Federal Income Tax Changes – 2020

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Special Note Concerning Recent Legislation

In the closing days of 2019, two pieces of legislation titled "Setting Every Community Up for Retirement Enhancement Act of 2019" (SECURE Act) and "Taxpayer Certainty and Disaster Tax Relief Act of 2019" became law, generally effective January 1, 2020. Although the bulk of the provisions in the Act address retirement plans, the new law's provisions that may affect clients' tax returns are the following:

- Revision of the requirements for multiple employer pension plans and pooled employer plans that –
  - establish pooled employer plans not requiring a common characteristic, and
  - provide that the failure of one employer in a multiple employer retirement plan will not cause all plans to fail and that assets in the failed plan will be transferred to another plan;
- The permitting of amendments to nonelective status at any time before the 30th day prior to the close of a matching contribution plan's year;
- An increase in the tax credit for small employer pension plan startup costs;
- Creation of a three-year tax credit for small employers for startup costs for new pension plans that include automatic enrollment;
- The inclusion of stipends and non-tuition fellowships in the definition of compensation for purposes of individual retirement account (IRA) contributions;
- The repeal of the prohibition on traditional IRA contributions by taxpayers who have reached age 70 ½;
- Prohibition of the distribution of qualified plan loans through credit cards or similar arrangements;
- A provision for the portability of lifetime income investments from a defined contribution retirement plan to another employer plan or IRA if a lifetime income investment is no longer permitted in the plan;
- A provision allowing long-term employees working at least 500 hours but less than 1000 hours in three consecutive 12 month periods and who have reached age 21 to participate in cash or deferred arrangements (CODAs);
- A provision that would permit penalty-free qualified birth or adoption distributions of up to $5,000 from retirement plans within one year following the birth of the individual's child or legal adoption of an eligible adoptee;
- An increase in the age of required minimum distributions from retirement plans from age 70 ½ to age 72;
- Elimination of the taxation of children's unearned income at rates applicable to trusts and estates;
- Expansion of § 529 Plan definition of eligible education costs to include costs associated with apprenticeship programs and certain student loan repayments;
- Revision of the required minimum distribution regulations affecting beneficiaries other than certain eligible designated beneficiaries following the death of a defined contribution plan participant or IRA owner;
- Effective for discharges of indebtedness after December 31, 2017, amounts of qualified principal residence indebtedness discharged for certain taxpayers excluded from income is extended from before January 1, 2018 to before January 1, 2021;
- Effective for taxable years after December 31, 2017, the mortgage interest deduction permitted for certain qualified mortgage insurance premiums is extended through December 31, 2020;
- Effective for taxable years ending after December 31, 2018, the adjusted gross income floor applicable to deduction of unreimbursed medical expenses is reduced from 10% to 7.5% for taxable years before January 1, 2021; and
- Effective for taxable years beginning after December 31, 2017, qualified tuition and related expenses are deductible subject to existing rules through December 31, 2020.

Introduction to the Course

Each year, various limits affecting income tax preparation and planning change. Some changes commonly occur each year as a result of inflation indexing, while others occur because of new legislation or the sunsetting of existing law. This course will examine the tax changes that took effect as a result of passage of the Tax Cuts and Jobs Act of 2017 (TCJA) and the inflation-changed limits effective for 2020 that are more significant from the perspective of an income tax preparer. Some context will be supplied, as appropriate, to assist readers in understanding the changes.

Learning Objectives

Upon completion of this course, you should be able to:

- List the 2020 changes in various amounts including –
    - Standard mileage rates,
    - The standard deduction,
    - The AMT exemption amount,
    - The limits related to income from U.S. Savings Bonds for taxpayers paying higher education expenses, and
    - Deductions for qualified long-term care insurance premiums;
- Identify the 2020 tax credit changes affecting the –
    - Saver's credit,
    - Earned income credit, and
    - Adoption credit;
- Recognize the 2020 changes affecting –
    - Health Savings Account (HSA) and Archer Medical Savings Accounts (MSA) requirements and contribution limits,
    - Roth IRA eligibility, and
    - Traditional IRA contribution deductibility for active participants in employer-sponsored qualified plans;
- List the changes effective for 2020 with respect to the –
    - Small employer premium tax credit, and
    - Applicable large employer mandate.

Chapter 1 – Changes in Various Limits

Introduction

Federal tax law requires that various limits be adhered to in the preparation of tax returns, and such limits may change from year to year based on an inflation adjustment or on other factors. Included in those changes for 2020 are standard mileage rates, standard deductions and various other limits.

This chapter will examine these changes for 2020 and will offer some context within which they apply.

Chapter Learning Objectives

Upon completion of this chapter, you should be able to:

- Calculate the standard mileage deductions for –
    - Use of a personal vehicle for business purposes,
    - Use of a personal vehicle to obtain medical care, and
    - Charitable use of a personal vehicle;
- Identify the 2020 standard deduction amounts available to taxpayers;
- Recognize the changes made to the alternative minimum tax exemption amount for 2020;
- Apply the tax-free United States savings bond income limits for taxpayers who paid qualified higher education expenses in 2020; and
- Calculate the tax-deductible premiums for and tax-free benefits received under qualified long-term care insurance contracts.

Standard Mileage Rates

The standard mileage rates enable a taxpayer using a vehicle for specified purposes to deduct vehicle expenses on a per-mile basis rather than deducting actual car expenses that are incurred during the year. The rates vary, depending on the purpose of the transportation.

Accordingly, the standard mileage rates differ from one another depending on whether the vehicle is used for:

- Business purposes;
- Charitable purposes; or
- Obtaining medical care or moving.

Rather than using the optional standard mileage rates, however, a taxpayer may choose to take a deduction based on the actual costs of using the vehicle.

Business Use of a Taxpayer's Personal Vehicle

As a result of the passage of the TCJA, taxpayers may no longer deduct unreimbursed employee expenses—including unreimbursed expenses related to business use of a personal vehicle—as "miscellaneous itemized deductions" to the extent the total of such expenses exceeds 2% of his or her AGI. However, the 2020 alternative standard mileage rate applicable to ***eligible*** business use of a vehicle is 57.5¢ per mile, down from 58¢ in 2019. In order for such expenses to be deductible, they must have been:

- Paid or incurred during the tax year;
- For the purpose of carrying on the taxpayer's trade or business; and
- Ordinary and necessary.

Provided the vehicle expenses meeting these three criteria are not reimbursed, the deductible personal vehicle expenses include those incurred while traveling:

- Between workplaces;
- To meet with a business customer;

- To attend a business meeting located away from the taxpayer's regular workplace; or
- From the taxpayer's home to a *temporary* place of work.

In addition to using the standard mileage rate, a taxpayer may also deduct any business-related parking fees and tolls paid while engaging in deductible business travel. However, parking fees paid by a taxpayer to park his or her vehicle at the usual place of business are considered commuting expenses and are not deductible.

Personal Vehicle Use for Charitable Purposes

A taxpayer may deduct as a charitable contribution any unreimbursed out-of-pocket expenses, such as the cost of gas and oil, directly related to the use of a personal vehicle in providing services to a charitable organization. Alternatively, a taxpayer may use the standard mileage rate applicable to the use of a personal vehicle for charitable purposes. The standard mileage rate applicable to a taxpayer's use of a personal vehicle for charitable purposes is based on statute and remains unchanged at 14¢ per mile. The taxpayer may also deduct parking fees and tolls regardless of whether the actual expenses or standard mileage rate is used.

A related issue involves a taxpayer's travel expenses incurred in providing services to a charity. Thus, in addition, a taxpayer may generally claim a charitable contribution deduction for travel expenses necessarily incurred while away from home performing services for a charitable organization. In order to claim a charitable deduction for such travel expenses, however, certain criteria must be met. Pursuant to federal regulations, in order to take a charitable contribution deduction for such travel expenses:

- There must be no significant element of personal pleasure, recreation, or vacation in the travel; and
- The taxpayer must be on duty in a genuine and substantial sense throughout the trip. (A taxpayer having only nominal duties in connection with the trip or who has no duties for a significant part of it would not be permitted to deduct the travel expenses.)

Use of a Taxpayer's Personal Vehicle to Obtain Medical Care

A taxpayer may also deduct medical and dental expenses to the extent they exceed the applicable percentage of his or her adjusted gross income (AGI). The vehicle expenses a taxpayer may include as medical and dental expenses are the amounts paid for transportation to obtain medical care for the taxpayer, a spouse or a dependent. A taxpayer may also include as medical and dental expenses those transportation costs incurred:

- By a parent who must accompany a child needing medical care;
- By a nurse or other person who can administer injections, medications or other treatment required by a patient traveling to obtain medical care and unable to travel alone; or
- For regular visits to see a mentally-ill dependent, if such visits are recommended as a part of the mentally-ill dependent's treatment.

A taxpayer who uses a personal vehicle for such medical reasons is permitted to include the out-of-pocket vehicle expenses incurred—the expenses for gas and oil, for example—or deduct medical travel expenses at the standard medical mileage rate. For 2020, the standard medical mileage rate is 17¢ per mile, down 3¢ from 2019. The taxpayer may also deduct any parking fees or tolls, regardless of whether the actual expense or the standard mileage rate is used.

Use of a Taxpayer's Personal Vehicle to Move

Many taxpayers change their residence each year, and many of those taxpayer relocations involve new jobs. Prior law permitted a taxpayer to deduct moving expenses by car provided the new location was at least 50 miles farther from the taxpayer's former home than the former main job location. However, except in the case of military relocations, the TCJA has suspended the moving expense deduction and made any moving expense reimbursement taxable income.

Moving Expenses in Military Relocations

The inclusion of reimbursed moving expenses in the recipient's gross income does not apply to military relocations meeting certain criteria. In the case of a military relocation, the taxpayer's move must be pursuant to a military order and involve a permanent change of station. If those criteria are met, no paid or incurred moving and storage expenses:

- Furnished in kind, or
- For which reimbursement or allowance is provided to the service member, spouse or dependents

…are includible in gross income or reported.

In addition, if the moving expenses paid or incurred in connection with a military relocation are furnished or reimbursed (or an allowance is provided) to the service member's spouse and dependents to move:

- To a location other than the one to which the service member moves, or
- From a location other than the one from which the service member moves

…such expenses are likewise neither includible in gross income nor reported.

Standard Mileage Rates

Activity	2019 Mileage Rate	2020 Mileage Rate
Eligible business use	58¢	57.5¢
Medical or moving purposes	20¢	17¢
Charitable purposes*	14¢	14¢

*Set by statute; not subject to inflation adjustment

Standard Deduction Increased

The Act has increased the standard deduction for 2020. Under the new law, standard deductions are:

- $24,800 for married couples whose filing status is "married filing jointly" and surviving spouses;
- $12,400 for singles and married couples whose filing status is "married filing separately"; and
- $18,650 for taxpayers whose filing status is "head of household."

A taxpayer who can be claimed as a dependent is generally limited to a smaller standard deduction, regardless of whether the individual is actually claimed as a dependent. For 2020 returns, the standard deduction for a dependent is the greater of:

- $1,100; or
- The dependent's earned income from work for the year plus $350 (but not more than the standard deduction amount, generally $12,400).

Standard Deduction for Blind and Senior Taxpayers

Elderly and/or blind taxpayers receive an additional standard deduction amount added to the basic standard deduction. The additional standard deduction for a blind taxpayer—a taxpayer whose vision is less than 20/200—and for a taxpayer who is age 65 or older at the end of the year is:

- $1,300 for married individuals; and
- $1,650 for singles and heads of household.

The additional standard deduction for taxpayers who are both age 65 or older at year-end and blind is double the additional amount for a taxpayer who is blind (but not age 65 or older) or age 65 (but not blind). For example, a 65 year-old single blind taxpayer would add $3,300 to his or her usual standard deduction: $1,650 for being age 65 plus $1,650 for being blind. ($1,650 x 2 = $3,300). Thus, his or her standard deduction would normally be $15,700. ($12,400 + $3,300 = $15,700)

Standard Deduction Eligibility

The general rule with respect to deductions is that a taxpayer may choose to take a standard deduction or itemize his or her deductions. Although that general rule applies in the case of most taxpayers, certain taxpayers are ineligible to take the standard deduction and must itemize.

Taxpayers who are ineligible to take the standard deduction are the following:

- Taxpayers whose filing status is “married filing separately” and whose spouse itemizes deductions;
- Taxpayers who are filing a tax return for a short tax year due to a change in their annual accounting period; and
- Taxpayers who were nonresident aliens or dual-status aliens during the year.

Standard Deductions

	2019		2020	
Filing Status	**Standard**	**Blind/Age 65+**	**Standard**	**Blind/Age 65+**
Married filing jointly & surviving spouses	$24,400	$1,300	$24,800	$1,300
Unmarried (other than surviving spouses)	$12,200	$1,650	$12,400	$1,650
Married filing separately	$12,200	$1,300	$12,400	$1,300
Head of household	$18,350	$1,650	$18,650	$1,650
Dependent	$1,100 or earned income + $350		$1,100 or earned income + $350	

Exemption Amount

The TCJA, effective for 2018 through 2025, suspends personal exemptions.

Alternative Minimum Tax (AMT)

A taxpayer's income tax liability is generally reduced under the federal tax code as a result of the preferential treatment the Code gives to certain kinds of taxpayer income. In addition, the Code permits taxpayers to take special deductions and credits for certain kinds of expenses.

To help ensure that taxpayers with higher incomes who avail themselves of the preferences that exist under the Code pay no less than a minimum amount of federal income tax, Congress passed the predecessor to the alternative minimum tax (AMT) in 1969. Under the earlier legislation and the current alternative minimum tax provisions, taxpayers who benefit from special treatment or special deductions and credits may be required to pay at least a minimum amount of federal tax. That minimum tax amount payable under the AMT is the result of adding back certain amounts deducted from the taxpayer’s income, applying an alternative minimum taxable income exemption and then applying the federal income tax rates to that income amount.

Thus, imposition of an alternative minimum tax was designed to ensure that at least a minimum amount of tax is paid by higher-income taxpayers who enjoy significant tax savings through the use of certain tax deductions, exemptions, losses and credits. Absent the alternative minimum tax, such taxpayers could conceivably avoid federal income tax liability completely despite their high income level.

Tax Preference Items Added Back to Produce Alternative Minimum Taxable Income

The deductions identified as sources of extraordinary tax savings are referred to as “tax preference items.” Because the tax preference items generate tax savings by reducing the taxpayer's taxable income, they are added back to the taxpayer's taxable income for purposes of computing the alternative minimum taxable income (AMTI). The result is that unreasonably-high tax breaks are recaptured. After the various tax-preference items are added back, the applicable AMTI exemption, discussed below, is subtracted.

Although AMTI includes a wide range of recaptures, the principal tax preference items added back in determining AMTI are:

- The amount by which a depletion deduction claimed by a taxpayer exceeds the adjusted basis of the interest at the end of the tax year;
- Tax-exempt interest on certain specified private activity bonds;
- For property placed in service before 1987, the excess of accelerated depreciation on non-recovery real property over straight line depreciation; and
- For most property placed in service before 1987, the excess of the ACRS deduction for leased recovery property over the straight-line depreciation deduction that would have been allowed if a half-year convention had been used and specified recovery periods have been used.

In addition to these tax preference items, the alternative minimum tax aims to recover some of the tax savings generated by other deductions and methods for computing tax liability. Thus, for purposes of determining alternative minimum taxable income, taxpayers are required to re-compute certain regular tax deductions in a less preferential manner. As a result of re-computing such tax deductions, the alternative minimum taxable income is usually increased.

Alternative Minimum Tax Exemption Amount Increased

The tax code provides for an AMTI exemption for purposes of determining the alternative minimum tax amount. The amount of the AMTI exemption varies according to the taxpayer's filing status and the tax year. The applicable AMTI exemption amounts are as follows:

AMTI Exemption Amounts

	2019		**2020**	
Filing Status	**Exemption Phaseout Begins**	**AMTI Exemption**	**Exemption Phaseout Begins**	**AMTI Exemption**
Married filing jointly & surviving spouses	$1,020,600	$111,700	$1,036,800	$113,400
Unmarried (other than surviving spouses)	$510,300	$71,700	$518,400	$72,900
Married filing separately	$510,300	$55,850	$518,400	$56,700
Estates and trusts	$83,500	$25,000	$84,800	$25,400

The AMTI exemption amounts are indexed for inflation.

The AMTI exemption amount is reduced (but not below zero) by 25 percent of the amount by which the taxpayer’s alternative minimum taxable income exceeds:

- $1,036,800 for taxpayers whose filing status is “married filing jointly” or “qualifying widow(er)”;
- $518,400 for taxpayers whose filing status is “single,” “head of household,” and “married filing separately”; and
- $84,800 for trusts and estates.

Education Savings Bond Program

Although the interest on U.S. savings bonds is normally taxable as ordinary income, a taxpayer may exclude some or all of the interest on certain cashed in savings bonds if he or she pays qualified education expenses and meets federal income tax filing status and income requirements. Under the federal education savings bond program, a taxpayer may exclude some or all interest income received on qualified U.S. savings bonds if the taxpayer:

- Paid qualified education expenses for the taxpayer, a spouse or a dependent claimed as an exemption;
- Has a modified adjusted gross income (MAGI) not exceeding specified maximum amounts that are adjusted for inflation each year; and
- Has a federal income tax filing status other than married filing separately.

The U.S. savings bonds that qualify for the education savings program are series EE bonds issued after 1989 and series I bonds. The bonds must be issued either in the taxpayer's name as sole owner or in the name of the taxpayer and spouse as co-owners. Furthermore, in order for the bond to qualify, the owning taxpayer must have been at least age 24 before the bond's date of issue.

Qualified Education Expenses

Education expenses considered qualified education expenses under the education savings bond program are education expenses incurred at an eligible educational institution by the taxpayer for the taxpayer, the taxpayer's spouse or a dependent claimed by the taxpayer. Such expenses include:

- Tuition and fees;
- Contributions to a qualified tuition program; and
- Contributions to a Coverdell education savings account (ESA)

Room and board expenses **are not** qualified education expenses for purposes of the education savings bond program.

