finders' fees or brokers' commissions (including contingency fees);

• architectural, geological, survey, engineering, environmental, or inspection services pertaining to particular properties; and

• services provided by a qualified intermediary or other facilitator of a like-kind exchange (see 300.E.1.).

Employee compensation and overhead are not treated as costs facilitating the acquisition of real or personal property. Taxpayers, though, may elect to treat such amounts as facilitative costs, and thus may capitalize them. Additionally, amounts paid in the process of investigating or otherwise pursuing the acquisition of real property is not a facilitative cost if it relates to activities performed in the process of determining whether to acquire real property and which real property to acquire [Reg. §1.263(a)-2(f)(2)(iii), §1.263(a)-2(f)(2)(iv)].

Business Acquisitions. A taxpayer must capitalize an amount paid to facilitate each of the following transactions, without regard to whether the transaction consists of a single step or a series of steps carried out as part of a single plan and without regard to whether gain or loss is recognized in the transaction [Reg. §1.263(a)-5(a)]:

• an acquisition of assets that constitute a trade or business (whether the taxpayer is the acquirer in the acquisition or the target of the acquisition);

• an acquisition of an ownership interest in a business entity if, immediately after the acquisition, the taxpayer and the business entity are related (within the meaning of §267(b) or §707(b));

• an acquisition of an ownership interest in the taxpayer (other than an acquisition by the taxpayer of an ownership interest in the taxpayer, whether by redemption or otherwise);

• a restructuring, recapitalization, or reorganization of the capital structure of a business entity (including reorganizations described in §368 and distributions of stock by the taxpayer as described in §355);

• a transfer described in §351 or §721 (whether the taxpayer is the transferor or transferee);

• a formation or organization of a disregarded entity;

• an acquisition of capital;

• a stock issuance;

• a borrowing; and

• writing an option.

Chapter 700. Nonbusiness Deductions

700.B. Above-The-Line Deductions

700.B.1. Classroom Expenses of Teachers

Certain teachers and educators can take an above-the-line deduction for up to $250 of expenses paid in connection with books, supplies, computer equipment, other equipment, personal protective equipment, disinfectant, and other supplies used for the prevention of the spread of COVID-19, and supplementary materials used in the classroom and for relevant professional development courses on Schedule 1 (Form 1040 or Form 1040-SR) [§62(a)(2)(D); Pub. L. No. 116-260, Div. N, Title II, Subtitle B, §275, effective for supplies paid for or incurred after March 20, 2020; Rev. Proc. 2021-15]. Taxpayers eligible for this deduction include teachers, instructors, counselors, principals, and aides in a school providing elementary or secondary education (kindergarten through grade 12) who work at such a school for at least 900 hours during a school year [§62(d)(1); Rev. Proc. 2019-44, Rev. Proc. 2020-45].

700.B.6. Moving Expenses

Active duty members of the U.S. Armed Forces who move pursuant to a military order and incident to a permanent change of station may deduct their moving expenses. If such a taxpayer's spouse and/or dependents are moved to or from different locations than the taxpayer, those moves can be treated as part of the taxpayer's move [§62(a)(15), §217(g)]. The deduction for moving expenses is computed and reported on Form 3903, Moving Expenses and on Schedule 1 (Form 1040 or Form 1040-SR).

Other taxpayers may not deduct moving expenses during tax years beginning in 2018 through 2025 [§217(k)].

The following two types of moving expenses are deductible by active duty members of the U.S. Armed Forces [§217(b)]:

1. the reasonable expenses of moving household goods and personal effects from the old home to the new home; and

2. the reasonable expenses of traveling from the old home to the new home (including lodging costs, but not meals or sightseeing costs).

An active duty U.S. Armed Forces member who uses his or her own automobile to travel from the old home to the new home may elect either of two methods to calculate the transportation costs. The taxpayer may deduct actual out-of-pocket costs, including oil and gas, but not depreciation, insurance, or repair and maintenance. Alternatively, the taxpayer may deduct a standard mileage rate of 16 cents per mile for 2021. Parking fees and tolls can also be deducted under either method [Notice 2021-2].

In the case of a foreign move, deductible moving expenses also include [§217(h)]:

1. the reasonable expenses of moving household goods and personal effects to and from storage; and

2. the reasonable expenses of storing household goods and personal effects during the period in which the new workplace continues to be the taxpayer's principal place of work.

Note that active duty members of the U.S. Armed Forces are not subject to the time and distance requirements that most taxpayers previously had to meet to qualify for the moving expense deduction.

700.B.13. Student Loan Interest

700.B.13.C. Determining Amount Of Deduction

The amount of the student loan interest deduction is subject to a maximum dollar limitation and a modified adjusted gross income (MAGI) limitation. The maximum deduction that can be taken for any tax year is $2,500 [§221(b)(1)]. Thus, a taxpayer's deduction is generally equal to the smaller of the amount of interest he or she paid on qualified student loans during the year or $2,500.

However, a taxpayer's deduction is phased out if his or her MAGI is between $70,000 and $85,000 ($140,000 and $170,000 if married filing jointly) [§221(b)(2); Rev. Proc. 2019-44, Rev. Proc. 2020-45]. Thus, for 2020, a taxpayer cannot take any deduction if his or her MAGI is $85,000 or more ($170,000 or more if married filing jointly).

For most taxpayers, MAGI is the taxpayer's adjusted gross income computed without taking into account the student loan interest deduction and the tuition and fees deduction (see 700.B.13.). Taxpayers also do not take the following into account in computing MAGI, if applicable: (i) the 2020 unemployment compensation income exclusion (see 200.N.16); (ii) the foreign earned income exclusion

(see 2000.C.1.a.), (iii) the foreign housing exclusion or deduction (see 2000.C.1.c.), and (iv) the exclusions of income for bona fide residents of American Samoa or Puerto Rico [§221(b)(2)(C)].

Taxpayers who took out Federal student loans that are discharged under settlement discharge actions, the Department of Education's Closed School discharge process, or the Defense to Repayment discharge process and who claimed a deduction for student loan interest attributable to interest paid on the discharged loan in a prior year do not have to recognize gross income under the tax benefit rule (see 100.B.6.) [Rev. Proc. 2015-57; Rev. Proc. 2017-24; Rev. Proc. 2018-39; Rev. Proc. 2020-11].

Most taxpayers can compute their student loan interest deduction using the Student Loan Interest Deduction Worksheet (Source: Form 1040 Draft Instructions).

700.D. Medical Expenses

Taxpayers are allowed a deduction for unreimbursed medical expenses paid during the tax year to the extent that such expenses exceed 7.5% of their adjusted gross income (AGI) [§213(a)]. The deduction for medical expenses cannot be claimed unless a taxpayer itemizes deductions.

Example: Dan pays medical expenses of $5,750 for himself during 2020. Dan's AGI for the year is $50,000 and he itemizes his deductions. Dan can deduct the amount by which his medical expenses exceed 7.5% of his AGI ($50,000 × 7.5% = $3,750). Thus, Dan can deduct $2,000 ($5,750 − $3,750) of his medical expenses for the year.

700.D.1. What Medical Expenses Are Deductible?

700.D.1.a. Medical Expenses Related to Disease and Treatments Affecting The Body

Deductible medical expenses include the costs of diagnosis, cure, mitigation, treatment, or prevention of disease. Deductible medical expenses also include the costs of treatments affecting any part or function of the body [§213(d)(1)(A)]. More specifically, deductible medical expenses include, but are not limited to, the costs of [Reg. §1.213-1(e)(1), §1.213-1(e)(2)]:

- medical doctors, osteopathic doctors, podiatrists, eye doctors, dentists, acupuncturists, chiropractors, physical therapists, occupational therapists, psychiatrists, psychoanalysts, and psychologists;

- medical examinations;

- X-rays;

- laboratory services;

- diagnostic tests (e.g., a full-body scan, a pregnancy test, or a blood sugar test kit);

- clinic costs;

- nursing care (however, no deduction is allowed for nursing care for a healthy baby);

• hospital care, including meals and lodging;

• lodging expenses (limited to $50 per night) while away from home to receive outpatient medical care in a hospital or medical facility related to a hospital (however, no deduction is allowed if a significant element of the travel is personal pleasure, recreation, or vacation) [§213(d)(2)];

• prescription medicines and insulin (however, no deduction is allowed for nonprescription medicines and imported drugs not approved by the FDA) [§213(b)];

• medical aids such as eyeglasses, contact lenses, hearing aids, braces, crutches, wheelchairs, and guide dogs (including the cost of maintaining them);

• capital expenditures for special medical equipment or to accommodate a home for a disabled taxpayer;

• surgery to improve defective vision, such as laser surgery and radial keratotomy;

• a program to stop smoking and prescription medicines to alleviate nicotine withdrawal;

• a weight loss program as treatment for a specific disease diagnosed by a doctor, including obesity;

• medical treatment at a center for drug or alcohol addiction;

• special education for mentally or physically disabled persons; and

• amounts paid for personal protective equipment (PPE), such as masks, hand sanitizer and sanitizing wipes, for the primary purpose of preventing the spread of COVID-19 [Announcement 2021-7].

These types of expenses are deductible only if they are paid primarily to alleviate or prevent a physical or mental defect or illness. Expenses that are merely beneficial to general health are not deductible. Thus, for example, the cost of a vacation recommended by a doctor is not deductible. Examples of other expenses that are not deductible as medical expenses include the costs of vitamins, diet food, illegal drugs, illegal operations, and cosmetic surgery (unless necessary to improve a deformity from a congenital abnormality, an injury, or a disfiguring disease) [§213(d)(9); Reg. §1.213-1(e)(2)].

700.G. Charitable Contributions

Individual taxpayers who itemize their deductions generally can take a deduction for charitable contributions made during the tax year. A charitable contribution is a donation or gift to, or for the use of, a qualified charitable organization [§170(c)]. A contribution is "for the use of" a qualified charitable organization when it is held for the organization in a legally enforceable trust or under a similar arrangement. For a discussion of the definition of a qualified charitable organization, see 700.G.1.

A charitable contribution generally may be made in the form of money or property. For special rules that apply to contributions of property, see 700.G.2. For other special charitable contribution rules, see 700.G.3. For limitations on the amount of the charitable contributions that can be deducted by a taxpayer, see 700.G.4. For the rules on when charitable contributions can be deducted, see 700.G.5. For

the recordkeeping requirements that must be met by taxpayers making charitable contributions, see 700.G.6.

For tax years beginning in 2020 and 2021, taxpayers who do not itemize deductions are entitled to deduct up to $300 in charitable contributions made in cash in computing adjusted gross income [§170(p) (applicable for 2021), former §62(a)(22) (applicable for 2020; struck for tax years beginning after December 31, 2020), former §62(f) (struck for tax years beginning after December 31, 2020)]. According to the IRS, the $300 limit applies to a joint return filed by a married couple [2020 Form 1040 and Form 1040-SR Draft Instructions].

Chapter 800. Losses and Limitations on Losses and Deductions

800.A. Section 165 Losses

800.A.5. Farming Losses

Losses incurred from the operation of a farm as a trade or business are deductible (see 400.F.3. for a discussion of farming expense deductions). However, losses arising from the operation of a farm for pleasure or recreation are not deductible [Reg. §1.165-6(a)(1), §1.165-6(a)(3)].

Loss of Livestock or Crops. If livestock used in the trade or business of farming die as a result of disease, exposure, or injury, the loss is deductible. Additionally, the loss is deductible if livestock purchased and used in a farming trade or business are destroyed by federal, state, or other governmental order. However, the death of livestock raised for sale does not qualify for the loss deduction [Reg. §1.165-6(d), §1.165-6(e)]. The cost of feed, pasture, and care of livestock is not considered part of the cost of the livestock in determining the amount of a loss; however these expenses may qualify for deduction as a trade or business expense [Reg. §1.165-6(f)(1), §1.162-12].

Generally, if a prospective crop being grown in a farming business is totally destroyed by frost, storm, flood, or fire, no loss deduction is allowed [Reg. §1.165-6(c)].

Limitation on Excess Farm Losses. For tax years beginning in 2017 and earlier, taxpayers (other than C corporations) receiving an applicable subsidy for any tax year could not deduct excess farm losses for that year. [§461(j)] For a discussion of this limitation, see prior editions of the Bloomberg Tax Federal Tax Guide. For tax years beginning in 2018 through 2026, the limitation on excess farm losses is suspended. [§461(l)(1)(A)] Instead, the limitation on excess business losses (see 800.J.) can apply to farm losses of noncorporate taxpayers in tax years beginning in **2021 through 2026**. [§461(l)(1)(A)]

Both limitations (excess farm losses and excess business losses) are applied at the partner or shareholder level. [§461(j)(5), §461(l)(4)]

800.B. Bad Debt Deductions

800.B.1. Business Bad Debts

Bona fide business bad debts are deductible as ordinary losses in the tax year the debt became partly or totally worthless. A business bad debt is a loss from the worthlessness of a debt that was either (i)

created or acquired in the taxpayer's trade or business, or (ii) closely related to the taxpayer's trade or business when it became partly or totally worthless. Debts are closely related to a trade or business if the taxpayer's primary motive for incurring the debt is business related. All corporate loans are treated as business debts, regardless of the context [§166].

A taxpayer may claim a business bad debt only if he or she previously included the amount owed in gross income. Thus, a taxpayer using the accrual method of accounting (see 1100.B.1.d.) can only claim a bad debt deduction for an uncollectible receivable if the taxpayer previously included the uncollectible amount in income. Cash method taxpayers, on the other hand, cannot claim a bad debt deduction for amounts owed because the taxpayer never included those amounts in income [Reg. §1.166-1(c), §1.166-1(e)].

Common types of business bad debts include loans to clients and suppliers, debts of an insolvent partner paid by the taxpayer, and certain business loans that the taxpayer guarantees. However, no deduction is allowed for the bad debts of political organizations, except by banks and certain suppliers of goods and services [§271(a), §271(c)].

Example: Tiffany owns a dress company. Motivated by the desire to retain one of her largest clients and keep a sales outlet, Tiffany guarantees the payment of a $20,000 note for her client, Dress Outlet. Dress Outlet later defaults on the loan and Tiffany pays the remaining $10,000 balance of the loan in full to the bank. Tiffany can claim a $10,000 business bad debt deduction because her guarantee was made in the course of her trade or business and for a good faith purpose.

Individuals claim the business bad debt deduction on Schedule C (Form 1040 or Form 1040-SR). Farmers claim the deduction on Schedule F (Form 1040 or Form 1040-SR). Corporations, S corporations, and partnerships report the deduction on their respective income tax return forms.

Bona Fide Debt. A debt is bona fide if all of the following conditions are satisfied [Reg. §1.166-1(c)]:

- the obligation arose from a true debtor-creditor relationship;

- the debtor-creditor relationship is based on a valid and enforceable obligation to pay a fixed or determinable amount of money;

- the lender has an intention to seek repayment; and

- repayment is not contingent on an event that has not occurred.

Loans to family members and loans by shareholders to corporations are likely to receive extra scrutiny and may be considered gifts and capital contributions, respectively.

Worthlessness. Whether a debt is worthless is determined based on the facts and circumstances. Generally, a debt becomes worthless when there is no longer any chance the amount owed will be paid. The taxpayer must show that he or she has taken reasonable steps to collect the debt, but was unable to do so. A judgment from a court is not necessary if the taxpayer can show a judgment would be uncollectible [Reg. §1.166-2]. The following factors may be indicative of worthlessness:

• the insolvency or bankruptcy of the debtor;

• the debtor's lack of assets;

• the termination of the debtor's business;

• the death of a key employee of the debtor if no one else is capable of sustaining the business;

• the disappearance or incarceration of the debtor; and

• certain international political crises (e.g., where a debtor's assets are frozen by the U.S. government).

Not enforcing payment on a debt does not establish that the debt is worthless. The debtor may waive or fail to assert the protection of the statute of limitations, in which case the debt remains enforceable. Additionally, voluntary cancellation of a debt does not establish worthlessness, and the cancellation of a debt established to be worthless does not preclude a deduction. A taxpayer who compromises a debt by accepting less than the full amount because the debtor is unable to pay more is entitled to a worthless debt deduction for the unrecovered balance.

Securities that become worthless during a tax year are treated as having been sold on the last day of that tax year, resulting in a loss, rather than being treated as a bad debt. Worthless securities are discussed in 800.A.3.

Partial Worthlessness. Business debts may be deducted when partially worthless. If the taxpayer demonstrates that it can recover only part of a business debt, the taxpayer may deduct the worthless portion as long as it is “charged off” [§166(a)(2); Reg. §1.166-3(a)(2)]. A deduction for a partially worthless debt may be claimed either in the year that part of the debt becomes worthless, or in any subsequent year before the time the debt becomes wholly worthless. Thus, the taxpayer has the following options when a business debt becomes partially worthless:

• charge off and deduct the worthless portion in the current year;

• charge off and deduct the worthless portion in a subsequent year (but not later than the year the debt becomes wholly worthless);

• spread the charge-off and deduction of the worthless portion over more than one year; or

• deduct the entire amount in the year the debt becomes wholly worthless.

Charge-Off Requirement. Most taxpayers must use the specific charge-off method. To satisfy the charge-off requirement, the taxpayer must take some action (normally a bookkeeping entry) that clearly establishes that a specific portion of the debt has become worthless and will no longer be treated as an asset [Reg. §1.166-3(a)(2)]. When there has been a significant modification (within the meaning of Reg. §1.1001-3) of a partially worthless debt instrument (see 300.B.2.a.), the taxpayer may deduct an amount on account of the partially worthless debt even though no amount has been charged off within the tax year. This rule only applies if the modification would result in recognition of gain and if the debt was charged off and deducted in a previous tax year in accordance with the charge-off rules. If these

conditions are satisfied, a modified debt is deemed charged off (in an amount limited to the difference between the tax basis of the debt and the greater of either the book basis or the fair market value of the debt) in the year in which gain is recognized [Reg. §1.166-3(a)(3)].

Nonaccrual Experience Method. Certain accrual method taxpayers may use the nonaccrual experience method for bad debts instead of the specific charge-off method. To be eligible to use the nonaccrual experience method for accounts receivable for services performed, either (i) the services the taxpayer provides must be in the fields of accounting, actuarial science, architecture, consulting, engineering, health, law, or the performing arts, or (ii) the taxpayer's average annual gross receipts for any consecutive three-year period cannot exceed $26 million (for 2020 and 2021) [§448(d)(5), §448(c); Rev. Proc. 2019-44, Rev. Proc. 2020-45].

Under the nonaccrual experience method, a taxpayer does not accrue services-related income he or she expects to be uncollectible. Because the expected uncollectible amounts are not included in income, these amounts are not later deducted from income [§448(d)(5)].

Recovery of a Bad Debt. A taxpayer that claims a deduction for a bad debt on its tax return and later recovers all or a part of it must include the recovery in income. The amount included is limited to the amount that the deduction in the prior year reduced the amount of tax [§111(a); Reg. §1.111-1]. The tax benefit rule and the recovery of amounts previously deducted are discussed in 100.B.6.

Coordination with Loss Rules. A transaction coming within the literal language of both the loss provisions (see 800.A.) and the bad debt provisions must be treated as a bad debt [Spring City Foundry Co. v. Commissioner, 292 U.S. 182 (1934)].

If mortgaged or pledged property is lawfully sold (whether to the creditor or another purchaser) for less than the amount of the debt, and the portion of the indebtedness remaining unsatisfied after the sale is wholly or partially uncollectible, the mortgagee or pledgee may claim a bad debt deduction for the tax year in which it becomes wholly worthless or is charged off as partially worthless [Reg. §1.166-6].

800.C. Transactions Between Related Taxpayers

800.C.3. Special Loss and Deduction Limitation Rules Applicable to Related Parties

Partners and Partnerships. A transaction between a partnership and a partner is treated as a transaction between the partnership and a non-partner if the partner engages in the transaction in a capacity other than as a partner. Common examples include loans from a partner to the partnership, leases of property by a partner to the partnership, or sales of property between the partnership and its partners [§707].

No deduction is allowed for losses from the direct or indirect sale or exchange of property (other than the sale or exchange of an interest in the partnership) between (i) a partnership and a person directly or indirectly owning more than 50% of the capital interest or profits interest in the partnership, or (ii) two partnerships in which the same person directly or indirectly owns more than 50% of the capital interests or profits interests. If the property is later sold or exchanged, the rules applicable to the subsequent sale of property previously subject to the general loss disallowance rule apply (see 800.C.1.) [§707(b)(1)]. Transactions between partnerships and partners are discussed in 1400.D.3.

Business Interest. Interest deductions for business interest expense incurred by a business are limited to the sum of: (i) business interest income, plus (ii) 50% of adjusted taxable income (for tax years beginning in 2020) or 30% of adjusted taxable income (for tax years beginning in 2021), plus (iii) floor plan financing interest. The business interest deduction limitation applies regardless of whether the debt is between related parties, regardless of whether the debt is incurred by a sole proprietor, a corporation, a pass-through entity, or an entity subject to tax under §511, and regardless of whether the taxpayer is thinly capitalized. The limitation does not apply to businesses with average annual gross receipts of $26 million or less or to certain regulated utilities. Additionally, real property trades and businesses and farming businesses that use the alternative depreciation system (ADS) (see 500.B.4.g.) may elect not to be subject to the business interest deduction limit provision. A taxpayer may elect to use the taxpayer's ATI for its last tax year beginning in 2019 (2019 ATI) as the ATI for any tax year beginning in 2020. All interest either paid or received by a C corporation is considered business interest. Amounts carried forward under pre-2018 §163(j) are included as disallowed business interest expense carryforwards of a taxpayer to the extent the interest is properly allocable to a non-excepted trade or business [§163(j), §448(c); Reg. §1.163(j)-2(b)(1), Reg. §1.163(j)-2(b)(2), Reg. §1.163(j)-2(b)(3), §1.163(j)-4(b)(1), §1.163(j)-9, §1.163(j)-11(c)(1); Rev. Proc. 2019-44, Rev. Proc. 2020-45].

Note: For tax years beginning in 2019 and 2020 (2020 only for partnerships), the deduction for business interest expense is limited to the sum of (i) business interest income, (ii) 50% of ATI, and (iii) floor plan financing interest expense. Taxpayers may elect not to use the increased limitation for 2019 and 2020 and may also elect to substitute 2019 taxable income for 2020 income in computing the limitation. If so, special rules apply to short tax years [§163(j)(10); Reg. §1.163(j)-2(b)(1), Reg. §1.163(j)-2(b)(2)].

<u>Deductibility of interest as a business expense is discussed in 400.A.13. Deductibility of investment interest as an expense for the production of income is discussed in 400.B.</u>

Like-Kind Exchanges of Real Property. Like-kind exchanges of real property between related parties receives non-recognition treatment. However, if the taxpayer or the related party disposes of the property received in the exchange within two years of the last transfer, both the taxpayer and the related party must recognize gain or loss on the exchanged property [§1031(f)(1)]. For purposes of this rule, a related person is any person related to the taxpayer within the meaning of the general loss disallowance rule (see 800.C.1.) or the §707(b)(1) rule disallowing losses from the sale or exchange of property between partners and certain controlled partnerships [§1031(f)(3)]. Like-kind exchanges of real property are discussed in 300.E.1.

800.J. Excess Business Losses

For tax years beginning in 2021 through <u>2026</u>, the excess business loss of a taxpayer other than a C corporation is disallowed and any excess business loss is treated as part of the taxpayer's net operating loss carryover to the following year (see 800.G. and Form 461). A taxpayer's excess business loss for the tax year is the excess of aggregate deductions related to the taxpayer's trades or businesses over the sum of (i) aggregate gross income or gain, plus (ii) a threshold amount (indexed for inflation). The excess business loss limitation applies after application of the passive loss rules (see 800.F.). [§461(l)(1)(B)].

The limitation applies at the partner or S corporation shareholder level [§461(l)].

2021 Federal Tax Guide Updates and Changes

Chapter 900. Credits

900.A. Business Credits

900.A.5. Investment Credit

900.A.5.b. Energy Credit

Taxpayers are allowed a credit for a portion (the “energy percentage”) of the basis of energy property placed in service during the tax year. The energy percentage is phased down for certain energy property the construction of which begins after 2016 or after 2019 (depending on the type of energy property) [§48(a)(1), §48(a)(2), §48(a)(3), §48(a)(5), §48(a)(6), §48(a)(7)].

Amount of Credit. The energy credit amount is the product of the energy percentage and the basis of the energy property placed in service during the tax year. The energy percentage is 30% for [§48(a)(2)(A)(i), §48(a)(5)(A)(ii)]:

• qualified fuel cell property, the construction of which begins before 2022;

• equipment, the construction of which begins before 2022, which uses solar energy to generate electricity, to heat or cool (or provide hot water for use in) a structure, or to provide solar process heat (other than for heating a swimming pool);

• equipment that uses solar energy to illuminate the inside of a structure using fiber-optic distributed sunlight, but only for property the construction of which begins before 2022;

• qualified small wind energy property;

• qualified investment credit facility property; and

• qualified waste energy recovery property.

The energy percentage is 10% for [§48(a)(2)(A)(ii)]:

• geothermal energy equipment;

• qualified microturbine property;

• combined heat and power system property; and

• qualified geothermal heat pump system property, the construction of which begins before 2022.

The energy credit for qualified fuel cell property is limited to $1,500 for each 0.5 kilowatts of capacity. The credit for microturbine property is limited to $200 for each kilowatt of capacity [§48(c)].

Phaseout. The energy percentage for 30% property decreases if the property's construction begins after 2019. The energy percentage is 30% for solar energy property, the construction of which begins before

2020, 26% for solar energy property, the construction of which begins in 2020 through 2022, and 22% for solar energy property, the construction of which begins in 2023. If solar energy property the construction of which begins before 2024, and which is not placed in service before 2026, the energy percentage is 10% [§48(a)(6)]. For qualified fuel cell property, qualified small wind energy property, and fiber-optic solar property, the energy percentage is 30% for property if construction begins before 2020, 26% for property if construction begins in 2020 through 2022, and 22% for property if construction begins in 2023. If qualified fuel cell property, qualified small wind energy property, fiber-optic solar property or waste recovery property is placed in service after December 31, 2025, the energy percentage is 0%, so no credit is available [§48(a)(7)].

Construction Start Date for Energy Property. The taxpayer may establish the beginning of construction by either: (i) starting physical work of a significant nature (physical work test); or (ii) paying or incurring 5% or more of the total cost of the facility (5% safe harbor test). Each test requires that a taxpayer make continuous progress towards completion once construction has begun. Whether the taxpayer is making continuous progress towards completion is determined by a continuous construction test under the physical work test or by a continuous effort test under the 5% safe harbor test. Construction is deemed to begin on the date the taxpayer first satisfies one of these two methods. If construction is delayed due to an excusable disruption, that delay will not mean that a taxpayer has failed to make continuous progress [Notice 2018-59]. The continuity safe harbor can be tolled and extended for a period of time to account for delays that result from pursuing a modification to a plan to mitigate significant national security concerns raised by the Department of Defense as long as certain requirements are met [Notice 2019-43].

Energy Property. To be energy property, property must satisfy four conditions [§48(a)(3)]:

1. Either the construction, reconstruction, or erection of the property is completed by the taxpayer, or, the property is acquired by the taxpayer if the original use of the property commences with the taxpayer.

2. Depreciation or amortization must be allowable for the property.

3. The property must meet any performance and quality standards prescribed by the IRS after consultation with the Department of Energy that are in effect when the property is acquired.

4. The property must not be property that is part of a facility, the production from which is allowed as part of the §45 renewable electricity production credit, unless the property is part of a qualified investment credit facility.

Investment Credit Facility Property. For property the construction of which begins before 2021, taxpayers otherwise entitled to the §45 renewable electricity production credit (“production credit”) (see 900.A.12.) may irrevocably elect to take the energy credit in lieu of the production credit. The energy percentage is generally 30% for such property, but is decreased for wind facilities placed in service after 2016 [§48(a)(5)]. If the taxpayer makes the election, no production credit for any year is allowed for any qualified investment credit facility. The election is made by attaching a statement to Form 3468, Investment Credit [Notice 2009-52]. Because eligibility to claim the credit for investment credit facility property depends on the construction start date, the credit may be claimed in the year the facility is placed in service (which may be in 2021 or later) or if the progress expenditure rule applies

(see 900.A.5.c.), if construction started by December 31, 2020. The rules for determining the construction start date for property used to claim the energy credit in lieu of the production credit are discussed in 900.A.12.a.

A qualified investment facility is any of the following facilities [§48(a)(5)(C)]:

- qualified wind facility;
- qualified closed-loop biomass facility;
- qualified open-loop biomass facility;
- qualified geothermal facility;
- qualified landfill gas facility;
- qualified trash facility;
- qualified hydropower facility; and
- qualified marine and hydrokinetic renewable energy facility.

Special Rules. No credit is permitted for expenditures for property for which the taxpayer receives a grant under §1603 of the 2009 American Recovery and Reinvestment Act for the tax year in which the grant is made or any subsequent tax year [§48(d)(1)].

No energy credit under §48 is permitted on the portion of the basis of property attributable to qualified rehabilitation expenditures [§48(a)(2)(B)]. However, at the time the energy property is placed in service, the basis must be reduced, but not below zero, by the amount of qualified progress expenditures for the property for which the §48(a) energy credit was allowed for a tax year before the property was placed in service.

The basis of property for which the rehabilitation credit is claimed must be reduced by 50% of the amount of the credit. The basis is increased by 50% of the extent to which the credit is subsequently recaptured [§50(c)(2), §50(c)(3)].

