

Chapter 1: Individual Taxpayer Issues

Affordable Care Act Review.....	A3	TCJA Changes	A58
Shared Responsibility Payment.....	A3	U.S. Savings Bonds Used for	
Premium Tax Credit.....	A5	Educational Expenses	A59
Qualified Charitable Distributions	A16	Qualified U.S. Savings Bonds	A59
IRA Accounts Eligible for a QCD	A17	Qualified Higher Education Expenses	A60
Organizations Qualifying for a QCD	A18	Income Limits	A61
Filing Requirements	A19	Claiming the Interest Exclusion	A61
Married Filing Separately Filing Status.....	A22	Tax-Free Interest Calculation	
Special Rules.....	A22	When Proceeds Exceed Expense	A64
Community Property Rules	A24	Coverdell Education Savings Account	A64
Joint and Several Liability.....	A27	Qualified Education Expenses.....	A65
Income-Driven Repayment Plan	A28	Eligible Educational Institutions.....	A66
Itemized Deductions	A29	Contributions to a Coverdell ESA	A67
Tax Refund Offset.....	A31	Rollovers.....	A69
Amending Returns.....	A31	Distributions.....	A70
Qualified Business Income Deduction	A34	Scholarships or Fellowships	A74
Summary of Factors Affecting the		Exclusion Requirements.....	A75
QBID of Married Taxpayers	A40	Reporting Scholarship Income	A76
Education Credits.....	A41	Qualified Tuition Reduction.....	A78
American Opportunity Credit.....	A41	Eligible Educational Institutions.....	A79
Lifetime Learning Credit.....	A49	Officers, Owners, and Highly	
Comparing the AOC and		Compensated Employees	A79
Lifetime Learning Credit.....	A53	Education Below the Graduate Level.....	A79
Coordinating Education Tax Benefits	A54	Graduate Level Education.....	A79
Qualified Tuition Programs.....	A56	Reporting Tuition Reductions	A79
Eligible Educational Institutions	A57	Other Forms of Educational Assistance.....	A80
Qualified Higher Education Expenses	A57	Fulbright Grants.....	A80
Rollover to a New §529 Plan	A58	Pell Grants.....	A80
Contribution Amounts	A58	Veterans' Benefits.....	A80

Please note. Corrections were made to this workbook through January of 2020. No subsequent modifications were made. For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

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AFFORDABLE CARE ACT REVIEW

This section includes information on updates to the Affordable Care Act of 2010¹ (ACA) relevant to the tax practitioner. The following general areas are covered.

- Shared responsibility payment
- Premium tax credit

SHARED RESPONSIBILITY PAYMENT

The ACA created an individual mandate, which became effective January 1, 2014. The individual mandate generally required individuals to maintain qualifying healthcare coverage, called minimum essential coverage (MEC), or pay a penalty.² The penalty is called the **shared responsibility payment (SRP)**. Unless an individual qualified for an exception, the annual penalty (sometimes referred to as a tax) was the **greater** of the following for 2016–2018.³

1. \$695 per adult plus \$347.50 per child under the age of 18, with a maximum penalty per family of \$2,085
2. 2.5% of the household's annual income above the tax filing threshold

Effective January 1, 2019, the Tax Cuts and Jobs Act (TCJA) reduced the penalty imposed on individuals who do not maintain health insurance that provides MEC to **zero**.⁴ Technically, individuals who do not qualify for an exception are still required to carry MEC; however, they are not subject to a penalty if they do not have MEC.

Exemptions from Penalty

For 2014 through 2018, the SRP provision required each individual to have MEC, have an exemption, or make a shared responsibility payment with their tax return. If the taxpayer had full-year coverage or was exempt, they indicated this by checking a box on page 1 of Form 1040, *U.S. Individual Income Tax Return*. If the taxpayer could not check this box but they or a member of their tax household had a coverage exemption that did not cover every month of the tax year, taxpayers were instructed to file Form 8965, *Health Coverage Exemptions*, with their tax return, if all the following applied.⁵

- The taxpayer was filing a Form 1040.
- The taxpayer could not be claimed as a dependent by another taxpayer.
- For one or more months of the tax year, the taxpayer or someone in the taxpayer's tax household did not have MEC or a coverage exemption.
- The taxpayer can claim part-year exemptions or exemptions for specific members of their tax household. This reduced the amount of the SRP.

¹. PL 111-148.

². IRC §5000A.

³. *Individual Shared Responsibility Provision—Reporting and Calculating the Payment*. Mar. 29, 2019. IRS. [www.irs.gov/affordable-care-act/individuals-and-families/aca-individual-shared-responsibility-provision-calculating-the-payment] Accessed on Apr. 24, 2019; IRC §5000A.

⁴. IRC §5000A(c)(3)(A), as amended by the TCJA.

⁵. Instructions for Form 8965.

2019 Workbook

The following chart from the 2018 instructions to Form 8965 shows the types of coverage exemptions that were available.

Types of Coverage Exemptions

This chart shows all of the coverage exemptions available for 2018, including information about where each can be obtained and the code that is to be used on Form 8965 when you claim the exemption. If your coverage exemption was granted by the Marketplace, you will need to enter the Exemption Certificate Number (ECN) provided by the Marketplace (see the instructions for [Part I](#)). For additional details about the eligibility rules for the coverage exemptions that are claimed on the tax return, see the instructions for Part III, later. For additional details about how you can check the “Full-year health care coverage or exempt” box on Form 1040 if your household or gross income is below your filing threshold, see the instructions for Part II, later.

Coverage Exemption	Granted by Marketplace	Claimed on Tax Return	Code for Exemption
Income below the filing threshold —Your gross income or your household income was less than your applicable minimum threshold for filing a tax return.		✓	No Code See Part II
Coverage considered unaffordable —The <u>required contribution</u> is more than 8.05% of your household income.		✓	A
Short coverage gap —You went without coverage for less than 3 consecutive months during the year.		✓	B
Citizens living abroad and certain noncitizens —You were: <ul style="list-style-type: none"> • A U.S. citizen or a resident alien who was physically present in a foreign country or countries for at least 330 full days during any period of 12 consecutive months; • A U.S. citizen who was a bona fide resident of a foreign country or countries for an uninterrupted period that includes the entire tax year; • A bona fide resident of a U.S. territory; • A resident alien who was a citizen or national of a foreign country with which the U.S. has an income tax treaty with a nondiscrimination clause, and you were a bona fide resident of a foreign country for an uninterrupted period that includes the entire tax year; • Not lawfully present in the U.S. and not a U.S. citizen or U.S. national. For more information about who is treated as lawfully present in the U.S. for purposes of this coverage exemption, visit www.HealthCare.gov; or • A nonresident alien, including (1) a dual-status alien in the first year of U.S. residency and (2) a nonresident alien or dual-status alien who elects to file a joint return with a U.S. spouse. This exemption doesn't apply if you are a nonresident alien for 2018, but met certain presence requirements and elected to be treated as a resident alien. For more information, see Pub. 519. 		✓	C
Members of a health care sharing ministry —You were a member of a health care sharing ministry.		✓	D
Members of Indian tribes —You were either a member of a federally recognized Indian tribe, including an Alaska Native Claims Settlement Act (ANCSA) Corporation Shareholder (regional or village), or you were otherwise eligible for services through an Indian health care provider or the Indian Health Service.	*	✓	E
Incarceration —You were in a jail, prison, or similar penal institution or correctional facility after the disposition of charges.		✓	F
Aggregate self-only coverage considered unaffordable —Two or more family members' aggregate cost of self-only employer-sponsored coverage was more than 8.05% of household income, as was the cost of any available employer-sponsored coverage for the entire family.		✓	G
Resident of a state that didn't expand Medicaid —Your household income was below 138% of the federal poverty line for your family size and at any time in 2018 you resided in a state that didn't participate in the Medicaid expansion under the Affordable Care Act.		✓	G
General hardship —You experienced a hardship that prevented you from obtaining coverage under a qualified health plan.		✓	G
Member of tax household born or adopted during the year —The months before and including the month that an individual was added to your tax household by birth or adoption. You should claim this exemption only if you also are claiming another exemption on your Form 8965.		✓	H
Member of tax household died during the year —The months after the month that a member of your tax household died during the year. You should claim this exemption only if you also are claiming another exemption on your Form 8965.		✓	H
Members of certain religious sects —The Marketplace determined that you are a member of a recognized religious sect.	✓		Need ECN See Part I
Ineligible for Medicaid based on a state's decision not to expand Medicaid coverage —The Marketplace found that you would have been determined ineligible for Medicaid solely because the state in which you resided didn't participate in Medicaid expansion under the Affordable Care Act.	✓		Need ECN See Part I
Coverage considered unaffordable based on projected income —The Marketplace determined that you didn't have access to coverage that is considered affordable based on your projected household income.	✓		Need ECN See Part I
Certain Medicaid programs that are not minimum essential coverage —The Marketplace determined that you were (1) enrolled in Medicaid coverage provided to a pregnant woman that isn't recognized as minimum essential coverage; (2) enrolled in Medicaid coverage provided to a medically needy individual (also known as Spend-down Medicaid or Share-of-Cost Medicaid) that isn't recognized as minimum essential coverage; or (3) enrolled in Medicaid coverage provided to a medically needy individual and were without coverage for other months because the spend-down had not been met.	✓		Need ECN See Part I

*The coverage exemption for members of Indian tribes is no longer granted by the Marketplace, except in Connecticut. See the instructions for Part I, later, to claim the exemption.

Obtaining Refund of Penalty

The law prohibits the IRS from using liens or levies to collect any unpaid SRP. However, the IRS can offset the taxpayer's SRP liability against any tax refund that may be due to the taxpayer.⁶

If the IRS assessed the SRP against a taxpayer, the taxpayer may be able to obtain a refund by filing Form 843, *Claim for Refund and Request for Abatement*. In *Cash v. U.S.*,⁷ the taxpayers filed a Form 843 to claim a refund of the \$575 SRP that had been deducted from their 2014 income tax refund. Along with the Form 843, the taxpayers raised various constitutional objections to the assessment. The IRS returned the form to them with instructions to file a Form 1040X, *Amended U.S. Individual Income Tax Return*, if they wanted to change anything on their original return. Instead of filing a Form 1040X, the taxpayers filed suit in district court.

The district court dismissed the complaint for lack of jurisdiction. According to the court, the taxpayers should have filed a Form 1040X instead of a Form 843.

Treas. Reg. §301.6402-3(a) provides special rules that “apply to a claim for credit or refund of income tax.” These rules state that, “in the case of an overpayment of income taxes for a taxable year of an individual for which a Form 1040 or 1040A has been filed, a claim for refund shall be made on Form 1040X...” The taxpayers argued that the district court erred in concluding that these special rules applied to their claim. They contended that the SRP was not a tax, but rather a penalty for which Form 843 was the proper vehicle for seeking a refund.

To support their argument, the taxpayers cited the Supreme Court's decision in *National Federation of Independent Business et al. v. Sebelius*,⁸ which held that the SRP was a penalty for purposes of the anti-injunction act but recognized that the payment could be considered a tax for “constitutional purposes.”⁹

The Third Circuit Court of Appeals disagreed with the district court that the taxpayers were seeking a refund of income taxes. The appeals court noted that although the \$575 SRP was offset against the taxpayer's income tax refund, the payment was remitted to the government as a “penalty” under IRC §5000A(b). The taxpayers challenged the assessment of this “penalty,” rather than the withholding of income taxes. Accordingly, the appeals court concluded that Form 843 was the proper form to be used when seeking the refund of penalties.

PREMIUM TAX CREDIT

Generally, taxpayers with incomes between 100% and 400% of the federal poverty guidelines applicable for the taxpayer's family size may be entitled to the premium tax credit (PTC), which is a refundable tax credit. For the taxpayer or qualifying individual within the taxpayer's household to qualify for the PTC, the taxpayer must have MEC. A taxpayer's PTC is based on the number of coverage months during the year in which the taxpayer qualifies for the PTC.¹⁰

Note. For the definition of applicable taxpayers, MEC, and related rules associated with qualification for the PTC, see IRC §36B and the related regulations and the 2012 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 7: Healthcare Reform Act. This can be found at uofi.tax/arc [taxschool.illinois.edu/taxbookarchive].

For federal poverty guideline amounts, which are updated annually, see uofi.tax/19a1x2 [aspe.hhs.gov/poverty-guidelines].

⁶ *Questions and Answers on the Individual Shared Responsibility Provision*. Mar. 8, 2019. IRS. [www.irs.gov/affordable-care-act/individuals-and-families/questions-and-answers-on-the-individual-shared-responsibility-provision] Accessed on Apr. 25, 2019.

⁷ *Cash v. U.S.*, No. 17-1441 (3rd Cir. 2018).

⁸ *Nat'l Fed. of Indep. Bus. v. Sebelius*, 567 U.S. 519, 564 (2012).

⁹ *Ibid* at 566.

¹⁰ IRC §36B.

The PTC is intended to assist qualifying taxpayers with the cost of MEC. A taxpayer who qualifies for the PTC may either:¹¹

- Pay the full amount of the monthly health insurance premiums (or make one annual payment for the year), or
- Choose to receive an advance premium tax credit (APTC), which provides direct monthly payments to the health insurance company on the taxpayer's behalf to assist with the monthly cost of their health coverage.



Practitioner Planning Tip

Some individuals may have purchased insurance through the Marketplace yet opted out of the PTC when they signed up. This does not preclude the taxpayer from receiving a PTC when filing their tax return. In addition, it may be necessary to obtain data about the second lowest cost silver plan from the Marketplace to determine the applicable benchmark, as explained below. It is important to note that taxpayers must have purchased their health insurance through the Marketplace in order to be eligible for a PTC or APTC.

One factor used in the calculation that determines the amount of PTC to which the taxpayer is entitled is the cost of the **“second lowest cost silver plan”** that is available to the taxpayer in the Marketplace.¹² The second lowest-cost silver plan is referred to as the **applicable benchmark plan**. The applicable benchmark plan is generally self-only coverage for either single taxpayers without dependents or family coverage for taxpayers with a spouse and/or dependents.¹³

Calculating the PTC amount for a qualifying taxpayer begins by analyzing their income against a sliding scale. The low end of the sliding scale is 100% of the poverty income guideline for the taxpayer, based on the number of persons in the taxpayer's family. The high end of the scale is 400% of the poverty income guideline that applies to the taxpayer based on family size. If the taxpayer's household income is not within these two end points of the sliding scale, the taxpayer does not qualify for the PTC.¹⁴

The taxpayer's household income is multiplied by the applicable percentage to arrive at the annual contribution for healthcare. The applicable percentage depends on where the taxpayer's household income falls on the sliding scale.¹⁵

¹¹ *Questions and Answers on the Premium Tax Credit*. Feb. 8, 2019. IRS. [www.irs.gov/affordable-care-act/individuals-and-families/questions-and-answers-on-the-premium-tax-credit] Accessed on Apr. 23, 2019.

¹² IRC §36B(b)(2)(B)(i).

¹³ Treas. Reg. §1.36B-3(f).

¹⁴ Treas. Reg. §1.36B-3(g).

¹⁵ Ibid.

The sliding scale is **tiered**. A lower and upper applicable percentage define each tier. For tax years beginning in 2019, the sliding scale's tiers and the applicable percentages for each tier are summarized as follows.¹⁶

Amount of Household Income ^a	Lower Applicable Percentage ^b	Upper Applicable Percentage ^c
100% to 133%	2.08%	2.08%
133% to 150%	3.11%	4.15%
150% to 200%	4.15%	6.54%
200% to 250%	6.54%	8.36%
250% to 300%	8.36%	9.86%
300% to 400%	9.86%	9.86%

^a Expressed as a percentage of the poverty income guideline for the taxpayer's family size.

^b Also referred to as the "Initial Premium Percentage."

^c Also referred to as the "Final Premium Percentage."

For taxpayers with household incomes within an income tier in the above table, the income and the applicable percentage are linearly related and the applicable percentage is rounded to the nearest one-hundredth of 1%. For example, a taxpayer with household income of 275% of the poverty income guideline falls into the fifth tier and is exactly at the midpoint between 250% and 300%. That taxpayer's applicable percentage is therefore at the midpoint between the lower 8.36% and upper 9.86% applicable percentages, rounded to the nearest one-hundredth of 1% (which is 9.11%).¹⁷

Calculating the PTC

The taxpayer's PTC is the lesser of:¹⁸

1. The premiums paid, or
2. The cost of the applicable benchmark plan available to the taxpayer minus the annual contribution for healthcare. This is expressed by the following formula.

$$\text{Amount of PTC available} = \text{Cost of applicable benchmark plan available to the taxpayer} - \text{Annual contribution for healthcare}$$

Note. For additional details on PTC eligibility and on the calculation of a taxpayer's PTC, including the definition of "applicable benchmark plan," see Treas. Reg. §1.36B-3 and the 2012 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 7: Healthcare Reform Act. This can be found at uofi.tax/arc [taxschool.illinois.edu/taxbookarchive].

¹⁶ Rev. Proc. 2018-34, 2018-23 IRB 748.

¹⁷ Treas. Reg. §1.36B-3(g).

¹⁸ Treas. Reg. §1.36B-3(d).

Example 1. Annabeth is a single taxpayer living in Illinois. She has no dependents. She estimates her 2018 household income will be \$30,150. For the 2018 tax year, the 2017 federal poverty guideline amounts are used. For the 48 contiguous states and the District of Columbia, for her family size of one, the applicable federal poverty guideline is \$12,060.¹⁹ Therefore, her estimated household income is 250% ($\$30,150 \div \$12,060$) of the federal poverty guideline.

She purchased insurance from the Marketplace that had a monthly premium of \$519 and received a \$200 per month advance payment of her PTC (applied against her premium). The cost of the applicable benchmark plan in the Marketplace was \$478 per month.

Based on Annabeth's estimated 2018 household income, the PTC available to her is calculated as follows.

$(\$478 \text{ applicable benchmark plan} \times 12 \text{ months}) - (\$30,150 \text{ household income} \times 8.10\% \text{ applicable percentage for 2018}^{20}) = \$3,294 \text{ PTC available}$

Reconciling the PTC

Generally, at the time a taxpayer applies for Marketplace coverage, the taxpayer provides the Marketplace with an income estimate for the year. This income estimate affects the provisional amount of PTC the taxpayer will receive for the year.²¹ This amount is later reconciled with actual income on the taxpayer's return for the year using Form 8962, *Premium Tax Credit (PTC)*. Multiple factors can result in a difference between the estimated PTC (upon which APTCs used to pay for premiums during the year are based) and the actual PTC (calculated later on the taxpayer's return for the year). Some of these factors include the following.²²

- The taxpayer's actual household income is higher or lower than the amount estimated.
- The taxpayer, or a member of the taxpayer's household, becomes eligible or ineligible for MEC.
- The taxpayer, or a member of the taxpayer's household, becomes eligible for employer-sponsored coverage (and therefore no longer qualifies for the PTC).
- Events such as a birth or adoption of a child, a divorce, or a marriage affects the taxpayer's family size.

Note. For additional details on PTC eligibility and on the calculation of a taxpayer's PTC, including the definition of "applicable benchmark plan," see Treas. Reg. §1.36B-3 and the 2012 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 7: Healthcare Reform Act. This can be found at uofi.tax/arc [taxschool.illinois.edu/taxbookarchive].

Example 2. Use the same facts as **Example 1**. Annabeth's household income for 2018 was \$31,000, rather than the \$30,150 that she estimated in early 2018. Her tax preparer completes the following Form 8962 to reconcile the estimated PTC with the actual PTC she is entitled to. Annabeth received total APTCs of \$2,400 ($\200×12) but the total PTC calculated on Form 8962 is \$3,163, for a difference of \$763. This amount is entered on Schedule 5, *Other Payments and Refundable Credits*, which is shown after the Form 8962. Annabeth claims the \$763 refundable credit on her 2018 Form 1040.

¹⁹ Instructions for Form 8962 (2018).

²⁰ Rev. Proc. 2017-36, 2017-21 IRB 1251.

²¹ *How to save on your monthly insurance bill with a premium tax credit*. U.S. Centers for Medicare & Medicaid Services. [www.healthcare.gov/lower-costs/save-on-monthly-premiums] Accessed on Apr. 23, 2019.

²² *Questions and Answers on the Premium Tax Credit*. Feb. 8, 2019. IRS. [www.irs.gov/affordable-care-act/individuals-and-families/questions-and-answers-on-the-premium-tax-credit] Accessed on Apr. 23, 2019.

For Example 2

Form 8962 Department of the Treasury Internal Revenue Service Name shown on your return	Premium Tax Credit (PTC) ▶ Attach to Form 1040 or Form 1040NR. ▶ Go to www.irs.gov/Form8962 for instructions and the latest information.	OMB No. 1545-0074 2018 Attachment Sequence No. 73				
Annabeth Lee		Your social security number 456-78-9123				
You cannot take the PTC if your filing status is married filing separately unless you qualify for an exception (see instructions). If you qualify, check the box <input type="checkbox"/>						
Part I Annual and Monthly Contribution Amount						
1 Tax family size. Enter your tax family size (see instructions)		1				
2a Modified AGI. Enter your modified AGI (see instructions)	2a 31,000					
b Enter the total of your dependents' modified AGI (see instructions)	2b					
3 Household income. Add the amounts on lines 2a and 2b (see instructions)		31,000				
4 Federal poverty line. Enter the federal poverty line amount from Table 1-1, 1-2, or 1-3 (see instructions). Check the appropriate box for the federal poverty table used. a <input type="checkbox"/> Alaska b <input type="checkbox"/> Hawaii c <input checked="" type="checkbox"/> Other 48 states and DC		12,060				
5 Household income as a percentage of federal poverty line (see instructions)		257 %				
6 Did you enter 401% on line 5? (See instructions if you entered less than 100%.) <input checked="" type="checkbox"/> No. Continue to line 7. <input type="checkbox"/> Yes. You are not eligible to take the PTC. If advance payment of the PTC was made, see the instructions for how to report your excess advance PTC repayment amount.						
7 Applicable Figure. Using your line 5 percentage, locate your "applicable figure" on the table in the instructions0830				
8a Annual contribution amount. Multiply line 3 by line 7. Round to nearest whole dollar amount	8a 2,573					
b Monthly contribution amount. Divide line 8a by 12. Round to nearest whole dollar amount		8b 214				
Part II Premium Tax Credit Claim and Reconciliation of Advance Payment of Premium Tax Credit						
9 Are you allocating policy amounts with another taxpayer or do you want to use the alternative calculation for year of marriage (see instructions)? <input type="checkbox"/> Yes. Skip to Part IV, Allocation of Policy Amounts, or Part V, Alternative Calculation for Year of Marriage. <input checked="" type="checkbox"/> No. Continue to line 10.						
10 See the instructions to determine if you can use line 11 or must complete lines 12 through 23. <input checked="" type="checkbox"/> Yes. Continue to line 11. Compute your annual PTC. Then skip lines 12–23 and continue to line 24. <input type="checkbox"/> No. Continue to lines 12–23. Compute your monthly PTC and continue to line 24.						
Annual Calculation	(a) Annual enrollment premiums (Form(s) 1095-A, line 33A)	(b) Annual applicable SLCSP premium (Form(s) 1095-A, line 33B)	(c) Annual contribution amount (line 8a)	(d) Annual maximum premium assistance (subtract (c) from (b), if zero or less, enter -0-)	(e) Annual premium tax credit allowed (smaller of (a) or (d))	(f) Annual advance payment of PTC (Form(s) 1095-A, line 33C)
11 Annual Totals	6,228	5,736	2,573	3,163	3,163	2,400
Monthly Calculation	(a) Monthly enrollment premiums (Form(s) 1095-A, lines 21–32, column A)	(b) Monthly applicable SLCSP premium (Form(s) 1095-A, lines 21–32, column B)	(c) Monthly contribution amount (amount from line 8b or alternative marriage monthly calculation)	(d) Monthly maximum premium assistance (subtract (c) from (b), if zero or less, enter -0-)	(e) Monthly premium tax credit allowed (smaller of (a) or (d))	(f) Monthly advance payment of PTC (Form(s) 1095-A, lines 21–32, column C)
12 January						
13 February						
14 March						
15 April						
16 May						
17 June						
18 July						
19 August						
20 September						
21 October						
22 November						
23 December						
24 Total premium tax credit. Enter the amount from line 11(e) or add lines 12(e) through 23(e) and enter the total here						24 3,163
25 Advance payment of PTC. Enter the amount from line 11(f) or add lines 12(f) through 23(f) and enter the total here						25 2,400
26 Net premium tax credit. If line 24 is greater than line 25, subtract line 25 from line 24. Enter the difference here and on Schedule 5 (Form 1040), line 70, or Form 1040NR, line 65. If line 24 equals line 25, enter -0-. Stop here. If line 25 is greater than line 24, leave this line blank and continue to line 27						26 763
Part III Repayment of Excess Advance Payment of the Premium Tax Credit						
27 Excess advance payment of PTC. If line 25 is greater than line 24, subtract line 24 from line 25. Enter the difference here						27
28 Repayment limitation (see instructions)						28
29 Excess advance premium tax credit repayment. Enter the smaller of line 27 or line 28 here and on Schedule 2 (Form 1040), line 46, or Form 1040NR, line 44						29

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 37784Z

Form **8962** (2018)

2019 Workbook

For Example 2

SCHEDULE 5 (Form 1040) Department of the Treasury Internal Revenue Service		Other Payments and Refundable Credits ▶ Attach to Form 1040. ▶ Go to www.irs.gov/Form1040 for instructions and the latest information.		OMB No. 1545-0074 2018 Attachment Sequence No. 05	
Name(s) shown on Form 1040 Annabeth Lee				Your social security number 456-78-9123	
Other Payments and Refundable Credits	65	Reserved	65		
	66	2018 estimated tax payments and amount applied from 2017 return	66		
	67a	Reserved	67a		
	b	Reserved	67b		
	68-69	Reserved	68-69		
	70	Net premium tax credit. Attach Form 8962	70		763
	71	Amount paid with request for extension to file (see instructions)	71		
	72	Excess social security and tier 1 RRTA tax withheld	72		
	73	Credit for federal tax on fuels. Attach Form 4136	73		
	74	Credits from Form: a <input type="checkbox"/> 2439 b <input checked="" type="checkbox"/> Reserved c <input type="checkbox"/> 8885 d <input type="checkbox"/>	74		
75	Add the amounts in the far right column. These are your total other payments and refundable credits . Enter here and include on Form 1040, line 17.	75		763	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71482C Schedule 5 (Form 1040) 2018

As mentioned earlier, taxpayers who receive APTCs to assist with premium payments during the year must reconcile the estimated PTC with the actual PTC for which they are eligible.²³ If APTC payments exceed the PTC for which the taxpayer actually qualifies, the excess is reported as additional tax liability on the taxpayer's return for the year. However, if the taxpayer who received an excess APTC has a household income of less than 400% of the federal poverty guideline, the amount of any such repayment is limited.²⁴ The repayment limitations are discussed later.