Eligible Educational Institutions

An eligible educational institution for purposes of the education savings bond program is broadly defined as one eligible to participate in a student aid program administered by the U.S. Department of Education and includes:

- College;
- University;
- Vocational school; and
- Other post-secondary educational institution.

Thus, the definition of an eligible educational institution includes virtually all accredited U.S. public, nonprofit, and proprietary post-secondary institutions.

Qualified Education Expenses Reduced by Certain Tax-free Benefits Received

To determine the amount of tax-free interest, the qualified education expenses incurred must be reduced, for purposes of the education savings bond program, by certain tax-free education benefits received. The resulting education expenses, reduced as required, are referred to as "adjusted qualified education expenses."

Thus, *adjusted* qualified education expenses are equal to the qualified education expenses reduced by all of the following tax-free benefits:

- The tax-free part of scholarships and fellowships;
- Expenses used to figure the tax-free portion of Coverdell ESA distributions;
- Expenses used to figure the tax-free portion of qualified tuition program distributions;
- Any tax-free payments received as education assistance, including –
  - Veterans' educational assistance benefits,
  - Qualified tuition reductions, and
  - Employer-provided educational assistance; and
- Any expenses used in figuring the American opportunity and lifetime learning credits.

Neither gifts nor inheritances received, however, reduce qualified education expenses for purposes of the education savings bond program.

Figuring the Tax-Free Amount

If the total amount received by the taxpayer when eligible bonds are cashed in, including both the bond investment and accrued interest, does not exceed the adjusted qualified education expenses, all interest received may be tax free. (Note, the taxpayer must still be eligible based on income.) If the total amount received on liquidation of the bonds is greater than the adjusted qualified education expenses, only a portion of the interest may be tax free.

Determining the tax-free amount of the interest distributed when the bonds are cashed in **and the adjusted qualified education expenses are less than the distribution** requires that the interest received be multiplied by a fraction. The numerator of the fraction is the adjusted qualified education

expenses, and the denominator of the fraction is the total proceeds received on liquidation of the bonds during the year the bonds were cashed in.

We can illustrate the part of the interest that may be tax free in this case by considering an example. Suppose a taxpayer received a $9,000 distribution of bond proceeds during the year, and the proceeds consisted of $6,000 of invested principal and $3,000 of interest. Further suppose that the adjusted qualified education expenses were $7,650—less than the bond proceeds, in other words. To determine the part of the $3,000 of interest that may be tax free, we need to use the following equation:

$$\text{Interest} \times \frac{\text{Adjusted qualified education expenses}}{\text{Total proceeds received}} = \text{Maximum tax-free interest}$$

By substituting the appropriate numbers into the equation, we can see that the amount of the tax-free interest in this example is $2,550, as shown below:

$$\$3{,}000 \times \frac{\$7{,}650}{\$9{,}000} = \$2{,}550$$

Since the taxpayer received $9,000 when cashing in the bonds, the $6,000 invested (or any portion of it) is tax free as a recovery of cost basis, but the portion of the interest other than the $2,550 tax-free amount—$450 in this case—is taxable interest. As noted earlier, however, a taxpayer's eligibility for the education savings bond program is determined by the taxpayer's income and filing status, discussed immediately below. Depending on the taxpayer's MAGI/filing status, some or all of the maximum tax-free interest may also be includible in income.

Education Savings Bond Program Eligibility Subject to Income Limits/Filing Status

The exclusion of interest under the education savings bond program reduces as the taxpayer's income increases and is eliminated at higher income levels. Under the bond program rules, the amount of a taxpayer's interest exclusion is gradually reduced if the taxpayer's modified adjusted gross income (MAGI) exceeds the applicable dollar amount for the taxpayer's filing status. (See **Determining Taxpayer's Modified Adjusted Gross Income** below.)

When the part of the bond interest that normally would be tax free under the education savings bond program is determined, the taxpayer's MAGI is compared to the applicable dollar amount for the tax year to calculate the amount of the potentially tax-free interest that is excludible by the taxpayer. If a taxpayer whose filing status is married filing jointly has a MAGI that exceeds the applicable dollar amount by $30,000 or more, no interest may be excluded under the program. Similarly, if a taxpayer whose filing status is single, qualifying widow(er) or head of household has a MAGI that exceeds the applicable dollar amount by $15,000 or more, no interest is excludible under the program.

The applicable dollar amounts with which taxpayers' MAGI are compared are as follows:

Taxpayer's Filing Status	2020 Applicable Dollar Amount	Phase-Out Income Range	Completely Phased-Out
Single, qualifying widow(er) or Head of Household (HH)	$82,350	$82,350 - $97,350	$97,350
Married filing jointly	$123,550	$123,550 - $153,550	$153,550

The amount of excludible savings bond interest to which a taxpayer whose MAGI is in the phase-out income range is entitled, if any, can be determined using the following equation that calculates the part of the interest that is includible:

$$\frac{\text{(MAGI – Applicable dollar amount)}}{\text{\$30,000 (\$15,000 single or HH)}} \times \text{Maximum tax-free interest} = \text{Includible interest}$$

The amount determined under the equation is then subtracted from the maximum tax-free interest amount to figure the amount of excludible savings bond interest.

When figuring the excludible interest amount, use IRS Form 8815, a replicated sample of which is shown in Appendix A. The excludible interest amount should be shown on Schedule B, line 3.

Determining Taxpayer's Modified Adjusted Gross Income

For most taxpayers, modified adjusted gross income (MAGI), is the taxpayer's adjusted gross income (AGI) without taking the interest exclusion into account. However, in some cases determining a taxpayer's MAGI requires additional modifications to AGI.

When the taxpayer files IRS Form 1040, the taxpayer's MAGI is his or her AGI (without taking the savings bond interest exclusion into account) and is further modified by adding back any of the following that apply:

- Foreign earned income exclusion;
- Student loan interest deduction;
- Foreign housing deduction;
- American Samoa residents' income exclusion;
- Puerto Rico residents' income exclusion;
- Foreign housing exclusion;
- Excluded employer adoption assistance benefits; and
- Domestic production activities deduction.

Limitation on Itemized Deductions

The Act suspended the phase-out of itemized deductions for higher-income taxpayers for 2018 through 2025. Accordingly, itemized deductions are unlimited regardless of the taxpayer's income.

Qualified Long-Term Care Insurance Premiums and Benefits

In 1996, Congress passed the Health Insurance Portability and Accountability Act (HIPAA). The law clarified the tax treatment of long-term care insurance policies by defining "qualified long-term care insurance." In addition, it provided for the tax-deductibility of qualified long-term care insurance premiums and the tax-exemption of long-term care insurance benefits within certain limits for individuals deemed to be chronically-ill.

Those limits generally change yearly.

Favorable Benefits Tax Treatment Reserved for Chronically-Ill

In order for long term care benefits to receive favorable tax treatment, the individual on whose behalf they are paid must meet the "chronically-ill" definition included in HIPAA. A *chronically-ill individual* is defined as an insured individual who has been certified by a licensed health care practitioner within the previous 12 months as an individual who:

- Is unable, for at least 90 days, to perform at least two activities of daily living (ADLs) without substantial assistance from another individual, due to loss of functional capacity; or
- Requires substantial supervision to be protected from threats to health and safety due to severe cognitive impairment.

Tax-Qualified Long Term Care Premiums Deductible within Limits

Premiums paid for tax-qualified long term care insurance may be deductible. Tax-qualified long term care insurance policy premiums are included in the definition of "medical care" and are, therefore, eligible for income tax deduction within certain limits.

For *individuals* who itemize deductions, the amounts paid for medical care—a category of expenses that includes tax-qualified long term care insurance premiums not exceeding the dollar limitations discussed below—are deductible. Medical expenses were scheduled to be tax-deductible only to the extent the taxpayer's medical expenses for the year exceeds 10% of the taxpayer's adjusted gross income. However, the 7.5% floor for unreimbursed medical expenses has been reinstated for taxable years beginning before January 1, 2021.

Self-employed persons[1] may also deduct such premiums not in excess of the dollar limitations (noted in the chart below) ***without*** the need for medical care expenses to exceed the applicable AGI threshold. In short, tax-qualified long term care insurance policy premiums are 100% tax-deductible for self-employed taxpayers to the extent they don't exceed the dollar limits or the self-employed individual's net earnings.

The amount of any long term care insurance premium that may be included in medical care expenses is limited by certain dollar maximums that are indexed for inflation and which change as the insured's attained age changes. The dollar limitations applicable to tax-qualified long term care premiums in 2019 and 2020 are as follows:

Attained Age Before Close of Tax Year	2019 Limitation on Premium*	2020 Limitation on Premium*
40 or younger	$420	$430
41 to 50	$790	$810
51 to 60	$1,580	$1,630
61 to 70	$4,220	$4,340
Older than 70	$5,270	$5,430
** Indexed for inflation*		

Tax-Qualified Long Term Care Insurance Benefits Tax-Free within Limits

Just as the treatment of a tax-qualified long term care insurance policy as an accident & health insurance contract results in the tax-deductibility of premiums within certain limits, having such status also affects the tax treatment of benefits paid under it. Benefits, other than dividends or premium refunds, received under a tax-qualified long term care insurance policy are treated as reimbursements for expenses incurred for medical care and are generally not included in the recipient's income. Also similar to the tax treatment of premiums, the benefits from a tax-qualified long term care insurance policy that may avoid inclusion in the recipient's income are limited by certain maximums.

Benefits received under tax-qualified long term care insurance policies that may be excluded from income are those benefits not exceeding the greater of:

- The applicable *per diem* limitation for the year; or
- The costs incurred for qualified long term care services provided for the insured.

The applicable *per diem* limitation for 2020 is $380. The *per diem* limitation amount is adjusted each year, as needed, to reflect inflation. (Note: Periodic payments under a life insurance contract received on behalf of a chronically-ill insured are likewise tax-exempt, subject to the limits applicable to qualified long-term care insurance benefits.)

Social Security Taxable Earnings Limit

Social Security taxes are comprised of two components: OASDI (old age, survivors and disability income) and HI (health insurance) taxes. OASDI is a tax imposed on a worker's wages up to the applicable Social Security taxable earnings limit. That limit is $137,700 in 2020 and generally increases annually. The employee tax rate for the OASDI part of Social Security is 6.2%.

HI, the second component of Social Security taxes, is a tax of 1.45% imposed on all taxpayer wages—no earnings limit applies, in other words—to fund Medicare Part A.

[1] A self-employed individual, for purposes of long term care insurance premium tax-deductibility, includes sole proprietors, partners, and owners of S corporations, limited liability partnerships and limited liability companies.

Maximum Capital Gain/Dividend Tax Rate Increased for High-Income Taxpayers

- High-income taxpayers are subject to higher capital gain and qualified dividend tax rates. For tax years beginning in 2020, the long-term capital gain and qualified dividend tax rate is as follows:
- The 0% rate applies to –
    - Single filers with income up to $40,000,
    - Head of household filers with income up to $53,600,
    - Joint filers with income up to $80,000,
    - Trusts and estates with income up to $2,650;
- The 15% rate applies to –
    - Single filers with income between $40,000 and $441,450,
    - Married filers filing separately with income between $40,000 and $248,300,
    - Head of household filers with income between $53,600 and $469,050,
    - Joint filers with income between $80,000 and $496,600,
    - Trusts and estates with income between $2,650 and $13,150; and
- The 20% rate applies to –
    - Single filers with income exceeding $441,450,
    - Married filers filing separately with income exceeding $248,300,
    - Head of household filers with income exceeding $469,050,
    - Joint filers with income exceeding $496,600,
    - Trusts and estates with income exceeding $13,150.

Thumbnail Summary of 2020 Changes

Subject	**2020 Change**
Standard mileage rates	Charity - 14¢ Medical & moving – 17¢ Business – 57.5¢
Standard deduction	Married filing jointly & surviving spouses - $24,800 Married filing separately & single - $12,400 Head of household - $18,650 Additional standard deduction for blind or elderly: Married - $1,300 Head of household and single - $1,650
Personal exemption	Suspended under Tax Cuts and Jobs Act of 2017 beginning in 2018
Alternative minimum tax	Single and head of household - $72,700 exemption; 25% phaseout beginning at $518,400 taxable income Married filing jointly and qualifying widow(er) - $113,400 exemption; 25% phaseout beginning at $1,036,800 taxable income Married filing separately - $56,700 exemption; 25% phaseout beginning at $518,400 taxable income Estates and trusts - $25,400 exemption; 25% phaseout beginning at $84,800 taxable income
Education savings bond interest exclusion	Single, head of household and qualifying widow(er) – MAGI of $82,350 to $97,350 Married filing jointly - $123,550 to $153,550
Limitation on itemized deductions	Phase out of itemized deductions suspended under Tax Cuts and Jobs Act of 2017 beginning in 2018

Qualified LTCi premiums & benefits Limit on premium deduction	Age of taxpayer: 40 or younger - $430 41 to 50 - $810 51 to 60 - $1,630 61 to 70 - $4,340 71 or older - $5,430
Per diem limit on benefit exclusion	$380
Social Security taxable earnings limit	$137,700
Medical expense deduction threshold	7.5% of AGI for 2020

Chapter Review

1. Philip uses his personal vehicle for charitable purposes. If he drove 1,400 miles, spent $50 on gas and oil, $40 on parking fees, $60 on tolls and elected to use the standard mileage deduction, how much of the expenses would be tax-deductible?

   A. $0

   B. $196

   C. $296

   D. $346

2. Karl received qualified long term care insurance benefits in 2020 of $400 per day. How much of such daily benefits must he include in income, if any, assuming his actual long term care costs were $310 per day and the applicable per diem limitation is $380?

   A. $0

   B. $20

   C. $70

   D. $90

Chapter 2 – Tax Credit Changes

Introduction

Although the U.S. Tax Code serves as the legal authority facilitating the nation's funding, it is also an instrument through which the government attempts to bring about social change by encouraging certain types of behavior and discouraging other types. Many of the behaviors the federal government wishes to promote are encouraged through the use of tax credits. Principal among the tax credits providing such encouragement are the retirement savings contribution credit—often referred to as the "saver's credit"—and the child adoption credit. Other tax credits—the earned income credit, for example—are designed to provide additional funds to working taxpayers whose income is below certain levels. The limits affecting these and other credits may change from one year to the next.

This chapter will briefly discuss the principal tax credit changes for 2020.

Chapter Learning Objectives

Upon completion of this chapter, you should be able to:

- Calculate the retirement savings contribution credit available to eligible taxpayers;
- Recognize the rules and income limits applicable to eligibility for the earned income credit; and
- Apply the adoption credit rules.

Retirement Savings Contribution Credit

Traditional defined benefit pension plans in which employers provided virtually all the funding of employees' retirement income were among the most popular qualified plans sponsored by employers until the decade of the 1980s. Beginning in the early 1980s—a period characterized by abnormally high interest rates and rampant employer downsizing in an effort to bolster bottom lines—many employers terminated existing defined benefit pension plans under which they had enormous liability and began sponsoring the then-new 401(k) plans. These 401(k) plans shift the principal burden of providing employee retirement income from the employer to the employee. Studies have indicated that the level of employee participation in and contribution to these plans has generally been insufficient to enable the individual to maintain his or her lifestyle in retirement.

Since 401(k) plans were introduced, the tax code has been changed to provide an additional incentive for lower-income taxpayers to provide for their own retirement. The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) brought about the incentive by offering a tax credit—referred to as the Retirement Savings Contribution Credit or "saver's credit"—to make a retirement plan contribution.

The retirement savings contribution tax credit is a *nonrefundable* credit that is limited to the applicable percentage of the taxpayer's eligible retirement savings contributions; the credit cannot exceed $1,000 per taxpayer. A nonrefundable tax credit is a tax credit that is limited by the individual's tax liability and acts to reduce the amount of federal income tax payable. If a taxpayer has no income tax liability, or has an income tax liability that is less than the tax credit, a nonrefundable tax credit will not result in a payment of any amount in excess of the taxpayer's tax liability from the federal government.

The retirement savings contribution tax credit, if any, for which a taxpayer is eligible does not affect the tax treatment to which the contribution would normally be subject. For example, if a taxpayer's contribution to a traditional individual retirement account made him or her eligible for the credit, the taxpayer would still normally be able to take a tax deduction for the IRA contribution. In other words, retirement savings contributions made by individuals who are otherwise eligible for the tax credit receive the credit *in addition to* enjoying any other tax advantages for which they are eligible.

Saver's Credit Applicable to Range of Retirement Contributions

The retirement savings contribution credit is available to taxpayers who make a wide range of retirement plan contributions. The retirement plan contributions eligible for the credit are contributions to traditional and Roth individual retirement arrangements (IRAs) and elective deferrals to:

- 401(k) plans;
- 403(b) tax sheltered annuity plans;
- Section 457 governmental plans;
- SIMPLE IRAs; and
- Salary reduction SEPs (SARSEPs).

In addition, the SECURE Act amends the term "compensation," for purposes of the retirement savings tax deduction to include any amount included in the taxpayer's gross income and paid to the taxpayer in the pursuit of graduate or postdoctoral studies. The SECURE Act addition is effective for years after December 31, 2019. Thus, a contribution to an IRA based on that compensation could enable the recipient, if otherwise eligible, to qualify for a saver's credit. Despite the number of plans to which the taxpayer makes contributions and the amount of those contributions, the total saver's credit will not exceed $1,000 per taxpayer for the year.

