Quickfinder®

Individuals—Special Tax Situations Quickfinder® Handbook (2019 Tax Year)

Updates for December 2019 Legislation and Other Recent Guidance

Instructions: This packet contains "marked up" changes to the pages in the *Individuals—Special Tax Situations Quickfinder® Handbook* that were affected by December 2019 legislation, which was enacted after the *Handbook* was published. Additionally, changes were made based on other guidance issued after the *Handbook* was published. To update your *Handbook*, you can make the same changes in your *Handbook* or print the revised page and paste over the original page.

If the property is neither Section 1245 nor Section 1250 property, it is treated as Section 1245 property. If the property is Section 1250 property, the calculation of straight-line depreciation that would have been allowed (for computing recapture) is made as if no basis reduction had occurred. Thus, the amount of the basis reduction recaptured as ordinary income on Section 1250 property is reduced over time as the taxpayer forgoes depreciation deductions because of the basis reduction.

Basis reduction limitation. If the basis of a taxpayer's property is reduced under the general attribute reduction ordering rules (after NOL, general business credit, minimum tax credit and capital loss carryovers, if any, have been reduced), a special limitation on the amount of basis reduction applies. The aggregate basis of the taxpayer's assets cannot be reduced below the aggregate of the taxpayer's liabilities immediately after the discharge [IRC Sec. 1017(b)(2)]. This limitation does not apply to depreciable property if the election is made to first reduce its basis before other tax attributes. However, the basis of depreciable property cannot be reduced below zero [IRC Sec. 108(b)(5)(B)].

Timing of attribute reduction. When tax attributes of bankrupt or insolvent taxpayers are reduced because of excluded COD income, the required attribute reductions are deemed to occur after taxable income for the year of discharge has been determined [IRC Sec. 108(b)(4)(A)]. This rule allows the taxpayer to use any NOL, capital loss or credit carryovers into the year of discharge to offset other taxable income for that year before the carryovers are reduced for COD income. Further, the taxpayer can depreciate or amortize the full tax basis of property in computing taxable income for the year of discharge before reducing tax basis for excludable COD income. In effect, the attribute reductions occur on the first day of the tax year after the discharge occurs.

Cancellation of Mortgage Debt

~~**Expired Provision Alert:** Taxpayers could exclude COD income arising from qualified principal residence indebtedness for loans forgiven before 2018. Unless Congress extends it, this provision will not be available for loans forgiven after 2017. This discussion is retained in the event that the provision is extended to 2019.~~

For loans forgiven before 2021, taxpayers can exclude COD income from taxable gross income to the extent it arises from the cancellation of qualified principal residence indebtedness [IRC Sec. 108(a)(1)(E)]. The exclusion is limited to $2 million ($1 million for married filing separately) [IRC Sec. 108(h)(2)].

Qualified principal residence indebtedness is debt that is incurred in the acquisition, construction or substantial improvement of a taxpayer's principal residence and that is secured by that residence. It does not include home equity loans used for other purposes or second home mortgages. The basis of the taxpayer's principal residence is reduced (but not below zero) by the amount that is excluded.

If there is cancellation from a loan where only part of that loan is qualified principal residence indebtedness, the exclusion only applies to the amount of discharged debt that exceeds the part of the loan (as determined immediately before the discharge) that is not qualified principal residence indebtedness.

The exclusion doesn't apply if the discharge is 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 to the taxpayer's financial condition.

Example: In 2017, Lois and Clark, a married joint-filing couple, lost their home in a foreclosure when the property was burdened by a $450,000 recourse mortgage, all of which qualified as acquisition indebtedness. The first $350,000 of the mortgage was paid off when the bank sold the property in the foreclosure sale. Lois and Clark came up with $30,000 to extinguish part of the remaining balance, and the lender forgave the last $70,000.

Lois and Clark can exclude the $70,000 of the debt discharge income from their gross income under the principal residence indebtedness exclusion. The basis of the home is also reduced by $70,000.

If the basis of the home before the foreclosure was $525,000, after subtracting $70,000, the basis is reduced to $455,000. Assuming the $350,000 price collected by the lender represented the home's FMV, Lois and Clark have a $105,000 nondeductible loss on sale ($350,000 sale price – $455,000 basis).

Observation: Without the principal residence indebtedness exclusion (and assuming no other exclusions apply), the taxpayers would have had to include $70,000 in gross income and their nondeductible personal loss would have been $175,000 ($350,000 – $525,000).

Reporting the COD Income Exclusion

Form 982 [Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)] must be filed whenever COD income is excluded from gross income. The two basis reduction elections (see *Basis reduction elections* on Page 1-21) are made on Form 982.

Form 1099-C: Reporting Debt Cancellation

Banks and other financial institutions are required to report debt discharges (partial or complete) on Form 1099-C (Cancellation of Debt) if the discharge is $600 or more [IRC Sec. 6050P; Reg. 1.6050P-1]. Debt includes any amount owed to the financial institution, including principal, interest, penalties, costs and fines.

A debt is deemed canceled on the date an identifiable event occurs or, if earlier, the date of the actual discharge if the institution chooses to file Form 1099-C for the year of cancellation. The issuer of the Form 1099-C must show in box 6 a code describing the type of identifiable event that led to the issuance of the form. A discharge in bankruptcy under Title 11 is described with Code A.

Foreclosures and Repossessions

When a borrower fails to make payments on a loan secured by property, the lender may foreclose on the loan or repossess the property. The foreclosure or repossession is treated as a sale or exchange from which the borrower may realize gain or loss. This is true even if the property is voluntarily returned to the lender.

Note: Abandonment of property subject to debt is treated similarly to foreclosures and repossessions.

Practice Tip: The IRS Audit Technique Guide titled *Real Estate Property Foreclosure and Cancellation of Debt* discusses the tax consequences of real property disposed of through foreclosure, short sale, deed in lieu of foreclosure and abandonments. It also discusses cancellation of debt income exclusions that are most commonly applicable to these types of dispositions and community property considerations. The guide is available on the IRS website.

Borrower's Gain or Loss

A borrower's gain or loss from a foreclosure or repossession is computed and reported the same way as gain or loss from a sale or exchange of the property. The gain or loss is the difference between the transferred property's adjusted basis and the amount realized.

Reporting income under either items 1 or 2 requires that the personal representative make an election to report the bond's accrued interest income. Between these two, option 1 will most often result in tax savings because the 37% (for 2019) maximum income tax rate applies at a much lower amount of taxable income for an estate ($12,750 for 2019) than for an individual.

Making the election. In the year of election, the taxpayer reports all income accrued on the bonds from date of acquisition. Thus, an election made on the decedent's final return will include all accrued income through the date of death. The transferee (estate or beneficiary) then includes in its return only the interest earned after the date of death.

The election is made by reporting the accrued interest income on the tax return in the year the election is made. Although not required by the regulations, some tax preparers choose to include an election statement, such as the following, to the taxpayer's return for the year it is effective [Reg. 1.454-1(a)].

Election to Accrue Interest on U.S. Savings Bonds

The taxpayer hereby elects under IRC Sec. 454 of the Internal Revenue Code to currently recognize as income the increment in the periodic redemption price over original purchase price of U.S. savings bonds described in Reg. 1.454-1(a)(1) that were owned as of January 1, [year] , or that are acquired after that date.

Example #1: Uncle Joe, a cash method taxpayer, died owning a $10,000 Series EE savings bond. He had bought the bond for $5,000 and had not chosen to report the increase in value each year. At the date of death, interest of $940 had accrued on the bond, and its value at date of death ($5,940) was included in Uncle Joe's estate. Uncle Joe's personal representative did not choose to include the $940 accrued interest in his final Form 1040 or his estate's initial Form 1041.

Uncle Joe's nephew, Tom, inherits the savings bond. Tom does not elect to report the increase in value of the bond each year. Tom cashes the savings bond when it reaches its maturity value of $10,000. Tom reports $5,000 of interest income (the difference between maturity value of $10,000 and the original cost of $5,000) in that year. Of the $5,000 of income, $940 is income in respect of a decedent and is available for the *Section 691 deduction* on Page 3-4.

Example #2: Same facts, except that Uncle Joe's personal representative elected to include the $940 of interest earned on the bonds before death in Uncle Joe's final Form 1040. Tom would report $4,060 ($5,000 − $940) as interest when he cashed the bond at maturity. This $4,060 represents the interest earned after Uncle Joe's death. It is not IRD.

Community Income

If the decedent was married and domiciled in a community property state (AZ, CA, ID, LA, NV, NM, TX, WA and WI), half of the income received and half of the expenses paid during the decedent's tax year by either the decedent or spouse may be considered to be the income and expenses of the other. [For more information, see *Community Property States* on Page 5-7 or IRS Pub. 555 (Community Property).]

Deductions and Credits in Year of Death

Most rules for deductions for a decedent are the same as those for other individuals. Deductions are allowed if they were paid prior to the decedent's death (except for the special rule for medical expenses) and would have been deductible by the decedent as of the date of death (accrued before death for accrual method taxpayers).

Medical Expenses

Medical costs paid from the decedent's estate within one year of the day following death can be deducted either on Schedule A of the decedent's Form 1040 or on the estate tax return (Form 706) [IRC Sec. 213(c)].

- If medical costs are deducted on the decedent's Form 1040, they are deducted in the year incurred, either on the decedent's final Form 1040 or by amending the Form 1040 from a prior year, and are subject to the 7.5%-of-AGI threshold.
- If the expenses are claimed on Form 1040 or 1040X, a waiver listing the expenses must be attached, in duplicate, to the return. The waiver is irrevocable. The statement is required even if the estate is not required to file Form 706.

Waiver of Right to Deduct Medical Expenses on Decedent's Estate Tax Return

The undersigned personal representative of the above-named taxpayer hereby waives the right to deduct the following medical expenses paid within one year of death on the decedent's estate tax return. These amounts have not been claimed as deductions on Form 706, and the estate waives the right to claim these amounts at any time as estate tax deductions.

Description		Amount
	$	
Total	$	

Signed: ______________________

Personal Representative

Strategy: Claiming medical expenses on the decedent's Form 1040 normally will be appropriate only for decedents who do not owe estate tax or whose marginal income tax rate is greater than their marginal estate tax (Form 706) rate. Claiming the medical expenses on the decedent's final Form 1040 subjects them to the percentage-of-AGI limit, whereas no such limit applies when the expenses are deducted on the estate's Form 706.

Example: Alice was diagnosed with cancer in early 2017 and died in August 2019 at the age of 70. Her unreimbursed and unpaid medical expenses at her date of death were $70,000, all of which were incurred in 2019. The estate sold her home and paid off the medical bills in November 2019. Her estate is not subject to estate tax. The estate waived the right to claim a deduction for the outstanding medical bills on Form 706. Therefore, a $70,000 medical deduction can be claimed on Alice's final Form 1040 (for 2019), subject to the 7.5%-of-AGI limitation.

Observation: A taxpayer who paid medical expenses for a deceased spouse or dependent can deduct them in the year paid without attaching an election statement. Expenses are deductible if the decedent was the taxpayer's spouse or dependent or would have been a dependent if the individual did not have too much gross income or filed a joint return, either at the time the medical service was provided or the time the expense was paid.

Standard Deduction and Personal Exemption

The standard deduction and personal exemption can be claimed in full as if death had not occurred. However, the higher standard deduction for age is not allowed unless the decedent was age 65 or older at the time of death. A decedent cannot use the standard deduction if the surviving spouse files separately and itemizes. The decedent cannot claim the personal exemption if someone else can claim the decedent as a dependent.

Note: For 2019, the personal exemption deduction amount is $0.

Exception. The exclusion does not apply to any amount paid to a person (other than the insured) who has an insurable interest in the life of the insured because the insured:

- Is a director, officer, or employee of the person; or
- Has a financial interest in the person's business.

Form 8853. To claim an exclusion for accelerated death benefits made on a per diem or other periodic basis, file Form 8853 (Archer MSAs and Long-Term Care Insurance Contracts) with the individual's Form 1040.

Expenses

Medical Expenses

Deductible medical expenses include payments made for the diagnosis, cure, mitigation, treatment or prevention of disease and for treatment affecting any part or function of the body [IRC Sec. 213(d)]. They also include the cost of transportation for needed medical care and payments for medical insurance. Medical expenses are deductible only to the extent they exceed 7.5% of the taxpayer's AGI.

Law Change Alert: The 2019 Disaster Act reduced the deduction floor from 10%-of-AGI to 7.5%-of-AGI for all taxpayers for 2019 and 2020.

Medical Expenses of the Disabled

The following list includes some of the medical expenses that disabled individuals may incur because of their disability (not an all-inclusive list):

- Artificial limbs, contact lenses, eyeglasses, and hearing aids.
- Cost of Braille books and magazines that is more than the price of regular printed editions.
- Cost and repair of special telephone equipment for hearing-impaired persons.
- Cost of equipment that displays the audio part of television programs as subtitles for hearing-impaired persons.
- Cost and maintenance of a wheelchair or autoette.
- Cost and care of a guide dog or other service animal aiding a person with a physical disability.
- A special school, if the main reason for using the school is its resources for relieving a mental or physical disability. This includes the cost of teaching and the cost of remedial language training to correct a condition caused by a birth defect.
- Premiums for qualified long-term care insurance, up to the following limits (for 2019):
  - Age 40 or under: $420.
  - Age 41 to 50: $790.
  - Age 51 to 60: $1,580.
  - Age 61 to 70: $4,220.
  - Over age 70: $5,270.
- Improvements to a home that do not increase its value if the main purpose is medical care.
- Cost of in-home health care.

Improvement to home. Certain improvements made to accommodate a home for a taxpayer's disabled condition or that of his spouse or dependents who live with him, do not usually increase the value of the home and the cost can be included in full as medical expenses. These improvements include, but are not limited to, the following items (Rev. Rul. 87-106; IRS Pub. 502):

- Constructing entrance or exit ramps.
- Widening doorways at entrances or exits.
- Widening or otherwise modifying hallways and interior doorways.
- Installing railings, support bars, or other modifications to bathrooms.
- Lowering or modifying kitchen cabinets and equipment.
- Moving or modifying electrical outlets and fixtures.
- Installing porch lifts and other forms of lifts (but elevators generally add value to the house).
- Modifying fire alarms, smoke detectors, and other warning systems.
- Modifying stairways.
- Adding handrails or grab bars anywhere (whether or not in bathrooms).
- Modifying hardware on doors.
- Modifying areas in front of entrance and exit doorways.
- Grading the ground to provide access to the residence.