Note. For information about estimating income for the year, see uofi.tax/16a6x3 [www.healthcare.gov/income-and-household-information/how-to-report].

Observation. Because the reconciliation and APTC recovery rules are complex, frequently a taxpayer does not understand why they either owe tax or have a substantially reduced tax refund from the amount they anticipated. It is essential for the tax preparer to advise taxpayers to be as accurate as possible with income estimates provided to the Marketplace. To prevent an unexpected tax liability, updated income information should be provided to the Marketplace.

Definition of Household Income

For a taxpayer to provide an accurate income estimate to the Marketplace, it is essential that the taxpayer understand what is included in the definition of income. For health coverage calculation purposes, **income** means **household income**, which is defined as the sum of the following.²⁵

- The taxpayer's modified adjusted gross income (MAGI)
- The aggregate MAGI of other members of the taxpayer's family who are required to file a tax return for the year

²³ IRC §36B(f).

²⁴ Ibid.

²⁵ IRC §36B(d)(2).

MAGI is defined as the taxpayer's adjusted gross income **increased** by:

- Tax-exempt interest,
- The **nontaxable portion** of social security benefits, and
- Untaxed foreign income.²⁶

The **taxpayer's family** includes individuals for whom the taxpayer may appropriately claim a personal exemption.²⁷

Note. Under the TCJA, the personal exemption amount is reduced to zero for tax years beginning after December 31, 2017, and before January 1, 2026.²⁸ IRC §151(d)(5)(B) states that, "For purposes of any other provision of this title, the reduction of the exemption amount to zero... shall not be taken into account in determining whether a deduction is allowed or allowable, or whether a taxpayer is entitled to a deduction, under this section." This means that if a taxpayer is required to qualify for a personal exemption for purposes of any other Code provision (e.g., the PTC), they are still required to do so, even though the personal exemption is reduced to zero.



Practitioner Planning Tip

Many taxpayers think that social security benefits, disability income, or other benefits are not part of their income for purposes of a Marketplace income estimate. Tax preparers should advise clients of the broad definition of household income so that the taxpayer may provide a more accurate estimate. This will help prevent large discrepancies in PTC reconciliations on Form 8962. For a recent case involving taxpayers who received advance payments of the PTC but were determined to be ineligible because of lump-sum social security payments, see *Charles and Rebecca Monroe v. Comm'r*,²⁹ which is summarized in the 2019 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 4: Rulings and Cases.

Note. For taxpayers who anticipate a change in household income or family size during the year, the Taxpayer Advocate Service provides an online Premium Tax Credit Change Estimator that may be used to predict the amount by which the taxpayer's PTC will change as a result of such events during the year. This online tool can be found at **uofi.tax/16a6x5** [www.taxpayeradvocate.irs.gov/estimator/premiumtaxcreditchange]. In addition, the U.S. Centers for Medicare & Medicaid Services provides a tool that helps taxpayers estimate the amount of their Marketplace healthcare premium and PTC, if any. This can be found at **uofi.tax/19a1x3** [www.healthcare.gov/lower-costs].

²⁶ Ibid.

²⁷ Treas. Reg. §1.5000A-1(d)(4).

²⁸ IRC §151(d)(5).

²⁹ *Charles and Rebecca Monroe v. Comm'r*, TC Memo 2019-41 (Apr. 24, 2019).

Repayment Limitations

If the APTCs exceed the amount of PTC for which the taxpayer actually qualifies, the taxpayer owes an additional tax liability on the return filed for the year.³⁰ However, taxpayers who must repay APTC amounts may benefit from the caps on such repayments if household income is below 400% of the federal poverty guideline for their family size. For 2019, the limits on repayment of the APTC are shown in the following table.³¹ These amounts are adjusted annually for inflation.³²

Household Income Percentage of Federal Poverty Guideline	Maximum Repayment (Single Filing Status)	Maximum Repayment Amount (Filing Status other than Single)
Less than 200%	\$ 300	\$ 600
At least 200% but less than 300%	800	1,600
At least 300% but less than 400%	1,325	2,650

For taxpayers with household incomes that are slightly above 400% of the federal poverty guideline applicable to the taxpayer's family size, it may be possible to reduce the taxpayer's MAGI in order to limit the repayment amount. Such a taxpayer would otherwise not qualify for a repayment limitation.



Practitioner Planning Tip

Practitioners should consider the following strategies to reduce a taxpayer's MAGI to prevent or reduce a potential PTC repayment. The goal of these strategies is to keep the taxpayer's MAGI at or below 400% of the federal poverty guideline amounts.

Taxpayers may reduce their MAGI by using the following methods.

- IRA deduction
- Health savings account deduction
- Self-employed retirement plan contributions (e.g., SEP, SIMPLE, and 401(k))
- Other above-the-line deductions, such as depreciation and IRC §179 expense

Because the self-employed health insurance deduction is allowed in calculating adjusted gross income (AGI) and because AGI is needed to calculate the PTC, the taxpayer must know the allowable self-employed health insurance deduction to calculate the PTC. This requires a circular calculation. Therefore, a taxpayer who is eligible for both a self-employed health insurance deduction and a PTC may have difficulty determining the amounts of those items.³³ This, in turn, makes it difficult to know whether the taxpayer will qualify for PTC repayment limitations.

³⁰ Treas. Reg. §1.36B-4(a)(1)(i).

³¹ Treas. Reg. §1.36B-4(a)(3); Rev. Proc. 2018-57, 2018-49 IRB 827.

³² IRC §36B(f)(2)(B)(ii).

³³ Rev. Proc. 2014-41, 2014-33 IRB 364.

Example 3. Luka, who is single and self-employed, obtained health insurance coverage for himself through the Marketplace. He estimated his 2018 income would be \$25,000 when he applied for coverage. Based on his age, income, and family size, he qualified for a subsidy (APTC) of \$362 per month, or \$4,344 for the year.

Luka got a better-paying job during 2018, which he did not report to the Marketplace. Luka's actual MAGI on his 2018 return was \$50,000. Because his MAGI was greater than 400% of the federal poverty level ($\$12,140 \times 4 = \$48,560$),³⁴ he must repay the entire subsidy of \$4,344 in addition to other taxes on his 2018 return.

If Luka contributed \$3,000 to his traditional IRA for 2018, it would lower his MAGI to \$47,000 and qualify him for the repayment limitation of \$1,300, which was the inflation-adjusted amount for single taxpayers with income between 300% and 400% of the federal poverty guideline for 2018.³⁵ This would save Luka \$3,044 ($\$4,344 - \$1,300$) in subsidy repayment.

Allocating Premium Tax Credit³⁶

Taxpayers who are allocating healthcare policy amounts with another taxpayer must complete part IV of Form 8962. The taxpayers can agree on an **allocation percentage** for the following policy amounts.

- The premiums paid
- The cost of the appropriate benchmark plan
- The amount of any APTC that was received during the year

Taxpayers need to allocate policy amounts reported on a Form 1095-A, *Health Insurance Marketplace Statement*, between the taxpayer's tax family and another tax family if:

1. The policy covered at least one individual in the taxpayer's tax family and at least one individual in another tax family, and
2. Either:
 - a. The taxpayer received a Form 1095-A for the policy that does not accurately represent the members of their tax family who were enrolled in the policy (i.e., it either lists someone who is not in the taxpayer's tax family or does not list a member of the taxpayer's tax family who was enrolled in the policy), or
 - b. The other tax family received a Form 1095-A for the policy that includes a member of the taxpayer's tax family.

A policy may have covered at least one individual in the taxpayer's tax family and one individual not in the taxpayer's tax family if any of the following apply.

- The taxpayer divorced during the year.
- The taxpayer is married but filing a separate return.
- The taxpayer or an individual in their tax family was enrolled in a health plan by someone who is not part of their tax family.
- The taxpayer or an individual in their tax family enrolled someone who was not part of their tax family in a qualified health plan.

³⁴ *Federal Poverty Level (FPL)*. U.S. Centers for Medicare & Medicaid Services. [www.healthcare.gov/glossary/federal-poverty-level-FPL] Accessed on Apr. 23, 2019.

³⁵ Rev. Proc. 2017-58, 2017-45 IRB 489.

³⁶ Instructions for Form 8962.

The rules for allocating policy amounts vary depending on which of the following situations apply.

- The taxpayers divorced or legally separated during the tax year.
- The taxpayers were married at yearend but filed separate returns.
- The taxpayers did not receive any APTC.
- The taxpayers were married during the tax year and want to use the alternative calculation to repay less excess APTC than they would under the general rules.

A brief description of these situations follows. For detailed information, including several examples, see the instructions for Form 8962.

Taxpayers Divorced or Legally Separated During the Tax Year. Taxpayers who divorced or legally separated during the tax year must allocate policy amounts on their separate returns to calculate their PTC and reconcile it with their APTC if both of the following apply.

- The taxpayer and former spouse were married to each other at some point during the tax year but were no longer married at the end of the tax year.
- For one or more months of marriage, the policy covered at least one individual in the taxpayer's tax family and at least one individual in their former spouse's tax family.

The divorced taxpayers must allocate the following for the months they were married.

1. The cost of the applicable benchmark plan
2. The cost of the plan in which they are enrolled
3. Any APTC payments they received for the period during the year they were married

These amounts can be found on Form(s) 1095-A, part III. The divorced taxpayers may agree on the allocation percentage (from 0% to 100%) that applies to the taxpayer, with the remainder of the amounts allocated to the former spouse. However, they must allocate all three amounts using the same percentage. If they cannot agree on a percentage, they must allocate 50% of each applicable item to each divorced taxpayer.

Note. For further details associated with the allocation between divorced taxpayers, including examples, see the instructions for Form 8962 and IRS Pub. 974, *Premium Tax Credit (PTC)*.

Married Taxpayers Filing Separate Returns. Taxpayers who were married at yearend but file separate returns **must** allocate policy amounts 50% to each spouse if they meet all the following conditions.

- They were married at the end of the tax year.
- They are filing separate returns.
- The taxpayer or an individual in their tax family was enrolled in the same policy as the taxpayer's spouse or an individual in the spouse's tax family at any time during the tax year.

Married taxpayers who file separate returns generally cannot take the PTC. However, they may be able to take the PTC if they meet either of the following conditions.

1. They file a return as single on Form 1040NR, *U.S. Nonresident Alien Income Tax Return*, or head of household on Form 1040.³⁷
2. They file a return as married filing separately (MFS) because of domestic abuse or spousal abandonment if all the following conditions apply.³⁸
 - a. They are living apart from their spouse at the time they file their tax return.
 - b. They are unable to file a joint return because they are a victim of domestic abuse or spousal abandonment.
 - c. They check the box at the top of Form 8962 to certify that they are a victim of domestic abuse or spousal abandonment. (For definitions of domestic abuse and spousal abandonment, see IRS Pub. 974.)

Form 8962 Department of the Treasury Internal Revenue Service Name shown on your return	Premium Tax Credit (PTC) ▶ Attach to Form 1040 or Form 1040NR. ▶ Go to www.irs.gov/Form8962 for instructions and the latest information.	OMB No. 1545-0074 2018 Attachment Sequence No. 73
Your social security number		
You cannot take the PTC if your filing status is married filing separately unless you qualify for an exception (see instructions). If you qualify, check the box <input checked="" type="checkbox"/>		

- d. They have not used this exception to take the PTC in each of the three preceding tax years.

If the taxpayer does not meet either of these exceptions, they are not eligible for the PTC. If they received the APTC, they must repay it subject to the repayment limitations.

Note. The proper method for completing Form 8962 depends on which category the taxpayer falls into. For specific information about completing Form 8962 to allocate policy amounts (including examples), see the instructions for Form 8962.

No APTC. If the taxpayer received no APTC, the enrollment premiums are allocated in proportion to the benchmark premium that applies to each taxpayer's coverage family. If no APTC was paid, the Marketplace may furnish only one Form 1095-A showing the total premiums paid for the policy. The taxpayer who receives the Form 1095-A should provide a copy to the other taxpayers.

Note. For an example detailing the proper method to complete Form 8962 for taxpayers who did not receive an APTC, see the instructions to Form 8962. The instructions also provide information on completing Form 8962 for other situations in which a policy is shared between two families.

³⁷ IRS Pub. 974, *Premium Tax Credit (PTC)*.

³⁸ Ibid.

Recently Married Taxpayers.³⁹ Taxpayers who marry during the tax year may use an optional method for computing and reconciling the APTC with the PTC. This method may be used only to reduce the tax liability associated with an APTC repayment. It cannot be used to create or increase a credit.

The taxpayers must have been **unmarried on the first day** of the tax year to use the optional method. In addition, the taxpayers must file a joint return for the year.

Note. IRS Pub. 974 includes a complete step-by-step explanation of this method and five worksheets to use for making the calculation, as well as examples.

QUALIFIED CHARITABLE DISTRIBUTIONS⁴⁰

A qualified charitable distribution (QCD) is a transfer by a trustee or custodian from a taxpayer's individual retirement arrangement (IRA) made directly by the trustee to a charitable organization. The distribution must be made on or after the date that the individual for whom the plan is maintained attains age 70½. Only the amount of the distribution that would otherwise be included in the taxpayer's gross income counts toward the QCD.⁴¹

Example 4. Rhonda is 72 years old in 2019 when she makes a \$1,000 QCD out of her traditional IRA. The QCD goes directly to Ronald McDonald House Charities. Rhonda reduces her gross income by \$1,000.

The total amount of QCDs for a taxpayer cannot exceed \$100,000 in any calendar year. However, each married taxpayer may make QCDs up to \$100,000 if the couple files a joint return.⁴²

IRA distributions that **do not comply** with the requirements for QCDs under IRC §408(d)(8) (e.g., the taxpayer is under age 70½) are taxable distributions. If the taxpayer directs the proceeds of an IRA distribution into a qualified charity, they may take an itemized contribution deduction pursuant to IRC §170, subject to the percentage of adjusted gross income (AGI) limitations. If an IRA distribution qualifies as a QCD, the taxpayer can **either** exclude the QCD from income or itemize the amount of the QCD as a charitable deduction under §170 but cannot do both in the same tax year.⁴³

Example 5. Use the same facts as **Example 4**, except Rhonda is 69 years old in 2019 when she takes an IRA distribution of \$1,000. For 2019, Rhonda is in the 12% tax bracket. Because she has not attained age 70½ by the time she makes the IRA distribution, it does not comply with the requirements for QCDs. Therefore, Rhonda must include the \$1,000 as a taxable distribution from her IRA.

She is eligible to claim a charitable deduction of \$1,000 on her Schedule A, *Itemized Deductions*. However, she does not have any other itemized deductions for 2019, so the standard deduction is more advantageous for her. Rhonda pays income tax of \$120 (\$1,000 distribution × 12% tax rate) on her distribution.

A QCD can be used to satisfy the taxpayer's required minimum distribution (RMD).⁴⁴

³⁹ Treas. Reg. §1.36B-4(b)(2)(i).

⁴⁰ IRC §408(d)(8)(B).

⁴¹ Ibid.

⁴² Ibid; IRS Notice 2007-7, 2007-5 IRB 395.

⁴³ IRS Notice 2007-7, 2007-5 IRB 395.

⁴⁴ Ibid.

**Practitioner Planning Tip**

IRC §4974 imposes a 50% penalty on the amount of an RMD not taken by a taxpayer. Thus, taking timely RMDs should be a priority for taxpayers. If a taxpayer is over age 70½, does not need the cash flow, wants to satisfy the RMD for an IRA, and wishes to make a charitable contribution, then the QCD may be a convenient way to accomplish the taxpayer's goals. For information on how to calculate an RMD, see IRS Pub. 590-B, *Distributions from Individual Retirement Accounts (IRAs)*.

IRA ACCOUNTS ELIGIBLE FOR A QCD

A QCD can be made from a traditional IRA, a Roth IRA,⁴⁵ or a deemed IRA.⁴⁶ QCDs **cannot** be made from an active SEP⁴⁷ or an active SIMPLE.⁴⁸ An “active” SEP IRA or SIMPLE IRA is a plan that the employer contributed to during the same tax year in which the IRA owner directed the charitable contribution(s) to be made.

Traditional IRAs for this purpose can include inherited IRAs,⁴⁹ spousal IRAs,⁵⁰ direct rollovers from other IRAs or qualified retirement plans,⁵¹ IRA transfers incident to divorce,⁵² and IRAs opened by the taxpayer.⁵³

**Practitioner Planning Tip**

Making a QCD from a Roth IRA may not be efficient from a tax-planning perspective because Roth IRAs are funded with after-tax dollars.⁵⁴ Qualified distributions from a Roth IRA are usually not subject to income tax; however, the source of funds, timing between contribution and distribution, and reason for the distribution are among the factors that may make a distribution subject to income tax.⁵⁵ Thus, tracing IRA contributions can be as important for Roth IRAs as for traditional IRAs.

^{45.} IRC §408A.

^{46.} IRC §408(q).

^{47.} IRC §408(k).

^{48.} IRC §408(p).

^{49.} Treas. Reg. §1.408-2(b)(7).

^{50.} IRC §219(c); IRS Notice 87-16, 1987-1 CB 446, modified for Roth IRAs by IRS Notice 98-49, 1998-38 IRB 5.

^{51.} Treas. Reg. §1.408-4(b).

^{52.} Treas. Reg. §1.408-4(g).

^{53.} Treas. Reg. §1.408-2(a).

^{54.} IRC §408A(c)(1).

^{55.} See IRC §408A(d); Treas. Reg. §1.408A-6.

ORGANIZATIONS QUALIFYING FOR A QCD

A QCD may be distributed only to organizations described in §170(b)(1)(A) **except** supporting organizations described in IRC §509(a)(3), and donor-advised funds described in IRC §4966(d)(2).⁵⁶ Under §170(b)(1)(A), individuals can make charitable contributions to the following types of organizations.

- Churches and conventions or associations thereof
- Educational organizations that normally have a regular facility, curriculum, and student body
- Hospitals and providers of medical care, research, or education
- State college or university endowment
- Governmental entity, but only if the contribution is made for exclusively public purposes
- Corporation, trust, or community chest, fund, or foundation (i.e., a publicly supported charity) for support of religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but not to provide facilities or equipment), or for the prevention of cruelty to children or animals within the United States or any of its possessions, that does not attempt to influence legislation or participate in political campaigns, and for which no benefit inures to a private individual
- Certain private foundations⁵⁷
- Publicly supported organization (and its supporting organization even if it is not publicly supported)⁵⁸ that normally receives more than one-third of its support in each tax year from gifts, grants, contributions, or membership fees, and gross receipts from related trade or business activity, and not more than one-third of its support from gross investment income and net unrelated business taxable income⁵⁹
- Organization engaged in continuous and active agricultural research in conjunction with a land grant college or university or with a non-land grant college of agriculture

QCDs may **not** be made to private foundations,⁶⁰ or to donor-advised funds.⁶¹ Generally, a **private foundation** is any domestic or foreign organization satisfying the requirements of IRC §501(c)(3). All tax-exempt organizations under §501(c)(3) are private foundations unless they satisfy the requirements of §509(a).⁶²

Donor-advised funds are owned and controlled by sponsoring organizations that track contributions by individual donors and grant advisory privileges to each donor regarding investment or distribution of the donor's contributions.⁶³

⁵⁶ IRC §§408(d)(8)(B)(i) and 170(b)(1)(A); IRS Notice 2007-7, 2007-5 IRB 395.

⁵⁷ See IRC §170(b)(1)(F).

⁵⁸ See IRC §509(a)(3).

⁵⁹ See IRC §509(a)(2).

⁶⁰ IRC §509(a)(3).

⁶¹ IRC §4966(d)(2).

⁶² IRC §509(a).

⁶³ IRC §4966(d)(2).

FILING REQUIREMENTS

Gross distributions from IRAs are reported on Form 1099-R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*⁶⁴ QCDs are not identified as such on Form 1099-R. The table below indicates where information from key boxes on Form 1099-R is reported on Form 1040 for the 2018 tax year.

Form 1099-R ⁶⁵		Form 1040 (Tax Year 2018) ⁶⁶	
Box	Notes	Line	Notes
Box 1: Gross distribution	Total amount distributed inclusive of QCD amount	Page 2, Line 4a	Same amount as appears in Box 1 on the Form 1099-R
Box 2a: Taxable amount	QCD amount is not identified on Form 1099-R or deducted to calculate the amount in Box 2a	Page 2, Line 4b Add "QCD" if possible to explain why the amount on Line 4b is less than that on Line 4a.	Line 4a minus QCD amount calculated by the taxpayer. The total QCD amount may not exceed \$100,000 per taxpayer per year. A QCD is not subject to the percentage of AGI limitations on charitable contributions by individuals under §170(b). ⁶⁷
Box 2b: Taxable amount not determined	Usually checked because the taxpayer calculates the taxable amount		
Box 4: Federal income tax withheld	Federal income tax is usually not withheld for QCDs	Page 2, Line 16	Amount reported in Box 4 of the Form 1099-R

The taxpayer must file Form 8606, *Nondeductible IRAs*, if the taxpayer:

1. Made a QCD from a traditional IRA that received nondeductible contributions (i.e., had basis in the IRA, which would not be subject to income tax) and received a distribution that was not a QCD; or
2. Made a QCD from a Roth IRA.⁶⁸

Calculating and Reporting QCD Amounts

IRAs were established by the Employee Retirement Income Security Act of 1974 (ERISA). Thus, clients may have only paper records for their early contributions. For tax years ending prior to 2018, **deductible** contributions were reported on Form 5498, *IRA Contribution Information*, by the IRA custodian, or on line 32 on Form 1040.⁶⁹ **Nondeductible** contributions should have been reported on Form 8606.

⁶⁴ Treas. Reg. §1.408-7(d).

⁶⁵ See Instructions for Form 1099-R.

⁶⁶ See Instructions for Form 1040.

⁶⁷ IRS Notice 2007-7, 2007-5 IRB 395.

⁶⁸ *IRA FAQs — Distributions (Withdrawals)*. May 16, 2019. IRS. [www.irs.gov/retirement-plans/retirement-plans-faqs-regarding-iras-distributions-withdrawals]. Accessed on Jun. 6, 2019.

⁶⁹ See 2018 Instructions for Forms 1040 and 5498.

2019 Workbook

For tax years ending after 2017, a QCD is reported on Form 1040, line 4a. Generally, the full amount of the charitable distribution is reported on line 4a. If the entire amount distributed is a QCD, a zero is entered on line 4b for the taxable amount. If only part of the distribution is a QCD, the part that is **not** a QCD is entered on line 4b. "QCD" is entered in the space next to line 4b.⁷⁰

Example 6. In 2018, Christina is 72 years old, has her own designated Roth IRA from her former employer, a local high school where she chose to make Roth contributions. She also owns a traditional IRA. Christina's RMD for 2018 is \$7,000 (which is only based on her traditional IRA, not her Roth). She withdraws \$1,000 from her **Roth IRA** for her personal expenses. She directs the custodian of the **traditional IRA** to make a QCD for \$5,000 to Land Grant University, and to distribute \$2,000 directly to Christina, which she then donates to her sorority via its §501(c)(3) foundation. Christina receives the following Forms 1099-R.