900.A.5.c. Progress Expenditures and The Investment Credit

For credits other than the rehabilitation credit (see 900.A.5.a.), the taxpayer may elect to increase its basis in eligible property by the qualified progress expenditures made for that year. If the eligible property is self-constructed property, the qualified progress expenditures equal the amount properly chargeable to capital account for the tax year. If the eligible property is not self-constructed property, the qualified progress expenditures for the property equal the lesser of: (i) the amount paid during the tax year to another person for construction, reconstruction, or erection of the property; or (ii) the amount that represents that portion of the overall cost to the taxpayer of the construction by such other person that is properly attributable to that portion of such construction that is completed during the tax year [§48(b), §48A(b)(3), §48B(b)(3), §48C(b)(2)].

Eligible Property. Eligible property is progress expenditure property if: (i) the property is constructed by or for the taxpayer; (ii) the normal construction period for the property is two years or more; and (iii) it is reasonable to expect that the property will be energy property in the taxpayer's hands when it is placed in service [§48(b), §48A(b)(3), §48B(b)(3), §48C(b)(2)].

900.A.6. Work Opportunity Credit

Employers may claim a credit for a portion of wages paid to certain new employees who are members of targeted groups [§51(a)]. The work opportunity credit is a component of the general business credit. The employer must reduce the deduction for wages paid by the amount of the work opportunity credit, even if some or all of the credit is unused in the year it is generated [§280C(a)]. The work opportunity credit does not apply to wages paid to an individual who starts employment after December 31, 2025 [§51(c)(4)].

Amount of Credit. The work opportunity tax credit amount is 40% of the qualified first-year wages for that tax year [§51(a)]. The percentage is reduced to 25% for individuals who perform at least 120 hours but less than 400 hours of service for the employer during the one-year period beginning on the day the employee begins work for the employer. No credit applies to individuals performing less than 120 hours of service during the one-year period [§51(i)(3)]. The credit also includes 50% of qualified second-year wages that are paid to long-term family assistance recipients [§51(e)(1)(B)].

Qualified first-year wages are limited to $6,000 ($3,000 for a summer youth employee) for any one employee. For long-term family assistance recipients, the $6,000 limitation is increased to $10,000 [§51(e)(1)(B)].

Qualified Veterans. The wage limitation is $6,000 for qualified veterans who are either a member of a family receiving food stamps for at least a three-month period during the one-year period before the date of hire, or who have been unemployed for at least four weeks but less than six months during the one-year period before the date of hire. The limitation is $12,000 for qualified veterans with a service-connected disability hired within one year of discharge from active duty, $14,000 for qualified veterans unemployed a total of six months or more during the one year period before the date of hire, and $24,000 for qualified veterans with a service-connected disability who have been unemployed a total of six months or more during the one year period before the date of hire [§51(b)(3), §51(d)(3)(A)].

Targeted Group. An individual is a member of a targeted group if the individual is [§51(d)(1)]:

• a qualified IV-A recipient (receiving assistance under certain state programs),

• a qualified veteran,

• a qualified ex-felon,

• a designated community resident,

• a vocational rehabilitation referral,

• a qualified summer youth employee,

• a qualified supplemental nutrition assistance program recipient,

• a qualified SSI (supplemental security income benefits) recipient,

• a long-term family assistance recipient, or

• a qualified long-term unemployment recipient.

Additionally, on or before the day on which the individual begins work for the employer, the employer must receive a certification from a designated local agency that the individual is a member of a targeted group. To meet this requirement, the employer may submit a completed pre-screening notice and request (Form 8850, Pre-Screening Notice and Certification Request for the Work Opportunity Credit) to the designated local agency and to obtain certification no later than the 28th day after the individual begins work for the employer [§51(d)(13)].

A disqualified individual is an individual who is a related individual, a nonqualifying rehire (an individual who was previously employed by the employer at any time), or a minimum employment individual (an individual who performs less than 120 hours of service for the employer) [§51(i)].

Claiming the Credit. The credit is claimed on Form 5884, Work Opportunity Credit. The credit amount is added to Form 3800, General Business Credit, except for partnerships and S corporations, which must complete Form 5884 and attach it to their returns and report the amount on Schedule K. If the taxpayer's only source of this credit is from a partnership, S corporation, estate, trust, or cooperative, Form 5884 need not be completed, and this credit is claimed directly on Form 3800.

A taxpayer may elect to forgo the work opportunity credit for a tax year by not claiming the credit on the return or amended return. The election may be made or revoked at any time before the expiration of the three-year period beginning on the due date for filing the income tax return for that tax year, without regard to extensions [§51(j)].

Tax-Exempt Organizations. While the work opportunity credit is generally not available to tax-exempt organizations (except §521 farmers' cooperatives), a qualified tax-exempt organization may claim the credit against the employer's share of FICA tax for hiring qualified individuals [§3111(e)(3)]. Qualified tax-exempt organizations may claim the credit on Form 5884-C, Work Opportunity Credit for Qualified Tax-Exempt Organizations Hiring Qualified Veterans, which is filed after the employment tax return has been filed.

900.A.7. Second Generation Biofuel Producer Credit

For biofuel produced before January 1, 2022, taxpayers may claim a credit for qualified second generation biofuel production [§40(a)(4), §40(b)(6), §40(b)(6)(J)(i)].

Amount of Credit. The second generation biofuel producer credit equals the second generation biofuel rate multiplied by the number of gallons of qualified second generation biofuel production [§40(b)(6)].

Claiming the Credit. The second generation biofuel producer credit is claimed on Form 6478, Biofuel Producer Credit. The credit amount is added to Form 3800, General Business Credit, except for

partnerships and S corporations, which must attach Form 6478 to their returns and report the amount on Schedule K. If the taxpayer's only source of this credit is from a partnership, S corporation, estate, trust, or cooperative, Form 6478 need not be completed, and this credit is claimed directly on Form 3800.

The second generation biofuel producer credit may not be claimed if the alternative fuel mixture excise tax credit is claimed for the same gallon of production [§40(c), §6426(h)].

A taxpayer may elect to forgo the credit for a tax year. The election may be made or revoked at any time before the expiration of the three-year period beginning on the due date, without regard to extensions, for filing the income tax return for that tax year [§40(f)].

Recapture of Credit. If the taxpayer uses the biofuel for which a credit has been taken for any purpose other than as qualified second generation biofuel, the credit amount applicable to the amount of biofuel is recaptured as a tax [§40(d)(3)(D)]. Recapture of the credit is reported on Form 720, Quarterly Federal Excise Tax Return.

If the second generation biofuel producer credit ceases to apply because of the termination of the credit, any general business credit attributable to the second generation biofuel producer credit arising before the termination may not be carried to any tax year beginning after the three-tax-year period beginning with the tax year in which occurs the first day of the termination of the credit [§40(e)(2), §40(b)(6)(J)(ii)]. If the credit expires, any unused second generation biofuel producer credit is deductible in the first tax year after the end of the three-year period for claiming the credit [§196(a), §196(c)(3)].

900.A.9. Low-Income Housing Credit

Taxpayers may claim a credit for a portion of their investments in qualified low-income housing. The low-income housing credit is a component of the general business credit.

900.A.9.b. Amount of Low-Income Housing Credit

The low-income housing credit amount equals the applicable percentage multiplied by the qualified basis of each qualified low-income building and is computed for each tax year in the credit period and is prorated in the first year (any reduction is allowed in the 11th year) [§42(a), §42(f)(2)]. The applicable percentage is determined by when the building was placed in service and whether the building is: (i) new and not federally subsidized, or (ii) either new and federally subsidized, or existing (whether or not federally subsidized). Buildings placed in service during 1987 receive a 4% credit (9% for a new building (or substantial rehabilitation expenditures that are treated as a separate new building) that is not federally subsidized). For buildings placed in service after 1987, the percentage is determined monthly by the IRS so that 10 annual installments have a present value equal to 70% of the qualified basis of the building (for non-federally subsidized buildings) or 30% of the qualified basis (for federally subsidized buildings and existing buildings). However, for non-federally subsidized buildings placed in service after July 30, 2008, with respect to housing credit dollar amount allocations made before January 1, 2015, the applicable percentage must be at least 9%. In the case of any new or existing building which is not considered non-federally subsidized and which is placed in service by the taxpayer after December 31, 2020, the applicable percentage shall not be less than 4% [§42(b)].

Limitation. The credit amount is limited by the housing credit dollar amount allocated to the low-income building by the appropriate state or local agency [§42(h)(1)(A)]. The housing credit dollar amount limit does not apply to the extent the credit is attributable to eligible basis financed with certain tax-exempt obligations [§42(h)(4)]. To obtain a housing credit allocation, the taxpayer and the appropriate state or local agency must each complete portions of Form 8609, Low-Income Housing Credit Allocation and Certification, and the taxpayer must submit the form to the IRS.

Qualified Basis. Qualified basis in any qualified low-income building for any tax year equals the applicable fraction (proportion of low-income housing capacity in the building to total housing capacity in the building, determined by number of units or by floor space) multiplied by the eligible basis of the building [§42(c)(1)]. The eligible basis of a new building is its adjusted basis as of the close of the first tax year of the credit period. The eligible basis of a qualified existing building equals its adjusted basis as of the close of the first tax year of the credit period [§42(d)(1)].

The applicable percentage is reduced if the qualified basis increases after the close of the first tax year in the credit period. The applicable percentage that applies to that excess qualified basis equals two-thirds of the applicable percentage that would otherwise apply [§42(f)(3)].

Buildings located in qualified census tracts or difficult development areas are eligible for a 30% increase in the basis attributable to new construction or rehabilitation eligible for credits. In addition, for buildings placed in service after July 30, 2008, any building designated by a state housing agency as requiring the enhanced credit in order for such building to be financially feasible is also eligible for the 30% increase in basis [§42(d)(5)(B)].

At-Risk Limitations. At-risk limitations apply, except that: (i) loans for low-income housing credit projects are not treated as nonqualified nonrecourse financing merely because the lender and taxpayer are related persons; (ii) the general investment credit at-risk rule, limiting the amount of nonrecourse financing to 80% of the credit base of the property, does not apply; and (iii) certain loans on low-income housing credit projects from certain nonprofit lenders are treated as qualified nonrecourse financing even if the lender is not a commercial lender and/or is the seller of the property (or is related to the seller) [§42(k)].

900.A.12. Renewable Electricity Production Credit

900.A.12.a. Eligibility for The Renewable Electricity Production Credit

The renewable electricity production credit applies to electricity that is [§45(e)(1)]:

1. produced by the taxpayer from qualified energy resources;

2. produced by the taxpayer at a qualified facility during the credit period;

3. sold by the taxpayer to an unrelated person [§45(a)(2)]; and

4. produced in the United States or a U.S. possession.

Qualified Energy Resources. Qualified energy resources consist of [§45(c)(1)]:

- wind;
- closed-loop biomass;
- open-loop biomass;
- geothermal energy;
- solar energy (credit period expired);
- small irrigation power (credit period expired);
- municipal solid waste;
- qualified hydropower production; and
- marine and hydrokinetic renewable energy.

Qualified Facility. A qualified facility is any wind, closed-loop biomass, open-loop biomass, geothermal energy, solar energy (credit period expired), small irrigation power (credit period expired), marine and hydrokinetic renewable energy, landfill gas, trash, or qualified hydropower facility. The credit applies to renewable electricity production facilities the construction of which begins before January 1, 2022. A qualified facility does not include any facility that produces electricity from gas derived from the biodegradation of municipal solid waste if that biodegradation occurs in a facility the production from which the expired §45K credit was allowed for the tax year or any prior tax year [§45(d)].

Construction Start Date for Renewable Electricity Production Credit and Energy Credit in Lieu of Renewable Electricity Production Credit. The taxpayer may establish the beginning of construction by either: (i) starting physical work of a significant nature (physical work test); or (ii) paying or incurring 5% or more of the total cost of the facility (5% safe harbor test). Each method requires that the taxpayer make continuous progress towards completion once construction has begun [Notice 2021-41, modifying and clarifying Notice 2021-5, Notice 2020-41, Notice 2019-43, Notice 2018-59, Notice 2017-4, Notice 2016-31, Notice 2015-25, Notice 2014-46, Notice 2013-60, and Notice 2013-29]. Further, the continuous progress requirement can be met by the continuous safe harbor, which for any facility that began construction under the physical work test or the 5% safe harbor in calendar year 2016, 2017, 2018, or 2019, is satisfied if a taxpayer places the facility by the end of a calendar year that is no more than six calendar years after the calendar year during which construction with respect to that facility began. Also, for any facility that began construction under the physical work test or the 5% safe harbor in calendar year 2020, the continuity safe harbor is satisfied if a taxpayer places the facility in service by the end of a calendar year that is no more than five calendar years after the calendar year during which construction with respect to that facility began. If the continuity safe harbor does not apply, the continuous progress requirement is satisfied if the taxpayer demonstrates satisfaction of either the continuous construction test or the continuous efforts test [Notice 2021-41]. A qualified facility or energy property construction project that is an offshore project or a federal land project satisfies the continuity safe harbor if a taxpayer places the qualified facility or energy property that is the subject of the project into service within 10 calendar years after the calendar year during which construction of the project began [Notice 2021-5]. The continuity safe harbor can be tolled and extended for a period of

time to account for delays that result from pursuing a modification to a plan to mitigate significant national security concerns raised by the Department of Defense [Notice 2019-43].

Credit Period. Generally, the credit period is the 10-year period beginning on the date the facility was originally placed in service. However, for open-loop biomass, geothermal energy, solar energy, small irrigation power, landfill gas, and trash facilities placed in service before August 9, 2005, the credit period was a five-year period beginning on the placed-in-service date; consequently, electricity produced at such facilities is no longer eligible for the credit. For any qualified hydropower facility that produces incremental hydropower production, the credit period begins on the date the efficiency improvements or additions to capacity are placed in service [§45(a)(2), §45(b)(4), §45(d)(9)(B)].

900.A.12.b. Amount of Renewable Electricity Production Credit

Credit Rate. For wind, closed-loop biomass, and geothermal energy, the renewable electricity production credit amount for calendar year 2020 is 2.5 cents ($0.025) multiplied by the kilowatt hours of renewable electricity produced and sold by the taxpayer [§45(a), §45(b)(2); Notice 2020-38]. The renewable electricity production credit per kilowatt hour is reduced by one-half if it is produced and sold at any open-loop biomass facility, small irrigation power facility, landfill gas facility, trash facility, qualified hydropower facility, or marine and hydrokinetic energy facility. The credit amount for 2020 for those facilities is 1.3 cents ($0.013) multiplied by the kilowatt hours of renewable electricity produced and sold by the taxpayer [§45(b)(4); Notice 2020-38].

Credit Reduction for Phaseout. The credit is potentially reduced by a phaseout amount determined by a reference price relating to the price of electricity, adjusted for inflation [§45(b)(1), §45(b)(2)]. The phaseout of the credit provided in §45(b)(1) does not apply to electricity sold in 2019. [Notice 2020-38]. The credit is also reduced for electricity produced at new wind facilities for which construction begins after 2016. It is reduced by 20% for wind facilities for which construction began in 2017, 40% in 2018, 60% in 2019, and 40% in 2020 and 2021 [§45(b)(5)].

Credit Reduction for Subsidies. The credit allowable for any project is reduced by the subsidy reduction amount. The subsidy reduction amount equals the credit that would otherwise be allowable multiplied by the lesser of one-half or the reduction fraction, the numerator of which equals the sum, for the tax year and all prior tax years, of subsidy grants, subsidy bond proceeds, subsidized energy financing, and other project credits; and the denominator of which is the aggregate amount of additions to the capital account for the project for the tax year and all prior tax years. The subsidy reduction does not apply to certain closed-loop biomass facilities [§45(b)(3)].

900.A.12.d. Indian Coal Credit

Indian coal is coal produced from coal reserves that, on June 14, 2005, were either owned by an Indian tribe, or held in trust by the United States for the benefit of an Indian tribe or its members [§45(c)(9)(A)]. The credit for producers of Indian coal equals the applicable dollar amount per ton of Indian coal that: (i) is produced by the taxpayer at an Indian coal production facility during the 16-year period beginning on January 1, 2006; (ii) is sold by the taxpayer to an unrelated person (either directly by the taxpayer or after sale or transfer to one or more related persons); and (iii) is sold during that 16-year period and that tax year [§45(e)(10)]. The applicable dollar amount is $2.00 per ton, adjusted for inflation every year ($2.570 for 2020) [§45(e)(10)(B); Notice 2020-38]. The Indian coal credit expires

December 31, 2021 [§45(e)(10)(A)]. For credit amounts for prior years, see prior editions of the Bloomberg Tax Federal Tax Guide.

900.A.13. Empowerment Zone Employment Credit

Employers can claim an empowerment zone employment credit for qualified zone wages paid to qualified zone employees. The empowerment zone employment credit is a component of the general business credit. The employer's deduction otherwise allowed for wages paid for a tax year is reduced by the amount of the empowerment zone employment credit claimed for that year [§280C(a)]. The empowerment zone employment credit is set to expire December 31, 2025 [§1391(d)(1)(A)(i)]. Any nomination for an empowerment zone with a December 31, 2017 termination date (which was the previous credit expiration date before the most recent legislative extension) can be extended if the nominating entity amends the nomination to provide a new termination date [§1391(d), §1396(d)(1)(A); Pub. L. No. 116-94, Div. Q, §118].

Amount of Credit. The empowerment zone employment credit amount for any tax year equals the applicable percentage multiplied by the qualified zone wages paid or incurred during the calendar year ending with or within the tax year [§1396(a)]. For the originally designated empowerment zones, the applicable percentage is 20% [§1396(b)].

Limitation. Only the first $15,000 of qualified zone wages for each employee each year is taken into account in computing the credit (so that the maximum credit per employee is $3,000). The $15,000 limitation is reduced by the amount of wages paid or incurred during that year which are taken into account in determining the work opportunity credit under §51 [§1396(c)].

Claiming the Credit. The credit is claimed on Form 8844, Empowerment Zone Employment Credit. The credit amount is added to Form 3800, General Business Credit, except for partnerships and S corporations, which must attach Form 8844 to their returns and report the amount on Schedule K. If the taxpayer's only source of this credit is from a partnership, S corporation, estate, or trust, Form 8844 need not be completed, and the credit is claimed directly on Form 3800. The instructions to Form 8844 contain a list of empowerment zone designations.

900.A.14. Indian Employment Credit

Employers of certain members of Indian tribes or their spouses may claim a credit for their qualified wages and employee health insurance costs. The Indian employment credit is a component of the general business credit. An employer's deduction otherwise allowed for wages paid for a tax year is reduced by the Indian employment credit claimed for that tax year [§280C(a)]. The credit does not apply to tax years beginning after December 31, 2021 [§45A(f)].

Eligibility. The employer must be engaged in a trade or business. The credit may not be claimed by tax-exempt organizations, except for §521 farmers' cooperatives [§45A(c)(4), §45A(e)(3)].

Amount of Credit. The amount of the Indian employment credit amount is 20% of the net incremental Indian employment wages. Net incremental Indian employment wages equals the excess of combined qualified wages and qualified employee health insurance costs paid or incurred during a tax year, over the sum of qualified wages and qualified employee health insurance costs paid or incurred by the

employer (or predecessor employer) during calendar year 1993 [§45A(a)]. The aggregate amount of qualified wages and qualified health insurance costs taken into account for any employee for any tax year is limited to $20,000 [§45A(b)(3)].

Claiming the Credit. The credit is claimed on Form 8845, Indian Employment Credit. The credit amount is added to Form 3800, General Business Credit, except for partnerships and S corporations, which attach Form 8845 to their returns and report the amount on Schedule K. If the taxpayer's only source of this credit is from a partnership, S corporation, estate, or trust, Form 8845 need not be completed, and this credit is claimed directly on Form 3800.

900.A.17. New Markets Tax Credit

A taxpayer who holds a qualified equity investment on a credit allowance date that occurs during the tax year is allowed to claim a new markets tax credit for that year [§45D]. There is an annual national designated investment limitation on the total amount of new markets credits. The limitation is $5 billion for 2020 through 2025 [§45D(f)(1)(H)].

Eligibility. The credit may be claimed by a taxpayer that holds a qualified equity investment (QEI) in a qualified Community Development Entity (CDE) on a credit allowance date of the investment that occurs during the tax year. CDEs must provide notice to any taxpayer that acquires a QEI in the CDE at its original issue that the equity investment is a QEI entitling the taxpayer to claim the new markets credit. Notice is to be provided on Form 8874-A, Notice of Qualified Equity Investment for New Markets Credit, no later than 60 days after the date the taxpayer makes the investment in the CDE [Reg. §1.45D-1(g)(2)(i)(A)]. See www.cdfifund.gov for more information on certification.

Amount of Credit. The total credit is up to 39% of the investment to be applied over seven years beginning with the initial qualified investment and for each of the six anniversary dates of the initial investment date.

The amount of the credit is the applicable percentage of the amount paid to the CDE for the investment at its original issue. The applicable percentage is 5% of the investment for the first three credit allowance dates, and 6% for the other four credit allowance dates [§45D(a)].

Qualified Community Development Entity (CDE). A qualified community development entity is any domestic corporation or partnership that satisfies the following three requirements [§45D(c)]:

1. Its primary mission must be serving, or providing investment capital for, low-income communities or low-income persons.

2. It must maintain accountability to residents of low-income communities through their representation on any governing board of the entity or on any advisory board to the entity.

3. It must be certified by the Director of the Department of Treasury Community Development Financial Institutions Fund (CDFIF) as being a CDE. Certain entities qualify without certification but must register as CDEs with CDFIF.

The primary role of the CDE in the credit program is to receive and provide “Allocation” to projects. The CDE is awarded Allocation from Treasury and can receive capital from investors and provide the tax credit to such investors, up to the maximum amount of its Allocation. The Allocation must be used by the CDE within five years of receipt. CDEs must satisfy certain reporting requirements [Reg. §1.45D-1(g)(2)]. A CDE may be only a corporation or partnership, or a single member LLC that has elected to be taxed as an association taxable as a corporation. An LLC that has not made such an election must therefore have at least two members at all times following its formation.

Qualified Equity Investment (QEI). A qualified equity investment is any equity investment for which the following three conditions are satisfied [§45D(b)]:

1. The investment must be in a CDE, the investment must be acquired by the taxpayer at its original issue, directly or through an underwriter, solely in exchange for cash (an investor may borrow funds from a lender to finance a portion of the investment).

2. At least 85% (75% for the seventh year of the credit period) of the cash must be used by the qualified community development entity to make qualified low-income community investments (determined based on credit periods, not tax year).

3. The investment must be designated for purposes of this section by the qualified community development entity.

Claiming the Credit. The credit is claimed on Form 8874, New Markets Credit. The credit amount is added to Form 3800, General Business Credit, except for partnerships and S corporations, which must attach Form 8874 to their returns and report the amount on Schedule K. If the taxpayer's only source of this credit is from partnerships or S corporations, Form 8874 need not be completed, and this credit is claimed directly on Form 3800.

Termination and Recapture of Credit. The credit terminates at the end of the seven-year credit period, or upon any termination event that requires recapture of the credit amount claimed, unless the failure that triggers termination is corrected within six months of the date the CDE becomes aware or should have become aware of the failure [§45D(a), §45D(g)].

Any termination event requires recapture of the credit amount claimed in its entirety, is treated as an addition to tax in the termination year and is reported on the taxpayer's income tax return [§45D(g)(1)].

The credit is recaptured if the entity fails to continue to be a CDE, the proceeds of the investment cease to be used as required, or the interest is redeemed or otherwise cashed out within seven years, unless it corrects its failure within six months after the date it becomes aware or should have become aware of the failure. Only one correction is permitted for each QEI during the seven-year credit period [§45D(g)(3)]. The IRS may waive a requirement or extend a deadline if the waiver or extension does not materially frustrate the purposes of §45D. A waiver or extension is requested by submitting a ruling request. The IRS may require appropriate adjustments of the CDE's requirements as a condition to a waiver or extension [Reg. §1.45D-1(e)(5)].

The amount to be recaptured is the sum of the aggregate decrease in the general business credits allowed to the taxpayer for all prior tax years that would have resulted if no new markets credit had

been allowed for the investment, plus interest at the statutory underpayment rate. No deduction is allowed for the interest [§45D(g)(2)].

Special Rules. Claiming the new markets tax credit requires an adjustment in the basis of the investment in the CDE by the amount of the credit on the date of the initial investment and on each of the six anniversary dates thereafter [§45D(h)]. The basis is reduced even if the credit is not currently useable and is carried forward. If a QEI is held by a partnership or S corporation, the basis in the partnership interest or S corporation stock must also be adjusted [Reg. §1.45D-1(f)(1)]. The basis adjustment does not apply for purposes of §1202 (partial exclusion of gain from certain small business stock) [§45D(h); Reg. §1.45D-1(f)(1)].

900.A.20. Railroad Track Maintenance Credit

Eligible taxpayers may claim a credit for qualified railroad track maintenance expenditures paid or incurred during the tax year [§45G(a)]. The railroad track maintenance credit is a component of the general business credit.

Eligibility. Eligible taxpayers include Class II (mid-size) and Class III (small) railroads, and any person that transports property using the rail facilities of a Class II or Class III railroad or that furnishes railroad-related property or services to a Class II or Class III railroad, but only for miles of railroad track assigned to that person by that Class II or Class III railroad for purposes of the limitation on the credit [§45G(c)]. There are special rules for controlled groups [§45G(e)(2)].

Amount of Credit. The credit amount is 40% (50% in the case of any taxable year beginning before January 1, 2023) of qualified maintenance expenditures made during the tax year, up to the maximum credit amount, which equals $3,500 multiplied by the sum of: (i) the number of miles of eligible railroad track owned or leased by the eligible taxpayer as of the close of the tax year, and (ii) the number of miles of eligible railroad track assigned for purposes of the limitation to the eligible taxpayer by a Class II or Class III railroad that owns or leases that railroad track as of the close of the tax year. For eligible taxpayers other than Class II and Class III railroads, the maximum credit amount is $3,500 multiplied by the number of miles of eligible railroad track assigned by a Class II or Class III railroad to the eligible taxpayer for the tax year [§45G(b)(1)]. Any amount of the otherwise computed credit that exceeds these amounts may not be carried to another tax year [Reg. §1.45G-1(c)(2)(iii)].

Claiming the Credit. The credit is claimed by filing Form 8900, Qualified Railroad Track Maintenance Credit. The credit amount is added to Form 3800, General Business Credit, except for partnerships and S corporations, which must attach Form 8900 to their returns and report the amount on Schedule K [Reg. §1.45G-1(a)]. Form 8900 must be filed if the taxpayer assigns any mile of railroad track, even if the taxpayer is not claiming the credit for that tax year [Reg. §1.45G-1(d)(4)]. If the taxpayer's only source of this credit is from partnerships or S corporations, Form 8900 need not be completed, and the credit is claimed directly on Form 3800.

900.A.29. Mine Rescue Team Training Credit

For tax years beginning before 2022, a taxpayer that employs individuals as miners in underground mines in the United States may claim a credit for the mine rescue team training expenses for each

qualified mine rescue team employee [§45N, §45N(e)]. The mine rescue team training credit is a component of the general business credit.

Amount of Credit. The credit amount is 20% of the expenditures the taxpayer paid or incurred during the tax year for mine rescue team training program costs of each employee, including the employee's wages while attending the program, but not over $10,000. The 20% / $10,000 limit applies per employee [§45N(a)].

Claiming the Credit. The credit is claimed on Form 8923, Mine Rescue Team Training Credit. The credit amount is added to Form 3800, General Business Credit, except for partnerships and S corporations, which must attach Form 8923 to their returns and report the amount on Schedule K. If the taxpayer's only source of this credit is from a partnership, S corporation, estate, trust, or cooperative, Form 8923 need not be completed, and this credit is claimed directly on Form 3800.

900.A.31. Carbon Oxide Sequestration Credit

Taxpayers may claim a credit for sequestering qualified carbon oxide that otherwise would have been released into the atmosphere. The carbon oxide sequestration credit is a component of the general business credit [§45Q].

Eligibility. To be eligible for the credit, the taxpayer must own a qualified industrial facility [§45Q(d)]:

• for which construction begins before January 1, 2026;

• where either construction of the carbon capture equipment begins before January 1, 2026, or the original planning and design for the facility includes installation of carbon capture equipment;

• that meets the utilization (i.e., carbon capture) requirement for the facility: (1) for a facility that emits not more than 500,000 metric tons of carbon oxide into the atmosphere during the tax year, the facility must utilize, as discussed below, not less than 25,000 metric tons of qualified carbon oxide during the tax year; (2) for an electricity generating facility, the facility must utilize, as discussed below, not less than 500,000 metric tons of qualified carbon oxide during the tax year; or (3) for a direct air capture facility, or any facility, the facility must utilize not less than 100,000 metric tons of qualified carbon oxide during the tax year.

Qualified carbon oxide is carbon oxide from industrial sources that otherwise would have been released into the atmosphere as industrial emission of greenhouse gas and must be measured at the source of capture and verified at the point of disposal or injection. It does not include carbon oxide that is recaptured, recycled and re-injected as part of the enhanced oil and natural gas recovery process. The carbon oxide must be captured and either disposed of or used within the United States or its possessions [§45Q(c)].

