

Chapter 2: Unexpected Issues for Individual Taxpayers

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Please note. Corrections were made to this workbook through January of 2021. No subsequent modifications were made.

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This chapter discusses the tax treatment of less commonly encountered sources of money or benefits, which may or may not represent income to the recipient. While not all-encompassing as to every potential source of money a taxpayer may receive, this chapter seeks to assist tax professionals in determining the taxability of several of these less common items. Adjustments to less common types of income are also covered.

In addition, this chapter discusses the taxpayer's level of participation in an activity and concludes with a discussion of the net investment income tax.

LESS COMMON SOURCES OF INCOME

DISABILITY PAYMENTS

If a disability payment reimburses the taxpayer for medical expenses and other deductions taken in prior years under IRC §213, then the disability payment is taxable to the extent of the previous deductions.¹

Taxable Amount Based on Source of Premium Payment

Whether the disability payment is taxable depends on who paid the premium for the insurance policy.²

1. If both the employer and the employee paid the premiums for the plan, only the amount received for disability that is due to the employer's payments is reported as income by the employee.
2. If the employee pays the entire cost of the plan, none of the amounts the employee receives for disability is reported as income.
3. If the employee pays the premiums of a health or accident insurance plan through a cafeteria plan and the employee did not include the amount of the premium as taxable income, then the premiums are considered paid by the employer and the disability benefits are fully taxable.

Incentives/Rewards Related to the Policy

If the employer offers an arrangement by which the employee's pre-tax salary is reduced to pay for the disability insurance and the employee is subsequently rewarded or receives incentives coinciding with the amount by which the salary was reduced to pay for the disability insurance, then exclusions from the employee's gross income under IRC §§105(b) and 106(a) do not apply.³

Chief Counsel Memorandum 201622031 states that "[A]n employer may not exclude from an employee's gross income" direct payments of cash for participating in a wellness program or reimbursement of premiums originally made by salary reduction through a cafeteria plan under IRC §125.⁴ IRC §125 includes cafeteria plans under which an employee may elect supplemental disability insurance.

Disability Payments in Lieu of Wages

Payments under worker compensation acts for personal injuries or sickness are not taxable.⁵ Similarly, payments for damages due to personal physical injuries or physical sickness (whether by judgment or settlement, or lump-sum or periodic payments) are not taxable.⁶

¹ IRC §104(a).

² *Life Insurance & Disability Insurance Proceeds*. IRS. [www.irs.gov/faqs/interest-dividends-other-types-of-income/life-insurance-disability-insurance-proceeds/life-insurance-disability-insurance-proceeds-1#:~:text=You%20must%20report%20as%20income,payments%20is%20reported%20as%20income] Accessed on Jul. 21, 2020.

³ Rev. Rul. 2002-3, 2002-3 IRB 316. Treas. Reg. §1.105-1 discusses various types of funding arrangements: employer-only contributions and part-employer and part-employee contributions.

⁴ CCM 201622031 (Apr. 14, 2016).

⁵ IRC §104(a)(1).

⁶ IRC §104(a)(2) and Treas. Reg. §1.104-1(c).

Other Disability Payments

Disability payments to veterans, to victims of terrorist or military action (or their surviving spouses), or to surviving dependents of a public safety officer are not taxable.⁷ A taxpayer who retires on disability that is taxable should receive Form 1099-R, *Distributions from Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, and report payments as follows.⁸

- As wages on Form 1040, *U.S. Individual Income Tax Return*, line 1, until the taxpayer reaches minimum retirement age (MRA)
- As pension or annuity income on Form 1040, lines 4c and 4d, after the taxpayer reaches MRA

MRA, for this purpose, is generally the age at which the taxpayer can first receive a pension or annuity if they are not disabled.⁹



Practitioner Planning Tip

When considering how to report disability income for a client, a practitioner should determine the following.

- Who (employer/employee) paid the premiums for the policy
- Whether the taxpayer-employee received any incentives or rewards that effectively offset the cost of the policy
- Any special arrangements, such as a union contract, which may allow the taxpayer to continue to treat disability payments as such, rather than as retirement income after the taxpayer reaches MRA

LIFE INSURANCE

Premiums paid for a life insurance policy are usually apportioned between the death benefit, the issuer's operating costs, and the policy's cash value. Cash value accumulates differently depending upon whether the policy is whole or variable life. Once the purchaser has paid premiums and accumulated death benefits and cash value, the purchaser can transfer the policy for valuable consideration.

Transfer of Policy by Insured

The "transfer for value rule" is invoked if the original purchaser of the life insurance policy transfers the policy to a second purchaser for valuable consideration.¹⁰ Upon the death of the insured, the amount of death benefit exempt from income tax is only equal to the amount paid for the policy to the original purchaser by the second purchaser, plus any premiums paid by the second purchaser.¹¹

⁷ IRC §§104(a)(4), (5), and (6).

⁸ IRS Pub. 575, *Pension and Annuity Income*.

⁹ *Ibid.*

¹⁰ IRC §101(a)(2) and Treas. Reg. §1.101-1(b).

¹¹ Treas. Reg. §1.101-1(b)(1)(ii)(B)(2).