Roth IRA:

<input type="checkbox"/> CORRECTED (if checked)			<div> <div>1 Gross distribution</div> <div> <div>\$</div> <div>1,000</div> </div> </div>		<div> <div>OMB No. 1545-0119</div> <div>2018</div> <div>Form 1099-R</div> </div>		Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
<div> <div>PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and phone no.</div> <div> Teachers Credit Union PO Box 47 Ruler, IL 61234 </div> </div>			<div> <div>2a Taxable amount</div> <div> <div>\$</div> <div>0</div> </div> </div>				
<div> <div>PAYER'S TIN</div> <div>34-5678901</div> </div>			<div> <div>2b Taxable amount not determined <input checked="" type="checkbox"/></div> <div>Total distribution <input type="checkbox"/></div> </div>		<div> <div>3 Capital gain (included in box 2a)</div> <div>\$</div> </div>		Copy B Report this income on your federal tax return. If this form shows federal income tax withheld in box 4, attach this copy to your return. This information is being furnished to the IRS.
<div> <div>RECIPIENT'S TIN</div> <div>901-23-4567</div> </div>			<div> <div>4 Federal income tax withheld</div> <div>\$</div> </div>		<div> <div>5 Employee contributions/ Designated Roth contributions or insurance premiums</div> <div>\$</div> </div>		
<div> <div>RECIPIENT'S name</div> <div>Christina Cross</div> </div>			<div> <div>6 Net unrealized appreciation in employer's securities</div> <div>\$</div> </div>		<div> <div>7 Distribution code(s)</div> <div>B</div> </div>		
<div> <div>Street address (including apt. no.)</div> <div>55 Sutter Street</div> </div>			<div> <div>8 Other</div> <div>\$</div> </div>		<div> <div>9a Your percentage of total distribution</div> <div>%</div> </div>		
<div> <div>City or town, state or province, country, and ZIP or foreign postal code</div> <div>Ruler, IL 61234</div> </div>			<div> <div>9b Total employee contributions</div> <div>\$</div> </div>		<div> <div>10 Amount allocable to IRR within 5 years</div> <div>\$</div> </div>		
<div> <div>11 1st year of desig. Roth contrib.</div> <div><input type="checkbox"/></div> </div>			<div> <div>FATCA filing requirement</div> <div><input type="checkbox"/></div> </div>		<div> <div>12 State tax withheld</div> <div>\$</div> </div>		
<div> <div>13 State/Payer's state no.</div> <div></div> </div>			<div> <div>14 State distribution</div> <div>\$</div> </div>		<div> <div>15 Local tax withheld</div> <div>\$</div> </div>		
<div> <div>16 Name of locality</div> <div></div> </div>			<div> <div>17 Local distribution</div> <div>\$</div> </div>		<div> <div>Account number (see instructions)</div> <div></div> </div>		
<div> <div>Date of payment</div> <div></div> </div>			<div> <div>18 Total distribution</div> <div>\$</div> </div>		<div> <div>19 Total taxable distribution</div> <div>\$</div> </div>		

Form 1099-R

www.irs.gov/Form1099R

Department of the Treasury - Internal Revenue Service

⁷⁰ IRA FAQs — Distributions (Withdrawals). May 16, 2019. IRS. [www.irs.gov/retirement-plans/retirement-plans-faqs-regarding-iras-distributions-withdrawals]. Accessed on Jun. 7, 2019; Instructions for Form 1040.

Traditional IRA:

☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and phone no. Family Financial Institution 47 Main Street Unit B Santa Fe, New Mexico 87504		1 Gross distribution \$ 7,000 2a Taxable amount \$ 7,000	OMB No. 1545-0119 <div style="font-size: 2em; font-weight: bold; text-align: center;">2018</div> Form 1099-R	Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
PAYER'S TIN 45-6789012	RECIPIENT'S TIN 901-23-4567	3 Capital gain (included in box 2a) \$	4 Federal income tax withheld \$	Copy B Report this income on your federal tax return. If this form shows federal income tax withheld in box 4, attach this copy to your return. This information is being furnished to the IRS.
RECIPIENT'S name Christina Cross Street address (including apt. no.) 55 Sutter Street City or town, state or province, country, and ZIP or foreign postal code Ruler, IL 61234		5 Employee contributions/ Designated Roth contributions or insurance premiums \$	6 Net unrealized appreciation in employer's securities \$	
10 Amount allocable to IRR within 5 years \$		11 1st year of desig. Roth contrib. <input type="checkbox"/>	12 State tax withheld \$	
13 State/Payer's state no. \$		14 State distribution \$		
Account number (see instructions) \$		15 Local tax withheld \$	16 Name of locality \$	17 Local distribution \$

Form **1099-R** www.irs.gov/Form1099R Department of the Treasury - Internal Revenue Service

On her Form 1040, Christina reports gross distributions of \$8,000 (\$1,000 Roth + \$7,000 traditional) on line 4a. Of the \$7,000 distribution from the traditional IRA, only \$2,000 is taxable and the \$5,000 QCD is not taxable. On line 4b, she reports a taxable amount of \$2,000 from the traditional IRA only. Christina can report the \$2,000 donation to the sorority's foundation on Schedule A because the contribution was not accomplished via a QCD. The reporting of the distributions is shown as follows on Christina's Form 1040.

Form 1040 (2018)				Page 2																						
Attach Form(s) W-2. Also attach Form(s) W-2G and 1099-R if tax was withheld.	<table style="width: 100%;"> <tr> <td style="width: 50%;">1 Wages, salaries, tips, etc. Attach Form(s) W-2</td> <td style="width: 50%;">1</td> </tr> <tr> <td>2a Tax-exempt interest</td> <td>2b</td> </tr> <tr> <td>3a Qualified dividends</td> <td>3b</td> </tr> <tr> <td>4a IRAs, pensions, and annuities</td> <td>4b 8,000</td> </tr> <tr> <td>5a Social security benefits</td> <td>5b</td> </tr> <tr> <td>6 Total income. Add lines 1 through 5. Add any amount from Schedule 1, line 22</td> <td>6</td> </tr> <tr> <td>7 Adjusted gross income. If you have no adjustments to income, enter the amount from line 6; otherwise, subtract Schedule 1, line 10 from line 6</td> <td></td> </tr> </table>	1 Wages, salaries, tips, etc. Attach Form(s) W-2	1	2a Tax-exempt interest	2b	3a Qualified dividends	3b	4a IRAs, pensions, and annuities	4b 8,000	5a Social security benefits	5b	6 Total income. Add lines 1 through 5. Add any amount from Schedule 1, line 22	6	7 Adjusted gross income. If you have no adjustments to income, enter the amount from line 6; otherwise, subtract Schedule 1, line 10 from line 6		<table style="width: 100%;"> <tr> <td style="width: 50%;">b Taxable interest</td> <td style="width: 50%;">1</td> </tr> <tr> <td>b Ordinary dividends</td> <td>2b</td> </tr> <tr> <td>b Taxable amount QCD</td> <td>3b</td> </tr> <tr> <td>b Taxable amount</td> <td>4b 2,000</td> </tr> <tr> <td>b Taxable amount</td> <td>5b</td> </tr> </table>	b Taxable interest	1	b Ordinary dividends	2b	b Taxable amount QCD	3b	b Taxable amount	4b 2,000	b Taxable amount	5b
1 Wages, salaries, tips, etc. Attach Form(s) W-2	1																									
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b Taxable amount	4b 2,000																									
b Taxable amount	5b																									

Traditional IRAs may contain deductible and nondeductible contributions; the latter is tracked on Form 8606.

The QCD amount is limited to the distribution amount that would otherwise be included in income. If the IRA includes nondeductible contributions, the **QCD is first considered paid out of otherwise taxable income.**

Example 7. Willow has an IRA with a total value of \$35,000. It consists of \$25,000 deductible contributions and earnings, and \$10,000 nondeductible contributions (basis). Willow's \$5,000 QCD is considered paid from the \$25,000 portion of the IRA. Her basis remains \$10,000.

Example 8. Use the same facts as **Example 7**, except Willow's IRA trustee transfers \$31,000 in a QCD to her church. The \$25,000 portion of the IRA that is from deductible contributions qualifies as a QCD. The excess \$6,000 (\$31,000 – \$25,000) reduces her basis to \$4,000 (\$10,000 – \$6,000). In addition, the \$6,000 paid from her basis is included in charitable deductions on Schedule A. The \$6,000 is treated as though it was separately contributed to the church as a nontaxable distribution.

MARRIED FILING SEPARATELY FILING STATUS

Married taxpayers **generally** pay more combined tax if they file separate returns than they would if they file jointly. However, there are certain circumstances in which married taxpayers may find it advantageous to file separately. These situations include the following.

- To avoid joint and several liability
- To obtain lower student-loan payments under income-driven repayment plans
- To itemize a larger amount of deductions that are limited by AGI
- When one spouse has unpaid obligations that may be subject to offset
- To maximize the qualified business income deduction

These situations, along with special rules that apply to taxpayers filing separately and the rules that apply in community property states, are discussed in this section.

SPECIAL RULES⁷¹

Taxpayers that choose the MFS filing status are subject to special rules. These rules include the following.

- An MFS taxpayer's tax rate is generally higher than taxpayers who use the married filing jointly (MFJ) status.
- An MFS taxpayer's exemption amount for calculating the alternative minimum tax (AMT) is half that allowed on an MFJ return. For 2019, the AMT exemption amount for MFJ taxpayers is \$111,700, which begins to phase out for taxpayers with alternative minimum taxable income (AMTI) that exceeds \$1,020,600. For MFS taxpayers, the 2019 exemption amount is \$55,850, which begins to phase out for taxpayers with AMTI that exceeds \$510,300.⁷²
- In most cases, an MFS taxpayer cannot take the credit for child and dependent care expenses. In addition, the amount an MFS taxpayer can exclude from income under an employer's dependent care assistance program is limited to \$2,500, instead of the \$5,000 allowed on an MFJ return.

Note. Married couples generally must file a joint return to take the credit for child and dependent care expenses. However, if a married taxpayer is legally separated or living apart from their spouse, they may be able to file a separate return and take the credit. For more information, see IRS Pub. 503, *Child and Dependent Care Expenses*.

- MFS taxpayers cannot take the earned income credit.
- In most cases, MFS taxpayers cannot take the exclusion or credit for adoption expenses.
- MFS taxpayers cannot take the American opportunity credit, the lifetime learning credit, or the deduction for student loan interest.
- MFS taxpayers cannot exclude any interest income from qualified U.S. savings bonds used for higher education expenses.

⁷¹ IRS Pub. 501, *Dependents, Standard Deduction, and Filing Information*.

⁷² Rev. Proc. 2018-57, 2018-49 IRB 827.

- An MFS taxpayer who lived with their spouse at any time during the tax year:
 - ♦ Cannot claim the credit for the elderly or the disabled, and
 - ♦ Must include at least 50% (up to 85%) of any social security or railroad retirement benefits in income for the year.
- The child tax credit (CTC) and the credit for other dependents is reduced for an MFS taxpayer with MAGI in excess of \$200,000. For MFJ taxpayers, the MAGI phase-out threshold is \$400,000.⁷³

Note. Under the TCJA, the CTC is \$2,000 per qualifying child. If the CTC exceeds the taxpayer's tax liability, the taxpayer can qualify for a refundable additional child tax credit (ACTC) equal to 15% of earned income in excess of \$2,500. In addition, a \$500 nonrefundable credit for qualifying dependents other than qualifying children is available. These amounts apply to tax years beginning after December 31, 2017, and before January 1, 2026.⁷⁴

- For 2019, the retirement savings contributions credit (saver's credit) is not available for an MFS taxpayer with AGI in excess of \$32,000. For MFJ taxpayers, the AGI limit is \$64,000.⁷⁵ These amounts are adjusted annually for inflation.⁷⁶

Note. For more information about the retirement savings contributions credit, see the instructions to Form 8880, *Credit for Qualified Retirement Savings Contributions*.

- An MFS taxpayer's capital loss deduction is limited to \$1,500. For MFJ taxpayers, the limit is \$3,000.
- An MFS taxpayer cannot claim the standard deduction if their spouse itemizes deductions. If an MFS taxpayer **can** claim the standard deduction, their basic standard deduction is half the amount allowed on a joint return.
- The deduction for taxpayers making contributions to a traditional IRA is phased out for certain taxpayers who are active participants in a qualified retirement plan. For MFS taxpayers, the income phase-out range is \$0 to \$10,000 and is not subject to annual inflation adjustments. For MFJ taxpayers, the income phase-out range is between \$103,000 and \$123,000 for 2019 if the spouse who makes the IRA contribution is an active participant. The MFJ phase-out range is subject to annual inflation adjustments.⁷⁷
- The 2019 AGI phase-out range for MFJ taxpayers making contributions to a Roth IRA is \$193,000 to \$203,000. This amount is subject to annual inflation adjustments. For MFS taxpayers, the phase-out range is not subject to annual inflation adjustments and is \$0 to \$10,000.⁷⁸
- Taxpayers whose AGI does not exceed \$100,000 may be eligible for up to \$25,000 in passive activity losses for the tax year. The AGI limit for taxpayers who are MFS is \$50,000. The special allowance for passive rental losses is not allowed for married persons filing separate returns who lived together at any time during the year. Married persons filing separate returns who lived apart at all times during the year are each allowed a \$12,500 maximum special allowance for losses from passive real estate activities.⁷⁹

⁷³ IRC §24(h). Under the TCJA, these amounts apply to tax years beginning after Dec. 31, 2017, and before Jan. 1, 2026.

⁷⁴ IRC §24(h).

⁷⁵ *Retirement Savings Contributions Credit (Saver's Credit)*. Dec. 13, 2018. IRS. [www.irs.gov/retirement-plans/plan-participant-employee/retirement-savings-contributions-savers-credit] Accessed on Mar. 19, 2019.

⁷⁶ IRC §25B(b)(3).

⁷⁷ IRS Notice 2018-83, 2018-47 IRB 774.

⁷⁸ Ibid.

⁷⁹ IRC §469(i).

COMMUNITY PROPERTY RULES⁸⁰

Income

If a married taxpayer lives with their spouse in a community property state, half of any income defined by state law as community income is generally allocated to each taxpayer. Community property states include the following.⁸¹

- Arizona
- California
- Idaho
- Louisiana
- Nevada
- New Mexico
- Texas
- Washington
- Wisconsin

A taxpayer that files an MFS return must report half of all community income and all of their separate income. Each spouse must attach Form 8958, *Allocation of Tax Amounts Between Certain Individuals in Community Property States*, to their tax return showing how they calculated the amount they are reporting on their return.

Generally, the laws of the state in which the taxpayer is domiciled govern whether they have community property and community income or separate property and separate income for federal tax purposes. The following table from IRS Pub. 555, *Community Property*, summarizes the general rules.

Table 1. **General Rules — Property and Income: Community or Separate?**

<p>Community property is property:</p> <ul style="list-style-type: none"> • That you, your spouse (or your registered domestic partner), or both acquire during your marriage (or registered domestic partnership) while you and your spouse (or your registered domestic partner) are domiciled in a community property state. (Includes the part of property bought with community property funds if part was bought with community funds and part with separate funds.) • That you and your spouse (or your registered domestic partner) agreed to convert from separate to community property. • That can't be identified as separate property. 	<p>Separate property is:</p> <ul style="list-style-type: none"> • Property that you or your spouse (or your registered domestic partner) owned separately before your marriage (or registered domestic partnership). • Money earned while domiciled in a noncommunity property state. • Property either of you received as a gift or inherited separately during your marriage (or registered domestic partnership). • Property bought with separate funds, or exchanged for separate property, during your marriage (or registered domestic partnership). • Property that you and your spouse (or your registered domestic partner) agreed to convert from community to separate property through an agreement valid under state law. • The part of property bought with separate funds, if part was bought with community funds and part with separate funds.
<p>Community income ^{1,2,3} is income from:</p> <ul style="list-style-type: none"> • Community property. • Salaries, wages, or pay for services of you, your spouse (or your registered domestic partner), or both during your marriage (or registered domestic partnership) while domiciled in a community property state. • Real estate that is treated as community property under the laws of the state where the property is located. 	<p>Separate income ^{1,2} is income from:</p> <ul style="list-style-type: none"> • Separate property which belongs to the spouse (or registered domestic partner) who owns the property.

¹In Idaho, Louisiana, Texas, and Wisconsin, income from most separate property is community income.

²Check your state law if you are separated but don't meet the conditions discussed in *Spouses living apart all year*, later. In some states, the income you earn after you are separated and before a divorce decree is issued continues to be community income. In other states, it is separate income.

³Under special rules, income that can otherwise be characterized as community income may not be treated as community income for federal income tax purposes in certain situations. See *Community Property Laws Disregarded*, later.

⁸⁰ IRS Pub. 555, *Community Property*; Instructions for Form 8958.

⁸¹ IRS Pub. 501, *Dependents, Standard Deduction, and Filing Information*.

Following is a summary of the general effect of community property laws on the federal income tax treatment of certain items of income. For more information, see IRS Pub. 555.

Wages and Self-Employment Income from Sole Proprietorships. A spouse's wages and self-employment (SE) income from a sole proprietorship are community income and must be split evenly between the spouses.

Interest, Dividends, and Rents. Interest, dividends, and rents from community property are community income and must be split evenly between the spouses.

Gains and Losses. Gains and losses may be classified as either community or separate income depending on how the property is held.

Withdrawals from IRAs. IRA distributions are deemed to be separate property, even if the funds in the account would otherwise be community property. These distributions are wholly taxable to the spouse whose name is on the account.

Pensions. Pension distributions generally are characterized as community or separate income depending on the respective periods of participation in the pension while married and domiciled in a community or noncommunity property state during the period of participation in the pension. These rules may vary between states.

Partnership Income. If a spouse holds an interest in a partnership and partnership income is attributable to the efforts of either spouse, the partnership income is community property.

Tax-Exempt Income. Community income exempt from federal tax generally keeps its exempt status for both spouses. For example, income earned outside the United States is tax exempt under certain circumstances. If a taxpayer earned income and met the conditions that made the income exempt, the income is also exempt for the taxpayer's spouse in a community property state, even though the spouse may not have met the conditions.

Income from Separate Property. In some states, income from separate property is separate income. These states are Arizona, California, Nevada, New Mexico, and Washington. Other states characterize income from separate property as community property. These states are Idaho, Louisiana, Texas, and Wisconsin.

Deductions

The deductions for taxpayers who file MFS returns generally depend on whether the expenses involve community or separate income.

Business and Investment Expenses. For MFS taxpayers, expenses incurred to earn or produce community business or investment income are generally divided equally between the spouses. Each spouse can deduct half of the expenses on their separate returns. Expenses incurred by a spouse to produce separate business or investment income is deductible by the spouse who earns the corresponding separate business or investment income.

Payments not Alimony. Prior to the enactment of the TCJA, payments that otherwise qualified as alimony were not deductible by the payer if they were the recipient spouse's part of community income.

Example 9. Dylan and Maggie are married and live in a community property state. They are separated in 2017. Under a court order, Dylan pays Maggie \$12,000 of the \$20,000 total community income for the 2018 tax year. Maggie does not receive any other community income. Under state law, earnings of a spouse who lives separately and apart from the other spouse continue as community property.

On their MFS returns, Dylan and Maggie each must report \$10,000 of the total community income. In addition, Maggie must report \$2,000 as alimony received. Dylan can report \$2,000 as alimony paid.

2019 Workbook

The TCJA **permanently** repeals the deduction for alimony and separate maintenance payments by the payor spouse and the inclusion in income by the recipient spouse for the following situations.⁸²

- Divorce or separation instruments executed after December 31, 2018
- Pre-January 1, 2019 agreements modified after December 31, 2018, if the modification expressly provides that the repeal applies

Note. For more information about the tax implications of alimony, see the 2018 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 5: Divorce.

Example 10. Use the same facts as **Example 9**, except Dylan pays Maggie pursuant to a separation agreement executed on January 2, 2019. Both Dylan and Maggie must report \$10,000 of the total community income. However, Dylan cannot deduct \$2,000 as alimony paid and Maggie does not report \$2,000 as alimony received.

IRA Deduction. Deductions for IRA contributions cannot be split between spouses. The deduction for each spouse is calculated separately, without regard to community property laws.

Personal Expenses. Expenses paid out of separate funds (e.g., medical expenses) are deductible by the spouse who pays for them. Expenses paid from community funds are divided equally between the spouses.

Credits, Taxes, and Payments

Self-Employment Tax. If any of the income from a trade or business (other than a trade or business carried on by a partnership) is community income under applicable community property laws, the gross income and deductions attributable to the trade or business are nevertheless treated as the gross income and deductions of the spouse who carries on the trade or business.⁸³

For the net income of a sole proprietorship that is community income, SE tax is imposed on the spouse who carries on the trade or business.

All of the distributive share of a married partner's income or loss from a partnership is attributable to the partner for computing any SE tax.

Federal Income Tax Withheld. For spouses who file MFS returns on which each reports half the community wages, each spouse is entitled to credit for half the income tax withheld on those wages.

Note. For more information about the effect of community property laws on the tax treatment of certain items of income, deductions, credits, taxes, and payments on MFS returns, see IRS Pub. 555.

⁸² IRC §61(a)(8).

⁸³ IRC §1402(a)(5).

JOINT AND SEVERAL LIABILITY

Married taxpayers are **jointly and severally liable** for the taxes owed on an MFJ return.⁸⁴ A couple remains jointly and severally liable for all taxes on joint returns and any additions to tax, interest, or penalties that arise from a joint return even if they later divorce. Joint and several liability means that each taxpayer is legally responsible for the **entire** liability.⁸⁵



Practitioner Planning Tip

A married spouse may be able to obtain relief from joint and several liability if they are eligible for **innocent spouse relief**. This may be advisable when, for example, there was an understatement on the return caused by erroneous items of one spouse and the other spouse had neither actual knowledge nor any reason to know of the understatement. However, the need to file for innocent spouse relief can be avoided if the taxpayers file separate returns. This may be prudent when, for example, one spouse suspects that the other spouse is being dishonest in financial matters. In this situation, filing separately prevents the taxpayer from becoming potentially liable for taxes in arrears and penalties.

For information about innocent spouse relief, see the 2018 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 5: Divorce.

To avoid joint and several liability, some married taxpayers choose to file MFS returns. Married taxpayers who file MFS returns are only responsible for the tax due on their own return.⁸⁶

Example 11. Vincent and Claudette are married taxpayers who file MFJ every year. In 2018, Vincent sold some GM stock at a gain, which resulted in substantial additional tax liability for 2018. Vincent and Claudette also had an unpaid tax liability for 2016 and 2017. They filed tax returns with the following tax liabilities.

Tax Year	Filing Status Used	Joint Tax Liability
2016	MFJ	\$ 6,000 (unpaid)
2017	MFJ	4,200 (unpaid)
2018	MFJ	17,400

Because Vincent and Claudette filed MFJ for the 2018 tax year, they are **both** jointly and severally liable for the 2018 taxes as well as for the 2016 and 2017 taxes. This means that both Vincent and Claudette are liable for the entire \$17,400 2018 tax liability and for the unpaid balances for 2016 and 2017 of \$6,000 and \$4,200, respectively, until paid in full.

⁸⁴ IRC §6013(d)(3); Treas. Reg. §1.6013-4(b).

⁸⁵ *Topic Number 205—Innocent Spouse Relief (Including Separation of Liability and Equitable Relief)*. Mar. 18, 2019. IRS. [www.irs.gov/taxtopics/tc205] Accessed on Mar. 20, 2019.

⁸⁶ IRS Pub. 504, *Divorced or Separated Individuals*.

Example 12. Use the same facts as **Example 11**, except Vincent and Claudette decide to file MFS for the 2018 tax year. Vincent reports the sale of GM stock on his return, and has a \$15,400 tax liability. He is solely liable for this tax liability. For 2018, Claudette is liable for only the \$4,000 tax reported on her MFS return. She remains jointly and severally liable for the 2016 and 2017 unpaid balances because she filed MFJ with Vincent for those years.

Tax Year	Taxpayer	Filing Status Used	Joint Tax Liability	Separate Tax Liability
2016	Joint	MFJ	\$6,000	
2017	Joint	MFJ	4,200	
2018	Vincent	MFS		\$15,400
2018	Claudette	MFS		4,000

INCOME-DRIVEN REPAYMENT PLAN⁸⁷

Taxpayers with **federal student loans** can choose a standard repayment plan or they can choose to repay their federal student loans based on their incomes. **This type of arrangement is called an income-driven repayment plan (IDRP).** Under an IDRP, the payment amount is a percentage of the taxpayer's discretionary income. **Discretionary income** is defined as the difference between the taxpayer's AGI and 150% of the U.S. Department of Health and Human Services' poverty guideline amount for the taxpayer's family size and state.⁸⁸

Note. The poverty guideline amounts can be found at [uofi.tax/19a1x1 \[aspe.hhs.gov/poverty-guidelines\]](https://aspe.hhs.gov/poverty-guidelines).

If the taxpayer's loan balance is not fully repaid at the end of the IDRP repayment period, the remaining loan balance is forgiven. If the taxpayer's student loan debt is partially forgiven, they may have to pay income tax on the amount of the canceled debt.⁸⁹

Because the IDRP payment is partly based on AGI, the amount generally varies depending on whether the taxpayer files an MFS or an MFJ return. Under the general rule, the student loan payment is based on joint income if the taxpayer files an MFJ return and is based on the borrower's separate income if they file an MFS return. There is one exception to this general rule. The revised pay as you earn (REPAYE) plan bases the student loan payment on the combined income of both spouses regardless of whether they file jointly or separately.

However, filing separately may not always result in lower student loan payments. If both spouses have federal student loan debt, then both debts may affect how the payment is calculated. The U.S. Department of Education takes both spouses' loan debts into consideration if:

- The spouses file an MFJ return or chose the REPAYE arrangement, and
- Both spouses have federal student loan debt.

When joint income is used, the payment amount is prorated if both spouses have federal student loan debt. However, if only one spouse has federal student loan debt, the borrower can get a lower payment by filing MFS under all IDRPs except the REPAYE.

⁸⁷ *Something Borrowed: How Marriage Impacts Your Student Loans*. Foss, Ian. Jul. 10, 2017. U.S. Department of Education. [blog.ed.gov/2017/07/something-borrowed-how-marriage-impacts-your-student-loans] Accessed on Mar. 27, 2019.

⁸⁸ *Do you have questions about the different types of income-driven repayment plans?* U.S. Department of Education. [studentaid.ed.gov/sa/repay-loans/understand/plans/income-driven/questions] Accessed on Mar. 27, 2019.

⁸⁹ *Federal Student Aid*. U.S. Department of Education. [studentaid.ed.gov/sa/repay-loans/understand/plans/income-driven] Accessed on Mar. 27, 2019.