Saver's Credit Eligibility Based on Income and Filing Status

The percentage of the retirement savings contribution (not exceeding $2,000) available to the taxpayer as a tax credit, up to the $1,000 maximum tax credit, depends upon the individual's adjusted gross income and income tax filing status. The applicable percentages for 2020 retirement contributions are as shown below:

Saver's Credit Adjusted Gross Income Limits (2020)[2]						
Joint Return		**Head of Household Return**		**All Other Statuses**		**Applicable Credit**
Over	Not over	Over	Not over	Over	Not over	Percentage
$0	$39,000	$0	$29,250	$0	$19,500	50%
$39,000	$42,500	$29,250	$31,875	$19,500	$21,250	20%
$42,500	$65,000	$31,875	$48,750	$21,250	$32,500	10%
$65,000		$48,750		$32,500		0%

Since the maximum tax credit percentage is 50% and the maximum contribution eligible for the tax credit is $2,000, the maximum retirement savings contribution tax credit that may be taken for 2020 is $1,000 per taxpayer. For example, suppose Bill and Trudy Smith file a joint federal income tax return and have an adjusted gross income of $39,000. If Bill and Trudy each make a $2,000 eligible retirement savings contribution—to an IRA, a 401(k), 403(b), or other eligible plan—they would receive a total tax credit of $2,000, i.e. $1,000 for each of them. ($4,000 x 50% = $2,000) If their adjusted gross income was $39,001, however, their total tax credit would be reduced to $800 because the applicable percentage falls to 20%. ($4,000 x 20% = $800)

When taking the credit, a taxpayer must subtract the amount of any distributions received from his or her retirement plans from the contributions made. The distributions that must be subtracted for purposes of determining the saver's credit are those received:

- During the two years before the year the credit is claimed;
- In the year the credit is claimed; and
- The period after the end of the credit year but before the due date (including any extensions) for filing the return for the credit year.

[2] Note that the adjusted gross income limits may change from year to year.

The saver's credit is not available to a taxpayer who a) is single, married filing separately or a qualifying widow(er) with a 2020 income of more than $32,500, b) is a head of household with a 2020 income of more than $48,750, or c) files a return as married filing jointly with a 2020 income of more than $65,000.

Earned Income Credit

The earned income credit (EIC) is a tax credit for certain low-income working taxpayers who meet income, filing status and other requirements. Eligibility to claim the credit requires, among other things, that the taxpayer have an earned income; the taxpayer must also have an adjusted gross income (AGI) below a specific level. The applicable AGI level generally changes annually. Unlike the saver's credit, EIC is a *refundable* credit and, accordingly, it is available to eligible individuals regardless of whether or not they have a federal income tax liability.

In order to receive EIC, the taxpayer must meet certain rules. The EIC rules fall into three categories:

- Rules that apply to everyone;
- Rules that apply if the taxpayer has a qualifying child; and
- Rules that apply if the taxpayer does not have a qualifying child.

EIC Rules Applicable to Everyone

Determining whether a taxpayer qualifies for EIC begins with the seven rules that apply to everyone. If the taxpayer meets all of the seven rules that apply to everyone, the taxpayer must then meet the additional rules that apply a) if the taxpayer has a qualifying child, or b) if the taxpayer does not have a qualifying child.

The rules for everyone relate to:

- Adjusted gross income (AGI) limits;
- Social Security number;
- Tax filing status;
- Citizenship or residency;
- Foreign earned income;
- Investment income; and
- Earned income.

If the taxpayer does not meet all seven of the rules applicable to everyone, the taxpayer cannot receive the earned income credit, regardless of whether or not the taxpayer has a qualifying child.

Adjusted Gross Income Limits

To meet the rule concerning adjusted gross income limits, a taxpayer must have an AGI that is less than the maximum amount for his or her filing status and number of qualifying children. The applicable AGI limits generally change each year and, for 2020, are as shown in the following chart:

2020 EIC ADJUSTED GROSS INCOME LIMITS		
Children	**Married Filing Jointly**	**Other Than Married Filing Jointly***
3 or more qualifying children	$56,844	$50,954
2 qualifying children	$53,330	$47,440
1 qualifying child	$47,646	$41,756
No qualifying children	$21,710	$15,820

*Taxpayer's filing status cannot be married filing separate.

Valid Social Security Number Required

In order to claim the EIC, the taxpayer—and spouse, if filing a joint return—must have a valid social security number issued by the Social Security Administration. In addition, if a qualifying child is listed

on Schedule EIC the child must also have a valid social security number. A social security card stating "Not valid for employment" is not sufficient for purposes of the EIC.

Tax Filing Status

A married taxpayer cannot qualify for the EIC if he or she has a "married filing separate" filing status. If the taxpayer is married, he or she must normally file a joint return to claim the EIC. (An exception may apply if the taxpayer's spouse did not live with the taxpayer during the last 6 months of the year. In such a case, the taxpayer may be able to file as head of household and claim the EIC.)

Citizenship or Residency

If the taxpayer (or spouse, if married) was a nonresident alien for any part of the tax year, the taxpayer cannot claim the EIC unless the taxpayer's filing status is married filing jointly. (Such filing status is available only if one spouse is a U.S. citizen or resident alien and chooses to treat the nonresident spouse as a U.S. resident.) If the taxpayer or spouse was a nonresident alien for any part of the year and the taxpayer's filing status is other than married filing jointly, the EIC is not available.

Note: Making the election to treat the nonresident spouse as a U.S. resident will cause the worldwide income of both spouses to be subject to U.S. taxation.

Foreign Earned Income

A taxpayer is ineligible for the EIC if he or she files Form 2555, Foreign Earned Income, or Form 2555-EZ, Foreign Earned Income Exclusion. These forms are used to exclude income earned in foreign countries from the taxpayer's gross income or to exclude a foreign housing amount.

Investment Income

The 2020 investment income of a taxpayer eligible for EIC cannot be greater than $3,650. If the taxpayer's investment income is greater than $3,650, the taxpayer is ineligible for the EIC.

Earned Income

A taxpayer eligible for the EIC must work and have earned income. The requirements of the earned income rule are met if the taxpayer is married, files a joint return and at least one spouse works and has earned income. Eligibility for the EIC does not require that both spouses be employed.

Earned income includes:

- Wages, salaries, tips and other taxable employee pay;
- Net earnings from self-employment; and
- Gross income received by the taxpayer as a statutory employee.

Although earned income generally excludes non-taxable pay, a taxpayer can elect to include non-taxable combat pay in earned income for purposes of the EIC.

EIC Rules That Apply if Taxpayer Has a Qualifying Child

In addition to meeting the EIC rules that apply to everyone, a taxpayer who has a qualifying child must meet certain other rules in order to qualify for the EIC. The rules applicable to a taxpayer with a qualifying child are:

- The relationship, age, residence and joint return tests;
- The qualifying child of more than one person rule; and
- The qualifying child of another taxpayer rule.

Relationship, Age, Residence and Joint Return Tests

A taxpayer's child is a qualifying child for purposes of the EIC if the child meets four tests:

- The relationship test;
- The age test;
- The residency test; and
- The joint return test.

All four tests must be met.

Qualifying Child of More than One Person Rule

In some cases, a child may meet the tests to be a qualifying child of more than one person. However, even if a child meets the tests to be a qualifying child of more than one person, only one person is permitted to treat the child as a qualifying child. Only that person is permitted to use the child as a qualifying child to take all the following tax benefits, assuming the taxpayer is eligible for each benefit:

- The exemption for the child;
- The child tax credit;
- Head of household filing status;
- The credit for child and dependent care expenses;
- The exclusion for dependent care benefits; and
- The EIC.

The other person cannot take any of these benefits based on the same qualifying child. Accordingly, the taxpayer and the other person cannot divide these tax benefits between themselves based on the same child. In the event the taxpayer and another person meet the qualifying child tests, the tiebreaker rules are used to determine which person can treat the child as a qualifying child.

However, the IRS has recently changed its position so that even if a taxpayer is not permitted to claim an individual as a qualifying child after application of the tiebreaker rules, the taxpayer may still be able to claim the EITC without a qualifying child ***for all open tax years*** if all other requirements are met. In such a case, the taxpayer not claiming the EITC with the qualifying child may become an eligible individual for claiming the EITC without a qualifying child if the taxpayer otherwise qualifies and meets ***all*** the following rules:

- A resident of the United States for more than half of the year,
- Cannot be claimed as a dependent or qualifying child on anyone else's return, and
- Be at least 25 but under 65 years old at the end of the tax year.

Taxpayer as the Qualifying Child of Another Taxpayer Rule

A taxpayer cannot claim the EIC if he or she is a qualifying child of another taxpayer. A taxpayer is considered a qualifying child of another person only if *all* of the following are true:

- The taxpayer is the other taxpayer's son, daughter, stepchild, grandchild, or foster child;
- The taxpayer is the brother, sister, half-brother, half-sister, stepbrother, or stepsister (or a child or grandchild of the brother, sister, half-brother, etc.) of the other taxpayer;
- The taxpayer was –
  - Under age 19 at the end of the tax year and younger than the other taxpayer (or spouse, if the other taxpayer files jointly),
  - Under age 24 at the end of the tax year, a student, and younger than the other taxpayer (or spouse, if the other taxpayer files jointly), or
  - Permanently and totally disabled, regardless of age;
- The taxpayer lived with the other taxpayer in the United States for more than half of the year; and
- The taxpayer is not filing a joint return for the year (or is filing a joint return only as a claim for an income tax refund).

EIC Rules That Apply if Taxpayer Does Not Have a Qualifying Child

A taxpayer may claim the EIC without a qualifying child, provided the taxpayer meets all the rules that apply to everyone and all the following rules that apply to taxpayers without qualifying children. The EIC rules applicable to a taxpayer with no qualifying children are:

- The age rule;
- The dependent of another person rule;
- The qualifying child of another taxpayer rule; and
- The main home rule.

The Age Rule

A taxpayer claiming the EIC must be at least age 25 but less than age 65 at the end of the tax year. If the taxpayer is married filing a joint return, either the taxpayer or spouse must be at least age 25 but under age 65 at the end of the year. Either spouse may meet the age test as long as one of the

spouses does. A surviving spouse filing a joint return with a deceased spouse who died during the tax year meets the age test if the deceased spouse was at least age 25 but under age 65 at the time of death.

The Dependent of Another Person Rule

A taxpayer claiming the EIC cannot be the dependent of another person, regardless of whether or not the other person actually claimed the taxpayer as a dependent. Thus, if someone else can claim the taxpayer (or the taxpayer's spouse, if filing a joint return) as a dependent, the taxpayer cannot claim the EIC.

The Qualifying Child of Another Taxpayer Rule

A taxpayer claiming the EIC cannot be a qualifying child of another taxpayer. As noted earlier, a taxpayer is a qualifying child of another person if all of the following are true:

- The taxpayer is the other person's son, daughter, stepchild, grandchild, or foster child;
- The taxpayer is the brother, sister, half-brother, half-sister, stepbrother, or stepsister (or a child or grandchild of the brother, sister, half-brother, etc.) of the other person;
- The taxpayer was –
    - Under age 19 at the end of the tax year and younger than the other person (or spouse, if the other person files jointly),
    - Under age 24 at the end of the tax year, a student, and younger than the other person (or spouse, if the other person files jointly), or
    - Permanently and totally disabled, regardless of age;
- The taxpayer lived with the other person in the United States for more than half of the year; and
- The taxpayer is not filing a joint return for the year (or is filing a joint return only as a claim for an income tax refund).

The Main Home Rule

Under the main home rule, a taxpayer claiming the EIC must have lived in the United States more than half the year. A taxpayer will meet this rule if he or she lived in the 50 states or the District of Columbia for more than half the year. It does not include Puerto Rico or U.S. possessions. The rule does not require that a taxpayer reside in a traditional home; instead, a taxpayer who lived in one or more homeless shelters in the United States for more than half the year will meet the rule.

U.S. military personnel stationed outside the United States on extended active duty are considered to live in the United States during that duty period for purposes of the EIC.

Figuring the Amount of the Earned Income Credit

If the taxpayer meets all of the rules applicable to his or her claiming EIC, the next step is figuring the amount of EIC. Determining the earned income credit is done on either EIC Worksheet A or EIC Worksheet B, as discussed below:

- **EIC Worksheet A** is used if the taxpayer was not self-employed at any time during the tax year and was not a member of the clergy, a church employee who files Schedule SE, or a statutory employee filing schedule C or C-EZ.
- **EIC Worksheet B** is used if the taxpayer was self-employed at any time during the year or was a member of the clergy, a church employee who files schedule SE or a statutory employee filing schedule C or C–EZ.

Adoption Credit/Exclusion

The adoption credit is a nonrefundable tax credit designed to offset qualified adoption expenses for eligible taxpayers adopting an eligible child or children. The adoption assistance program enables a taxpayer to exclude from income amounts a) paid by the taxpayer to adopt an eligible child or b) paid for the taxpayer by an employer to offset qualified adoption expenses under a qualified adoption assistance program.

The American Taxpayer Relief Act, legislation enacted on January 2, 2014, permanently extended the adoption credit and adoption assistance programs for tax years beginning after December 31, 2012.

Both the adoption credit and exclusion from income are subject to phase out and elimination at higher incomes.

Let's briefly consider the rules associated with the adoption credit and income exclusion for employer-provided adoption benefits.

Eligible Child

An eligible adopted child, for whose adoption expenses an adoption credit or exclusion could apply, may be a) a U.S. citizen or resident, or b) a foreign child. However, the rules concerning the benefit vary somewhat depending upon the citizenship status of the adopted child and whether the child has special needs.

A child whose qualified adoption expenses may give rise to the adoption credit or exclusion is a child who is:

- Under age 18 (if the child turned age 18 during the year, the child is an eligible child for the part of the year he or she was under age 18); or
- A disabled individual physically or mentally unable to care for himself or herself, regardless of age; such a child is generally referred to in connection with the adoption credit and exclusion as a "special needs" child.

Qualified Adoption Expenses

Qualified adoption expenses are those expenses that are reasonable and necessary and which are related to, and for the principal purpose of, a legal adoption of an eligible child. Such expenses include:

- Adoption fees;
- Attorney fees;
- Court costs;
- Travel expenses, including meals and lodging, while away from home; and
- Re-adoption expenses relating to the adoption of a foreign child.

Expenses that are not considered qualified adoption expenses for purposes of the adoption credit or exclusion include expenses:

- For which the taxpayer received funds under a state, local, or federal program;
- That violate state or federal law;
- For carrying out a surrogate parenting arrangement;
- Paid or reimbursed by the taxpayer's employer or any other person or organization; or
- Allowed as a credit or deduction under any other provision of federal income tax law.

The Benefit

A taxpayer may be able to take the adoption credit or exclusion if the following criteria are met:

1. The taxpayer's filing status is single, head of household, qualifying widow(er), or married filing jointly. In most cases, a married taxpayer must file a joint return in order to take the credit or exclusion;
2. The taxpayer's modified adjusted gross income (MAGI) is less than the applicable limit for the year; and
3. The taxpayer reports the required information concerning the eligible child in part I of IRS Form 8839.

Timing of the Credit/Exclusion

The year in which the taxpayer can take the adoption credit or exclusion depends upon whether the eligible child is a citizen or resident of the United States at the time the adoption effort began. If the eligible child is a U.S. citizen or resident—an adoption referred to as a "domestic adoption"—the taxpayer can take the adoption credit or exclusion even if the adoption never became final.

The year in which a taxpayer may take the credit or exclusion in connection with a domestic adoption is as shown in the following table:

Domestic Adoptions

Qualifying Expenses Paid by Taxpayer in…	**Credit Taken in…**
Any year before the year the adoption becomes final	The year after the year of the payment
The year the adoption becomes final	The year the adoption becomes final
Any year after the year the adoption becomes final	The year of the payment
Qualifying expenses paid by an employer under an adoption assistance program in…	**Exclusion Taken in…**
Any year	The year of the payment

A taxpayer who adopts a U.S. child with special needs may be able to exclude up to the maximum amount **and** take a credit for additional expenses up to the maximum amount. The exclusion may be available even if neither the taxpayer nor the taxpayer's employer paid any qualified adoption expenses.

The year in which a taxpayer may take the credit or exclusion in connection with a foreign adoption is similarly shown in the chart below (foreign adoption rules that vary from domestic adoption rules are highlighted):

Foreign Adoptions

Qualifying Expenses Paid by Taxpayer in…	**Credit Taken in…**
Any year before the year the adoption becomes final	The year the adoption becomes final
The year the adoption becomes final	The year the adoption becomes final
Any year after the year the adoption becomes final	The year of the payment
Qualifying expenses paid by an employer under an adoption assistance program in…	**Exclusion Taken in…**
Any year before the year the adoption becomes final	The year the adoption becomes final
The year the adoption becomes final	The year the adoption becomes final
Any year after the year the adoption becomes final	The year of the payment

Unlike the rules applicable to domestic adoptions that permit a taxpayer to take the adoption credit or exclusion even if the adoption never became final, an adoption credit or exclusion for a foreign adoption is available to a taxpayer only if the adoption becomes final.

Benefit Phased-Out at Higher Taxpayer MAGI

In 2020, the maximum adoption credit is $14,300 per child. Similarly, the maximum amount of employer-provided adoption assistance that a taxpayer may exclude from gross income in 2020 is $14,300 per child. The amount of the adoption credit or excludable assistance, however, is phased out for taxpayers whose 2020 modified adjusted gross income (MAGI) exceeds $214,520 (the "applicable amount") and is eliminated for taxpayers whose MAGI is $254,520 or more.

The reduction in the maximum adoption credit or exclusion for taxpayers whose MAGI exceeds the applicable amount may be determined by using the following equation:

$$\text{Maximum adoption credit/excludable amount} \times \frac{\text{MAGI} - \text{Applicable amount}}{\$40{,}000} = \text{Reduction in maximum adoption credit/excludable amount}$$

Thumbnail Summary of 2020 Changes

Subject	**2020 Change**

Saver's credit	Available at AGI up to: Married filing jointly - $65,000 Head of household - $48,750 All other statuses - $32,500
Earned income credit AGI limits	Married filing jointly: 3 or more children - $56,844 2 children - $53,330 1 child - $47,646 No children - $21,710 Other qualifying statuses: 3 or more children - $50,954 2 children - $47,440 1 child - $41,756 No children - $15,820
Adoption credit/excluded assistance Maximum amount Phase-out MAGI range	 $14,300/child $214,520 to $254,520

Chapter Review

1. Hank is single and has a $30,000 adjusted gross income in 2020. What would his saver's credit be if he deferred $1,000 in his employer's 401(k) plan and received a $500 employer match?