Amount of Credit. The credit is the sum of four amounts [§45Q(a); Notice 2020-40]:

• $20 per metric ton (adjusted for inflation to $23.82 for 2020) of qualified carbon oxide that is captured by a taxpayer using carbon capture equipment originally placed in service at a qualified facility before February 9, 2018, and disposed of by the taxpayer in secure geological storage;

• $10 per metric ton (adjusted for inflation to $11.91 for 2020) of qualified carbon oxide that is captured by the taxpayer using carbon capture equipment originally placed in service at a qualified facility before February 9, 2018, and is used as a tertiary injectant in a qualified enhanced oil or natural gas recovery project, and disposed in secure geological storage;

• the applicable dollar amount (determined under §45Q(b)(1)) per metric ton of qualified carbon oxide that is captured by the taxpayer using carbon capture equipment originally placed in service at a qualified facility on or after February 9, 2018 (during a 12-year period beginning on the date the equipment was originally placed in service), and disposed of in secure geological storage; and

• the applicable dollar amount (determined under §45Q(b)(1)) per metric ton of qualified carbon oxide that is captured by the taxpayer using carbon capture equipment originally placed in service at a qualified facility on or after the February 9, 2018 (during a 12-year period beginning on the date the equipment was originally placed in service) and used by the taxpayer as a tertiary injectant in a qualified enhanced oil or natural gas recovery project and disposed of by the taxpayer in secure geological storage, or for any other purpose for which a commercial market exists (except for use as a tertiary injectant in a qualified enhanced oil or natural gas recovery project).

Claiming the Credit. The credit is claimed on Form 8933, Carbon Dioxide Sequestration Credit. The credit amount is added to Form 3800, General Business Credit, except for partnerships and S corporations, which must attach Form 8933 to their returns and report the amount on Schedule K. If the taxpayer's only source of this credit is from a partnership, S corporation, estate, trust, or cooperative, Form 8933 need not be completed, and this credit is claimed directly on Form 3800.

Recapture of Credit. Taxpayers must recapture the benefit of any carbon oxide sequestration credit allowable for any qualified carbon oxide that ceases to be captured, disposed of, or used as a tertiary injectant in a manner consistent with the requirements to claim the credit [§45Q(f)(4)].

900.A.34. Paid Family and Medical Leave Credit

Employers that provide paid family and medical leave to their employees may claim a general business credit in tax years beginning before <u>2026</u> for a percentage of the wages paid to qualifying employees on leave under the Family and Medical Leave Act. To be eligible, employers must provide at least two weeks of leave and compensate employees on leave at a minimum of 50% of their regular wages. The credit percentage ranges from 12.5% to 25% of the cost of paid leave, depending on how much of an employee's regular earnings the benefit replaces. Eligible employers may claim or elect not to claim the credit any time within three years from the due date of the return on either the original return or an amended return. [§45S].

Employers can claim a credit for up to 12 weeks of leave per employee. Employers can claim the credit only for workers who have been employed by the employer for at least a year and who earn less than $72,000 per year.

Claiming the Credit. The credit is claimed on Form 8994, Employer Credit for Paid Family and Medical Leave. The credit amount is added to Form 3800, General Business Credit, except for partnerships and S corporations, which must attach Form 8994 to their returns and report the amount on Schedule K. If the taxpayer's only source of this credit is from a partnership, S corporation, estate, trust, or cooperative,

the taxpayer does not file Form 8994 and instead must report this credit directly on Form 3800, General Business Credit. Partnerships and S corporations must file Form 8994.

Note: For the purposes of determining the Paid Family and Medical Leave Credit, eligible wages may not include “qualified sick leave wages” and “qualified family leave wages” used to determine tax credits against social security taxes as provided by the Families First Coronavirus Response Act (Families First Act or FFCRA) [Pub. L. No. 116-127, §7001(e), §7003(e)] (see 2200.B.1.a.(1)).

900.B. Personal Credits

900.B.1. Household And Dependent Care Credit

Eligible taxpayers may claim a nonrefundable credit for a portion of the qualifying child or dependent care expenses incurred while working out of the home or actively seeking employment.

Eligibility. To be eligible, the taxpayer must incur eligible employment-related expenses for the care of one or more “qualified persons,” who include: (i) a dependent under age 13; (ii) a dependent who is physically or mentally incapable of self-care; or (iii) a spouse who is physically or mentally incapable of self-care [§21(b)(1) (reference to §152)].

Note: For tax years beginning in 2018 through 2025, the personal exemption, including the exemption for dependents, has been suspended by reducing the exemption amount to zero. Although no exemption for dependents is allowed during these tax years, this does not change the application of the definition of “dependent” for the dependent care credit.

Amount of Credit. The amount of the credit is the applicable percentage multiplied by the eligible employment-related expenses. For taxpayers with adjusted gross income (AGI) of $15,000 or less, the applicable percentage is 35%, reduced by 1% (but not below 20%) for each $2,000 or fraction thereof by which the taxpayer's AGI exceeds $15,000. The 20% figure is reached at an AGI of $43,000 [§21(a)(2)].

For tax years beginning in 2021 only, the applicable percentage is 50%, reduced by 1% for each $2,000 or fraction thereof by which the taxpayer's AGI exceeds $125,000, but not below the phaseout percentage. The “phaseout percentage” is 20%, reduced by 1% for each $2,000 or fraction thereof by which the taxpayer's AGI exceeds $400,000, but not below zero [§21(g)].

Limitation on Expenses. The maximum amount of eligible employment-related expenses that may be taken into account is $3,000 ($8,000 for 2021 only) for expenses for one qualified person, and $6,000 ($16,000 for 2021 only) for expenses for two or more qualified persons. The limitation amount is reduced by the amount excludable from the taxpayer's gross income for employer-provided dependent care assistance programs under §129 [§21(c), §21(g)] (see 1700.E.2.).

Expenses must be allocated in any year in which the taxpayer is gainfully employed or actively pursuing gainful employment for less than the full year, but not for short, temporary absences such as vacation or minor illness. A taxpayer who is employed part-time must allocate expenses for dependent care between days worked and days not worked [Reg. §1.21-1(c)(2)].

Example: Jane works three days per week and her child attends a qualifying dependent care center to enable her to be gainfully employed. The dependent care center allows payment for any three days per week for $150 or five days per week for $250. Jane enrolls her child for five days per week. Jane must allocate her expenses for dependent care between days worked and days not worked. Jane may claim 3/5 of the $250, or $150 per week, as an employment-related expense for purposes of the credit. However, if the dependent care center does not offer a three-day option, Jane may claim the entire $250 weekly fee as an employment-related expense for purposes of the credit.

Earned Income Limitation. The amount of the eligible employment-related expenses may not exceed the taxpayer's earned income for the tax year. For married taxpayers, expenses are limited to the lesser of the taxpayer's earned income or the spouse's earned income. If one spouse is a student or is incapable of self-care, that spouse's monthly earned income is deemed to be $250 in the case of expenses for one qualified person, and $500 in the case of expenses for two or more qualified persons [§21(d)].

Eligible Employment-Related Expenses. Eligible employment-related expenses are those incurred to enable the taxpayer to be gainfully employed and that are for the care of a qualified person. Eligible employment-related expenses include:

• some household services, such as a babysitter, maid, or cook, if related at least in part to the care of the qualified person;

• expenses for the care of the qualifying individual if the primary purpose is the individual's protection and well-being (however, amounts paid to provide clothing, food, and education are not included unless they are incident to, and inseparable from, the cost of the care); and

• expenses incurred outside the taxpayer's home for the benefit of a qualified person if that person regularly spends at least eight hours a day in the taxpayer's home.

A taxpayer may claim a credit for services provided outside the taxpayer's home by a dependent care center that (i) provides care for more than six individuals who do not reside at the facility; and (ii) receives payment or grants for providing the services only if the center complies with all applicable state or local laws and regulations.

Eligible expenses can include amounts paid for items other than the care of a child (such as food and schooling) if the items are incidental to the care of the child and cannot be separated from the total cost. However, the cost of schooling for a child in kindergarten or above is not an eligible expense.

Eligible expenses can include the cost of a day camp, even if it specializes in a particular activity, such as computers or soccer. However, eligible expenses cannot include any expenses for sending a dependent to an overnight camp, summer school, or a tutoring program [§21(b)(2); Reg. §1.21-1(d)].

Example: To be gainfully employed, Natalie sends her nine-year-old child to a summer day camp that offers computer activities and recreational activities such as swimming and arts and crafts. The full cost of the summer day camp is eligible for the credit.

Example: To be gainfully employed, Oliver sends his nine-year-old child to a math tutoring program for two hours per day during the summer. The cost of the tutoring program is not eligible for the credit.

The credit is not permitted for payments to a dependent of the taxpayer or his or her spouse, a child of the taxpayer under age 19 at the end of the tax year, the taxpayer's spouse, or the parent of the taxpayer's child who is a qualified person [§21(e)(6); Reg. §1.21-4(a)].

Tax Liability Limitation. The total amount of all nonrefundable personal credits, including the dependent care credit, is allowed to the full extent of the taxpayer's regular tax (as defined in §26(b)) reduced by the foreign tax credit, plus any alternative minimum tax [§26(a)]. Any unused credit may not be carried forward.

For tax years beginning in 2021 only, the dependent care credit is fully refundable for eligible taxpayers with a principal place of abode in the United States for more than half of 2021 [§21(g)].

Claiming the Credit. The credit for child and dependent care expenses is claimed by completing Form 2441, Child and Dependent Care Expenses, and attaching it to Form 1040 or Form 1040-SR. The taxpayer identification number (TIN) must be provided for the qualifying individual, and the name, address and TIN of any service provider must be provided [§21(e)(9), §21(e)(10)]. If the taxpayer is married at the close of the tax year, the taxpayer must file a joint return with his spouse in order to claim the credit [§21(e)(2)]. Taxpayers may file married filing separately if they meet the requirements to be treated as unmarried.

Divorced or Separated Parents. A child of divorced or legally separated taxpayers is considered the qualifying individual of the custodial parent for that tax year [§21(e)(5), Reg. §1.21-1(b)(5)(ii)].

900.B.4. Child Tax Credit And Credit For Other Dependents

Taxpayers may claim a credit against tax for each qualifying child.

Amount of Credit. The credit is $2,000 for each qualifying child for whom the taxpayer is allowed a dependency exemption under §151 [§24(a), §24(h)]. The total credit is reduced by $50 for each $1,000 or increment thereof that the taxpayer's modified adjusted gross income (AGI) exceeds the threshold amount ($400,000 for joint filers and $200,000 for all other filers). The amount of the credit is increased by $500 for each dependent who is not a qualifying child (i.e., for each “qualifying relative”) [§24(b), §24(c) §24(h) (references to §152)].

For tax years beginning in 2021 only, the credit amount is increased to $3,000 for each qualifying child ages six to 17, and $3,600 for those under age six. The additional credit amount above $2,000 (i.e., $1,000 or $1,600 per qualifying child, as applicable) is reduced by $50 for each $1,000 or (fraction thereof) of modified AGI above the threshold amounts ($150,000 for joint filers and surviving spouses, $112,500 for heads of households, and $75,000 for all other filers) [§24(i)].

Note: For tax years beginning in 2018 through 2025, the personal exemption, including the exemption for dependents, has been suspended by reducing the exemption amount to zero. Although no exemption for dependents is allowed during these tax years, this does not change the application of the

definition of “dependent,” “qualifying child,” and “qualifying relative” for purposes of the child tax credit.

Qualifying Child. A qualifying child is an individual who [§24(c)]:

1. is the taxpayer's child or a descendant of such child, or is the taxpayer's brother, sister, stepbrother, or stepsister or a descendant of any such relative;

2. lives with the taxpayer for more than half of such tax year;

3. has not provided over half of such individual's own support for the calendar year in which the taxpayer's tax year begins;

4. has not attained the age of 17 (or, for 2021 only, has not attained the age of 18);

5. is younger than the taxpayer;

6. has not filed a joint return (other than only for a claim for refund) with their spouse for the tax year beginning in the calendar year in which the taxpayer's tax year begins; and

7. is a citizen, national or resident alien of the United States.

For divorced and separated parents, if the custodial parent releases the dependency exemption to the noncustodial parent under §152(e), the child is considered the qualifying child of the noncustodial parent, who is then entitled to claim the child tax credit [§24(c), §152(c)].

Qualifying Relative. For purposes of determining whether an individual qualifies for the credit for other dependents, a qualifying relative is an individual who [§152(d)(1)]:

1. bears one of the following relationships to the taxpayer:

- is the child of the taxpayer or a descendant of such child;

- is the brother, sister, stepbrother, or stepsister of the taxpayer;

- is the father or mother of the taxpayer, or the ancestor of either;

- is the stepfather or stepmother of the taxpayer;

- is the niece or nephew of the taxpayer;

- is the brother or sister of the taxpayer's mother or father;

- is an in-law to the taxpayer (son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law); or

• is an individual (other than a spouse), who has the same principal place of abode as the taxpayer and is a member of the taxpayer's household.

2. whose gross income for the calendar year in which the tax year of the taxpayer begins is less than the exemption amount under §151(d) ($4,300 for 2020 and 2021) [Rev. Proc. 2019-44, Rev. Proc. 2020-45];

3. who receives over half of his or her support from the taxpayer for the calendar year in which the taxpayer's tax year begins; and

4. who is not a qualifying child of the taxpayer or any other taxpayer for the calendar year in which the taxpayer's tax year begins.

Note: Despite the personal exemption deduction being zero for tax years 2018 through 2025, that amount does not apply to the gross income limitation in the qualifying relative definition [§151(d)(5)]. Thus, for purposes of the gross income test in §152(d)(1)(B), taxpayers should use the exemption amount in §151(d)(1) to determine whether an individual is a qualifying relative in 2018–2025 [Reg. §1.152-2(e)(1)].

Refundable Portion of Credit. For tax years beginning in 2021 only, the child tax credit is fully refundable (other than the $500 partial credit for certain other dependents) if the taxpayer has a principal place of abode in the United States for more than half of the tax year or is a bona fide resident of Puerto Rico for the tax year [§24(i)].

For 2020, part of the child tax credit is nonrefundable and part is refundable. The total amount of all nonrefundable personal credits, including the nonrefundable portion of the child tax credit, is allowed to the full extent of the taxpayer's regular tax (as defined in §26(b)) reduced by the foreign tax credit, plus any alternative minimum tax [§26(a)]. The refundable portion of the child tax credit is the “additional tax credit.” The child tax credit is refundable to the extent of the lesser of: (i) the unclaimed portion of the nonrefundable credit amount, or (ii) the greater of 15% of the taxpayer's earned income in excess of $3,000 or, for taxpayers with three or more qualifying children, the excess of the taxpayer's Social Security taxes over his or her earned income credit for the tax year. The maximum amount of refundable credit for any qualifying child is $1,400 for 2020 [§24(d), §24(h); Rev. Proc. 2019-44].

The child tax credit is not refundable for taxpayers electing to exclude foreign earned income under §911 [§24(d)(5)].

Example: Sue had earned income in 2020 of $22,000, but could only claim a $1,500 child tax credit for her two children because that was the extent of her ordinary income tax liability. The unclaimed portion of the nonrefundable credit amount is $2,500 ($4,000 – $1,500). 15% of her earned income over $3,000 is $2,850 (($22,000 – $3,000) × .15). Sue may claim the lesser amount of $2,500 as the refundable portion of the credit.

Claiming the Credit. The child tax credit is claimed on Form 1040, Form 1040-SR, or 1040-NR. The refundable portion or “additional child tax credit” is claimed on Schedule 8812, Child Tax Credit, and is attached to Form 1040, Form 1040-SR, or Form 1040-NR. Taxpayers must include the name and taxpayer identification number of each qualifying child on the return in order to claim the child tax credit. The child tax credit is not allowed if either the child's or the taxpayer's identification number is

issued after the due date of the return [§24(e)]. Form 14815, Supporting Documents to Prove the Child Tax Credit (CTC) and Credit for Other Dependents (ODC) for 2018-2025, and Form 14815-A, Supporting Documents to Prove the Child Tax Credit (CTC) and Credit for Other Dependents (ODC) for 2021, list supporting documents required to claim the credit.

No credit or refund due to a taxpayer because of the refundable portion of the child tax credit may be made before February 15 of the following year [§6402(m)]. Taxpayers who make improper child tax credit claims are barred from claiming the credit for: (i) a period of 10 tax years if there is a final determination that the improper claim was due to fraud; (ii) a period of two tax years if the improper claim was due to reckless or intentional disregard of rules and regulations other than through fraud; and (iii) any subsequent year if the credit is denied as a result of assessment of a tax on account of the credit, other than on account of a mathematical or clerical error, unless the taxpayer provides evidence of eligibility for the credit [§24(g)].

2021 Advance Payments. The IRS will make advance payments of the child tax credit to taxpayers from July 1, 2021 until December 31, 2021. In total, the advance payments are meant to equal 50% of the taxpayer's 2021 child tax credit amount, determined based on 2020 (or 2019) tax return information. Any remainder of the taxpayer's 2021 child tax credit, which is not provided by advance payment, can be claimed on the taxpayer's 2021 tax return [§7527A].

If the total amount of advance payments exceeds the taxpayer's allowable 2021 child tax credit, the taxpayer's 2021 federal income tax liability will be increased by the excess amount. A safe harbor exists for low to moderate income taxpayers who receive excess payments due to a decrease in their number of qualifying children between 2020 (or 2019) and 2021, under which the additional tax liability may be reduced [§24(j)].

Special Rules. No credit is allowed for a short tax year, unless the tax year is less than 12 months because of the taxpayer's death [§24(f)].

900.B.5. Education Tax Credit

900.B.5.c. Limitations Based on Modified Adjusted Gross Income

The allowable amount of the American Opportunity and Lifetime Learning Credits is phased out ratably for taxpayers with MAGI between $80,000 and $90,000 ($160,000 and $180,000 for joint returns). Taxpayers with MAGI of $90,000 or more (or $180,000 or more for joint returns) cannot claim a Lifetime Learning Credit [§25A(d)(1)(A); §25A(d)(1)(B)]. The threshold amount is not indexed for inflation.

900.B.8. Earned Income Credit

900.B.8.A. Eligibility For Earned Income Credit

Eligible Taxpayers. Although originally enacted to provide a credit for taxpayers with children, currently both individuals with a “qualifying child,” and individuals without a qualifying child may claim the credit. An individual who does not have a qualifying child for the tax year is eligible for the credit if: (i) the individual's principal place of abode is in the United States (i.e., the 50 states and the District of Columbia) for more than half of the tax year; (ii) the individual (or, if married, his or her spouse) has

reached age 25, but not 65, by the end of the tax year; and (iii) the individual may not be claimed as a dependent by another taxpayer for a tax year beginning in the same calendar year in which the individual's tax year begins [§32(c)(1)].

For tax years beginning in 2021 only, the minimum age requirement of 25 is decreased to 19 (24 for specified students and 18 for qualified former foster youth and homeless youth) and the maximum age limit of 65 is eliminated [§32(n)].

The following individuals are not eligible for the EIC: (i) the otherwise qualifying child of a taxpayer; (ii) an individual who lives abroad and elects the foreign earned income and housing cost amount exclusion (see 2000.C.1.); and (iii) a nonresident alien for any portion of the tax year, unless married to a U.S. citizen or resident and agreeing to subject his or her worldwide income to U.S. income tax [§32(c)(1)].

Only one taxpayer may actually treat a child as a qualifying child and taxpayers may not divide the various tax benefits between or among themselves, although different taxpayers may claim different children as their qualifying children [Notice 2006-86].

Taxpayers who are married at the end of the tax year may not claim the credit unless they file a joint return. For this purpose, a taxpayer who is legally separated under a decree of divorce or separate maintenance is not considered to be married. For tax years beginning in 2021 and later, a married spouse can claim the credit without filing jointly if the spouse lives with a qualifying child for more than half the tax year and either (1) does not live with the other spouse during the last six months of the tax year, or (2) has a decree, instrument, or agreement of separation (other than a divorce decree) and does not live with the other spouse by the end of the tax year. In the case of a joint return, the credit is available if either spouse is an eligible individual and the earned income of the taxpayer for the preceding tax year is the sum of the earned income of each spouse for the preceding tax year [§32(d), §7703(a)(2)].

Qualifying Child. A qualifying child must be a qualifying child under §152(c) for purposes of the dependency exemption (see 1200.D.2.a.), except that: (i) there is no requirement that the child does not provide over half of his own support; (ii) the special rules for children of divorced or separated parents under §152(e) are disregarded, i.e., a custodial parent waiving the dependency exemption is still entitled to any EIC; and (iii) the requirement that the qualifying child have the same principal place of abode as the taxpayer for more than one-half of the tax year cannot be satisfied unless the abode is in the United States. Additionally, a qualifying child may not be married unless the taxpayer is entitled to a dependency exemption [§32(c)(3)]. An individual is not a qualifying child of “any other taxpayer” if the individual's parent (or other person with respect to whom the individual is defined as a qualifying child) is not required by §6012 to file an income tax return and (i) does not file an income tax return, or (ii) files an income tax return solely to obtain a refund of withheld income taxes [Notice 2008-5].

Note: For tax years beginning in 2018 through 2025, the personal exemption, including the exemption for dependents, has been suspended by reducing the exemption amount to zero. Although no exemption for dependents is allowed during these tax years, this does not change the application of the §152 definition of “dependent” and “qualifying child” for purposes of the EIC.

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Earned Income. Earned income consists generally of amounts includible in gross income that are wages, salaries, tips, and other employee compensation and net earnings from self-employment. Earned income does not include:

• any amount received as a pension or annuity;

• unemployment compensation or worker's compensation;

• income of a nonresident alien that is not effectively connected with the conduct of a U.S. trade or business;

• any amount received for services provided by an inmate at a penal institution;

• certain workfare payments earned by the taxpayer; or

• nontaxable employee compensation.

Taxpayers may elect to include in earned income amounts excluded from income as combat zone compensation for U.S. Armed Forces members [§32(c)(2)(A)].

Earned income includes the taxpayer's net earnings from self-employment, determined with regard to the deduction allowed for one-half of the self-employment taxes. Net earnings from self-employment includes the gross income derived from any trade or business, less any deductions allowed attributable to the trade or business, and the taxpayer's distributive share of income or loss from any trade or business carried on by a partnership. A taxpayer with minimal net earnings may elect to be treated as having received net earnings from self-employment equal to four times the amount of earnings needed to earn one quarter of coverage under §213(d) of the Social Security Act [§32(c)(2)(A)(ii)].

If a taxpayer's 2021 and/or 2020 earned income is less than the taxpayer's 2019 earned income, the taxpayer can elect to determine the EIC by substituting 2019 earned income for 2021 and/or 2020 earned income [Pub. L. No. 117-2, §9626; Pub. L. No. 116-260, Div. EE, Title II, §211].

Disqualified Income . No EIC is allowed for the tax year for a taxpayer whose aggregate amount of disqualified income for the tax year exceeds $3,650 for 2020 or $10,000 for 2021 and later [§32(i), §32(j); Rev. Proc. 2019-44; Rev. Proc. 2021-23]. Disqualified income consists of interest and dividends, tax-exempt interest, net income (if greater than zero) from rents and royalties not derived in the ordinary course of business, capital gain net income, and net passive income (if greater than zero) that is not self-employment income. However, disqualified income does not include gain from selling business assets treated as long-term capital gain [§32(i)].

900.B.8.B. Amount Of Earned Income Credit

The amount of earned income credit amount is the “credit percentage” multiplied by the portion of the taxpayer's earned income that does not exceed a specified “earned income amount” [§32(a)(1)]. EIC amounts are available at *Schedules & Tables 7* in the Earned Income Credit Table.

The earned income amounts, credit percentages and maximum credit amounts for 2020 are as follows [§32(b); Rev. Proc. 2019-44]:

Number of Children	Earned Income Amount	Credit Percentage	Maximum Credit Amount
0	$ 7,030	7.65%	$ 538
1	$ 10,540	34%	$3,584
2	$ 14,800	40%	$5,920
3+	$ 14,800	45%	$6,660

The earned income amounts, credit percentages and maximum credit amounts for 2021 are as follows [§32(b), §32(n); Rev. Proc. 2021-23]:

Number of Children	Earned Income Amount	Credit Percentage	Maximum Credit Amount
0	$ 9,820	15.3%	$1,502
1	$ 10,640	34%	$3,618
2	$ 14,950	40%	$5,980
3+	$ 14,950	45%	$6,728

Credit Phaseout . The credit begins to phase out if the taxpayer's adjusted gross income (or, if greater, the taxpayer's earned income) exceeds the phaseout amount. The EIC may not exceed the excess of: (i) the credit percentage multiplied by the earned income amount, over (ii) the phaseout percentage multiplied by the portion of the taxpayer's adjusted gross income (or earned income amount, if greater) that exceeds the beginning phaseout amount [§32(a)(2)].

The 2020 earned income phaseout amounts for an unmarried taxpayer (including qualifying widow(er)s and heads of household) are as follows [§32(b); Rev. Proc. 2019-44]:

Number of Children	Beginning Phaseout Amount	End Phaseout Range	Phaseout Percentage
0	$ 8,790	$ 15,820	7.65%
1	$ 19,330	$ 41,756	15.98%
2	$ 19,330	$ 47,440	21.06%
3+	$ 19,330	$ 50,954	21.06%

For married taxpayers filing a joint return, the beginning and ending phaseout amounts are each increased by $5,890.

The 2021 earned income phaseout amounts for an unmarried taxpayer (including qualifying widow(er)s and heads of household) are as follows [§32(b), §32(n); Rev. Proc. 2021-23]:

Number of Children	Beginning Phaseout Amount	End Phaseout Range	Phaseout Percentage
0	$ 11,610	$ 21,430	15.3%
1	$ 19,520	$ 42,158	15.98%
2	$ 19,520	$ 47,915	21.06%
3+	$ 19,520	$ 51,464	21.06%

For married taxpayers filing a joint return, the beginning and ending phaseout amounts are each increased by $5,950.

900.B.8.C. Claiming The Earned Income Credit

Taxpayers who claim the EIC for a qualifying child must attach Schedule EIC, Earned Income Credit, to Form 1040 or Form 1040-SR. Taxpayers must include on the tax return for the tax year his or her valid Social Security number, and, if married, the spouse's valid Social Security number. Additionally, the taxpayer must include on the return the name, age, and Social Security number of any qualifying child. The Social Security number must be issued on or before the due date of the return. For tax years beginning in 2021 and later, taxpayers can claim the childless EIC even if all of their qualifying children lack Social Security numbers. [§32(c)(1)(E), former §32(c)(1)(F), §32(m)].

Individuals filing returns for less than a 12-month period are not permitted to claim the credit unless the short period is due to the individual's death [§32(e)].

Improper EIC Claims. Taxpayers who make improper EIC claims are barred from claiming the EIC for: (i) a period of 10 tax years if there is a final determination that the improper claim was due to fraud; (ii) a period of two tax years if the improper claim was due to reckless or intentional disregard of rules and regulations other than through fraud; and (iii) any subsequent year if the credit is denied as a result of assessment of a tax on account of the credit, other than on account of a mathematical or clerical error, unless the taxpayer provides evidence of eligibility for the credit [§32(k)].

900.B.9 Credit for Health Insurance Costs of Eligible Individuals (Health Coverage Tax Credit)

Individual taxpayers who suffered job displacements due to import competition and certain individuals receiving benefits from the Pension Benefit Guaranty Corporation (PBGC) may claim a credit for health insurance premiums paid for themselves and their qualifying family members (health coverage tax credit, or HCTC). The HCTC of eligible individuals is refundable [§35(a)].

The HCTC is available for coverage months that begin before January 1, 2022 [§35(b)(1)(B)].

Eligibility. An eligible individual is an individual who is: (i) receiving trade adjustment assistance (TAA) (including alternative TAA) due to job dislocation caused by import competition, or (ii) at least 55 years of age and is receiving a benefit from PBGC for a termination of a pension plan under title IV of the Employee Retirement Income Security Act (ERISA). To be entitled to the credit, the insurance premiums must be paid for coverage of the taxpayer or the taxpayer and a qualifying family member for eligible coverage months (as defined in §35(b)). No credit is allowed to an individual for whom a dependency deduction is allowed to another taxpayer for a tax year beginning in the calendar year in which such individual's tax year begins [§35(c), §35(g)(4)].

Amount of Credit. The credit amount is 72.5% of the amount paid for the coverage of the taxpayer and qualifying family members under qualified health insurance (as defined in §35(e)) during eligible coverage months [§35(a)]. The amount of the credit is reduced by any payments made to the qualified health insurance provider on behalf of the eligible individual on an advance basis under §7527 [§35(g)(1)].

Qualifying Family Member. A qualifying family member includes the taxpayer's spouse and any dependent for whom the taxpayer is entitled to a deduction. A family member that has other specified coverage is not a qualifying family member. In the case of divorced or separated parents (see 1200.D.2.a.(6)), the child is treated as a qualifying family member of the custodial parent and not the noncustodial parent even if §152(e) applies [§35(d)].

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An eligible individual's family members may continue to be qualifying family members even upon the occurrence of certain events [§35(g)(10)]:

• The month in which the eligible individual is entitled to Medicare is treated as an eligible coverage month to determine the amount of credit for qualifying family members.

• Upon the eligible individual's final divorce, the ex-spouse is treated as an eligible individual for 24 months.

• Upon the eligible individual's death, the surviving spouse is treated as an eligible individual for 24 months.