Caution: Only reasonable costs to accommodate a home for a disabled condition are considered medical care. Additional costs for personal motives, such as for architectural or aesthetic reasons, are not medical expenses [Rev. Rul. 87-106; *Ferris*; 42 AFTR 2d 78-5674 (7th Cir. 1978)].

Example: Alfred is advised by a physician to install an elevator in his residence so that his wife, Mildred, who is afflicted with heart disease, will not be required to climb stairs. The cost of installing the elevator is $5,000, and the increase in the value of the residence is determined to be $3,000. Therefore, the difference of $2,000, which is the cost in excess of the value enhancement, is deductible as a medical expense.

If, however, by reason of this expenditure, it is determined that the value of the residence has not been increased, the entire $5,000 cost of installing the elevator qualifies as a medical expense.

In-home health care costs. For deduction of in-home health care costs, see *Elderly* on Page 5-15.

Impairment-Related Work Expenses

An employee who has a physical or mental disability that functionally limits his employment, or a physical or mental impairment that substantially limits one or more of his major life activities (for example, walking, speaking, breathing, learning), may be able to deduct impairment-related work expenses. These are allowable business expenses for attendant care at the workplace and other expenses in connection with the workplace that are necessary for the disabled person to work [IRC Sec. 67(d)].

Impairment related work expenses are deductible as an itemized deduction on Schedule A. **Note:** Unlike regular employee unreimbursed business expenses, impairment-related work expenses were not subject to the 2%-of-AGI limit that applied to miscellaneous itemized deductions before 2018 [IRC Sec. 67(b)(6)]. Therefore, the disallowance of miscellaneous itemized deductions under the TCJA does not impact the deductibility of impairment-related work expenses.

For impairment-related work expenses, complete Form 2106 (Employee Business Expenses) and attach it to Form 1040. Enter the amount of the impairment-related expenses on line 16 of Schedule A and identify as such on the dotted line next to line 16.

Observation: The impairment-related work expense deduction is for *handicapped individuals* as opposed to *disabled individuals* used elsewhere in the Code. A handicapped person is [IRC Sec. 190(b)(3)]:

> "any individual who has a physical or mental disability (including, but not limited to, blindness or deafness) which for such individual constitutes or results in a functional limitation to employment, or who has any physical or mental impairment (including, but not limited to, a sight or hearing impairment) which substantially limits one or more major life activities of such individual."

Qualified ABLE Programs

States are allowed to establish tax-exempt Achieving a Better Life Experience (ABLE) accounts to assist persons with disabilities. These accounts can be established to pay qualified disability expenses. A qualified ABLE account is generally exempt from

Disaster Victims

Contents

Quick Tax Briefing

Overview

To help taxpayers recover financially from the impact of a disaster, special rules may allow disaster victims to deduct part or all of their losses due to casualties. To claim a loss, taxpayers must complete Form 4684 and file it with their income tax return (Form 1040).

Tax highlights

- ✓ For 2018–2025, personal casualty losses are not deductible unless attributable to a federally declared disaster or, if the taxpayer has a casualty gain, to the extent of such gain.
- ✓ Taxpayers must itemize deductions to claim non-business casualty losses attributable to federally-declared disasters.
- ✓ If the damaged property is covered by insurance, a timely insurance claim must be filed in order to deduct the loss. However, an insurance claim does not need to be filed to deduct the part of the loss that is not covered by insurance (for example, a deductible).
- ✓ The deduction for personal casualty losses attributable to federally declared disasters must be reduced by (1) $100 per casualty and (2) 10% of the taxpayer's AGI.
- ✓ The IRS has provided safe harbor methods for individuals to use in determining the amount of their casualty losses for their personal-use residential real property and personal belongings.
- ✓ Losses on employee business-use property are not deductible since they are treated as miscellaneous itemized deductions subject to the 2%-of-AGI threshold, which is not allowed for 2018–2025.
- ✓ Losses on business or income-producing property are not subject to the $100 and 10% limits.
- ✓ Special tax rules apply to victims of Hurricanes Harvey, Irma, and Maria, the California wildfires, and qualified 2018 and 2019 disasters.
- ✓ Taxpayers who move due to damage to their main home should use their current address at the time they file tax returns. Taxpayers who move after filing the return should update their address with the IRS by calling the IRS Disaster Assistance Hotline at 866-562-5227 or by filing Form 8822 (Change of Address).

IRS materials

- Form 4684 (Casualties and Thefts).
- IRS Pub. 547 (Casualties, Disasters, and Thefts).
- IRS Pub. 584 [Casualty, Disaster, and Theft Loss Workbook (Personal-Use Property)].
- IRS Pub. 584-B (Business Casualty, Disaster, and Theft Loss Workbook).
- IRS Pub. 976 (Disaster Relief).
- IRS Pub. 2194 (Disaster Resource Guide for Individuals and Businesses).
- IRS Pub. 3067 (IRS Disaster Assistance—Federally Declared Disaster Area).

Useful websites

- Federal Emergency Management Agency: **www.fema.gov**.
- Access to Disaster Help and Resources: **www.disasterassistance.gov.**
- IRS: **www.irs.gov** (for example, search for "*Disaster Assistance*").

Key Terms

Business or income-producing property. Property used in a business or held for the production of income (for example, rental real estate).

Casualty. Property damage, destruction or loss resulting from a sudden, unexpected or unusual identifiable event.

Fair market value. The price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of the relevant facts.

Federally declared disaster. Any disaster subsequently determined by the President of the United States to warrant assistance by the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. It includes a major disaster or emergency declaration under the Act.

Federal Emergency Management Agency (FEMA). An agency of the United States Department of Homeland Security (DHS). The purpose of FEMA is to coordinate the response to a disaster which has occurred in the United States and which overwhelms the resources of local and state authorities.

Involuntary conversion. Loss or destruction of property as a result of theft, casualty, seizure, requisition or condemnation.

Personal use property. Property held for personal use as opposed to business or income-producing property.

Qualified disaster relief payments. Nontaxable payments a victim of a qualified disaster, which includes federally-declared disasters, receives from a government, charity or employer to pay for or reimburse certain living, repair or other related costs.

Casualties

For 2018–2025, personal casualty losses are not deductible unless attributable to a federally declared disaster or, if the taxpayer has a casualty gain, to the extent of such gain.

Disaster Relief Alert: Special rules apply to victims of qualified disasters. See *Taxpayer Certainty and Disaster Tax Relief Act of 2019* in the *Handbook Updates* section of the Quickfinder website (**tax.thomsonreuters.com/quickfinder**) for a table summarizing key provisions of this December 2019 legislation.

What Is a Casualty Loss?

A loss to personal-use property is deductible if the loss is due to fire, storm, shipwreck or other casualty or from theft [IRC Sec. 165(c)(3)].

Example: Jack, a self-employed contractor, drives a pickup truck that cost $16,250. He uses it 60% for business and 40% for personal purposes. His adjusted basis in the pickup truck is $3,000 for the business use portion ($9,750 cost less $6,750 of accumulated depreciation) and $6,500 for the personal use portion.

In July 2019, Jack's truck was damaged in a fire. His insurance company reimbursed him for the cost to repair the truck, subject to his $1,000 deductible. It cost Jack $4,000 to have his pickup repaired. Because the pickup was used partly for business and partly for personal purposes, a separate casualty loss is calculated for each.

	Business Loss	Personal Loss	Total
1) Adjusted basis in truck before fire	$ 3,000	$ 6,500	$ 9,500
2) Decrease in FMV (cost to repair)............	2,400	1,600	4,000
3) Amount of loss (lesser of line 1 or 2)......	2,400	1,600	4,000
4) Less insurance reimbursement	(1,800)	(1,200)	(3,000)
5) Loss after reimbursement......................	$ 600	$ 400	$ 1,000

The $600 business loss is reported in Part 1, Section B, of Form 4684. The $400 loss related to the personal-use portion of the pickup is not deductible since it was not incurred in a federally declared disaster area.

Deductible Losses Exceed Income

If casualty or theft losses along with other deductions cause a taxpayer's deductions to exceed his income for that year, the taxpayer may have a net operating loss (NOL). Deductible personal casualty losses are fully allowed in determining a taxpayer's NOL. Thus, the limitation on certain other non-business deductions in calculating an individual's NOL does not apply to personal casualty loss deductions [IRC Sec. 172(d)(4)(C)].

Federally Declared Disasters

For 2018–2025, a personal casualty loss is deductible only if attributable to a federally declared disaster [IRC Sec. 165(h)(5)(A)]. Such losses are subject to the $100 and 10%-of-AGI thresholds described under *Determining the Deductible Loss* on Page 4-15.

Federally declared disaster losses are also subject to the special tax relief provisions described in the table *Federally Declared Disasters—Summary of Special Tax Relief Provisions* on Page 4-16.

Disaster Relief Alert: In addition to the rules discussed in this section, special rules apply to victims of Hurricanes Harvey, Irma, and Maria and victims of the 2017 California wildfires. See *Victims of Hurricanes Harvey, Irma, and Maria* on Page 4-21 and *Victims of California Wildfire* on Page 4-21.

Disaster Relief Alert: The 2019 Disaster Act addresses special rules which apply to victims of qualified disasters from January 1, 2018, through February 18, 2020. See *Taxpayer Certainty and Disaster Tax Relief Act of 2019* in the *Handbook Updates* section of the Quickfinder website (**tax.thomsonreuters.com/quickfinder**) for a table summarizing key provisions of this December 2019 legislation.

Note: *Qualified disaster area* is any area with respect to which a major disaster was declared, during the period beginning on January 1, 2018 and ending on February 18, 2020, by the President under Section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act if the incident period of the disaster with respect to which such declaration is made begins on or before December 20, 2019. To prevent potential double tax benefits, a qualified disaster area does not include the California wildfire disaster area as defined in the Bipartisan Budget Act of 2018 (see *Victims of California Wildfire* on Page 4-21).

In addition, the additional standard deduction allowed by this provision is not treated as a preference item for alternative minimum tax [Sec. 204(b)(1)(D) of the 2019 Disaster Act].

Federally Declared Disasters—Summary of Special Tax Relief Provisions

Item	Special relief
Casualty loss deduction—when to deduct	Can elect to claim in year before year of the disaster.
Disaster relief payments	Payments are nontaxable.
Involuntary conversions of business or income-producing property	Any tangible replacement property acquired for use in any business is treated as similar or related in service or use to the destroyed property.
Involuntary conversions of principal residence	• Replacement period is four years rather than two years. • Special rules for avoiding gain on receipt of insurance proceeds.

Federally Declared Disaster

A *federally declared disaster* is a disaster that occurs in an area directed by the President to be eligible for federal assistance under the Robert T. Stafford Disaster Relief and Emergency Assistance Act [IRC Sec. 165(i)(5)]. It includes a major disaster or emergency declaration under the Act (Rev. Rul. 2003-29; Pub. 547).

For a list of 2019 federally declared disasters at the time of publication, see *2019 Federally Declared Disasters* on Page 4-25.

Casualty Loss—Election to Deduct in the Prior Year

A casualty loss attributable to a federally declared disaster can be claimed in the year the disaster occurred or in the year preceding the loss on a timely return or amended return (Form 1040X) [IRC Sec. 165(i)]. This may increase the tax savings from the loss and entitle the taxpayer to a refund earlier than if he waited to claim it on the loss year's return. If a taxpayer owns multiple properties that are damaged by a federally declared disaster, he must report all losses from that disaster together, either in the year of the disaster or in the prior year [Reg. 1.165-11(c)].

Practice Tip: Determining the most beneficial year to claim the loss requires a careful evaluation of the taxpayer's entire tax picture for both years, including filing status, amount of income and other deductions, and the applicable tax rates. For example, claiming the loss in the higher income year may not be the most advantageous approach.

Casualty Loss—Deduction Limit Rules for Personal-Use Property[1]

		$100 Rule	10% Rule
General Application		Reduce each casualty loss by $100 when figuring the deduction. Apply this rule to personal-use property after determining the amount of the loss.	Reduce the net casualty loss by 10% of taxpayer's AGI. Apply this rule to personal-use property after reducing each loss by $100 (the $100 rule).
Single Event		Apply this rule only once, even if many pieces of property are affected.	Apply this rule only once, even if many pieces of property are affected.
More Than One Event		Apply to the loss from each event.	Apply to the total of all losses from all events during the tax year.
More Than One Person—With loss from the same event (other than a married couple filing jointly)		Apply separately to each person.	Apply separately to each person.
Married Couple—With loss from the same event	Filing joint return	Apply as if spouses were one person.	Apply as if spouses were one person.
	Filing separate return	Apply separately to each spouse.	Apply separately to each spouse.
More Than One Owner (other than a married couple filing jointly)		Apply separately to each owner of jointly owned property.	Apply separately to each owner of jointly owned property.

[1] For 2018–2025, personal casualty losses are deductible only if attributable to a federally declared disaster.

Head of Household—Qualifying Person to Claim Status[1]		
If the person is the taxpayer's. . .	And. . .	Then that person is. . .
Qualifying child[2] (such as a son, daughter or grandchild who lived with the taxpayer more than half the year and meets certain other tests)	He is single	A qualifying person, whether or not the taxpayer can claim an exemption for the person.
	He is married and the taxpayer can claim an exemption for him	A qualifying person.
	He is married and the taxpayer cannot claim an exemption for him	Not a qualifying person.[3]
Qualifying relative[2] who is the taxpayer's father or mother	The taxpayer can claim an exemption for him[4]	A qualifying person.[5]
	The taxpayer cannot claim an exemption for him	Not a qualifying person.
Qualifying relative[2] other than the taxpayer's father or mother (such as a grandparent, brother or sister who meets certain tests)[6]	He lived with the taxpayer more than half the year, and the taxpayer can claim an exemption for him[4]	A qualifying person.
	He did not live with the taxpayer more than half the year	Not a qualifying person.
	The taxpayer cannot claim an exemption for him	Not a qualifying person.