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Gifted Policies. Generally, the rule for the taxability of proceeds is similar to that for gifted property: the portion of the proceeds that is excludable from gross income equals what would have been excluded from gross income if the transfer had not occurred, plus any additional premiums paid by the recipient of the gift.¹²

Transferred as Part-Gift and Partially For Value. As is the case for a part-gift, part-sale transaction, the proceeds of a life insurance policy are first classified as gift and transfer, and then the exclusion amount is calculated for each part.¹³

Life Insurance Proceeds Received by Beneficiary. The amount received by the beneficiary due to the death of the insured party is usually not taxable, subject to the calculations for transfers for value described earlier.¹⁴

Viatical Settlement.¹⁵ A viatical settlement accelerates the death benefit for a terminally or chronically ill person under a life insurance contract by selling or assigning the contract to a viatical settlement provider. Such providers are governed by state law and such settlement agreements must comport with the Viatical Settlements Model Act of the National Association of Insurance Commissioners. The amount paid for the sale or assignment is excluded from the taxpayer's gross income because the proceeds are treated as though the insured has died.

Note. For the viatical settlement provider, the proceeds paid upon the death of the insured person represent ordinary business income to the provider. The cost the provider paid the insured for the policy is considered a reasonable and necessary business expense.

SALE OF PRINCIPAL RESIDENCE

The definition of a principal residence depends upon the taxpayer's facts and circumstances. If the taxpayer has more than one residence, the determination of which residence is the principal one will likely be based on the amount of time spent at each property and factors such as the taxpayer's address used for voting registration, driver's license, and tax returns, as well as proximity to the taxpayer's employment, banks, and other associations.¹⁶

Exclusion of Capital Gain Under IRC §121

An individual taxpayer can exclude up to \$250,000 of capital gain on the sale of the taxpayer's principal residence if the taxpayer:

- Owned and used the property as a principal residence within any two years (not necessarily consecutive) of the five years preceding the sale, and
- Has not claimed the exclusion amount under §121 in the prior two years.¹⁷

Example 1. Regis owns two residences — one in Illinois and one in Florida. During 2016 and 2017, he lived in the Illinois residence. During 2018 and 2019, he lived in the Florida residence. During 2020, he lives in the Illinois residence. Regis's principal residence during 2016, 2017, and 2020 is the Illinois residence. Regis's principal residence during 2018 and 2019 is the Florida residence. Regis is eligible for the §121 exclusion of gain from the sale or exchange of either residence (but not both) during 2020.¹⁸

¹² Treas. Reg. §1.101-1(b)(2)(i).

¹³ Treas. Reg. §1.101-1(b)(2)(ii).

¹⁴ IRC §101(a)(1) and Treas. Reg. §1.101-1(a)(1).

¹⁵ IRC §101(g)(2).

¹⁶ Treas. Reg. §1.121-1(b)(2).

¹⁷ IRC §§121(a) and (b)(1) and (3).

¹⁸ Adapted from an example in Treas. Reg. §1.121-1.

A married couple who files joint tax returns may exclude up to \$500,000 of capital gain.¹⁹ Each spouse must meet the same criteria as listed above.

Note. For married couples who have lived in separate homes for two out of the last five years, the homes can be sold in the same year and up to \$250,000 of gain can be excluded on each home. The tax returns must be filed as married filing separately (MFS) in the year of sale.²⁰

A surviving spouse who has not remarried may also exclude up to \$500,000 of capital gain if:

1. The house is sold within **two years** of the deceased spouse's date of death, and
2. The deceased spouse would have satisfied the criteria under §121 as of the spouse's date of death.²¹

Example 2. Mary's spouse dies January 1, 2018. The following year, she meets Joe. They fall in love and wish to marry. Mary may elect to sell her house and take advantage of the \$500,000 gain exclusion if she sells the house within two years of her spouse's death and before she and Joe marry.

Partial Exclusion. When taxpayers do not meet the criteria for the exclusion under §121, they are not eligible for the maximum exclusion. However, they may qualify for a partial exclusion if the main reason for the home sale was a change in workplace location, a health issue, or an unforeseeable event.²²

Note. For information about calculating a partial exclusion, see IRS Pub. 523, *Selling Your Home*.

Periods of Nonqualified Use. The §121 exclusion does not apply to the extent gain from the sale or exchange of a principal residence is allocated to periods of nonqualified use.²³

Generally, **nonqualified use** is **any period (other than the portion of any period before January 1, 2009)** during which the property is not used as the principal residence of the taxpayer or spouse.²⁴

For determining the amount of gain that is allocated to periods of nonqualified use, gain is allocated to periods of nonqualified use based on the following ratio.

- The aggregate periods of nonqualified use during the period the property was owned by the taxpayer, divided by
- The period the property was owned by the taxpayer.²⁵

The numerator does **not include any period before January 1, 2009.**²⁶ However, the denominator (i.e., the period that the taxpayer owned the property) includes **all** periods of ownership (even those before January 1, 2009).

Note. For more information about periods of nonqualified use, see the 2019 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 3: Calculating Basis.

¹⁹ IRC §121(b)(2).

²⁰ IRS Pub. 523, *Selling Your Home*.

²¹ IRC §121(b)(4).

²² IRS Pub. 523, *Selling Your Home*.

²³ IRC §121(b)(5), as amended by PL 110-289.

²⁴ IRC §121(b)(5)(C)(i).