Qualifying Individual. A qualifying individual is an individual who, as of the date he or she seeks to enroll in coverage, has an aggregate of creditable coverage of three months or longer, and who does not have other specified coverage and is not imprisoned. The term qualified health insurance does not include a flexible spending plan or similar arrangement, or insurance if substantially all of its coverage consists of “excepted benefits” [§35(e)(2)(B)].

Other Specified Coverage. “Other specified coverage” includes subsidized coverage (at least 50% of the cost is paid by an employer) and coverage under Medicare or Medicaid. Benefits from the Department of Veterans Affairs are not “other specified coverage” [§35(f)].

Claiming the Credit. The credit is claimed on Form 8885, Health Coverage Tax Credit, which is attached to the taxpayer's Form 1040, Form 1040-SR, Form 1040-NR, Form 1040-SS, or Form 1040-PR.

For payments made on an advance basis by the Treasury Department to a qualified health insurance provider under §7527, a qualified health insurance costs credit eligibility certificate issued by the Department of Labor or PBGC must be in effect for the taxpayer [§35(g)(1), §7527]. To receive the HCTC on an advance monthly basis so that the credit percentage (72.5%) of the qualified health insurance premiums are paid in advance directly to the taxpayer's health plan administrator each month, taxpayers must begin the process by completing and mailing to the IRS Form 13441-A, Health Coverage Tax Credit (HCTC) Monthly Registration and Update, with all required supporting documents. The taxpayer must continue to pay the 27.5% portion in advance to the HCTC program. Until the taxpayer receives confirmation of registration for advance payment, the taxpayer must continue to pay 100% of the premiums directly to the health plan and may claim the yearly credit for those payments.

For years beginning after 2013, eligible individuals must elect allowance of the HCTC on a timely filed return (including extensions). However, because the credit was extended retroactively, the election to claim the HCTC for a tax year beginning in 2014, 2015, and 2016 for calendar year taxpayers, may be made any time on or after June 29, 2015, but before expiration of the three-year period of limitations [§35(g)(11); Pub. L. No. 114-27, §407(f)(3); Notice 2017-16].

Special Rules. Amounts taken into account in determining the HCTC may not be taken into account in determining the amount allowable under the §213 itemized deduction for medical expenses or the §162(l) deduction for health insurance expenses of self-employed individuals [§35(g)(2)].

Amounts distributed from a medical savings account are not eligible for the credit [§35(g)(3)].

Coordination with Post-2013 Health Insurance Premium Tax Credit (Affordability Credit). A taxpayer is not entitled to the health insurance premium tax credit (affordability credit) (see 1700.F.2.) for any coverage month for which he or she elects the HCTC. A taxpayer may not claim the HCTC for qualified health insurance purchased through an exchange [§35(g)(12); Notice 2016-2].

900.B.11. Nonbusiness Energy Property Credit

Taxpayers can claim the nonbusiness energy property credit for expenditures for certain qualified energy efficient improvements and residential energy property expenditures placed in service or installed during the tax year in the taxpayer's principal residence. The credit expires for property placed in service after December 31, 2021 [§25C(g)(2)].

Amount of Credit. The nonbusiness energy property credit is the sum of [§25C(a)]:

1. 10% of the amount paid or incurred for qualified energy efficiency improvements; and

2. any residential energy property costs.

Limitations on Credit. The credit is limited as follows [§25C(b)]:

• A total combined credit limit of $500 per taxpayer for all tax years after 2005.

• A combined credit limit of $200 for windows for all tax years after 2005.

• A credit limit for residential energy property costs for each year of $50 for any advanced main air circulating fan; $150 for any qualified natural gas, propane, or oil furnace or hot water boiler; and $300 for any item of energy efficient building property.

Tax Liability Limitation and Carryover. The total amount of all nonrefundable personal credits, including the nonbusiness energy property credit, is allowed to the full extent of the taxpayer's regular tax (as defined in §26(b)) reduced by the foreign tax credit, plus any alternative minimum tax [§26(a)]. Unused credit may not be carried forward.

Eligible Property: Qualified energy efficiency improvements include [§25C(c)]:

• insulation;

• exterior windows and skylights;

• exterior doors;

• certain metal roofs.

Residential energy property costs include [§25C(d)]:

• certain electric heat pump water heaters, electric heat pumps, central air conditioners, natural gas, propane, or oil water heaters;

• qualified natural gas, propane, or oil furnaces and qualified natural gas, propane, or oil hot water boilers;

• certain advanced main air circulating fans used in natural gas, propane, or oil furnaces.

Claiming the Credit. The credit is claimed on Form 5695, Residential Energy Credits, which is attached to Form 1040 or Form 1040-SR.

Special Rules. The increase in the taxpayer's basis that would otherwise result from credit-eligible expenditures is reduced by the amount of the nonbusiness energy property credit allowed for such expenditures [§25C(f)].

If more than 20% of an item's use is for business purposes, then only the portion of the expenditures allocable to the nonbusiness use is eligible for the credit. Expenditures made from subsidized energy financing are not eligible for the credit [§25C(e)].

900.B.12. Residential Energy Efficient Property Credit

Taxpayers may claim a credit for a portion of expenditures associated with: qualified solar electric property; qualified solar water heating property; qualified fuel cell power plants; qualified small wind energy property; qualified geothermal heat pump property; or qualified biomass fuel property expenditures [§25D(a)]. The credit has expired for all types of qualified property except qualified solar electric property and qualified solar water heating property.

The residential energy efficient property credit does not apply to property placed in service after 2023 [§25D(h)].

Eligibility. To be eligible for the residential energy efficient property credit, the property: (i) must be used to generate energy for a dwelling unit in the United States that the taxpayer uses as his or her residence; and (ii) must not be used for a swimming pool, hot tub, or any other energy storage medium that has a function other than storage. Expenditures for onsite preparation, assembly, and original installation of qualified property, as well as expenditures for piping or wiring to interconnect such property to the dwelling unit, as well as labor costs allocable to such expenditures, are eligible for the credit [§25D(e)].

Amount of Credit. The credit amount is 30% of the expenditures associated with qualified property for property placed in service before January 1, 2020 [§25D(a)]. For property placed in service in 2020 through 2022, the applicable percentage is 26%, and for property placed in service in 2023, the applicable percentage is 22% [§25D(g)]. In the case of an expenditure for the construction (or reconstruction) of a structure, the expenditure is treated as made when the taxpayer's original use of the structure begins; otherwise, the expenditure is treated as made when the original installation is complete [§25D(e)(8)].

Limitation on Credit. There is no maximum credit for qualified property. If more than 20% of an item's use is for business purposes, then only the portion of the expenditures allocable to the nonbusiness use is eligible for the credit [§25D(e)(7)]. See 900.A.5.b. for a discussion of the business credit for energy property.

Qualified Solar Electric Property. Qualified solar electric property is property that uses solar energy to generate electricity for use in the taxpayer's residence [§25D(d)(2)].

Qualified Solar Water Heating Property. Qualified solar water heating property is property used to heat water for use in the taxpayer's residence, if at least half of the energy that it uses to heat the water is derived from the sun [§25D(d)(1)].

Qualified Fuel Cell Property. Qualified fuel cell property means a fuel cell power plant which has a nameplate capacity of at least 0.5 kilowatt of electricity using an electrochemical process, and has an electricity-only generation efficiency greater than 30% and is installed on or in connection with a dwelling unit located in the United States and used as a principal residence by the taxpayer [§25D(d)(3)].

Qualified Small Wind Energy Property. Qualified small wind energy property means property which uses a wind turbine to generate electricity for use in connection with a dwelling unit located in the United States and used as a residence by the taxpayer [§25D(d)(4)].

Qualified Geothermal Heat Pump Property. Qualified geothermal heat pump property means any equipment which (i) uses the ground or ground water as a thermal energy source to heat a dwelling unit located in the United States and used as a residence by the taxpayer or as a thermal energy sink to cool such dwelling unit, and (ii) meets the requirements of the Energy Star program which are in effect at the time that the expenditure for such equipment is made [§25D(d)(5)].

Qualified Biomass Fuel Property. Qualified biomass fuel property means property which uses the burning of biomass fuel to heat a dwelling unit located in the United States and used as a residence by the taxpayer, or to heat water for use in such a dwelling unit, and which has a thermal efficiency rating of at least 75% (measured by the higher heating value of the fuel) [§25D(d)(6)].

Tax Liability Limitation and Carryover. The total amount of all nonrefundable personal credits, including the nonbusiness energy property credit, is allowed to the full extent of the taxpayer's regular tax (as defined in §26(b)) reduced by the foreign tax credit, plus any alternative minimum tax [§26(a)]. Excess nonbusiness energy property credit may be carried forward indefinitely to succeeding tax years [§25D(c)].

Claiming the Credit. The credit is claimed on Form 5695, Residential Energy Credits, which is attached to Form 1040 or Form 1040-SR.

Special Rules. The basis increase that would otherwise result from the purchase of qualified property must be reduced by the amount of the residential energy efficient property credit allowed for such property [§25D(f)].

900.B.14. 2020 And 2021 Recovery Rebate Credits

In response to the COVID-19 pandemic, eligible individuals are permitted a refundable credit in their first tax year that begins in 2020. An eligible individual is any individual other than a nonresident alien, an individual who can be claimed as a dependent on another tax return, or an estate or trust. The credit is in the form of a recovery rebate and is a refundable credit against tax liability. The credit claimed on the 2020 return must be reduced by the amount of any advance payment (“economic impact payment”

(EIP) or "stimulus payment") received. Eligible individuals were automatically issued advance payments of the refundable credit if they filed a 2018 or a 2019 tax return [§6428].

The amount of the credit is $1,200 ($2,400 for eligible individuals filing jointly) plus an additional $500 for each qualifying child (as defined by §24(c)) (see 900.B.4.)). The credit is subject to limitations based on adjusted gross income (AGI). The amount of the credit is reduced by the amount of 5% of the taxpayer's AGI that exceeds $150,000 for taxpayers filing joint returns, $112,500 for heads of household, and $75,000 for all other taxpayers [§6428(a), §6428(c)].

If the amount of the credit is more than the EIP (e.g., if the taxpayer's income was reduced in 2020 and is not subject to the phaseout or if the taxpayer had additional children after the year the IRS computed the EIP), the additional credit can be claimed on Form 1040 or Form 1040-SR, line 30. If the credit is less than the EIP, the difference does not have to be reported or repaid.

EIP amounts are not includible in taxable income.

Special procedures for obtaining the payments apply to those eligible individuals that are otherwise not required to file returns [Rev. Proc. 2020-28].

See https://www.irs.gov/coronavirus/economic-impact-payment-information-center for more information on obtaining advance payments of the credit.

In addition, eligible individuals are permitted a refundable credit in their first tax year beginning in 2020 of $600 ($1,200 for eligible individuals filing jointly) plus an additional $600 for each qualifying child (as defined by §24(c)). Like the first 2020 recovery rebate credit, the additional 2020 recovery rebate credit is subject to limitations based on AGI, and eligible individuals were automatically issued advance payments of the refundable credit if they filed a 2019 tax return [§6428A].

Eligible individuals are permitted a refundable credit in their first tax year beginning in 2021 of $1,400 ($2,800 for joint filers), plus an additional $1,400 for each dependent (defined in §152 to include adult dependents). The credit is subject to phaseout based on AGI ($150,000 for joint returns and surviving spouses, $112,500 for heads of households, and $75,000 for all others). The IRS is issuing advance payments of the credit using information from prior year returns (or other information available) [§6428B].

900.B.15. Credit For Sick Leave And Family Leave For Self-Employed Individuals (COVID-19 Credits)

900.B.15.A. Credit For Sick Leave For Certain Self-Employed Individual

For the period beginning April 1, 2020, until September 30, 2021, an eligible self-employed individual is allowed a refundable income tax credit for any tax year in an amount equal to the individual's qualified sick leave equivalent amount. An "eligible self-employed individual" is one who regularly carries on a trade or business within the meaning of §1402 (see 1000.A.7.) and who would be entitled to receive paid leave during the tax year under the Emergency Paid Sick Leave Act (EPSLA) if the individual were an employee of an employer (other than themselves) (see 2200.B.1.a.(1)).

The EPSLA requires employers to provide employees with paid sick time where an employee is unable to work due to a need for leave relating to COVID-19 (e.g., quarantining under direction from the government or a health care provider (or caring for someone who is), experiencing symptoms and seeking a medical diagnosis, caring for a child due to school or child care closures).

An individual's "qualified sick leave equivalent amount" equals the number of days during the tax year (but no more than 10) that the individual cannot perform services for which that individual would have been entitled to sick leave under the EPSLA, multiplied by the lesser of:

• $200 ($511 in the case of paid sick time due to a governmental quarantine or isolation order, a health care provider's advice to self-quarantine, or the individual experiencing symptoms and seeking a medical diagnosis); or

• 67% of the individual's average daily self-employment income for the tax year (100% in the case of any day of paid sick time otherwise payable at the $511 rate).

"Average daily self-employment income" equals the net earnings from self-employment income for the tax year divided by 260. For the period beginning April 1, 2021 through September 30, 2021, an individual can elect to use the prior tax year's net earnings to calculate average daily self-employment income.

If an eligible self-employed individual receives qualified sick leave wages from an employer, the individual's qualified sick leave equivalent amount is reduced (but not below zero) to the extent that the sum of the qualified sick leave equivalent amount and the qualified sick leave wages received exceeds $2,000 ($5,110 in the case of any day any portion of which is paid sick time due to a governmental quarantine or isolation order, a health care provider's advice to self-quarantine, or the individual experiencing symptoms and seeking a medical diagnosis) [Pub. L. No. 117-2, §9642; Pub. L. No. 116-127, Div. E, §5102, Div. G, §7002; Notice 2020-54].

900.D. Automotive Credits

900.D.1. Alternative Motor Vehicle Credit

Taxpayers may claim a credit for placing in service alternative motor vehicles. The business portion of the alternative motor vehicle credit is a component of the general business credit (see 900.A.27.). The alternative motor vehicle credit originally included credits for fuel cell, advanced lean burn technology, hybrid, and alternative fuel motor vehicles, as well as a plug-in conversion credit [§30B(a)]. However, all components of the alternative motor vehicle credit, except for the qualified fuel cell motor vehicle credit, have expired. The qualified fuel cell motor vehicle credit expires for property purchased after December 31, 2022 [§30B(k)(1)].

Amount of the credit. The new qualified fuel cell motor vehicle credit is [§30B(b)(1)]:

• $4,000 for a qualifying vehicle with a gross vehicle weight up to 8,500 pounds;

• $10,000 for a vehicle with a gross vehicle weight of more than 8,500 pounds but not more than 14,000 pounds;

• $20,000 for a vehicle with a gross vehicle weight of more than 14,000 pounds but not more than 26,000 pounds; and

• $40,000 for a vehicle with a gross vehicle weight of more than 26,000 pounds.

The credit may increase by amounts ranging from $1,000 to $4,000 if the vehicle achieves increases in fuel economy ranging from 150% to 300% of the 2002 model year city fuel economy [§30B(b)(2)(A)].

Claiming the Credit. The credit is claimed on Form 8910, Alternative Motor Vehicle Credit. The nonbusiness credit is nonrefundable, i.e., it may be claimed against the taxpayer's regular tax (as defined by §26(a)) reduced by the foreign tax credit, plus any alternative minimum tax [§30B(g)(2)]. Unused credit may not be carried forward. For limitations applicable to the business credit, see 900.A.2. A taxpayer may elect to forgo the credit for any vehicle [§30B(h)(9)].

Recapture of Credit. Recapture applies if the property ceases to be eligible for the credit, including if there is a lease period of less than the vehicle's economic life, unless the cessation is by reason of conversion to a qualified plug-in electric drive motor vehicle [§30B(h)(8)].

Tax-Exempt Use Vehicles. Under certain circumstances, the person who sells qualified alternative motor vehicles may claim the credit if the seller clearly discloses to the user the amount of any allowable credit. The property (i) must be used by a tax-exempt organization other than a §521 cooperative, or by a government, foreign person, or foreign entity; (ii) must not be used predominantly in an unrelated trade or business subject to the §511 unrelated business income tax; and (iii) must not be leased by the organization [§30B(h)(6)].

900.D.2. Alternative Fuel Vehicle Refueling Property Credit

Taxpayers may claim a credit for placing in service qualified alternative-fuel vehicle refueling property. The business portion of the alternative fuel vehicle refueling property credit is a component of the general business credit (see 900.A.28.). The credit expires for property placed in service after December 31, 2021 [§30C(g)].

Amount of Credit. The alternative-fuel vehicle refueling property credit equals 30% of the cost of the qualified alternative-fuel vehicle refueling property placed in service by the taxpayer during the tax year [§30C(a)]. The credit for all qualified property placed in service by the taxpayer during the tax year at a location is limited to $30,000 for depreciable (business) property, and $1,000 for nondepreciable (nonbusiness) property [§30C(b)].

The cost of dual-use property used to store or dispense both alternative fuel and conventional fuel is included in the cost of qualified alternative-fuel vehicle refueling property only to the extent it exceeds the cost of equivalent conventional refueling property. Special rules apply to qualified alternative-fuel vehicle refueling property that is converted from previously nonqualified property [Notice 2007-43].

Claiming the Credit. The credit is claimed on Form 8911, Alternative Fuel Vehicle Refueling Property Credit. The nonbusiness portion is nonrefundable, i.e., it is limited to the excess, if any, of the taxpayer's modified §26(b) regular tax liability limitation over the taxpayer's tentative minimum tax [§30C(e)(2)].

Unused credit may not be carried forward. For limitations applicable to the business credit, see 900.A.2. A taxpayer may elect to forgo the credit for any property [§30C(e)(4)].

Recapture of Credit. The alternative-fuel vehicle refueling property credit is subject to recapture rules when the property ceases to be alternative-fuel vehicle refueling property before the end of its recovery period [§30C(e)(5)].

Tax-Exempt Use Property. Under certain circumstances, the person who sells qualified alternative fuel vehicle refueling property may claim the credit if the seller clearly discloses to the user the amount of any allowable credit. The property (i) must be used by a tax-exempt organization other than a §521 cooperative, or by a government, foreign person, or foreign entity; (ii) must not be used predominantly in an unrelated trade or business subject to the §511 unrelated business income tax; and (iii) must not be leased by the organization [§30C(e)(2)].

900.D.3. Qualified Plug-In Electric Drive Motor Vehicle Credit

Taxpayers may claim a credit for placing in service new qualified plug-in motor vehicles for the tax year in which the vehicle is placed in service. The portion of the qualified plug-in electric drive motor vehicle credit attributable to depreciable property (i.e., business vehicles) is a component of the general business credit (see 900.A.32.). The current version of the credit applies to four-wheeled vehicles acquired after 2009 and to two-wheeled vehicles acquired during 2015 through 2021 [§30D(g)(3)(E)(ii)].

Amount of Credit. The credit amount per four-wheeled vehicle equals the sum of [§30D(b)]:

1. the base amount ($2,500), plus

2. for a vehicle that draws its propulsion energy from a battery with not less than five kilowatt-hours (kwh) of capacity, $417 plus $417 for each kwh in excess of five kwh (not to exceed $5,000).

Thus, the total amount of the credit per four-wheeled vehicle is limited to a maximum of $7,500 per vehicle (i.e., $2,500 + $5,000).

The credit amount per two-wheeled vehicle is the lesser of $2,500 or 10% of the cost of the vehicle [§30D(g)(2)].

The full amount of the credit may be claimed for the first 200,000 new qualified plug-in electric-drive motor vehicles sold for use in the United States after December 31, 2009, after which taxpayers placing in service such a vehicle must claim a reduced credit amount [§30D(e)].

Per-vehicle credit amounts acknowledged by the IRS are available at http://www.irs.gov/Businesses/Qualified-Vehicles-Acquired-after-12-31-2009.

Claiming the Credit. The credit is claimed on Form 8936, Qualified Plug-in Electric Drive Motor Vehicle Credit. The nonbusiness credit is nonrefundable, i.e., it may be claimed against the taxpayer's regular tax (as defined in §26(b)) reduced by the foreign tax credit, plus any alternative minimum tax [§30D(c)(2)]. Unused credit may not be carried forward. For limitations applicable to the business credit, see 900.A.3. A taxpayer may elect not to apply §30D to a given qualifying vehicle [§30D(f)(6)].

Recapture of Credit. Recapture applies for any vehicle that ceases to be eligible for the credit [§30D(f)(5)].

Chapter 1000. Computation of Tax

1000.A. Federal Income Tax Liability of Individuals

1000.A.2. Alternative Minimum Tax

1000.A.2.b. Alternative Minimum Taxable Income: AMT Adjustments

(25) Excess Business Loss Limitation

The excess business loss limitation is temporarily suspended until the 2021 tax year. AMT Form 461 will be used for AMT adjustments relating to the excess business loss limitation, beginning in that tax year. If you filed a 2018 and/or 2019 return(s) with the limitation, you can file an amended return. [§461(l)(1)(B)].

1000.A.7. Self-Employment Tax

1000.A.7.d. Covid-19 Relief for Self-Employed Individuals

Credits for sick leave and family leave. For 2020 through March 2021, eligible self-employed individuals may claim a credit for sick leave and family leave similar to the credits available to employers [COVID-related Tax Relief Act of 2020, Pub. L. No. 116-260, Div. N., Title II, Subtitle B, §286 - §288; Pub. L. No. 116-127, Div. G. §7002, §7004; Notice 2020-54]. These credits are computed on Form 7202, Credits for Sick Leave and Family Leave for Certain Self-Employed Individuals, and carried to Form 1040 or Form 1040-SR, Schedule 3, line 12b. The credits are refundable; i.e., the amounts can be refunded or credited to the taxpayer even though the taxpayer has no tax to offset. For a detailed discussion, see 900.B.15.

Deferral of payment of 50% of Social Security tax. Self-employed individuals may defer payment of 50% of the Social Security portion (but not the Medicare portion) of the self-employment tax on income earned during the period beginning on March 27, 2020, and ending December 31, 2020. Taxpayers may use any reasonable method to allocate the self-employment tax attributable to net earnings from self-employment earned during the period in question. 50% of the deferred amount is payable by December 31, 2021, and the other 50% by December 31, 2022 [Pub. L. No. 116-136, §2302]. The deferral is shown on Form 1040 or Form 1040-SR, Schedule 3, line 12e. For further information, see https://www.irs.gov/newsroom/deferral-of-employment-tax-deposits-and-payments-through-december-31-2020.

1000.A.8. Other Taxes

1000.A.8.J. Repayment of Excess Advance Premium Tax Credit

Certain individual taxpayers who enroll, or whose family members enroll, in a qualified health plan offered through a Health Insurance Marketplace may be eligible for a premium tax credit (PTC) and may receive advance payments of the premium tax credit as a means of financial assistance to help them pay

for all or part of the premiums for the qualified health plan. A taxpayer's advance payment eligibility is based on the Marketplace's estimate of the PTC the taxpayer will be able to claim on his or her return for the year. If an advance payment was paid for a taxpayer or a member of his or her family during the year, the taxpayer must file Form 8962, Premium Tax Credit (PTC), to reconcile the advance payment with the PTC. If the advance payment is more than the PTC, then the taxpayer has excess advance payment and must repay the excess, subject to certain limitations. A taxpayer who is required to repay excess advance payment does so by reporting it as an increase in tax on the appropriate line on Schedule 2 (Form 1040 or Form 1040-SR) [§36B(f)(2)]. For a more detailed discussion of the PTC and advance payment of the PTC, see 1700.F.2.].

Chapter 1100. Accounting Periods And Methods

1100.B. Accounting Methods

1100.B.1. Permissible Methods Of Accounting

1100.B.1.C. Cash Method Of Accounting

The cash method of accounting is used by most individual taxpayers and many small businesses. The cash method is often advantageous to taxpayers because of its simplicity and the control it provides over the timing of the recognition of income and expenses. Because of this control element, certain types of taxpayers are prohibited from using the cash method.

1100.B.1.C.(1) Treatment Of Income Under Cash Method

Under the cash method, a taxpayer must recognize income in the year it is actually or constructively received. Income is constructively received by a taxpayer in the year in which it is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that he or she may draw upon it at any time. A taxpayer does not need to have possession of income for there to be constructive receipt. However, if a taxpayer's control of its receipt is subject to substantial limitations or restrictions, there is no constructive receipt [§451; Reg. §1.451-1(a), §1.451-2(a)].

Examples of income that is constructively received include (i) interest, dividends, or other earnings on deposits or accounts with financial institutions, (ii) interest coupons that have matured and are payable, and (iii) dividends on corporate stock that are subject to the demand of the shareholder [Reg. §1.451-2(b)].

Example: Steve is a calendar year taxpayer who uses the cash method of accounting. His bank credited interest to his bank account in December of Year 1. Steve did not withdraw it or enter it in his books until January of Year 2. Steve must include the interest in his gross income for Year 1 because he constructively received it in that year.

Interest, dividends, or other earnings payable on a deposit or account with a financial institution are not constructively received to the extent that they are not subject to withdrawal at the time credited. However, the following are not considered substantial limitations or restrictions on the taxpayer's control of the receipt of such earnings [Reg. §1.451-2(a), §1.451-2(b)]:

• a requirement that the deposit or account, and the earnings thereon, must be withdrawn in multiples of even amounts;

• a requirement that the earnings may be withdrawn only upon a withdrawal of all or a part of the deposit or account; or

• a requirement that notice of intention to withdraw must be given in advance of the withdrawal.

If dividends on corporate stock are declared payable on December 31 but the corporation follows its usual practice of paying the dividends by checks mailed so that the shareholders will not receive them until January of the following year, the dividends are not considered to be constructively received in December.

1100.B.1.C.(2) Treatment Of Expenses Under Cash Method

Under the cash method, a taxpayer generally can deduct expenses in the year they are paid. However, an expenditure that results in the creation of an asset having a useful life that extends substantially beyond the end of the tax year must be capitalized and deducted over the period to which it relates [§461; Reg. §1.461-1(a)(1)].

Under a special 12-month rule, a taxpayer is not required to capitalize amounts paid to create certain rights or benefits for the taxpayer if the rights or benefits do not extend beyond the earlier of [Reg. §1.263(a)-4(f)]:

1. 12 months after the right or benefit begins; or

2. the end of the tax year after the tax year in which the payment is made.

Example: Laura is a calendar year, cash method taxpayer. She pays $3,000 in Year 1 for a business insurance policy that is effective for 36 months, beginning on July 1 of Year 1. Because this expense does not qualify for the 12-month rule, it must be capitalized and deducted over the period to which it relates. Laura can only deduct $500 ($3,000 × (6 mos./36 mos.)) of the expense in Year 1.

Example: Assume the same facts as in the previous example, except that the business insurance policy is only effective for 12 months beginning on July 1 of Year 1. Under the 12-month rule, the full $3,000 expense can be deducted in Year 1.

1100.B.1.C.(3) Taxpayers Prohibited From Using Cash Method

General Rule. The following types of taxpayers are generally prohibited from using the cash method of accounting [§448(a); Reg. §1.448-2(a)(2)]:

1. a C corporation;

2. a partnership with a C corporation as a partner; and

3. a tax shelter.

A tax shelter includes: (i) an enterprise (other than a C corporation) in which interests have been offered for sale in an offering required to be registered with any federal or state agency authorized to regulate securities offerings, (ii) an enterprise (other than a C corporation) for which more than 35% of losses are allocated to limited partners or limited entrepreneurs (a "syndicate"), or (iii) any entity, plan, or arrangement that has as a significant purpose the avoidance or evasion of federal income tax (a "tax shelter") [§448(d)(3), §461(i)(3), §6662(d)(2)(C)(ii) (incorporated by reference in Reg. §1.448-2(b)(2)); Reg. §1.448-2(b)(2)].

A trust is treated as a C corporation with respect to its activities that constitute an unrelated trade or business (see Chapter 1800) [§448(d)(6); Reg. §1.448-2(b)(1)].

Exceptions. There are three exceptions under which a C corporation or a partnership with a C corporation as a partner may use the cash method of accounting [§448(b); Reg. §1.448-2(c), Reg. §1.448-2(d), Reg. §1.448-2(e)]:

1. For 2020 and 2021, a C corporation, or a partnership with a C corporation as a partner, may use the cash method if (1) it is not a tax shelter, and (2) its average annual gross receipts for the three preceding tax years are $26 million or less [Reg. §1.448-2(c); Rev. Proc. 2019-44, Rev. Proc. 2020-45].

2. A farming business may generally use the cash method. However, see 1100.H. for a discussion of farming businesses that must use the accrual method.

3. A qualified personal service corporation (PSC) may use the cash method (see 1300.C.6.c.).

1100.B.1.D. Accrual Method Of Accounting

1100.B.1.D.(1) Treatment Of Income Under Accrual Method

Under the accrual method, a taxpayer generally must recognize income when (i) all events have occurred that fix the taxpayer's right to receive the income, and (ii) the amount of the income can be determined with reasonable accuracy (referred to as "the all events test") [§451(b)(1)(C); Reg. §1.446-1(c)(1)(ii), §1.451-1(a)]. Under the first part of the all events test, a taxpayer's right to income is fixed when either the amount is unconditionally due or the taxpayer has performed. Thus, accrual method taxpayers generally must recognize income when it is paid, due, or earned, whichever occurs first. Under the second part of the all events test, the amount of income can be determined with reasonable accuracy if a reasonable basis for calculation exists. The exact amount need not be known.