[1] A person cannot qualify more than one taxpayer to use the HOH filing status for the year.

[2] See *Claiming a Dependent—Quick Reference (2019)* on Page 11-6 for definition.

Note: Releasing the dependency exemption does not affect qualification for HOH status. For HOH status, a child who otherwise qualifies is the qualifying child of the custodial parent, even if the dependency exemption is released to the noncustodial parent.

[3] This person is a qualifying person if the only reason the taxpayer cannot claim the exemption is that the taxpayer can be claimed as a dependent on someone else's return.

[4] If the taxpayer can claim an exemption for a person only because of a multiple support agreement, that person is not a qualifying person.

[5] A parent need not live in the taxpayer's home if the taxpayer pays more than half the cost of maintaining the parent's home.

[6] A person who is the taxpayer's qualifying relative only because he lived with the taxpayer all year as a member of the household is not a qualifying person.

can take steps to make sure that each parent is the custodial parent of at least one child. Tracking the number of nights each child spends with each parent so that each parent has a greater number of nights with one child will accomplish this.

Caution: Tax preparers are subject to a penalty ($530 for 2019) for each failure to comply with due diligence requirements imposed by IRS regulations when determining whether a taxpayer is eligible to file as HOH [IRC Sec. 6695(g)].

Legally Married on Last Day of Tax Year

Taxpayers are considered married for the whole year if they are separated but have not obtained a final decree of divorce or separate maintenance by the last day of the tax year. An interlocutory decree is not a final decree. Taxpayers who are in the process of getting a divorce but are still legally married on the last day of the tax year can file as either married filing jointly, married filing separately or in certain circumstances, as head of household.

Married filing jointly (MFJ). If taxpayers are married as of December 31, they can choose to file a joint return. To file jointly, both spouses must include all of their income, exemptions, deductions and credits on that return. Spouses can file a joint return even if one spouse had no income or deductions.

Both spouses generally must sign the return, or it will not be considered a joint return.

Caution: A separated couple may want to file a joint income tax return in order to save income taxes. However, a joint income tax return carries joint and several liability for all income taxes, interest and penalties, if any, to each party. Thus, one spouse may be held liable for all the tax due even if the income was earned by the other spouse.

Innocent spouse relief for joint filers. Sometimes, after a divorce, the IRS assesses additional tax on a joint return filed before the divorce occurred. Generally, the IRS can collect that tax from either spouse, regardless of which spouse's income was underreported. Innocent spouse relief may be available for tax on a joint return, if the understatement was due to one spouse's income and the other spouse had no knowledge (or reason to know) of the understated income. See IRC Sec. 6015 and Form 8857 (Request for Innocent Spouse Relief) for details.

Married filing separately (MFS). If married taxpayers file separate returns, each spouse should report only his own income, exemptions, deductions and credits on their individual return. Taxpayers can file separate returns even if only one spouse had income. Some married couples file separate returns because each wants to be responsible only for his own tax. There is no joint liability. But in almost all cases, taxpayers who file separate returns will pay more combined federal tax than they would with a joint return.

Disadvantages of Married Filing Separately *(in addition to various amounts being half of the MFJ amount)*	
Lost Credits	• Earned income credit. • Credit for the elderly or the disabled unless spouses lived apart for the entire year. • Child and dependent care credit unless spouses lived apart for last six months of the year. • Adoption credit unless spouses lived apart for last six months of the year.
Lost Education Benefits	• Student loan interest deduction. • Tuition and fees deduction ~~(if available)~~. • Savings bond interest exclusion. • Education credits.
Standard Deduction	If one spouse itemizes deductions, the other must also itemize (that is, cannot claim the standard deduction).
Taxable Social Security	A greater percentage of social security benefits may be taxable unless the spouses lived apart for the entire year.
IRAs	• Traditional IRA deduction and Roth IRA contributions phased out at $10,000 of modified AGI unless the spouses lived apart for the entire year. • Spousal IRA rules do not apply.
Passive Losses	• Rental real estate loss allowance is limited to $12,500 per spouse ($0 if spouses lived together at any time during the year), with lower phase-out thresholds. • One spouse's passive loss cannot be offset by the other spouse's passive income.
AMT Exemption	In addition to exemption phasing out, some high income taxpayers must add an amount back to AMTI.

Community or separate income. Taxpayers who live in a community property state and file a separate return, may be considered

When Is a Return Required?

Because a higher standard deduction is allowed for taxpayers age 65 or older, the income levels at which a return is required are greater for elderly taxpayers.

Who Must File a 2019 Return[1]	
Filing Status	*Must file if gross income is at least:*
Single:	
Under 65	$12,200
65 or older	13,850
Married Filing Jointly:	
Both spouses under 65	$24,400
One spouse 65 or older	25,700
Both spouses 65 or older	27,000
Married Filing Separately	$ 5
Head of Household:	
Under 65	$18,350
65 or older	20,000
Qualifying Widow(er):	
Under 65	$24,400
65 or older	25,700

[1] Assumes taxpayer cannot be claimed as a dependent on another return.

Note: For years 2018–2025, the filing requirement rules based on the exemption amount and standard deduction do not apply. Due to the suspension of the personal exemption deduction, every individual who has gross income for the tax year must file an income tax return except for those listed in the table above based on the standard deduction and the additional standard deductions for the elderly and the blind [IRC Sec. 6012(f)]. For 2019, the additional standard deduction for the elderly or the blind is $1,300. The additional standard deduction amount increases to $1,650 for unmarried taxpayers.

Retirement Income

Social Security Benefits

Taxpayers may have to include up to 85% of social security benefits (paid because of retirement, survivorship, or disability) in taxable income. The amount of benefits includable in income depends on whether the taxpayer's provisional income exceeds the applicable base amount (IRC Sec. 86).

Calculation of Provisional Income
Begin with: Adjusted gross income (before taxable social security benefits).
Add: 1) One-half of social security benefits. 2) Tax-exempt interest. 3) Excluded Series EE and I bond interest used to pay college expenses. 4) Excluded employer-provided adoption assistance benefits. 5) Excluded foreign earned income and housing costs. 6) Excluded income of certain bona fide residents of American Samoa or Puerto Rico. 7) Student loan interest deduction. 8) Tuition and fees deduction ~~(if available)~~.
Equals: Provisional Income.

To what extent, if any, the taxpayer's social security benefits are taxable depends on how his provisional income compares to the amounts shown in the *Taxation of Social Security Benefits—Base Amounts* on Page 5-16.

Taxation of Social Security Benefits—Base Amounts		
Filing Status	Base Amount	Adjusted Base Amount
Single, HOH, QW, or MFS and the taxpayer did not live with spouse at any time during the year	$ 25,000	$ 34,000
MFJ	32,000	44,000
MFS and the taxpayer lived with spouse at any time during the year	0	0

- None of the taxpayer's social security benefits are taxable if provisional income does not exceed the base amount.
- Up to 50% are taxable when provisional income exceeds the base amount but is less than the adjusted base amount.
- Up to 85% are taxable if provisional income exceeds the adjusted base amount.

See the *Social Security Benefits Worksheet (2019)* on Page 5-22.

Note: Social security recipients can request that income tax be withheld from their benefit payments [IRC Sec. 3402(p)(1)]. Withholding is voluntary and is initiated by completing IRS Form W-4V (Voluntary Withholding Request) requesting to have 7%, 10%, 12%, or 22% withheld for federal income tax and submitting the form to the recipient's local social security office.

Social security lump-sum election. Taxpayers must include the taxable part of a retroactive payment of benefits in current-year income even if the payment includes benefits for a prior year. There are two methods to calculate the taxable part of the total benefits received:

1) *Regular method*. Use current-year income to figure the taxable part of the total benefits (including those from a prior year) received in the current year.
2) *Lump-sum election method* [IRC Sec. 86(e)]:
   a) Refigure the taxable part of benefits for each prior year using that year's income, any benefits paid during that year, and benefits paid during the current year designated for that year.
   b) Subtract any taxable benefits for the refigured year that were previously reported. The remainder is the taxable part of the lump-sum payment.
   c) Refigure current-year taxable benefits without the lump-sum payment.
   d) Add all prior-year taxable benefits to current-year taxable benefits. Compare to taxable benefits calculated using the regular method and use the method that allows the lower taxable benefits.

To report benefits using the lump-sum election method, enter "LSE" on Form 1040 to the left of line 5a.

Example: In 2019, Irma received a lump-sum social security payment of $10,000, $4,000 of which was attributable to 2018. Irma's 2019 provisional AGI is such that 85% of her social security benefits are included in her taxable income. In 2018, only 50% of any social security benefits she received would have been included in income.

Without an election, $8,500 ($10,000 × 85%) of benefits will be included in Irma's 2019 AGI. However, Irma can elect to include the 2018 benefits in 2019 income only to the extent they would have been taxable based on the 2018 facts and law. If Irma makes this election, she will include only $7,100 [($6,000 × 85%) + ($4,000 × 50%)] of benefits in her 2019 income.

To make the election, Irma should report $7,100 on line 5b of her 2019 Form 1040 (the full $10,000 should be reported on line 5a). She should also enter "LSE" to the left of line 5a.

the annuity is for life, determine the total number of payments by using a multiple from the appropriate actuarial table in Pub. 939.

Nonperiodic Payments

Payments received that are not part of an annuity stream (that is, a nonperiodic payment) are typically allocated first to earnings and then to investment in the contract [IRC Sec. 72(e)]. Thus, such payments are fully taxable to the extent of earnings on the contract. See IRS Pub. 575 for more information on nonperiodic payments.

Disability Pensions

For the taxation of various disability pensions and payments, see *Disabled Individuals* on Page 4-1.

Accelerated Life Insurance Proceeds

For taxation of accelerated death benefits from life insurance policies, see *Accelerated Death Benefits* on Page 3-4.

Standard Deduction

Taxpayers age 65 or older or who are blind get a higher standard deduction amount [IRC Sec. 63(f)].

Age 65 or Older

A taxpayer is entitled to a higher standard deduction if he is age 65 or older at the end of the year. An individual is considered 65 on the day before his 65th birthday. Therefore, the higher standard deduction is available for 2019 to taxpayers born on or before January 1, 1955.

Blind

A taxpayer who is blind on the last day of the year is entitled to a higher standard deduction. To qualify, the taxpayer must be totally or partly blind.

Partly blind. To qualify as partly blind, the individual must obtain a certified statement from an eye physician or registered optometrist stating that he:

- Cannot see better than 20/200 in the better eye with glasses or contact lenses or
- Has a field of vision that is not more than 20 degrees [IRC Sec. 63(f)(4)].

If the eye condition will never improve beyond these limits, the statement should include this fact. The taxpayer must keep the statement in his records.

Note: If the taxpayer's vision can be corrected beyond these limits only by contact lenses that he can wear only briefly because of pain, infection or ulcers, the taxpayer can take the higher standard deduction for blindness if he otherwise qualifies.

Spouse 65 or Older or Blind

A higher standard deduction is available if the taxpayer's spouse is age 65 or older or blind and:

- A joint return is filed or
- Separate returns are filed but the taxpayer can claim an exemption for his spouse because his spouse had no gross income and an exemption for his spouse could not be claimed by another taxpayer.

2019 Standard Deduction Chart for People Born On or Before January 1, 1955 or Who Are Blind

Check the correct number of boxes below. Then go to the chart.

Taxpayer	Born On or Before January 1, 1955 ☐	Blind ☐
Spouse, if claiming spouse's exemption	Born On or Before January 1, 1955 ☐	Blind ☐
Total number of boxes checked ☐		

If filing status is . . .	And the number in the box above is . . .	Then standard deduction is . . .
Single	1	$ 13,850
	2	15,500
Married filing jointly or Qualifying widow(er) with dependent child	1	$ 25,700
	2	27,000
	3	28,300
	4	29,600
Married filing separately	1	$ 13,500
	2	14,800
	3	16,100
	4	17,400
Head of household	1	$ 20,000
	2	21,650

Note: Do not use if someone can claim an exemption for the taxpayer (or spouse if married filing jointly). Also, the standard deduction is zero for the following individuals: (1) a married individual who files a separate return, if the individual's spouse itemizes deductions; (2) a nonresident alien; or (3) an individual filing a short-year return due to a change in annual accounting period.

Medical Expenses

Elderly individuals are likely to incur deductible medical and dental expenses. In addition, a parent's medical expenses can be claimed by a child if the parent would have been a dependent if not for the gross income requirement. This section highlights particular expenses that often apply to the elderly.

For 2019, medical expenses claimed on Form 1040 are generally deductible only to the extent they exceed 7.5% of AGI.

Law Change Alert: The 2019 Disaster Act reduced the deduction floor from 10%-of-AGI to 7.5%-of-AGI for all taxpayers for 2019 and 2020.

When to Deduct

Medical and dental expenses normally are deductible in the year deemed paid, regardless of when the services were provided.

Payment Method	Date of Deemed Payment
Check	Date mailed or delivered
Pay-by-phone	Reported date shown on statement of financial institution
Online account	Reported date shown on statement of financial institution
Credit card	Date of credit charge[1]

[1] Date credit charge is paid does not matter (Rev. Rul. 78-39).

Medical Insurance

Deductible medical expenses include insurance premiums paid for policies that cover medical care. Policies can provide payment for:

- Hospitalization, surgical fees, x-rays, etc.;
- Prescription drugs;
- Replacement of lost or damaged contact lenses;
- Qualified long-term care insurance contracts (see *Long-Term Care Insurance and Expenses* on Page 5-20); or
- Membership in an association that gives cooperative or so-called free-choice medical service, or group hospitalization and clinical care.

Note: Insurance premiums paid with pre-tax dollars to an employer's health plan are not deductible because the premiums are not included in box 1 of Form W-2.