Example 13. Robin and Sean are married and file MFJ returns. In 2018, Robin earns \$30,000 and Sean earns \$40,000. Under the IDR plan (PAYE), the student loan payments would be \$380 for their combined income.⁹⁰ If Robin and Sean both owe \$30,000 in federal student loans, they each owe half of the combined student loan debt. Therefore, each would owe \$190 ($\$380 \div 2$) monthly. However, if Robin has federal student loan debt but Sean does not (or vice versa), her monthly payment would be \$380, because she owes 100% of the couple's combined federal student loan debt.⁹¹

Example 14. Use the same information as **Example 13**, except Robin and Sean file MFS returns. Robin's student loan payment, therefore, is based solely on her income of \$30,000. Under the PAYE plan, her monthly payment is only \$47 per month, or \$333 less ($\$380 - \47) than the amount she would owe if she files jointly with Sean.⁹²

Note. Taxpayers who have an IDR must recertify their income and family size each year to remain on their plans.

ITEMIZED DEDUCTIONS

Married taxpayers may want to consider filing MFS returns when both spouses have taxable income and one spouse has significant itemized deductions that are limited by AGI. The following itemized deductions are limited by AGI.

- Medical expenses are deductible only to the extent they exceed 10% of AGI for tax years beginning after December 31, 2018.⁹³

Note. For tax years beginning after December 31, 2016, and ending before January 1, 2019, taxpayers could claim an itemized deduction for medical expenses that exceeded 7.5% of AGI.⁹⁴

- For tax years beginning after December 31, 2017, and ending before January 1, 2026, a taxpayer can deduct personal casualty losses attributable to a **federally declared disaster** to the extent the loss exceeds \$100 per casualty and only to the extent that aggregate casualty losses exceed 10% of AGI.⁹⁵

Note. Prior to January 1, 2018, a taxpayer could claim a deduction for property losses incurred arising from casualty or theft. Such losses were deductible only if they exceeded \$100 per casualty or theft and only to the extent that aggregate net casualty and theft losses exceeded 10% of the taxpayer's AGI. However, there was no requirement that casualty losses be attributable to a federally declared disaster.⁹⁶

⁹⁰ *Something Borrowed: How Marriage Impacts Your Student Loans*. Foss, Ian. Jul. 10, 2017. U.S. Department of Education. [blog.ed.gov/2017/07/something-borrowed-how-marriage-impacts-your-student-loans] Accessed on Mar. 27, 2019.

⁹¹ Based on an example at *Something Borrowed: How Marriage Impacts Your Student Loans*. Foss, Ian. Jul. 10, 2017. U.S. Department of Education. [blog.ed.gov/2017/07/something-borrowed-how-marriage-impacts-your-student-loans] Accessed on Mar. 27, 2019.

⁹² Ibid.

⁹³ IRC §213(a).

⁹⁴ IRC §213(f).

⁹⁵ IRC §165.

⁹⁶ Ibid.

Before a married couple files MFS returns on which one spouse attempts to claim large medical expenses to take advantage of the lower AGI on his or her separate return, it is important to know how itemized deductions must be allocated between the spouses. The following table is from IRS Pub. 504, *Divorced or Separated Individuals*.

Table 1. Itemized Deductions on Separate Returns

This table shows itemized deductions you can claim on your married filing separate return whether you paid the expenses separately with your own funds or jointly with your spouse.

Caution: *If you live in a community property state, these rules don't apply. See [Community Property](#).*

IF you paid ...	AND you ...	THEN you can deduct on your separate federal return ...
medical expenses	paid with funds deposited in a joint checking account in which you and your spouse have an equal interest	half of the total medical expenses, subject to certain limits, unless you can show that you alone paid the expenses.
state income tax	file a separate state income tax return	the state income tax you alone paid during the year.
	file a joint state income tax return and you and your spouse are jointly and individually liable for the full amount of the state income tax	the state income tax you alone paid during the year.
	file a joint state income tax return and you are liable for only your own share of state income tax	the smaller of: <ul style="list-style-type: none"> the state income tax you alone paid during the year, or the total state income tax you and your spouse paid during the year multiplied by the following fraction. The numerator is your gross income and the denominator is your combined gross income.
property tax	paid the tax on property held as tenants by the entirety	the property tax you alone paid.
mortgage interest	paid the interest on a qualified home ¹ held as tenants by the entirety	the mortgage interest you alone paid.
casualty loss	have a casualty loss ² resulting from a federally declared disaster on a home you own as tenants by the entirety	half of the loss, subject to the deduction limits. Neither spouse may report the total casualty loss.

¹ For more information on a qualified home and deductible mortgage interest, see Pub. 936, Home Mortgage Interest Deduction.

² For more information on casualty losses, see Pub. 547, Casualties, Disasters and Thefts.

As shown in the table, medical expenses must be split equally between spouses filing separate returns, unless one spouse can show that they alone paid the expenses. These rules limit the tax savings that could potentially be obtained by allocating the entire amount of medical expenses to the lower-earning spouse. In addition, the larger standard deduction implemented by the TCJA (\$24,400 for MFJ taxpayers, \$18,350 for head of household filers, and \$12,200 for all other individuals in 2019)⁹⁷ makes it less likely that married taxpayers would find it advantageous to file separate returns to claim medical expenses. Most professional tax preparation software includes a tool that helps the preparer determine which filing status is the most beneficial for their married clients.

⁹⁷ Rev. Proc. 2018-57, 2018-49 IRB 827.

TAX REFUND OFFSET

When a tax overpayment is shown on an MFJ return, the IRS generally applies the entire tax overpayment against any of the following debts, in the following order.⁹⁸

1. Unpaid federal tax liabilities
2. Past due child support
3. Past due debts owed to other federal agencies
4. Past due legally enforceable state income tax obligations owed to a state

Applying a tax overpayment to satisfy (or partially satisfy) such debts is referred to as an **offset**. The entire overpayment can offset the debts of one spouse even if part of the overpayment is applicable to the spouse who had no such debts to offset. The spouse who would have obtained a refund except for the other spouse's debts is the **injured spouse**. The injured spouse can request a refund of their portion of a joint tax overpayment by filing Form 8379, *Injured Spouse Allocation*.⁹⁹

A married taxpayer may want to consider filing MFS if they know their spouse has unpaid obligations that may be subject to offset. However, filing MFJ and claiming injured spouse status may result in a larger tax refund for the injured spouse. This is another situation in which the tax professional can help determine which filing status is most advantageous for their clients.

Note. For a thorough explanation of the relief available to injured spouses, see the 2016 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 1: Individual Taxpayer Issues. This can be found at uofi.tax/arc [taxschool.illinois.edu/taxbookarchive].

AMENDING RETURNS¹⁰⁰

After taxpayers file a joint return, they **cannot** choose to file separate returns for that year after the due date of the return. Conversely, taxpayers **can** change their filing status from MFS to MFJ by filing an amended return using Form 1040X. However, a taxpayer cannot file an amended return to elect MFJ status if any of the following conditions apply.

- It is more than three years after the due date for filing the return (not including extensions).
- Either spouse filed a petition with the Tax Court within the time prescribed in IRC §6213 after receiving a notice of deficiency for the tax year.
- Either spouse commenced a suit for the recovery of any part of the income tax for the tax year.
- Either spouse entered into a closing agreement for the tax year or has compromised any civil or criminal case that arose against either spouse for the tax year.

⁹⁸ IRM 25.18.5.1 (Mar. 2017).

⁹⁹ IRC §6402; *Topic Number 203—Reduced Refund*. Jan. 29, 2019. IRS. [www.irs.gov/taxtopics/tc203] Accessed on Mar. 29, 2019.

¹⁰⁰ IRS Pub. 17, *Your Federal Income Tax*; IRC §6013(b).

2019 Workbook

A married couple who amends their return to change from MFS to MFJ status must follow these steps in completing Form 1040X.¹⁰¹

1. Enter the amounts from the taxpayer's originally filed or previously adjusted return in column A.
2. Enter the spouse's income and deductions from their originally filed or previously adjusted return and any other changes the couple is making in column B.
3. Add any increase in column B to the amount in column A or subtract any decrease in column B from the amount in column A and then enter in column C.
4. Enter an explanation for the change in part III.
5. Both spouses must sign and date the form.

Example 15. Bert and Ernestine were married on August 1, 2018. They filed their 2018 tax returns on April 1, 2019, using the MFS status. On December 15, 2019, they realized it would be beneficial to amend their 2018 tax returns and file a joint return.

The following table shows relevant information from Bert and Ernestine's originally filed Forms 1040. Their Form 1040X follows the table.

	Bert	Ernestine
Wages	\$75,005	\$109,949
Interest	300	200
Educator expenses	(150)	0
Adjusted gross income	\$75,155	\$110,149
Standard deduction	(12,000)	(12,000)
Taxable income	\$63,155	\$ 98,149
Federal tax withheld	\$10,500	\$ 19,000
Tax owed	(9,838)	(17,840)
Overpayment	\$ 662	\$ 1,160

¹⁰¹. Instructions for Form 1040X.

For Example 15

Form 1040X (Rev. January 2019)	Department of the Treasury—Internal Revenue Service Amended U.S. Individual Income Tax Return ▶ Go to www.irs.gov/Form1040X for instructions and the latest information.	OMB No. 1545-0074
This return is for calendar year <input checked="" type="checkbox"/> 2018 <input type="checkbox"/> 2017 <input type="checkbox"/> 2016 <input type="checkbox"/> 2015 Other year. Enter one: calendar year _____ or fiscal year (month and year ended): _____		
Your first name and initial Bert	Last name Hanson	Your social security number 111 11 1111
If a joint return, spouse's first name and initial Ernestine	Last name Hanson	Spouse's social security number 222 22 2222
Current home address (number and street). If you have a P.O. box, see instructions. 1900 Sesame Street		Apt. no. _____ Your phone number _____
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below. See instructions. Altoona, PA 16602		
Foreign country name _____	Foreign province/state/county _____	Foreign postal code _____
Amended return filing status. You must check one box even if you are not changing your filing status. Caution: In general, you can't change your filing status from a joint return to separate returns after the due date. <input type="checkbox"/> Single <input checked="" type="checkbox"/> Married filing jointly <input type="checkbox"/> Married filing separately <input type="checkbox"/> Qualifying widow(er) <input type="checkbox"/> Head of household (If the qualifying person is a child but not your dependent, see instructions.)		<input checked="" type="checkbox"/> Full-year health care coverage (or, for 2018 amended returns only, exempt). See inst.
Use Part III on the back to explain any changes		
Income and Deductions	A. Original amount reported or as previously adjusted (see instructions)	B. Net change—amount of increase or (decrease)—explain in Part III
1 Adjusted gross income. If a net operating loss (NOL) carryback is included, check here ▶ <input type="checkbox"/>	1 75,155	110,149
2 Itemized deductions or standard deduction	2 12,000	12,000
3 Subtract line 2 from line 1	3 63,155	98,149
4a Exemptions (amended returns for years before 2018 only). If changing, complete Part I on page 2 and enter the amount from line 29	4a	
b Qualified business income deduction (2018 amended returns only)	4b	
5 Taxable income. Subtract line 4a or 4b from line 3. If the result is zero or less, enter -0-	5 63,155	98,149
Tax Liability		
6 Tax. Enter method(s) used to figure tax (see instructions):	6 9,838	17,840
7 Credits. If a general business credit carryback is included, check here ▶ <input type="checkbox"/>	7	
8 Subtract line 7 from line 6. If the result is zero or less, enter -0-	8 9,838	17,840
9 Health care: individual responsibility (see instructions)	9	
10 Other taxes	10	
11 Total tax. Add lines 8, 9, and 10	11 9,838	17,840
Payments		
12 Federal income tax withheld and excess social security and tier 1 RRTA tax withheld. (If changing, see instructions.)	12 10,500	19,000
13 Estimated tax payments, including amount applied from prior year's return	13	
14 Earned income credit (EIC)	14	
15 Refundable credits from: <input type="checkbox"/> Schedule 8812 Form(s) <input type="checkbox"/> 2439 <input type="checkbox"/> 4136 <input type="checkbox"/> 8863 <input type="checkbox"/> 8885 <input type="checkbox"/> 8962 or <input type="checkbox"/> other (specify): _____	15	
16 Total amount paid with request for extension of time to file, tax paid with original return, and additional tax paid after return was filed		16
17 Total payments. Add lines 12 through 15, column C, and line 16		17 29,500
Refund or Amount You Owe		
18 Overpayment, if any, as shown on original return or as previously adjusted by the IRS		18 1,822
19 Subtract line 18 from line 17. (If less than zero, see instructions.)		19 27,678
20 Amount you owe. If line 11, column C, is more than line 19, enter the difference		20
21 If line 11, column C, is less than line 19, enter the difference. This is the amount overpaid on this return		21 312
22 Amount of line 21 you want refunded to you		22 312
23 Amount of line 21 you want applied to your (enter year): _____ estimated tax 23		

Complete and sign this form on page 2.

For Paperwork Reduction Act Notice, see instructions.

Cat. No. 11360L

Form 1040X (Rev. 1-2019)

QUALIFIED BUSINESS INCOME DEDUCTION

The TCJA introduced the qualified business income deduction (QBID), which is applicable for tax years starting after December 31, 2017, and before January 1, 2026.¹⁰² Married taxpayers can claim the QBID whether filing jointly or separately. This section compares QBID calculations under both filing statuses and explores how overall federal income tax liability can vary depending upon whether spouses file separately or jointly.

Note. The 2018 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 2: Small Business Issues includes a section devoted to the QBID. Further information on the QBID is available in the 2019 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 1: QBID Update. This section uses terms and concepts explained in detail in those chapters.

For purposes of the QBID, a **qualified business** is any trade or business of the taxpayer that is operated within the United States or Puerto Rico if the income is effectively connected with the conduct of a trade or business in the United States (in the case of Puerto Rican businesses).¹⁰³ Moreover, the TCJA denotes that **any** trade or business is a “qualified trade or business” except for the following.¹⁰⁴

- A specified service trade or business (SSTB)
- The trade or business of performing services as an employee

The SSTB exception does **not** apply to the trades or businesses of taxpayers whose taxable income is **below** certain thresholds (discussed later).

Under IRC §199A, a taxpayer’s **final QBID** is the **lesser** of:¹⁰⁵

1. The taxpayer’s combined QBID, or
2. An amount equal to 20% of the excess (if any) of:
 - ♦ The taxpayer’s taxable income, over
 - ♦ The taxpayer’s net capital gain.

The second component of the above formula is known as the **overall taxable income limitation (OTI)**.

A taxpayer’s **combined QBID** (the first item in the preceding formula) is composed of the following.¹⁰⁶

1. The sum of the **initial QBIDs** for each of the taxpayer’s qualified businesses, **plus**
2. 20% of the aggregate amount of the taxpayer’s qualified real estate investment trust (REIT) dividends and qualified publicly traded partnership (PTP) income for the tax year.

¹⁰². PL 115-97 §11011; IRC §199A.

¹⁰³. IRC §§199A(c)(3)(A) and (f)(1)(C).

¹⁰⁴. IRC §199A(d).

¹⁰⁵. IRC §199A(a).

¹⁰⁶. IRC §199A(b).

The portion of the combined QBID formula pertaining to REIT dividends and PTP income does not change based on filing status (i.e., the total amount of this portion is the same regardless of whether the spouses file jointly or separately). However, the first element of the combined QBID formula can vary depending upon taxable income and whether the **W-2 wages/qualified property (QP) limit** applies in determining the **initial QBID** of a qualifying trade or business. The **W-2 wages/QP limit** is the **greater** of:¹⁰⁷

1. 50% of the **W-2 wages** with respect to the qualified business, **or**
2. The sum of 25% of the W-2 wages with respect to the qualified business, plus 2.5% of the **unadjusted basis** immediately after acquisition of all **QP**.

The **initial QBID** calculation depends upon which of the following three taxable income scenarios applies.

1. Taxable income equal to or below threshold
2. Taxable income between threshold and upper threshold
3. Taxable income equal to or above upper threshold

Taxable Income Equal to or Below Threshold

When the taxpayer's taxable income is equal to or below the applicable taxable income threshold, the **initial QBID** for a trade or business (whether it is a general trade or business **or** an SSTB) is simply **20% of its net QBI**.¹⁰⁸

For 2018, the amount of the QBID taxable income threshold is \$315,000 for MFJ taxpayers and \$157,500 for all other filing statuses.¹⁰⁹ These thresholds are adjusted for inflation for post-2018 tax years.¹¹⁰ According to Rev. Proc. 2018-57, the 2019 thresholds are \$321,400 for MFJ taxpayers, **\$160,725 for MFS taxpayers**, and \$160,700 for all other filing statuses.

Observation. Due to the inflation adjustment, the taxable income thresholds for MFS taxpayers (\$160,725) and other filing statuses (\$160,700) are different for 2019 as compared to 2018 when they were identical (\$157,500).

If the total taxable income of married taxpayers is less than the applicable **MFS** taxable income threshold, then the **initial QBID** of the taxpayer's qualifying trade or business does not change regardless of whether they file jointly or separately. However, because the **final QBID** also depends on the **OTI**, this can result in a lower QBID for spouses filing separately, as illustrated in the following example.

¹⁰⁷ IRC §199A(b)(2)(B).

¹⁰⁸ IRC §§199A(b)(2) and (3) and 199A(d)(3).

¹⁰⁹ IRC §199A(e)(2)(A).

¹¹⁰ IRC §199A(e)(2)(B).

2019 Workbook

Example 16. John and Sandy are married taxpayers who claim the standard deduction. In 2019, they have total income of \$150,000, which consists of John's \$50,000 wages, Sandy's sole proprietorship retail business income of \$80,000, and Sandy's net capital gain of \$20,000. Sandy's 2019 **final QBID** and taxable income for her and John is calculated as shown in the following table, using both MFJ and MFS status.

	MFJ	MFS	
		Sandy	John
Sandy's QBI	\$ 80,000	\$80,000	
Less: 50% SE tax deduction $(\$80,000 \times 92.35\% \times 15.3\%) \times 50\%$	(5,652)	(5,652)	
Sandy's net QBI	\$ 74,348	\$74,348	
Sandy's net capital gain	20,000	20,000	
John's wages	50,000		\$50,000
Less: standard deduction	(24,400)	(12,200)	(12,200)
Taxable income before QBID	\$119,948	\$82,148	\$37,800
Final QBID for MFJ is lesser of:			
• \$14,870 $(\$74,348 \text{ net QBI} \times 20\%)$, or			
• \$19,990 OTI $(\$119,948 \text{ taxable income} - \$20,000 \text{ net capital gain}) \times 20\%$	(14,870)		
Final QBID for MFS is lesser of:			
• \$14,870 $(\$74,348 \text{ net QBI} \times 20\%)$, or			
• \$12,430 OTI $(\$82,148 \text{ taxable income} - \$20,000 \text{ net capital gain}) \times 20\%$		(12,430)	N/A
Taxable income after QBID	\$105,078	\$69,718	\$37,800
2019 Federal income tax (excluding SE tax)	\$ 14,834	\$11,196	\$ 4,342

The resulting **\$704** tax savings $(\$14,834 - (\$11,196 + \$4,342))$ from filing jointly is partly attributable to the \$2,440 additional QBID $(\$14,870 - \$12,430)$ and partly to the different tax rates.

Taxable Income Between Threshold and Upper Threshold

If a taxpayer's taxable income exceeds the applicable income threshold, then the **initial QBID** for a qualified trade or business is the **lesser** of:¹¹¹

1. 20% of the QBI with respect to each qualified business, or
2. The **W-2 wages/QP limit**.

When a trade or business's W-2 wages/QP limit is less than 20% of its QBI, the difference between the two is gradually phased in.¹¹² For MFJ taxpayers, the phase-in range is \$100,000. For all other filing statuses, the phase-in range is \$50,000. This yields 2019 upper thresholds of \$421,400 for MFJ taxpayers $(\$321,400 \text{ threshold} + \$100,000)$, \$210,725 for MFS taxpayers $(\$160,725 \text{ threshold} + \$50,000)$, and \$210,700 for all other filing statuses $(\$160,700 \text{ threshold} + \$50,000)$.

¹¹¹. IRC §199A(b)(2).

¹¹². IRC §199A(b)(3)(B).

Phase-in of the W-2 wages/QP limit is accomplished using an **applicable percentage** determined from the following formula.¹¹³

$$\text{Applicable percentage} = 1 - \frac{\text{Taxable income} - \text{Income threshold}}{\text{Phase-in range}}$$

Consequently, the QBID may be reduced for taxpayers with taxable income over the applicable threshold. The formula for the **reduced QBID** that applies to general trades or businesses is as follows.

$$\text{Reduced QBID} = \text{W-2 wages/QP limit} + (\text{QBI} \times 20\% - \text{W-2 wages/QP limit}) \times \text{Applicable percentage}$$

Note. See **Example 4** in the 2018 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 2: Small Business Issues, for an illustration of the **reduced QBID** calculation.

When a trade or business's W-2 wages/QP limit **equals or exceeds** 20% of its QBI, the **reduced QBID** does not apply because its initial QBID is 20% of its QBI, as illustrated in the following example.¹¹⁴

Example 17. Tom and Anita are married taxpayers. In 2019, they have taxable income of \$371,400, which includes \$100,000 of net QBI and \$50,000 of W-2 wages from Tom's solely owned S corporation. Tom's S corporation has zero QP. Therefore, the W-2 wages/QP limit is \$25,000 (\$50,000 wages × 50%).

Consequently, Tom's initial QBID is the lesser of \$20,000 (\$100,000 QBI × 20%) and the \$25,000 W-2 wages/QP limit.

Because the W-2 wages/QP limit exceeds 20% of the QBI, the reduced QBID does not apply.

In certain circumstances, married taxpayers whose joint taxable income falls between the threshold and upper threshold can obtain a higher QBID that yields overall tax savings by filing separately rather than jointly. The next example illustrates this.

¹¹³ Ibid.

¹¹⁴ IRC §199A(b)(3)(B)(i)(II).

2019 Workbook

Example 18. Diana and Roger are married taxpayers who claim the standard deduction. In 2019, they have total income of \$450,000, which consists of Diana's \$300,000 wages, Roger's sole proprietorship business income of \$130,000, and Roger's \$20,000 interest income. Roger's sole proprietorship has no W-2 wages and no QP. Diana and Roger's 2019 tax liabilities filing jointly and separately are as follows.

	MFJ	MFS	
		Diana	Roger
Roger's QBI	\$ 130,000		\$130,000
Less: 50% SE tax deduction $((\$130,000 \times 92.35\% \times 15.3\%) \times 50\%)$	(9,184)		(9,184)
Roger's net QBI	\$120,816		\$120,816
Diana's wages	300,000	\$300,000	
Roger's interest income	20,000		20,000
Less: standard deduction	(24,400)	(12,200)	(12,200)
Taxable income before QBID	\$416,416	\$287,800	\$128,616
Final QBID for MFJ is lesser of:			
<ul style="list-style-type: none"> Reduced QBID of \$1,208 $(\\$0 \text{ W-2 wages/QP limit} + (\\$120,816 \text{ net QBI} \times 20\% - \\$0 \text{ W-2 wages/QP limit}) \times 5\% ^a)$, or \$83,283 OTI $(\\$416,416 \times 20\%)$ 			
	(1,208)		
Final QBID for MFS is lesser of:			
<ul style="list-style-type: none"> \$24,163 $(\\$120,816 \text{ net QBI} \times 20\%)$, or \$25,723 OTI $(\\$128,616 \text{ taxable income} \times 20\%)$ 			
		N/A	(24,163)
Taxable income after QBID	\$415,208	\$287,800	\$104,453
2019 Federal income tax (excluding SE tax)	\$ 95,709	\$ 75,924	\$ 19,243

^a Applicable percentage of 5% = $1 - ((\$416,416 \text{ taxable income} - \$321,400 \text{ threshold}) \div \$100,000)$

The **reduced QBID** applies when the spouses file jointly because their combined income is over the applicable income threshold and the W-2 wages/QP limit is less than 20% of QBI. When filing separately, Roger's taxable income is below the threshold, so his QBID is not reduced.

The resulting **\$542** tax savings $(\$95,709 - (\$75,924 + \$19,243))$ from filing separately is attributable to the \$22,955 $(\$24,163 - \$1,208)$ additional QBID, offset by the steeper MFS tax rates.

The reduced QBID for SSTBs is modified so that the difference between 20% of the SSTB's QBI and its W-2 wages/QP limit is phased in more rapidly. This modified formula is as follows.

$$\text{SSTB reduced QBID} = (\text{W-2 wages/QP limit} \times \text{Applicable percentage}) + ((\text{QBI} \times 20\% \times \text{Applicable percentage}) - (\text{W-2 wages/QP limit} \times \text{Applicable percentage})) \times \text{Applicable percentage}$$

Essentially, for SSTBs, the applicable percentage is applied to **each** element of the reduced QBID formula that applies to general trades or businesses.¹¹⁵

Note. For more information on the reduced QBID for SSTBs, see the 2018 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 2: Small Business Issues and the 2019 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 1: QBID Update.

¹¹⁵ IRC §199A(d)(3)(A)(ii).

The following example illustrates the difference in QBID and tax liability using the MFJ and MFS statuses for taxpayers with an SSTB.

Example 19. Use the same facts as **Example 18**, except Roger's business is an SSTB. Reclassifying Roger's business as an SSTB has the following impact on the QBID and Diana and Roger's 2019 tax liabilities.