An accrual method taxpayer subject to the all events test generally must recognize income no later than the tax year in which such income is taken into account as revenue in an applicable financial statement (AFS) or another financial statement specified by the IRS (the AFS income inclusion rule) [§451(b)(1)(A); Reg. §1.451-3(b)(2)]. In determining whether an item of gross income is treated as taken into account as revenue for this purpose, taxpayers must make adjustments to revenue for: (i) the cost of goods sold and liabilities required to be accounted for under other provisions, (ii) amounts anticipated to be in dispute or uncollectible, (iii) amounts the taxpayer would not have an enforceable right to recover if the customer terminated the contract, (iv) amounts attributable to an increase in transaction price because a significant financing component is deemed to exist, and (v) other amounts provided in IRS guidance [Reg. §1.451-3(b)(2)].

The following are not subject to the AFS income inclusion rule: (i) taxpayers that do not have such financial statements, (ii) income from mortgage servicing contracts, and (iii) income for which a special accounting method is used [§451(b)(1)(B), §451(b)(2); Reg. §1.451-3(b)(3)]. However, credit card late fees, credit card cash advance fees, and interchange fees may not be taken into income later than the tax year in which such income is taken into account as revenue in an applicable financial statement, regardless of whether the timing of the income inclusion for such fees is normally determined using a special method of accounting [Reg. §1.451-3(j)].

An applicable financial statement is: (i) a financial statement certified as prepared in accordance with generally accepted accounting principles (including a Form 10-K required to be filed with the SEC, an audited financial statement used for substantial non-tax purposes such as credit purposes, or a financial statement filed with another federal agency for non-tax purposes), (ii) a financial statement made on the basis of international financial reporting standards not less stringent than the standards required by the SEC and filed with a foreign government agency that is equivalent to the SEC, or (iii) a financial statement filed with any other regulatory or governmental body specified by the IRS. [§451(b)(3); Reg. §1.451-3(a)(5)]

The regulations provide optional rules for determining the AFS income inclusion amount for an item of gross income from the sale of inventory. Under the cost offset method, a taxpayer may reduce the amount of revenue from the sale of inventory that is otherwise required to be included in gross income under the AFS income inclusion rule in a tax year prior to the year in which ownership of the inventory is transferred to the customer and defer such revenue to the tax year in which the ownership of the inventory is transferred to the customer [Reg. §1.451-3(c)].

Advance Payments. Special rules apply to advance payments. An accrual method taxpayer that receives advance payments generally must include those advance payments in income in the year they are received. However, such taxpayers may defer the inclusion of certain types of advance payments. Accrual method taxpayers may elect to defer the inclusion in income of advance payments for goods, services, and other items specified in Reg. §1.451-8 until the end of the tax year following the tax year in which the advance payments are received, as long as such income is also deferred for financial statement purposes under the general accrual method rules discussed above. The deferral election is not available for advance payments of (i) rent, (ii) insurance premiums, (iii) payments with respect to financial instruments, (iv) payments with respect to warranty or guaranty contracts for which a third party is the primary obligor, (v) payments subject to §871(a), §881, §1441, or §1442 (taxes and withholding taxes on nonresident aliens and foreign corporations), (vi) payments in property to which §83 applies, (vii) payments received in a tax year earlier than the year immediately before the year of the contractual delivery date for a specified good unless the taxpayer elects to treat such payments as advance payments, and (viii) any other payment specified by the IRS. The election also does not apply to advance payments received by a taxpayer if the taxpayer ceases to exist during the year in which the payments are received [§451(c); Reg. §1.451-8].

Special statutory provisions apply to advance payments for subscriptions and dues. An accrual method taxpayer that receives prepaid subscription payments may elect to defer the prepaid subscription income over the period of the subscription liability [§455]. An accrual method taxpayer that receives prepaid dues payments as a qualified membership organization may elect to defer the prepaid dues income over the period of the services or privileges liability (but not to exceed 36 months) [§456].

Uncollectible Amounts. Certain accrual method taxpayers may adopt a nonaccrual experience method under which they can defer recognition on the portion of their receivables from the performance of services that they determine, based on past experience, will not be collected (i.e., on doubtful accounts). The nonaccrual experience method may be adopted by the following taxpayers [§448(d)(5); Reg. §1.448-3(a)]:

1. taxpayers that provide services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting; and

2. taxpayers (other than tax shelters) that provide services in other fields and have average annual gross receipts for the three preceding tax years of $26 million or less (for 2020 and 2021) [Reg. §1.448-2(c); Rev. Proc. 2019–44, Rev. Proc. 2020-45].

1100.C. Inventory

1100.C.1. Inventory Accounting Requirements

A taxpayer is required to account for inventories to clearly reflect income if the production, purchase, or sale of merchandise is an income-producing factor in the taxpayer's business [§471(a); Reg. §1.471-1(a)]. When a taxpayer is required to account for inventories, it generally must use an accrual method to account for purchases and sales of inventory items [Reg. §1.446-1(c)(2)(i)].

For 2020 and 2021, taxpayers (other than tax shelters) with average annual gross receipts for the three preceding tax years of $26 million or less are not required to account for inventories [§448(c), §471(c); Reg. §1.448-2(c), §1.471-1(b); Rev. Proc. 2019-44, Rev. Proc. 2020-45]. Such taxpayers may use an accounting method that either (i) treats inventory items as non-incidental materials and supplies, or (ii) conforms to the taxpayer's financial accounting treatment of inventory [§471(c)(1); Reg. §1.471-1(b)(3)]. If a taxpayer chooses to treat inventory items as non-incidental materials and supplies, it can deduct the cost of those items in the tax year in which the materials and supplies are first used in the taxpayer's operations or are consumed in the taxpayer's operations [Reg. §1.162-3(a)(1)]. An accounting method is treated as conforming to the taxpayer's financial accounting treatment of inventory if the accounting method is reflected in an “applicable financial statement” of the taxpayer (as defined in §451(b)(3)) or, if the taxpayer has no applicable financial statement, the books and records of the taxpayer [§471(c)(3); Reg. §1.471-1(b)(3)(ii)].

1100.D. Uniform Capitalization Rules

1100.D.1. Property Subject To Uniform Capitalization Rules

The uniform capitalization rules generally apply to [§263A(b); Reg. §1.263A-1(a)(3)]:

• real property and tangible personal property produced by a taxpayer; and

• real property and personal property acquired by a taxpayer for resale.

For 2020 and 2021, taxpayers (other than tax shelters) with average annual gross receipts for the three preceding tax years of $26 million or less are exempt from the uniform capitalization rules [§263A(i); Reg. §1.263A-1(j); Rev. Proc. 2019-44, Rev. Proc. 2020-45].

Property Produced by Taxpayer. The uniform capitalization rules generally apply to real property and tangible personal property produced by a taxpayer (a “producer”). A taxpayer is treated as producing such property if it constructs, builds, installs, manufactures, develops, improves, creates, raises, or grows the property. A taxpayer is not considered to be producing property unless, under federal tax principles, it is considered an owner of the property produced. Property produced for a taxpayer under a contract with another party is treated as property produced by the taxpayer to the extent the taxpayer makes payments or otherwise incurs costs in connection with the property. The uniform capitalization rules apply only to property produced by a taxpayer for use in its trade or business or for sale to customers. They do not apply to property produced for personal purposes [§263A(g); Reg. §1.263A-2(a)].

Property Acquired by Taxpayer for Resale. The uniform capitalization rules generally apply to real property and personal property acquired for resale by a retailer, wholesaler, or other taxpayer (a “reseller”). For resellers, personal property includes both tangible and intangible property. Property acquired for resale includes stock in trade and other property includible in inventory if on hand at the end of the tax year. It also includes property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business [Reg. §1.263A-3(a)].

Additional Rules on the Application of the Uniform Capitalization Rules. Additional rules on the application of the uniform capitalization rules include the following [Reg. §1.263A-1(a)(3)]:

• The uniform capitalization rules also generally apply to foreign persons.

• Taxpayers engaged in a farming business are required to capitalize certain costs under the uniform capitalization rules (see 1100.H.3. for discussion of the application of the uniform capitalization rules to farmers).

• Taxpayers engaged in the production/resale of creative property are required to capitalize certain costs under the uniform capitalization rules.

• The uniform capitalization rules generally apply to inventories valued at cost, lower of cost or market, or market. However, the rules do not apply to inventories valued at market if the market valuation used by the taxpayer generally equals the property's fair market value.

1100.E. Accounting For Long-Term Contracts

1100.E.3.A. Home Construction And Small Contractor Construction Contracts

Home construction and small contractor construction contracts may be accounted for using the percentage-of-completion method (PCM) (see 1100.E.2.), the exempt-contract percentage-of-completion method (EPCM), the completed-contract method (CCM), or any other permissible method [§460(e); Reg. §1.460-3(b), §1.460-4(c)]. A home construction contract is a construction contract for which 80% of the total estimated contract costs are reasonably expected to be attributable to (i)

dwelling units in buildings containing four or less dwelling units, and (ii) improvements to real property directly related to, and located at the site of, those dwelling units [§460(e)(5)(A); Reg. §1.460-3(b)(2)]. A small contractor construction contract is a construction contract of a taxpayer that (i) is not a tax shelter, (ii) has average annual gross receipts of $26 million or less (for 2020 and 2021) for the three tax years immediately preceding the tax year the contract is entered into, and (iii) estimates that construction under the contract will be completed within two years [§460(e)(1)(B), §448(c); Reg. §1.460-3(b)(1)(ii), §1.460-3(b)(3), §1.448-2(c); Rev. Proc. 2018-57, Rev. Proc. 2019-44, Rev. Proc. 2020-45].

Exempt-Contract Percentage-of-Completion Method. The exempt-contract percentage-of-completion method (EPCM) is similar to the percentage-of-completion method (PCM) (see 1100.E.2.). However, under the EPCM, the percentage of completion may be determined by comparing costs other than contract costs (e.g., direct labor costs) or by comparing the work actually performed with the estimated total work to be performed, as long as such method is consistently applied and clearly reflects income. In addition, the following rules do not apply to the EPCM: (i) the look-back method (see 1100.E.5.), (ii) the treatment of contract costs incurred after the year the contract is completed (see 1100.E.2.b.), and (iii) the 10% method (see 1100.E.2.d.) [Reg. §1.460-4(c)(2)].

Completed Contract Method. Under the completed-contract method (CCM), a taxpayer includes the entire gross contract price in income and takes a deduction for all contract costs in the year the contract is completed (the completion year). However, there are special rules that apply when a disputed claim exists after the subject matter of the contract has been tendered to the customer [Reg. §1.460-4(d)(4)].

1100.H. Accounting Methods For Farmers

1100.H.1. General Methods Of Accounting For Farmers

Even though the accrual method is normally required for most taxpayers for whom inventories are a material income-producing factor, farmers generally have the choice of using either the cash method or the accrual method of accounting [Reg. §1.61-4]. However, certain types of farming businesses are required to use the accrual method (see below). Certain farmers may elect to use a special crop method of accounting (see below). For discussion of special rules that apply in determining the gross income of a farmer, see 100.H.2. For discussion of special rules that apply in determining deductions and losses of a farmer, see 400.F.3. and 800.A.5., respectively.

Accrual Method Requirement for Certain Farming Businesses. The following types of farming businesses are required to use the accrual method [§447, §448(c); Reg. §1.448-2(c)]:

• for 2020 and 2021, a C corporation (other than a tax shelter) that had gross receipts for the three preceding tax years of more than $26 million [§448(c); Reg. §1.448-2(c); Rev. Proc. 2019-44, Rev. Proc. 2020-45];

• a partnership with such a C corporation as a partner; or

• a tax shelter.

In addition to C corporations with gross receipts under the applicable threshold (and partnerships with such C corporations as partners), the accrual method requirement does not apply to an S corporation, a

farming business operating a nursery or sod farm, or a farming business raising or harvesting trees other than fruit and nut trees (unless they are tax shelters) [§447(a), §447(c)].

Crop Method. A farmer that does not harvest and dispose of its crop in the same tax year the crop is planted may, with IRS approval, use a special method of accounting known as the crop method. Under the crop method, a farmer deducts the entire cost of producing such a crop in the year it realizes the income from the crop, and not earlier [Reg. §1.162-12(a)].

Chapter 1200. Individuals

1200.B. Computing Income Tax Liability and Paying the Tax

1200.B.1. Taxable Income

Taxable income is equal to gross income less the standard deduction, the personal and dependency exemption deduction ($0 for tax years beginning in 2018 through 2025), the qualified business income deduction, and the charitable contributions deduction for non-itemizers [§63(b)].

1200.E. Standard Deduction

Most individual taxpayers who do not elect to itemize deductions for the tax year may claim a standard deduction. The standard deduction is a fixed amount that may be subtracted from adjusted gross income. The amount of a taxpayer's standard deduction is based on the taxpayer's filing status (see 1200.C.). The standard deduction is unlike any other deduction because it does not require a taxpayer to prove that expenditures have been made.

Choice Between Itemized Deductions and Standard Deduction. Most individual taxpayers have a choice of itemizing their deductions or taking the standard deduction. Because deductions reduce taxable income, a taxpayer will benefit by choosing to use the method that results in the greatest amount of deductions.

The amount of a taxpayer's itemized deductions is determined by completing Schedule A (Form 1040 or Form 1040-SR). Itemized deductions are allowed for expenses such as mortgage interest, taxes, charitable contributions, medical expenses, etc. (see 700.C.).

The amount of a taxpayer's basic standard deduction is a fixed dollar amount based on a taxpayer's filing status and is adjusted annually for inflation (see 1200.E.1.). Taxpayers who are age 65 or older and/or blind generally qualify for an additional standard deduction (see 1200.E.2.). The standard deduction for a taxpayer who can be claimed as a dependent on another taxpayer's return is generally limited (see 1200.E.3.) [§63(c)]. If an individual has a net disaster loss for the tax year, the standard deduction amount is increased by the net disaster loss. A net disaster loss is the excess of qualified disaster-related personal casualty losses for the tax year over personal casualty gains (as defined in §165(h)(3)(A)) for the tax year [Taxpayer Certainty and Disaster Tax Relief Act of 2020, Pub. L. No. 116-260, Div. EE, Title I, Subtitle A, §304(b)(1)(C)].

Although the choice to use the standard deduction generally eliminates the need for a taxpayer to track expenses and apply the sometimes complex rules for the various types of itemized deductions, it is

generally beneficial for a taxpayer to at least make an estimate as to whether his or her itemized deductions would be greater than the standard deduction.

Chapter 1500. S Corporations

1500.C. Taxation Of S Corporation

1500.C.4. S Corporation Filing Requirements

1500.C.4.B. Form To File S Corporation Return

An S corporation must file Form 1120-S, U.S. Income Tax Return for an S Corporation, for each tax year in which its S election is in effect [Reg. §1.6012-2(h)]. A Schedule K-1 must be attached to Form 1120-S for each person who was a shareholder at any time during the tax year and a copy of the Schedule K-1 must be furnished to the relevant shareholder [§6037(b)].

Form 1120-S must be signed and dated by the president, vice president, treasurer, assistant treasurer, chief accounting officer, or any other corporate officer authorized to sign the return. It may be signed by a receiver or bankruptcy trustee if such fiduciary has possession of, or holds title to, substantially all the property or business of the corporation [§6062, §6012(b)(3)].

An S corporation generally has the option of filing either a paper Form 1120-S. However, an S corporation is required to file all returns (including Form 1120-S) electronically if: (i) it has assets of $10 million or more, and (ii) it is required to file at least 250 for calendar year 2020 (100 for calendar year 2021) federal returns of all types during the calendar year that ends with or within its tax year [§6011(e)(2)(A), §6011(e)(5); Reg. §301.6011-5, §301.6037-2]. S corporations filing a Form 1120-S through an internet service provider (ISP) and/or transmitter and not using an electronic return organizer (ERO) use Form 8453-S, U.S. S Corporation Income Tax Declaration for an IRS e-file Return, to authenticate an electronic Form 1120-S. An S corporation can request a waiver of the electronic filing requirements under the procedures of Notice 2010-13.

Chapter 1700. Retirement Plans and Benefit Arrangements

1700.B. Nonqualified Deferred Compensation

1700.B.2. Compensatory Stock Arrangements

1700.B.2.b. Nonstatutory Stock Options

Nonstatutory stock options (NSOs) are stock options that do not meet the requirements of an incentive stock option (ISO). An NSO must be in writing (in paper or electronic form), and the writing must be adequate to establish an option right or privilege that is enforceable under applicable law.

No particular combination of words is necessary, but the writing should express:

• the selling price;

• the number of shares subject to the option; and

• the period of time during which the option will remain open.

Income Tax Treatment. The timing of an employee's recognition of compensation income, if any, caused by the grant of an NSO depends upon whether that option has a “readily ascertainable fair market value” at the time it is granted. If it does, the employee will be taxed immediately. If it does not, the employee generally will not be taxed until the employee exercises the option. At either date, the income that is taxable to the employee will be taxed as ordinary compensation income.

Most NSOs will not have a readily ascertainable fair market value due to the restrictive way in which the regulations define the term. As a result, most NSOs do not cause taxation to the employee when they are granted and are not taxable until the employee exercises the option, even if the fair market value becomes readily ascertainable after the grant [Reg. §1.83-7(b)].

In determining whether an option has a readily ascertainable fair market value, options are divided into two categories:

1. those that are actively traded on an established market; and

2. those that are not.

Options Actively Traded on an Established Market. An option that is actively traded on an established market is deemed to have a readily ascertainable fair market value. If an option has a “readily ascertainable fair market value” at the date of grant, the employee will recognize ordinary compensation income. The employee includes in income the fair market value of the option, less any amount paid for the option, for the tax year of the receipt of the option [Reg. §1.83-7(b)(1)].

An employee holds an option taxed at grant with a basis that includes both the amount of income taxed at grant and any amount paid for the option by the employee. If the employee pays nothing for the option, the option's basis in the hands of the employee is the amount included in income at grant [Reg. §1.83-7(b)(1)].

Example: On July 1, 2020, Price, Inc., grants to Brady, a key employee of the corporation, in consideration for services rendered or to be rendered to Price, an option to buy 2,000 shares of Price common stock. The exercise price is $10 per share. The option has a readily ascertainable fair market value because this option is actively traded. The option may be exercised, in whole or in part, at any time over the five-year period following the date of its grant year.

On July 1, 2023, when the fair market value of the Price stock is $40 per share, Brady exercises the option in full, acquiring 2,000 shares for $10 per share. On July 1, 2025, Brady sells the 2,000 shares for $50 per share.

If this option is taxable at grant, Brady includes the value of the option (less any amount paid) in income for the tax year of receipt of the option. Assuming the fair market value of the option is $20 per share, Brady includes $40,000 in income for his 2020 tax return.

Property acquired upon the exercise of a compensatory option taxed at grant has a basis equal to the amount paid upon the exercise of the option plus any basis that the employee had in the option itself [§83(a), §83(f)].

Example: Under the facts of the above example, Brady would hold Price, Inc. stock with a basis of $30 per share ($10 per share exercise price plus $20 per share basis in the option, which is the amount of the readily ascertainable fair market value of the option that was included in income at grant).

The remaining bargain inherent in the property as a result of the appreciation of the underlying stock in excess of the sum of the exercise price, plus the amount included in income at grant, is not taxed until the employee disposes of the stock acquired with the option. The holding period of the stock acquired pursuant to the exercise of a compensatory option taxed at grant begins only with the day after the exercise. The holding period of the option is not tacked to the holding period of the underlying stock.

Before the employee may sell the stock and receive long-term capital gain treatment, the employee must hold the property for the requisite long-term holding period (e.g., more than one year for long-term capital gain treatment) [§1001(a)].

Options Not Actively Traded on an Established Market. An option that is not actively traded on an established market will not have a readily ascertainable fair market value unless the fair market value "can otherwise be measured with reasonable accuracy." There is a presumption that an untraded option does not have a readily ascertainable fair market value unless certain conditions are met, such as transferability and the absence of restrictions that impair the option's value. The effect of the presumption is that untraded options almost never have a readily ascertainable fair market value at the date of grant. As a result, untraded options usually will be taxed when they are exercised rather than when they are granted [Reg. §1.83-7(b)(2)].

For options that do not have a readily ascertainable fair market value at grant, there will be a tax-significant event upon the exercise of the option, and not at the date of the grant of the option. Generally, in the tax year an employee exercises the option, the employee must include in gross income the difference between the value of the stock acquired and the exercise price. The amount is considered ordinary compensation income [§83(e)(3), §83(e)(4)].

When such an option is not taxed at grant, however, the difference between the share value of the common stock on the exercise date and the per share exercise price is taxed to the employee as the compensation income arising under §83(a) from the option transaction. The transaction's compensatory aspect is considered closed upon exercise of the option [§83(a); Reg. §1.61-2(d)(2)(i)].

The property acquired pursuant to the exercise of an option that is not taxed at grant takes a basis equal to the sum of the property's cost (the exercise price) and the option's basis in the hands of the option holder [Reg. §1.83-1(b)(2)].

Example: On June 1, 2020, when Price, Inc. stock had a fair market value of $30 per share, Price Inc. granted to Brady, in consideration of services rendered to Price, Inc., an option to buy 2,000 shares of common stock. The option price was $30 per share. On July 1, 2021, when the fair market value of the Price, Inc. stock is $45 per share, Brady exercises the option in full, acquiring 2,000 shares for $30 per

share. The basis in the stock acquired is $45 per share (the sum of the exercise price of $30 per share and the amount included in income of $15 per share).

The employee's holding period in the underlying stock begins the day on which the property is acquired pursuant to the exercise of the option. There is no tacking of holding periods. Property acquired pursuant to the exercise of a compensatory option taxed at exercise is normally investment property and is taxable only when that property is disposed of [§83(f); Reg. §1.83-4(a)].

Example: In the above example, if Brady sells the property for $50 per share on July 1, 2024, a gain of $5 per share will be recognized ($50 per share amount realized less $45 share adjusted basis in the stock). This gain is long-term capital gain.

Employer Deduction. Generally, employers may take a trade or business expense deduction for compensation paid to employees, including nonstatutory stock options. The deduction may be taken for the amount included in income by the employee. The deduction is available if the amounts meet the "ordinary and necessary" requirement test applicable to deducting business expenses, and the amount reasonably compensates personal services actually rendered [§83, §162(a)(1)].

A publicly held corporation's deduction for compensation paid or accrued with respect to a "covered employee" is limited to $1 million per year. A publicly held corporation is defined as <u>an issuer in §12 of the 1934 Act or if it is required to file reports under §15(d) of the 1934 Act</u> (which includes certain large private C corporations and S corporations with public debt) [§162(m)(1), §162(m)(2)].

A covered employee is [§162(m)(3)]:

• the principal executive officer of the corporation (or an individual acting in such capacity) at any time during the tax year;

• the principal financial officer of the corporation (or an individual acting in such capacity) at any time during the tax year;

• the three highest paid employees of the corporation;

<u>• for tax years beginning after December 31, 2026, the five highest compensated employees for the taxable year other than those described in the first three bullets;</u> and

• an employee who qualified as a covered employee for any preceding tax year beginning after December 31, 2016.

An employee remains a covered employee even after termination or death. Remuneration paid to a beneficiary of a covered employee, such as death benefits, is considered remuneration to a covered employee [§162(m)(4)].

The $1 million compensation deduction limit applies to all remuneration for services. The limit applies to the year in which the deduction would otherwise be taken. Thus, for NSOs, the deduction normally is taken in the year the option is exercised. Compensation that exceeds $1 million that is paid solely because the executive has attained one or more performance goals is excluded from the $1 million limit

for payments made in tax years beginning before January 1, 2018. The commission and performance-based compensation exceptions to the $1 million yearly limit on the deduction for compensation paid with respect to a covered employee of a publicly traded corporation were repealed, effective for tax years beginning after December 31, 2017.

A transition rule applies so that the changes do not apply to payments under a written binding contract in effect on November 2, 2017, that is not modified in any material respect on or after that date [§162(m)(4)]. Remuneration is payable under a written contract that was in effect on November 2, 2017, only to the extent that the corporation is obligated under applicable law to pay the remuneration under such contract if the employee performs services or satisfies the applicable vesting conditions. A contract is deemed materially modified if the contract is amended to increase the amount of compensation payable to the employee. Similarly, any modification to a contract that accelerates the payment of compensation is considered a material modification unless the amount of compensation is discounted to reasonably reflect the time value of money [Reg. §1.162-33(g)].

Employer Gain or Loss. The employer's use of property to compensate an employee is considered a disposition of that property. In most cases, the employer does not recognize gain (or is denied the benefit of recognizing loss) in an NSO transaction because the property used to compensate employees is the employer's own stock. The employer's disposition of its own stock is protected from gain recognition (and denied loss recognition) under §1032. This section extends to transfers of employer stock as compensation for services [§1032; Reg. §1.1032-1(a)].

Employment Taxes and Withholding. When an employee recognizes ordinary compensation income upon exercise of an NSO, the employer must report the amount on Form W-2, withhold for purposes of federal income taxes as well as for FICA, and must include such compensation in wages for purposes of FUTA [§3101, §3301, §3401].

The duty to pay employment taxes and to withhold belongs to the employer in most situations. The employer is potentially subject to penalties for failure to discharge these duties. The obligation to pay employment taxes and to withhold occurs at the same time that income is recognized under §83. In the case of NSOs as compensation, stocks are eligible for the flat withholding rate that applies to "supplemental wage payments" if the employer has withheld taxes from the employee's regular wages [§3102(a), §3111(a), §3301, §3402(a), §3403, §6672; Reg. §31.3402(g)-1].

1700.C. Sickness, Injury, And Death Benefits

1700.C.4. Flexible Spending Accounts (FSAs)

A flexible spending account (FSA) is a salary reduction program that provides employees with coverage that reimburses specified, incurred expenses (subject to reimbursement maximums and any other reasonable conditions). An expense for qualified benefits must not be reimbursed from the FSA unless it is incurred during a period of coverage [Prop. Reg. §1.125-5(a)(1)]. An employer may establish health FSAs and dependent care FSAs. Employees covered by an FSA can reduce their pay and have the amounts deposited in their FSA. Generally, no contribution or benefit from a FSA may be carried over to any subsequent plan year or period of coverage. Unused benefits or contributions remaining at the end of the plan year (or at the end of a grace period, if applicable) are forfeited [Prop. Reg. §1.125-5(c)(1)]. However, due to the Covid-19 pandemic, cafeteria plans may be amended to permit participants to

carry over any unused benefits or contributions remaining in a health FSA or dependent care FSA from its plan year ending in 2020 to its plan year ending in 2021. Likewise, a cafeteria plan may permit unused benefits or contributions from its plan year ending in 2021 to be carried over to its plan year ending in 2022. In addition, cafeteria plans may provide for a 12-month grace period for plan years ending in 2020 or 2021. [Pub. L. No. 116–260, Div. EE, Title II, §214(a)-(c)(1); Notice 2020-29, Notice 2020-33]. For plan years ending in 2021, a cafeteria plan that includes a health FSA or dependent care FSA may permit employees to prospectively modify the amount of the employee's contribution to the FSA, without regard to any change in status [Pub. L. No. 116–260, Div. EE, Title II, §214(e)].

Health FSAs. A health FSA may reimburse medical expenses (as defined in §213(d) (see 700.D.1.)) and is permitted to limit payment or reimbursement to only certain medical expenses. A prescription is not needed for reimbursement of expenses for drugs and medicines [Pub. L. No. 116-136, §3702]. Also, qualifying expenses for menstrual care products may be reimbursed through a health FSA [§106(f)].

A health FSA may not reimburse employees for premium payments for other health coverage, including premiums for COBRA coverage, accidental death and dismemberment insurance, long-term disability or short-term disability insurance or for health coverage under a plan maintained by the employer of the employee or the employer of the employee's spouse or dependent. Also, a health FSA may not reimburse expenses for long-term care insurance premiums or for long-term care services for the employee or employee's spouse or dependent [Prop. Reg. §1.125-5(k)(4)].

Salary reduction contributions to a health FSA are limited to $2,750 in 2020 and 2021 [Rev. Proc. 2019-44, Rev. Proc. 2020-45] and, unless the plan either provides a grace period or includes a carryover provision, unused benefits remaining at the end of the plan year are forfeited. A grace period must apply to all participants and generally may not extend beyond 2 ½ months after the end of the plan year (March 15 for calendar year plans). An annual carryover of unused amounts may be used only for medical care expenses incurred in the immediately following plan year, and, for the 2021 plan year, this carryover amount may be up to $550 [§125(i); Rev. Proc. 2020-45. Due to the Covid-19 pandemic, cafeteria plans may permit an employee who ceases participation in the plan during calendar year 2020 or 2021 to continue to receive reimbursements from unused benefits or contributions through the end of the plan year in which such participation ceased (including any grace period) [Pub. L. No. 116–260, Div. EE, Title II, §214(c)(2)].

Reimbursing advance payments for orthodontia services does not violate the prohibition against deferring compensation in a cafeteria plan [Prop. Reg. §1.125-5(k)(3)(i)].

Example: Employer D sponsors a calendar year cafeteria plan that offers a health FSA. Employee K elects a salary reduction of $2,750 for a health FSA for the 2020 plan year. K's dependent requires orthodontic treatment, but K's accident and health insurance does not cover orthodontia. Following normal practice, the orthodontist charges $3,000, all due in 2021, for treatment to begin in 2021 and end in 2022. K pays the $3,000 in 2021. In 2021, D's cafeteria plan may reimburse $2,750 to K without violating the prohibition against deferring compensation in a cafeteria plan [Prop. Reg. §1.125-5(k)(3)(ii)].