   A. $100

   B. $150

   C. $200

   D. $500

2. Sally made a $4,000 traditional IRA contribution in 2020 and received a $1,000 saver's credit. If she would be eligible to deduct the contribution in the absence of a saver's credit, how much of her contribution may she deduct?

   A. $0

   B. $2,000

   C. $3,000

   D. $4,000

Chapter 3 – PPACA-Related Tax Changes

Introduction

In addition to its various healthcare-related provisions, the PPACA also brought about several changes that affect the tax liability of many taxpayers. They include changes in allowable health flexible spending arrangement contributions, unreimbursed medical expense deductions and Social Security tax rates for higher-income taxpayers. In 2020 additional changes may affect taxpayers, including a) an increase in the limit for employee contributions to an employer-sponsored health care flexible spending arrangement, b) an increase in the level of a small employer's average annual wages at which the health care premium credit is phased out, and c) changes in the employer mandate under which large employers employing 100 or more full-time employees are required to offer affordable health insurance coverage and make contributions toward premiums or potentially pay a penalty.

In this chapter we will briefly summarize the principal tax changes that became effective as a result of passage of the healthcare law and will then discuss the changes effective in 2020.

Chapter Learning Objectives

Upon completion of this chapter, you should be able to identify the changes effective in 2020 related to the –

- Health flexible spending arrangement contribution limits;
- Small business health care tax credit; and
- Large employer shared responsibility provision.

Health Flexible Spending Arrangement Contributions

Health FSAs enable workers to contribute before-tax amounts to an account that may then be accessed tax-free to pay various out-of-pocket health-related expenses. Although annual caps on the amount that can be contributed to a health FSA are generally imposed by employers—usually as a way to limit their risk of pre-funding—no limit was previously imposed by the federal government. That changed for years 2013 and later.

For years 2013 and 2014 a $2,500 per year limit was imposed on the amount that may be contributed to a flexible spending arrangement for medical expenses. That limit may be increased annually by a cost of living adjustment and, for 2020, is $2,750.

PPACA's Individual Shared Responsibility Provision

The individual shared responsibility provision of the PPACA—sometimes referred to as the "individual mandate"—imposes a tax penalty for failure to maintain minimum essential coverage. Any tax penalty imposed under the provision—a penalty called an "individual shared responsibility payment"—for the failure to maintain minimum essential coverage is payable when the taxpayer files his or her federal income tax return. The tax penalty for failure to maintain minimum essential coverage remained the same for 2018. However, under the Tax Cuts and Jobs Act of 2017 the penalty for a failure to maintain minimum essential coverage for years after 2018 is reduced to zero.

In December 2019 a federal appeals court ruled that the Affordable Care Act's requirement that individuals maintain health insurance coverage was unconstitutional but sent the case back to the district court to rule on which of the law's other provisions could survive without the individual mandate. Regardless of this ruling, however, it is expected to be a long time before anything actually changes.

Refundable Premium Tax Credit to Assist in Purchase of Qualified Health Plan

Although the tax penalty for a taxpayer's failure to maintain health coverage has been reduced to zero, individuals who meet specified income, coverage and other criteria are eligible to receive a refundable tax credit to enable them to purchase a qualified health plan. Since the tax credit is a *refundable* tax credit, the taxpayer may receive the credit even though he or she has no income tax liability.

Eligibility for Credit

Individuals are eligible to receive a refundable tax credit for purchase of one or more qualified health plans provided they meet all of the following criteria:

- The covered individuals are enrolled in a qualified health plan through an Affordable Insurance Exchange;
- The individual's household income is between less than 133% and 400% of the federal poverty level;
- Covered individuals are legally present in the United States and not incarcerated;
- Covered individuals are not eligible for other qualifying coverage, such as Medicare, Medicaid, or affordable employer-sponsored coverage; and
- The individual cannot be claimed as a dependent by another person.

In order to be eligible for a premium tax credit, a taxpayer who is married at the close of the taxable year must file a joint income tax return, unless he or she meets the criteria that allow victims of domestic abuse to claim the premium tax credit for the year while using the Married Filing Separately filing status. The applicable criteria an otherwise eligible married taxpayer filing a tax return as Married Filing Separately must meet in order to be eligible for the credit are that the taxpayer:

1. Is living apart from his or her spouse at the time the taxpayer files the tax return;
2. Is unable to file a joint return because the taxpayer is a victim of domestic abuse; and
3. Indicates on the tax return that he or she meets criteria 1 and 2 above.

Federal Poverty Level

The federal government's poverty level is based on the amount of income received in a year relative to annually-published poverty guidelines. The incomes in the guidelines, which are published by the federal government in January each year, generally increase annually to account for the higher prices for goods and services that result from inflation.

The federal poverty guidelines are as shown in the chart below:

HHS Poverty Guidelines			
Persons in family/household	**48 Contiguous States and D.C.**	**Alaska**	**Hawaii**
1	$12,490	$15,600	$14,380
2	$16,910	$21,130	$19,460
3	$21,330	$26,660	$24,540
4	$25,750	$32,190	$29,620
5	$30,170	$37,720	$34,700
6	$34,590	$43,250	$39,780
7	$39,010	$48,780	$44,860
8	$43,430	$54,310	$49,940
For each additional person add	$4,420	$5,530	$5,080

Assuming the poverty guidelines for any subsequent year are as shown above (they typically would not be the same because of inflation), a taxpayer living in the contiguous 48 states, whose household is comprised of three persons and whose income is between $21,330 (see highlighted number in the chart) and $85,320, i.e. 400% of the federal poverty level, would have a household income that would make the taxpayer eligible for the credit. ($21,330 x 4 = $85,320)

Amount of the Credit

The amount of the tax credit for an eligible taxpayer is generally equal to the difference between the premium for the benchmark plan and the taxpayer's expected contribution, a contribution that increases as the taxpayer's income increases. The amount of the credit is capped at the premium for the plan chosen. Thus, the tax credit will never be larger than the premium for the plan.

Tax Credit = Benchmark Plan Premium - Taxpayer's Expected Contribution

Benchmark Plan

The "benchmark plan," as the term is used in connection with the insurance premium tax credit, is the second-lowest-cost plan that would cover the family at the silver level of coverage. The PPACA defines[3] such a silver level plan as one "designed to provide benefits that are actuarially equivalent to 70 percent of the full actuarial value of the benefits provided under the plan." In other words, the plan pays at least 70 percent of covered charges.

Taxpayer's Expected Contribution

The taxpayer's expected contribution, as the term is used with respect to the premium tax credit, is a specified percentage of the taxpayer's household income. The applicable percentage of the taxpayer's household income applicable in 2020 increases—from 2.06% of income for families at less than 133% of the federal poverty level to 9.78% of income for families at 300% to 400% of the federal poverty level—as the taxpayer's income increases. The amount a family actually pays for coverage will be less than the expected contribution if the family chooses a plan that is less expensive than the benchmark plan.

The income percentages, based on the taxpayer's household income as a percentage of the federal poverty line, are as shown in the table below:

Household Income Percentage of Federal Poverty Line – 2020	Initial Percentage	Final Percentage
Less than 133%	2.06	2.06
At least 133% but less than 150%	3.09	4.12
At least 150% but less than 200%	4.12	6.49
At least 200% but less than 250%	6.49	8.29
At least 250% but less than 300%	8.29	9.78
At least 300% but less than 400%	9.78	9.78

Calculating the Credit

The tax credit available for premium assistance for a coverage month is equal to the lesser of:

1. The premiums for the month for one or more qualified health plans in which a taxpayer or member of the taxpayer's family enrolls; or
2. The excess of the adjusted monthly premium for the benchmark plan over 1/12th of the product of a taxpayer's household income and the applicable percentage for the taxable year. (see **Adjusted Monthly Premium** below.)

Although the language of the regulations makes the calculation of the second part of the tax credit appear complicated, the calculation is fairly simple and is more readily understood by considering an equation. Thus, in the form of an equation, the calculation of the second component of the tax credit is as follows:

$$\text{Adjusted monthly premium for the benchmark plan} - \frac{\text{Taxpayer's household income x applicable \%age}}{12} = \text{Tax credit (component 2)}$$

[3] Affordable Care Act §1302(d)(1)(B).

We can illustrate how component 2 is determined by looking at an example. For purposes of the example, assume the following:

Adjusted monthly premium: $1,000 Taxpayer's household income: $58,657 Members of taxpayer's family: 3 Applicable poverty level guideline: $21,330

The only value that we need to calculate before substituting them into the equation is the applicable percentage that is multiplied by the taxpayer's household income.

The following steps will produce the correct applicable percentage for the equation:

1. Divide the taxpayer's household income ($58,657) by the applicable poverty level guideline for a three-person household ($21,330); by doing so, we can see that the taxpayer's household income is 275% of the poverty level. ($58,657 ÷ $21,330 = 2.75 = 275%)
2. Consult the household income percentage chart (above) to determine the initial and final percentages for the taxpayer's household income; by doing so, we see that the initial percentage for a taxpayer whose household income is between 250% and 300% of the federal poverty level is 8.29%; the final percentage is 9.78%.
3. Determine the excess of the taxpayer's federal poverty line percentage over the initial household income percentage in the taxpayer's range; that amount is 25. (275% - 250% = 25)
4. Determine the difference between the initial household income percentage and the final household income percentage in the taxpayer's range, which is 50. (300% - 250% = 50)
5. Divide the result in step 3 by the result in step 4; the answer is .50. (25 ÷ 50 = .50)
6. Subtract the initial percentage (8.29%) from the final percentage (9.78%) in the taxpayer's range; the amount is 1.49. (9.78 – 8.29 = 1.49)
7. Multiply the result obtained in step 6 by the result obtained in step 5; that calculation yields .745. (1.49 x .50 = .745)
8. Add the result obtained in step 7 (.745) to the initial premium percentage in the taxpayer's range to calculate the applicable percentage; the result is 9.04. (8.29% + .745% = 9.035% = 9.04%)

Now that we have the applicable percentage value, we can substitute the amounts into the equation to determine component 2 of the tax credit calculation as follows:

$$\$1,000 \quad - \quad \frac{\$58,657 \times .0904}{12} \quad = \quad \$558.12$$

By solving the equation, we see that component 2 of the tax credit calculation for any month is $558.12. Since $558.12 is less than the $1,000 monthly premium (component 1), it is the tax credit available as a premium assistance amount. The balance of the monthly premium—$441.88 in this case—is the taxpayer's contribution. The tax credit for the entire year would be $6,697.44. ($558.12 x 12 = $6,697.44) (Note: The CBO estimates that, when the PPACA is completely phased in, individuals receiving premium tax credits will receive an average subsidy of more than $5,000 annually.)

Adjusted Monthly Premium

The term used for the monthly premium in the final regulations implementing the PPACA when calculating the tax credit is *adjusted monthly premium* rather than simply *monthly premium*. The "adjusted monthly premium" used in the calculation of the credit is the premium an issuer would charge for the applicable benchmark plan to cover all members of the taxpayer's coverage family, *adjusted only for the age of each member*.

Thus, the adjusted monthly premium for purposes of the credit:

- Is determined without regard to any premium discount or rebate under a wellness program. Thus, participation in such a program could reduce the taxpayer's actual premium without reducing the credit to which the taxpayer is entitled under the PPACA; and

- Does not include any adjustments for tobacco use. Accordingly, although tobacco use could increase a taxpayer's premium, any increased premium reflecting tobacco use would not increase the taxpayer's credit.

Special Rules Applicable to the Tax Credit

Although tax credits are normally applied at the conclusion of the year, the premium tax credit may be advanced if desired by the taxpayer. Such advance payments are made directly to the insurer on the taxpayer's behalf. When the taxpayer's federal income tax return is filed, the advance payments are reconciled with the amount of the taxpayer's actual premium tax credit. Although a repayment of the advance payment may be due, any repayment due from the taxpayer may be subject to a cap. (See **Reconciling Advance Premium Tax Credits** below.)

Tax credits are also available to qualified individuals who are offered, but not enrolled in, employer-sponsored insurance. Such tax credits are available only if:

- The self-only premium payable by the taxpayer under the employer-sponsored insurance would exceed 9.5% of household income (9.86% in 2019 and 9.78% in 2020); or
- The employer-sponsored insurance does not provide a minimum value, i.e. it covers less than 60% of total covered costs.

Reconciling Advance Premium Tax Credits

If advance premium tax credits are provided for a taxpayer, the individual must file a federal income tax return for that year. Such advance credits must be reconciled at the time of filing the individual's federal income tax return for the year in which advance credits were received. The tax credit is computed on the taxpayer's return using the taxpayer's family size and household income for the taxable year. Since a taxpayer's actual modified adjusted gross income for the year may be larger or smaller than expected at the time of determining the advance tax credits, the advance premium tax credits paid to the insurer may be more or less than the amount for which a taxpayer is eligible.

A taxpayer whose premium tax credit for the taxable year exceeds the taxpayer's advance credit payments may receive the excess credit as an income tax refund, regardless of whether the taxpayer has any federal income tax liability. A taxpayer whose advance credit payments for the taxable year exceed the premium tax credit for which the taxpayer is eligible owes the excess as an additional income tax liability, subject to any applicable limitation (discussed next).

Additional Tax Limitation

In general, if the reconciliation of the premium tax credit with advance tax credit payments made on behalf of the taxpayer shows an excess payment, that excess is owed by the taxpayer as an additional income tax liability. In certain cases, however, the amount of any additional income tax liability resulting from such excess payment may be limited.

The additional tax imposed on a taxpayer because of excess advance credit payments is limited to the dollar amounts in the additional tax limitation table if the taxpayer's household income is less than 400% of the federal poverty line. The dollar limit on the additional tax depends upon the taxpayer's filing status and his or her household income as a percentage of the federal poverty line.

The limits for 2020 are as shown in the additional tax limitation table below:

2020 - Additional Tax Limitation Table*

Household Income Percentage of Federal Poverty Line	**Limitation Amount for Unmarried Individuals (other than surviving spouses or heads of households)**	**Limitation Amount for All Other Taxpayers**
Less than 200%	$325	$650
At least 200% but less than 300%	800	1,600
At least 300% but less than 400%	1,350	2,700

*Subject to inflation adjustment.

Small Business Tax Credit

Small employers may be eligible to receive a nonrefundable tax credit for premiums paid for employee health insurance coverage. The credit may be carried back one year and forward 20 years.

The credit is available to eligible employers for two consecutive taxable years and is subject to limitations based on:

- The number of employees; and
- The average annual wages paid to employees.

The maximum small employer health insurance premium credit available to eligible small employers is 50% of workers' healthcare premiums paid by small employers and 35% of such premiums paid by small tax-exempt employers, such as charities. If an employer receives a tax credit for premiums paid, its tax deduction for the cost of providing health insurance coverage is reduced by the amount of the credit.

Eligibility Requirements

Not all small employers are likely to be eligible to receive the small employer health insurance premium credit. The credit is available only if the employer meets the following three requirements:

1. The employer paid premiums for employee health insurance coverage under a qualifying arrangement—one under which the employer is required to pay at least 50% of the premium for the employee—obtained through a Small Business Health Options Program (SHOP);
2. The employer had fewer than 25 full-time equivalent employees, not counting employees with ownership interest, for the tax year; and
3. The employer paid average annual wages for the tax year of less than $50,000 (indexed for inflation) per full-time equivalent employee.

Small employer health insurance premium tax credits are available for no more than two consecutive years.

Limitations Affect Health Insurance Premium Credit

Various limitations may apply that have the effect of reducing any health insurance premium credit to which a small employer is entitled. Those limitations are the:

- Full-time equivalent employee (FTE) limitation;
- Average annual wage limitation;
- State average premium limitation; and
- State premium subsidy and tax credit limitation.

Full-Time Equivalent Employee (FTE) Limitation

A small employer's health insurance premium credit will be reduced if the employer had more than 10 FTEs for the tax year. If the employer had 25 or more FTEs for the tax year, the credit is reduced to zero. A small employer has 1 FTE for each 2,080 hours worked by an individual considered an employee.

Average Annual Wage Limitation

A small employer's health insurance premium credit is also reduced if the employer paid average annual wages of more than $25,000 (inflation-adjusted to $27,100 in 2019 and $27,600 in 2020) for the tax year and is eliminated if the employer paid average annual wages of $50,000 or more for the tax year ($54,200 in 2019 and $55,200 in 2020). For purposes of the health insurance premium credit, the term "wages" means wages subject to Social Security and Medicare tax withholding determined without considering any wage base limit. For purposes of this limitation, wages paid to a seasonal employee who worked 120 or fewer days during the tax year should not be included.

In order to figure the average annual wages an employer paid for the tax year, follow the steps below:

1. Figure the total wages paid for the tax year to all individuals considered employees; and

2. Divide the total wages paid by the employer by the number of FTEs the employer had for the tax year.

If the result of the following the steps above is not a multiple of $1,000—$1,000, $10,000 or $20,000, for example—the result should be rounded down to the next lowest multiple of $1,000. Thus, if the result is $25,750, it should be rounded down to $25,000.

Average Premium Limitation

A small employer's credit is reduced if the employer premiums paid are more than the employer premiums that would have been paid if individuals who are considered employees enrolled in a plan with a premium equal to the average premium for the small group market in the rating area in which the employee enrolls for coverage.

The average premium for the small group market in the rating area in which the employee enrolls is determined by referring to the current table of average premiums for small group markets which is contained in the IRS Form 8941 instructions for the applicable tax year. A small excerpt from a representative table listing the average premiums for small group markets by rating area within a state is shown below:

Average Premiums Needed To Figure Adjusted Amounts on Worksheet 4 (sample only*)

County	Employee-Only	Dependent, Family	County	Employee-Only	Dependent, Family
Albemarle	$5,363	$13,185	Williamsburg City	$5,433	$11,739
Alexandria City	7,961	16,808	Winchester City	5,463	13,270
Amelia	4,946	12,006	York	5,417	12,125
Amherst	4,546	10,575	All others	6,153	15,367

*NOT a current table; provided only to illustrate determination of adjusted amounts.