²⁵ IRC §121(b)(5)(B).

²⁶ IRC §121(b)(5)(C)(i).

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Reporting a Taxable Sale. When taxpayers have gain from the sale or disposition of their residence that is not excludable, they should report it on Form 8949, *Sales and Other Dispositions of Capital Assets*.

Note. For detailed information about the tax implications of selling a principal residence, see IRS Pub. 523.

Sale of Property Acquired in an IRC §1031 Exchange. When taxpayers sell a home they acquired in a like-kind exchange, they must apply the following test and cannot claim the §121 exclusion if:²⁷

- The taxpayer acquired the home in a like-kind exchange (IRC §1031 exchange), or
- The taxpayer's basis in the home is determined by reference to a previous owner's basis, and the previous owner acquired the property in a like-kind exchange, and
- The taxpayer sold the home within five years of the date the home was acquired in the like-kind exchange.

Sale of Vacant Land Next to the Home.²⁸ Taxpayers may include the sale of vacant land adjacent to the land on which the primary residence is located as part of a sale of a home if all the following are true.

- The taxpayers owned and used the vacant land as part of their home.
- The sale of the vacant land and the sale of the home occurred within two years of each other.
- Both sales either meet the eligibility test for the §121 exclusion or qualify for a partial exclusion, as described earlier.

If the sale of vacant land meets all these requirements, taxpayers must treat that sale and the sale of the home as a single transaction for tax purposes, meaning that the §121 exclusion may only be applied once.

However, if the taxpayer moves the home from the land on which it stood (i.e., the actual structure is relocated), then that land no longer qualifies as part of the residence. For example, if the taxpayer moves a mobile home to a new lot and sells the old lot, then the sale of the old lot cannot be treated as the sale of a principal residence.

Note. The Code and regulations do not define “adjacent.” Adjacent can mean all land that borders the property, if the property was not separated by a river, road, railway line, pipeline, or a similar feature.

Example 3. Herb and Mary own a home that sits on a one-acre lot. They also own 20 acres across the road from their house and they use the vacant land as part of their personal home. They sell the vacant land in June 2020 for a gain of \$180,000. They sell their home in October 2020 for a gain of 150,000. Because they meet all other criteria, the entire \$330,000 gain can be excluded under §121 by treating the sale as a single transaction.

Sale of Principal Residence with Home Office. If a bona fide business was conducted from the principal residence, then gain from a sale may be subject to taxation and/or depreciation recapture. The issue as to the potential taxability of gain depends on whether the home office was within the living area or was an appurtenant structure detached from the home.²⁹

²⁷ IRS Pub. 523, *Selling Your Home*.

²⁸ *Ibid.*

²⁹ *Ibid.*

Practitioner Planning Tip

When the simplified method is used for the home office deduction (\$5 per square foot up to a maximum of \$1,500), depreciation recapture is not necessary.³⁰

Note. For information regarding the sale of a principal residence with a home office, see the 2020 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Small Business Issues.

Note. For detailed information about the sale of a residence, see IRS Pub. 523.

GIFTS

Property received as a gift or received under a will is not includable in gross income. However, the income from such property is includable in gross income.³¹

Note. When a beneficiary receives distributions from an estate, income generated by estate assets from the date of the decedent's death is normally includable in the beneficiary's gross income.

Taxable Gifts

Taxable gifts consist of all gifts made during the calendar year, excluding the inflation-adjusted amount in IRC §2503(b) for gifts of present interests.³² A **present interest** in property is defined as the “unrestricted right to the immediate use, possession, or enjoyment of property or the income from property.”³³ In 2020, gifts of up to \$15,000 per person are not taxable.³⁴ In addition, the following **are not considered taxable gifts**.

- Qualified transfers for the payment of another person's tuition to a qualified organization under IRC §170, or to the provider of medical care under §213(d) are not taxable gifts.³⁵
- Gifts to a spouse are not included in the amount of taxable gifts.³⁶

Taxable gifts are reported on Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return*.

³⁰ *Simplified Option for Home Office Deduction*. Jun. 12, 2020. IRS. [www.irs.gov/businesses/small-businesses-self-employed/simplified-option-for-home-office-deduction] Accessed on Aug. 10, 2020.

³¹ Treas. Reg. §1.102-1(a).

³² IRC §§2503(a) and (b); Treas. Reg. §25.2503-3.

³³ Treas. Reg. §25.2503-3(b).

³⁴ *Frequently Asked Questions on Gift Taxes*. Jan. 16, 2020. IRS. [www.irs.gov/businesses/small-businesses-self-employed/frequently-asked-questions-on-gift-taxes] Accessed on Jul. 23, 2020.

³⁵ IRC §2503(e).

³⁶ IRC §2523.

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Gifts to Minors

Gifts made for the benefit of a person under age 21, and the income from such gifts, are deemed present interests provided that the property and income from it:

1. May be spent by, or for the benefit of, the minor-donee; and
2. The minor-donee will receive the remaining property and income attributable to it upon turning age 21.³⁷

Gift Tax Liability

Gift tax is a liability of the donor.³⁸ The recipient of the transferred property may be liable for income, estate, or gift taxes if the donor or the donor's estate is unable to pay the taxes.³⁹ Transferees retain the liability for paying income tax on the income generated by the property received.⁴⁰

Basis in the Gift

The donee's basis in property is the same as the adjusted basis in the hands of the donor.⁴¹ For beneficiaries of large estates required to file Form 706 under IRC §6018(a)(1), the basis in the property transferred is reported on Form 8971, *Information Regarding Beneficiaries Acquiring Property From a Decedent*, in order to provide for consistent basis reporting.⁴²

Note. Generation-skipping transfer tax may apply in addition to gift tax.