A health FSA may include qualified reservist distributions (QRDs). QRDs are defined as distributions to a participant in a health FSA of all or a portion of the participant's FSA balance if (i) the participant is a reservist ordered or called to active duty for a total period of at least 180 days or for an indefinite period, and (ii) the request for a distribution is made during the period beginning with the order or call

to active duty and ending on the last day of the plan year (or grace period, if applicable). A QRD is included in an employee's gross income and wages and is subject to employment taxes. The employer must report the QRD as wages on the employee's Form W-2 for the year in which the QRD is paid [§125(h); Notice 2008-82].

Dependent Care FSAs. A dependent care FSA may reimburse employees for dependent care costs subject to the limitations that apply to dependent care assistance programs (see 1700.E.2.). Accordingly, the maximum reimbursement is limited to $5,000 per employee ($2,500 for married filing separately).

Only expenses with respect to the care of a qualifying individual may be reimbursed from a dependent care FSA. Generally, the qualifying individual must be a dependent of the employee under age 13. Because of the Covid-19 pandemic, plans may extend the maximum age of eligible dependents from 12 to 13 for dependent care FSAs for the 2020 plan year, and unused amounts from the 2020 plan year may be carried over into the 2021 plan year. The maximum age remains 13 for the 2021 plan year, but this relief only applies to dependent care FSA funds that remained unspent at the end of the 2020 plan year [Pub. L. No. 116–260, Div. EE, Title II, §214(d)].

1700.F.2.C. Definitions Applicable To Health Insurance Premium Tax Credit

Premium Assistance Amount. The premium assistance amount for a coverage month is the lesser of: (i) the monthly premiums for that month for one or more qualified health plans offered in the individual market that cover the taxpayer, the taxpayer's spouse, or the taxpayer's dependent who were enrolled through a public health insurance exchange, or (ii) any excess of the adjusted monthly premium for the month for the applicable second lowest cost silver plan for the taxpayer (often called the benchmark plan), over 112 of the taxpayer's contribution amount, which is the applicable percentage (listed below) multiplied by the taxpayer's household income for the year. The adjusted monthly premium is the amount an issuer would charge for the benchmark plan to cover the members of the coverage family, as adjusted for the age of each member but not for tobacco use [§36B(b)(2); Reg. §1.36B-3(d), Reg. §1.36B-3(e)].

The applicable percentages for 2020 are as follows [**Rev. Proc. 2019-29**]:

Household Income (as % of FPL)	Initial Premium Percentage	Final Premium Percentage
100% to 133%	2.06%	2.06%
133% to 150%	3.09%	4.12%
150% to 200%	4.12%	6.49%
200% to 250%	6.49%	8.29%
250% to 300%	8.29%	9.78%
300% through 400%	9.78%	9.78%

The applicable percentages for 2021 and 2022 are as follows [§36B(b)(3)(A)(iii); Rev. Proc. 2021-23, §5.01]:

Household Income (as % of FPL)	Initial Premium Percentage	Final Premium Percentage
100% to 150%	0%	0%
150% to 200%	0%	2%

200% to 250%	2%	4%
250% to 300%	4%	6%
300% to 400%	6%	8.5%
400% and higher	8.5%	8.5%

Coverage Month. A coverage month is any month in which, as of the first day of the month, the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer is enrolled in a qualified health plan through a public health insurance exchange, as long as the premium for coverage is paid by the taxpayer by the unextended due date for filing the taxpayer's income tax return or through advance payment of the credit. It does not include any month for which the individual is eligible for minimum essential coverage elsewhere (other than coverage in the individual market) [§36B(c)(2)]. A coverage month also does not include any month for which the individual is provided a qualified small employer health reimbursement arrangement that is affordable coverage (see 1700.C.1.g.) [§36B(c)(4); Reg. §1.36B-3(c)].

Example: Mel is single with no dependents. In November 2020, Mel enrolls in a qualified health plan for 2021 and the exchange approves advance credit payments. Mel pays Mel's share of the premiums. On May 15, 2021, Mel enlists in the U.S. Army and is eligible immediately for government-sponsored minimum essential coverage. January through May 2021 are coverage months for Mel, but June through December are not because Mel is eligible for minimum essential coverage for those months. Mel's premium assistance credit amount for 2021 is the sum of the premium assistance amounts for the months January through May.

Household Income. Household income is the taxpayer's modified adjusted gross income (MAGI) (including the MAGI of a child for whom an election under §1(g)(7) (see 1200.A.1.d.) is made), plus the aggregate MAGIs of all other individuals for whom the taxpayer properly claims a personal exemption deduction and who are required to file a tax return under §1. Although the exemption amount currently is zero, a personal exemption deduction is considered claimed for an individual in the taxpayer's family if the taxpayer otherwise would be allowed to take it and lists the individual's name and TIN on the return [§36B(d)(2); Reg. §1.36B-1(d)(2), §1.36B-1(e)].

For this purpose, MAGI includes: (i) any amount excluded from gross income for foreign earned income and housing by U.S. citizens and residents living abroad (see 2000.C.1.); (ii) tax-exempt interest received or accrued by the taxpayer during the tax year (see 200.B.); and (iii) Social Security benefits not included in the taxpayer's gross income (see 100.K.). The calculation includes all Social Security benefits received during the year, without regard to any §86(e) election (see 100.K.). The rule for determining household income is temporarily modified for unemployment compensation in 2021. If a taxpayer has received or is approved to receive unemployment compensation for any week beginning during 2021, for the tax year in which the week begins, no household income of the taxpayer in excess of 133% of the poverty line for the family's size is taken into account in determining the premium tax credit. [§36B(g); §36B(d)(2)(B); Johnson v. Commissioner, 152 T.C. 121 (2019)].

Benchmark Plan. The applicable benchmark plan is the second lowest cost silver plan that applies to the taxpayer. A silver plan is a plan that covers at least 70% of the value of benefits provided and: (i) is in the rating area in which the individual resides; (ii) is offered through a public health insurance exchange in the area in which the individual resides; and (iii) provides self-only coverage in the case of an individual who purchases self-only coverage, or family coverage in the case of any other individual. If family

members live in different states and enroll in separate qualified health plans, the sum of the premiums for the applicable benchmark plans for each group of family members living in the same state is the premium for the applicable benchmark plan [§36B(b)(3)(B); Reg. §1.36B-3(f)].

No benefits other than essential health benefits are considered, even if the individual's home state requires the additional benefits. If an individual enrolls in both a qualified health plan and a pediatric dental plan for a plan year, the portion of the premium for the plan that is properly allocable to pediatric dental benefits that are included in the essential health benefits required to be provided by a qualified health plan must be treated as a premium payable for a qualified health plan [§36B(b)(3)(D), §36B(b)(3)(E); Reg. §1.36B-3(k)(1)].

If a taxpayer files a joint return, but the credit is not allowed for one spouse because the spouse is not lawfully present in the United States, the taxpayer will be treated as having self-only coverage for this purpose unless a personal exemption deduction is allowed for another dependent who is lawfully present in the United States [§36B(b)(3)(B), §36B(e); Reg. §1.36B-3(f)(1), §1.36B-3(l)].

A qualified health plan may cover more than one family under a single policy, in which case each applicable taxpayer covered by the plan may claim a premium tax credit using that taxpayer's applicable percentage, household income, and applicable benchmark plan, assuming he or she is eligible for the credit. For example, a parent and a 25-year-old child may be on the same policy but they are separate families when determining premium tax credit eligibility [Reg. §1.36B-3(h)].

1700.F. Health Care Reform

1700.F.2. Health Insurance Premium Tax Credit

1700.F.2.D. Claiming The Health Insurance Premium Tax Credit

The public health insurance exchange determines eligibility for advance payments to the insurance plan of the premium tax credit based on the taxpayer's family size and household income, generally using the most recent tax year for which information is available. The amount of advance payment may be redetermined during the year based on changes in circumstances. Thus, taxpayers should promptly inform the exchange of changes in circumstances (such as estimated household income) so that it can adjust the advance payment amount, if appropriate.

A taxpayer who receives an advance credit payment must file an income tax return and reconcile the actual credit for the tax year computed on the taxpayer's tax return with the amount of advance payments. A taxpayer whose allowed credit for the tax year exceeds the taxpayer's advance credit payments may receive the excess as an income tax refund. For tax years other than 2020, a taxpayer whose advance credit payments for the tax year exceed the taxpayer's premium tax credit owes the excess as an additional income tax liability. Thus, for tax years other than 2020, if an individual's income is higher than the estimated amount used to calculate the advanced premium tax credit payment, the individual must return part or all of the excess payment to the government through a tax increase. However, for individuals whose actual household income is less than 400% of the FPL, the maximum amount of the tax increase is based on a sliding scale, subject to tax indexing, starting at $650 for household income below 200% ($325 for an unmarried individual not filing as a qualifying widow(er) or head of a household) of the FPL and topping out at $2,700 for 2021 ($1,325 for an unmarried individual)

for household income at 300% to less than 400% of the FPL. Married taxpayers who receive advance credit payments and file separate income tax returns are treated as receiving excess advance payments, and the advance credit payments are allocated equally to each taxpayer [§36B(a), §36B(f); Reg. §1.36B-4(a); Rev. Proc. 2020-45].

Due to the suspension of the requirement to repay excess advance credit payments for 2020 only, a taxpayer with advance credit payments that exceed the credit allowed is not required to file Form 8962, report an excess advance credit repayment on Form 1040, or amend a 2020 return to claim the relief for the year. A taxpayer who claims a net premium tax credit for 2020 must file Form 8962 with the income tax return [IRS News Release IR-2021-84 (Apr. 9, 2021); IRS Pub. 974, Premium Tax Credit (PTC) (2020) (Rev. Apr. 2021)].

No cap is provided for the additional tax due from individuals whose household income is at or above 400% of the federal poverty level (FPL). Adjusted gross income cannot be decreased, except as provided under §36B. Relief is not available to an individual for unforeseen events that cause income to be above the limit, such as discharged debt or a one-time capital gain, and the entire premium assistance amount must be repaid.

If any additional tax is not timely paid, interest and late payment and underpayment penalties may apply (see 2300.D.1.).

The credit is claimed on Form 8962, Premium Tax Credit (PTC), based on information furnished to the taxpayer on Form 1095-A, Health Insurance Marketplace Statement. The credit is reportable on Schedule 3, Part II (Form 1040 or Form 1040-SR). Repayment of excess advance payments is report on Schedule 2, Part I.

No income tax deduction is allowed for the portion of health plan premiums paid using the premium tax credit [§280C(g)].

Chapter 1900. Tax-Exempt Organizations

1900.A. Section 501(C)(3) Charitable Organizations

1900.A.10. Compliance for §501(C)(3) Organizations: Applying for and Maintaining Exempt Status

1900.A.10.a. Applying for Exempt Status

An organization that wishes to be tax exempt as a charitable organization must electronically file either Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code, or Form 1023-EZ, Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code [Reg. §1.508-1(a)(2)(i); Rev. Proc. 2021-5, §4.02]. Generally, an organization can use Form 1023-EZ if it has gross receipts of $50,000 or less and assets of $250,000 or less, unless it is specifically designated ineligible [Rev. Proc. 2021-5, §6.05].

The organization must electronically file Form 1023 or Form 1023-EZ at http://www.pay.gov, within 15 months (or 27 months if filed pursuant to the automatic 12-month extension) from the end of the month of its organization. If the organization does not file or files late, it will not be treated as exempt

under §501(c)(3) for any period before the filing of the notice, unless it submits, and the IRS approves, Form 1023, Schedule E [Reg. §1.508-1(a)(2)(i), §301.9100-2; Rev. Proc. 2021-5]. The IRS generally will not require domestic business entities to file a new exemption application when they change their form or state of organization [Rev. Proc. 2018-15].

Churches, conventions or associations of churches, and integrated auxiliaries of churches are not required to file Form 1023 (and are ineligible to file Form 1023-EZ). Also, any organization other than a private foundation with gross receipts that are normally not more than $5,000 does not need to file either Form 1023 or Form 1023-EZ. Further, any subordinate organization other than a private foundation covered by a group exemption or a parent and certain nonexempt charitable trusts does not need to file an application for exempt status.

Hospitals must meet additional requirements to obtain or maintain exempt status. Failure to meet certain requirements can result in a $50,000 excise tax [§501(r), §4959; Reg. §1.501(r)-1 through §1.501(r)-6; Rev. Proc. 2015-21].

The user fee for Form 1023-EZ is $275, and the application must be filed and the user fee paid through http://www.pay.gov [Rev. Proc. 2016-32, Rev. Proc. 2021-5, app. A]. There is a $600 user fee for all other initial applications under §501 or §521 for exempt status (other than pension, profit-sharing, and stock bonus plans). An additional user fee of $2,500 must be paid for a group exemption letter [Rev. Proc. 2021-5, app. A]. Unlike Form 1024 (discussed at 1900.B.2.), organizations applying for exemption under §501(c)(3) need not file Form 8718 when paying the user fee.

If the IRS Exempt Organizations (EO) Determinations Office (part of EO Rulings and Agreements) reaches the conclusion that an organization claiming exemption under §501(c)(3) does not satisfy the requirements for exempt status, the IRS generally will issue a proposed adverse determination letter. Proposed adverse determinations may be appealed to the IRS Independent Office of Appeals [§7123; Rev. Proc. 2021-5, §9.04, §9.07]. If the IRS denies an application for tax-exempt status or fails to act on an application, the organization may seek declaratory judgment in the Tax Court, the U.S. District Court for the District of Columbia, or the Court of Federal Claims. Under the declaratory judgment procedure, an organization must exhaust all administrative remedies with the IRS. An organization is deemed to have exhausted its administrative remedies at the expiration of 270 days after it has requested a determination. If the IRS makes an adverse determination during the 270-day period or the 270-day period has expired, an organization may immediately seek declaratory relief [§7428].

1900.A.10.c. Revocation or Modification of Determination Letter

A ruling or determination letter may be revoked or modified by: (i) notice to the organization, presumably after audit; (ii) enactment of legislation or ratification of a tax treaty; (iii) a Supreme Court decision; (iv) issuance of temporary or final regulations; (v) publication of a revenue ruling, revenue procedure, or other statement in the Internal Revenue Bulletin; or (vi) automatically, pursuant to §6033(j), for failure to file a required annual return or notice for three consecutive years [Rev. Proc. 2021-5, §12]. Organizations failing to file an annual return or notice for two years will receive a notice from the IRS [§6033(j)(1)(A)]. The revocation or modification may be retroactive if the organization omitted or misstated a material fact or operated in a manner materially different from that originally represented. A court may overturn a retroactive revocation if it finds that the organization did not omit or misstate a material fact or operate in a manner materially different from that originally represented.

If the IRS proposes to revoke a determination letter recognizing exemption, the IRS Office of EO Determinations (part of EO Rulings and Agreements) generally will issue a proposed adverse determination letter. The IRS will no longer allow modifications of tax-exempt status (such as modifying a recognized §501(c)(4) exemption to a §501(c)(7) exemption). Instead, a revoked organization may apply or reapply for recognition under a different Code section.

Proposed adverse determinations may be appealed to the IRS Independent Office of Appeals. In filing its appeal, the organization must also indicate whether it is requesting an Appeals conference [§7123; Rev. Proc. 2021-5, §9.04]. An organization may appeal a final IRS determination by seeking declaratory judgment in the Tax Court, the U.S. District Court for the District of Columbia, or the Court of Federal Claims [§7428].

1900.B. Other Exempt Organizations

1900.B.2. Compliance for Noncharitable Tax-Exempt Organizations

Most organizations choose to seek a determination letter from the IRS recognizing exemption under §501, but are not required to do so except in certain cases. Organizations that seek to operate under §501(c)(9) or §501(c)(17) must apply for recognition of tax-exempt status. An organization seeking a determination letter recognizing exemption under §501(c)(2), (5), (6), (7), (8), (9), (10), (12), (13), (15), (17), (19), or (25) must submit a completed Form 1024, Application for Recognition of Exemption Under Section 501(a), along with Form 8718, User Fee for Exempt Organization Determination Letter Request. Other organizations seeking a determination letter must submit a letter application (rather than Form 1024), along with Form 8718 [Rev. Proc. 2021-5].

A $600 user fee must be included with the initial exemption application under §501(a). The user fee for group exemption letters is $2,500 [Rev. Proc. 2021-5]. For organizations that qualify to file Form 1023-EZ, the user fee is $275 and the application must be filed and the user fee paid through http://www.pay.gov [Rev. Proc. 2016-32; Rev. Proc. 2021-5].

Farmers' Cooperatives. Farmers' cooperatives must use Form 1028, Application for Recognition of Exemption Under Section 521 of the Internal Revenue Code, and pay a $600 user fee [Rev. Proc. 2021-5]. An organization that is recognized as exempt under §521 must file an annual return on Form 1120-C, U.S. Income Tax Return for Cooperative Associations (see 1300.F.4.).

CO-OP Health Insurance Issuers. CO-OP health insurance issuers seeking exemption under §501(c)(29) must apply to the IRS by submitting a letter application in lieu of a form [Rev. Proc. 2015-17].

Political Organizations. Political organizations must electronically file Form 8871, Political Organization Notice of Section 527 Status, to apply for exemption. There are five types of organizations that do not need to file Form 8871:

1. persons required to report under the Federal Election Campaign Act of 1971 as a political committee;

2. organizations that reasonably anticipate that their annual gross receipts will always be less than $25,000;

3. organizations described in §501(c) that are subject to §527(f)(1) because they have made an "exempt function" expenditure;

4. political committees of a state or local candidate; and

5. state or local committees of a political party.

A political organization that transfers $500 or more per calendar year to a single recipient, or that receives aggregate contributions of at least $200 from a single contributor during a calendar year must file, either monthly or quarterly, Form 8872, Political Organization Report of Contributions and Expenditures. Section 527(j) excludes some organizations from this filing requirement. Tax-exempt political organizations with gross receipts of $25,000 or more are required to file Form 990. Political organizations that receive contributions of $5,000 or more from any one contributor must include Form 990, Schedule B. A tax-exempt political organization is not required to file Form 990 if it is (i) not required to file Form 8871 (including an organization required to file as a political committee with the Federal Election Commission), or (ii) a caucus or association of state or local officials. Organizations with taxable political expenditures under §527(f) must file Form 1120-POL, U.S. Income Tax Return for Certain Political Organizations.

Social Welfare Organizations (§501(c)(4)). Social welfare organizations may choose to seek a determination letter from the IRS, but generally are not required to do so. An organization seeking a 501(c)(4) determination letter must electronically submit a completed Form 1024-A, Application for Recognition of Exemption Under Section 501(c)(4) of the Internal Revenue Code, and the required user fee online, at http://www.pay.gov [Rev. Proc. 2021-8, §3.02, modifying Rev. Proc. 2021-5, §4.02(4)]. Section 501(c)(4) organizations organized after July 8, 2016, must notify the IRS within 60 days of the organization's establishment that it is operating as such by submitting a completed Form 8976, Notice of Intent to Operate Under Section 501(c)(4). Form 8976 must be submitted online and not on paper. Form 8976 is subject to a $50 user fee. See https://www.irs.gov/charities-non-profits/electronically-submit-your-form-8976-notice-of-intent-to-operate-under-section-501c4 for more information. However, organizations that on or before July 8, 2016, filed either a Form 990 (or, if eligible, Form 990-EZ or Form 990-N (e-postcard)) or a Form 1024 seeking a determination letter recognizing exemption under §501(c)(4) are not required to submit Form 8976. Existing organizations that did not meet either exception had until September 6, 2016, to submit Form 8976. Failure to file the initial notice may subject the organization and its managers to penalties. Additionally, the first annual return by an affected organization must include information required by the IRS in support of treatment as a §501(c)(4) organization [§506, §6033(f)(2), §6652; Reg. §1.506-1; Rev. Proc. 2016-41; Rev. Proc. 2021-5].

IRS Procedures and Appeal Rights. If the IRS Office of EO Determinations (part of EO Rulings and Agreements) reaches the conclusion that an organization claiming exemption under §501(c) does not satisfy the requirements for exempt status, the IRS generally will issue a proposed adverse determination letter. Proposed adverse determinations may be appealed to the IRS Independent Office of Appeals. In filing its appeal, the organization must also indicate whether it is requesting an Appeals conference. These procedures also apply to revocations or modifications of determination letters [§7123; Rev. Proc. 2021-5, §9].

If the IRS denies an application for tax-exempt status or fails to act on an application within 270 days, the organization may seek declaratory judgment in the Tax Court, the U.S. District Court for the District

of Columbia, or the Court of Federal Claims. The declaratory judgment process, previously available for §501(c)(3) organizations (as well as private foundations, private operating foundations, and cooperatives), was extended to other organizations described in §501(c). Under the declaratory judgment procedure, an organization must exhaust all administrative remedies with the IRS. An organization is deemed to have exhausted its administrative remedies at the expiration of 270 days after it has requested a determination. If the IRS makes an adverse determination during the 270-day period or the 270-day period has expired, an organization may immediately seek declaratory relief. Organizations may also seek declaratory relief if the IRS revokes or modifies previously issued determination letters [§7428].

Annual Information Return. Generally, organizations exempt from tax under §501(a) must file Form 990 (see 1900.A.10.b.).

Chapter 2000. U.S. International Taxation

2000.C. Foreign Activities of U.S. Taxpayers

2000.C.1.A. Basic Qualifications for §911 Exclusion

To claim the exclusion, an individual must have a tax home (see 400.A.11.) in a foreign country and be [§911(d)(1)]:

• a U.S. citizen who can establish an uninterrupted period of residency in a foreign country (or countries) over the entire tax year (bona fide residence test), or

• a U.S. citizen or resident alien who was physically present in a foreign country (or countries) for 330 full days (in the aggregate) over any consecutive 12-month period (physical presence test).

An individual is not treated as having a tax home in a foreign country for any period for which his or her abode is within the United States, unless the individual is serving in a combat zone in support of the Armed Forces. This includes otherwise eligible U.S. contractors and employees of contractors supporting U.S. armed forces in designated combat zones [§911(d)(3); *IR-2018-173*].

The 330 days need not be consecutive. A full day is a continuous period of 24 hours from midnight to midnight [Reg. §1.911-2(d)(2)].

There is an exception to the bona fide residence and physical presence tests if the taxpayer is required to leave a foreign country as a result of war, civil unrest, or other similar conditions that preclude the normal conduct of business by the individual [§911(d)(4)].

The IRS waived the tests for individuals who departed a foreign country because of the Covid-19 emergency [Rev. Proc. 2020-27].

Also, a resident alien who is a citizen of a country that has an income tax treaty with the United States may usually qualify by applying the nondiscrimination clause found in most bilateral U.S. tax treaties [§7701(b)(1)(A); Rev. Rul. 91-58].

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2000.C.1.B. Foreign Earned Income for Purposes of §911 Exclusion

Foreign earned income refers to amounts received by an individual from sources within a foreign country (or countries) that constitute earned income attributable to personal services performed by that individual (e.g., wages, salaries, professional fees, bonuses, and tips). A limited amount of foreign earned income is excludible from gross income. The annual limit is adjusted for inflation and, for individuals, is $107,600 for 2020 and $108,700 for 2021 [§911(b); Rev. Proc. 2019-44, Rev. Proc. 2020-45]. To determine an individual's maximum exclusion amount, the annual exclusion amount is multiplied by the fraction of qualifying days (i.e., days in which an individual meets either the bona fide resident test or the physical presence test) over the total days in the tax year. Married couples may apply the exclusion separately up to the maximum amount per individual and thus exclude a total up to $215,200 for 2020 and $217,400 for 2021.

Example: In 2021, Sandy returned to the United States after having spent 185 qualifying days in Country A, during which she earned $32,000 in foreign income. Sandy's maximum exclusion for 2021 would be $55,094 ($108,700 × 185/365); however, because her actual foreign earned income was $32,000, she may exclude only $32,000 from gross income.

The following amounts are not included in foreign earned income and may not be excluded from gross income [§911(b)(1)(B)]:

• amounts received as a pension or annuity or from a qualified retirement plan or as a U.S. government salary; and

• amounts received after the close of the tax year following the year in which the relevant services are performed.

In the case of a taxpayer who operates an unincorporated business (e.g., a sole proprietor or a partner in a partnership) in which both personal services and capital are material income-producing factors, foreign earned income includes a reasonable allowance as compensation for personal services not in excess of 30% of the taxpayer's share of the net profits of the business [§911(d)(2)].

2000.C.1.C. Foreign Housing Costs

Foreign housing expenses are also excludible from gross income to the extent the costs are provided by an employer and exceed an annual base amount, subject to a limitation amount [§911(c)(2); Notice 2021-18]. These amounts are 16% and 30%, respectively, of the maximum foreign earned income exclusion amount for the year multiplied by the number of qualifying days and are computed on a daily basis [§911(c)(1), §911(c)(2)]. If the taxpayer chooses the foreign housing cost exclusion, he or she computes and applies it first, then the foreign earned income exclusion. That is, the foreign earned income exclusion limit is first reduced by the housing cost exclusion, and the foreign earned income exclusion is available only to the extent of the remainder [§911(a)(2), §911(c); Reg. §1.911-4(d)].

Example: The base amount for 2021 is $17,392 ($108,700 × 16%), resulting in a daily rate of $47.65 ($17,392/365), and the limitation amount is $32,610 ($108,700 × 30%), resulting in a daily rate of $89.34 ($32,610/365). Thus, the maximum annual exclusion for foreign housing costs in 2021 is $15,218 ($32,610 − $17,392), or a daily rate of $41.69 ($89.34 − $47.65). In the example above, because Sandy

had 185 qualifying days and a maximum foreign earned income exclusion of $55,094 she can exclude $7,712.65 in housing costs ($41.69 × 185 days).

Additional housing limitations may be elected for certain high-cost foreign geographic areas in the current and immediately preceding tax year pursuant to an annual IRS notice [Notice 2021-18 (for 2021); Notice 2020-13 (for 2020)].

Eligible housing costs are those that are reasonable expenses (i.e., not extravagant), and are paid or incurred by (or on behalf of) an individual (and any immediate family members) while in a foreign country. This includes rent and associated expenses (e.g., utilities and home insurance), but not amounts that qualify as deductible interest or taxes [§911(c)(3)]. A partial exclusion of foreign housing costs is not permitted [Reg. §1.911-4(d)(1)].

Qualified individuals who are self-employed or who do not have an employer-provided housing allowance can instead claim a deduction for housing costs, but only to the extent of the excess of one's foreign earned income exclusion over the housing cost amount exclusion for the tax year [§911(c)(4); Reg. §1.911-4(e)]. Any portion of the housing cost amount that is disallowed due to the limitation can be carried over only once to the next tax year [§911(c)(4)(C); Reg. §1.911-4(e)(2)]. Where an individual has self-employment income and employee wages, a portion of the housing cost amount is attributed to each income amount.

2000.C.2.A. Eligible Taxpayers

A direct foreign tax credit is available to U.S. citizens, resident aliens, and domestic corporations [§901(b); Reg. §1.901-1(a), Prop. Reg. §1.901-1(a)]. Partners in partnerships [§901(b)(5), §704(b); Reg. § 1.704-1(b)(4)(ii)], shareholders of S corporations [§1363(c)(2)(B)], and estate and trust beneficiaries are all entitled to claim the credit on a proportionate basis [§901(b)(5)]. A nonresident alien and a foreign corporation engaged in a U.S. trade or business may also claim the credit in connection with creditable foreign tax on effectively connected foreign-source income [§901(b)(4), §906(a)].

2000.C.2.B. Creditable Foreign Taxes

To claim the direct foreign tax credit, a foreign levy must be creditable, meaning it must be [Reg. §1.901-2(a)]:

• a compulsory tax (or a tax imposed in lieu of an income tax);

• a tax on realized net income; and

• a tax that is imposed on or accrued and paid by the taxpayer-claimant.

In evaluating a foreign levy, the predominant character must be that of an income tax, with reference made to U.S. law. Thus, a creditable foreign tax is one that is triggered by a taxable realization event and is based on the gross receipts and reaches the net income of the taxpayer. A certification by a foreign country that a levy is a tax is not enough [Reg. §1.901-2(a)(2)(i), §1.901-2(b)]. A tax in lieu of an income tax (e.g., a withholding tax on interest payments) may be creditable if it is imposed as a substitute for an otherwise applicable income tax and does not confer a special economic benefit [§903; Reg. §1.903-

1(a)] The 2020 proposed regulations would also revise the definition of an in-lieu-of tax, including by revising the substitution requirement. See generally Prop. Reg. §1.903-1; REG-101657-20, 85 Fed. Reg. 72,078 (Nov. 12, 2020). The 2020 proposed regulations would apply to foreign taxes paid or accrued in taxable years beginning on or after the date the final regulations are filed with the Federal Register. Prop. Reg. §1.903-1(e).

Certain foreign taxes do not qualify for the credit. For instance, the denial of double benefits rule prevents a taxpayer from claiming a foreign tax credit or itemized deduction for foreign taxes paid on income that is excluded from U.S. gross income or for which only an itemized deduction is permitted. Similarly, foreign taxes that arise in connection with operations in countries participating in an international boycott (see 2000.H.1.) are not creditable [§908]. Moreover, customs duties, penalties and fines, interest, and similar obligations are not considered taxes [Reg. §1.901-2(a)(2)(i)]. A tax payment that results in a "subsidy" for a taxpayer (or related person), such as through the use of rebates, credits, and refunds also does not qualify for the credit [§901(i); Reg. §1.901-2(e)(2), §1.901-2(e)(3)]. Certain "dual-capacity" taxpayers who receive a special economic benefit linked to a foreign levy have the burden of demonstrating what portion is the true tax [Reg. §1.902-1(a)(2), §1.902-1(b)(1)]. Likewise, a so-called "soak-up" tax, the liability for which depends on its creditability in a second country, is disqualified [Reg. §1.901-2(c)]. The foreign tax credit is suspended in certain "splitter" transactions, which often arise in the parent-subsidiary context, by disallowing the splitting of foreign taxes for crediting until the year the related income is taken into account [§909; Reg. §1.909-1 through §1.909-6].