	MFJ	MFS	
		Diana	Roger
Roger's QBI	\$ 130,000		\$130,000
Less: 50% SE tax deduction $((\$130,000 \times 92.35\% \times 15.3\%) \times 50\%)$	(9,184)		(9,184)
Roger's net QBI	\$120,816		\$120,816
Diana's wages	300,000	\$300,000	
Roger's interest income	20,000		20,000
Less: standard deduction	(24,400)	(12,200)	(12,200)
Taxable income before QBID	\$416,416	\$287,800	\$128,616
Final QBID for MFJ is lesser of:			
<ul style="list-style-type: none"> • Reduced QBID of \$60 $(\\$0 \text{ W-2 wages/QP limit} + (\\$120,816 \text{ net QBI} \times 20\% \times 5\% - \\$0 \text{ W-2 wages/QP limit}) \times 5\% ^a)$, or • \$83,283 OTI $(\\$416,416 \times 20\%)$ 			
	(60)		
Final QBID for MFS is lesser of:			
<ul style="list-style-type: none"> • \$24,163 $(\\$120,816 \text{ net QBI} \times 20\%)$, or • \$25,723 OTI $(\\$128,616 \text{ taxable income} \times 20\%)$ 			
		N/A	(24,163)
Taxable income after QBID	\$416,356	\$287,800	\$104,453
2019 Federal income tax (excluding SE tax)	\$ 96,111	\$ 75,924	\$ 19,243

^a Applicable percentage of 5% = $1 - ((\$416,416 \text{ taxable income} - \$321,400 \text{ threshold}) \div \$100,000)$

The resulting **\$944** tax savings $(\$96,111 - (\$75,924 + \$19,243))$ from filing separately is attributable to the \$24,103 $(\$24,163 - \$60)$ additional QBID, offset by the steeper MFS tax rates.

Taxable Income Equal to or Above Upper Threshold

When taxable income equals or exceeds the upper threshold, the **reduced QBID** no longer applies and the **initial QBID** is simply the lesser of 20% of QBI and the general trade/business's W-2 wages/QP limit.¹¹⁶ Therefore, if the general trade/business does not have any W-2 wages and/or QP, the initial QBID is zero.

Note. The **initial QBID** for an **SSTB** of a taxpayer with taxable income equal to or above the upper threshold is **always zero** because, in these circumstances, an SSTB is **not** a qualified trade or business.¹¹⁷

¹¹⁶ IRC §199A(b)(2).

¹¹⁷ IRC §§199A(d)(1) and (2).

2019 Workbook

Application of these rules is illustrated in the next example.

Example 20. Use the same facts as **Example 18**, except Roger has \$25,000 of interest income. Diana and Roger's 2019 tax liabilities filing jointly and separately are as follows.

	MFJ	MFS	
		Diana	Roger
Roger's QBI	\$ 130,000		\$130,000
Less: 50% SE tax deduction $(\$130,000 \times 92.35\% \times 15.3\%) \times 50\%$	(9,184)		(9,184)
Roger's net QBI	\$120,816		\$120,816
Diana's wages	300,000	\$300,000	
Roger's interest income	25,000		25,000
Less: standard deduction	(24,400)	(12,200)	(12,200)
Taxable income before QBID	\$421,416	\$287,800	\$133,616
Final QBID for MFJ is lesser of:			
<ul style="list-style-type: none"> • \$84,283 OTI $(\\$421,416 \text{ taxable income} \times 20\%)$, or • \$0, which is the lesser of: <ul style="list-style-type: none"> ♦ \$24,163 $(\\$120,816 \text{ net QBI} \times 20\%)$, or ♦ \$0 W-2 wages/QP limit 			
			(0)
Final QBID for MFS is lesser of:			
<ul style="list-style-type: none"> • \$24,163 $(\\$120,816 \text{ net QBI} \times 20\%)$, or • \$26,723 OTI $(\\$133,616 \text{ taxable income} \times 20\%)$ 			
Taxable income after QBID	\$421,416	N/A	(24,163)
		\$287,800	\$109,453
2019 Federal income tax (excluding SE tax)	\$ 97,882	\$ 75,924	\$ 20,443

The upper threshold for MFJ taxpayers is \$421,400, so the reduced QBID no longer applies and the **initial QBID** is simply the **lesser** of 20% of QBI and the general trade/business's W-2 wages/QP limit. When filing separately, Roger's taxable income is below the threshold.

The resulting \$1,515 tax savings $(\$97,882 - (\$75,924 + \$20,443))$ from filing separately is attributable to the \$24,163 $(\$24,163 - \$0)$ additional QBID, offset by the steeper MFS tax rates.

SUMMARY OF FACTORS AFFECTING THE QBID OF MARRIED TAXPAYERS

When deciding on their filing status, married taxpayers should consider the following QBID-related factors.

- The OTI limit
- Taxable income level
- Applicability of the W-2 wages/QP limit
- Trade or business classification (general or SSTB)

In addition, married taxpayers should consider that when the final QBID is higher under MFS, the associated tax benefit is offset by the steeper MFS tax rates and, as a result, may not produce overall tax savings.

EDUCATION CREDITS

Two credits are available to reduce the cost of higher education for taxpayers, their spouses, and their dependents: the American opportunity credit (AOC) and the lifetime learning credit.

Note. As of the date of publication, the tuition and fees deduction had not been extended for tax years after 2017.

AMERICAN OPPORTUNITY CREDIT

The AOC is a credit for qualified education expenses paid for an eligible student for the first four years of higher education.¹¹⁸

Note. The AOC, which expanded and renamed the then-existing Hope scholarship credit, was made permanent by Division Q of the Consolidated Appropriations Act, 2016 (PL 114-113), named the Protecting Americans from Tax Hikes Act of 2015.

The AOC includes various restrictions on eligible students, qualified expenses, income limitations, and eligible institutions. These are explained in greater detail later in this section. Basic components of the AOC include the following.¹¹⁹

- The maximum AOC per eligible student is \$2,500, calculated as the sum of 100% of the first \$2,000 of qualifying expenses and 25% of the next \$2,000.
- Forty percent of the AOC is refundable; therefore, the maximum refundable amount is \$1,000.
- Individuals can claim the full \$2,500 AOC for each eligible student for whom they paid at least \$4,000 of qualified education expenses.
- The AOC is available for four tax years per eligible student and applies only to the first four years of postsecondary education for students pursuing a degree or other recognized education credential. This is a lifetime limit and includes the years when the credit was known as the Hope credit.
- The AOC is phased out for modified AGI of \$80,000 to \$90,000 for single, head of household, and qualifying widow(er) filers and \$160,000 to \$180,000 for MFJ taxpayers. MFS taxpayers cannot claim the AOC.

¹¹⁸. IRC §25A(1).

¹¹⁹. IRS Pub. 970, *Tax Benefits for Education*.

Student Eligibility

The AOC may be claimed for a student only if all of the following four requirements are met.¹²⁰

1. The student has not completed the first four years of postsecondary education, as determined by the eligible educational institution's class standing rules as of the beginning of the calendar year.

Note. For this purpose, academic credit awarded solely because of the student's performance on proficiency examinations is not included.

2. The student (or anyone else on behalf of the student) has not claimed either the AOC or the Hope credit for any four earlier tax years. If the AOC (and Hope credit) has been claimed for this student for any three or fewer prior tax years, this requirement is met.
3. For at least one academic period during the tax year, the student was enrolled at least half-time in a program that leads to a degree, certificate, or other recognized educational credential.
4. The student has not been convicted of a federal or state felony for possessing or distributing a controlled substance.

Example 21. Sharon was never eligible for the Hope credit (available before 2009) but was eligible for the AOC for 2012, 2013, 2015, and 2017. Her parents claimed the AOC for Sharon's education expenses on their 2012, 2013, and 2015 tax returns. Sharon claimed the AOC on her 2017 tax return. The AOC was claimed for Sharon's education expenses for four tax years before 2018. Therefore, Sharon cannot claim the AOC for 2018.

Qualified Tuition and Related Expenses

Qualified tuition and related expenses (QTRE) include tuition, fees, and course materials (including a computer if needed as a condition of enrollment or attendance¹²¹) that are required for enrollment or attendance at an eligible educational institution. Expenses must be paid on behalf of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer under IRC §151.¹²²

Note. The TCJA suspended the IRC §151 dependency exemption for tax years 2018–2025.¹²³ For AOC purposes, the individual must qualify as a dependent (i.e., be "allowed" a deduction, when applicable, under IRC §§151 and 152.¹²⁴

Any expenses paid by a dependent claimed by a taxpayer are considered paid by that taxpayer. If the taxpayer does not claim a dependent who is an eligible student, the nonrefundable portion of the AOC may be claimed by the dependent. In that situation, the taxpayer may not claim any portion of the AOC.¹²⁵

QTRE does not include student activity fees (unless required as a condition of enrollment or attendance), athletic fees, insurance, or other expenses unrelated to an individual's academic course of instruction. In addition, costs of room and board, transportation, and medical expenses do not qualify, even if the costs are a condition of enrollment or attendance.¹²⁶

¹²⁰. IRC §25A(b)(2).

¹²¹. IRS Pub. 970, *Tax Benefits for Education*.

¹²². IRC §25A(f)(1)(A).

¹²³. IRC §151(d)(5).

¹²⁴. IRS Pub. 970, *Tax Benefits for Education*.

¹²⁵. *Ibid.*

¹²⁶. *Ibid.*

QTRE must be reduced by the following tax-free educational assistance.¹²⁷

- Scholarships and fellowships excluded from gross income
- Veterans' or armed forces members' educational benefits
- Pell grants (allocated to QTREs)
- Employer-provided educational assistance
- Any other payment of educational expenses that is excluded from gross income

Practitioner Planning Tip

A student may choose to treat their Pell Grant as paying for living expenses even if the institution applies the Pell Grant against tuition and fees, up to the amount of the actual living expenses. Pell grants treated as paying for living expenses are included in the student's taxable income and are not subtracted from qualified education expenses.¹²⁸ This may increase their allowable AOC.

In addition, QTREs are reduced by any refund received by the taxpayer.¹²⁹

Prepayments. If a taxpayer pays QTREs during a tax year for an academic period that begins during the first three months following the tax year, the taxpayer can claim the expenses only in the tax year in which the expenses are paid.¹³⁰ For example, expenses paid in December 2018 for the spring semester that starts in January 2019 are claimed on the 2018 return. To claim these expenses on the 2019 return, they must be paid in 2019.¹³¹

Payments with Borrowed Funds. A taxpayer can claim the AOC for QTREs paid with the proceeds of a loan. For determining the AOC, the taxpayer uses the year the expenses are paid, not the year the loan is repaid. Loan proceeds disbursed directly to the educational institution are treated as paid on the date credited to the student's account by the institution.¹³²

Income Limits

As mentioned earlier, the AOC is phased out pro rata for higher-income taxpayers based on their MAGI. MAGI is the taxpayer's adjusted gross income, with additions for the following.¹³³

- Foreign earned income exclusion, foreign housing exclusion, and foreign housing deduction
- Exclusion of income by bona fide residents of American Samoa and Puerto Rico

¹²⁷ Ibid.

¹²⁸ *Fact Sheet: Interaction of Pell Grants and Tax Credits: Students May be Foregoing Tax Benefits by Mistake*. U.S. Department of the Treasury. [www.treasury.gov/resource-center/tax-policy/Documents/Report-Pell-AOTC-Interaction-2014.pdf] Accessed on Jun. 5, 2019.

¹²⁹ IRS Pub. 970, *Tax Benefits for Education*.

¹³⁰ Treas. Reg. §1.25A-5(e)(2).

¹³¹ IRC §25A(g)(4).

¹³² Treas. Reg. §1.25A-5(e)(3).

¹³³ IRC §25A(d)(3).

2019 Workbook

The following table shows the AOC phase-out ranges for 2019.

Filing Status	Phase-out Range
MFJ	\$160,000–\$180,000
Single, head of household, qualifying widow(er)	80,000–90,000
MFS	Not eligible for AOC

Example 22. In 2019, Ellen and Max, who file MFJ returns, paid \$2,800 for tuition and \$500 for books for their dependent son, Steve, to attend Florida State University. What is the maximum AOC they can claim for the tuition payment and books if their modified AGI is \$170,000?

Ellen and Max's tentative AOC is \$2,325 $((\$2,000 \times 100\%) + (\$1,300 \times 25\%))$. Because the couple's MAGI is within the phase-out range, the tentative credit must be multiplied by a fraction. The numerator of the fraction is \$180,000 (upper limit for filing a joint return) minus the couple's MAGI. The denominator is \$20,000 (the range of incomes for the phase-out (\$160,000 to \$180,000)). Accordingly, Ellen and Max can claim an AOC of \$1,163.

$$\begin{aligned}\text{AOC} &= \$2,325 \times \frac{\$180,000 - \$170,000}{\$20,000} \\ &= \$1,163\end{aligned}$$



Practitioner Planning Tip

In certain situations, practitioners may want to advise eligible clients to consider contributing to their employer-sponsored 401(k) or deductible IRA and/or health savings accounts (HSA) to reduce MAGI and perhaps increase the amount of the AOC.

Eligible Education Institutions

For the AOC, an eligible educational institution is any accredited public, nonprofit, or proprietary (privately owned profit-making) college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the U.S. Department of Education.¹³⁴ Eligible institutions include online colleges and universities, provided they meet the other requirements.

¹³⁴. IRS Pub. 970, *Tax Benefits for Education*. IRC §25A defines an eligible educational institution as one “described in section 481 of the Higher Education Act of 1965 (20 U.S.C. 1088) ... eligible to participate in a program under title IV of such Act.”

Form 1098-T

For determining eligible deductions and credits, educational institutions should provide Form 1098-T, *Tuition Statement*, by January 31 of the year following the year in which the expenses were paid. In some cases, an educational institution is not required to furnish a Form 1098-T to the student. In these cases, the AOC can still be claimed. Examples of such situations include the following.¹³⁵

- The student is a qualified nonresident alien.
- The student has QTREs paid entirely with scholarships.
- The student has QTREs paid under a formal billing arrangement.
- The student is enrolled in courses for which no academic credit is awarded.

To claim the AOC without a Form 1098-T, the student (if otherwise qualified) must demonstrate that they were enrolled at an eligible educational institution and can substantiate the payment of QTRE.

The major components of Form 1098-T are explained below.¹³⁶

Note. Prior to 2018, the amount reported in box 2 of Form 1098-T represented QTRE billed to the student's account for the calendar (tax) year. Due to a change to institutional reporting requirements under federal law, beginning with tax year 2018, educational institutions should report the amount of QTRE **paid** during the year in box 1.¹³⁷

☐ CORRECTED

FILER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone number		1 Payments received for qualified tuition and related expenses \$	OMB No. 1545-1574 <div style="font-size: 2em; font-weight: bold; text-align: center;">2019</div>	Tuition Statement Form 1098-T	
		2			
FILER'S employer identification no.	STUDENT'S TIN	3			Copy B For Student This is important tax information and is being furnished to the IRS. This form must be used to complete Form 8863 to claim education credits. Give it to the tax preparer or use it to prepare the tax return.
STUDENT'S name		4 Adjustments made for a prior year \$	5 Scholarships or grants \$		
Street address (including apt. no.)		6 Adjustments to scholarships or grants for a prior year \$	7 Checked if the amount in box 1 includes amounts for an academic period beginning January—March 2020 <input type="checkbox"/>		
City or town, state or province, country, and ZIP or foreign postal code		8 Check if at least half-time student <input type="checkbox"/>	9 Checked if a graduate student <input type="checkbox"/>		
Service Provider/Acct. No. (see instr.)		10 Ins. contract reimb./refund \$			

Form **1098-T**
(keep for your records)
www.irs.gov/Form1098T
Department of the Treasury - Internal Revenue Service

Box 1 reports total payments received by an eligible educational institution from any source for qualified tuition and related expenses less any reimbursements or refunds made during the tax year that relate to those payments received during the year. For tax years ending after December 31, 2018, educational institutions report expenses in box 1 for the year in which payments were received instead of when tuition was billed (box 2 in prior years).

Box 4 includes any adjustment made by an eligible educational institution for a prior year for qualified tuition and related expenses that were reported on a prior year Form 1098-T. This amount may reduce any allowable education credit that may be claimed for the prior year (may result in an increase in tax liability for the year of the refund).

¹³⁵ IRS Pub. 970, *Tax Benefits for Education*.

¹³⁶ See Form 1098-T instructions for student.

¹³⁷ Instructions for Forms 1098-E and 1098-T.

Box 5 reports the total of all scholarships or grants administered and processed by the eligible educational institution. The amount of scholarships or grants for the calendar year (including those not reported by the institution) may reduce the amount of the education credit the taxpayer claims for the year.

Box 6 includes adjustments to scholarships or grants for a prior year. This amount may affect the amount of any allowable tuition and fees deduction or education credit that was claimed for the prior year. The taxpayer may have to file an amended income tax return for the prior year.

Box 7 shows whether the amount reported in box 1 includes amounts for an academic period beginning January through March of the subsequent year.

Box 8 is checked if the student was at least a half-time student during any academic period that began during the tax year.

Box 9 is checked if the student was a graduate student during any academic period that began during the tax year.

Box 10 shows the total amount of reimbursements or refunds of qualified tuition and related expenses made by an insurer. The amount of reimbursements or refunds for the calendar year may reduce the amount of any education credit that may be claimed for the year.

Penalties and Restrictions

IRC §25A(b)(4) imposes restrictions on taxpayers who improperly claimed the AOC in prior years. Individuals are barred from claiming the credit for 10 years if the claim was due to fraud and for two years if their claim was due to a reckless or intentional disregard of the rules. After a disallowance, the taxpayer must file Form 8862, *Information to Claim Certain Credits After Disallowance*, in order to claim the AOC. In addition, with math error authority, the IRS can disallow improperly claimed credits without a formal examination.¹³⁸

Caution. Practitioners must meet due diligence requirements when they prepare a return claiming the AOC. These requirements include completing Form 8867, *Paid Preparer's Due Diligence Checklist*.¹³⁹

Calculating the AOC

Taxpayers complete Form 8863, *Education Credits*, to calculate and claim both the AOC and lifetime learning credits. The AOC's refundable portion is calculated in part I, and the nonrefundable portion is calculated in part II. Student and educational information is reported in part III.

Example 23. Diane Carter is a single mother, filing as head of household, with 2018 MAGI of \$18,000. Her dependent child, Ronald Carter, attends the University of Michigan. Ronald paid \$12,000 of 2018 QTREs using proceeds from a student loan. Diane's tax liability is zero and thus she is not eligible to claim the nonrefundable credit. However, Diane is eligible to claim \$1,000 of refundable AOC ($\$2,500 \times 40\%$). Diane's Form 8863 follows.

¹³⁸. IRC §6213(g)(2)(Q).

¹³⁹. Treas. Reg. §1.6695-2.

For Example 23

Form	8863	Education Credits (American Opportunity and Lifetime Learning Credits) ▶ Attach to Form 1040. ▶ Go to www.irs.gov/Form8863 for instructions and the latest information.	OMB No. 1545-0074 <div style="font-size: 24pt; font-weight: bold;">2018</div> Attachment Sequence No. 50
Department of the Treasury Internal Revenue Service (99)			
Name(s) shown on return Diane Carter		Your social security number <div style="display: flex; justify-content: space-between; border-top: 1px solid black; padding-top: 2px;"> 123 55 5555 </div>	



Complete a separate Part III on page 2 for each student for whom you're claiming either credit before you complete Parts I and II.

Part I Refundable American Opportunity Credit	
1 After completing Part III for each student, enter the total of all amounts from all Parts III, line 30	1 2,500
2 Enter: \$180,000 if married filing jointly; \$90,000 if single, head of household, or qualifying widow(er)	2 90,000
3 Enter the amount from Form 1040, line 7. If you're filing Form 2555, 2555-EZ, or 4563, or you're excluding income from Puerto Rico, see Pub. 970 for the amount to enter	3 18,000
4 Subtract line 3 from line 2. If zero or less, stop ; you can't take any education credit	4 72,000
5 Enter: \$20,000 if married filing jointly; \$10,000 if single, head of household, or qualifying widow(er)	5 10,000
6 If line 4 is: • Equal to or more than line 5, enter 1.000 on line 6 • Less than line 5, divide line 4 by line 5. Enter the result as a decimal (rounded to at least three places)	6 1 .000
7 Multiply line 1 by line 6. Caution: If you were under age 24 at the end of the year and meet the conditions described in the instructions, you can't take the refundable American opportunity credit; skip line 8, enter the amount from line 7 on line 9, and check this box <input type="checkbox"/>	7 2,500
8 Refundable American opportunity credit. Multiply line 7 by 40% (0.40). Enter the amount here and on Form 1040, line 17c. Then go to line 9 below	8 1,000
Part II Nonrefundable Education Credits	
9 Subtract line 8 from line 7. Enter here and on line 2 of the Credit Limit Worksheet (see instructions)	9 1,500
10 After completing Part III for each student, enter the total of all amounts from all Parts III, line 31. If zero, skip lines 11 through 17, enter -0- on line 18, and go to line 19	10 0
11 Enter the smaller of line 10 or \$10,000	11
12 Multiply line 11 by 20% (0.20)	12
13 Enter: \$134,000 if married filing jointly; \$67,000 if single, head of household, or qualifying widow(er)	13
14 Enter the amount from Form 1040, line 7. If you're filing Form 2555, 2555-EZ, or 4563, or you're excluding income from Puerto Rico, see Pub. 970 for the amount to enter	14
15 Subtract line 14 from line 13. If zero or less, skip lines 16 and 17, enter -0- on line 18, and go to line 19	15
16 Enter: \$20,000 if married filing jointly; \$10,000 if single, head of household, or qualifying widow(er)	16
17 If line 15 is: • Equal to or more than line 16, enter 1.000 on line 17 and go to line 18 • Less than line 16, divide line 15 by line 16. Enter the result as a decimal (rounded to at least three places)	17
18 Multiply line 12 by line 17. Enter here and on line 1 of the Credit Limit Worksheet (see instructions) ▶	18 0
19 Nonrefundable education credits. Enter the amount from line 7 of the Credit Limit Worksheet (see instructions) here and on Schedule 3 (Form 1040), line 50	19 0

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 25379M

Form **8863** (2018)

2019 Workbook

For Example 23

Form 8863 (2018)

Page **2**

Name(s) shown on return

Diane Carter

Your social security number

123 55 5555



Complete Part III for each student for whom you're claiming either the American opportunity credit or lifetime learning credit. Use additional copies of page 2 as needed for each student.

Part III Student and Educational Institution Information. See instructions.

20 Student name (as shown on page 1 of your tax return) Ronald Carter	21 Student social security number (as shown on page 1 of your tax return) 321 55 5555
22 Educational institution information (see instructions)	
a. Name of first educational institution University of Michigan	b. Name of second educational institution (if any)
(1) Address. Number and street (or P.O. box). City, town or post office, state, and ZIP code. If a foreign address, see instructions. 100 First Street, Ann Arbor, MI 48109	(1) Address. Number and street (or P.O. box). City, town or post office, state, and ZIP code. If a foreign address, see instructions.
(2) Did the student receive Form 1098-T from this institution for 2018? <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	(2) Did the student receive Form 1098-T from this institution for 2018? <input type="checkbox"/> Yes <input type="checkbox"/> No
(3) Did the student receive Form 1098-T from this institution for 2017 with box 2 filled in and box 7 checked? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No	(3) Did the student receive Form 1098-T from this institution for 2017 with box 2 filled in and box 7 checked? <input type="checkbox"/> Yes <input type="checkbox"/> No
(4) Enter the institution's employer identification number (EIN) if you're claiming the American opportunity credit or if you checked "Yes" in (2) or (3) . You can get the EIN from Form 1098-T or from the institution. 3 8 - 6 0 0 6 3 0 9	(4) Enter the institution's employer identification number (EIN) if you're claiming the American opportunity credit or if you checked "Yes" in (2) or (3) . You can get the EIN from Form 1098-T or from the institution. _____ - _____
23 Has the Hope Scholarship Credit or American opportunity credit been claimed for this student for any 4 tax years before 2018? <input type="checkbox"/> Yes — Stop! Go to line 31 for this student. <input checked="" type="checkbox"/> No — Go to line 24.	
24 Was the student enrolled at least half-time for at least one academic period that began or is treated as having begun in 2018 at an eligible educational institution in a program leading towards a postsecondary degree, certificate, or other recognized postsecondary educational credential? See instructions. <input checked="" type="checkbox"/> Yes — Go to line 25. <input type="checkbox"/> No — Stop! Go to line 31 for this student.	
25 Did the student complete the first 4 years of postsecondary education before 2018? See instructions. <input type="checkbox"/> Yes — Stop! Go to line 31 for this student. <input checked="" type="checkbox"/> No — Go to line 26.	
26 Was the student convicted, before the end of 2018, of a felony for possession or distribution of a controlled substance? <input type="checkbox"/> Yes — Stop! Go to line 31 for this student. <input checked="" type="checkbox"/> No — Complete lines 27 through 30 for this student.	



You can't take the American opportunity credit and the lifetime learning credit for the same student in the same year. If you complete lines 27 through 30 for this student, don't complete line 31.

American Opportunity Credit

27 Adjusted qualified education expenses (see instructions). Don't enter more than \$4,000.	27 4,000
28 Subtract \$2,000 from line 27. If zero or less, enter -0-.	28 2,000
29 Multiply line 28 by 25% (0.25).	29 500
30 If line 28 is zero, enter the amount from line 27. Otherwise, add \$2,000 to the amount on line 29 and enter the result. Skip line 31. Include the total of all amounts from all Parts III, line 30, on Part I, line 1.	30 2,500

Lifetime Learning Credit

31 Adjusted qualified education expenses (see instructions). Include the total of all amounts from all Parts III, line 31, on Part II, line 10.	31
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Form **8863** (2018)

LIFETIME LEARNING CREDIT

The lifetime learning credit is a nonrefundable credit equal to 20% of the first \$10,000 of qualified tuition and related expenses (tuition and fees, but generally not books) paid by the taxpayer during the tax year. The maximum credit is \$2,000 per year.¹⁴⁰

Note. Unlike the AOC, the lifetime learning credit is not restricted to just the first four years of postsecondary study.

Who Can Claim the Credit?

Generally, an individual who meets all of the following requirements can claim the lifetime learning credit.¹⁴¹

- The taxpayer pays QTREs for higher education.
- The taxpayer pays the education expenses for an eligible student.
- The eligible student is either the taxpayer, the taxpayer's spouse, or the taxpayer's dependent.