Practitioner Planning Tip

Often gift tax returns are not filed when they are required after a completed gift has been made. Taxpayers often do not want to be told they have made taxable gifts. However, until a taxpayer exceeds \$11.58 million in taxable gifts (2020 lifetime exclusion limitation),⁴³ no gift tax is owed by the donor.

³⁷ IRC §2503(c); Treas. Reg. §25.2503-4.

³⁸ IRC §2501(c).

³⁹ IRC §§6901(a)(1) and (b).

⁴⁰ IRC §102(b).

⁴¹ IRC §1015.

⁴² IRC §6035.

⁴³ *What's New — Estate and Gift Tax*. Apr. 15, 2020. IRS. [www.irs.gov/businesses/small-businesses-self-employed/whats-new-estate-and-gift-tax] Accessed on Jul. 29, 2020.

Example 4. Joe Gotrocks gives \$100,000 cash to his son, Spencer, on December 30, 2020. Joe needs to file a 2020 Form 709 by April 15, 2021, indicating he made a taxable gift of \$85,000 (\$100,000 gift amount – \$15,000 annual exclusion). Joe’s lifetime exclusion amount is reduced to \$11.495 million (\$11.58 million lifetime exclusion – \$85,000 taxable gift in 2020), assuming he did not make any other taxable gifts in prior years. No tax is due when Joe files the 2020 Form 709. There are no income tax consequences for Spencer.

Note. For detailed information about the rules that apply to estate and gift taxes, see IRS Pub. 559, *Survivors, Executors, and Administrators*. For information about how to report taxable gifts, see the instructions for Form 709.

SHORT-TERM RENTALS OF DWELLING UNIT

An analysis of whether a dwelling unit is used for short-term rental purposes begins with understanding what the dwelling unit is, how it is used, and by whom. In addition, it must be determined whether the taxpayer materially participates in the rental activity or whether the rental is a passive activity.⁴⁴ Passive activities and material participation are discussed later.

A dwelling unit may be a house, apartment, condominium, mobile home, boat, or similar property, and all structures or other property appurtenant to it.⁴⁵ A dwelling unit does not include any portion of a unit that is used exclusively as a hotel, motel, inn, or similar establishment.⁴⁶

No deductions are allowed for expenses associated with a dwelling unit used as a residence, but deductions are allowed for any portion of a dwelling unit that is rented up to the amount of rental income received.⁴⁷

Minimal Rental Use

A special rule exists if a taxpayer uses their principal residence and rents it for fewer than 15 days. In this case, rental income is not reportable and no rental expenses are deductible.⁴⁸

Example 5. A professional golfing event is held at the country club adjacent to the personal residence of Walter and Wanda Bushwood. Eager to capitalize on the event, they rent their home for \$2,000 per day. The event lasts for 10 days. The income from the rental of their residence is not includable as income, and the Bushwoods cannot deduct any expenses incurred for the rental.

If, during the tax year, the taxpayer uses the dwelling unit for personal purposes for the number of days that exceeds the greater of 14 days or 10% of the total number of days the unit is rented at a fair rental price, then the unit is considered to have been used as a residence.⁴⁹ **Personal purposes** do not include the taxpayer being onsite to make repairs or perform annual maintenance.⁵⁰

Note. The test for the greater of 14 days or 10% of the total number of days the unit is rented at fair rental value is often applicable when taxpayers own a timeshare for a week per year. While their personal use is less than 14 days, the personal use would most likely exceed the 10% limitation in a given year.

⁴⁴ See *Topic 415 — Renting Residential and Vacation Property*. May 27, 2020. IRS. [www.irs.gov/taxtopics/tc415] Accessed on Jun. 22, 2020; and *Topic 425 — Passive Activities*. May 28, 2020. IRS. [www.irs.gov/taxtopics/tc425] Accessed on Jun. 2, 2020.

⁴⁵ IRC §280A(f)(1)(A).

⁴⁶ IRC §280A(f)(1)(B).

⁴⁷ IRC §§280A(c)(3) and (f)(5).

⁴⁸ IRS Pub. 527, *Residential Rental Property*.

⁴⁹ IRC §280A(d)(1).

⁵⁰ IRC §280A(c).

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As previously mentioned, the unit must be rented at least 15 days during the tax year for the rental income to be includable in the taxpayer's gross income and for associated expenses to be deductible.⁵¹ The income and expenses are then typically reported on Schedule E, *Supplemental Income and Loss*.