In November 2020, Treasury and the IRS published proposed regulations that would revise and narrow the definition of a creditable foreign income tax under Reg. §1.901-2 [See Prop. Reg. §1.901-2; REG-101657-20, 85 Fed. Reg. 72,078 (Nov. 12, 2020).] The proposed rules revise the net gain requirement, limit the need for empirical analysis in the existing regulations, and introduce a jurisdictional nexus requirement that must be satisfied for a foreign income tax to be creditable [Prop. Reg. §1.901-2(c)]. The 2020 proposed regulations would apply to foreign taxes paid or accrued in taxable years beginning on or after the date the final regulations are filed with the Federal Register [Prop. Reg. §1.901-2(h)].

2000.C.2.E. Election

The foreign tax credit requires an affirmative election, made annually, and is computed and claimed on Form 1116, Foreign Tax Credit (Individual, Estate, or Trust), or Form 1118, Foreign Tax Credit — Corporations, and filed with one's tax return [Reg. §1.905-2(a)(2)]. However, separate forms must be used for each applicable category of foreign-source income. Proof of foreign taxes paid, such as receipts or tax returns, need not be attached to the form, but taxpayers must produce authentic documentation to substantiate a claim if requested by the IRS; if unavailable, certain forms of secondary evidence will suffice [Reg. §1.905-2(a)(2), §1.905-2(b)]. Generally, the election applies to all creditable foreign income taxes for the tax year, meaning one cannot choose to credit some foreign taxes and deduct others in the same year [Reg. §1.901-1(c)]. Proposed regulations issued in November 2020 would provide exceptions to this rule for taxes not subject to §275 and for additional taxes paid by an accrual basis taxpayer that relate to a prior year for which the taxpayer deducted foreign income taxes. See Prop. Reg. §1.901-1(c); REG-101657-20, 85 Fed. Reg. 72,078 (Nov. 12, 2020). The proposed regulations would apply to foreign taxes paid or accrued in taxable years beginning on or after the date that final regulations are filed with the Federal Register. Prop. Reg. §1.901-1(j).

2000.C.3. Foreign Corporations Owned by U.S. Persons

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2000.C.3.C. Base Erosion and Anti-Abuse Tax (BEAT)

2000.C.3.C.(1). Related-Party Hybrid Payments

No deduction is allowed for any disqualified related-party amount paid or accrued pursuant to a hybrid transaction or by, or to, a hybrid entity. The rule applies to payments by all U.S. taxpayers. A disqualified related-party amount is any interest or royalty paid or accrued to a related party if: (1) the payment is not included in the income of the related party under the tax law of recipient's country of residence; or (2) the related party is allowed a deduction for the payment under the tax law of recipient's country of residence. To the extent an interest or royalty payment is included in the gross income of a U.S. shareholder under subpart F, the payment will not be a disqualified related-party amount. A related party is a person related to the payor within the meaning of §954(d)(3) (i.e., a related person is an individual, corporation, partnership, trust or estate that controls or is controlled by the payor or who is controlled by the same persons who control the payer, with control being ownership of more than 50% of the total voting power or value of corporate entities or more than 50% of the value of beneficial interests of a partnership, trust or estate). A hybrid transaction is defined as a transaction, series of transactions, agreement, or instrument one or more payments with respect to which are treated as interest or royalties for U.S. income tax purposes and that are not so treated for purposes of the tax law of the recipient's country of residence for tax purposes. A hybrid entity is any entity that is either treated as fiscally transparent under U.S. tax law, but is not so treated for purposes of the tax law of the foreign country of which the entity is resident for tax purposes or is subject to tax, or is treated as fiscally transparent for purposes of the tax law of the foreign country of which the entity is resident for tax purposes, but is not so treated for purposes of U.S. income tax law [§267A; Reg. §1.267A-1 through §1.267A-7].

2000.C.3.F. Passive Foreign Investment Companies

A foreign corporation is a passive foreign investment company (PFIC) if it meets one of two tests during the tax year: (i) at least 75% of its gross income is passive (the income test); or (ii) at least 50% of its average assets (by adjusted basis or fair market value) are assets that produce or could produce passive income (the asset test) [§1297(a)]. These tests are applied on a look-through basis in certain circumstances, such as in the case of 25%-owned subsidiaries and passive income from a related person [§1297(c)].

Narrow exceptions to PFIC status obtained under these tests are available under certain conditions, such as for: (i) 10% shareholders of a CFC that is a PFIC (who are instead subject to subpart F, GILTI and §965); (ii) start-up companies and other corporations if they can show that they and any predecessors were not previously PFICs and will not be PFICs in the succeeding two years; and (iii) tax-exempt organizations that are shareholders of a PFIC [§1297(d), §1298(b)(2), §1298(b)(3); Reg. §1.1291-1(e)].

Final regulations issued in 2021 provide guidance for determining whether a foreign corporation is a PFIC, including rules for the income test, the asset test, the PFIC look-through rules, and the various PFIC exceptions. The regulations also provide guidance for determining whether a U.S. person is treated as a shareholder of a PFIC [T.D. 9936, 86 Fed. Reg. 4516 (Jan. 15, 2021)].

Concurrently with the 2021 final regulations, proposed regulations were issued providing additional guidance for determining PFIC status, including income derived in the active conduct of a banking business, classification of working capital, the exception for qualifying insurance corporations, and the active conduct of an insurance business. [REG-111950-20, 86 Fed. Reg. 4582 (Jan. 15, 2021)].

The significance for U.S. shareholders of a PFIC is that in targeting the sheltering of passive investment income from U.S. taxation, the PFIC rules subject distributions to a tax-and-interest regime. Tax is levied at the maximum ordinary income tax rate upon receipt of an "excess distribution" or upon disposition of PFIC stock and is accompanied by an interest charge [§1291(a), §1291(c)]. The regime applies in both instances to any distribution or gain that exceeds 125% of the average distributions of the PFIC for the prior three years, with the tax-and-interest charge levied on amounts allocated equally over each year on a daily pro rata basis reflecting one's holding period and class of stock. The interest charge is treated as interest on an underpayment of tax when due, thus, it is characterized as a nondeductible personal interest expense for individuals [§1291(c)(1); Reg. §1.163-9T(b)(2)].

The taint of PFIC stock remains indefinitely, except that once a corporation loses its PFIC status, the taint of prior earnings can be purged voluntarily with a mark-to-market election to be taxed as though the stock was sold for fair market value [§1298(b)(1)].

There are also some other avenues available to mitigate the often harsh results of the PFIC regime. For example, provided a PFIC furnishes the information necessary to determine a U.S. shareholder's annual inclusions, one can elect out of the PFIC regime by making a qualified electing fund (QEF) election, the tradeoff for which is current taxation of a pro rata share of the PFIC's earnings [§1291(d)(1)]. If a QEF election is made, the shareholder can also elect to defer payment of the tax until the earlier of an excess distribution or disposition of the PFIC stock, but this is subject to an interest charge [§1294]. Furthermore, a shareholder who makes a QEF election is also allowed to make a one-time mark-to-market (MTM) election, which results in the current taxation of prior year PFIC earnings [§1291(d)(2)]. An MTM election can also be made by a U.S. shareholder holding marketable PFIC stock [§1296].

U.S. shareholders of a PFIC must annually file Form 8621, Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund, if they are direct owners of PFIC stock or if they are indirect shareholders and certain conditions apply [§1298(f); Reg. §1.1298-1(b)].

Shareholders of a PFIC are eligible for the foreign tax credit, to the extent an excess distribution is allocated to the current year. To the extent an excess distribution is allocable to prior years, foreign taxes may reduce the special tax computed under the PFIC rules but may not otherwise be claimed as a credit. Those who make a QEF election are not subject to this limitation.

2000.D. U.S. Activities Of Foreign Persons

2000.D.1. Income From A U.S. Trade Or Business

2000.D.1.A. Effectively Connected Income

If a foreign person engages in a U.S. trade or business during a tax year, the person is subject to U.S. tax at graduated rates on a net-basis on the portion of taxable income that is effectively connected with

that trade or business [§871(b), §882(a)]. Other income that is classified as fixed or determinable annual or periodical ("FDAP") income is taxed separately on a gross basis at a flat 30% rate [§871(a), §881(a)].

U.S.-source income that is not FDAP income or capital gain is considered effectively connected to a U.S. trade or business [§864(c)(3)]. Chiefly, this refers to inventory sales taking place in the United States.

To determine whether U.S.-source FDAP income or capital gain is effectively connected to a U.S. trade or business, the Code provides two tests, and with each prescribes that "due regard" is to be given to whether the asset or income was accounted for through the trade or business [§864(c)(2)]. The first test is the "asset-use" test, which provides that income derived from assets used in or held for use in the trade or business is effectively connected income. Assets "used in or held for use in" refers to three categories of assets: (i) assets held for the principal purpose of promoting the present conduct of the trade or business in the U.S.; (ii) assets acquired and held in the ordinary course of the trade or business; and (iii) assets otherwise held in a "direct relationship" to the trade or business. This test is most likely to apply to a passive item of income in relation to a business that does not ordinarily generate passive income, for example, interest earned by a sales business, which may be from accounts receivable or from passive investment.

The second test is the "business-activities" test, which looks to whether the activities of the trade or business were a material factor in the realization of the income. Unlike the asset-use test, which is relevant primarily when the foreign corporation's trade or business-activities as such do not give rise directly to the investment income at issue, this test ordinarily applies to investment income that arises directly from the active conduct of the taxpayer's U.S. trade or business (e.g., banking).

In addition, the regulations provide a third test, the "active and material participation" test, for determining whether certain U.S.-source investment income earned by a foreign person engaged in the active conduct of a "banking, financing, or similar business" in the United States is effectively connected income [Reg. §1.864-4(c)(5)]. This test applies in place of the asset-use or business-activities test in determining whether U.S.-source dividend or interest income or gain or loss from the sale or exchange of stocks or securities is effectively connected income.

As a general rule, a foreign person's foreign-source income cannot be effectively connected income. However, some types of foreign-source income are treated as effectively connected if they are attributable to a U.S. office maintained by the taxpayer [§864(c)(4)]. These items are:

1. rents, royalties, or gains from the sale of intangible property;

2. dividends, interest, or gains or loss from the sale of stocks or securities;

3. income, gain or loss from the sale of goods or merchandise through a U.S. office; and

4. income or gain that is equivalent to items 1 through 3.

Under special rules, income attributable to a U.S. life insurance business is effectively connected [§864(c)(4)(C)].

Gain or loss from the sale or exchange after November 27, 2017, of an interest in a partnership engaged in a U.S. trade or business is treated as effectively connected with a U.S. trade or business to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange. Any gain or loss from the hypothetical asset sale by the partnership is allocated to interests in the partnership in the same manner as nonseparately stated income and loss [§864(c)(8); for sales, exchanges, and dispositions of partnership interests on or after December 26, 2018, see T.D. 9919].

Computation of taxable income for a foreign person is calculated by taking the gross income that is effectively connected income and deducting amounts for: (i) expenses that are allocable or apportionable to the U.S. trade or business; (ii) charitable contributions; (iii) casualty and theft losses; or (iv) in the case of an individual, a single personal exemption.

2000.F. Select Withholding Obligations

2000.F.1. Income Subject To Withholding

2000.F.1.B. Partnerships

2000.F.1.B.(3). Withholding On Foreign Partner's Share Of Partnership Effectively Connected Income

A partnership (domestic or foreign) with income, gain, or loss effectively connected with a U.S. trade or business must withhold at a special rate from any effectively connected income that is allocable to a foreign partner [§1446(a)]. The withholding is based on the percentage of partnership ECI that is allocable to foreign partners, and is determined at the highest tax rate attributable to that foreign partner [§1446(b)]. Beginning in 2018, the transferee of an interest in a partnership engaged in a U.S. trade or business that is treated as effectively connected with a U.S. trade or business must withhold 10% of the amount realized on the transfer [§1446(f)]. However, this requirement does not apply for dispositions of certain interests in publicly traded partnerships until 2022 [Reg. §1.1446(f)-4(f)]. The IRS also announced the following exceptions to the withholding requirement, which generally will require a certification from the transferor [Reg. §1.1446(f)-2(b)]:

1. non-foreign status;

2. no realized gain;

3. less than 10% effectively connected taxable income in three prior tax years;

4. less than 10% effectively connected gain under §864(c)(8);

5. nonrecognition transactions; and

6. treaty benefits.

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2000.F.2. FATCA Withholding

The Foreign Account Tax Compliance Act (FATCA) generally requires foreign financial institutions (FFIs) to identify U.S. account holders and report them to the IRS [§1471(b)(1)]. It also requires foreign entities that are not FFIs, i.e., nonfinancial foreign entities (NFFEs), to provide information regarding their ownership to withholding agents, including identifying any U.S. owners that hold an interest of more than 10% in the NFFE [§1472(a)]. FFIs and NFFEs that do not comply with the FATCA rules suffer a 30% withholding tax on withholdable payments to them. The IRS will not ordinarily rule on the application of FATCA [Rev. Proc. 2021-7, §4.01(26)].

Chapter 2100. Estate, Gift, and Generation-Skipping Transfer Tax

2100.C. Gift Tax

2100.C.7. Returns and Payment of Gift Tax

Generally, a donor must file a gift tax return, Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, for any calendar year that he/she gives gifts to a donee totaling more than the annual exclusion amount ($15,000 for gifts given in 2020 and 2021) [Rev. Proc. 2019-44, Rev. Proc. 2020-45]. The gift tax return for a calendar year is due on April 15 of the following calendar year [§6075(b)(1)]. Similarly, any gift tax due for a calendar year is due and payable on April 15 of the following calendar year [§6161(a)].

To start the statute of limitations for valuation and legal issues, certain valuations and disclosures must be attached to the gift tax return [Reg. §301.6501(c)-1(f)].

Spouses must file gift tax returns to elect gift splitting [Reg. §25.2513-1].

The election to apply generation-skipping tax exemption to a trust and the election to not automatically apply generation-skipping exemption to a trust are made on timely filed gift tax returns [§2632(c)(5)(B)].

Extensions of Time to Pay. The IRS also may grant an extension of time to pay of up to six months if timely payment will create an undue hardship (substantial financial loss if required to pay the tax when due) [§6161(a)]. Form 1127, Application for Extension of Time for Payment of Tax, is used for extension requests for gift tax.

Chapter 2200. Withholding and Employment Taxes

2200.A. Income Tax Withholding

2200.A.2. Computation of Withholding Taxes

2200.A.2.b. Withholding Allowances and Withholding Certificates

Exemptions. The wage withholding rules generally are based on a withholding allowance, instead of the former rule basing withholding on the number of withholding allowances or exemptions claimed by the employee. The amount of tax that is withheld from an employee's wages is determined as the amount

by which the employee's wages exceed the taxpayer's withholding allowance, prorated to the payroll period. The withholding allowance is calculated on Form W-4, Employee's Withholding Certificate, using tables and computational procedures provided in the form and IRS Pub. 15-T, Federal Income Tax Withholding Methods [§3402(a)(1)].

Allowances. Generally, an employee receiving wages is entitled to a withholding allowance based on the following conditions [§3402(f), §3402(m); Reg. §31.3402(f)(1)-1(b)]:

• whether the employee can be claimed as a dependen**t on another tax return;**

• if the employee is married, whether the employee's spouse is entitled to an allowance, or would be so entitled if such spouse were an employee receiving wages, but only if such spouse does not have in effect a withholding allowing certificate claiming such allowance;

• the number of individuals who reasonably can expect to claim the child tax credit;

• any additional reductions that the employee elects to take into account;

• the standard deduction allowable to such employee; and

• whether the employee has withholding allowance certificates in effect for more than one employer.

Withholding Certificates. On or before the employee's employment commencement date, an employee must furnish the employer with a signed Form W-4 from which the employer figures withholding.

The 2020 Form W-4 requests information regarding multiple jobs, a working spouse, dependents, and other potential bases for adjustment. An employee provides the employer with amounts to increase or decrease the amount of taxes withheld and amounts to increase or decrease the amount of wage income subject to income tax withholding, instead of stating withholding allowances claimed. An employee is not required to submit a new Form W-4 for 2020 unless changes to the employee's personal or financial situation would change the entries on the form. The employer withholds according to the employee's last valid Form W-4 in effect if the employee submits an invalid W-4 and does not comply with the employer's request for a valid form. If no valid Form W-4 is in effect, the employer treats the employee as single but having the withholding allowance provided by IRS forms, instructions, and publications. Employers are required to submit copies of withholding certificates to the IRS when requested by written notice or as directed in published guidance [§3402(f)(2); Reg. §31.3402(f)(2)-1(f), §31.3402(f)(2)-1(g)].

2200.A.2.c. Withholding Methods

The amount of tax that an employer is required to withhold from an employee's wages may be determined through use of alternative methods, the most common of which are the percentage method and the wage bracket method. Different methods may be used by the employer for different groups of employees. Publication 15-T provides separate percentage method and wage bracket method tables for use with 2020 Forms W-2 and pre-2020 Forms W-2 [§3402(a)(1); Reg. §31.3402(a)-1(a)].

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2200.A.2.c.(1) Percentage Method

The percentage method of withholding computes the amount of the tax required to be withheld as follows [§3402(b); Reg. §31.3402(b)-1]:

1. Determine adjusted wage amount by: (a) combining taxable wages for pay period with the amount obtained after dividing additional non-job income by the number of pay periods per year, and (b) reducing the resulting amount by the estimated annual itemized deductions divided by the number of pay periods per year.

2. Figure the tentative withholding amount on the resulting adjusted wage amount in step 1 according to the appropriate table in IRS Pub. 15-T utilizing pay period frequency, filing status, and number of jobs held (e.g., multiple jobs, working spouse).

3. Account for tax credits by: (a) dividing the available child and dependent credits reported by the number of pay periods, and (b) subtracting the result from the tentative withholding amount.

4. Figure final amount to withhold by combining additional withholding requested on Form W-4 to the result of step 3 to obtain the final withholding amount for the pay period.

2200.B. Federal Insurance Contributions Act (FICA) And Federal Unemployment Tax Act (FUTA) Taxes

2200.B.1. Rate Of Tax

2200.B.1.e. Railroad Retirement Tax Act (RRTA)

Railroad employers are subject to employment taxes that are separate from the FICA and FUTA systems covering most other employers. As such, payments subject to railroad retirement taxes are exempt from FICA, FUTA, and the Self-Employment Contributions Act (SECA). Instead, railroad employers are subject to the RRTA in determining railroad worker retirement benefits and the Railroad Unemployment Insurance Act in determining unemployment and sickness insurance benefits. The taxes under the railroad retirement system are included in two tiers. The first tier is based on combined railroad retirement and Social Security credits, using Social Security benefit formulas. The employee's and employer's share of first tier taxes are based on the same rates and taxable wage base (if any) used to determine old-age, survivor and disability insurance (OASDI) and hospital insurance (HI or Medicare) taxes. For 2020, the taxable wage base is $137,700 ($142,800 for 2021). The second tier is based on railroad service only and funds a private pension benefit. A separate wage base applies to second tier taxes (e.g., $102,300 in 2020). The tier II tax rates are 4.9% for employees and 13.1% for employers. “Compensation” for computation of RRTA taxes has the same meaning as the term “wages” under §3121(a), except as specifically limited by the RRTA or regulations. Stock options are not compensation for purposes of the RRTA [§3201–§3233; Reg. § 31.3231(e)-1(a)(1); SSA Notice, 84 Fed. Reg. 56,515 (Oct. 22, 2019), SSA Notice, 85 Fed. Reg. 67,413 (Oct. 22, 2020); IRS Notice, 85 Fed. Reg. 77,486 (Dec. 2, 2020) (2021 rates), IRS Notice, 84 Fed. Reg. 64,964 (Nov. 25, 2019) (2020 rates); Wis. Cent. Ltd. v. United States, 138 S. Ct. 2067 (2018)].

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Chapter 2300. Procedure and Administration

2300.A. Tax Returns

2300.A.1. Income Tax Returns

2300.A.1.D. Extensions Of Time To File

2300.A.1.D.(6) Federally Declared Disasters

In the case of a federally declared disaster, the IRS has the authority to postpone tax-related deadlines for affected taxpayers, including filing and paying tax, for a period of up to one year. The IRS also has the authority to suspend interest, penalties, additional amounts, and additions to tax that normally would accrue during the time the tax-related act is postponed [§7508A(a); Rev. Proc. 2018-58 (listing of postponements due to combat zone service or federally declared disaster area)]. Aside from discretionary postponements declared by the IRS, tax-related deadlines are statutorily postponed for a 60-day period for qualified taxpayers [§7508A(d); Reg. §301.7508A-1(g)].

When the original due date precedes the first day of the postponement period, and the extended due date falls within the postponement period, the following rules apply [Reg. §301.7508A-1(b)(3)(ii)]:

• If an affected taxpayer received an extension of time to file, filing will be timely on or before the last day of the postponement period, and the taxpayer is eligible for relief from penalties and additions to tax related to the failure to file during the postponement period.

• If an affected taxpayer received an extension of time to pay, payment will be timely on or before the last day of the postponement period, and the taxpayer is eligible for relief from interest, penalties, and additions to tax and additional amounts related to the failure to pay during the postponement period.

An affected taxpayer is [Reg. §301.7508A-1(d)(1)]:

• any individual whose principal residence is located in a covered disaster area;

• any individual who is a relief worker affiliated with a recognized government or philanthropic organization and who is assisting in a covered disaster area;

• any individual whose principal residence is not located in a covered disaster area, but whose records necessary to meet a deadline for a tax-related act are maintained in a covered disaster area;

• the spouse of an affected taxpayer, solely with regard to a joint return;

• any business entity or sole proprietor whose principal place of business is located in a covered disaster area;

• any individual, business entity, or sole proprietor not located in a covered disaster area, but whose records necessary to meet a deadline for a tax-related act are maintained in a covered disaster area;

• an estate or trust that has tax records necessary to meet a deadline for a tax-related act and that are maintained in a covered disaster area;

• any individual visiting the covered disaster area who was killed or injured as a result of the disaster; or

• any other person determined by the IRS to be affected by a federally declared disaster.

In Notice 2021-21, the Secretary of the Treasury issued guidance providing relief under §7508A for taxpayers adversely affected by the COVID-19 (coronavirus) emergency. The guidance provides postponements for certain payment and filing obligations, time-sensitive taxpayer and IRS actions, and participation in the Annual Filing Season Program.

Note: Absent authority under §7508A, the IRS has discretion to deem that notice and demand letters that were mailed out late due to the temporary closure of IRS printing services during the COVID-19 pandemic were sent out on a date later than the date shown on the notice in order to grant relief from penalties and interest [PMTA 2020-07 (May 21, 2020)].

2300.A.1.G. What Constitutes A Valid Return

Individuals may file either paper income tax returns or file Forms 7004, 1040, 1040-SR and 1040-NR electronically. However, neither amended returns nor late-filed returns can be filed electronically. The IRS provides four methods through which individuals can file over the internet using its e-file system:

• **Free File**. Individuals with income below a certain level (adjusted gross income of $72,000 for 2020 returns) can use a variety of free commercial tax preparation software online to prepare and file returns electronically. Some of the software also supports state returns [Draft Instructions to 2020 Form 1040]. Free File is available at https://www.irs.gov/filing/free-file-do-your-federal-taxes-for-free.

• **IRS Free File Fillable Forms**. All taxpayers can use online fillable forms, also available at https://www.irs.gov/filing/free-file-do-your-federal-taxes-for-free. Free File Fillable Forms uses a fill-in-the-blank format that performs some basic math calculations and provides for electronic filing. There are no income restrictions for using Free File Fillable Forms. It does not support any state tax returns.

• **Commercial Tax Software**. Most commercial tax preparation software also provides for electronic filing.

• **Paid Tax Preparer**. While the use of e-filing is optional for preparers who prepare a small number of returns each year, returns prepared by preparers who reasonably expect to file 11 or more returns for individual taxpayers must be filed electronically, unless the preparer obtains a hand-signed and dated statement containing the taxpayer's choice to have the return filed in paper format or unless the preparer is located in an area that does not have access to internet service (other than dial-up or satellite service) [§6011(e)(3); Reg. §301.6011-7].

Rev. Proc. 2007-40 and Pub. 1345, Handbook for Authorized IRS e-file Providers of Individual Income Tax Returns, outline the requirements and procedures for participating in the IRS e-file program.

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E-file Providers. Individuals, businesses, and organizations that want to become "Authorized IRS e-file Providers" must apply for acceptance into the program by creating an IRS e-services account and submitting an e-file application on https://www.irs.gov/tax-professionals/e-services-online-tools-for-tax-professionals, and must pass a suitability check. Instructions for becoming an IRS e-file provider are in Pub. 3112, E-File Application and Participation.

Electronic Return Signatures. Taxpayers and the preparer/transmitter generally use Form 8879, IRS e-file Signature Authorization, to "sign" the return. Taxpayers either provide their own Personal Identification Number (PIN) or authorize the preparer/transmitter to generate a PIN on their behalf. The preparer/transmitter also must provide their Electronic Filing Identification Number (EFIN) and PIN before transmitting the completed return. Form 8879 is not mailed to the IRS but must be retained by the preparer for three years.

Transmitting Paper Attachments and Other Documents. Form 8453, U.S. Individual Income Tax Transmittal for an IRS e-file Return, is used to send any required paper forms or supporting documentation that cannot be transmitted electronically. Electronic return preparers must mail Form 8453 to the IRS within three business days after receiving acknowledgement that the IRS has accepted the electronically filed return. Taxpayers that must mail in any documentation not listed on Form 8453 cannot file the return electronically.

Payment. A taxpayer who electronically files a balance due return must pay any tax that is due. Failure to make full payment of any tax that is due on or before the due date of the return (without regard to extensions) will result in the imposition of interest and may result in the imposition of penalties. Taxpayers who e-file balance due returns may pay by electronic funds withdrawal, credit card, check (using Form 1040-V, Payment Voucher), IRS Direct Pay, cash, or through the Electronic Federal Tax Payment System (EFTPS) (see IRS Pub. 966, Electronic Federal Tax Payment System: A Guide to Getting Started). Taxpayers also may request an installment agreement [IRS Pub. 1345].

Refunds. An e-file preparer should advise the taxpayer of the option to receive a refund by paper check or direct deposit and must accept any direct deposit election to any eligible financial institution designated by the taxpayer. A separate fee may not be charged for a direct deposit. The IRS has stated that neither it nor Treasury's Financial Management Service is responsible for the misapplication of a direct deposit that is caused by error, negligence, or malfeasance on the part of the taxpayer, electronic filer, financial institution, or any of their agents. However, the IRS maintains procedures for taxpayers to report and recover misdirected direct deposit refunds [§6402(n); Reg. §301.6402-2(g); IRM 21.4.1 (10-01-20), IRM 21.4.2 (10-01-20), IRM 21.4.3 (10-01-20)].

Refund Anticipation Loans. A refund anticipation loan (RAL) is money borrowed by a taxpayer based on the taxpayer's anticipated income tax refund. The IRS is not involved with RALs; rather, an RAL is a contract between the taxpayer and a lender. An entity that is involved in the IRS e-file program has an obligation to every taxpayer who applies for an RAL to advise the taxpayer as to the various aspects of RALs. Specifically, an e-file provider must advise the taxpayer that if a direct deposit is not timely, the taxpayer may be liable to the lender for additional interest on the RAL. In addition, electronic filers may assist taxpayers in applying for an RAL and may charge a flat fee for doing so. The fee must be identical for all clients and must not be related to the amount of the refund or RAL. Electronic filers may not accept a fee from a financial institution for any service connected with an RAL that is contingent upon the amount of the refund or RAL. IRS e-file providers that assist taxpayers in applying for an RAL must

obtain the taxpayer's written consent to disclose tax information to the lending financial institution in connection with an application for an RAL [Reg. §301.7216-3(b)].

Corporations may file either paper income tax returns or file electronically. However, corporations (including S corporations) with assets of $10 million or more that are required to file at least 250 returns (including information returns such as Forms W-2 and 1099) must file using magnetic media [§6011(e); Reg. §301.6011-5].

Any organization required to file Form 990-T for unrelated business income tax under §511 must file the return electronically [§6011(h)].

2300.A.2. Frequently Filed Information Returns

2300.A.2.e. Other Information Returns

Mortgage Interest and Mortgage Insurance Premiums. Any person who, in the course of a trade or business, receives mortgage interest aggregating $600 or more for any calendar year on any one mortgage from any individual must file Form 1098, Mortgage Interest Statement, and furnish a statement to the payer [§6050H(a); Reg. §1.6050H-1(a), §1.6050H-2(a)]. The reporting requirement also applies to persons who receive premiums (including prepaid premiums) for mortgage insurance from any individual aggregating $600 or more for any calendar year [§6050H(h)].

Receipt of Cash of More than $10,000. Any person engaged in a trade or business who, in the course of such trade or business, receives more than $10,000 in cash in one transaction (or two or more related transactions) must file Form 8300, Report of Cash Payments Over $10,000 Received in a Trade or Business, and furnish a written statement to the payer [§6050I].