Eligible Students

To be eligible for the lifetime learning credit, the student must meet three requirements.

1. Be enrolled or taking courses at an eligible educational institution¹⁴²
2. Be taking higher education course(s) to earn a degree or other recognized education credential or to acquire or improve job skills¹⁴³
3. Be enrolled for at least one academic period beginning in the tax year¹⁴⁴

Note. The academic period can be semesters, trimesters, quarters, or any other period of study such as a summer school session. Academic periods are determined by the school.

Eligible Educational Institutions

An eligible educational institution for purposes of the lifetime learning credit is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the U.S. Department of Education.¹⁴⁵

Qualified Education Expenses

QTREs for purposes of the lifetime learning credit are tuition and certain related expenses required for enrollment in a course at an eligible educational institution. The course must be either part of a postsecondary degree program or taken by the student to acquire or improve job skills. Student activity fees and expenses for course-related books, supplies, and equipment are considered QTREs only if the fees and expenses must be paid to the institution for enrollment or attendance.¹⁴⁶

¹⁴⁰. IRC §25A(c)(1).

¹⁴¹. IRS Pub. 970, *Tax Benefits for Education*; IRC §25A(f)(1).

¹⁴². IRC §25A(c)(2)(B).

¹⁴³. *Ibid.*

¹⁴⁴. IRC §25A(c)(1).

¹⁴⁵. IRC §25A(f)(2).

¹⁴⁶. IRS Pub. 970, *Tax Benefits for Education*.

2019 Workbook

QTREs paid in a tax year for an academic period that begins in the first three months of the following year can be used in calculating a lifetime learning credit only for the year in which the expenses were paid.

Example 24. Marla pays \$2,000 in December 2018 for qualified tuition for the 2019 winter quarter that begins in January 2019.

If Marla meets the other requirements for the lifetime learning credit, she can claim the lifetime learning credit based on the payments in December 2018 only on her 2018 return. She cannot claim the credit for the \$2,000 paid in December 2018 on her 2019 return.

Income Limits

The lifetime learning credit is phased out at higher income levels based on the taxpayer's MAGI, as shown in the following table.¹⁴⁷

Filing Status	2019 Phase-out Range
MFJ	\$116,000–\$136,000
Single, head of household, qualifying widow(er)	58,000–68,000
MFS	Not eligible for credit

Note. The income phase-out range for the lifetime learning credit is indexed for inflation, but the phase-out range for the AOC is not.¹⁴⁸

Calculating the Lifetime Learning Credit

Form 8863, part II is used to calculate and report the lifetime learning credit.

Example 25. Ron and Sarah Simpson file a joint return. For 2018, their MAGI is \$120,000, and they paid \$14,000 of QTREs for their daughter, Margaret Simpson. Margaret is a second-year graduate student in biology at the University of Florida. Ron and Sarah's MAGI is within the phase-out range for 2018. Therefore, they do not qualify for the \$2,000 maximum lifetime learning credit.

Ron and Sarah file the following Form 8863, which shows they are entitled to a \$1,400 lifetime learning credit.

¹⁴⁷. Rev. Proc. 2018-57, 2018-49 IRB 827.

¹⁴⁸. IRC §25A(h)(1).

For Example 25

Form 8863 Department of the Treasury Internal Revenue Service (99)	Education Credits (American Opportunity and Lifetime Learning Credits) Attach to Form 1040. Go to www.irs.gov/Form8863 for instructions and the latest information.	OMB No. 1545-0074 2018 Attachment Sequence No. 50
Name(s) shown on return Ron and Sarah Simpson		Your social security number <div style="display: flex; justify-content: space-between; border-top: 1px solid black; border-bottom: 1px solid black;"> 555 99 5555 </div>



Complete a separate Part III on page 2 for each student for whom you're claiming either credit before you complete Parts I and II.

Part I Refundable American Opportunity Credit		
1 After completing Part III for each student, enter the total of all amounts from all Parts III, line 30	1	
2 Enter: \$180,000 if married filing jointly; \$90,000 if single, head of household, or qualifying widow(er)	2	
3 Enter the amount from Form 1040, line 7. If you're filing Form 2555, 2555-EZ, or 4563, or you're excluding income from Puerto Rico, see Pub. 970 for the amount to enter	3	
4 Subtract line 3 from line 2. If zero or less, stop ; you can't take any education credit	4	
5 Enter: \$20,000 if married filing jointly; \$10,000 if single, head of household, or qualifying widow(er)	5	
6 If line 4 is: • Equal to or more than line 5, enter 1.000 on line 6 • Less than line 5, divide line 4 by line 5. Enter the result as a decimal (rounded to at least three places)	6	.
7 Multiply line 1 by line 6. Caution: If you were under age 24 at the end of the year and meet the conditions described in the instructions, you can't take the refundable American opportunity credit; skip line 8, enter the amount from line 7 on line 9, and check this box <input type="checkbox"/>	7	
8 Refundable American opportunity credit. Multiply line 7 by 40% (0.40). Enter the amount here and on Form 1040, line 17c. Then go to line 9 below	8	
Part II Nonrefundable Education Credits		
9 Subtract line 8 from line 7. Enter here and on line 2 of the Credit Limit Worksheet (see instructions)	9	
10 After completing Part III for each student, enter the total of all amounts from all Parts III, line 31. If zero, skip lines 11 through 17, enter -0- on line 18, and go to line 19	10	14,000
11 Enter the smaller of line 10 or \$10,000	11	10,000
12 Multiply line 11 by 20% (0.20)	12	2,000
13 Enter: \$134,000 if married filing jointly; \$67,000 if single, head of household, or qualifying widow(er)	13	134,000
14 Enter the amount from Form 1040, line 7. If you're filing Form 2555, 2555-EZ, or 4563, or you're excluding income from Puerto Rico, see Pub. 970 for the amount to enter	14	120,000
15 Subtract line 14 from line 13. If zero or less, skip lines 16 and 17, enter -0- on line 18, and go to line 19	15	14,000
16 Enter: \$20,000 if married filing jointly; \$10,000 if single, head of household, or qualifying widow(er)	16	20,000
17 If line 15 is: • Equal to or more than line 16, enter 1.000 on line 17 and go to line 18 • Less than line 16, divide line 15 by line 16. Enter the result as a decimal (rounded to at least three places)	17	.700
18 Multiply line 12 by line 17. Enter here and on line 1 of the Credit Limit Worksheet (see instructions)	18	1,400
19 Nonrefundable education credits. Enter the amount from line 7 of the Credit Limit Worksheet (see instructions) here and on Schedule 3 (Form 1040), line 50	19	1,400

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 25379M

Form **8863** (2018)

2019 Workbook

For Example 25

Form 8863 (2018)

Page **2**

Name(s) shown on return

Ron and Sarah Simpson

Your social security number

555 99 5555



Complete Part III for each student for whom you're claiming either the American opportunity credit or lifetime learning credit. Use additional copies of page 2 as needed for each student.

Part III Student and Educational Institution Information. See instructions.

20 Student name (as shown on page 1 of your tax return) Margaret Simpson	21 Student social security number (as shown on page 1 of your tax return) 999 00 5555
22 Educational institution information (see instructions)	
a. Name of first educational institution University of Florida	b. Name of second educational institution (if any)
(1) Address. Number and street (or P.O. box). City, town or post office, state, and ZIP code. If a foreign address, see instructions. 1324 Criser Hall, Room 345 Gainesville, FL 32608	(1) Address. Number and street (or P.O. box). City, town or post office, state, and ZIP code. If a foreign address, see instructions.
(2) Did the student receive Form 1098-T from this institution for 2018? <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No	(2) Did the student receive Form 1098-T from this institution for 2018? <input type="checkbox"/> Yes <input type="checkbox"/> No
(3) Did the student receive Form 1098-T from this institution for 2017 with box 2 filled in and box 7 checked? <input type="checkbox"/> Yes <input checked="" type="checkbox"/> No	(3) Did the student receive Form 1098-T from this institution for 2017 with box 2 filled in and box 7 checked? <input type="checkbox"/> Yes <input type="checkbox"/> No
(4) Enter the institution's employer identification number (EIN) if you're claiming the American opportunity credit or if you checked "Yes" in (2) or (3) . You can get the EIN from Form 1098-T or from the institution. 5 9 - 0 9 7 4 7 3 9	(4) Enter the institution's employer identification number (EIN) if you're claiming the American opportunity credit or if you checked "Yes" in (2) or (3) . You can get the EIN from Form 1098-T or from the institution. -
23 Has the Hope Scholarship Credit or American opportunity credit been claimed for this student for any 4 tax years before 2018? <input checked="" type="checkbox"/> Yes — Stop! Go to line 31 for this student. <input type="checkbox"/> No — Go to line 24.	
24 Was the student enrolled at least half-time for at least one academic period that began or is treated as having begun in 2018 at an eligible educational institution in a program leading towards a postsecondary degree, certificate, or other recognized postsecondary educational credential? See instructions. <input type="checkbox"/> Yes — Go to line 25. <input type="checkbox"/> No — Stop! Go to line 31 for this student.	
25 Did the student complete the first 4 years of postsecondary education before 2018? See instructions. <input type="checkbox"/> Yes — Stop! Go to line 31 for this student. <input type="checkbox"/> No — Go to line 26.	
26 Was the student convicted, before the end of 2018, of a felony for possession or distribution of a controlled substance? <input type="checkbox"/> Yes — Stop! Go to line 31 for this student. <input type="checkbox"/> No — Complete lines 27 through 30 for this student.	
<p>You <i>can't</i> take the American opportunity credit and the lifetime learning credit for the <i>same student</i> in the same year. If you complete lines 27 through 30 for this student, don't complete line 31.</p>	
American Opportunity Credit	
27 Adjusted qualified education expenses (see instructions). Don't enter more than \$4,000.	27
28 Subtract \$2,000 from line 27. If zero or less, enter -0-.	28
29 Multiply line 28 by 25% (0.25).	29
30 If line 28 is zero, enter the amount from line 27. Otherwise, add \$2,000 to the amount on line 29 and enter the result. Skip line 31. Include the total of all amounts from all Parts III, line 30, on Part I, line 1.	30
Lifetime Learning Credit	
31 Adjusted qualified education expenses (see instructions). Include the total of all amounts from all Parts III, line 31, on Part II, line 10.	31 14,000

Form **8863** (2018)

COMPARING THE AOC AND LIFETIME LEARNING CREDIT

Expenses may qualify for both the AOC and lifetime learning credit (i.e., tuition and fees for the first four years of postsecondary education). In these cases, taxpayers may choose which credit to use, **but they may not claim both credits for the same student in the same year.**¹⁴⁹

Example 26. Carter, filing as head of household, paid \$6,000 of tuition for her child, Bill, to attend the University of Houston during the summer following the end of his first year. Carter's AGI is \$45,000. Therefore, her education credits are not subject to the phase-out.

Carter is allowed to claim the maximum AOC of \$2,500 on the first \$4,000 of the QEEs. She cannot claim the lifetime learning credit on the remaining \$2,000 of tuition costs (\$6,000 total expenses – \$4,000 maximum AOC expenses). She cannot claim both the AOC **and** lifetime learning credit for Bill in the same year.

The AOC and lifetime learning credit have several differences and share some common elements, as shown in the following table.

	American Opportunity Credit	Lifetime Learning Credit
Refundable	40% of the credit may be refundable (limited to \$1,000 per student).	Nonrefundable
Annual limit	\$2,500 credit per student	\$2,000 credit per tax return
Qualified expenses	Tuition, books, supplies, equipment needed for a course of study, required enrollment or admission fees	Tuition and fees required for enrollment or admission
Qualifying expenses	Undergraduate	Undergraduate, graduate, and professional courses to acquire or improve job skills
Felony drug conviction restriction	Yes	No
Degree or certificate requirement	Yes: degree or other recognized credential	No requirement
Enrollment requirement	Yes, at least half-time for at least one academic period in tax year	One or more courses
MAGI phaseout for MFJ filers	\$160,000–\$180,000	\$116,000–\$136,000 (for 2019)
MAGI phaseout for single, head of household, qualifying widow(er)	\$80,000–\$90,000	\$58,000–\$68,000 (for 2019)

¹⁴⁹. Treas. Reg. §1.25A-1(b)(1); IRC §25A(c)(2)(A).

In evaluating the two credit options, several factors warrant consideration.

- For each student, either the AOC or the lifetime learning credit may be claimed, but not both. If both credits are available, the AOC will always be greater than the lifetime learning credit.
- If qualified educational expenses are paid for more than one student, taxpayers can choose to claim the AOC for one student and the lifetime learning credit for another student in the same year. The AOC limitation is per student, not per tax return filed. The lifetime learning credit limit is per tax return, not per student.
- Unlike the AOC, there is no limit on the number of years the lifetime learning credit can be claimed for each student. The AOC is limited to four years.

COORDINATING EDUCATION TAX BENEFITS

Congress provides several options to reduce education expenses in the form of credits, deductions, the Coverdell education savings account (ESA), the §529 qualified tuition program, and savings bonds. Taxpayers often can choose one or more plans but, as a general rule, they cannot receive double benefits from the education tax savings opportunities. In addition, if a taxpayer receives a refund of education expenses or tax-free assistance after claiming an education credit, the taxpayer may have to repay part or all of the credit.¹⁵⁰

Disallowance of Double Benefits

For a single tax year, the taxpayer cannot receive multiple tax benefits for the same education expenses. For example, the following situations are not allowed.¹⁵¹

- Deduct higher education expenses (for example, a business expense) and also claim a lifetime learning credit based on those same expenses
- Claim a lifetime learning credit for any student and use any of that student's expenses in calculating the AOC
- Claim a lifetime learning credit based on the same expenses used to calculate the tax-free portion of a distribution from a Coverdell ESA or qualified tuition program (QTP)
- Claim a credit based on qualified education expenses paid with tax-free educational assistance, such as a scholarship, grant, or assistance provided by an employer

However, planning opportunities exist to take maximum advantage of other education tax benefits. If the student receives scholarships that cover all or most of the eligible expenses, **the taxpayer can elect to treat all or part of the scholarship as taxable income to increase the combined value of education credits and certain educational assistance (including Pell Grants).**

¹⁵⁰. IRS Pub. 970, *Tax Benefits for Education*.

¹⁵¹. *Ibid.*

Example 27. Sue is a full-time undergraduate student at the University of Texas. In 2018, she earned \$4,000 of income from a part-time job. Sue paid \$5,000 for her tuition and books. She also received a \$5,000 scholarship that is not restricted to payment of tuition, fees, or books. Her parents file jointly and their taxable income after claiming the \$24,000 standard deduction is \$50,000.

Sue does not report any of the scholarship as income. Her tuition and books are treated as paid by the scholarship and her living expenses are treated as paid by her parents. Her parents' 2019 income tax liability is \$5,612 on their taxable income of \$50,000.

	Sue	Sue's Parents
Salaries and wages	\$4,000	
Scholarship income	0	
Total income	\$4,000	\$50,000
Income tax	0	5,612
Qualified education expenses	N/A	0
American opportunity credit	N/A	0

Example 28. Use the same facts as **Example 27**, except Sue reports all of the scholarship as income.

Sue treats her living expenses as paid by the scholarship and her tuition and books as paid by her parents. Her parents claim the AOC for Sue's \$5,000 expenses for tuition and books.

As shown in the following table, Sue still pays no tax because the standard deduction fully offsets her income. However, Sue's parents qualify for a \$2,500 AOC, reducing their income tax liability to \$3,112. Therefore, there is a net tax benefit of \$2,500 in reporting the scholarship as taxable income and claiming the AOC.

Tax Return	Sue	Sue's Parents
Salaries and wages	\$4,000	
Scholarship income	5,000	
Total income	\$9,000	\$50,000
Income tax (before credits)	\$ 0	\$ 5,612
Less: AOC	N/A	(2,500)
Income tax (after AOC)	\$ 0	\$ 3,112

Note. Scholarships are discussed later in this chapter.

QUALIFIED TUITION PROGRAMS

QTPs, also known as §529 plans, are tax-advantaged savings plans to encourage future savings for education costs. Under these plans, individuals can prepay or contribute to an account for a designated beneficiary's qualified higher education expenses (QHEE) at an eligible educational institution. Section 529 plans provide three major tax benefits.

1. Earnings accumulate tax free while in the plan account.¹⁵²
2. The beneficiary generally does not have to include the earnings from a QTP as income.¹⁵³
3. Distributions are not taxable when used to pay for QHEE or up to \$10,000 for tuition at an elementary or secondary public, private, or religious school.¹⁵⁴

Note. If the amount of a distribution exceeds the beneficiary's education expenses, a portion of the earnings is taxable. Generally, a 10% additional tax also applies under this rule. For more information, see IRS Pub. 970, *Tax Benefits for Education*.

QTPs are established and maintained by a state, its agent, or an eligible educational institution. Under these plans, a person may purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to the waiver or payment of the beneficiary's QHEE. In the case of a program established and maintained by a state (or a state agency or instrumentality), a person may make contributions to an account that is established for the purpose of meeting the QHEE of the designated beneficiary of the account and which meets the other requirements of §529.¹⁵⁵

QTPs are subject to the following requirements.

- All purchases or contributions may only be made in cash.¹⁵⁶
- The QTP must provide separate accounting for each designated beneficiary.¹⁵⁷
- No interest in the program or any portion thereof may be used as security for a loan.¹⁵⁸
- The QTP must provide adequate safeguards to prevent contributions on behalf of a designated beneficiary in excess of those necessary to provide for the QHEE of the beneficiary.¹⁵⁹

¹⁵². IRC §529(c).

¹⁵³. IRC §529(c)(1)(B).

¹⁵⁴. IRC §§529(c)(3)(B), (c)(7), and (e)(3).

¹⁵⁵. IRC §529(b).

¹⁵⁶. IRC §529(b)(2).

¹⁵⁷. IRC §529(b)(3).

¹⁵⁸. IRC §529(b)(5).

¹⁵⁹. IRC §529(b)(6).

ELIGIBLE EDUCATIONAL INSTITUTIONS

Eligible educational institutions for purposes of §529 plans include most accredited public, nonprofit, and privately owned for-profit postsecondary institution or an eligible elementary or secondary school. Specifically, to qualify, an institution must have the following characteristics.¹⁶⁰

- Accredited by the appropriate agencies
- Offers post-secondary credit courses for associate degrees, bachelor's degrees, graduate degrees, professional degrees, or another recognized post-secondary credential
- Is eligible to participate in a program under title IV of the Higher Education Act of 1965¹⁶¹

Note. In §529(e)(5), the term “eligible educational institution” only includes postsecondary schools (described in section 481 of the Higher Education Act of 1965 and eligible to participate in a program under title IV of this act). However, one of the changes enacted by the TCJA allows distributions from QTPs to be used to pay up to \$10,000 of expenses for tuition in connection with elementary or secondary public, private, or religious schools.¹⁶²

QUALIFIED HIGHER EDUCATION EXPENSES

QHEE include expenses related to enrollment or attendance at an eligible postsecondary school. QHEE under §529 include the following.¹⁶³

1. Tuition, fees, books, supplies, and equipment are QHEE if they are required for the enrollment or attendance of a designated beneficiary at an eligible educational institution. In addition, as mentioned earlier, “qualified higher education expenses” include up to \$10,000 for tuition in connection with enrollment or attendance at an elementary or secondary public, private, or religious school.¹⁶⁴
2. Expenses for special-needs services in the case of a special-needs beneficiary are QHEE if they are incurred in connection with such enrollment or attendance.¹⁶⁵
3. Expenses for the purchase of computers or peripheral equipment, Internet access, and related services are QHEE if such equipment, software, or services are to be used primarily by the beneficiary during any of the years the beneficiary is enrolled at an eligible educational institution.¹⁶⁶
4. Expenses for room and board must be incurred by students who are enrolled at least half-time.¹⁶⁷ The expense for room and board qualifies only to the extent that it is not more than the **greater** of the following two amounts.¹⁶⁸
 - a. The allowance for room and board, as determined by the school, that was included in the cost of attendance (for federal financial aid purposes) for a particular academic period and living arrangement of the student
 - b. The actual amount charged if the student is residing in housing owned or operated by the school

¹⁶⁰ IRS Pub. 970, *Tax Benefits for Education*. To determine if a school is an eligible educational institution, the Dept. of Education maintains the “U.S. Federal Student Aid Code List,” available at ifap.ed.gov/ifap/fedSchoolCodeList.jsp.

¹⁶¹ IRC §529(e)(5).

¹⁶² IRC §529(c)(7).

¹⁶³ IRS Pub. 970, *Tax Benefits for Education*.

¹⁶⁴ IRC §529(c)(7).

¹⁶⁵ IRC §529(e)(3)(A)(ii).

¹⁶⁶ IRC §529(e)(3)(A)(iii).

¹⁶⁷ IRC §529(e)(3)(B)(i).

¹⁶⁸ IRC §529(e)(3)(B)(ii).

ROLLOVER TO A NEW §529 PLAN

Distributions from a §529 plan can be rolled over tax-free to another §529 plan. Several conditions must be met for the rollover to be tax-free. It must be made within 60 days of the distribution, and the new §529 plan must be for the benefit of the same designated beneficiary or another designated beneficiary within the same family.¹⁶⁹

Note. IRS Notice 2001-81 requires that the distributing §529 plan provide a breakdown of the earnings portion of the rollover amount to the recipient §529 plan. Until the recipient §529 plan receives documentation showing the earnings portion, the entire rollover amount is treated as earnings.¹⁷⁰

CONTRIBUTION AMOUNTS

Contributions to a §529 plan on behalf of any beneficiary cannot be more than the amount necessary to provide for the qualified education expenses of the beneficiary.¹⁷¹ Because contributions to these plans are considered a completed gift that is not a future interest,¹⁷² contributors can gift \$15,000 per year in 2019,¹⁷³ per beneficiary, with no gift tax consequences. Gifts in excess of the annual gift exclusion amount generally count against the lifetime estate and gift tax exemption and must be reported on Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return*. For decedents dying in 2019, the lifetime estate and gift tax exclusion is \$11.4 million.¹⁷⁴

Five-Year Election

Contributors can elect to prorate their contribution over five years so they do not exceed the annual gift tax exclusion. Therefore, in 2019, individuals may contribute up to \$75,000 (\$15,000 × 5 years) to a §529 plan with no gift tax consequences. In order to make this election, a Form 709 must be filed for each of the five years.¹⁷⁵

TCJA CHANGES

The TCJA¹⁷⁶ made several significant changes to §529 plans.

1. Expanded the definition of QHEE to include tuition for the designated beneficiary's enrollment or attendance at an **elementary or secondary public, private, or religious school**¹⁷⁷
2. Amended §529(e)(3)(A) to limit the total amount of these **elementary or secondary public, private, or religious school** tuition distributions for each designated beneficiary to **\$10,000** per year from all §529 plans of the designated beneficiary (Both amendments apply to distributions made after December 31, 2017.)

Caution. Approximately 10 states, including Illinois, do not allow tax-free §529 plan distributions for K-12 tuition.¹⁷⁸

¹⁶⁹ IRC §§529(c)(3)(C)(i)(I) and 529(c)(3)(C)(i)(II).

¹⁷⁰ IRS Notice 2001-81, 2001-52 IRB 617.

¹⁷¹ IRS Pub. 970, *Tax Benefits for Education*.

¹⁷² IRC §529(c)(2)(A)(i).

¹⁷³ IRC §2503(b); Rev. Proc. 2018-57, 2018-49 IRB 827.

¹⁷⁴ Rev. Proc. 2018-57, 2018-49 IRB 827.

¹⁷⁵ IRC §529(c)(2)(B); Instructions for Form 709.

¹⁷⁶ PL 115-97.

¹⁷⁷ IRC §529(c)(7). The IRS intends to issue regulations defining the term “elementary or secondary” to mean kindergarten through grade 12 as determined under state law, consistent with the Coverdell ESA accounts.

¹⁷⁸ *Most States Allow Tax-Free 529 Withdrawals for K-12 Tuition*. Dec. 20, 2018. CCHTaxGroup. [news.cchgroup.com/2018/12/20/state-allow-529-plan-withdrawal-k-12-tuition/news/tax-headlines] Accessed on Aug. 12, 2019.

3. Added §529(c)(3)(C)(i)(III), which provides that a distribution from a §529 plan made after December 22, 2017, and before January 1, 2026, is not subject to income tax if, within 60 days of the distribution, it is transferred to an Achieving a Better Life Experience (ABLE) account of the designated beneficiary or a member of the family of the designated beneficiary

Note. An ABLE account is a tax-advantaged savings account for individuals with disabilities and their families. Similar to a §529 plan, the ABLE account is established and maintained by a state or its agency. A qualified ABLE account is exempt from taxation.¹⁷⁹ Distributions from a qualified ABLE program that do not exceed the qualified disability expenses of the designated beneficiary are not included in gross income.¹⁸⁰

The amount of any rollover to an ABLE account is limited to the amount that, when added to all other contributions made to the ABLE account for the tax year, does not exceed the contribution limit for the ABLE account, which is the annual gift tax exclusion amount under IRC §2503(b) (\$15,000 in 2019).¹⁸¹

U.S. SAVINGS BONDS USED FOR EDUCATIONAL EXPENSES

Investors who purchase U.S. savings bonds typically choose to defer the reporting of interest until they redeem the bonds. Alternatively, taxpayers can elect to include the annual increase in the redemption value in gross income.¹⁸² Taxpayers must use the same method for all series EE and series I bonds that they own.

Note. A change from reporting interest at redemption to annual reporting does not require permission from the IRS. However, permission is required when changing from annual interest reporting to reporting at redemption or maturity.¹⁸³

Taxpayers may be able to exclude the interest from qualified U.S. savings bonds from their income if they meet the following conditions.¹⁸⁴

- They pay QHEE for themselves, their spouse, or a dependent.
- Their 2019 MAGI does not exceed \$96,100 (\$151,600 for MFJ taxpayers).¹⁸⁵
- Their filing status is not MFS.