Use of a dwelling unit does not qualify as a rental if the unit is:

- Rented to a taxpayer's family member for use as a residence;⁵²
- Used for personal purposes by a party with an interest in the property, unless in accordance with a shared equity agreement⁵³ or by a family member as defined in IRC §267(c)(4);⁵⁴
- Part of an arrangement whereby the taxpayer uses another unit (regardless of whether the taxpayer pays rent);⁵⁵ or
- Rented for less than fair rental, unless to an employee as part of employer-provided lodging under IRC §119.⁵⁶

Trade or Business

If the rental activity qualifies as a trade or business under IRC §162, the taxpayer is not subject to self-employment (SE) tax unless the taxpayer provides extraordinary services akin to a hotel, motel, inn, or similar establishment (e.g., maid service and meals).⁵⁷ The provision of extraordinary services excludes the rental from being classified as a dwelling unit.⁵⁸

Note. The §162 trade or business rules are not the same as those invoked to calculate the qualified business income deduction (QBI). For information about real estate activities and the QBI, see the 2020 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 6: Schedule E.

A passive activity generally includes any rental activity.⁵⁹ Special rules under §469(c)(7), though, can allow the taxpayer to qualify as having a real property trade or business.

A rental as a trade or business activity is defined at Treas. Reg. §1.469-4(b)(2), which references Temp. Treas. Reg. §1.469-1T(e)(3). An activity involving the use of tangible property is not a rental activity if the average period of customer use does not exceed seven days.

A rental activity may qualify as a trade or business if the taxpayer performed more than half of the taxpayer's personal services in real property trades or businesses in which the taxpayer materially participates, and those services totaled more than 750 hours.⁶⁰ Material participation is discussed later.

Note. A rental activity can qualify as a trade or business under §162 but not subject the taxpayer to SE tax. Providing extraordinary services can satisfy the trade or business requirement of §162 and triggers SE tax.

For more information about real estate rentals, see the 2020 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 6: Schedule E.

⁵¹ IRC §280A(g).

⁵² IRC §280A(d)(2)(A).

⁵³ IRC §§280A(d)(3)(B) and (C).

⁵⁴ IRC §280A(d)(2)(A).

⁵⁵ IRC §280A(d)(2)(B).

⁵⁶ IRC §280A(d)(2)(C).

⁵⁷ Temp. Treas. Reg. §1.469-1T(e)(3)(v).

⁵⁸ IRC §1402(a)(1).

⁵⁹ IRC §469(c)(2).

⁶⁰ IRC §469(c)(7)(B).

PERSONAL PROPERTY RENTAL

The treatment of personal property rental income is relatively straightforward.

- If the taxpayer has a business renting personal property, then the rental income and associated expenses are reported on Schedule C, *Profit or Loss From Business*.⁶¹

Example 6. Kip Skernan owns Rent Your Stuff Here, a sole proprietorship that rents furniture, appliances, electronics, and lawncare equipment on an hourly or daily basis to customers. Kip is in the business of renting personal property and reports his income and expenses on Schedule C.

- If the taxpayer is not in the business of renting personal property, then the rental income is reported on line 8 of Schedule 1, *Additional Income and Adjustments to Income*. The type and amount of the income should be entered on the dotted line next to line 8. The amount of associated expenses is included in line 22 of Schedule 1. The amount and “PPR” should be entered on the dotted line next to line 22. The amount of deductions cannot exceed the amount of income reported for the property.⁶²

Example 7. Walter Koll is an electrician employed by Shocking Electrics, Inc. The company does not provide Walter with a company vehicle but instead pays him \$500 per month as a rent payment for the use of his personally owned truck. Walter reports the rental income on line 8 of Schedule 1. Any expenses Walter pays related to the rental use of the truck are reported on line 22 of Schedule 1 but cannot exceed the amount of income reported on line 8 of Schedule 1.

Jointly Owned Tangible Personal Property

If the taxpayer owns a fractional interest in tangible personal property, then income and expenses should be apportioned according to the taxpayer’s share. Owning a fractional interest in tangible personal property prevents the taxpayer from making a charitable contribution of the property.⁶³

EASEMENT PAYMENT

A payment made in exchange for granting a perpetual easement reduces the cost or other basis in the land subject to the easement.⁶⁴ If the amount of the easement payment exceeds the amount used to reduce the cost or basis in the land affected by the easement to zero, then the excess is recognized as taxable capital gain. Such gain is short- or long-term, depending on the holding period of the land for which the easement is granted.⁶⁵

The gross proceeds from the easement payments are reported to the taxpayer in box 2 of Form 1099-S, *Proceeds From Real Estate Transactions*.

⁶¹ *Topic 414 — Rental Income and Expenses*. May 28, 2020. IRS. [www.irs.gov/taxtopics/tc414] Accessed on Jun. 22, 2020.

⁶² Instructions for Forms 1040 and 1040-SR.

⁶³ IRC §170(a)(3); IRS Pub. 526, *Charitable Contributions*.

⁶⁴ Ltr. Rul. 201250008 (Dec. 14, 2012), citing Rev. Rul. 68-291, 1968-1 CB 351.

⁶⁵ Rev. Rul. 70-510, 1970-2 CB 159. See also IRS Pub. 544, *Sales and Other Dispositions of Assets*.

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Conservation Easements

IRC §170(h) and Treas. Reg. §1.170A-14 address charitable contributions of qualified conservation easements. This is a complex topic, and much litigation has focused on the valuation of such easements.⁶⁶ Treas. Reg. §1.170A-14(a) provides the following definition.

A qualified conservation contribution is the contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. To be eligible for a deduction under this section, the conservation purpose must be protected in perpetuity.