Government Program Income

Government Farm Programs—Overview

Government programs administered by the U.S. Department of Agriculture (USDA) are a significant source of revenue for most farmers and ranchers. Generally, these programs involve cash assistance in times of poor commodity prices, but they can also involve subsidies for undergoing conservation practices, or for idling land that was considered erodible or of marginal production value. Also, the USDA administers various disaster programs to compensate farmers for losses associated with weather-related conditions.

Practice Tip: Market Facilitation Payments (MFPs) received as a result of the recent trade wars are taxable in the year received (PMTA 2018-21).

Tax reporting. In general, these program benefits are reported to the farmer and to the IRS on Form 1099-G (Certain Government Payments) but may be reported on another type of Form 1099. See the table *Farmers—Where to Report Income* on Page 6-20.

Practice Tip: Local USDA offices that administer these programs (Farm Service Agency offices) can be a valuable source of information about the various programs.

Commodity Credit Corporation Loans

The USDA administers a government-backed commodity loan program through the Commodity Credit Corporation (CCC).

- Under this program, a farmer may pledge grain as collateral, securing a loan from the CCC that is often in excess of the market value of the commodity.
- A unique feature of CCC loans is that the farmer may surrender the commodity to the CCC in satisfaction of the loan, even if the commodity's value is below the loan liability.

Farmers can choose between two different methods of accounting for CCC loans for income tax purposes: (1) loan method or (2) income method.

Loan method. The loan method of accounting for CCC loans treats the loan like any other debt.

- When the loan proceeds are received, a liability is created, and when the loan principal is repaid, no deduction, other than interest expense, may be claimed.
- If the farmer surrenders the commodity in satisfaction of the loan, the USDA will issue a Form 1099-A to report the debt relief income that has occurred.
- The farmer reports the 1099-A amount as income on line 5b of Schedule F or line 4b of Form 4835. If there is no tax basis in the forfeited commodity, the full loan relief amount is taxable income on line 5c or 4c, respectively.

Caution: In periods of sustained low commodity prices, the loan method of reporting CCC loans can often lead to low income, followed by a significant escalation of taxable income in a later year when commodity prices improve and the loan is repaid. This may result in grain produced over several years all being sold in a single year, but without any extra cash flow to pay the tax (the cash was received in prior years as loan proceeds but was not reported as income).

Example: Caleb is a cash method farmer of soybeans and corn. At harvest, corn prices are low. Rather than sell his corn, Caleb collateralizes the 10,000 bushel crop with a CCC loan, for which he receives $2.50 per bushel or $25,000 (the current market price at harvest is under $2.25 per bushel). Caleb's corn crop, stored in bins on his farm, is collateralized or "sealed" against this loan. Caleb, who reports CCC loans on the loan method, records no income at the time of receiving the loan proceeds.

By summer of the next year, the corn price has not increased, and Caleb decides to forfeit his crop against the CCC loan. Caleb will receive a Form 1099-A from the USDA, reporting the prior year CCC loan amount of $25,000 as income. This income is reported on lines 5b and 5c of Caleb's Schedule F. Generally, in forfeiture situations where the commodity price is below the loan balance, interest will not be charged by the CCC.

Practice Tip: Farmers may satisfy CCC loans by delivering the commodity to an elevator or grain warehouse, which in turn repays the CCC loan. Here, the farmer's records will not contain any sales proceeds for the commodity, as the cash flow from the crop sale was sent directly to the CCC to retire the debt. Since this was not a forfeiture but rather the use of cash proceeds to retire the debt, the CCC issues no Form 1099-A.

Income method. A taxpayer who receives a loan from the CCC is permitted to make an election to report the loan proceeds as gross income in the year the loan is received [IRC Sec. 77(a)]. Once a taxpayer has elected to report a CCC loan as income, all CCC loans in later years must be reported in gross income, unless the taxpayer changes its accounting method for these loans (see Section 2.01 of Rev. Proc. 2019-43 for automatic change procedures).

To adopt the income method, the farmer includes CCC loans as income for any year. A statement should be attached to the return showing the details of the loan (IRS Pub. 225).

- In the year a farmer first elects to include CCC loans in income, all CCC loans occurring within that year must be reported on the income method; it is not possible to elect the income method only with respect to loans originating after some specific point within the tax year (TAM 8819004).
- The election to adopt the income method must be made on a timely return; it cannot be made on an amended return (Rev. Rul. 56-358), unless that amended return is filed within six months of the original due date of the return. Attach the statement to the amended return and write "Filed pursuant to Section 301.9100-2" at the top of the return (IRS Pub. 225).

Under the income method, the amount reported as income on the CCC loan results in a corresponding basis increase in the commodity [IRC Sec. 1016(a)(8)]. Thus, for those producers who forfeit the commodity against the loan under the income method, no further income recognition will generally occur.

Example: Delmar, a cash method grain producer, uses the income method of reporting CCC loans. In the current year, Delmar receives a CCC loan against his corn crop, pledging 10,000 bushels of corn to secure a loan at $2.50 per bushel. Delmar reports the $25,000 of CCC loan income on his current-year Schedule F on line 5a. Delmar also notes in his records that the corn he has pledged to CCC against this loan now has an adjusted tax basis of $25,000. (Prior to creating this loan, Delmar's raised crop had a zero tax basis, since he uses the cash method.)

Next year, realizing that commodity prices are not improving, Delmar forfeits his corn crop against the CCC loan. Effectively, Delmar has repaid the $25,000 CCC loan by applying a corn crop with a tax basis of $25,000 against the loan. At the end of the year, Delmar will receive a Form 1099-A from the CCC, indicating a loan forfeiture of $25,000. Delmar should enter this $25,000 loan forfeiture amount on line 5b of his Schedule F, but he should enter zero in the taxable amount at line 5c.

Rather than forfeit a commodity against a CCC loan, many producers will pay back the loan and sell the commodity on the open market. This is the normal strategy when the commodity value has risen in excess of the loan. These repayments often are made indirectly (the commodity is delivered to a commercial elevator or warehouse for sale, the grain buyer repays the CCC loan and issues the net proceeds to the farmer).

Example #1: Kane is a sugar beet farmer who markets his beets through a nearby co-op. For the current year, Kane receives a certificate from the co-op indicating that he has been allocated $4,800 of nonqualified per-unit retains. In addition, Kane received cash of $4,250 for the redemption of prior year nonqualified per-unit retain certificates. The $4,800 certificate reporting the allocation of nonqualified per-unit retains is not currently taxable, and is not reported on the Form 1099-PATR received from the co-op. However, the former nonqualified per-unit retains that were currently redeemed for cash in the amount of $4,250 are taxable (reported on Form 1099-PATR, box 5, by the co-op). Kane reports this income on Schedule F, lines 3a and 3b.

Example #2: Lem is a dairy farmer who markets his milk through a co-op. For the current year, Lem receives a Form 1099-PATR reflecting issuance of qualified per-unit retain certificates of $5,900. Lem did not receive any current cash payments on the per-unit retains. His Form 1099-PATR from the co-op reports $5,900 in box 3 (per-unit retain allocations). This entire amount is taxable and is reported on both lines 3a and 3b of Lem's Schedule F.

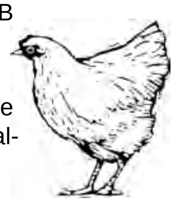
Losses on Co-Op Equity

Co-ops occasionally have suffered financial problems, failed or gone away in takeover transactions or mergers. A financially distressed co-op might permanently reduce the member's equity account, issuing a notice that the account has been adjusted downward or eliminated. This write-off is deductible in Part II of Schedule F in the year the writedown occurs.

Depreciable Property

Depreciating Farm Property

A five-year recovery period applies to farm machinery and equipment (other than any grain bin, cotton ginning asset, fence or other land improvement) if the original use commences with the taxpayer after 2017. The regular 200% DB method under MACRS applies. However, buildings and trees or vines bearing fruits or nuts are depreciated using the straight-line method. 15–or 20–year property (such as land improvements and farm buildings) is depreciated under the 150% DB method. Taxpayers can elect to use the straight-line (SL) method for any assets. The SL method also applies if the taxpayer is required (or elects) to use the alternative depreciation system (ADS). For example, farmers who elect to be exempt from the business interest expense limit under IRC Sec. 163(j) that applies to taxpayers with average annual gross receipts over inflation-adjusted $25 million ($26 million in 2019) must use the ADS for their assets with a recovery period of ten years or more (see *Business Interest Expense Limitation* in Tab B of the *Small Business Quickfinder®* Handbook).



Note: Farm machinery and equipment used in a farming business and placed in service before 2018 is depreciated using the 150% declining balance method over a seven-year recovery period.

A farming business includes:

- Raising and harvesting crops.
- Raising, shearing, feeding, caring for, training, and managing animals.
- Operating a nursery or sod farm.
- Raising or harvesting trees bearing fruit, nuts, or other crops.
- Raising ornamental trees.

Note: The ADS method is required if a farmer elects out of UNICAP (see *Electing out of farming UNICAP* on Page 6-25).

Farmers Depreciation Table—Quick Summary (2019)	
System/Method	Type of Property
GDS using 200% DB using 150% DB	• All property used in a farming business (except real property). • All 15- and 20-year property.
GDS using SL	• Nonresidential real property. • Trees or vines bearing fruit or nuts.
ADS using SL	Farm property used when an election not to apply the uniform capitalization rules or excess business interest is in effect. Can also be elected.
Note: This table shows depreciation methods that typically apply to property used in farming. Other elective methods are available.	

Recovery Periods for Farm Property (*Property placed in service in 2019*)		
	Recovery Period (Yrs.)	
Asset Description	GDS (MACRS)	ADS
Agricultural structures (single purpose)	10	15
Cattle (dairy or breeding)	5	7
Cotton ginning assets	7	12
Drainage facilities	15	20
Farm buildings (other than single purpose structures)	20	25
Farm machinery and equipment—new	5	10
Farm machinery and equipment—used	7	10
Fences (agricultural)	7	10
Goats and sheep (breeding)	5	5
Grain bins	7	10
Hogs (breeding)	3	3
Horses (age when placed in service):		
• Breeding and working (12 years or less)	7	10
• Breeding and working (more than 12 years)	3	10
• Racing horses ~~(two years or less)~~	3	12
~~• Racing horses (more than two years)~~	~~3~~	~~12~~
Horticultural structures (single purpose)	10	15
Tractor units (over-the-road)	3	4
Trees or vines bearing fruits or nuts	10	20
Truck (heavy duty, unloaded weight 13,000 lbs. or more)	5	6
Truck (weight less than 13,000 lbs.)	5	5
Water wells	15	20
~~[1] Expired Provision Alert: Race horses placed in service in 2017 were assigned a three-year recovery period regardless of age. Tax professionals should watch for an extension of that provision to 2018 and 2019.~~		

Section 179 Deduction

For tax years beginning in 2019, the Section 179 deduction limit is $1.02 million (see Tab 10 in the *1040 Quickfinder® Handbook* for more details).

Farm property eligible for Section 179 expensing includes:

- Tangible personal property (tangible property other than real property) such as machinery and equipment, milk tanks, automatic feeders, barn cleaners and office equipment.
- Livestock (horses, cattle, hogs, sheep, goats and mink and other fur-bearing animals).

Continued on the next page

5) Income excluded under an employer's adoption assistance program,
6) Any passive income or loss or any rental loss allowed because the taxpayer materially participated in the activity as a real estate professional,
7) Any overall loss from a publicly traded partnership,
8) Deduction for employer portion of self-employment (SE) tax,
9) Deduction allowed for interest on student loans, or
10) Deduction for tuition and fees~~ (if extended by legislation)~~.

Example #1: Fred and Ginger are married taxpayers who actively participate in a rental activity. Their income consists of $75,000 in wages, $250 in interest and a rental loss of $1,500.

Even with no passive income, Fred and Ginger can deduct the rental loss on their joint tax return because they actively participate in the rental activity and their modified AGI is below the phase-out range.

Example #2: Ted owns an apartment building. Ted is not a real estate professional and has no other passive activities. He actively participates in operating the building. His 2019 income before any passive loss limitation consists of the following:

Form W-2 wages	$ 20,000
Schedule C proprietorship	100,000
Schedule E rental loss	(35,000)
IRA deduction	(2,000)
SE tax deduction	(7,065)
Tentative AGI	$ 75,935

Ted's modified AGI is $120,000 ($75,935 + 35,000 + 2,000 + 7,065). The allowable rental loss is $15,000 [$25,000 – 50% × (120,000 – 100,000)].

Strategy: Because the $25,000 loss allowance begins phasing out when modified AGI exceeds $100,000 ($50,000 MFS) and is completely phased out when modified AGI exceeds $150,000 ($75,000 MFS), taxpayers with income within or around this range can maximize the allowance by employing strategies to reduce AGI. Effective strategies include:

- For self-employed taxpayers, making deductible contributions to Keogh, SEP or SIMPLE retirement plans.
- Investing in tax-exempt securities or investments that defer income to later years.
- Sell assets which will generate a capital loss. This is especially effective if the taxpayer has capital gains which can be offset. Otherwise, this strategy will only decrease MAGI by $3,000 ($1,500 if MFS).
- For cash method sole proprietors, shifting income from one year to another by carefully timing when expenses are paid and when revenue might be collected (for example, delaying mailing of invoices until after year end).

Credits and the $25,000 Special Loss Allowance

Taxpayers who qualify for the special rental allowance can use credits from active participation rental activities to offset tax liability created by nonpassive income. To calculate the amount of the $25,000 special loss allowance used by a credit, the $25,000 must be converted to an amount of tax based on the taxpayer's marginal tax rate.

Real Estate Professionals

Real estate professionals who meet eligibility requirements are able to deduct losses from rental real estate from nonpassive income. The $25,000 active rental loss limitation does not apply to these taxpayers. To be eligible for this exception, both of the following conditions must be met: (1) more than half of the personal services performed by the taxpayer during that year are performed in real property trades or businesses in which the taxpayer materially participates and (2) the taxpayer performs more than 750 hours of services during that year in such trades or businesses. Taxpayers are also allowed to elect under Reg. 1.469-9(g) to treat all interests in rental real estate as a single activity.