QUALIFIED U.S. SAVINGS BONDS

Qualified U.S. savings bonds include series EE bonds issued after 1989 and series I bonds.¹⁸⁶ The bonds must have been issued to an individual who has reached age 24 before the bond issue date.¹⁸⁷

¹⁷⁹. IRC §§529A(a) and (b).

¹⁸⁰. IRC §529A(c)(1)(B)(i).

¹⁸¹. IRC §§529(c)(3)(C)(i) and 529A(b)(2)(B)(i).

¹⁸². IRC §454(a).

¹⁸³. IRS Pub. 550, *Investment Income and Expenses*.

¹⁸⁴. IRS Pub. 970, *Tax Benefits for Education*.

¹⁸⁵. Rev. Proc. 2018-57, 2018-49 IRB 827.

¹⁸⁶. Series I bonds were first offered in 1998. These bonds are indexed for inflation and issued at face value with a maturity period of 30 years. IRC §135(c)(1)(A).

¹⁸⁷. IRC §135(c)(1)(B).

When using bonds for a child's education, the bonds must be registered in the parents' names. The child can be listed as a beneficiary but not as a co-owner.¹⁸⁸

QUALIFIED HIGHER EDUCATION EXPENSES

QHEE, for this purpose, includes items paid for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer at an eligible educational institution.¹⁸⁹ To qualify for the gross income exclusion, the savings bonds must be redeemed in the same year that the QHEE are incurred.¹⁹⁰

QHEE include the following.¹⁹¹

- Tuition and fees required for the enrollment or attendance at an eligible educational institution (The cost of books and room and board are not qualified expenses.)
- Contributions to a qualified §529 tuition program¹⁹²
- Contributions to a Coverdell ESA

QHEE must be reduced by all of the following tax-free benefits to determine **adjusted qualified education expenses (AQEE)**.¹⁹³

- Tax-free part of scholarships and fellowship grants
- Expenses used to calculate the tax-free portion of distributions from a Coverdell ESA
- Expenses used to calculate the tax-free portion of distributions from a QTP
- Any tax-free payments (other than gifts or inheritances) received as educational assistance, such as:
 - ♦ Veterans' educational assistance benefits
 - ♦ Qualified tuition reductions
 - ♦ Employer-provided educational assistance
- Any expenses used in calculating the AOC and lifetime learning credit

There is no penalty for rolling over series EE bonds to a Coverdell or §529 plan.

Note. Savings bond interest is not included in the taxpayer's basis in a §529 plan or Coverdell ESA.¹⁹⁴

QHEE do not include expenses with respect to any course or other education involving sports, games, or hobbies other than as part of a degree program.¹⁹⁵

^{188.} *Registering an EE Bond or I Bond.* TreasuryDirect. [www.treasurydirect.gov/indiv/research/indepth/ebonds/res_e_bonds_eebuy_register.htm] Accessed on Jul. 2, 2019.

^{189.} IRC §135(c)(2)(A).

^{190.} IRC §135(b)(1).

^{191.} IRS Pub. 970, *Tax Benefits for Education*.

^{192.} IRC §135(c)(2)(C).

^{193.} IRS Pub.970, *Tax Benefits for Education*.

^{194.} Ibid.

^{195.} IRC §135(c)(2)(B).

Eligible Educational Institutions

An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the U.S. Department of Education.¹⁹⁶

INCOME LIMITS

The interest exclusion is phased out for taxpayers with MAGI that exceeds the limit. The following are the MAGI phase-out limits for 2018 and 2019.

Filing Status	2018 ¹⁹⁷	2019 ¹⁹⁸
MFJ	\$119,300–\$149,300	\$121,600–\$151,600
Single, head of household, qualifying widow(er)	\$79,550–\$94,550	\$81,100–\$96,100
MFS		Not eligible for exclusion

The phase-out is calculated by multiplying the otherwise excludable interest by a fraction. The numerator of the fraction is the amount that the taxpayer's MAGI exceeds the lower limit of the phase-out threshold, and the denominator is \$15,000 (\$30,000 for MFJ taxpayers). The resulting amount is subtracted from the taxpayer's total savings bond interest.

CLAIMING THE INTEREST EXCLUSION

Form 8815, *Exclusion of Interest From Series EE and I U.S. Savings Bonds Issued After 1989*, is used to compute the education savings bond interest exclusion and report the savings bond redemption. The taxpayer's exclusion amount is entered on line 3 of Schedule B, *Interest and Ordinary Dividends*.

Example 29. Henry and Karen Smith, a married couple filing jointly, have a son, Carl. On Carl's first birthday, Henry and Karen purchased series EE savings bonds to save for his education. In 2018, Henry and Karen's MAGI is \$130,300 for the year. To pay for Carl's \$82,000 of QHEE at UCLA, Henry and Karen cash in their series EE bonds held by Third Street Bank. The \$82,000 proceeds include \$70,000 of principal and \$12,000 of interest. They did not make an election to report the savings bond interest annually.

Henry and Karen's MAGI of \$130,300 exceeds the lower amount of the phase-out range (\$119,300) for joint filers in 2018. Therefore, some of the interest from the redemption of the series EE bonds must be included in their 2018 income. The reduction of excluded interest income is calculated as follows.

$$\begin{aligned}
 \text{Reduction of interest exclusion} &= \frac{\$130,300 \text{ MAGI} - \$119,300 \text{ threshold}}{\$30,000} \times \$12,000 \text{ interest} \\
 &= \frac{\$11,000}{\$30,000} \times \$12,000 \\
 &= 0.36667 \times \$12,000 \\
 &= \$4,400
 \end{aligned}$$

Henry and Karen's interest exclusion is reduced by \$4,400. Therefore, they may exclude \$7,600 of the interest from their gross income (\$12,000 – \$4,400). Their Form 8815 and Schedule B follow.

¹⁹⁶. IRC §§135(c)(3) and 529(e)(5).

¹⁹⁷. IRS Pub. 970, *Tax Benefits for Education*.

¹⁹⁸. Rev. Proc. 2018-57, 2018-49 IRB 827.

2019 Workbook

For Example 29

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) ► Go to www.irs.gov/Form8815 for the latest information. ► Attach to Form 1040.	OMB No. 1545-0074 <div style="font-size: 2em; font-weight: bold; text-align: center;">2018</div> Attachment Sequence No. 167															
Name(s) shown on return Henry and Karen Smith		Your social security number 555-00-5555															
<table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="width: 5%;"></th> <th style="width: 45%; text-align: center;">(a) Name of person (you, your spouse, or your dependent) who was enrolled at or attended an eligible educational institution</th> <th style="width: 50%; text-align: center;">(b) Name and address of eligible educational institution</th> </tr> </thead> <tbody> <tr> <td style="text-align: center;">1</td> <td>Carl Smith</td> <td>University of California Los Angeles Charles E Young Dr E, Los Angeles, CA 90024</td> </tr> <tr><td> </td><td> </td><td> </td></tr> <tr><td> </td><td> </td><td> </td></tr> <tr><td> </td><td> </td><td> </td></tr> </tbody> </table>				(a) Name of person (you, your spouse, or your dependent) who was enrolled at or attended an eligible educational institution	(b) Name and address of eligible educational institution	1	Carl Smith	University of California Los Angeles Charles E Young Dr E, Los Angeles, CA 90024									
	(a) Name of person (you, your spouse, or your dependent) who was enrolled at or attended an eligible educational institution	(b) Name and address of eligible educational institution															
1	Carl Smith	University of California Los Angeles Charles E Young Dr E, Los Angeles, CA 90024															
If you need more space, attach a statement.																	
2 Enter the total qualified higher education expenses you paid in 2018 for the person(s) listed in column (a) of line 1. See the instructions to find out which expenses qualify		<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 5%; text-align: center;">2</td> <td style="width: 45%; text-align: center;">82,000</td> <td style="width: 50%;"></td> </tr> </table>	2	82,000													
2	82,000																
3 Enter the total of any nontaxable educational benefits (such as nontaxable scholarship or fellowship grants) received for 2018 for the person(s) listed in column (a) of line 1. See instructions		<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 5%; text-align: center;">3</td> <td style="width: 45%;"></td> <td style="width: 50%;"></td> </tr> </table>	3														
3																	
4 Subtract line 3 from line 2. If zero or less, stop . You cannot take the exclusion		<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 5%; text-align: center;">4</td> <td style="width: 45%; text-align: center;">82,000</td> <td style="width: 50%;"></td> </tr> </table>	4	82,000													
4	82,000																
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 2018		<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 5%; text-align: center;">5</td> <td style="width: 45%; text-align: center;">82,000</td> <td style="width: 50%;"></td> </tr> </table>	5	82,000													
5	82,000																
6 Enter the interest included on line 5. See instructions		<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 5%; text-align: center;">6</td> <td style="width: 45%; text-align: center;">12,000</td> <td style="width: 50%;"></td> </tr> </table>	6	12,000													
6	12,000																
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)		<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 5%; text-align: center;">7</td> <td style="width: 45%; text-align: center;">× 1.000</td> <td style="width: 50%;"></td> </tr> </table>	7	× 1.000													
7	× 1.000																
8 Multiply line 6 by line 7		<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 5%; text-align: center;">8</td> <td style="width: 45%; text-align: center;">12,000</td> <td style="width: 50%;"></td> </tr> </table>	8	12,000													
8	12,000																
9 Enter your modified adjusted gross income. See instructions Note: If line 9 is \$94,550 or more if single, head of household, or qualifying widow(er); or \$149,300 or more if married filing jointly, stop . You cannot take the exclusion.		<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 5%; text-align: center;">9</td> <td style="width: 45%; text-align: center;">130,300</td> <td style="width: 50%;"></td> </tr> </table>	9	130,300													
9	130,300																
10 Enter: \$79,550 if single, head of household, or qualifying widow(er); \$119,300 if married filing jointly		<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 5%; text-align: center;">10</td> <td style="width: 45%; text-align: center;">119,300</td> <td style="width: 50%;"></td> </tr> </table>	10	119,300													
10	119,300																
11 Subtract line 10 from line 9. If zero or less, skip line 12, enter -0- on line 13, and go to line 14		<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 5%; text-align: center;">11</td> <td style="width: 45%; text-align: center;">11,000</td> <td style="width: 50%;"></td> </tr> </table>	11	11,000													
11	11,000																
12 Divide line 11 by: \$15,000 if single, head of household, or qualifying widow(er); \$30,000 if married filing jointly. Enter the result as a decimal (rounded to at least three places)		<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 5%; text-align: center;">12</td> <td style="width: 45%; text-align: center;">× 0.36667</td> <td style="width: 50%;"></td> </tr> </table>	12	× 0.36667													
12	× 0.36667																
13 Multiply line 8 by line 12		<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 5%; text-align: center;">13</td> <td style="width: 45%; text-align: center;">4,400</td> <td style="width: 50%;"></td> </tr> </table>	13	4,400													
13	4,400																
14 Excludable savings bond interest. Subtract line 13 from line 8. Enter the result here and on Schedule B (Form 1040), line 3 ►		<table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 5%; text-align: center;">14</td> <td style="width: 45%; text-align: center;">7,600</td> <td style="width: 50%;"></td> </tr> </table>	14	7,600													
14	7,600																

For Paperwork Reduction Act Notice, see your tax return instructions.

Cat. No. 10822S

Form **8815** (2018)

TAX-FREE INTEREST CALCULATION WHEN PROCEEDS EXCEED EXPENSE²⁰¹

If the total proceeds from redeeming eligible U.S. savings bonds is less than or equal to the AQEE, the savings bond interest may be tax-free (subject to MAGI limits, as discussed earlier). If the amount the taxpayer receives when they cash in the bonds is more than their AQEE, the tax-free interest is calculated by multiplying the total interest proceeds by a fraction. The numerator of the fraction is the AQEE and the denominator is the total proceeds the taxpayer received during the year.

Note. Taxpayers must use **both** the principal and interest from the bonds to pay qualified expenses to exclude the interest from gross income.

Example 30. Mary redeemed a series EE bond to pay her QHEE. The bond proceeds were \$10,000, including \$8,000 principal and \$2,000 interest. She had not made an election to report the interest earned annually. Her AQEE were \$7,000. Mary can exclude \$1,400 of interest, which is calculated as follows.

$$\begin{aligned}\text{Excluded interest income} &= \frac{\$7,000 \text{ AQEE}}{\$10,000 \text{ total proceeds}} \times \$2,000 \text{ interest} \\ &= .70 \times \$2,000 \\ &= \$1,400\end{aligned}$$

COVERDELL EDUCATION SAVINGS ACCOUNT

A Coverdell ESA is a trust or custodial account created to pay the qualified education expenses of an individual who is the designated beneficiary of the trust or custodial account.²⁰²

A Coverdell ESA can be established with any bank or other approved nonbank trustee or custodian of an individual retirement account, or other entity offering Coverdell ESAs.²⁰³ The account must be designated as a Coverdell ESA at the time it is created or organized in order to be treated as a Coverdell ESA for federal tax purposes. The trustee or custodian must be a bank or an entity approved by the IRS.²⁰⁴

Note. The Coverdell ESA must have a written governing instrument that complies with specific statutory requirements.²⁰⁵ Form 5305-EA, *Coverdell Education Savings Custodial Account*, is a model custodial account that meets the §530(b)(1) requirements. This form is not filed with the IRS. Instead, it is retained by the grantor or depositor.

The designated beneficiary of a Coverdell ESA must be an individual.²⁰⁶ The beneficiary can be changed, and this change is not treated as a distribution for tax purposes if the new beneficiary is a member of the family of the previous beneficiary who has not reached **age 30** as of the date of change.²⁰⁷

²⁰¹. IRS Pub. 970, *Tax Benefits for Education*.

²⁰². IRC §530(b)(1).

²⁰³. IRC §530(b)(1)(B).

²⁰⁴. IRC §530(g).

²⁰⁵. IRC §530(b)(1).

²⁰⁶. *Ibid.*

²⁰⁷. IRC §530(d)(6). The age requirement does not apply to any designated beneficiary with special needs. IRC §530(b)(1).

There is no limit on the number of Coverdell ESAs that can be established for a particular beneficiary. However, in any tax year, the total aggregate contributions to **all** the accounts designating a particular beneficiary cannot exceed \$2,000.²⁰⁸

QUALIFIED EDUCATION EXPENSES

Qualified education expenses for a Coverdell ESA include qualified higher education expenses (as defined in IRC §529(e)(3))²⁰⁹ and qualified elementary and secondary education expenses.²¹⁰

Qualified Higher Education Expenses²¹¹

QHEE are costs related to enrollment or attendance at an eligible postsecondary school. As shown in the following list, to be qualified, some of the expenses must be required by the school and some must be incurred by students who are enrolled at least half-time.

1. The following expenses must be required for enrollment or attendance of a designated beneficiary at an eligible postsecondary school.
 - a. Tuition and fees
 - b. Books, supplies, and equipment
2. Expenses for special-needs services used by a special-needs beneficiary must be incurred in connection with enrollment or attendance at an eligible postsecondary school.
3. Expenses for room and board must be incurred by students who are enrolled at least half-time. The expense for room and board qualifies only to the extent that it is not more than the greater of the following two amounts.
 - a. The allowance for room and board, as determined by the school, that was included in the cost of attendance (for federal financial aid purposes) for a particular academic period and living arrangement of the student
 - b. The actual amount charged if the student is residing in housing owned or operated by the school
4. The purchase of computer or peripheral equipment, computer software, or Internet access and related services qualifies if it is to be used primarily by the beneficiary during any of the years the beneficiary is enrolled at an eligible postsecondary school. (This does not include expenses for computer software for sports, games, or hobbies unless the software is predominantly educational in nature.)

²⁰⁸. IRC §530(b)(1)(A)(iii); IRS Notice 97-60, 1997-2 CB 310.

²⁰⁹. IRC §530(b)(2)(A)(i); IRS Pub. 970, *Tax Benefits for Education*.

²¹⁰. IRC §530(b)(2)(A)(ii); IRS Pub. 970, *Tax Benefits for Education*.

²¹¹. IRC §529(e)(3).

Qualified Elementary and Secondary Education Expenses²¹²

Qualified elementary and secondary education expenses are expenses related to enrollment or attendance at an eligible elementary or secondary school. As shown in the following list, some of the expenses must be required or provided by the school. There are special rules for computer-related expenses.

1. The following expenses must be incurred by a designated beneficiary in connection with enrollment or attendance at an eligible elementary or secondary school.
 - a. Tuition and fees
 - b. Books, supplies, and equipment
 - c. Academic tutoring
 - d. Special-needs services for special-needs beneficiary
2. The following expenses must be required or provided by an eligible elementary or secondary school in connection with attendance or enrollment at the school.
 - a. Room and board
 - b. Uniforms
 - c. Transportation
 - d. Supplementary items and services (including extended day programs)
3. The purchase of computer technology or equipment, computer software, fiber optic cables related to computer use, or Internet access and related services is a qualified elementary and secondary education expense if it is to be used by the beneficiary and the beneficiary's family during any of the years the beneficiary is in elementary or secondary school. (This does not include expenses for computer software designed for sports, games, or hobbies unless the software is predominantly educational in nature.)²¹³

ELIGIBLE EDUCATIONAL INSTITUTIONS

An eligible educational institution can be either an eligible postsecondary school or an eligible elementary or secondary school.²¹⁴

An eligible postsecondary school is generally any accredited public, nonprofit, or proprietary (privately owned profit-making) college, university, vocational school, or other postsecondary educational institution. In addition, the institution must be eligible to participate in a student aid program administered by the U.S. Department of Education.²¹⁵ Virtually all accredited postsecondary institutions meet this definition. An eligible educational institution also includes certain educational institutions located outside the United States that are eligible to participate in a student aid program administered by the U.S. Department of Education.

An eligible elementary or secondary school is any public, private, or religious school that provides elementary or secondary education (kindergarten through grade 12), as determined under state law.²¹⁶

²¹² IRC §530(b)(3); IRS Pub. 970, *Tax Benefits for Education*.

²¹³ IRC §530(b)(3)(A)(iii).

²¹⁴ IRS Pub. 970, *Tax Benefits for Education*.

²¹⁵ *Ibid.*

²¹⁶ *Ibid.*

CONTRIBUTIONS TO A COVERDELL ESA

Contributions to Coverdell ESAs can be made by any individual, including the designated beneficiary, subject to phase-out limits based on the individual's MAGI (discussed later). In addition, organizations such as corporations and trusts can contribute to Coverdell ESAs, with no income limitations. Contributions are not tax deductible. Contributions must meet the following requirements.²¹⁷

- Contributions must be in cash.²¹⁸
- Contributions cannot be made after the beneficiary reaches age 18, unless the beneficiary has special needs.²¹⁹
- Contributions must be made by the due date of the contributor's tax return (not including extensions). Any contributions made to a Coverdell ESA for the preceding tax year are treated as made on the last day of the preceding tax year.²²⁰
- Contributions can be made to both a Coverdell ESA and a §529 plan in the same year for the same designated beneficiary.
- There is a 6% excise tax on excess contributions to a Coverdell ESA (described later).
- An individual can create a Coverdell ESA for multiple beneficiaries (such as children and grandchildren).
- The total aggregate contributions to all the accounts designating a particular child as beneficiary cannot exceed \$2,000 per year.²²¹

Example 31. Ron Carter is age one. Four separate Coverdell ESAs are set up for Ron by his parents, aunt, uncle, and grandparents. This is permitted because there is no limit on the number of Coverdell ESAs that can be established for a particular child as beneficiary. However, there is a \$2,000 limit on the total contributions to Ron's Coverdell ESAs each year. If Ron's parents contribute \$1,000 to one of Ron's Coverdell ESAs, his aunt, uncle, and grandparents can contribute \$1,000 in total to his other Coverdell ESAs.

Example 32. Molly has a grandson who is age two and a granddaughter who is age three. Molly can contribute up to \$2,000 to a Coverdell ESA for her grandson, and she can also contribute up to \$2,000 to a Coverdell ESA for her granddaughter for the same year.

Income Limits²²²

The maximum Coverdell ESA **contribution** is phased out at higher income levels, as shown in the following table. These amounts are not subject to annual inflation adjustments.

Filing Status	Phase-out Range
MFJ	\$190,000–\$220,000
Single, head of household, qualifying widow(er)	\$95,000–\$110,000
MFS	Not eligible for contribution

²¹⁷. Ibid.

²¹⁸. IRC §530(b)(1)(A)(i).

²¹⁹. IRC §530(b)(1)(A)(ii).

²²⁰. IRC §530(b)(4).

²²¹. IRC §530(b)(1)(A)(iii); IRS Notice 97-60, 1997-2 CB 310.

²²². IRS Pub. 970, *Tax Benefits for Education*.

The phase-out of the contribution is determined by applying a fraction to the maximum contribution of \$2,000. The numerator of the fraction is the amount that the taxpayer's MAGI exceeds the lower limit of the phase-out threshold, and the denominator is \$15,000 (\$30,000 for MFJ taxpayers). The result is subtracted from \$2,000 (the maximum Coverdell ESA contribution). Taxpayers with income above the upper limit of the phase-out range cannot make contributions to an ESA.

Example 33. Kyle, a single taxpayer, has MAGI of \$99,500. This amount is \$4,500 over the lower MAGI limit, so Kyle's maximum Coverdell ESA contribution will be less than the statutory maximum of \$2,000. His disallowed contribution is calculated using the following formula.

$$\begin{aligned}\text{Disallowed ESA contribution} &= \frac{\$99,500 \text{ MAGI} - \$95,000 \text{ threshold}}{\$15,000} \times \$2,000 \text{ maximum contribution} \\ &= \frac{\$4,500}{\$15,000} \times \$2,000 \\ &= 0.3 \times \$2,000 \\ &= \$600\end{aligned}$$

Therefore, Kyle's allowable Coverdell ESA contribution is \$2,000 – \$600 = \$1,400.

MAGI is calculated as AGI plus the following items.

- Foreign earned income exclusion
- Foreign housing exclusion and foreign housing deduction
- Exclusion of income by bona fide residents of American Samoa and Puerto Rico

Observation. The income limitation is not an issue as to whether or not the taxpayer can deduct a contribution to a Coverdell ESA because no such deduction exists. Instead, taxpayers with MAGI over \$110,000 (or \$220,000 for MFJ taxpayers) cannot make **any** contributions to a Coverdell ESA.

Additional Tax on Excess Contributions²²³

The beneficiary may owe a 6% excise tax each year on excess contributions that are in a Coverdell ESA at the end of the year.²²⁴ Excess contributions are the total of the following two amounts.

- Contributions to any designated beneficiary's Coverdell ESA for the year that are more than \$2,000 (or, if less, the total of each contributor's limit for the year, as discussed earlier)
- Excess contributions for the preceding year, reduced by the total of the following two amounts
 - ♦ Distributions (other than those rolled over, as discussed later) during the year
 - ♦ The contribution limit for the current year minus the amount contributed for the current year

Exceptions. The 6% excise tax does not apply in the following situations.

1. Excess contributions made during the year (and any earnings on them) are distributed before the first day of the sixth month of the following tax year.
2. The contributions were from a rollover.

²²³. IRS Pub. 970, *Tax Benefits for Education*.

²²⁴. IRC §4973(a)(4).

The taxpayer must include the distributed earnings in gross income for the year in which the excess contribution was made. Each institution from which excess contributions were distributed should send Form 1099-Q, *Payments From Qualified Education Programs*. Box 2 of that form shows the amount of earnings on the excess contributions. The taxpayer enters the earnings amount on Schedule 1, *Additional Income and Adjustments to Income*, or line 21 of Form 1040NR, for the applicable tax year.

Example 34. In 2017, Kristen's parents and grandparents contributed a total of \$2,300 to Kristen's Coverdell ESA, which is an excess contribution of \$300. Because Kristen did not withdraw the excess before June 1, 2018, she had to pay an additional tax of \$18 (6% excise tax rate \times \$300 excess contribution) when she filed her 2017 tax return.

In 2018, excess contributions of \$500 were made to Kristen's account. However, she withdrew \$250 from that account to use for qualified education expenses. Kristen calculates the excess contribution and excise tax due at the end of 2018 as follows.

Excess contributions made in 2018	\$500
Excess contributions in ESA at end of 2017	300
Less: distribution during 2018	(250)
Excess at end of 2018	<u>\$550</u>
Excise tax rate	\times 6%
Excise tax due at the end of 2018	<u>\$ 33</u>

If Kristen limits 2019 contributions to \$1,450 (\$2,000 maximum allowed – \$550 excess contributions from 2018), she will not owe any additional tax in 2019 for excess contributions.²²⁵

The excise tax is calculated on part V of Form 5329, *Additional Taxes on Qualified Plans (Including IRAs) and Other Tax-Favored Accounts*. The excise tax is reported on line 59 of Schedule 4, *Other Taxes*.

ROLLOVERS²²⁶

Any amount distributed from a Coverdell ESA is not taxable if it is rolled over to another Coverdell ESA for the benefit of the same beneficiary or a member of the beneficiary's family (including the beneficiary's spouse) who is under age 30. This age limitation does not apply if the new beneficiary is a special-needs beneficiary.

An amount is rolled over if it is paid to another Coverdell ESA within 60 days after the date of the distribution. Qualifying rollovers are **not** reported on Form 1040 because they are not taxable distributions.

The beneficiary's family includes the beneficiary's spouse and the following relatives of the beneficiary.

- Spouse
- Son, daughter, stepchild, foster child, adopted child, or a descendant of any of them
- Brother, sister, stepbrother, or stepsister
- Father or mother or ancestor of either
- Stepfather or stepmother
- Niece or nephew
- Aunt or uncle
- Son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law
- The spouse of any individual listed above
- First cousin

²²⁵. IRS Pub. 970, *Tax Benefits for Education*.