Much of the litigation before the U.S. Tax Court has involved syndicated conservation easements offered by promoters.⁶⁷

Caution. Syndicated conservation easements have appeared on the IRS annual “Dirty Dozen” list of tax scams. See IRS Notice 2017-10 for a description of the listed transactions.



Practitioner Planning Tip

The conservation easement deduction is entered on Schedule A, *Itemized Deductions*. There is a 50% adjusted gross income (AGI) limitation for individuals who are not classified as a farmer or rancher. The AGI limitation is 100% for individuals classified as a farmer or rancher. Any excess may be carried forward for up to 15 years.⁶⁸

Taxpayers enter the information on Form 8283, *Noncash Charitable Contributions*, and then the amount is carried to Schedule A.

⁶⁶ IRS News Rel. IR-2019-213 (Dec. 20, 2019); Treas. Reg. §1.170A-1(c).

⁶⁷ IRS News Rel. IR-2020-130 (Jun. 25, 2020).

⁶⁸ IRS Notice 2007-50, 2007-25 IRB 1430.

Example 8. Farmer Bill grants an easement to the Missouri Conservation Heritage Fund and has the farmland appraised at \$1,053,450. He also makes a contribution to his church of \$2,124. Bill's charitable deduction is limited to his AGI of \$135,315. The remaining contribution of \$920,259 (\$1,053,450 farmland – \$133,191 deducted for easement) carries forward to 2020.

Farmer Bill files the following forms.

Form 8283 (Rev. November 2019) Department of the Treasury Internal Revenue Service	Noncash Charitable Contributions ▶ Attach one or more Forms 8283 to your tax return if you claimed a total deduction of over \$500 for all contributed property. ▶ Go to www.irs.gov/Form8283 for instructions and the latest information.	OMB No. 1545-0908 Attachment Sequence No. 155 Identifying number 111-33-2222
Name(s) shown on your income tax return Bill Cobb		

Note: Figure the amount of your contribution deduction before completing this form. See your tax return instructions.

Section A. Donated Property of \$5,000 or Less and Publicly Traded Securities—List in this section **only** an item (or groups of similar items) for which you claimed a deduction of \$5,000 or less. Also list publicly traded securities and certain other property even if the deduction is more than \$5,000 (see instructions).

Part I Information on Donated Property —If you need more space, attach a statement.		
1	(a) Name and address of the donee organization	(b) If donated property is a vehicle (see instructions), check the box. Also enter the vehicle identification number (unless Form 1098-C is attached).
A	Missouri Conservation Heritage Fund 330 Commerce Dr., Jefferson City, MO 65109	<input type="checkbox"/>
B		<input type="checkbox"/>
C		<input type="checkbox"/>
D		<input type="checkbox"/>
E		<input type="checkbox"/>

Conservation Easement for Wetlands

Note: If the amount you claimed as a deduction for an item is \$500 or less, you do not have to complete columns (e), (f), and (g).

A	(d) Date of the contribution	(e) Date acquired by donor (mo., yr.)	(f) How acquired by donor	(g) Donor's cost or adjusted basis	(h) Fair market value (see instructions)	(i) Method used to determine the fair market value
A	12/27/19	01/01/80	Purchase	374,000	1,053,450	Appraisal
B						
C						

2020 Workbook

For Example 8

SCHEDULE A
(Form 1040 or 1040-SR)
(Rev. January 2020)
Department of the Treasury
Internal Revenue Service (99)

Itemized Deductions

▶ Go to www.irs.gov/ScheduleA for instructions and the latest information.
▶ Attach to Form 1040 or 1040-SR.

OMB No. 1545-0074

2019

Attachment
Sequence No. **07**

Caution: If you are claiming a net qualified disaster loss on Form 4684, see the instructions for line 16.

Name(s) shown on Form 1040 or 1040-SR

Your social security number
111-33-2222

Medical and Dental Expenses	Caution: Do not include expenses reimbursed or paid by others. 1 Medical and dental expenses (see instructions) 2 Enter amount from Form 1040 or 1040-SR, line 8b 2 3 Multiply line 2 by 7.5% (0.075) 4 Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-		
Taxes You Paid	5 State and local taxes. a State and local income taxes or general sales taxes. You may include either income taxes or general sales taxes on line 5a, but not both. If you elect to include general sales taxes instead of income taxes, check this box <input type="checkbox"/> ▶ b State and local real estate taxes (see instructions) c State and local personal property taxes d Add lines 5a through 5c e Enter the smaller of line 5d or \$10,000 (\$5,000 if married filing separately) 6 Other taxes. List type and amount ▶ <hr/> 7 Add lines 5e and 6	5a 8,057 5b 1,342 5c 5d 9,399 5e 9,399 6 7 9,399	
Interest You Paid	8 Home mortgage interest and points. If you didn't use all of your home mortgage loan(s) to buy, build, or improve your home, see instructions and check this box <input type="checkbox"/> ▶ a Home mortgage interest and points reported to you on Form 1098. See instructions if limited b Home mortgage interest not reported to you on Form 1098. See instructions if limited. If paid to the person from whom you bought the home, see instructions and show that person's name, identifying no., and address <hr/> c Points not reported to you on Form 1098. See instructions for special rules d Mortgage insurance premiums (see instructions) e Add lines 8a through 8d 9 Investment interest. Attach Form 4952 if required. See instructions 10 Add lines 8e and 9	8a 8b 8c 8d 8e 9 10	
Gifts to Charity	11 Gifts by cash or check. If you made any gift of \$250 or more, see instructions 12 Other than by cash or check. If you made any gift of \$250 or more, see instructions. You must attach Form 8283 if over \$500. 13 Carryover from prior year 14 Add lines 11 through 13	11 2,124 12 133,191 13 14 135,315	
Casualty and Theft Losses	15 Casualty and theft loss(es) from a federally declared disaster (other than net qualified disaster losses). Attach Form 4684 and enter the amount from line 18 of that form. See instructions	15	
Other Itemized Deductions	16 Other—from list in instructions. List type and amount ▶ <hr/>	16	
Total Itemized Deductions	17 Add the amounts in the far right column for lines 4 through 16. Also, enter this amount on Form 1040 or 1040-SR, line 9	17 144,714	
	18 If you elect to itemize deductions even though they are less than your standard deduction, check this box <input type="checkbox"/> ▶		