Cancellation of Indebtedness by Financial Institutions. Certain financial institutions (including finance companies and credit card companies), government agencies, and organizations that discharge the indebtedness of any person during any calendar year in the amount of $600 or more must file Form 1099-C, Cancellation of Debt, showing the name, address, and taxpayer identification number of each person whose indebtedness was discharged during the calendar year, the date of the discharge, and the amount of the indebtedness discharged. Organizations must have a significant money-lending business to be required to file Form 1099-C [§6050P].

Fines, Penalties, and Restitution Amounts. Government agencies (or entities treated as government agencies) must report to the IRS and to each payor the amount of any settlement agreement or order entered into, if the total amount required to be paid to or at the direction of the government is at least $50,000. The report must separately identify any amounts that are for restitution or remediation of property, or correction of noncompliance. [§6050X; Reg. §1.6050X-1].

Long-Term Care Benefits. Any person who pays long-term care benefits must file Form 1099-LTC, Long Term Care and Accelerated Death Benefits, and provide a payee statement to the recipient of the benefits [§6050Q].

Health Insurance Coverage Information Reporting. See 1700.F.3.b.

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Higher Education and Tuition Related Expenses. The following must file Form 1098-T, Tuition Statement, annually and provide each student with a statement [§6050S]:

• an eligible educational institution that: (i) receives payments of qualified tuition and related expenses, (ii) makes reimbursements or refunds of qualified tuition and related expenses, or (iii) enrolls any individual for any academic period;

• any person engaged in a trade or business of making payments to any individual under an insurance arrangement as reimbursements or refunds of qualified tuition and related expenses; and

• any person engaged in a trade or business that, in the course of such trade or business, receives from any individual interest aggregating $600 or more for any calendar year on one or more educational loans.

The Form 1098-T must include [§6050S(b)]:

• the student's name, address, and taxpayer identification number (however, penalties will not apply to an educational institution that fails to provide the identification number if it has complied with IRS rules for obtaining it);

• the aggregate amount of payments received, as well as any adjustments or refunds;

• the aggregate amount of grants received by the student; and

• the institution's employer identification number.

For a discussion of information reporting penalties, see 2300.D.1.e.

Qualified Tuition Programs. Qualified tuition programs (529 plans) and Coverdell education savings accounts (see 200.L.) must file Form 1099-Q, Payments from Qualified Education Programs (under Sections 529 and 530), to report distributions, earnings, and other information.

ABLE Accounts. Achieving a Better Life (ABLE) accounts must file Form 1099-QA, Distribution From ABLE Accounts, to report distributions, earnings, and other information.

Gambling Winnings. Gambling winnings are reportable on Form W-2G, Certain Gambling Winnings, if: (i) the winnings (not reduced by the wager) are $1,200 or more from a bingo game or slot machine, (ii) the winnings (reduced by the wager) are $1,500 or more from a keno game, (iii) the winnings (reduced by the wager or buy-in) are more than $5,000 from a poker tournament, (iv) the winnings (reduced, at the option of the payer, by the wager) (except winnings from bingo, slot machines, keno, and poker tournaments), are $600 or more, and at least 300 times the amount of the wager, or (v) the winnings are subject to federal income tax withholding (either regular gambling withholding or backup withholding) [Reg. §1.6041-10(b)(1); Reg. §31.3402(q)-1(b)].

2300.C. Assessment and Collection of Tax

2300.C.1. Examination: Audits, Assessments, Appeals

2021 Federal Tax Guide Updates and Changes

Under the self-assessment system of federal income, taxpayers are required to fill out tax returns, determine their own tax liabilities, file the returns, and pay the tax shown on the returns. The vast majority of income tax returns and tax liabilities reported are accepted by the IRS after preliminary screening without being subjected to audit. Examinations of those returns that are selected for audit are conducted by the examination or compliance functions of IRS submission processing centers and area offices.

2300.C.1.a. Submission Processing Center Audits

The IRS submission processing centers (or "campuses") handle, entirely by direct correspondence with the taxpayer, routine errors or omissions such as a failure to sign the return, attach a schedule, or submit the correct amount of tax shown to be due on the return. In submission processing center examinations, the taxpayer is contacted by correspondence. Computer-generated programs and manual inspection techniques are used to select returns for audit by an area office. Three of the most important audit programs are:

• mathematical and clerical error program;

• information return program; and

• earned income tax credit (EIC)/revenue strategy program.

Mathematical and Clerical Error Program. The IRS can summarily assess additional tax arising from mathematical or clerical errors and the correction is not subject to the notice of deficiency procedures [§6213(b)]. Instead, the taxpayer has 60 days after a correction notice is sent to file a request for abatement. A mathematical or clerical error is defined to include [§6213(g)(2)]:

• errors in addition, subtraction, multiplication or division shown on any return;

• incorrect use of IRS tables if such incorrect use is apparent from other information on the return;

• an entry on a return that is inconsistent with another entry on the return;

• an omission of information that must be supplied on the return to substantiate an entry on the return;

• an entry on a return of a deduction or credit in an amount that exceeds a statutory limit (expressed as a dollar amount or as a percentage, ratio or fraction), if the items determining the limit appear on the return, such as where the taxpayer claims a standard deduction greater than the dollar or percentage limits applicable to that taxpayer;

• an entry on a return claiming the credit for earnings from self-employment to the extent the self-employment tax on such earnings has not been paid;

• an omission of a correct taxpayer identification number in connection with the claiming of certain types of tax credits (e.g., the earned income credit, child tax credit, dependent care credit and personal exemptions, education credits, recovery rebate credits (for 2020));

• the inclusion on a return of a tax identification number required if such number is of an individual whose age affects the amount of certain types of credits and the computation of the credit on the return reflects the treatment of such individual as being of an age different from the individual's age based on such taxpayer identification number;

• an entry on the return claiming the earned income tax credit if the taxpayer is a noncustodial parent of such child; and

• an omission of any increase required for recapture of the first-time homebuyer credit or information that must be provided to claim the credit.

Occasionally the mathematical and clerical error rules are modified to include incorrect use of disaster relief, including COVID-19 (coronavirus)-related relief. For example, §6213(g)(2) applies to §6428B when a taxpayer fails to include a correct identification number on a return [§6428B(e)(2)(G)]. These special rules are discussed with the credits (see Chapter 900).

Information Returns Program. An automated document matching program identifies returns where the amounts reported such as wages, interest or dividends do not correspond with the amounts reported on information returns such as Form W-2 or Form 1099 filed with the IRS by employers and payers.

Earned Income Tax Credit (EIC)/Revenue Strategy Program. This program covers a broad range of items that appear on their face to be unallowable under the law. The main audit issues are earned income credit, dependent exemptions, filing status, Schedule C (Form 1040 or Form 1040-SR) gross receipts, child tax credit, child care credit, education credit, adoption credit, false inflated income, and false inflated withholding.

2300.D. Penalties and Interest

2300.D.1. Penalties

2300.D.1.D. Penalty for Failure to Deposit Taxes

If a taxpayer is required to deposit taxes (see 2200.C.1.b. and 2200.C.2.b.), a penalty may be imposed if the taxpayer fails to make the deposit in the correct amount, within the prescribed time period, and/or in the required manner (e.g., by an electronic funds transfer). The penalty does not apply if the taxpayer has reasonable cause [§6656].

The amount of the penalty is based on the number of days a deposit is late [§6656(b)(1)]:

• 2% for deposits 1 – 5 days late;

• 5% for deposits 6 – 15 days late;

• 10% for all direct payments and those deposits made more than 15 days late, but paid on or before the 10th day following notice and demand; and

• 15% (i.e., a 5% addition to the 10% penalty) for all undeposited taxes still unpaid after the 10th day following the first balance due notice or the day on which notice and demand for immediate payment is given.

The deposit penalty applies to tax deposits for the following forms:

• Form 720, Quarterly Federal Excise Tax Return;

• Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return;

• Form 941, Employer's Quarterly Federal Tax Return;

• Form 943, Employer's Annual Tax Return of Agricultural Employees;

• Form 944, Employer's Annual Federal Tax Return;

• Form 945, Annual Return of Withheld Federal Income Tax;

• Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons; and

• Form CT-1, Employer's Annual Railroad Retirement and Unemployment Repayment Tax Return.

Electronic Deposit Method (EFTPS). All taxpayers required to make tax deposits must use the Electronic Deposit Method (EFTPS) (see IRS Pub. 966, Electronic Federal Tax Payment System: A Guide to Getting Started). A deposit of taxes by electronic funds transfer is deemed made when the amount is withdrawn from the taxpayer's account, provided the U.S. Government is the payee and the amount is not returned or reversed [Reg. §31.6302-1(h)(8)].

How IRS Applies Deposits. For penalty purposes, the IRS generally applies a tax deposit to the most recently ended deposit period or periods within the specified tax period to which the deposit relates and then applies any excess to deposit periods that end on or after the date of the deposit in period-ending-date order [Rev. Proc. 2001-58].

The failure to deposit penalty does not apply if [Reg. §31.6302-1(f)]: (1) the amount of any shortfall does not exceed the greater of $100 or 2% of the amount of employment taxes required to be deposited; and (2) the employer deposits the shortfall on or before the shortfall makeup date.

Special Exceptions to Penalty. The IRS may waive the failure-to-deposit penalty on a person's inadvertent failure to deposit any employment tax if [§6656(c)]:

• the failure occurs during the first quarter that such person was required to deposit any employment tax or the person is required to change the frequency of deposits and the failure relates to the first deposit to which the change in frequency applies;

• the return was filed on or before the due date; and

• the person meets the requirements of §7430(c)(4)(A)(ii).

2021 Federal Tax Guide Updates and Changes

COVID-19 (Coronavirus) Waivers. The IRS has authority to waive §6656 penalties if the failure was due to anticipation of the employee retention credit for employers subject to closure due to COVID-19 [Pub. L. No. 116-136, §2301, extended by Pub. L. No. 116-260, Div. EE, Title II, §207 and expanded to certain tax-exempt organizations by Pub. L. No. 116-260, Div. EE, Title III, §303], or the credits for required paid sick leave and required family leave [Pub. L. No. 116-136, §3606(a) (reference to Pub. L. No. 116-127, Div. G, §7001, §7003), extended by Pub. L. No. 116-260, Div. N, Title II, Subtitle B, §286]. These provisions, including the §6656 waivers, were codified with modifications as §3131-§3134 (see 2200.B.1.a.1.(a)). Additionally, the Secretary of Treasury must waive §6656 penalties if the failure was due to anticipation of the continuation of coverage premium assistance credit [§6432(c)(2)(C)] (see Chapter 1700).

For employment taxes related to required paid sick and family leave (qualified leave wages), the §6656 penalty does not apply to a calendar quarter if [Notice 2020-22, amplified by Notice 2021-24]:

• The employer paid qualified leave wages, qualified health plan expenses, or qualified collectively bargained contributions to its employees in the calendar quarter before the time of the required deposit,

• The amount of employment taxes that the employer does not timely deposit is less than or equal to the amount of the employer's anticipated credits under Pub. L. No. 116-127, Div. G, §7001 and §7003 (required paid sick and family leave) or §3131 and §3132 as of the time of the required deposit, and

• The employer did not seek payment of an advance credit by filing Form 7200, Advance Payment of Employer Credits Due to COVID-19, with respect to the anticipated credits it relied upon to reduce its deposits.

For employment taxes related to wages paid under the employee retention credit, the §6656 penalty does not apply to a calendar quarter if [Notice 2020-22, amplified by Notice 2021-24]:

• The employer paid qualified retention wages to its employees in the calendar quarter prior to the time of the required deposit,

• The amount of employment taxes that the employer does not timely deposit, reduced by the amount of employment taxes not deposited in anticipation of the credits claimed under Pub. L. No. 116-127, Div. G, §7001 and §7003 (required paid sick and family leave) or §3131 and §3132 is less than or equal to the amount of the employer's anticipated credits under Pub. L. No. 116-136, §2301 (employee retention credit) or §3134 for the calendar quarter as of the time of the required deposit, and

• The employer did not seek payment of an advance credit by filing Form 7200, Advance Payment of Employer Credits Due to COVID-19, with respect to the anticipated credits it relied upon to reduce its deposits.

For employment taxes related to the COBRA continuation coverage premium assistance credit, the §6656 penalty does not apply to a calendar quarter if [Notice 2021-24]:

• The employer is a "person to whom premiums are payable" under §6432(b),

• The amount of employment taxes that the employer does not timely deposit, reduced by the amount of employment taxes not deposited in anticipation of the credits claimed under Pub. L. No. 116-127, Div. G, §7001 and §7003 (required paid sick and family leave) or §3131 and §3132, and Pub. L. No. 116-136, §2301 (employee retention credit) or §3134, is less than or equal to the amount of the employer's anticipated credits under §6432 for the calendar quarter as of the time of the required deposit, and

• The employer did not seek payment of an advance credit by filing Form 7200, Advance Payment of Employer Credits Due to COVID-19, with respect to the anticipated credits it relied upon to reduce its deposits.

2300.D.1.E. Information Return Reporting Penalties

Three-tiered penalties may be imposed on each failure to timely file a correct information return or to furnish a statement to the payee. The penalties apply to each failure to file the return on or before the required due date, furnish the statement on or before the required due date, and to reporting incomplete or inaccurate information [§6721(a)(2), §6722(a)(2)]. The penalties vary based on when, if at all, the correct information return is filed or statement furnished [§6721(b), §6722(b)]. Both penalties may apply to the same information return and related statement. Penalty amounts are adjusted for inflation each year [§6721(f), §6722(f); Rev. Proc. 2019-44, Rev. Proc. 2020-45].

Note: A partnership will not be subject to penalty under §6721 and §6722 due to the inclusion of incorrect information in reporting its partners' beginning capital account balances on the 2020 Schedules K-1, or in reporting its partners' ending capital account balances on Schedules K-1 in taxable year 2020 or its partners' beginning or ending capital account balances on Schedules K-1 in taxable years after 2020 to the extent the incorrect information is attributable solely to the incorrect information reported as the beginning capital account balance on the 2020 Schedule K-1, subject to specific conditions [Notice 2021-13].

For a discussion of information return reporting penalties under §6652, see 1900.A.10.

§6721 Penalty Rates — Failure to File Correct Information Returns

Large Businesses with Gross Receipts of More than $5 Million			
Tax Year(s)	2019	2020	2021
Year Returns Due	2020	2021	2022
Not more than 30 days late	$50 per return, up to $556,500	$50 per return, up to $565,000	$50 per return, up to $571,000
31 days late – August 1	$110 per return, up to $1,669,500	$110 per return, up to $1,696,000	$110 per return, up to $1,713.000
After August 1	$270 per return, up to $3,339,000	$280 per return, up to $3,392,000	$280 per return, up to $3,426,000
Intentional disregard	$540 per return, no limitation*	$560 per return, no limitation*	$570 per return, no limitation*
Small Businesses with Gross Receipts of $5 Million or Less			

Tax Year(s)	2019	2020	2021
Year Returns Due	2020	2021	2022
Not more than 30 days late	$50 per return, up to $194,500	$50 per return, up to $197,500	$50 per return, up to $199,500
31 days late – August 1	$110 per return, up to $556,500	$110 per return, up to $565,000	$110 per return, up to $571,000
After August 1	$270 per return, up to $1,113,000	$280 per return, up to $1,130,500	$280 per return, up to $1,142,000
Intentional disregard	$550 per return, no limitation*	$560 per return, no limitation	$570 per return, no limitation*

***§6722* Penalty Rates — Failure to Furnish Correct Payee Statements**

Large Businesses with Gross Receipts of More than $5 Million			
Tax Year(s)	2019	2020	2021
Year Returns Due	2020	2021	2022
Not more than 30 days late	$50 per statement, up to $556,500	$50 per statement, up to $565,000	$50 per statement, up to $571,000
31 days late – August 1	$110 per statement, up to $1,669,500	$110 per statement, up to $1,696,000	$110 per statement, up to $1,713.000
After August 1	$270 per statement, up to $3,339,000	$280 per statement, up to $3,392,000	$280 per statement, up to $3,426,000
Intentional disregard	$550 per statement, no limitation*	$560 per statement, no limitation*	$570 per statement, no limitation*
Small Businesses with Gross Receipts of $5 Million or Less			
Tax Year(s)	2018	2019	2020
Year Returns Due	2019	2020	2022
Not more than 30 days late	$50 per statement, up to $191,000	$50 per statement, up to $194,500	$50 per statement, up to $199,500
31 days late – August 1	$100 per statement, up to 545,500	$110 per statement, up to $556,500	$110 per statement, up to $571,000
After August 1	$270 per statement, up to $1,113,000	$280 per statement, up to $1,130,500	$280 per statement, up to $1,142,000
Intentional disregard	$550 per statement, no limitation*	$560 per statement, no limitation*	$570 per return, no limitation*

*Generally, if there is intentional disregard of the filing requirements, the penalty per failure is the greater of the amount shown or a percentage of the aggregate amount of items required to be reported correctly, depending on the specific information return. [§6721(e), §6722(e)].

The penalties imposed for failing to file an information return, failing to furnish a correct payee statement, or failing to comply with other information reporting requirements are not imposed if the failure is due to reasonable cause. Reasonable cause exists if the filer establishes that either there are significant mitigating factors for the failure or the failure is due to events beyond the filer's control and the filer acted in a reasonable manner both before and after the failure. Whether the filer promptly corrects an erroneous information return is one factor that the IRS considers in deciding whether the filer has shown reasonable cause [§6724(a); Reg. §301.6724-1(a), §301.6724-1(d)]. Under proposed

regulations, the IRS would deem information to be promptly corrected for purposes of the penalty waiver, if corrected: (i) within 30 days of the required filing date; (ii) by August 1 following the required filing date; or (iii) after August 1, but by the deadline announced in IRS guidance for the electronic or magnetic filing of information returns, or in other published guidance [Prop. Reg. §301.6724-1(d)(1)(ii)(D)].

Even if reasonable cause is not shown, the penalties do not apply to a certain number of returns if: (i) those returns were filed; (ii) the payor either failed to include all the information required to be shown on the return or the information was incorrect; and (3) corrected forms are filed by August 1. This de minimis rule applies only to the greater of (i) 10 statements; or (ii) 0.5% of the total number of payee statements required to be furnished by the person during the calendar year. Additionally, safe harbors to avoid the penalties were established for payers who file returns reporting de minimis incorrect dollar amounts. However, the de minimis safe harbor does not apply to any payee statement if the payee makes an election that the safe harbor not apply. A payor may prescribe any reasonable manner for making the election, although an on-line option may not be the exclusive means. If an election is made and the payor then corrects the return and furnishes a copy to the payee, it will be considered to be reasonable cause and the penalties will not apply [§6721(c), §6722(c); Notice 2017-9].

Failure to File Electronically. Failure to timely file includes a failure to file in the required manner — for example, on magnetic media or in other machine readable form, or electronic filing— or a failure to include information in the correct format. However, in the case of a failure to comply with the magnetic media/electronic filing requirements in §6011, the penalty applies only to the extent that the failure occurs with respect to more than the "applicable number" of returns. For example, the penalty applies to persons required to file at least 250 returns for calendar year 2020 (100 for 2021) (100 and 50 for partnership returns, respectively, unless there are at least 100 partners) on magnetic media. [§6724(c), §6011(e)(5), §6011(e)(6)].

Example: For calendar year 2020, X Corp. files 300 Forms 1099-MISC on paper rather than on the required magnetic media. The paper forms are filed with the IRS on March 15, 2021, rather than the required February 28, Year 1, filing date. X further fails to file the returns on magnetic media by August 1, 2021. X is subject to a penalty of $12,500 (the then applicable penalty amount of $50 × 250) for filing 250 returns late and $5,000 ($100 × 50) for failing to file 50 returns on magnetic media, for a total penalty of $17,500 [See Reg. §301.6721-1(b)(5), Ex. 4].

2300.D.1.H. Penalty For Aiding And Abetting An Understatement Of Tax Liability

A penalty of $1,000 ($10,000 where the offense relates to the returns or documents of a corporation) may be imposed on any person who [§6701(a), §6701(b)]:

• aids, assists, procures or advises in the preparation or presentation of any portion of a return, claim, or other document;

• knows (or has reason to believe) that such portion will be used in connection with any material matter arising under the internal revenue laws; and

• knows that the portion, if so used, would result in an understatement of another person's tax liability.

2300.D.1.I. Other Civil Penalties

Payment of Tax with Bad Check, Bad Money Order, or Bad Electronic Payment Instrument. A penalty is imposed on any taxpayer who tenders a bad check, money order, or other payment instrument (including electronic payment) to the IRS. The penalty is 2% of the amount of the check (or other instrument) if the check (or other instrument) is for $1,250 or more. If the amount of the check (or other instrument) is less than $1,250, the penalty is $25 or the amount of the check (or other instrument), whichever is less [§6657].

Due to the COVID-19 pandemic, the IRS will provide relief from bad check penalties for dishonored checks due to delayed processing. The relief applies to payments IRS received starting March 1, 2020, and is intended to extend as late as December 31, 2020. However, interest and other penalties still may apply [Update on IRS Operations During COVID-19].

Instituting Suit for Purpose of Delay. The Tax Court may require the taxpayer to pay to the government a penalty of up to $25,000 if it determines that a proceeding was instituted or maintained by the taxpayer primarily for delay, that the taxpayer's position is frivolous or groundless, or that the taxpayer unreasonably failed to pursue available administrative remedies [§6673(a)(1)]. In addition, the Tax Court may require counsel to pay court costs and attorneys' fees if it determines that counsel multiplied the proceedings unreasonably and vexatiously [§6673(a)(2)]. A district court may impose a penalty not in excess of $10,000 in an action for damages for unauthorized collection action where it is determined that the taxpayer's position is frivolous or groundless [§6673(b)(1)].

Failure to File Returns Concerning Foreign Trusts. Any person who does not timely file any notice or return required by §6048(a) or §6048(c) (relating to information reporting about foreign trusts) or who fails to include any of the required information is subject to a penalty equal to the lesser of $10,000 or 35% of the gross reportable amount [§6677(a)]. A person who fails to file an annual return under §6048(b) (relating to owners of any portion of a foreign trust under the grantor trust rules) is subject to a penalty of 5% of the gross reportable amount [§6677(b)]. If the failure to file continues for more than 90 days after the day on which the IRS mails a notice to the person required to file, the IRS may impose an additional penalty of $10,000 for each 30-day period during which the failure continues. The IRS is required to refund the penalty if a taxpayer provides sufficient information to determine that the aggregate amount of the penalties exceeds the gross reportable amount [§6677(a)].

False Information on Withholding Allowances. A $500 penalty may be imposed on individuals who file false withholding information that results in reduced withholding if, at the time of the statement, there was no reasonable basis for the statement [§6682].

Failure to Provide Reports on Certain Tax-Favored Accounts and Annuities. A penalty of $50 per failure may be imposed on trustees or issuers for each failure to make required disclosure statements [§6693(a)].

Failure to File Partnership or S Corporation Returns. Partnerships or S corporations that fail to file information returns (Form 1065 or Form 1120S) on time or that file incomplete returns are liable for penalties equal to $210 for returns required to be filed in 2021 and 2022, multiplied by the number of persons who were partners or shareholders during any part of the tax year for each month that the failures continue (up to 12 months) [§6698, §6699(a); Rev. Proc. 2019-44, Rev. Proc. 2020-45].

Note: A partnership will not be subject to penalty under §6698 due to the inclusion of incorrect information in reporting its partners' beginning capital account balances on the 2020 Schedules K-1, or in reporting its partners' ending capital account balances on Schedules K-1 in taxable year 2020 or its partners' beginning or ending capital account balances on Schedules K-1 in taxable years after 2020 to the extent the incorrect information is attributable solely to the incorrect information reported as the beginning capital account balance on the 2020 Schedule K-1, subject to specific conditions [Notice 2021-13].

Fraudulent W-2 Statement, or Failure to Furnish Statement to Employee. Employers may be liable for a penalty of $50 per failure for willfully furnishing a false or fraudulent statement or willfully failing to furnish a timely statement showing the information [§6674].

Failure to Meet Disclosure Requirements for Quid Pro Quo Contributions. Charitable organizations receiving "quid pro quo" contributions exceeding $75 that do not provide written statements to donors containing information regarding the amount of the contribution that is deductible for tax purposes and the value of goods and services provided to the donor are subject to a penalty of $10 for each contribution for which the organization fails to make the required disclosure [§6714].

Erroneous Claim for Refund or Credit. A person making a claim for refund or credit is subject to a penalty equal to 20% of the amount by which the claim requested exceeds the amount of the claim allowable (i.e., the "excessive amount"). The penalty is not imposed if there is reasonable cause. Any excessive amount attributable to a transaction lacking economic substance is not treated as having reasonable cause. The penalty does not apply to any portion of the excessive amount that is subject to accuracy-related or fraud penalties [§6676].

2300.E. Overpayments of Tax

2300.E.1. Authority to Refund Overpayments

When taxpayers overpay their taxes (whether the overpayment results from excess withholdings, estimated payments, loss carrybacks, or credit adjustments), the IRS is authorized to refund the overpayment. The IRS also has full discretion to credit a tax overpayment against any other tax liability of the person who made the overpayment [§6402(a)]. In addition, any payment made with respect to any tax assessed or collected after the expiration of the statute of limitations constitutes an overpayment, as of the date of payment [§6401(a)].

Overpayments are applied in the following order [§6402]:

1. against any other tax liabilities;

2. to past due support obligations;

3. to past due debts owed to federal agencies (e.g., delinquent student loans); and

4. to past due state income tax obligations.

If there is any remaining overpayment, the taxpayer can request a refund or elect to apply it to estimated taxes for the next year, if the overpayment is shown on a tax return [§6402(b)].

The IRS may exercise its discretion to bypass the outstanding federal tax liability and issue an offset bypass refund (OBR) to a taxpayer experiencing economic hardship.

For purposes of determining the statute of limitations for filing a refund claim when the IRS applies an overpayment against a tax liability, the date the IRS credits the overpayment against the tax assessment is deemed to be the date of payment. Accordingly, the taxpayer has two years after this date, or three years after the date the subject return is filed (whichever is later), in which to file a refund claim with the IRS regarding the particular application of the overpayment [§6402(a)].

Offsets. The IRS may offset against a tax refund claim any additional amount the taxpayer owes for the tax shown on the return, even though the statute of limitations would bar assessing the additional tax (or interest or penalties). The rule is that before a refund is authorized, there must be an overpayment. In determining whether there is an overpayment, the IRS may re-audit a return. Therefore, a taxpayer's entire tax liability under the particular tax return is open for redetermination whenever a refund is claimed, regardless of the statute of limitations for making assessments [Lewis v. Reynolds, 284 U.S. 281 (1932)].

Note: Treasury may not offset the advance §6428 and §6428A payments under §6402(c)-§6402(f), 31 U.S.C. §3716, 31 U.S.C. §3720A, or for other assessed federal taxes that would otherwise be subject to levy or collection [Pub. L. No. 116-136, §2201(d), Pub. L. No. 116-260, Div. N, Title II, Subtitle B, §272(d), §273(b)]. For advance §6428B payments and advance child tax credit payments, Treasury may not offset the payments under §6402(c)-§6402(f), or for other assessed federal taxes that would otherwise be subject to levy or collection. Congress did not extend the offset prohibition for advance §6428B payments and advance child tax credit payments to 31 U.S.C. §3716 and 31 U.S.C. §3720A [Pub. L. No. 117-2, §9601(c)(2); §7527A(e)(3)].

Application of Overpayments of Tax Against Non-Tax Liabilities. The Financial Management Service (FMS) has the authority to credit a tax overpayment against other liabilities of the taxpayer in the following order [§6402(f)(2)]:

1. past-due child or spousal support assigned to a state;

2. past-due, legally enforceable debts (in the order they accrued) owed to federal agencies;

3. qualifying past-due child or spousal support not assigned to a state; and

4. (i) past-due, legally enforceable state income tax obligations, and (ii) state unemployment compensation debts resulting from fraud (both given equal priority, in the order they accrued).

The amount of overpayment remaining after reduction for these debts is refunded or credited against future tax liability as the taxpayer has elected.

Past-due support must be established by a court order or an administrative process established under state law and the obligation must be the subject of an assignment to the state. The amount of past due support must be at least $25. All such requirements are met if a state agency is providing support collection services, the amount of past-due support is $500 or more, and the past-due support is owed to or for the benefit of a qualified child. The notification of liability must be accompanied by a certification that the state has provided advance notification to the debtor of its intent to collect by tax refund offset, and has complied with applicable state law regarding the collection of past-due support by offsetting federal tax refunds [31 C.F.R. §285.3(a), 31 C.F.R. §285.3(c)].

The aggregate amount of income tax debts that an individual owes a state must be at least $25 or such greater amount as determined by FMS. A state must make reasonable efforts to collect the debt before submitting it to FMS for collection by tax refund offset [31 C.F.R. §285.8(c)].

Erroneous Refunds. When the IRS determines that it has made a refund erroneously, it (i) can make an additional assessment and/or issue a deficiency notice (assuming that there is still time for taking these actions); (ii) institute a suit against the taxpayer to recover the erroneous refund. Any suit must be filed within two years after the making of the refund [§6532(b)]. However, if any part of the refund was induced by fraud or misrepresentation of a material fact, the suit may be brought at any time within five years after the making of the refund. Misrepresentation does not require willfulness, but may include a grossly negligent misrepresentation; honest mistakes are not within the five-year purview.