²²⁶. *Ibid.*

Example 35. Karen graduated from college in 2018 and had \$5,000 left in her Coverdell ESA. She wanted to give this money to her younger brother Mike, who was still in high school. In order to avoid paying tax on the distribution of the amount remaining in her account, Karen contributed the same amount to her brother's Coverdell ESA within 60 days of the distribution.

Individuals can make only one rollover from a Coverdell ESA to another Coverdell ESA in any 12-month period regardless of the number of Coverdell ESAs owned. However, unlimited transfers are allowed from one Coverdell ESA trustee directly to another Coverdell ESA trustee because such transfers are not considered to be distributions or rollovers. The limit of one rollover during any 12-month period does not apply to the rollover of a military death gratuity or service members' group life insurance payment.

Note. There are no tax consequences to changing the designated beneficiary if, at the time of the change, the new beneficiary is under age 30 or is a special-needs beneficiary. Therefore, instead of closing her Coverdell ESA and paying the distribution into her brother's Coverdell ESA, Karen could have instructed the trustee of her account to simply change the name of the beneficiary on her account to that of her brother.

DISTRIBUTIONS²²⁷

Distributions to designated beneficiaries can be made at any time. The tax treatment of distributions depends, in part, on whether the distributions are less than or equal to the amount of the beneficiary's AQEE in the same tax year. Generally, distributions are tax-free if they are not more than the beneficiary's AQEE. Tax-free distributions (including rollovers) are not reported on the tax return.

Adjusted Qualified Education Expenses

To calculate AQEE, total qualified education expenses (described earlier) are reduced by any tax-free educational assistance. Tax-free educational assistance includes the following amounts.²²⁸

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

Taxable Distributions

A portion of the distributions is generally taxable to the beneficiary if the total distributions are more than the beneficiary's AQEE for the year.

Excess Distribution. An excess distribution is the part of the total distribution that is more than the beneficiary's AQEE for the year.

^{227.} Ibid.

^{228.} Ibid.

Earnings and Basis. The beneficiary should receive a Form 1099-Q for each of the Coverdell ESAs from which money was distributed. The amount of the gross distribution is shown in box 1.

Note. Starting in 2018, instead of dividing up the gross distribution between earnings (box 2) and basis (after-tax contributions, which are shown in box 3), the payer or trustee may report the fair market value (account balance) of the Coverdell ESA as of the end of the year. This is shown in the blank box below boxes 5 and 6.

Example 36. In 2019, Ron C. Davis received a \$19,000 distribution from his Coverdell ESA. The plan's fair market value at December 31, 2019, was \$20,000. Ron's Form 1099-Q is shown next.

<input type="checkbox"/> CORRECTED (if checked)		OMB No. 1545-1760		Payments From Qualified Education Programs (Under Sections 529 and 530)	
PAYER'S/TRUSTEE'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no. State Bank 1244 Third Street Houston, TX 77007		1 Gross distribution \$ 19,000	<div style="font-size: 2em; font-weight: bold;">2019</div> Form 1099-Q		
PAYER'S/TRUSTEE'S TIN 99-5555555	RECIPIENT'S TIN 999-55-0000	2 Earnings \$	3 Basis \$	4 Trustee-to-trustee transfer <input type="checkbox"/>	Copy B For Recipient This is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
RECIPIENT'S name Ron C. Davis Street address (including apt. no.) 1245 Montrose Rd., Apt. H-336 City or town, state or province, country, and ZIP or foreign postal code Houston, TX 77006		5 Distribution is from: • Qualified tuition program— Private <input type="checkbox"/> or State <input type="checkbox"/> • Coverdell ESA <input checked="" type="checkbox"/>		6 If this box is checked, the recipient is not the designated beneficiary <input type="checkbox"/>	
Account number (see instructions) C4349009		If the fair market value (FMV) is shown below, see Pub. 970 , Tax Benefits for Education, for how to figure earnings. <div style="text-align: right; font-weight: bold;">20,000</div>			

Form **1099-Q** (keep for your records) www.irs.gov/Form1099Q Department of the Treasury - Internal Revenue Service

Calculating the Taxable Portion of a Distribution. The taxable portion of a distribution is the amount of the excess distribution (distributions in excess of AQEE) that represents earnings that have accumulated tax free in the account. The taxable portion for 2019 is calculated as follows.²²⁹

- Step 1.** Multiply the total amount distributed by a fraction. The numerator is the basis (contributions not previously distributed) at the end of 2018, plus total contributions for 2019, and the denominator is the value (balance) of the account at the end of 2019, plus the amount distributed during 2019.
- Step 2.** Subtract the amount in step (1) from the total amount distributed during 2019. The result is the amount of earnings included in the distribution(s).
- Step 3.** Multiply the amount of earnings in step (2) by a fraction. The numerator is the AQEE paid during 2019 and the denominator is the total amount distributed during 2019.
- Step 4.** Subtract the amount determined in step (3) from the amount determined in step (2). The result is the amount the beneficiary must include in income.

Report the taxable amount on Schedule 1 or Form 1040NR, line 21.

²²⁹ IRS Pub. 970, *Tax Benefits for Education*.

2019 Workbook

Example 37. Rhonda received an \$850 distribution from her Coverdell ESA in 2019. No contributions were made in 2019, but \$1,500 was contributed before 2019. This is Rhonda's first distribution from her account, so her basis in the account on December 31, 2018, was \$1,500. The value (balance) of her account on December 31, 2019, was \$950. Rhonda had \$700 of AQEE for the year. She calculates the taxable portion of her distribution as follows.

$$\text{Step 1. } \frac{\$1,500 \text{ basis} + \$0 \text{ contributions}}{\$950 \text{ value} + \$850 \text{ distribution}} \times \$850 \text{ distribution} = \$708 \text{ basis portion of distribution}$$

$$\text{Step 2. } \$850 \text{ distribution} - \$708 \text{ basis portion of distribution} = \$142 \text{ earnings}$$

$$\text{Step 3. } \frac{\$700 \text{ AQEE}}{\$850 \text{ distribution}} \times \$142 \text{ earnings} = \$117 \text{ tax-free earnings}$$

$$\text{Step 4. } \$142 \text{ earnings} - \$117 \text{ tax-free earnings} = \$25 \text{ taxable earnings}$$

On her 2019 tax return, Rhonda must include \$25 in income as distributed earnings that were not used for qualified education expenses. She reports the amount as other income on Schedule 1, line 21, listing the type and amount of income on the dotted line.

10% Tax. If the taxpayer receives a taxable distribution from a Coverdell ESA, they may also be subject to a 10% additional tax on the amount included in income.²³⁰ The 10% additional tax does **not** apply to the following distributions.²³¹

- The distribution was paid to a beneficiary (or to the estate of the designated beneficiary) on or after the death of the designated beneficiary.
- The distribution was made because the designated beneficiary is disabled. A person is considered to be disabled if they show proof that they cannot do any substantial gainful activity because of their physical or mental condition. A physician must determine that the beneficiary's condition can be expected to result in death or to be of long-term and indefinite duration.
- The distribution was included in income because the designated beneficiary received a tax-free scholarship or fellowship grant, veterans' educational assistance, employer-provided educational assistance, or any other nontaxable (tax-free) payments (other than gifts or inheritances) received as educational assistance. This exception applies only to the extent the distribution is not more than the scholarship, allowance, or payment.
- The distribution was made because of the designated beneficiary's attendance at a U.S. military academy (such as the U.S. Military Academy at West Point). This exception applies only if the distribution does not exceed the costs of "advanced education," as defined in 10 USC §2005(d)(3).
- The distribution was included in income only because the qualified education expenses were taken into account in determining the AOC or lifetime learning credit.
- The distribution of an excess contribution made during any year (and any earnings on the contribution) was made before June 1 of the following year. The distributed earnings must be included in gross income for the year in which the excess contribution was made.

The taxpayer uses Part II of Form 5329, to report the additional tax. This amount is also entered on Schedule 4, line 59, or Form 1040NR, line 57.

²³⁰. IRC §530(d)(4)(A).

²³¹. IRS Pub. 970, *Tax Benefits for Education*.



Practitioner Planning Tip

An AOC or lifetime learning credit can be claimed in the same year that a distribution is taken from a QTP or Coverdell, **as long as the same expenses are not used for both benefits.**²³² This means that after the beneficiary reduces qualified education expenses by tax-free educational assistance, they must further reduce them by the expenses taken into account in determining the credit. This calculation results in the AQEE (defined earlier).

Situation 1. Tara incurs \$8,500 of qualified education expenses, receives \$3,500 in tax-free scholarships, and takes a \$5,000 distribution from a §529 plan, of which \$800 represents earnings.

Total qualified tuition expenses	\$8,500
Less: tax-free educational assistance	(3,500)
AQEE	\$5,000

$$\begin{aligned}\text{Tax-free earnings} &= \$800 \text{ earnings} \times \frac{\$5,000 \text{ AQEE}}{\$5,000 \text{ distribution}} \\ &= \$800\end{aligned}$$

No taxable distribution occurs in this situation, but no AQEE amount remains for potential education credits.

Situation 2. Use the same facts as **Situation 1**, except Tara's AQEE is reduced by \$4,000 to claim the AOC (assuming she meets all requirements to claim this credit).

Total qualified tuition expenses	\$8,500
Less: tax-free educational assistance	(3,500)
Less: expenses taken into account for the AOC	(4,000)
AQEE	\$1,000

$$\begin{aligned}\text{Tax-free earnings} &= \$800 \text{ earnings} \times \frac{\$1,000 \text{ AQEE}}{\$5,000 \text{ distribution}} \\ &= \$160\end{aligned}$$

\$800 earnings – \$160 tax-free earnings = \$640 taxable earnings (not subject to a 10% penalty).²³³

If Tara is in the 22% tax bracket, she incurs \$141 of tax on the \$640 of taxable earnings. However, if she qualifies, she can take a maximum \$2,500 AOC.²³⁴

²³². Ibid.

²³³. Ibid.

²³⁴. Ibid.

SCHOLARSHIPS OR FELLOWSHIPS

Taxpayers can exclude from gross income amounts received as a qualified scholarship or fellowship, if the amounts are used for qualified tuition and expenses.²³⁵

A scholarship is an amount paid to (or for the benefit of) a student to aid the student in pursuing their studies. Both graduate and undergraduate students can receive scholarships. A fellowship grant is an amount paid to (or for the benefit of) an individual to aid the individual in the pursuit of study or research. The amount of a scholarship or fellowship grant includes the following.²³⁶

- The value of contributed services and accommodations (This includes such services and accommodations as room, board, laundry service, and similar services or accommodations that are received by an individual as a part of a scholarship or fellowship grant.)
- The amount of tuition, matriculation, and other fees that are paid for or remitted to the student to aid the student in pursuing study or research
- Any amount received in the nature of a family allowance as a part of a scholarship or fellowship grant

The following payments or allowances do not qualify (or are not treated) as a scholarship or fellowship.

- An amount provided by an individual to aid a relative, friend, or other individual in pursuing studies when the grantor is motivated by family or philanthropic considerations²³⁷

Note. Family or philanthropic grants may be excludable by the recipient as gifts under IRC §102. In addition, payments for tuition made by an individual on behalf of another individual directly to an educational organization are not taxable gifts.²³⁸

- An amount received that constitutes a valid loan, even if the amount is labeled as a scholarship
- Educational and training allowances provided to veterans under Sec. 400 of the Servicemen's Readjustment Act of 1944 or under Sec. 1631 of Title 38 of the U.S. Code²³⁹
- Tuition and subsistence allowances to Armed Forces personnel who are students at an educational institution operated by the United States or approved by the United States for their education or training (e.g., the U.S. Naval Academy)²⁴⁰

²³⁵. IRC §117(a).

²³⁶. IRS Pub. 970, *Tax Benefits for Education*.

²³⁷. Treas. Reg. §1.117-3(a) and (c).

²³⁸. IRC §2503(e).

²³⁹. Treas. Reg. §1.117-4(a).

²⁴⁰. Treas. Reg. §1.117-4(a) and (b).

EXCLUSION REQUIREMENTS²⁴¹

To exclude scholarships and fellowships from gross income, the following three requirements must be met.

1. The student is a candidate for a degree at an eligible educational institution.
2. The amount of the scholarship or fellowship does not exceed the student's qualified education expenses.
3. The scholarship or fellowship does not represent payments for teaching, research, or other services required as a condition for receiving the qualified scholarship.

Candidate for a Degree

A student is a candidate for a degree if they meet either of the following conditions.

1. Attends a primary or secondary school or is pursuing a degree at a college or university
2. Attends an educational institution that meets both of the following requirements
 - a. Provides a program that is acceptable for full credit toward a bachelor's or higher degree, or offers a program of training to prepare students for gainful employment in a recognized occupation
 - b. Is authorized under federal or state law to provide such a program and is accredited by a nationally recognized accreditation agency

Eligible Educational Institutions

An eligible educational institution is an educational organization that meets the following two conditions.

1. Normally maintains a regular faculty and curriculum
2. Normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on²⁴²

Qualified Education Expenses

A scholarship or fellowship is not taxable income only to the extent that it does not exceed the student's qualified education expenses. Qualified education expenses for this purpose include the following.

- Tuition and fees required for the enrollment or attendance at an eligible educational institution
- Course-related expenses such as fees, books, supplies, and equipment that are required for all students in the course of instruction²⁴³

The following expenses do not constitute qualified education expenses.

- Room and board
- Travel
- Research
- Clerical help
- Equipment and other expenses that are not required for enrollment in or attendance at an eligible educational institution

²⁴¹. IRS Pub. 970, *Tax Benefits for Education*.

²⁴². IRC §§117(d)(2) and 170(b)(1)(A)(ii).

²⁴³. IRC §117(b)(2).

Payment for Services

Generally, no exclusion from gross income is allowed for the part of any scholarship or fellowship grant that represents payment for teaching, research, or other services required as a condition for receiving the scholarship. This applies even if all candidates for a degree must perform the services to receive the degree.²⁴⁴

Example 38. Mike, a single individual, received a scholarship of \$8,500 to Arizona State University. As a condition for receiving the scholarship, Mike must serve as a part-time teaching assistant in introductory biology courses. Of the \$8,500 scholarship, \$6,000 represents payment for teaching. The provider of the scholarship gives Mike a Form W-2, *Wage and Tax Statement*, that shows \$6,000 as income. His qualified education expenses were more than \$2,500.

If Mike meets all other conditions for excluding the scholarship from his income, the most he can exclude from gross income is \$2,500. The \$6,000 he received for teaching must be included in his gross income.

Example 39. Carly is a candidate for a degree at a medical school. In 2019, she receives a scholarship for her medical education and training. The terms of Carly's scholarship require her to perform future medical-related services. A substantial penalty applies if she does not comply.

The entire amount of the scholarship is taxable as payment for services in 2019.

Individuals do not have to treat as payment for services the part of any scholarship or fellowship grant that represents payment for teaching, research, or other services if the payment is received under one of the following three programs.²⁴⁵

1. The National Health Service Corps Scholarship Program
2. The Armed Forces Health Professions Scholarship and Financial Assistance Program
3. A comprehensive student work-learning-service program (as defined in section 448(e) of the Higher Education Act of 1965) operated by a work college (as defined in that section)

REPORTING SCHOLARSHIP INCOME²⁴⁶

If the individual's only income is a tax-free scholarship or fellowship grant, the individual is not required to file a tax return. If part or all of the scholarship is taxable, the taxpayer reports the taxable amount in the total on line 1 of Form 1040. If the taxable amount was not reported on Form W-2, the taxpayer also must enter "SCH" and the taxable amount on the dotted line next to line 1.²⁴⁷

²⁴⁴. IRS Pub. 970, *Tax Benefits for Education*.

²⁴⁵. Ibid.

²⁴⁶. Ibid.

²⁴⁷. Ibid.

Example 40. Steven received a \$9,500 scholarship in 2018 from Eastern University, where he is a degree candidate in physics. The scholarship terms provide that \$6,000 is for tuition and \$3,500 is for room and board.

The \$6,000 designated for tuition is excluded from Steven's gross income. The \$3,500 designated for room and board must be included in his gross income, as shown on his Form 1040, which follows. Steven had no taxable income for 2018, other than the taxable portion of the scholarship. He does not receive a Form W-2 that reports the taxable amount of the scholarship.

Form 1040 (2018)		Page 2
	1 Wages, salaries, tips, etc. Attach Form(s) W-2 SCH \$3,500.	1 3,500 00
Attach Form(s) W-2. Also attach Form(s) W-2G and 1099-R if tax was withheld.	2a Tax-exempt interest	2b Taxable interest
	3a Qualified dividends	3b Ordinary dividends
	4a IRAs, pensions, and annuities	4b Taxable amount
	5a Social security benefits	5b Taxable amount
	6 Total income. Add lines 1 through 5. Add any amount from Schedule 1, line 22	6 3,500 00
	7 Adjusted gross income. If you have no adjustments to income, enter the amount from line 6; otherwise, subtract Schedule 1, line 36, from line 6	7 3,500 00
Standard Deduction for — • Single or married filing separately, \$12,000 • Married filing jointly or Qualifying widow(er), \$24,000 • Head of household, \$18,000 • If you checked any box under Standard deduction, see instructions.	8 Standard deduction or itemized deductions (from Schedule A)	8 12,000 00
	9 Qualified business income deduction (see instructions)	9 0 00
	10 Taxable income. Subtract lines 8 and 9 from line 7. If zero or less, enter -0-	10 0 00
	11 a Tax (see inst.) (check if any from: 1 <input type="checkbox"/> Form(s) 8814 2 <input type="checkbox"/> Form 4972 3 <input type="checkbox"/>) b Add any amount from Schedule 2 and check here	11 0 00
	12 a Child tax credit/credit for other dependents b Add any amount from Schedule 3 and check here	12
	13 Subtract line 12 from line 11. If zero or less, enter -0-	13
	14 Other taxes. Attach Schedule 4	14
	15 Total tax. Add lines 13 and 14	15 0 00
	16 Federal income tax withheld from Forms W-2 and 1099	16
	17 Refundable credits: a EIC (see inst.) b Sch. 8812 c Form 8863 Add any amount from Schedule 5	17
	18 Add lines 16 and 17. These are your total payments	18 0 00
Refund Direct deposit? See instructions.	19 If line 18 is more than line 15, subtract line 15 from line 18. This is the amount you overpaid	19 0 00
	20a Amount of line 19 you want refunded to you . If Form 8888 is attached, check here <input type="checkbox"/> b Routing number c Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings d Account number	20a 0 00
	21 Amount of line 19 you want applied to your 2019 estimated tax 21	21
	22 Amount you owe. Subtract line 18 from line 15. For details on how to pay, see instructions	22
	23 Estimated tax penalty (see instructions) 23	23

Go to www.irs.gov/Form1040 for instructions and the latest information. Form **1040** (2018)



Practitioner Planning Tip

As with QTP or ESA distributions, taxpayers may be able to increase the value of an education credit if the student includes some or all of otherwise tax-free scholarships in income.²⁴⁸

²⁴⁸. Ibid.

2019 Workbook

Example 41. Use the same facts as **Example 38**. For 2018, the taxable portion of Mike's scholarship is \$6,000 for his teaching services. This was his only source of gross income for the year. The taxable amount was reported to Mike on Form W-2. Mike had no tax withheld during the year. Page 2 of Mike's Form 1040 follows.

Form 1040 (2018)		Page 2	
1 Wages, salaries, tips, etc. Attach Form(s) W-2		1	6,000 00
2a Tax-exempt interest 2a		2b	
3a Qualified dividends 3a		3b	
4a IRAs, pensions, and annuities 4a		4b	
5a Social security benefits 5a		5b	
6 Total income. Add lines 1 through 5. Add any amount from Schedule 1, line 22		6	6,000 00
7 Adjusted gross income. If you have no adjustments to income, enter the amount from line 6; otherwise, subtract Schedule 1, line 36, from line 6		7	6,000 00
8 Standard deduction or itemized deductions (from Schedule A)		8	12,000 00
9 Qualified business income deduction (see instructions)		9	0 00
10 Taxable income. Subtract lines 8 and 9 from line 7. If zero or less, enter -0-		10	0 00
11 a Tax (see inst.) (check if any from: 1 <input type="checkbox"/> Form(s) 8814 2 <input type="checkbox"/> Form 4972 3 <input type="checkbox"/>)		11	0 00
b Add any amount from Schedule 2 and check here <input type="checkbox"/>		12	
12 a Child tax credit/credit for other dependents b Add any amount from Schedule 3 and check here <input type="checkbox"/>		13	
13 Subtract line 12 from line 11. If zero or less, enter -0-		14	
14 Other taxes. Attach Schedule 4		15	0 00
15 Total tax. Add lines 13 and 14		16	
16 Federal income tax withheld from Forms W-2 and 1099		17	
17 Refundable credits: a EIC (see inst.) b Sch. 8812 c Form 8863		18	0 00
18 Add lines 16 and 17. These are your total payments		19	0 00
19 If line 18 is more than line 15, subtract line 15 from line 18. This is the amount you overpaid		20a	0 00
20a Amount of line 19 you want refunded to you . If Form 8888 is attached, check here <input type="checkbox"/>		21	
b Routing number c Type: <input type="checkbox"/> Checking <input type="checkbox"/> Savings		22	
d Account number		23	
21 Amount of line 19 you want applied to your 2019 estimated tax		22	
22 Amount you owe. Subtract line 18 from line 15. For details on how to pay, see instructions		23	
23 Estimated tax penalty (see instructions)			

Go to www.irs.gov/Form1040 for instructions and the latest information.

Form **1040** (2018)

QUALIFIED TUITION REDUCTION²⁴⁹

A tuition reduction provides lower tuition or free tuition to students at the undergraduate or graduate level. A **qualified tuition reduction (QTR)** is excluded from the recipient's gross income. A tuition reduction is qualified only if a taxpayer receives it from and uses it at an eligible educational institution.

The QTR must be offered to employees of the eligible educational institution on a nondiscriminatory basis. The employee does not have to use the tuition reduction at the eligible educational institution from which the employee received it. Instead, a person may work for one eligible educational institution and make arrangements to take courses at another eligible educational institution.

²⁴⁹. Ibid.

ELIGIBLE EDUCATIONAL INSTITUTIONS

An eligible educational institution is any college, university, trade school, or other post-secondary educational institution eligible to participate in a student aid program run by the U.S. Department of Education that meets both of the following requirements.

1. Maintains a regular faculty and curriculum
2. Normally has a regularly enrolled body of students in attendance at the place where it carries on its educational activities²⁵⁰

OFFICERS, OWNERS, AND HIGHLY COMPENSATED EMPLOYEES

QTRs apply to officers, owners, or highly compensated employees²⁵¹ only if benefits are available to employees on a nondiscriminatory basis. This means that the tuition reduction benefits must be available on substantially the same basis to each member of a group of employees. The group must be defined under a reasonable classification set up by the employer. The classification must not discriminate in favor of owners, officers, or highly compensated employees.

EDUCATION BELOW THE GRADUATE LEVEL

If an individual receives a tuition reduction for education below the graduate level (including primary, high school, or undergraduate education), it is a qualified tuition reduction only if the individual's relationship to the educational institution providing the benefit is one of the following.

1. Employee of the eligible educational institution
2. Former employee of the eligible educational institution who retired or left on disability
3. Widow or widower of an individual who died while an employee of the eligible educational institution or who retired or left on disability
4. Dependent child or spouse of an individual described in (1) through (3) above

GRADUATE LEVEL EDUCATION

A tuition reduction received for graduate education is qualified, and therefore tax-free, if both of the following requirements are met.

- The tuition reduction is provided by an eligible educational institution.
- The recipient of the tuition reduction is a graduate student who performs teaching or research activities for the educational institution.

Any other tuition reductions a taxpayer receives for graduate education must be included in their gross income.

REPORTING TUITION REDUCTIONS

A taxable tuition reduction should be included as wages on the recipient's Form W-2, box 1. The taxpayer reports the amount from Form W-2, box 1, on line 1 of Form 1040. This amount qualifies as AQEE.

²⁵⁰. IRC §§117(b)(2)(A) and 170(b)(1)(A)(ii).

²⁵¹. As defined in IRC §414(q).

OTHER FORMS OF EDUCATIONAL ASSISTANCE²⁵²

FULBRIGHT GRANTS

A Fulbright grant is generally treated as a scholarship or fellowship grant in calculating how much of the grant is tax-free.

PELL GRANTS

Pell grants are need-based grants that are treated as scholarships for federal tax purposes. These grants are tax-free to the extent they are used for qualified education expenses during the period for which a grant is awarded.

VETERANS' BENEFITS

Payments received by veterans for education, training, or subsistence under any law administered by the Department of Veterans Affairs (VA) are not taxable.²⁵³

If an individual qualifies for one or more education tax benefits, they may have to reduce the amount of education expenses qualifying for a specific tax benefit by part or all of the VA payments. This applies only to the part of the VA payments that the taxpayer is required to use for education expenses.

Example 42. Ron returned to college in 2019 and is receiving two education benefits under the GI Bill: a \$1,800 monthly basic housing allowance (BHA) that is directly deposited to his checking account and \$4,300 paid directly to his college for tuition. Neither of these benefits is taxable and Ron does not report them on his tax return.

Ron also wants to claim an AOC on his return. During 2019, Ron's total qualified education expenses were \$6,000. To determine the amount of the AOC, he must subtract the \$4,300 from his qualified education expenses because this payment under the GI Bill was required to be used for education expenses. He does not subtract any amount of the BHA from his qualified education expenses because it was paid to Ron and its use was not restricted.

²⁵². IRS Pub. 970, *Tax Benefits for Education*.

²⁵³. Treas. Reg. §1.117-4(a).