For Paperwork Reduction Act Notice, see the Instructions for Forms 1040 and 1040-SR. Cat. No. 17145C Schedule A (Form 1040 or 1040-SR) 2019

For Example 8

	1 Wages, salaries, tips, etc. Attach Form(s) W-2				1	
	2a Tax-exempt interest	2a		b Taxable interest. Attach Sch. B if required	2b	117
	3a Qualified dividends	3a		b Ordinary dividends. Attach Sch. B if required	3b	
	4a IRA distributions	4a	52,887	b Taxable amount	4b	52,887
	c Pensions and annuities	4c	19,372	d Taxable amount	4d	19,372
	5a Social security benefits	5a	49,668	b Taxable amount	5b	42,218
	6 Capital gain or (loss). Attach Schedule D if required. If not required, check here <input type="checkbox"/>				6	18,515
	7a Other income from Schedule 1, line 9				7a	2,206
	b Add lines 1, 2b, 3b, 4b, 4d, 5b, 6, and 7a. This is your total income ▶				7b	135,315
	8a Adjustments to income from Schedule 1, line 22				8a	0
	b Subtract line 8a from line 7b. This is your adjusted gross income ▶				8b	135,315
	9 Standard deduction or itemized deductions (from Schedule A)	9	144,714			
	10 Qualified business income deduction. Attach Form 8995 or Form 8995-A	10				
	11a Add lines 9 and 10				11a	144,714
	b Taxable income. Subtract line 11a from line 8b. If zero or less, enter -0-				11b	0

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions.
Cat. No. 11320B
Form **1040** (2019)

LEGAL SETTLEMENTS

Note. In most instances, taxable settlement proceeds not connected with a trade or business are reported on Schedule 1, line 8. The reporting of reductions or adjustments to the settlement amount is discussed later.

A legal settlement agreement should be reviewed to determine the **origin or the nature of the claim** and for an allocation of settlement payments for the following purposes.

- Settlements for physical sickness or injury are not taxable under IRC §104(a)(2).
- Settlements for emotional distress are taxable under §104(a)(6) unless attributable to a physical injury or physical sickness under Treas. Reg. §1.104-1(c)(1).
- Settlements involving lost wages/profits are taxable.
- Settlements for damaged/destroyed property are not taxed unless the award exceeds the taxpayer’s basis in the property.
- Settlements involving punitive damages are usually taxable.
- Attorney fees are usually, but not always, deductible.
 - ♦ For nondisclosure agreements, attorney fees are not deductible.
 - ♦ For discrimination claims, compensation is not taxable and attorney fees are deductible.
 - ♦ For whistleblowing claims, compensation is not taxable and attorney fees are deductible.

Note. In 2005, the U.S. Supreme Court held that plaintiffs must generally recognize gross income equal to 100% of a settlement.⁶⁹ Netting the settlement against the attorney’s fees is not permitted except in specific types of lawsuits, as discussed later. For the tax year at issue, the attorney fees could have been taken as miscellaneous itemized deductions; however, doing so would have been of no help to the taxpayers in the case because of the alternative minimum tax (AMT) provisions.

⁶⁹ *Comm’r v. Banks*, 543 U.S. 426 (2005).

2020 Workbook

Example 9. Fred Silversmith acted on the advice of Lacka Knowledge, a tax professional. The advice turned out to be erroneous. After filing a lawsuit against Lacka for the bad advice, Fred was awarded \$100,000. He received \$60,000 after attorney fees. The full \$100,000 settlement is includable in Fred's gross income.

Origin/Nature of the Claim

The origin or nature of the claim is the reason for which compensation is sought. Why did the taxpayer go to court as stated in the taxpayer's complaint?

If the origin of the claim or the allocation of the settlement amount is not clearly specified, look to the payor's intent.⁷⁰

*Ultimately, the character of the payment hinges on the payor's dominant reason for making the payment. The evidence considered by the court may include the amount paid, the evidence adduced at trial, the underlying judgment, the factual circumstances that led to the agreement, and any other facts that may reveal the payor's intent.*⁷¹

A settlement payment may consist of multiple elements that have been allocated by the parties involved (e.g., allocations for back pay, emotional distress, and attorneys' fees). Generally, the IRS will not challenge an allocation if it is consistent with the substance of the settled claims.⁷²

Caution. The origin of the claim is critical for determining whether attorney fees and court costs may be deducted from gross income. Problems can arise when multiple claims are filed, and attorneys are unlikely to segregate time and costs by claim. In addition, "global settlements" are meant to resolve all issues, and negotiations may focus on the total amount to be paid.