State Premium Subsidy and Tax Credit Limitation

A small employer's premium tax credit may be reduced if the employer is entitled to a state tax credit or a state premium subsidy for the cost of health insurance coverage it provides under a qualifying arrangement to individuals considered employees. Even though a state tax credit or premium subsidy does not reduce the amount of the employer premiums paid, the amount of an employer's credit cannot be greater than its net premium payments.

(Net premium payments are employer premiums paid less the amount of any state tax credits the employee or employer received or will receive and any state premium subsidies paid.)

Calculating the Credit

IRS Form 8941, **Credit for Small Employer Health Insurance Premiums**, is used to calculate the credit and is attached to the small employer's tax return. Several worksheets are used to assist preparers in figuring the amounts to report on various lines of the form, and those worksheets are contained in the instructions for Form 8941.

Large Employer Shared Responsibility: The Employer Mandate

The Affordable Care Act requires that large employers offer their full-time employees and dependents health plan coverage at least equal to minimum essential coverage or face a possible tax penalty. The possible penalties imposed on a large employer for failing to comply with the employer mandate vary, depending upon the nature of its noncompliance. Thus, liability for a penalty may arise as a result of:

- The employer's failure to offer coverage; or
- An employer's offering coverage whose employee received a premium tax credit.

Employers Not Offering Coverage

A large employer that does not offer full-time employees and their dependents the opportunity to enroll in minimum essential coverage under an employer-sponsored plan may be liable for a penalty[4] if one or more of its full-time employees enrolls in health insurance coverage through an exchange and receives a premium tax credit or cost-sharing reduction.

The penalty for each month in such a case is an amount equal to the number of the employer's full-time employees in excess of 30 multiplied by $1/12^{th}$ of \$2,000 adjusted for years after 2014. That penalty applies regardless of the number of employees who are enrolled in health insurance coverage obtained through a state exchange and who receive a tax credit or cost-sharing reduction. For calendar year 2018, the \$2,000 penalty is adjusted to \$2,500 for 2019 and is \$2,570 for 2020, i.e. \$214.17 per month.

For example, suppose only one employee of a large employer who does not offer health insurance coverage enrolled in health insurance coverage through an exchange and received a premium tax credit in 2020. If the employer employed 130 full-time employees, the penalty for which the employer would be liable is equal to:

(Full time employees – 30)	X	$\frac{\text{Annual penalty}}{12}$	=	Monthly penalty
(130 – 30)	X	$\frac{\$2,570}{12}$	=	\$21,417

If the employer provided no coverage for the entire year and its full-time employees remained at 130 throughout the year, the penalty for which the employer would be liable is \$257,000. (\$21,417 x 12 = \$257,000)

Since the liability imposed on a large employer for a failure to offer health insurance coverage to its full-time employees is triggered by an employee's obtaining health insurance coverage through a state exchange and receiving a tax credit or subsidy to assist in its purchase, an employer failing to offer such coverage may, nonetheless, avoid a penalty. Specifically, an employer who has no full-time employee whose income would qualify him or her for a subsidy when purchasing health insurance coverage through an exchange will not be liable for the penalty ***even though it offers no health insurance coverage to its full-time employees***.

Employers Offering Coverage

It is not only large employers who fail to offer coverage that may be liable for a penalty. In some cases, employers who offer health insurance coverage to their full-time employees may, nonetheless, be subject to a penalty. If a large employer offers coverage to its full-time employees but at least one full-time employee receives a premium tax credit or cost-sharing reduction, the employer is subject to a penalty. Thus, even if an applicable large employer offers coverage to at least 95% of its full-time employees and their dependents, it may be subject to a penalty if one or more of the full-time employees obtains a premium tax credit because the coverage fails to provide minimum value or its premium exceeds 9.78% (2020) of the individual's income[5] or the employee obtaining the premium tax credit is not one of the 95% of employees offered coverage.

Unlike the penalty to which an employer who fails to offer health insurance coverage to its full-time employees may be subject—whose penalty is based on the total number of full-time employees in excess of 30—the penalty applicable to an employer who offers coverage but whose employee purchases coverage through an exchange and receives a premium tax credit or subsidy is based solely on the number of full-time employees who actually purchase health insurance through a state exchange and receive a premium tax credit or cost-sharing reduction. For each full-time employee receiving a credit or subsidy through a state exchange, the penalty for any month is equal to $1/12^{th}$ of \$3,000, i.e. \$250. (\$3,000 ÷ 12 = \$250) For calendar year 2019, the penalty amount is adjusted to \$3,750 (\$312.50 per month); for calendar year 2020, the penalty amount is adjusted to \$3,860 (\$321.67 per month). Thus, if 25 employees of such large employer receive a credit or subsidy in

[4] IRC §4980H(a).

[5] IRC §4980H(b).

2020, the applicable employer penalty for that month would be $8,041.75. ($321.67 x 25 = $8,041.75)

The penalty for the month to which a large employer offering unaffordable coverage (or coverage failing to provide minimum value) to its full-time employees in 2020 would be subject is limited to no more than the penalty for which it would have been liable if it didn't offer coverage at all, i.e. an amount equal to the number of full-time employees in excess of 30 during the month multiplied by $1/12^{th}$ of $2,570. Accordingly, if the large employer employed 50 full-time employees in 2020, and 25 of those employees received a credit or subsidy, the applicable penalty limit would be the lesser of:

a) 25 x $321.67 (25 x $321.67 = $8,041.75), or
b) (50 – 30) x $214.17 (20 x $214.17 = $4,283.40)

Clearly, in such a case, the applicable monthly penalty for the employer who offered coverage in which 25 employees declined to participate and purchased coverage through an exchange and received a credit or subsidy would be the smaller of the two possible penalties, i.e. $4,283.40. ((50 – 30) x $214.17 = $4,283.40)

Thumbnail Summary of 2020 Changes

Subject	**2020 Change**
Individual mandate	All non-exempt individuals must have minimum essential coverage. However the penalty for failing to maintain coverage has been reduced to zero for 2019 and later.
Small business premium credit	Average annual wage at which small business premium credit begins to be reduced is increased to $27,550 in 2020.
Large employer mandate	Employers with 50 or more full-time employees must offer health coverage at least equal to minimum essential coverage to full-time employees and dependents or be subject to a possible tax penalty.

Chapter Review

1. Bob and Phyllis are married, and their household includes their 20 year-old daughter. Although they are not exempt from the federal requirement to maintain minimum essential healthcare coverage, they have chosen not to purchase it and have remained uncovered for the entire year. What is the *minimum penalty* for which they would be liable in 2020?

   A. $0

   B. $285

   C. $2,085

   D. $975

2. If a taxpayer's household income of $30,000 places the taxpayer at 110% of the federal poverty level, what is the taxpayer's normal expected contribution when calculating the refundable tax credit for which the taxpayer may be eligible under the PPACA to purchase a qualified health plan in 2020?

   A. $0

   B. $300

   C. $618

   D. $1,200

Chapter 4 – Changes in Archer MSAs, HSAs & IRAs

Introduction

Archer medical savings accounts and health savings accounts permit taxpayers to make deductible contributions annually to a trust from which they can take tax-free withdrawals, as needed, to pay qualified medical expenses. Individual retirement arrangements enable taxpayers to make annual contributions to a personal retirement plan that offers tax-deferred growth and either tax-deductible contributions or tax-free qualified distributions. The limits applicable to these tax-favored plans change from year to year.

This chapter will briefly discuss each of plans and the 2020 changes that affect them.

Chapter Learning Objectives

Upon completion of this chapter, you should be able to:

- Recognize the eligibility rules applicable to Archer MSAs and HSAs;
- Calculate the maximum contributions that may be made to an Archer MSA;
- Apply the tax treatment rules to contributions to and distributions from Archer MSAs and HSAs;
- Calculate the traditional IRA tax deduction available to a taxpayer who is an active participant in an employer-sponsored retirement plan; and
- Recognize the MAGI limits that apply to a taxpayer's eligibility to make a Roth IRA contribution.

Medical Savings Accounts

The Health Insurance Portability and Accountability Act (HIPAA) authorized the establishment of a pilot program designed to make individuals more cost-conscious in their selection and use of healthcare with the intention of reducing healthcare utilization. The pilot program which ended on December 31, 2007 allowed individuals to establish medical savings accounts. These medical savings accounts have been renamed and are now referred to as "Archer MSAs."

Archer MSAs are trusts created solely to pay the qualified medical expenses of the individuals for whom established. Archer MSAs call for an individual to:

- Buy a high-deductible health insurance policy (HDHP), and
- Make tax-deductible contributions to the trust.

Trust earnings are tax-deferred and may be withdrawn tax-free to pay qualified healthcare expenses. When the individual's expenses for healthcare exceed the policy's high deductible, the expenses would be covered—partly or fully—by the health insurance. The important incentive under the Archer MSA arrangement is that, if the individual's expenses for healthcare amount to less than the sum of the funds in the trust, the balance of the funds can be used for any other purpose the individual chooses, including to provide additional retirement income. Although the trust funds used for other than to pay qualified medical expenses would be subject to income taxation and—if distributed before the accountholder's age 65, death or disability—income tax penalties, it was expected that individuals covered under an Archer MSA would avoid unnecessary expenses for healthcare.

Even though the pilot program ended in 2007, existing Archer MSAs may continue in force.

High Deductible Health Plan Requirement

To be eligible for an Archer MSA, an otherwise eligible individual must be covered under a high-deductible health plan. A "high-deductible health plan" is defined differently for individuals and families, and the deductible under the definition of such a plan tends to increase annually. For a policy that covers only the individual, a high deductible health plan in 2020 is one whose annual deductible is

at least $2,350 but not more than $3,550. It must also provide that annual out-of-pocket expenses other than for premiums do not exceed $4,750.

A high-deductible health plan providing family coverage in 2020 must have an annual deductible of at least $4,750 but not more than $7,100 and must require annual out-of-pocket expenses other than for premiums of not more than $8,650. (These limits tend to be adjusted upward each year.) Since the term “family coverage” applies to any health plan coverage except self-only coverage, the term would apply to a health insurance plan covering only a husband and wife as well as one covering a husband, wife and multiple children.

High Deductible Health Plan (MSA) – 2020

Deductible and out-of-pocket limits in an Archer MSA high deductible health plan for a specific year depend on whether the plan provides self-only coverage or family coverage. The limits applicable to an Archer MSA in 2020 are the following:

	Minimum HDHP Deductible	***Maximum HDHP Deductible***	***Maximum Annual Out-of-Pocket***
Self-only coverage	$2,350	$3,550	$4,750
Family coverage	$4,750	$7,100	$8,650

Archer MSA Contributions

The maximum deductible contribution that may be made to an Archer MSA depends on whether the high deductible health plan provides self-only coverage or family coverage and the amount of the applicable deductible. An eligible individual may deduct the contributions he or she makes to an Archer MSA during the taxable year in an amount not to exceed:

- 65% of the annual deductible for individuals with self-only coverage; or
- 75% of the annual deductible for individuals with family coverage.

So, an individual with self-only coverage and a deductible of $2,500 may make a deductible contribution to an Archer MSA in 2020 of up to $1,625. ($2,500 X .65 = $1,625) If the self-only coverage had a $2,650 annual deductible, the permitted maximum deductible contribution to the accompanying Archer MSA would be $1,722.50. ($2,650 X .65 = $1,722.50)

Similarly, if an individual with family coverage had a deductible of $6,450, he or she could make an annual Archer MSA contribution of up to $4,837.50. ($6,450 x .75 = $4,837.50) While the participant in an Archer MSA is permitted to make contributions to the trust, there is no requirement that the contributions be made or that they be made in any specified amount, provided they don’t exceed the maximum allowable.

Often, a contribution to the Archer MSA is made at the same time that the premium for the high-deductible health plan is paid. Such simultaneous payments, however, are not required. In addition, the time of the year the qualifying high deductible coverage began is important since the maximum amount that may be contributed to the trust for any year is based on a full year; thus, if the MSA high-deductible health plan coverage began later than January 1st, the maximum trust contribution permitted for that calendar year would be reduced. (Note that this is different for health savings accounts, discussed next.)

For example, assume that a taxpayer with MSA self-only coverage having an annual deductible of $2,650 began the coverage on July 1st. If the taxpayer had maintained the high-deductible coverage for the entire year, rather than beginning it on July 1st, he or she could have contributed up to $1,722.50, i.e. .65 x $2,650. Since the taxpayer started the coverage after 6 months of the year had gone by, the maximum contribution that the taxpayer may make in the first year is reduced to one-half, or $861.25. ($1,722.50 x 1/2 = $861.25)

Penalty for Excess Contributions

A taxpayer's contributions to an Archer MSA in excess of the limits are subject to a 6% excise tax penalty, not to exceed 6% of the value of the Archer MSA at the close of the tax year. If a taxpayer makes an excess contribution to his or her Archer MSA, it may be withdrawn, along with any net income attributable to it, on or before the last day for filing the individual's income tax return (including extensions) for the year. The excess contribution withdrawn before the tax-filing date is not includible in the distributee's income, nor is the contribution deductible. Any income that is attributable to the excess contribution being withdrawn must be included in gross income in the year in which received.

Special Rules for Employer-Installed MSAs

Archer MSAs may be sponsored by small employers and self-employed individuals. Contributions made by an employer to employees' Archer MSAs are deductible by the employer on the "Employee benefit programs" line of the business income tax return for the year in which the employer made the contributions.

If an Archer MSA is installed by an employer, some additional rules come into play. The additional rules applicable to employer-installed MSAs that affect contributions to it include the following:

- In any year in which an employer makes a contribution to an Archer MSA, no contributions to the Archer MSA may be made by the individual account holder;
- The deduction for contributions made to an Archer MSA in any year cannot exceed the employee's compensation attributable to the employer maintaining the MSA. Likewise, a self-employed individual's Archer MSA contribution cannot exceed the individual's earned income from the self-employment with respect to which the plan is established; and
- Contributions for all employees of the employer must be comparable, but they are not required to be identical.

Archer MSA Distributions

Although distributions taken from Archer MSAs are designed principally to pay qualified medical expenses, they may be taken by the individual to meet any kind of need. The tax treatment of the distribution, however, is different—and less favorable—when distributions are taken to meet other than qualified medical expenses.

For Archer MSA purposes, ***qualified medical expenses*** are those expenses that would generally qualify for the medical and dental expenses deduction and include amounts paid by the individual for unreimbursed medical care for the taxpayer, a spouse and dependents. A medicine or drug is also considered a qualified medical expense but only if the medicine or drug for which the expense is incurred:

- Requires a prescription;
- Is available without a prescription *and the taxpayer obtains a prescription for it*; or
- Is insulin.

Archer MSA Rollovers

Not unlike other qualified funds, the funds in an Archer MSA can be rolled over to a different MSA or to an HSA. (See **Health Savings Accounts** below.) The applicable rollover rules are much like those that apply to IRA rollovers and rollovers from qualified plans insofar as they require the rollover to be completed within 60 days of a distribution and limited to once every 12 months.

Also similar to a traditional IRA rollover, no mandatory withholding for tax purposes applies even though the rolled-over Archer MSA funds may have been distributed to the account holder before being rolled over. An Archer MSA rollover does not affect the individual's current Archer MSA contribution.

Account Transfer Incident to Divorce

The account holder's divorce or death may cause the Archer MSA account to be transferred. If the account holder divorces, the Archer MSA interest may be transferred from one spouse (or former spouse) to another ***without income taxation***. To avoid taxation on the transfer it must be made

under a divorce or separation agreement. (See IRC §71(b)(2)(A).) Upon such a transfer, the Archer MSA is treated as the MSA of the spouse (or former spouse) to whom it was transferred.

Account Transfer at Death

The disposition of an Archer MSA upon the death of the account holder depends on who the beneficiary is. The Archer MSA designated beneficiary may be:

- A spouse;
- A designated beneficiary other than a spouse; or
- The individual account holder's estate.

If the designated beneficiary of the Archer MSA is the account holder's surviving spouse, he or she becomes the new account holder. In such a case, no income needs to be recognized as a result of the original account holder's death. Alternatively, an Archer MSA designated beneficiary may be someone other than a spouse—a friend or the individual's estate, for example. In such a case, the account stops being an Archer MSA when the account holder dies, and the value of the Archer MSA must be recognized by the beneficiary to the extent its value exceeds the amount of the decedent's qualified medical expenses paid by the beneficiary within one year following the account holder's death.

When the Archer MSA account holder's estate is designated as the beneficiary, the account's fair market value is taxable in the account holder's final taxable year and must be included in the final income tax return prepared by the executor or administrator. In such a case, the assets in the Archer MSA are distributed income tax-free according to the terms of the account holder's will or the intestacy laws if the account holder dies without a will.

Archer MSA Taxation

A taxpayer who is an MSA account holder must file Form 8853, Archer MSAs and Long-Term Care Insurance Contracts, and attach it to Form 1040 or Form 1040NR if:

- The taxpayer or employer made contributions to the taxpayer's Archer MSA during the year;
- The taxpayer files a joint return and his or her spouse or spouse's employer made contributions to the spouse's Archer MSA during the year; or
- The taxpayer (or spouse, if filing jointly) acquired an interest in an Archer MSA because of the death of the account holder.

In addition, the taxpayer must report any contributions and/or taxable MSA distributions on Form 1040 or 1040NR, as appropriate.

Contribution Tax Treatment

When Archer MSA contributions are made by an individual account holder they are deductible above the line. When an individual's employer makes Archer MSA contributions to an account for the individual, the contributions are considered employer-provided coverage for medical expenses up to the allowable amount of Archer MSA contributions. They are generally deductible to the employer as a business expense but are not included in the employee's gross income for tax purposes.

Contributions made to an Archer MSA earn tax-deferred interest, and tax-deferral continues as long as the funds remain in the MSA. However, tax-deferral may be lost if the account holder pledges the Archer MSA as security for a loan.