Note: In a chief counsel advice memorandum, the IRS indicated that this election doesn't affect the determination of whether the taxpayer qualifies for the real estate professional exception. Instead, the taxpayer first determines if the real estate professional exception applies using a reasonable combination of the activities based on the facts and circumstances. If the exception applies, real estate activities in which the taxpayer materially participated are treated as nonpassive. This determination is made separately for each rental property unless the taxpayer makes the election to treat all interests in rental real estate as a single activity (CCA 201427016).

Court Case #1: The taxpayer owned a small architectural business and two rental properties in California. During 2013, he made weekly trips to the properties to make sure the trash bins were set out for collection, cleaned and returned to their storage locations. He also performed minor repairs, maintained insurance policies and collected rent. According to his rental activity log, the taxpayer spent more than 750 hours managing the properties. On his 2013 return, the taxpayer claimed a net loss of $67,882 from his rental activities. The IRS allowed $25,000 of this amount under the Section 469(i) exception, but disallowed the rest under the passive activity loss (PAL) rules. The Tax Court disagreed, holding that the taxpayer qualified as a real estate professional and his rental real estate activities were regular, continuous and substantial (*Franco*, TC Summary Opinion 2018-9).

Court Case #2: A husband and wife owned three rental properties during the years at issue. The wife, a part-time ski instructor, managed the rental properties, was involved in extensive renovation efforts and maintained contemporaneous logs of the time spent on rental activities. Upon examination, the IRS disallowed the taxpayers' deductions for general rental expenses, claiming that the real estate activities were subject to PAL limitations. The Tax Court disagreed, concluding that the wife qualified as a real estate professional under IRC Sec. 469(c)(7) and that the IRS conceded that she materially participated in the rental activity. Therefore, the taxpayers' deductions were not limited (*Moon*, TC Summary Opinion 2016-23).

Court Case #3: The taxpayer, a stock broker, owned 12 rental properties and a 50% interest in a vacant lot in Florida. She managed all aspects of the properties, including vetting potential clients, collecting rentand overseeing contractors. According to her records, she spent 901.25 hours on real estate activities during the tax year in question. The rental properties gave rise to a loss of $307,933, which she used to offset her broker income. The IRS disallowed the loss claiming it was passive in nature.

The Tax Court found that each real estate interest had to be viewed as a separate activity because the taxpayer failed to make an election to group them. Despite this, the Court concluded that the taxpayer materially participated in each property except the vacant lot. In addition, the Court held that she qualified as a real estate professional and could therefore treat her rental real estate activities as nonpassive. Thus, her Schedule E rental losses were not subject to the passive loss limitations and instead, fully deductible (*Windham*, TC Memo 2017-68).

Rental Activities Considered Nonrental

The general rule is that any rental activity is a passive activity.

Note: Homes classified as dwelling units used as a residence discussed under *Mixed-Use Property* on Page 9-4 are not considered rental activities.

- Small appliances that cost $500 or less (for example, iced tea dispensers, can openers, food warmers, heat lamps, etc).

Smallwares do not include (1) office supplies; (2) general purpose cleaning supplies or maintenance tools; (3) extraordinary items, such as collectibles or other items of significant artistic or intrinsic value; (4) items that are accounted for separately for tax or financial purposes; or (5) items that generally are listed as scheduled property for insurance purposes.

Qualifying taxpayers are permitted to account for smallwares in the same manner as materials and supplies that are not incidental under Reg. 1.162-3, which means that the costs are deductible in the year the materials and supplies are actually consumed and used in the business. (For cash-method taxpayers, the cost is deducted in the year paid for, if later than the year the smallware is used or consumed.) Smallwares are consumed and used in a taxpayer's business in the tax year they are received at the restaurant and are available for use. The phrase "received and available for use" does not include purchasing and storing items at a warehouse or facility other than the restaurant where they will be used.

Generally, a taxpayer that wants to change its method of accounting to the smallwares method must follow the automatic change provisions of Rev. Proc. 2019-43 or its successor. A taxpayer changing its method of accounting for the cost of smallwares must take the entire Section 481(a) adjustment into account in computing taxable income for the year of change.

Gift Card Sales

Generally, prepaid inventory sales (that is, gift card sales) are reported in the year payment is received if the income is subject to the business's free and unrestricted use. Accrual method taxpayers can elect to defer the inclusion of income associated with certain advance payments to the end of the tax year following the tax year of receipt if such income also is deferred for financial statement purposes [IRC Sec. 451(c)]. In the case of advance payments received for a combination of services, goods or other specified items, the provision allows the taxpayer to allocate the transaction price in accordance with the allocation made in the taxpayer's applicable financial statement.

Due to the amount of gift cards sold in the restaurant industry, this issue is significant for taxpayers. It is also the subject of increased IRS scrutiny, so restaurants need to understand the applicable provisions.

Qualified Business Income Deduction

For tax years 2018–2025, individuals may deduct up to 20% of their QBI from sole proprietorships (including farms) and pass-through entities. The deductible amount is limited to an amount based on the business's W-2 wages or a combination of its W-2 wages and its investment in qualified property (the wage/investment limit) when the individual's taxable income exceeds certain threshold amounts. See *Qualified Business Income (QBI) Deduction* on Page 10-5 for details on computing the deduction.

Employment Issues

Labor costs are a major concern to the food and beverage industry. Payroll and the related payroll taxes often represent a large portion of all restaurant costs and require the constant attention of management. Also, restaurants must comply with a variety of other federal, state and local employment laws.

The Fair Labor Standards Act

The Fair Labor Standards Act of 1938 (FLSA) established minimum wage, overtime pay, recordkeeping and child labor standards for employers. The FLSA does not regulate holidays, holiday pay, vacations, pay raises or fringe benefits. The Wage and Hour Division of the Department of Labor (DOL) administers and enforces the FLSA with respect to private employment.

Some employees are exempt from both the minimum wage and overtime provisions. In addition, state and local governments may set their own criteria and therefore should also be contacted to ensure proper compliance with their statutes.

Minimum wage. The federal minimum wage of $7.25 per hour applies to:

1) All employees, if the establishment's gross annual sales are $500,000 or more, exclusive of excise or sales taxes and
2) Those employees who are engaged in interstate commerce during any workweek, irrespective of the gross annual sales test.

Involvement in interstate commerce means conducting certain business transactions across state lines. Some common examples of interstate commerce in the restaurant industry include the handling of customers' credit card charges, unloading delivery trucks that come across state lines or making telephone calls or fax communications with someone in another state. The interstate commerce test is performed on a task-by-task basis, not on the business as a whole. Thus, in a business with annual gross sales under $500,000, a worker who unloads delivery trucks that came across state lines would be subject to FLSA, but a cook might not be.

Caution: The minimum wage in many states is higher than the $7.25 federal rate. Information about state minimum wage laws is available at **www.dol.gov/whd/minwage/america.htm**.

Tip credit against minimum wage. Tipped employees may be paid a reduced rate under the FLSA. Tipped employees are those who customarily and regularly receive more than $30 per month in tips. Currently, a maximum tip credit of $5.12 can be taken against the $7.25 minimum wage rate thus reducing the employer's minimum wage rate to $2.13 per hour.

Employee notification. Employers taking advantage of the tip credit must notify the employee in advance, disclose the amount of the tip credit taken, and also guarantee that the employee receives the minimum wage when the direct tips received are added to the tip credit allowance. Employees must also be able to retain their tips on a per-person or pooling basis. Tips or service charges that revert to the house are not considered in this formula. The tip credit does not apply to the time an employee spends performing routine maintenance duties or if an employee spends more than 20% of his time performing general preparation or maintenance activities.

Employee uniforms. Under the DOL guidelines, a restaurant operator cannot require an employee to purchase or maintain a uniform if the cost results in reducing that employee's wage below the federal minimum. What constitutes a uniform is not entirely clear. Clothing with a company logo or that is typically not worn in public (such as a chef's coat) would seem to constitute a uniform. But if the employer requires employees to wear a button-down shirt with light colored pants, an argument could be made that this is not a uniform.

Employees who have to wear, for example, tuxedos or cocktail dresses may have to be reimbursed the cost of dry cleaning such uniforms. Employees who are paid more than the minimum wage, however, would not need to be reimbursed if the amount by which their pay exceeds the minimum wage would offset the cost of special cleaning.

year are matched with the costs of similar items that were most recently purchased.

LIFO method. The LIFO (last-in first-out) method assumes the items of inventory purchased last are the first items sold, consumed or otherwise disposed of. Items included in closing inventory are considered to be from the opening inventory in the order of acquisition and from those acquired during the tax year.

Differences between FIFO and LIFO. Each method produces different income results, depending on the trend of price levels. When prices are rising, LIFO will produce a larger COGS deduction and a lower closing inventory. Under FIFO, the cost of goods sold will be lower and the closing inventory will be higher. However, in times of falling prices, the opposite will hold.

Once the items in inventory have been identified (using specific identification, FIFO or LIFO) retailers can use any of the following methods to determine the value of those items:

1) Cost (discussed on Page 10-3),
2) Lower of cost or market (discussed on Page 10-3),
3) Rolling-average method (discussed on Page 10-3), or
4) Retail inventory method (see *Retail Inventory Method* on Page 10-3).

Cost Method

Under the cost method, items in inventory are valued at their cost.

- For merchandise on hand at the beginning of the tax year, cost means the prior year's ending inventory price of the goods.
- For merchandise purchased during the year, cost means the invoice price minus appropriate discounts plus transportation or other charges incurred in acquiring the goods.

Lower of Cost or Market (LCM) Method

Under the LCM method, the market value of each item on hand on the inventory date is compared with its cost. The lower of the two amounts is used as each item's inventory value.

Caution: The LCM method does not apply to goods accounted for under the LIFO method.

Example: Joni uses the LCM method to value her inventory. Her ending inventory is valued at $600, as follows:

Item	Cost	Market	Lower of Cost or Market
R	$ 300	$ 500	$ 300
S	200	100	100
T	450	200	200
Total	$ 950	$ 800	$ 600

Joni must value each item in the inventory separately. She cannot value the entire inventory at cost ($950) and at market ($800) and then use the lower of the two figures.

Market value. Under ordinary circumstances for normal goods, market value means the usual bid price on the date of inventory. This price is based on the volume of merchandise usually purchased.

Example: Walter buys items in small lots at $10 an item for his retail store. Even though a competitor buys identical items in larger lots at $8.50 an item, Walter's market value for that item is $10.

Goods sold for less than market. When merchandise is offered for sale at a price lower than market in the normal course of business, inventory can be valued at the lower price, minus the direct cost of disposition. Selling prices are determined based on actual sales within a reasonable period before and after the inventory date.

No market exists. If no market exists, or if quotations are nominal because of an inactive market, the taxpayer uses the best available evidence of fair market price on the date or dates nearest the inventory date. This evidence could include:

- Specific purchases or sales by the taxpayer or by others made in reasonable volume and in good faith.
- Compensation amounts paid for cancellation of contracts for purchase commitments.

Rolling-Average Method

The IRS considers the rolling-average method an acceptable inventory valuation method for tax purposes, if it is also used for financial accounting. The rolling-average method is an average cost method used in conjunction with a perpetual inventory system. Under this method, a new average cost is computed after each inventory purchase.

Recalculate the rolling average cost of an inventory item:

1) Each time a unit of that item is purchased or
2) On a regular basis but at least once a month; and the taxpayer must satisfy one of the following conditions:
   a) The variance percentage does not exceed one percent, or
   b) The entire inventory turns at least four times per year.

Calculate the variance percentage:

1) Determine the variance by subtracting the cost of the ending inventory using the rolling-average method from the cost of the ending inventory using either the FIFO method or the specific identification method to determine the variance, and then
2) Divide the variance by the aggregate rolling-average cost of the inventory.

Inventory turns. The number of times that the entire inventory turns during a taxable year is equal to the cost of goods sold divided by average inventory (average of beginning and ending inventory). A taxpayer that uses a LIFO cost-flow assumption for tax purposes must calculate inventory turns using rolling-average cost and a FIFO cost-flow assumption.

Changing to the rolling-average method. Qualifying taxpayers can automatically change their method of accounting for inventory to the rolling-average method. The accounting method change is made by attaching a Form 3115 (Application for Change in Accounting Method) to the return for the year the change is to be effective. (See Sec. 22.14 of Rev. Proc. 2019-43.)

Retail Inventory Method

Retailers can use the retail inventory method (RIM) to value their ending inventory, and thus, determine their cost of goods sold deduction (Reg. 1.471-8). The RIM is an averaging method, based on the average retail mark-up for each product (or class of products). The RIM can be more convenient than determining the actual cost of inventory, when the retailer has a large number of different inventory items but can determine a gross profit percentage based on classes of items (such as a grocery store). To qualify for the RIM, accurate accounts must be kept, and the method must be consistently used.

Practice Tip: Retailers filing a Form 1040, must check box c on Schedule C, Part III, line 33 and attach a statement that they are using the retail inventory method pursuant to Reg. 1.471-8.

Terminology

To use the retail inventory method, it is necessary to understand the following terms:

- *Retail selling price.* The bona fide retail selling price at the time an item is acquired.
- *Markups.* Increases in the current retail price of merchandise over the original retail selling price (usually because the goods can be sold at a higher-than-anticipated price). For example, if

Continued on the next page

the historical ratio. The amount cannot be adjusted by judgment or other factors.

For stores without departments, the historical ratio is computed separately for each store owned by the taxpayer. Stores with departments can compute the historical ratio separately for each store or for each department in the store. However, the same method (store-by-store or department-by-department) must be used for all stores in the same trade or business that are owned by the taxpayer.

If a taxpayer opens a new store for which shrinkage has not been verified by a physical inventory in each of the most recent three tax years, the average of the historical ratios of the taxpayer's other stores can be used for the new store. The same rule applies for taxpayers computing a separate ratio for each department when they open a new department.

Actual shrinkage differs from estimate. When the retail safe harbor is used, the taxpayer cannot adjust for differences between the estimated and actual shrinkage. Thus, if a post year-end inventory shows that shrinkage was greater than the estimate computed using the safe-harbor method, only the safe-harbor estimate can be deducted. However, the greater-than-expected shrinkage increases the ratio used for estimating shrinkage in future years. The same is true if the actual shrinkage is less than the estimate.