Deductible contributions may be made through the due-date of the federal income tax return (without extensions). Such contributions should be reported on Form 1040 or Form 1040NR, as appropriate.

Distribution Tax Treatment

Distributions from an Archer MSA may be tax-free or taxable as ordinary income. The difference between the tax treatments lies in the use to which the distribution is put.

A distribution, including a rollover distribution, from an Archer MSA must be reported on Form 8853, Archer MSAs and Long-Term Care Insurance Contracts. The amount by which a distribution (other than a distribution that is rolled over) exceeds the account holder's unreimbursed qualified medical expenses must be reported as "Other income" on Form 1040 or Form 1040NR. In addition, 20% of the taxable MSA distribution during the year that does not meet any of the exceptions to the tax penalty

must be reported as "Other taxes" on Form 1040 or Form 1040NR. The amount of the additional tax and "MSA" should be entered on the adjacent dotted line.

Archer MSA distributions are fully tax-free when the funds distributed are used to pay qualified medical expenses. For MSA purposes, ***qualified medical expenses*** are those expenses that would generally qualify for the medical and dental expense deduction and include amounts paid by the individual for unreimbursed medical care for the taxpayer, spouse and dependents.

Archer MSA distributions are taxable and must be included in the account holder's gross income for tax purposes to the extent used for any purpose other than the payment of qualified medical expenses.

Archer MSA Distribution Tax Penalty

A taxable Archer MSA distribution may also subject the account holder to a substantial tax penalty. Archer MSA distributions are includible in income ***and subject to income tax penalties*** when they are used for other than qualified medical expenses and fail to meet specific exceptions.

An Archer MSA distribution includible in an account holder's income is subject to a 20% penalty tax levied on the amount of the distribution includible in income, unless one of the following exceptions applies:

- The distribution is received while the account holder is disabled;
- The distribution is received following the account holder's death; or
- The distribution is received by the account holder after reaching the eligibility age for Medicare.

Even if one of these exceptions to the tax *penalty* applies, however, a distribution *not used to pay qualified medical expenses* is still includible in the distributee's income for tax purposes.

Health Savings Accounts

Based, in part, on the experience of the Archer MSA pilot program, legislation was signed into law establishing health savings accounts (HSAs). HSAs are similar to Archer MSAs in many areas. Like MSAs, HSAs are trusts created solely to pay the qualified medical expenses of an account beneficiary and call for an individual to:

- Buy a high-deductible health insurance policy, and
- Make tax-deductible contributions to the trust.

Contributions made to the trust and any earnings are tax-deferred for as long as they remain in the trust. HSA account holders may withdraw funds from the trust to pay any qualified healthcare expenses. When the account holder's expenses for healthcare exceed the policy's deductible, those expenses are covered, in whole or in part, by the health insurance.

Distributions from an HSA may be taken by an account holder at any time. If taken to pay or be reimbursed for qualified healthcare expenses, such distributions are tax free provided they are not compensated by insurance or otherwise. If taken for any purpose other than to pay qualified healthcare expenses, the distribution is taxable as ordinary income and may be subject to a tax penalty.

HSA Eligibility

An individual eligible to establish an HSA is one who meets all the following requirements. The individual:

- Is covered under a high deductible health plan (HDHP) on the first day of the month;
- Has no other health coverage except for certain specified coverages;
- Is not enrolled in Medicare; and
- Cannot be claimed as a dependent on another person's tax return for the year.

HSA High Deductible Health Plan Requirement

To be eligible for an HSA, an otherwise eligible individual must be covered under a high-deductible health plan. For a policy that covers only the *individual*, a high deductible health plan in 2020 is one whose annual deductible is at least $1,400 and which also provides that annual out-of-pocket

expenses do not exceed $6,900. A high-deductible health plan providing *family* coverage in 2020 must have an annual deductible of at least $2,800 and must require annual out-of-pocket expenses of not more than $13,800. (These limits tend to be adjusted upward each year.)

High Deductible Health Plan (HSA) – 2020				
Contribution, deductible and out-of-pocket limits in an HSA high deductible health plan for a specific year depend on whether the plan provides self-only coverage or family coverage. The limits applicable to an HSA in 2020 are the following:				
Coverage Type	Minimum Deductible	Maximum Annual Out-of-Pocket*	Maximum Individual Annual Contribution	Individual Annual Catch-up Contribution
Self-only coverage	$1,400	$6,900	$3,550	$1,000
Family coverage	$2,800	$13,800	$7,100	$1,000
*The maximum out-of-pocket limit does not apply to deductibles and expenses for out-of-network services if the plan uses a network of providers. Instead, only deductibles and out-of-pocket expenses for services within the network should be used to figure whether the limit applies.				

HSA Contributions

Contributions to an HSA may be made up until April 15th of the year following the year for which contributions are made. Similar to Archer MSA contribution limits, the maximum deductible contribution that may be made to an HSA depends on whether the high deductible health plan provides self-only coverage or family coverage. However, the *amount* of the applicable deductible—a factor in determining the maximum MSA contribution—does not affect the maximum HSA contribution. The test to determine whether self-only or family coverage limits apply occurs on the first day of the month.

An eligible individual who has not attained age 55 by the end of the taxable year may deduct the contributions he or she makes to an HSA during 2020 in an amount not to exceed:

- $3,550 for account holders with self-only coverage; or
- $7,100 for account holders with family coverage.

HSA Contributions from Multiple Sources

Contributions made to an account holder's HSA may come from multiple sources. If the account holder has an HSA under an employer's plan, contributions may be made by the employer, the employee or both for the same year. In addition, family members or any other person may also contribute to an HSA on behalf of an eligible individual.

Additional Contributions for Age 55 and Older Account Holders

HSA account holders who attain age 55 before the close of a taxable year are eligible to make an additional contribution. The maximum additional contribution amount is $1,000. Thus, an HSA account holder who is age 55 or older and has self-only coverage may make a maximum contribution in 2020 of $4,550; such an individual with family coverage may make a maximum contribution of $8,100. (If both spouses are age 55 or older, each may make a catch-up contribution of up to $1,000.)

First-Year Contributions for New Account Holders

An individual who becomes an eligible individual (for HSA purposes) after the beginning of a taxable year and who is an eligible individual for the last month of the taxable year is treated, for purposes of maximum contributions, as being an eligible individual for the entire year. Thus, an individual who becomes eligible for an HSA in December 2020 and establishes the HSA may make a contribution not exceeding the applicable maximum for the entire year. (Note the difference from an Archer MSA.)

However, if such an individual fails, at any time during the following taxable year (the same "plan" year, in other words), to be an eligible individual (for HSA purposes), the taxpayer must include in his or her gross income the aggregate amount of all HSA contributions made by the taxpayer that could not have been made under the general rule. The amount includible in the former account holder's gross income is also subject to a 10% penalty tax for failure to maintain HDHP coverage. An exception exists if the failure to remain HSA eligible is the result of death or disability.

Maximum HSA Contributions may be Reduced

An HSA account holder must reduce the amount that can be contributed to the HSA, but not below zero, by any amounts contributed:

- To an Archer MSA, including employer contributions, for the year;
- To the HSA by any other person, including the HSA account holder's employer, that are excludible from the account holder's income; and
- Under a qualified HSA funding distribution, i.e. a distribution from the account holder's IRA to the HSA.

Penalty for Excess Contributions

If a taxpayer makes an excess contribution for the year the account holder must withdraw it or be subject to a 6% excise tax penalty, not to exceed 6% of the value of the HSA at the close of the tax year. An excess contribution to an HSA may be withdrawn, along with any net income attributable to it, on or before the last day for filing the individual's income tax return (including extensions) for the year. The excess contribution withdrawn before the tax-filing date is not includible in the distributee's income, nor is the contribution deductible. Any income that is attributable to the excess contribution being withdrawn must be included in gross income in the year in which received.

Employer HSA Participation

Contributions made by an employer to employees' HSAs are deductible by the employer on the "Employee benefit programs" line of the business income tax return for the year in which the employer made the contributions. If an employer makes contributions to employees' HSAs, the employer is required to make comparable contributions to all comparable participating employees' HSAs.

HSA Distributions

Although distributions taken from HSAs are designed to pay qualified medical expenses, they may be taken by the individual to meet any kind of need. The tax treatment of the distribution, however, is different—and less favorable—when distributions are taken to meet other than qualified medical expenses.

Qualified medical expenses are those expenses that would generally qualify for the medical and dental expenses deduction and include amounts paid by the individual for unreimbursed medical care for the taxpayer, spouse and dependents. A medicine or drug is also considered a qualified medical expense but only if the medicine or drug for which the expense is incurred:

- Requires a prescription;
- Is available without a prescription *and the taxpayer obtains a prescription for it*; or
- Is insulin.

Health insurance premiums are not normally considered a qualified medical expense for HSA purposes; however, exceptions apply. The following health insurance premiums ***are*** deemed HSA-qualified medical expenses:

- Premiums for healthcare continuation coverage (such as coverage under COBRA);
- Premiums for long term care insurance; and
- Health plan premiums paid while the account holder is receiving unemployment compensation

HSA Rollovers

Funds in an HSA or Archer MSA can be rolled over to an HSA. The applicable rollover rules are much like those that apply to IRA rollovers and rollovers from qualified plans and require the rollover to be completed within 60 days of a distribution. Rollovers are limited to no more than one every 12 months.

Account Transfer Incident to Divorce

The account holder's divorce or death may cause the HSA account to be transferred. If the account holder divorces, the HSA interest may be transferred from one spouse (or former spouse) to another ***without income taxation***. To avoid taxation on the transfer it must be made under a divorce or

separation agreement. (See IRC §71(b)(2)(A).) Upon such a transfer, the HSA is treated as the HSA of the spouse to whom it was transferred.

Account Transfer at Death

The disposition of an HSA upon the death of the account holder depends on who the beneficiary is. If the designated beneficiary of the HSA is the account holder's surviving spouse, he or she becomes the new account holder and no income needs to be recognized. If the beneficiary is other than a spouse, the account stops being an HSA when the account holder dies and the value of the HSA must be recognized by the beneficiary to the extent its value exceeds the amount of the decedent's qualified medical expenses paid by the beneficiary within one year following the account holder's death.

When the HSA account holder's estate is designated as the beneficiary, the account's fair market value is taxable in the account holder's final taxable year and included in the final income tax form prepared by the executor or administrator. In such a case, the assets in the HSA are distributed income tax-free according to the terms of the account holder's will or the intestacy laws if the account holder dies without a will.

HSA Taxation

The tax treatment of HSA contributions varies, depending on the source of the contributions. A taxpayer who is an HSA account holder must file Form 8889, Health Savings Accounts (HSAs), and attach it to Form 1040 or Form 1040NR if:

- The taxpayer or employer made contributions to the taxpayer's HSA during the year;
- The taxpayer files a joint return and his or her spouse or spouse's employer made contributions to the spouse's HSA during the year; or
- The taxpayer (or spouse, if filing jointly) acquired an interest in an HSA because of the death of the account holder.

In addition, the taxpayer must report any contributions and/or taxable distributions on Form 1040 or 1040NR, as appropriate.

Contribution Tax Treatment

When HSA contributions are made by an individual account holder they are deducted by the individual from his or her income for purposes of determining the account holder's adjusted gross income.

When an individual's employer makes HSA contributions to an account for the individual, the contributions are considered employer-provided coverage for medical expenses up to the allowable amount of HSA contributions. Accordingly, employer-provided HSA contributions are generally deductible to the employer as a business expense but are not included in the employee's gross income for income tax purposes. Contributions made to an HSA earn tax-deferred interest, and tax-deferral continues as long as the funds remain in the account.

Deductible contributions may be made through the due-date of the federal income tax return (without extensions). Such contributions should be reported on Form 8889, Health Savings Accounts (HSAs) and on line 25 of Form 1040 or Form 1040NR.

Distribution Tax Treatment

Distributions from an HSA may be tax-free or taxable as ordinary income. The difference between the tax treatments lies in the use to which the distribution is put.

A distribution, including a rollover distribution, from an HSA must be reported on Form 8889, Health Savings Accounts (HSAs). The amount by which a distribution (other than a distribution that is rolled over) exceeds the account holder's unreimbursed qualified medical expenses must be reported as "Other income" on Form 1040 or Form 1040NR. On the adjacent dotted line, enter "HSA" and the amount. In addition, 20% of the taxable HSA distribution during the year that does not meet any of the exceptions to the tax penalty must be reported as "Other taxes" on Form 1040 or Form 1040NR. The amount of the additional tax and "HSA" should be entered on the adjacent dotted line.

Tax-Free HSA Distributions

HSA distributions are fully tax-free when the funds distributed are used to pay qualified medical expenses. A medicine or drug is also considered a qualified medical expense but only if the medicine or drug for which the expense is incurred:

- Requires a prescription;
- Is available without a prescription *and the taxpayer obtains a prescription for it*; or
- Is insulin.

Note that the prescription requirement for costs incurred for drugs other than insulin to be considered qualified medical expenses *applies only to drugs.* It does not apply to other non-drug medical expenses incurred to purchase supplies over the counter, such as:

- Bandages;
- Contact lenses cleaner;
- Blood pressure monitors; and
- Other similar medical supplies.

Taxable HSA Distributions

HSA distributions are taxable and must be included in the account holder's gross income for tax purposes to the extent used for any purpose other than the payment of qualified medical expenses.

An HSA owner who is at the age at which he or she is eligible for Medicare may withdraw funds from the account for other than to pay qualified medical expenses without incurring a tax penalty. Although the funds thus withdrawn are subject to income taxation as ordinary income—just as a distribution from a traditional IRA would be—no tax penalty applies.

HSA Distribution Tax Penalty

A taxable HSA distribution may also subject the account holder to a substantial tax penalty. HSA distributions are includible in income and subject to income tax penalties when they are used for other than qualified medical expenses and fail to meet specific exceptions. An HSA distribution includible in an account holder's income is subject to a 20% penalty tax levied on the amount of the distribution includible in income, unless one of the following exceptions applies:

- The distribution is received while the account holder is disabled;
- The distribution is received following the account holder's death; or
- The distribution is received by the account holder after reaching the eligibility age for Medicare.

Even if these exceptions apply, however, a distribution *not used to pay qualified medical expenses* is includible in the distributee's income for tax purposes.

Individual Retirement Accounts Affected by SECURE Act

The SECURE Act, which became law on December 20, 2019, affected individual retirement arrangements (IRA) with respect to:

- contributions; and
- distributions.

IRA Contribution Changes

The IRA contribution changes include:

- elimination of the age cap on traditional IRA contributions;
- addition of taxable non-tuition fellowship and stipend payments to the definition of "compensation" for purposes of IRA contributions; and
- the ability of certain foster care payment recipients to make nondeductible IRA contributions based on those payments.

Elimination of Age Cap on Traditional IRA Contributions

Before passage of the SECURE Act, traditional IRA contributions could be made only by taxpayers who had not yet reached age 70½ and were otherwise eligible to make a contribution. The age cap, however, never applied to Roth IRA contributions. Under the new tax rules effective for years after December 31, 2019, all taxpayers, regardless of age, who have earned income are eligible to make a traditional IRA contribution. (Spousal IRA contributions may be made despite the spouse for whom made having no earned income in an amount not to exceed the working spouse's earned income reduced by the working spouses IRA contribution.)

The elimination of the IRA age cap is effective for years after December 31, 2019.

Taxable Non-Tuition Fellowship and Stipend Payments Considered Compensation for IRAs

For purposes of retirement savings, the SECURE Act added "any amount included in the individual's gross income and paid to the individual to aid the individual in the pursuit of graduate or postdoctoral study" to the definition of compensation for purposes of making a contribution to an IRA. Accordingly, such payments may make the taxpayer (and spouse) eligible to make a traditional and/or Roth IRA contribution.

The ability to include non-tuition fellowship and stipend payments for graduate or postdoctoral study in income for purposes of IRA contribution is effective for years after December 31, 2019.

Certain Foster Care Payments as Basis for Non-Deductible IRA Contribution

In some cases, a state may pay additional compensation to individuals who provide foster care to others whose physical, mental or emotional handicap is such that additional compensation is warranted as a qualified foster care payment. Although the additional compensation is excluded from gross income, the recipient may make non-deductible IRA contributions based on the excluded compensation. The individual's total IRA contribution, however, cannot exceed the IRA contribution limits when added to amounts contributed based on compensation.

The ability to make non-deductible IRA contributions is effective on the date of passage of the legislation, i.e. December 20, 2019.

IRA Distribution Changes

The changes to the IRA rules affecting distributions are the following:

- required minimum distributions must be made at age 72;
- qualified birth or adoption distributions of up to $5,000 taken within one year avoid early distribution tax penalty; and
- inherited IRA balances following death of IRA holder before the required beginning date for other than certain designated beneficiaries must be entirely distributed within ten years.

Minimum Distributions Required at Age 72

Traditional IRAs (but not Roth IRAs) must meet required minimum distribution (RMD) rules during the holder's lifetime. Under prior law, that initial RMD was required for the year the holder reached age 70½, but the holder could delay receiving the initial RMD until April 1st of the following year, a date referred to as the "required beginning date." The problem in so doing is that the second RMD is required by December 31st of the same year, resulting in the need to include two year's worth of RMDs in the same yearly income.

Under the SECURE Act, RMDs are pushed back to age 72. However, that increase in the age at which RMDs must begin ***only applies to those traditional IRA holders who reach age 70½ in 2020.*** The same concept with respect to the first RMD continues to apply. Thus, traditional IRA holders who must begin RMDs at age 72 may defer their receipt of their first RMD until April 1st of the year following the year in which they attain age 72.

The change to age 72 for the commencement of RMDs is effective for years after December 31, 2019.

Certain Qualified Birth or Adoption Distributions Avoid Early Distribution Penalty

In most cases, taxpayers who receive a distribution from a traditional IRA before age 59½ or a nonqualified distribution of gain from a Roth IRA before age 59½ are liable for a premature

distribution tax penalty of 10% of the amount of the distribution included in income unless an exception to the tax penalty applies. The SECURE Act adds an additional exception to the tax penalty for qualified birth or adoption distributions.

A qualified birth or adoption distribution is a distribution of up to $5,000 from an IRA occurring within one year following the birth or the date the adoption of an eligible adoptee is finalized. In order to be considered a qualified birth or adoption distribution, the distribution must be made *after* the birth or the adoption is finalized. The language of the Act makes clear that the term "eligible adoptee" means any individual (other than a child of the taxpayer's spouse) who:

- has not attained age 18; or
- is physically or mentally incapable of self-support.

In addition, the taxpayer who has taken a qualified birth or adoption distribution may repay the distribution in one or more "repayments" in an aggregate amount not exceeding the amount of the qualified birth or adoption distribution.

The SECURE Act provision eliminating the premature distribution tax penalty for qualified birth or adoption distributions is effective for years after December 31, 2019.

Certain Inherited IRA Balances Must be Fully Distributed within 10 Years

The SECURE Act has revised the distribution requirements of inherited IRA balances for certain designated beneficiaries. Under the revised regulations, death of an original IRA owner before the annuity starting date occurring later than December 31, 2019 requires that the plan assets be distributed in their entirety by the end of the 10th year following the owner's death. Thus, for these beneficiaries, the option to stretch the IRA or retirement account assets over life expectancy has ended.

Certain designated beneficiaries, however, are not affected by the change in the law. Those unaffected designated beneficiaries are:

- spousal beneficiaries;
- disabled beneficiaries;
- chronically-ill beneficiaries; and
- designated beneficiaries who are not more than 10 years younger than the decedent.

For these beneficiaries, the options available under prior tax law to take distributions over life expectancy or, in the case of spousal beneficiaries, to take a spousal rollover, continue. Additionally, certain minor children of the original deceased plan participant or IRA owner are *temporarily* unaffected during their minority. However, when these minor children reach the age of majority, the 10-year rule applies.

The change to the distribution requirements for affected designated beneficiaries following the death of an IRA owner is effective for years after December 31, 2019.

Roth IRA Eligibility

A Roth IRA is a personal retirement savings plan, funded by an annuity or trust/custodial account, which provides income tax deferral and may provide tax-free distribution of earnings through qualified distributions. It does not provide for contribution deductibility. Eligibility for a Roth IRA is limited to individuals, regardless of age or qualified plan participation, whose income does not exceed certain modified adjusted gross income limits.

Limits on Contributions

The maximum amount an individual can contribute to a Roth IRA is $6,000 (in 2020) or, if he or she is age 50 or older, $7,000, less any amount contributed to a traditional IRA. The maximum contribution that may be made to a Roth IRA is reduced, based on the individual's modified adjusted gross income, according to the following formula:

$$\text{Contribution reduction} = \frac{\text{MAGI} - \text{applicable dollar amount}}{\$15{,}000\ (\$10{,}000 \text{ if married filing a separate return or jointly})} \times \text{Maximum contribution}$$

The "applicable dollar amount" in the Roth IRA formula is based on the individual's filing status, as shown in the following chart:

Federal Income Tax Filing Status	Applicable Dollar Amount (2019)	Applicable Dollar Amount (2020)
Individual	$122,000	$124,000
Married, filing a joint return	$193,000	$196,000
Married, filing separately	$0	$0

Traditional IRA Contributions by Active Participants

Every taxpayer who has earned income may make a traditional IRA contribution. In most cases, traditional IRA contributions are deductible by the taxpayer. However, when the taxpayer is an active participant in an employer-sponsored retirement plan, the usual deductibility of traditional IRA contributions may be changed, depending on the participant's MAGI and filing status.

Tax Treatment of Contributions by Active Participants

There are three possibilities with respect to the tax deductibility of a traditional IRA contribution made by an active participant in an employer-sponsored retirement plan. The traditional IRA contribution may be:

- Fully deductible, or
- Partially deductible, or
- Not deductible

The tax status of the traditional IRA contribution for an active participant depends entirely on his or her modified adjusted gross income and filing status. Traditional IRA contributions made by active participants whose MAGI does not exceed the applicable dollar amount for his or her filing status are fully deductible.

The applicable dollar amounts for tax year 2020 are as shown in the chart below:

Active Participants – Applicable Dollar Amounts - 2020		
Taxable Year	**Married Filing Jointly Return**	**Single or Head of Household Return**
2015 & 2016	$98,000	$61,000
2017	$99,000	$62,000
2018	$101,000	$63,000
2019	$103,000	$64,000
2020	$104,000	$65,000

Reduced Deductibility of Traditional IRA Contributions for Active Participants

The reduction of the deductible amount of a traditional IRA contribution for an active participant filing a *single or head-of-household* federal tax return is determined by using the following formula:

$$\text{Reduction of Deduction (Single or HOH)} = \text{Maximum contribution} \times \frac{\text{MAGI} - \text{applicable dollar amount}}{\$10{,}000}$$

The reduction of the deductible amount of a traditional IRA contribution for an active participant filing a *joint* federal tax return is determined by using the following formula:

$$\text{Reduction of Deduction (Married filing jointly)} = \text{Maximum contribution} \times \frac{\text{MAGI} - \text{applicable dollar amount}}{\$20{,}000}$$

(Note: The difference between the two formulas shown above is in the denominator of the fraction. For active participants filing single or head-of-household federal tax returns, the denominator is $10,000; for active participants filing a joint federal tax return, it is $20,000.)

If the taxpayer is an active participant in an employer-sponsored retirement plan and files his or her federal income tax return as single or head-of-household, the applicable dollar amount for 2020 is $65,000.

Notice that the formula is NOT a formula for determining the extent of the tax-deductibility of a traditional IRA contribution. It is the formula for determining an active participant's (or spouse's) REDUCTION in his or her traditional IRA deductibility.

Thumbnail Summary of 2020 Changes

Subject	**2020 Change**
MSA limits	Individual: Deductible - $2,350 to $3,550 Out-of-pocket maximum - $4,750 Maximum contribution – 65% of deductible Family: Deductible - $4,750 to $7,100 Out-of-pocket maximum - $8,650 Maximum contribution – 75% of deductible
HSA limits	Individual: Minimum deductible - $1,400 Out-of-pocket maximum - $6,900 Maximum contribution* - $3,550 Family: Minimum deductible - $2,800 Out-of-pocket maximum - $13,800 Maximum contribution* - $7,100 * HSA account holders age 55 or older may contribute up to an additional $1,000 annually
IRA contribution maximum	Regular - $6,000 Catch-up - $1,000
Roth IRA contribution income limits	Single & head of household: Maximum MAGI for full contribution - $124,000 Contribution eliminated at MAGI of - $139,000 Married Filing Jointly: Maximum MAGI for full contribution - $196,000 Contribution eliminated at MAGI of - $206,000
Traditional IRA deductibility for active participants in employer-sponsored qualified retirement plan	Single & head of household: Maximum MAGI for full deductibility - $65,000 All deductibility eliminated at MAGI of - $75,000 Married Filing Jointly: Maximum MAGI for full deductibility - $104,000 All deductibility eliminated at MAGI of - $124,000
SECURE Act-related IRA changes	• Traditional IRA contribution age cap eliminated • Taxable non-tuition fellowship & stipend payments for graduate or postdoctoral study deemed "compensation for IRA contribution purposes

	• Certain excluded foster care payments can provide basis for non-deductible IRA contributions • RMD age changed from 70½ to 72 • Qualified birth or adoption distributions up to $5,000 available within one year without premature distribution tax penalty • Qualified birth or adoption distributions may be "repaid" • Inherited IRA balances following death of IRA holder before required beginning date must be entirely distributed within ten years for other than certain designated beneficiaries

Chapter Review

1. Ellen has maintained self-only health insurance coverage with a $2,500 deductible under her Archer MSA throughout 2020. What is the maximum tax-deductible contribution she can make to the MSA in 2020?

   A. $1,875

   B. $1,625

   C. $4,750

   D. $3,550

2. Peter, age 45, had $5,000 in qualified medical expenses in 2020 and took an $8,000 Archer MSA distribution during the year. If the excess distribution fails to meet a specific exception applicable to the tax penalty, for what tax penalty will he be liable?

   A. $1,000

   B. $1,600

   C. $600

   D. $0

Chapter 5 – Tax Cuts and Jobs Act:
Principal Individual Taxpayer Changes for 2020

Introduction

The Tax Cuts and Jobs Act of 2017 (Act), signed into law in the closing days of 2017 and generally effective beginning in 2018, makes numerous changes to existing tax law. Among the more significant provisions of the Act bringing about changes for individual taxpayers are:

- Changes to individual tax rates;
- Changes to exemptions and deductions;
- Changes to the existing child tax credit;
- Changes affecting distributions of Tuition Savings Plan (§529) funds;
- Suspension of a taxpayers' ability to recharacterize a traditional IRA to Roth IRA conversion; and
- A change in the individual taxpayer penalty for a failure to maintain minimum essential coverage.

Although an analysis of the Act is beyond the scope of this course, this chapter will briefly discuss the principal changes made to various limits applicable in 2020 that affect provisions of the Act.

Chapter Learning Objectives

Upon completion of this chapter, you should be able to:

- Identify individual tax rate changes affecting taxpayers;
- Recognize the changes made to the standard deduction available to taxpayers;
- Calculate the alternative minimum tax;
- Determine the amount of assets that may be passed tax-free at death; and
- Identify the qualified business income (QBI) threshold amount.

Tax Cuts and Jobs Act of 2017

The majority of provisions of the Tax Cuts and Jobs Act of 2017 that relate to individual taxpayers are temporary in nature and generally apply beginning in 2018 and ending on December 31, 2025. Accordingly, the provisions of the Act applicable to individual taxpayers expire for years beginning in 2026.

Individual Tax Rate Changes

The Act maintains the current seven individual tax brackets but generally reduces the applicable tax rates. The individual tax brackets for 2020 are as follows:

2020	**Bracket for Income in Excess of…**				
Tax Bracket	**MFJ**	**HOH**	**Unmarried**	**MFS**	**Estates & Trusts**
10%	$0	$0	$0	$0	
12%	$19,750	$14,100	$9,875	$9,875	
22%	$80,250	$53,700	$40,125	$40,125	
24%	$171,050	$85,500	$85,525	$85,525	$2,600
32%	$326,600	$163,300	$163,300	$163,300	
35%	$414,700	$207,350	$207,350	$207,350	$9,450
37%	$622,050	$518,400	$518,400	$311,025	$12,950

Alternative Minimum Tax Exemption Amount Increased

The tax code provides for an AMTI exemption for purposes of determining the alternative minimum tax amount. The amount of the AMTI exemption varies according to the taxpayer's filing status and the tax year. The applicable AMTI exemption amounts[6] for 2020 are as follows:

Filing Status	Threshold for Phaseout of Exemption Amount	Alternative Minimum Taxable Income Exemption
Single or Head of Household	$518,400	$72,900
Married Filing Jointly & Qualifying Widow(er)	$1,036,800	$113,400
Married Filing Separately	$518,400	$56,700
Estates and Trusts	$84,800	$25,400

Standard Deductions

TCJA changed the standard deductions available to individual taxpayers and, for 2020, those changed amounts are as follows:

- Married filing jointly standard deduction is $24,800;
- Head of household standard deduction is $18,650; and
- Other tax status standard deductions are $12,400.

Individual Responsibility Penalty under ACA

Non-exempt taxpayers are required under the Affordable Care Act to maintain health coverage at least equal to minimum essential benefits. The requirement to maintain health coverage continues in effect during. However, the Act reduces the penalty for failing to maintain such coverage for years beginning after 2018 to zero.

Estate and Gift Tax Exemption

Every taxpayer is entitled to gift or bequeath assets during lifetime or at death tax free insofar as such assets do not exceed a basic exclusion amount. The gift and estate tax exemption is increased to $11.58 million in 2020.

Section 199A Threshold Amount

The TCJA's impact on many taxpayers is substantial. Among those for whom it has a more significant effect, however, are owners of businesses organized as pass-through entities, i.e. as sole proprietorships, partnerships (including certain LLCs) and S corporations. Such entities may qualify for a special tax deduction, generally referred to as the Section 199A pass-through deduction, which enables eligible taxpayers to deduct up to 20% of their qualified business income (QBI).

In general, the pass-through deduction under section 199A is available as follows:

- All pass-through business owners whose personal taxable income does not exceed a threshold amount are eligible for the deduction;
- Pass-through business owners of certain types of business known as "specified service trades or businesses (SSTBs)" whose personal taxable income is greater than the threshold amount but less than the sum of the threshold amount and $50,000 or $100,000, based on their filing status, are eligible for a reduced deduction; and

[6]AMTI exemption amounts are indexed for inflation.

- Pass-through business owners of non-SSTBs, irrespective of their personal taxable income, are eligible for the deduction.

The applicable threshold amounts are adjusted annually for inflation and, for 2020, are as shown in the chart below:

Taxpayer's Filing Status	**2020 Threshold Amount**	**Phase-In Range**
Married filing jointly	$326,600	$100,000
Married filing separately	$163,300	$50,000
Single & head of household filers	$163,300	$50,000

Summary

The Tax Cuts and Jobs Act of 2017 (Act)—legislation generally effective for years beginning after 12/31/17 and before 1/1/26—affected both individual and corporate taxation. The inflation-related and other changes for 2020 affecting provisions of the Act include:

- Increasing the AMT exemption and the income at which AMT exemption phaseout occurs;
- Increasing the standard deduction;
-
- Increasing the estate and gift tax exemption; and
- Increasing the threshold amount applicable to the section 199A pass-through deduction.

Thumbnail Summary of Inflation-related Changes to Tax Cuts and Jobs Act Changes (2020)

Provision	**Change**
AMT exemption	Exemption amounts increased to: • $113,400 for MFJ taxpayers • $72,900 for single and HOH taxpayers • $56,700 for MFS taxpayers • $25,400 for estates and trusts Exemption phaseout increased to: • $1,036,800 for MFJ taxpayers • $518,400 for single, HOH and MFS taxpayers • $84,800 for estates and trusts
Standard deduction	Standard deduction increased to: • $24,800 for MFJ taxpayers • $18.650 for HOH taxpayers • $12,400 for other filing statuses
Estate and gift tax exclusion	Increased to $11.58 million
Taxable income threshold amount applicable to section 199A pass-through deduction	Increased to: • $326,600 for taxpayers with MFJ filing status • $163,300 for taxpayers with all other filing statuses

Chapter Review

1. If Harriet, age 45, itemized her deductions for 2020, had an AGI of $60,000 and total unreimbursed medical expenses of $10,000, what part of her medical expenses, if any, can she deduct?

   A. $0

   B. $5,500

C. $4,000

D. $10,000

2. John incurred $1,000 of unreimbursed business expenses on behalf of his employer in 2020. If his AGI in 2020 is $60,000, how much of the business expenses can he deduct?

    A. $0

    B. $200

    C. $500

    D. $1,000

Glossary

Active participant	An active participant for traditional IRA purposes is an individual that participates in his or her employer's retirement plan. An employer-sponsored retirement plan includes a pension plan, profit sharing plan, 401(k) plan, 403(b) tax sheltered annuity plan, SEP or SIMPLE.
Alternative minimum tax	A special tax applicable to taxpayers who benefit from the tax law by being afforded special treatment or special deductions and credits. The alternative minimum tax is designed to ensure such taxpayers are required to pay at least a minimum amount of federal tax.
Benchmark plan	A benchmark plan is the second-lowest-cost health insurance plan that would cover a family at the silver level of coverage.
Catch-up IRA contributions	Additional contributions for individuals who have attained age 50 before the close of the taxable year for which the IRA contribution is made.
Citizen or resident test	Although an exception applies in the case of adopted children who meet certain conditions, a taxpayer cannot claim a person as a dependent unless that person is a U.S. citizen, U.S. resident alien, or U.S. national or a resident of Canada or Mexico.
Deductible moving expenses	Suspended under the Tax Cuts and Jobs Act of 2017.
Deductible unreimbursed employee expenses	Suspended under the Tax Cuts and Jobs Act of 2017. These formerly deductible unreimbursed employee expenses include the employee's car expenses incurred in traveling: • From one workplace to another; • In order to meet with customers; • To attend business meetings at a location away from the taxpayer's regular workplace; and • From the taxpayer's home to a temporary place of work.
Dependent	A person who meets either the qualifying child test or the qualifying relative test.
Dependent exemption	Exemptions are suspended under the Tax Cuts and Jobs Act of 2017.
Dependent taxpayer test	If a taxpayer can be claimed as a dependent by another taxpayer, he or she is not permitted to claim another person as a dependent.
Exemption	Exemptions are suspended under the Tax Cuts and Jobs Act of 2017.
Individual mandate	The individual shared responsibility provision of the PPACA—sometimes referred to as the "individual mandate"—imposed a tax penalty for a non-exempt individual's failure to maintain minimum essential coverage. The tax penalty is reduced to zero for years after 2018.