New taxpayers. The retail safe harbor apparently does not apply to businesses in existence for less than three years who cannot borrow the historical ratio of another store or department under common ownership. While these taxpayers can use some other reasonable method to estimate shrinkage, that method could be challenged by the IRS. However, once the taxpayer has three years of historical information based on actual physical inventories, it can automatically change to the retail safe-harbor method of estimating shrinkage.

Changing to the retail safe harbor method. Qualifying taxpayers can automatically change their method of accounting for estimating inventory shrinkage to the retail safe harbor. The accounting method change is made by attaching a Form 3115 to the return for the year the change is to be effective. (See Sec. 22.02 of Rev. Proc. 2019-43.)

Writing Down Unsalable Inventory

A special rule applies for valuing inventory that can't be sold at normal prices because of damage, imperfections, changes of style or similar identifiable reasons (other than a mere estimate of decline in future demand). This inventory may be valued at bona fide selling prices less direct cost of disposition, if the goods are actually offered for sale at the lower price within 30 days after the inventory date.

Observation: This rule applies whether the taxpayer values normal inventory at cost or the lower of cost or market [Reg. 1.471-2(c)]. However, taxpayers with average gross receipts of inflation-adjusted $25 million ($26 million for 2019) or less and who have elected to account for inventory as nonincidental supplies apparently cannot take this write-down. Instead, their loss will be recognized when the inventory is sold.

> Example: Mary Sweetbriar owns and operates Mary's Threads, a Schedule C fashion boutique. Mary uses the cost method to value her inventory. On December 31, she discovers that she has inventory costing $2,000 that she has been unable to sell at normal prices because of fashion changes. She decides to mark down these items to $1,500 to clear them out.
>
> If Mary offers to sell the merchandise for $1,500 within 30 days after the year-end inventory date (and maintains supporting records), she can write down her ending inventory at December 31, 2019 by $500 ($2,000 cost – $1,500 bona fide selling price). However, if Mary does not actually offer the clothes for sale at $1,500 by January 30, 2020, she cannot take an inventory write down for the out-of-style inventory she holds at December 31, 2019.

Qualified Business Income (QBI) Deduction

Under IRC Sec. 199A, individuals, estates and trusts may deduct up to 20% of their QBI from sole proprietorships (including farms) and pass-through entities for tax years 2018–2025.

Observation: IRC Sec. 199A is intended to provide tax relief to businesses not benefitting from the reduction in the top corporate rate from 35% to 21%. Thus, pass-through businesses (S corporations, partnerships and LLCs) as well as sole proprietorships (including single-member LLCs) are eligible for the deduction. The rules are complex and subject to phase-outs and limits.

Note: The IRS issued final regulations for IRC Sec. 199A in January 2019.

The computation can be broken down into the following four steps.

Step 1—Identifying QBI

QBI is generally the net amount of certain items of income, gain, deduction and loss from a qualified trade or business conducted within the U.S. [IRC Sec. 199A(c)(1) and (c)(3)(A)]. QBI doesn't include investment income (such as capital gains and losses), reasonable compensation paid by the qualified business to the taxpayer and payments to partners under IRC Secs. 707(a) and 707(c) [IRC Sec. 199A(c)(3)(B) and (c)(4)]. QBI is determined for each of the taxpayer's qualified trades and businesses.

A *qualified trade or business* is generally defined as any trade or business other than (1) the business of performing services as an employee and (2) a specified service trade or business [IRC Sec. 199A(d)(1)]. A *specified service trade or business (SSTB)* is one that involves the performance of services in certain fields (see the table *QBI Deduction Trades and Businesses* on Page 10-6).

The term *trade or business* for purposes of the QBI deduction is not specifically defined other than meaning "… a Section 162 trade or business other than the trade or business of performing services as an employee" [Reg. 199A-1(b)(14)]. Unfortunately, IRC Sec. 162 does not define a trade or business either. Instead, the Supreme Court's decision in *Groetzinger* [59 AFTR 2d 87-532 (S. Ct. 1987)] is typically looked to for a definition. There, the Court stated:

> Of course, not every income-producing and profit-making endeavor constitutes a trade or business. … We accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify.

The distinction of being a SSTB doesn't apply to taxpayers with 2019 taxable income of $321,400 or less if married filing jointly ($160,700 for Single and HOH; $160,725 for MFS). In other words, these taxpayers can treat an SSTB as a non-SSTB for Section 199A purposes.

Beginning at taxable income over $321,400 for MFJ ($160,700 for Single and HOH; $160,725 for MFS), the exclusion of an SSTB from the definition of QBI begins to phase-in. At taxable income of $421,400 for MFJ ($210,700 for Single and HOH: $210,725 for MFS), the phase-in is complete so no QBI deduction is allowed with respect to an SSTB when taxable income exceeds those amounts.

Continued on Page 10-7

gains or losses recognized under the MTM election increase or decrease the security's basis.

Observation: If the MTM election is made, gains and losses from trading are reported as ordinary gains and losses on line 10 in Part II of Form 4797, instead of as capital gains and losses on Schedule D. Attach to the tax return a statement, using the same format as line 10, showing the details of each transaction. Separately show and identify securities or commodities held and marked to market at the end of the year. On line 10, enter "Trader—see attached" in column (a) and the totals from the statement in columns (d), (f), and (g). Also, include on line 1 of Form 4797 the gross proceeds from the sales that are reported to the taxpayer on Form 1099-B.

The primary benefit of making the election is that the $3,000/$1,500 limit on net capital losses and the wash sale rules no longer apply. Although the trader must treat trading gains and losses as ordinary income, any negative effect should be minimal since traders by definition should have few, if any, long-term capital gains that would have qualified for the 20% maximum long-term capital gain rate.

A MTM election is effective for the year for which it is made and all subsequent tax years, unless revoked with IRS permission.

Caution: Only trading stock is marked to market. Even if a trader makes the MTM election, any stock held for investment is unaffected. Sales from those stocks are reported on Schedule D (or Form 8949).

Election does not affect SE tax. A MTM election converting a trader's gains and losses to ordinary income does not subject the gains to SE tax, including the additional 0.9% Medicare tax on earned income [IRC Sec. 475(f)(1)(D)].

Making the MTM election. Traders make the MTM election by filing the following statement with the IRS:

> Trader in Securities Election to Mark to Market
>
> Taxpayer hereby elects under IRC Sec. 475(f) to use the mark-to-market method of accounting for securities. The election will first be effective for the tax year ended [tax year end]. The election is made for the following trades or businesses: [list].

The statement must be attached to either of the following that is filed by the unextended due date:

1) Form 1040 for the year *before* the year the election is to be effective or
2) A request for an extension of time to file that return.

Caution: The time for making the MTM election is unusual. Taxpayers must make the election by the unextended due date for the return for the year *before* the year the election is to be effective. For taxpayers who wanted to elect for tax year 2019, the deadline for making the election was April 15, 2019. To be effective for 2020, the election must be made on or before April 15, 2020.

> Example: Ellen has actively bought and sold stocks for many years. Based on her past success, she believes she can generate significant income by trading on a daily basis. In May 2019, she begins trading full-time. Her increased activity qualifies her as a stock trader.
>
> To make an effective MTM election for 2019, Ellen must have filed an election statement by April 15, 2019, with either her 2018 Form 1040 or her 2018 return extension request (Form 4868). The fact that 2019 was the first year she qualified as a stock trader does not change this election deadline.
>
> She can make an election for 2020 by filing the election statement on or before April 15, 2020. If the MTM election is not in effect for 2019 (her first year as a trader), but will be in effect for 2020, Ellen will need to attach Form 3115 requesting permission to change her accounting method to the MTM method to her 2020 Form 1040.

Late elections. Taxpayers can request an extension to make the election by requesting a private letter ruling under Reg. 301.9100-3. However, the request will not be granted if doing so would prejudice the government's interest. In Ltr. Rul. 200304006, the IRS denied an extension to a taxpayer who failed to make a timely MTM election because his accountant advised him against doing so. (For additional rulings in which the IRS denied the taxpayer's request for an extension of time to make the MTM election, see Ltr. Ruls. 200209052, 200209053, 200209054, 200423015, and 200830023.)

Required change in accounting method. Unless the MTM election is made for the first year the taxpayer is in the stock trading business, it will be necessary to request an accounting method change by attaching Form 3115 (Application for Change in Accounting Method) to the return for the year the election is first effective. The IRS automatically grants permission to make this accounting method change (Rev. Proc. 2019-43, section 24.01).

In the year of change, a Section 481(a) adjustment must be computed. The adjustment is the amount of income that would have been recognized in prior tax years if the MTM method had always been used less the income actually recognized those years. Positive adjustments are spread over a four-year period, unless the amount is less than $50,000 and the taxpayer elects to use a one-year adjustment period. A negative adjustment is recognized in the year of change (Rev. Proc. 2015-13). The Section 481(a) adjustment is reported on Schedule C.

Making the election for a new taxpayer. A new taxpayer making the MTM election must place the election statement in its books and records no later than two months and 15 days after the beginning of its first tax year and attach a copy of the statement to its first-year tax return. A new taxpayer is a taxpayer for whom no federal income tax return was required for the year before the election year (Rev. Proc. 99-17).

Caution: A new taxpayer would include a newly formed entity (such as a partnership or S corporation) but generally would not include an individual, even though the individual did not qualify as a trader in the preceding tax year.

Strategy: Creating a new pass-through entity to conduct the trading activity is a possible solution for taxpayers who want to make a MTM election for the tax year but discover they are too late to make the election for their individual return. However, creating a new entity will not guarantee that the trading activity will qualify as a trade or business, as opposed to an investment activity (*Holsinger*, TC Memo 2008-191).

Expenses

Expenses are deducted by a trader on Schedule C of Form 1040. Although the Section 465 at-risk rules apply, in most cases, the trader will be fully at-risk for all amounts in the business.

Strategy: A trader is eligible for claiming a home office deduction, provided the requirements of Section 280A(c) are met.

Interest expense. A trader that materially participates in the activity also deducts interest expense related to the trading activity on Schedule C. The limit on investment interest expense, which applies to investors, does not apply to interest paid or incurred in a trading business. *Exception:* See *Nonmaterial Participation in the Trading Activity* on Page 11-4.

Note: Although a trader's stock gains and losses are excluded from SE earnings, there is no guidance on how the trading expenses impact SE earnings. Presumably, a trader who materially participates in the trading activity and who has SE earnings from other sources can reduce those earnings by the SE loss generated from the trading expenses.

Is the Student a Dependent?

Whether the student's parents or someone else can claim him as a dependent impacts various tax matters including filing requirements and eligibility for certain deductions and credits.

Tax Impact of Dependency Status on the Student (2019)[1]

	Can parents or someone else claim student as a dependent?	
	Yes	No
Standard deduction	Greater of $1,100 or earned income + $350 (not to exceed $12,200)[2]	$12,200[2]
Personal exemption deduction	$0	$0
Student is eligible for the following:		
• Education credits	No[3]	Yes
• Student loan interest deduction	No[3]	Yes
• Tuition and fees deduction ~~(if available for 2019)~~	No	Yes

[1] Assumes student is filing as a single taxpayer.
[2] Add $1,650 if blind.
[3] *Exception:* If the student's parents or other taxpayer who is eligible to claim the student as a dependent does not claim the student, the student can claim.

Filing Requirements

A student's return filing requirement differs depending on whether he's a dependent of another taxpayer.

2019 Student Filing Requirements

Dependent (single and under age 65)	Must file a return if any of the following apply: 1) Unearned income was more than $1,100.[1] 2) Earned income was more than $12,200.[1] 3) Gross income was more than the larger of: a) $1,100[1] or b) Earned income (up to $12,200) plus $350.[1]
Not a dependent (single and under age 65)	Must file a return if gross income was at least $12,200.

[1] Add $1,650 if blind.

Tests for Determining Dependents

A student who is either a qualifying child or a qualifying relative of his parents or another taxpayer is a dependent. The chart *Claiming a Dependent—Quick Reference (2019)* on Page 11-6 shows the general tests for determining whether or not the student can be claimed as dependent of someone else.

Full-time students. Students will often be a qualifying child of their parents because of the special rule that applies to full-time students under age 24. A full-time student is a student who is enrolled for the number of hours or courses the school considers to be full-time attendance.

• *Student.* To qualify as a student, the individual must be, during some part of each of any five calendar months (whether or not consecutive) of the year:

1) A full-time student at a school that has a regular teaching staff, course of study and a regularly enrolled student body at the school or
2) A student taking a full-time, on-farm training course given by a school described in item 1, or by a state, county or local government agency.

Note: The IRS has privately ruled that full-time student status includes any part of a month that the individual is registered in school for the number of hours considered to be full-time attendance, regardless of whether classes are actually attended in that month (Ltr. Rul. 9838027).

• *School.* A school can be an elementary school, junior and senior high school, college, university or technical, trade or mechanical school. However, an on-the-job training course, correspondence school or school offering courses only through the internet does not count as a school.

Note: Students who work on "co-op" (vocational) jobs in private industry as a part of a school's regular course of classroom and practical training are considered full-time students.

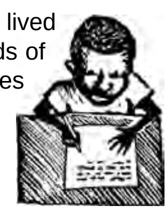
Claiming a Dependent—Quick Reference (2019)
(See Tab 4 in the *1040 Quickfinder® Handbook* for details)

Taxpayer cannot claim any dependents if taxpayer, or taxpayer's spouse if filing jointly, can be claimed as a dependent by another taxpayer.
To claim a person as a dependent, that person must be:

1) Unmarried or if married, does not file a joint return.
2) A U.S. citizen, resident alien, or national or a resident of Canada or Mexico.
3) Either a *qualifying child* or a *qualifying relative*.