Joint return test	Although certain exceptions apply, the joint return test generally prohibits a taxpayer from claiming as a dependent any married person if the married person's filing status is "married filing jointly."
Main home (first-time homebuyer's credit)	A home in which the taxpayer lives most of the time. It can be a house, houseboat, mobile home, cooperative apartment or condominium.
Minimum essential coverage	Minimum essential coverage refers to basic health insurance coverage that may be provided as a) employer-sponsored coverage, b) individual health insurance coverage, or c) coverage provided under government-sponsored programs.
Personal exemption	Exemptions are suspended under the Tax Cuts and Jobs Act of 2017.
Premature IRA distribution tax penalty	In order to ensure that traditional IRAs are used for the purpose they were designed—specifically to accumulate retirement savings—Congress imposed a limitation on their liquidity by specifying a penalty for premature distributions. Usually, in order to avoid a premature withdrawal penalty, the individual must be at least age 59 1/2 before receiving a distribution from a traditional IRA.
Premium tax credit	A tax credit provided for purchase of a qualified health plan available to individuals who cannot be claimed as a dependent by another person and whose household income is between 100% and 400% of the federal poverty level.
Qualified distribution from Roth IRA	A qualified distribution from a Roth IRA is one that is made no earlier than five years after the year for which the owner made his or her first Roth IRA contribution and: • The individual is age 59 1/2 or older; • The distribution is a qualified first-time homebuyer distribution; • The individual is disabled; or • The distribution is made to a beneficiary on or after the individual's death.
Roth conversion	A qualified rollover contribution from a traditional IRA or any eligible retirement plan to a Roth IRA or rollover from a 401(k) or 403(b) plan to a designated Roth account.
Roth IRA	A Roth IRA is a personal retirement savings plan, funded by an annuity or trust/custodial account, which provides income tax deferral and may provide tax-free distribution of earnings. Eligibility for a Roth IRA is limited to individuals, regardless of age or qualified plan participation, provided their AGI doesn't exceed certain limits.
Saver's credit	The saver's tax credit is a nonrefundable credit that is designed to encourage certain lower-income individuals to contribute to a retirement savings plan and is limited to the applicable percentage of such contributions but not more than $1,000 per taxpayer.
Short-term coverage gap	A gap in healthcare coverage for less than three consecutive months.
Silver level plan	A silver level plan as one designed to provide benefits that are actuarially equivalent to 70 percent of the full actuarial value of the benefits provided under the plan.

Small business tax credit A nonrefundable tax credit available to an employer equal to a percentage of premiums paid for employee health insurance coverage provided the employer a) paid average annual wages for the tax year of less than $50,000 per full-time equivalent employee (inflation adjusted), b) employed fewer than 25 full-time equivalent employees for the tax year, and c) paid premiums for employee health insurance coverage under a qualifying arrangement, i.e. one in which the employer pays at least 50% of the premium for employee-only coverage.

Standard deduction eligibility With certain exceptions, any taxpayer generally may elect to take a standard deduction rather than itemize deductions.

Standard mileage rates Per-mile amounts that a taxpayer may use to deduct car expenses in lieu of deducting the actual expenses incurred by the taxpayer.

Tax deferral Tax deferral is a favorable tax treatment under which an account's earnings are not subject to income taxation until distributed.

Traditional IRA A traditional IRA is a personal retirement savings plan, funded by an annuity or a trust that meets certain requirements and may permit tax-deductible contributions and tax-deferral of earnings.

U.S. national An individual who is not a U.S. citizen but who owes allegiance to the United States, such as an American Samoan or Northern Mariana Islander who chooses to be a U.S. national rather than a U.S. citizen.

Answers to Review Questions

Chapter 1

Question 1 Feedback

A. Your answer is incorrect. Although not all charitable expenses may be deductible, such expenses are normally deductible. Please try again.

B. Your answer is incorrect. Your answer identifies only the mileage as being deductible when using a personal vehicle for charitable purposes. However, more than just the mileage deduction is available. Please try again.

C. Your answer is correct. Philip's unreimbursed charitable expense deduction is limited to $296. Taxpayers are permitted to deduct personal vehicle expenses when used for charitable purposes. Since Philip traveled 1,400 miles, paid $40 for parking and $60 for tolls and chooses to use the standard mileage deduction, he may deduct $296. The money spent on gas and oil is not deductible, however, since the standard mileage deduction was elected.

D. Your answer is incorrect. Not all charitable expenses associated with a taxpayer's use of his personal vehicle are deductible. In this case, Philip elected to use the standard mileage deduction rather than actual costs. Since he did not choose to deduct actual costs, his expenses for gas and oil are not deductible. Please try again.

Question 2 Feedback

A. Your answer is incorrect. Qualified long term care insurance benefits are includible in the recipient's income to the extent such benefits exceed the greater of a per diem amount which is $380/day in 2020 or the actual costs for the care. Since the amount of benefits received exceeds those limits, some benefits must be included. Please try again.

B. Your answer is correct. Karl need include only $20 per day in his income. Benefits received under qualified long term care insurance policies that may be excluded from income are those benefits not exceeding the greater of:

   - The applicable *per diem* limitation for the year; or
   - The costs incurred for qualified long term care services provided for the insured.

   The applicable *per diem* limitation for 2020 is $380.

C. Your answer is incorrect. It erroneously suggests that the difference between the per diem limitation and the actual expenses, if less, would be includible in income. In contrast, the amount includible is the amount of the benefit that exceeds the greater of the actual costs or the per diem amount. Please try again.

D. Your answer is incorrect. The amount of the difference between the long term care insurance benefits received and the actual expenses incurred for the care is not necessarily includible in income. Only the amount by which such insurance benefits exceed the *greater* of the expenses or the applicable per diem amount needs to be recognized as income. Please try again.

Chapter 2

Question 1 Feedback

A. Your answer is correct. Hank qualifies for a 10% retirement savings contribution tax credit. Since the credit is based on his retirement savings contribution during the year, his saver's credit is $100. ($1,000 x 10% = $100)

B. Your answer is incorrect. The saver's credit for which Hank qualifies is based on his contribution to the 401(k) plan multiplied by the percentage credit to which he is entitled. However, the employer match is not considered in determining the credit. Please try again.

C. Your answer is incorrect. Your answer indicates that Hank's saver's credit would be based on a 20% rate. Although he would qualify for a 20% saver's credit if he filed as head of household, the saver's credit rate for a single taxpayer is not 20%. Please try again.

D. Your answer is incorrect. Although Hank would be eligible for a saver's credit equal to 50% of his $1,000 401(k) deferral if he were married and filed a joint tax return, the saver's credit to which he is entitled as a single taxpayer is less. Please try again.

Question 2 Feedback

A. Your answer is incorrect. Sally's receipt of a saver's credit does not eliminate her deduction of a traditional IRA contribution. Please try again.

B. Your answer is incorrect. The saver's tax credit for which Sally is eligible does not reduce the deductible portion of her traditional IRA contribution. Please try again.

C. Your answer is incorrect. Sally's traditional IRA deduction is not netted by the saver's credit she receives. Please try again.

D. Your answer is correct. Sally may deduct the entire traditional IRA contribution, provided she is otherwise eligible to take the deduction. The retirement savings contribution tax credit, if any, for which a taxpayer is eligible does not affect the tax treatment to which the contribution would normally be subject.

Chapter 3

Question 1 Feedback Resume here

A. Your answer is correct. The Tax Cuts and Jobs Act of 2017 reduced the tax penalty for failing to maintain health coverage to zero for 2020 and later.

B. Your answer is incorrect. If these taxpayers refused to maintain minimum essential coverage for all of 2014, the minimum penalty that would apply is $285. However, that is not the applicable minimum penalty in 2020. Please try again.

C. Your answer is incorrect. The minimum penalty for which Bob and Phyllis would be liable in 2018 is $2,085. That penalty amount does not apply for a failure to maintain coverage in 2020. Please try again.

D. Your answer is incorrect. If these taxpayers refused to maintain minimum essential coverage for all of 2015, the minimum penalty that would apply is $975. However, that is not the applicable penalty in 2020. Please try again.

Question 2 Feedback

A. Your answer is incorrect. Although the tax credit for which a taxpayer may be eligible can reduce the amount required to purchase a qualified health plan, a taxpayer whose household income is 110% of the federal poverty level is required to make some contribution towards the cost. Please try again.

B. Your answer is incorrect. The taxpayer's expected contribution, as the term is used with respect to the tax credit, is a specified percentage of the taxpayer's household income. The applicable percentage of the taxpayer's household income increases—from 2.06% of income for families at less than 133% of the federal poverty level to 9.78% of income for families at 400% of the federal poverty level—as the taxpayer's income increases. Please try again.

C. Your answer is correct. The taxpayer's expected contribution if he or she has a household income equal to 110% of the federal poverty level in 2020 is 2.06% of such income. The taxpayer's expected contribution, as the term is used with respect to the tax credit, is a specified percentage of the taxpayer's household income. The applicable percentage of the taxpayer's household income increases—from 2.06% of income for families at less than 133% of the federal poverty level to 9.78% of income for families at 400% of the federal poverty level—as the taxpayer's income increases.

D. Your answer is incorrect. The taxpayer's expected contribution, as the term is used with respect to the tax credit, is a specified percentage of the taxpayer's household income. The applicable percentage of the taxpayer's household income increases—from 2.06% of income

for families at less than 133% of the federal poverty level to 9.78% of income for families at 400% of the federal poverty level—as the taxpayer's income increases. Please try again.

Chapter 4

Question 1 Feedback

A. Your answer is incorrect. Ellen has self-only coverage under her MSA; accordingly, she is limited to a tax-deductible MSA contribution of no more than a specified percentage of her deductible. However, the answer chosen is based on an incorrect percentage. Please try again.

B. Your answer is correct. Ellen can contribute up to $1,625 to her MSA in 2020. An eligible taxpayer with self-only coverage may deduct the contributions he or she makes to an Archer MSA during the taxable year in an amount not to exceed 65% of the annual HDHP deductible.

C. Your answer is incorrect. That is the maximum out-of-pocket permitted under Ellen's high deductible health plan in 2020; however, it is not her maximum contribution. Please try again.

D. Your answer is incorrect. That is the maximum deductible Ellen could have under her Archer MSA in 2020; it is not the maximum contribution permitted her this year. Please try again.

Question 2 Feedback

A. Your answer is incorrect. The tax penalty is not applied to the portion of the distribution that is NOT in excess of the account holder's qualified medical expenses. Only the part of the distribution in excess of those expenses may be subject to it. Please try again.

B. Your answer is incorrect. Your selected answer would apply the tax penalty to the entire distribution. However, Peter's liability is assessed only against the amount of MSA distribution in excess of his qualified medical expenses. Please try again.

C. Your answer is correct. The tax penalty is $600. Only the $3,000 excess distribution is subject to the applicable tax penalty. Archer MSA distributions are includible in income and subject to a 20% income tax penalty when they are used for other than qualified medical expenses and fail to meet specific exceptions.

D. Your answer is incorrect. Although Archer MSA distributions are tax-free when used to pay qualified medical expenses, they are subject to a tax penalty when taken in excess of such expenses unless a specific exception applies. Please try again.

Chapter 5

Question 1 Feedback

A. Your answer is incorrect. The Tax Cuts and Jobs Act of 2017 changed the threshold for a taxpayer's deduction of unreimbursed medical expenses; however, it did not eliminate it. Please try again.

B. Your answer is correct. Harriet may deduct her unreimbursed medical expenses not exceeding $5,500. The applicable threshold for a taxpayer's deduction of unreimbursed medical expenses was scheduled to be 10% of AGI in 2020. However, tax extender legislation passed in late 2019 returned the applicable AGI threshold to 7.5%.

C. Your answer is incorrect. Under the TCJA, the applicable AGI threshold for deducting unreimbursed medical expenses in 2020 was scheduled to be 10%. However, tax extender legislation passed in late 2019 changed that threshold.

D. Your answer is incorrect. While unreimbursed medical expenses are deductible by a taxpayer choosing to itemize deductions, only such expenses in excess of a threshold amount are deductible. Please try again.

Question 2 Feedback

A. Your answer is correct. Miscellaneous itemized deductions subject to 2% of AGI limitation are suspended under the Tax Cuts and Jobs Act of 2017. For that reason, no part of John's business expenses incurred for his employer may be deducted.

B. Your answer is incorrect. Prior to passage of the Tax Cuts and Jobs Act of 2017, such business expenses incurred on behalf of an employer were deductible subject to a 2% of AGI threshold. The new law changed that. Please try again.

C. Your answer is incorrect. Although part of unreimbursed business expenses incurred by an employee on behalf of an employer were deductible under prior law subject to a specific AGI threshold, the Tax Cuts and Jobs Act of 2017, generally effective in 2018, amended that provision. Please try again.

D. Your answer is incorrect. Unreimbursed business expenses incurred by an employee on behalf of an employer have traditionally been deductible subject to an AGI threshold. Please try again.

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Appendix A

Form 8815 Department of the Treasury Internal Revenue Service (99)	**Exclusion of Interest From Series EE and I U.S. Savings Bonds Issued After 1989** (For Filers With Qualified Higher Education Expenses) ➢ Attach to Form 1040	OMB. No. 1545-0074 20XX Attachment Sequence No. 167

Name(s) shown on return	Your social security number

1 **(a)** Name of person (you, your spouse, or your dependent) who was enrolled at or attended an eligible education institution	**(b)** Name and address of eligible educational institution

If you need more space, attach a statement.

2	Enter the total qualified higher education expenses you paid in 201X for the person(s) listed in column (a) of line 1. See the instructions to find out which expenses qualify.	2	
3	Enter the total of any nontaxable educational benefits (such as nontaxable scholarship or fellowship grants) received for 201X for the person(s) listed in column (a) of line 1 (see instructions)	3	
4	Subtract line 3 from line 2. If zero or less, **stop**. You **cannot** take the exclusion.	4	
5	Enter the total proceeds (principal and interest) from all series EE and I U.S. savings bonds **issued after 1989** that you **cashed during 201X**	5	
6	Enter the interest included on line 5 (see instructions).	6	
7	If line 4 is equal to or more than line 5, enter "1.000." If line 4 is less than line 5, divide line 4 by line 5. Enter the result as a decimal (rounded to at least three places).	7	
8	Multiply line 6 by line 7	8	
9	Enter your modified adjusted gross income (see instructions). . . 9 ____ **Note:** *If line 9 is $97,350 or more if single or head of household, or $153,550 or more if married filing jointly or qualifying widow(er) with dependent child,* ***stop.*** *You* ***cannot*** *take the exclusion.*		
10	Enter: $82,350 if single or head of household; $123,550 if married filing jointly . . . . 10 ____		
11	Subtract line 10 from line 9. If zero or less, skip line 12, enter -0- on line 13, and go to line 14 . . . . 11 ____		
12	Divide line 11 by: $15,000 if single or head of household; $30,000 if married filing jointly or qualifying widow(er) with dependent child. Enter the result as a decimal (rounded to at least three places)	12	
13	Multiply line 8 by line 12	13	
14	**Excludable savings bond interest.** Subtract line 13 from line 8. Enter the result here and on Schedule B (Form 1040), line 3 . . . .>	14	

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FINAL EXAM

Federal Income Tax Changes - 2020

The following exam is attached only for your convenience. To access the official exam for this self-study course, please log into your account online and take the Final Exam from the course details page. A passing score of 70 percent or better will receive course credit and a Certificate of Completion.

1. What is the 2020 standard deduction for a 50 year-old married couple filing jointly, neither of whom is blind?
   A. $8,100
   B. $12,400
   C. $24,800
   D. $18,350
2. Julian is age 60 and paid $1,700 in premiums for qualified long-term care insurance in 2020, how much of the premium can he include in his medical expenses?
   A. $0
   B. $1,060
   C. $1,630
   D. $1,700
3. Lloyd is chronically-ill and received tax-qualified long-term care insurance benefits in 2020 amounting to $8,000 to cover a 30-day nursing home stay. What amount, if any, must he include in income if actual nursing home costs for the 30 days amounted to $7,500 and the applicable *per diem* limitation was $380?
   A. $0
   B. $500
   C. $7,500
   D. $8,000
4. Barbara is a single taxpayer who had a 2020 adjusted gross income of $25,000 and who contributed $4,000 to her traditional IRA. Assuming she has a $2,000 income tax liability for the year, what is her maximum retirement contribution savings credit?
   A. $200
   B. $800
   C. $1,000
   D. $2,000
5. Gail and Bob are married and file a joint tax return in 2020. They had a $34,000 adjusted gross income and each deferred $2,000 into their employer's 401(k) plan. If they have a $500 income tax liability, what is the amount of their retirement contribution savings credit?
   A. $0
   B. $500
   C. $1,000
   D. $2,000

6. Lois, a single taxpayer, contributed $1,200 to her traditional IRA in 2020. If she received a $240 saver's credit and was not an active participant in an employer-sponsored retirement plan, how much of the contribution can she deduct?

   A. $0

   B. $240

   C. $960

   D. $1,200

7. What is the minimum penalty for which a non-exempt family of four adults would be liable in 2020 for failing to maintain minimum essential coverage for the entire year under the provisions of the PPACA?

   A. $0

   B. $975

   C. $2,085

   D. $2,780

8. Barbara's employer offers health coverage to its employees. However, Barbara feels it is unaffordable and wants to apply for a health insurance premium tax credit. In order for the coverage to be deemed unaffordable in 2020, Barbara's self-only premium must exceed ___% of her household income.

   A. 2.08%

   B. 9.78%

   C. 12.05%

   D. 15.08%

9. What is the maximum amount that may be contributed to an employer's flexible spending arrangement for medical expenses in 2020?

   A. $2,750

   B. $5,100

   C. $10,200

   D. No dollar limit applies to flexible spending account contributions for medical expenses.

10. Bill, age 65, has 2020 unreimbursed medical expenses totaling $20,000 and an adjusted gross income of $170,000. What is the amount of such medical expenses he can deduct?

    A. $0

    B. $3,000

    C. $7,250

    D. $20,000

11. Marilyn is eligible to receive Medicare. If she receives a $15,000 taxable HSA distribution this year, what tax penalty, if any, will apply?

    A. $0

    B. $1,500

    C. $3,000

    D. $7,500

12. Linda, age 58, contributed $3,000 to her traditional IRA in 2020. If her permitted Roth IRA contribution is not reduced because of her income, what is the maximum amount she can contribute to it in 2020?

A. $7,000

B. $6,000

C. $4,000

D. $2,000

13. What is the standard deduction in 2020 for an unmarried taxpayer?

    A. $6,700

    B. $12,400

    C. $24,800

    D. The standard deduction is eliminated in 2020

14. What is the maximum per-child refundable Child Tax Credit in 2020?

    A. $2,000

    B. $1,400

    C. $1,000

    D. No part of the Child Tax Credit is refundable

15. Bob and Sharon reside in a state having high real property taxes. What amount of their $25,000 state and local taxes (including their property tax) can they deduct from income on their federal income tax return?

    A. $0

    B. $10,000

    C. $15,000

    D. $25,000