Qualifying Child	Qualifying Relative
The person must: 1) Be the taxpayer's child, brother, sister, stepbrother, stepsister or descendant of any of them. 2) Be either under age 19, a full-time student under age 24 or any age if totally and permanently disabled. 3) Be younger than the taxpayer. 4) Have lived with the taxpayer more than half the year.[1] 5) Not have provided more than half of his own support. 6) Not be a claimed qualifying child of another taxpayer with higher priority under the tie-breaker rules.	The person must: 1) Not be the taxpayer's or anyone else's qualifying child. 2) Either (a) have lived with the taxpayer all year as a member of his household or (b) be related to the taxpayer. 3) Have gross income less than $4,200. The taxpayer must provide more than half of the person's total support for the year.

[1] If parents are divorced, child is normally treated as a dependent of the custodial parent, unless the custodial parent releases the exemption to the other parent. See *Divorced Taxpayers* on Page 5-1 for more information.



Residency test. A student is considered to have lived with his parents (or other guardian) during periods of time when he is absent due to special circumstances such as education, business, vacation, military service or other special circumstances.

Support test. For a student to be a qualifying child, he cannot provide more than half of his own support during the year. Consider the following when computing support for a student:

• *Scholarships.* A scholarship received by a child who is a full-time student is not taken into account in determining whether the child provided more than half of his own support [IRC Sec. 152(f)].

• *Student loans.* A loan taken out by the student is treated as support he provides for himself [*McCauley*, 56 TC 48 (1971)].

• *Room and board.* Room and board are considered in the support calculations [*Blyth*, 21 TC 275 (1953)].

Example: Nancy is a 21-year-old college student attending State College. She lives on campus during the school year but returns home during the summer and breaks.

During the year, she receives two scholarships totaling $6,000. She also takes out her own student loan for $8,000 to pay remaining educational expenses and works at the university library, earning $4,000 that she uses for clothing, travel and other personal expenses. During the year, her parents contribute $10,000 to her support based on her proportionate share of household expenses and other expense they pay on her behalf.

When determining who pays how much of Nancy's support during the year, the $6,000 scholarship is ignored. Thus, Nancy contributed $12,000 to her own support while her parents contributed $10,000. Nancy is not a dependent of her parents because she provided more than half of her own support during the year.

Kiddie Tax

A child is subject to the *kiddie tax* if [IRC Sec. 1(g)(2)(A)]:

- He has not attained age 18 before the close of the tax year or, if age 18 or a full-time student age 19–23, the child's earned income for the tax year doesn't exceed one-half of his support;
- Either parent of the child is alive at the end of the tax year and
- The child does not file a joint return for the tax year.

Note: Beginning in 2018, the kiddie tax computation no longer includes the parents' marginal tax rate; instead, the income tax rates for trusts and estates are used. Thus, there is no longer a connection between the kiddie tax and the parents' return, unless the parents elect to report the child's income on their return.

Law Change Alert: The 2019 SECURE Act has repealed IRC Sec. 1(j)(4) for tax years beginning after December 31, 2019 [Sec. 501(a) of the 2019 SECURE Act]. This basically restores linking the child's tax rate to the parent's marginal tax rate, rather than to the trust and estate tax rate. However, a taxpayer may elect for this provision to apply to the 2018 and 2019 tax years [Sec. 501(c)(3) of the 2019 SECURE Act]. Amended returns may be beneficial for the 2018 tax year.

For children age 18 and full-time students age 19–23, the calculation of earned income and support is computed without regard to certain scholarship income.

Kiddie Tax Support Test Worksheet[1]	
Earned Income	
1) Child's earned income (excluding scholarships received by full-time students)	1) ________
Expenses for Entire Household:	
2) Lodging (complete 2a or 2b)	
a) Rent paid	2a) ________
b) If not rented, fair market value of housing	2b) ________
3) Food	3) ________
4) Utilities	4) ________
5) Repairs	5) ________
6) Other ____________	6) ________
7) Total household expenses (add lines 2–6)	7) ________
8) Number of persons, including child, in household	8) ________
Child's Expenses	
9) Child's household expenses (divide line 7 by line 8)	9) ________
10) Clothing	10) ________
11) Education (exclude amounts covered by scholarships)	11) ________
12) Medical and dental	12) ________
13) Travel and recreation	13) ________
14) Other: ____________	14) ________
15) Total cost of child's support (add lines 9–14)	15) ________
16) Divide line 15 by 2	16) ________
If Line 1 is greater than Line 16, the child meets the support test and is not subject to the kiddie tax.	

[1] For use by taxpayers age 18 or full-time students age 19–23.

Scholarships, Grants and Other Financial Aid

Scholarships and Fellowships

Qualified scholarships and fellowships that are received by a degree candidate and used for tuition and required enrollment fees generally are excluded from income (IRC Sec. 117). (Generally, payments received by a student who is not a degree candidate are taxable.)

General rules include:

1) Must be a full-time or part-time student at a primary or secondary school, pursue a degree at a college or university or attend an accredited educational institution.
2) Qualified expenses include tuition and enrollment fees and fees, books, supplies and equipment that are required for the courses by the educational institution.

A *scholarship* is generally an amount paid or allowed to, or for the benefit of, a student at an educational institution to aid in the pursuit of studies [Prop. Reg. 1.117-6(c)(3)]. The student may be either an undergraduate or a graduate. The term includes athletic scholarships.

A *fellowship* is generally an amount paid for the benefit of an individual to aid in the pursuit of study or research.

Scholarship and Fellowships[1]—Tax Summary

Use of Funds	Student's Degree Status: A degree candidate	Student's Degree Status: Not a degree candidate
Tuition	Nontaxable[3]	Taxable
Fees	Nontaxable[2, 3]	Taxable
Books	Nontaxable[2, 3]	Taxable
Supplies	Nontaxable[2, 3]	Taxable
Equipment	Nontaxable[2, 3]	Taxable
Room	Taxable	Taxable
Board	Taxable	Taxable
Travel	Taxable	Taxable

[1] Does not include payments received for past, present or future services.
[2] If required of all students in the course.
[3] Amounts used for these expenses are nontaxable only if the terms of the scholarship or fellowship do not prohibit the expense.

Degree candidate. A student is a candidate for a degree if he [Prop. Reg. 1.117-6(c)(4)]:

1) Attends a primary or secondary school,
2) Is pursuing a degree at a college or university, or
3) Attends an accredited educational organization that is authorized to provide:
   a) A program that is acceptable for full credit toward a bachelor's or higher degree or
   b) A program of training to prepare students for gainful employment in a recognized occupation.

Eligible educational organization. An eligible educational organization is one that maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where it carries on its educational activities [Prop. Reg. 1.117-6(c)(5)].

Dependent claimed on another person's return. If a parent claims a child as a dependent, only that parent may claim the education credit for the child. If the parent is eligible to, but does not claim the student as a dependent, only the student can claim the education credit [Reg. 1.25A-1(f)].

Qualifying expenses paid by a student are considered to have been paid by the parent if the student is claimed as a dependent on the parent's tax return [Reg. 1.25A-5(a)].

Beginning in 2018, the kiddie tax computation no longer includes the parents' marginal tax rate; instead, the income tax rates for trusts and estates are used. Thus, there is no longer a connection between the kiddie tax and the parents' return, unless the parents elect to report the child's income on their return.

Law Change Alert: The 2019 SECURE Act has repealed IRC Sec. 1(j)(4) for tax years beginning after December 31, 2019 [Sec. 501(a) of the 2019 SECURE Act]. This basically restores linking the child's tax rate to the parent's marginal tax rate, rather than to the trust and estate tax rate. However, a taxpayer may elect for this provision to apply to the 2018 and 2019 tax years [Sec. 501(c)(3) of the 2019 SECURE Act]. Amended returns may be beneficial for the 2018 tax year.

Example #1: In the current year, Ferdinand pays qualified tuition for his son to attend college. Ferdinand claims his son as a dependent on his tax return. Assuming he meets other requirements, Ferdinand is allowed an education credit on his tax return. If his son paid the qualified tuition, Ferdinand is still allowed the education credit. His son cannot claim the credit.

Example #2: Assume the same facts as Example #1, but Ferdinand chooses not to claim his son as a dependent on his tax return (even though eligible to do so). If his son meets other requirements, Ferdinand's son may claim the education credit on his return. The result would be the same regardless of whether Ferdinand or his son paid the qualified expenses.

Strategy: It may be advantageous for a parent who does not qualify for the education credit due to the AGI limitation not to claim an eligible dependent, so the student can claim the education credit on his return.

Third-party tuition payments. If a third party (such as a grandparent) makes a payment directly to an eligible institution for a student's qualified expenses, the student is treated as receiving the payment from the third party and, in turn, paying the qualified expenses. If the student is not claimed as a dependent on another person's return, the student claims the education credit (if otherwise eligible). If the student is claimed as a dependent on another person's return, the expenses treated as paid by the student are treated as paid by the person claiming the student as a dependent, and that person claims the education credit [Reg. 1.25A-5(b)].

Tuition paid under divorce decree. Qualified education expenses paid directly to an eligible educational institution for a dependent student under a court-approved divorce decree are treated as paid by the dependent student.

Qualified expenses. Qualified expenses include:

- Tuition and fees required for the enrollment or attendance of a student at an eligible educational institution. Fees other than for tuition are included only if the fees must be paid to the institution as a condition of enrollment or attendance.
- For the American opportunity tax credit, qualified course materials (expenses for books, supplies and equipment) required for enrollment or attendance at an eligible educational institution may also be used to compute the credit.

  Note: Prop. Reg. 1.25A-2 states that "required for enrollment or attendance" means that the course materials are needed for meaningful attendance or enrollment in a course of study, regardless of whether the course materials are purchased from the institution.
- Expenses qualify in the tax year paid. Payments must be for an academic period (such as quarter, semester or trimester) that begins either in the same tax year or in the first three months of the following tax year. For institutions that use credit hours or clock hours and not academic periods, each payment period may be treated as an academic period.

Court Case: The taxpayer was a student at Arizona State University. He paid his spring 2012 tuition on December 18, 2011, even though it was not due until January 25, 2012. On his 2012 tax return, the taxpayer claimed an AOTC of $2,500. The IRS disallowed the credit stating that early tuition payments for classes that begin within the first three months of the following year are eligible for the AOTC in the year of payment. The Tax Court agreed, stating that the taxpayer was required to take the AOTC in 2011. Unfortunately, the taxpayer had already taken the maximum credit in that year (*McCarville,* TC Summ. Op. 2016-14).

- An eligible institution is any accredited college, university, vocational school or other accredited post-secondary educational institution eligible to participate in a student aid program administered by the U.S. Department of Education (DOE). This includes certain institutions located outside the U.S. that participate in the DOE programs. An institution should be able to state whether it is eligible. There's also a searchable list at **https://studentaid.ed.gov/sa/fafsa** (select "School Code Search").

Nonqualified expenses. Qualified expenses do *not* include:

- Any expense for which a deduction is allowed (no double benefit).
- Expenses for hobby courses that involve sports, games or hobbies, or any noncredit course unless it is part of the student's degree program. *Exception:* In the case of the Lifetime Learning Credit, such expenses qualify if taken to acquire or improve job skills.
- Personal expenses such as room and board, insurance, medical expense and transportation. Bundled fees that include both qualified expenses and personal expenses must be allocated by the institution.
- Nonacademic fees, unless fee payment is a requirement for enrollment or attendance.
- Books, supplies and equipment, unless they are required to be purchased from the educational institution for the enrollment or attendance of the student [Reg. 1.25A-2(d)]. (However, note that course materials qualify for the American opportunity tax credit.)

Reimbursements. A credit may not be claimed for expenses that are covered by a tuition reimbursement that is excludable from income (such as a business-related course reimbursed by an employer). If the reimbursement is taxable, the credit is allowed.

Payments with borrowed funds. The credits can be claimed for qualified tuition and related expenses paid with the proceeds of a loan. The expenses are used to figure the credit for the year in which the expenses are paid, not the year in which the loan is repaid [Reg. 1.25A-5(e)(3)].

Adjustments to qualified education expenses. Qualified education expenses must be reduced by the amount of any tax-free educational assistance received, including:

- The tax-free parts of scholarships and fellowships,
- Pell grants,
- Employer-provided educational assistance,
- Veterans' educational assistance, and
- Any other nontaxable payments (other than gifts or inheritances) received as educational assistance.

Note: Total qualified education expenses must be reduced by amounts reported in box 5 (Scholarships or grants) of Form 1098-T (Tuition Statement) if the reported amounts are from tax-free educational assistance.

Do not reduce the qualified education expenses by any scholarship or fellowship reported as income on the student's tax return in the following situations:

- The use of the money is restricted to costs of attendance (such as room and board) other than qualified education expenses.
- The use of the money is not restricted and is used to pay education expenses that are not qualified (such as room and board).

American Opportunity Tax Credit

The AOTC is a partially (40%) refundable tax credit of 100% of the first $2,000 and 25% of the next $2,000 (maximum credit of $2,500 per eligible student) of eligible expenses for the first four years of post-secondary education. The credit is per student per year. A family may have more than one eligible student in a year.

Caution: The credit is not refundable if the taxpayer (1) is under age 18 [or age 18 (or a full-time student age 19–23) and whose earned income is less than or equal to half of his support], (2) has at least one living parent and (3) does not file a joint return.

Other AOTC requirements:

- *Degree requirement.* Student must be enrolled in a program that leads to a degree, certificate or other recognized educational credential.
- *Work load.* Student must take at least half of the normal full-time work load for the student's course of study for at least one academic period beginning during the tax year.
- *No felony drug conviction.* Student must be free of any felony conviction for possessing or distributing a controlled substance.
- *Modified AGI phase-outs* [IRC Sec. 25A(i)(4)]. For 2019, the AOTC phases out for modified AGI between $160,000 and $180,000 for married joint filers and $80,000 to $90,000 for other qualified taxpayers.

Lifetime Learning Credit

The Lifetime Learning Credit (LLC) is a nonrefundable tax credit of 20% of up to $10,000 of qualified tuition and fees paid during the tax year. Maximum credit is $2,000 per return.

Other LLC requirements:

- *Credit not workload-based.* Allowed regardless of the number of courses taken.
- *Both degree and nondegree courses eligible.* Available for undergraduate, graduate, professional degree students and students acquiring or improving their job skills.
- *Unlimited number of years.* There is no limit on the number of years for which the credit can be claimed for each student.
- *Per return per year.* The credit does not vary based on the number of students in a family.
- *Modified AGI phase-outs*. For 2019, the LLC phases out for modified AGI between $116,000 and $136,000 for married joint filers and $58,000 to $68,000 for other qualified taxpayers.

Example: Pam, a professional photographer, enrolls in an advanced photography course at a local college. The course is not part of a degree program, but Pam enrolls to improve her job skills. The expense qualifies for the LLC (provided Pam does not claim a business expense for it).

Coordination of Credits and Exclusions

Education credits. A taxpayer may not claim both an AOTC and an LLC for the same student in the same year.

Observation: Taxpayers with more than one student during the year can choose to take the credits on a per-student, per-year basis. For example, the American opportunity credit can be claimed for one student and the lifetime learning credit claimed for another in the same year.

Education savings account (ESA) and qualified tuition program (QTP). A taxpayer can claim the AOTC or LLC in the same year that the taxpayer excludes an ESA or QTP distribution from income as long as the same expenses are not used for both benefits. Qualified education expenses (QEE) are reduced in the following order:

1) Amounts excluded from income such as scholarships and employer-provided education assistance then
2) Amounts used to claim education credits such as the AOTC and LLC.

Thus, if an education credit is claimed, QEE are first allocated to the credit, and any remaining QEE go toward computing the taxable amount of the distribution.

If a student receives distributions from both an ESA and a QTP that are more than the remaining QEE, the expenses must be allocated between the distributions.

Tuition and fees deduction. A taxpayer may not claim the qualified tuition and fees deduction ~~(if extended by legislation)~~ if the AOTC or LLC is claimed for the same student in the same year [IRC Sec. 222(c)(2)(A)]. The taxpayer may claim either the credit or the deduction, whichever is more advantageous.

Education savings bond program. The amount of education expenses used to compute the AOTC or LLC reduces the amount used in computing the exclusion of interest on Series EE or Series I U.S. savings bonds [IRC Sec. 135(d)(2)].

Educational assistance program. Qualified education expenses are reduced by any tax-free educational assistance received.

Form 1098-T

To help compute the education credits, taxpayers should receive Form 1098-T from the educational institution by January 31 of the following year reporting payments actually received for qualified tuition and related expenses [IRC Sec. 6050S(b)(2)(B)]. In addition, Form 1098-T should provide other information for that institution, such as adjustments made for prior years, the amount of scholarships or grants, reimbursements or refunds, the educational institution's employer identification number (EIN) and whether the student was enrolled at least half-time or was a graduate student.

The eligible educational institution may ask for a completed Form W-9S (Request for Student's or Borrower's Taxpayer Identification Number and Certification) or similar statement to obtain the student's name, address and taxpayer identification number.

Caution: A taxpayer cannot claim an education credit unless he receives a payee statement, generally Form 1098-T, from the educational institution and includes on his return the institution's employer identification number (EIN) [IRC Secs. 25A(g)(8) and 25A(i)].

Comparing the Education Credits (2019)

American Opportunity Tax Credit	Lifetime Learning Credit
Up to $2,500 credit per *eligible student.*	Up to $2,000 credit per *return.*
Available for the first four years of post-secondary education.	Available for all years of postsecondary education and for courses to acquire or improve job skills.
Available *only* for four years per eligible student.	Available for an unlimited number of years.
Student must be pursuing an undergraduate degree or other recognized education credential.	Student does not need to be pursuing a degree or other recognized education credential.
Student must be enrolled at least half time for at least one academic period beginning during the year.	Available for one or more courses.
No felony drug conviction on student's record.	Felony drug conviction rule does not apply.
The ability to claim the credit is phased out between $160,000 and $180,000 for MFJ, and between $80,000 and $90,000 for other qualified taxpayers.	The ability to claim the credit is phased out between $116,000 and $136,000 for MFJ, and between $58,000 and $68,000 for other qualified taxpayers.

Example—Claiming Both Education Credits on Return

Carter and Ann Wiggins are married and file a joint tax return. For 2019, they have two dependent children and their modified AGI is $98,000. Their tax, before credits, is $8,499 and they are not subject to AMT. Their son, Stanley, will receive his graduate (post-four year) degree in psychology from State College in May 2020. Their daughter, Claire, enrolled full-time at State College in August 2019 to begin working on her bachelor's degree in physical education. In July 2019, the Wiggins paid $2,200 in tuition costs for each child for the Fall 2019 semester. In December 2019, they also paid $2,600 of tuition for each child for the Spring 2020 semester that begins in January. Carter and Ann, their children and the college meet all of the requirements for the education credits.

- Because Stanley is obtaining his graduate (master's) degree and is beyond the first four years of his postsecondary education, his expenses do not qualify for the AOTC. But, amounts paid for his expenses in 2019 for academic periods beginning in 2019 and the first three months of 2020 qualify for the LLC.
- Claire is in her first four years of postsecondary education and expenses paid for her in 2019, for academic periods beginning in 2019 and the first three months of 2020, qualify for the AOTC and the LLC. The Wiggins claim the AOTC for Claire's expenses, since it is the larger of the two.

The Wiggins' education credits for 2019 total $3,460, $1,000 of which is refundable, as shown on the completed Form 8863 on Page 11-17. They can claim the full amount because their modified adjusted gross income is less than $116,000.

Deducting Qualified Tuition

~~**Expired Provision Alert:** The tuition and fees deduction expired at the end of 2017. However, this discussion is retained in the event the deduction is extended, as it has been many times.~~

For 2019, taxpayers are allowed to deduct tuition and fees above the line. The allowable deduction is based on the taxpayer's modified AGI (IRC Sec. 222).

Caution: A taxpayer must receive a complete payee statement (generally, Form 1098-T) to claim the deduction [IRC Sec. 222(d)(6)].

Tuition and Fees Deduction Limit (2019)		
Deduction Limit	If Modified AGI is:	
	Single, HOH, QW	MFJ
$4,000	$0 – $65,000	$0 – $130,000
$2,000	$65,001 – $80,000	$130,001 – $160,000
$ 0	Over $80,000	Over $160,000

Qualified education expenses:

- Tuition and fees required for the enrollment or attendance at an eligible educational institution for the taxpayer, spouse or a dependent. Also includes course-related books, supplies and equipment if those expenses must be paid to the institution as a condition of enrollment or attendance.
- Expenses qualify in the tax year paid. Payment must be for education that begins either in the same tax year or in the first three months of the following tax year.
- An eligible institution is any accredited college, university, vocational school or other accredited post-secondary education institution.

Adjustments to qualified expenses. Qualified expenses are reduced by:

- Any tax-free educational assistance such as scholarships, Pell grants, employer-provided assistance, veterans' educational assistance and any other nontaxable payment (other than gifts, bequests or inheritances) received for education expenses.
- Interest on U.S. savings bonds used to pay for education that is excluded from income.
- Tax-free portion of distributions from an educational savings account (ESA).
- Tax-free earnings included in distributions from a qualified tuition plan (QTP).

Nonqualified expenses:

- Insurance.
- Medical expenses.
- Room and board.
- Transportation or similar personal, living or family expenses.

Student Loans—Interest Deduction

Taxpayers can deduct up to $2,500 of interest paid on qualified education loans for college or vocational school expenses as an adjustment to income (above-the-line) (IRC Sec. 221). The deduction is available on qualifying loans for the benefit of the taxpayer or the taxpayer's spouse or dependent at the time that the debt was incurred.

Student Loan Interest Deduction—Quick Glance	
Feature	Description
Benefit	Up to $2,500 tax deduction (above-the-line).
Qualified Loan	• Must have been taken out solely to pay qualified education expenses. • Cannot be from a related person or a qualified employer retirement plan.
Qualified Student	• Taxpayer, spouse or dependent. • Enrolled at least half-time in a degree program.
Phase-out	The ability to claim the deduction is phased out between $140,000 and $170,000 for MFJ, and between $70,000 and $85,000 for other qualified taxpayers.

Qualified loans. Qualified education loans are loans used solely for qualified education expenses, including tuition, fees, room and board, books, equipment and transportation for an eligible student to attend an eligible institution.

Coordination with other education benefits. Qualified education expenses do not include amounts paid with nontaxable education benefits received, such as employer-provided educational assistance, nontaxable distributions from an ESA or QTP, U.S. savings bond interest excluded from income or veteran's educational benefits.

Law Change Alert: For QTP distributions made after December 31, 2018, the 2019 SECURE Act allows up to $10,000 of student loan repayments (both principal and interest) for either the designated beneficiary of the QTP or a sibling of the designated beneficiary.

Eligible educational institutions include colleges, vocational schools and other post-secondary institutions that are eligible to participate in DOE student aid programs.

Eligible student. Students must take at least one half the normal full-time load in a degree, certificate or other qualified program at an eligible institution.

Restrictions

1) Not available to a taxpayer when a dependency exemption deduction for that person is claimed by another taxpayer. Another taxpayer is claiming an exemption for the taxpayer if he lists the taxpayer's name and other required information in the Dependents section of his Form 1040.

   Note: Even though there is no exemption deduction for tax years 2018–2025, taxpayers will still claim dependents for other tax purposes and doing so will prevent a claimed dependent from deducting student loan interest expense.

Education Tax Incentives Comparison Chart (2019)

	American Opportunity Credit	Lifetime Learning Credit	IRA Withdrawals	Savings Bond Interest Exclusion	Student Loan Interest Deduction	Tuition and Fees Deduction ~~Caution: Expired[1]~~	Qualified Tuition Program (QTP)	Education Savings Account (ESA)
IRC Sec.	25A	25A	72(t)	135	221	222	529	530
Tax Benefit	Tax credit— 40% refundable;[1] 60% nonrefundable.	Tax credit— nonrefundable.	10% early withdrawal penalty is waived.	Tax-free interest.	Above-the-line deduction.	Above-the-line deduction.	Tax-free earnings (savings plan) or tax-free education credits (prepaid plan).	Tax-free earnings.
2019 Annual Limits	Credit up to $2,500 per student (100% of first $2,000 of expenses and 25% of next $2,000).	Credit up to $2,000 per return (20% of up to $10,000 of expenses).	Amount of qualifying expenses.	Amount of qualifying expenses.	Deduction of up to $2,500 of interest paid on education loan.	Deduction of up to $4,000 of qualifying expenses paid.	Nondeductible contributions limited to amount necessary to cover qualified expenses.	$2,000 nondeductible contribution per child under age 18 and any age special-needs child.
Qualified Education Expenses (QEE)[2]	Tuition and fees; books, supplies and equipment.[3]	Tuition and fees; books, supplies and equipment.[4]	Tuition and fees; books, supplies and equipment;[3] room and board if at least half-time attendance.	Tuition and fees; contributions to QTPs and ESAs.	Tuition and fees; books, supplies and equipment; room and board, transportation, other necessary expenses.	Tuition and fees; books, supplies and equipment.[4]	Tuition and fees; books, supplies and equipment;[3] computer and internet service; room and board if at least half-time attendance.	Tuition and fees; books, supplies and equipment;[3] room and board if at least half-time attendance; contributions to QTP; computer and internet service (K–12 only).
QEE Must Be For	Taxpayer, spouse or dependent.	Taxpayer, spouse or dependent.	Taxpayer, spouse, child or grandchild.	Taxpayer, spouse or dependent.	Taxpayer, spouse or dependent.	Taxpayer, spouse or dependent.	Account beneficiary.	Account beneficiary.
Qualifying Education	First four years of undergraduate.	Undergraduate and graduate.	Undergraduate and graduate.	Undergraduate and graduate.	Undergraduate and graduate.	Undergraduate and graduate.	K–12 ($10k annual limit), undergraduate and graduate.	K–12, undergraduate and graduate.
Other Rules and Requirements	Must be enrolled at least half-time in a degree program; parents can shift credit to student by not claiming student as a dependent.	Available for unlimited number of years for both degree and non-degree programs; parents can shift credit to student by not claiming student as a dependent.	Penalty waived on IRA distributions up to the amount of qualified expenses for the year.	Applies only to qualified Series EE bonds issued after 1989 or Series I bonds; bond owner must be at least 24 years old when bond issued.	Loan must be incurred solely to pay qualified education expenses of student enrolled at least half-time in a degree program. Payer must be legally obligated to repay debt.	Not allowed if education expenses are deducted under another provision or education credit is claimed.	Account owner can change beneficiary or reclaim funds; can elect to spread gift over five years; some states allow deduction to residents; beneficiary can be anyone.	Contributions must be made by the original return due date; may also contribute to QTP; mandatory distributions at age 30; beneficiary can be anyone.
2019 Modified AGI Phase-Out						Not allowed if MAGI exceeds:[6]		
MFJ	$ 160,000 – 180,000	$ 116,000 – 136,000	N/A	$ 121,600 – 151,600	$ 140,000 – 170,000	$ 160,000	N/A	$ 190,000 – 220,000
Single, HOH, QW[5]	80,000 – 90,000	58,000 – 68,000		81,100 – 96,100	70,000 – 85,000	80,000		95,000 – 110,000
MFS	Do Not Qualify	Do Not Qualify		Do Not Qualify	Do Not Qualify	Do Not Qualify		95,000 – 110,000

~~[1] Expired Provision Alert: The tuition and fees deduction expired at the end of 2017. However, this coverage is retained in the event the deduction is extended, as it has been may times.~~

[1] *Exception*: Not refundable for certain children under age 24.

[2] Qualifying educational expenses must be reduced by any tax-free scholarships and grants. The same educational expenses cannot be used for figuring more than one benefit.

[3] Must be required for enrollment or attendance at an eligible educational institution.

[4] Must be paid to the eligible educational institution as a condition of the student's enrollment or attendance at the institution.

[5] For savings bond interest exclusion, QW is subject to the same phase-out range as MFJ.

[6] No AGI phase-out range. Up to $4,000 is deductible if MAGI does not exceed $65,000 ($130,000 for MFJ). Up to $2,000 is deductible if MAGI does not exceed $80,000 ($160,000 for MFJ).