As noted above, the IRS usually does not challenge an allocation that appears to be reasonable. Thus, the practitioner should request written documentation from the plaintiff's attorney to substantiate the deduction of some or all of the award from the plaintiff's gross income.

Physical Sickness or Injury

Damages for **physical** sickness or injury are usually excluded from gross income.⁷³

Workers Compensation. Amounts received from workers compensation programs are usually excluded from gross income.⁷⁴

Reimbursement of Previously Deducted Medical Expenses. If the taxpayer already deducted medical expenses under §213, then any reimbursement of those previously deducted expenses is taxable income to the extent the deductions provided a tax benefit.⁷⁵ This should be reported on Schedule 1, line 8.⁷⁶

Note. For information about how to determine whether the recovery of previously deducted expenses provided a tax benefit, see IRS Pub. 525, *Taxable and Nontaxable Income*.

⁷⁰ "The most important fact in making that determination [that payments for other than the taxpayer's personal injuries], in the absence of an express personal injury settlement agreement, is the intent of the payor as to the purpose in making the payment." *Knuckles v. Comm'r*, 349 F.2d 610, 613 (10th Cir. 1965).

⁷¹ *Green v. Comm'r*, 507 F.3d 857, 868 (5th Cir. 2007).

⁷² IRS Pub. 4345, *Settlements — Taxability*.

⁷³ IRC §104(a)(2) and Treas. Reg. §1.104-1(c).

⁷⁴ IRC §104(a)(1) and Treas. Reg. §1.104-1(b).

⁷⁵ IRC §104(a).

⁷⁶ IRS Pub. 525, *Taxable and Nontaxable Income*.

Emotional Distress

Amounts received for emotional distress are usually included in taxable income unless the emotional distress is attributable to physical sickness or injury.⁷⁷ The taxable amount is reported on line 8 of Schedule 1.⁷⁸

Lost Wages or Profits

Amounts received for **lost wages** are usually included in taxable income and subject to withholding for income, Medicare, and the employee's portion of the Federal Insurance Contributions Act (FICA) taxes.⁷⁹ Such amounts are reported on line 1 of Form 1040.⁸⁰

Amounts received for **lost profits** are usually included as ordinary income⁸¹ and are subject to SE tax.⁸² These amounts are reported on line 8 of Schedule 1. The proceeds are also included on line 2 of Schedule SE, *Self-Employment Tax*, when calculating SE tax.⁸³

Damaged/Destroyed Property

An award for damaged or destroyed property is usually treated as a return of capital. Such awards reduce the taxpayer's basis in the property and are nontaxable. However, if the award exceeds the taxpayer's basis in the property, the excess is usually taxable as ordinary income.⁸⁴

Punitive Damages

Punitive damages are assessed in order to punish the defendant for outrageous conduct. They are included in gross income⁸⁵ unless the damages were awarded in a civil wrongful death action for which punitive damages were the only remedy under state law.⁸⁶ Punitive damages should be reported as other income on line 8 of Schedule 1.⁸⁷

Attorney Fees

Individuals could deduct attorneys' fees as miscellaneous itemized deductions subject to the 2% of AGI floor before the Tax Cuts and Jobs Act (TCJA) of 2017 suspended such deductions beginning January 1, 2018, through December 31, 2025.⁸⁸ The TCJA also disallowed any deduction for attorney fees pertaining to sexual harassment or abuse suits resulting in a **nondisclosure agreement**.⁸⁹

Example 10. Use the same facts as **Example 9**. If Fred received the settlement before 2018, the \$40,000 of attorneys' fees would have been deductible as a miscellaneous itemized deduction. However, the deductible amount would have been subject to AMT. If the settlement occurred after 2017 and before 2026, no miscellaneous itemized deduction for the attorney's fees is permitted.

⁷⁷ Treas. Reg. §1.104-1(c)(1).

⁷⁸ See IRS Pub. 4345, *Settlements — Taxability*.

⁷⁹ Rev. Rul. 96-65, 1996-2 CB 6 and TAM 200244004 (Nov. 1, 2002).

⁸⁰ See IRS Pub. 4345, *Settlements — Taxability*.

⁸¹ Rev. Rul. 75-527, 1975-2 CB 30.

⁸² IRS Pub. 4345, *Settlements — Taxability*.

⁸³ *Ibid.*

⁸⁴ Rev. Rul. 81-277, 1981-2 CB 14.

⁸⁵ IRC §104(a)(2).

⁸⁶ IRC §104(c).

⁸⁷ IRS Pub. 4345, *Settlements — Taxability*.

⁸⁸ IRC §67(g).

⁸⁹ IRC §162(q).

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Businesses can deduct attorney fees for ordinary and necessary matters involving the client's trade or business under §162.

Example 11. Use the same facts as **Example 9**. Lacka Knowledge had to pay \$100,000 to settle the lawsuit with Fred Silversmith. Lacka had no liability insurance to cover her bad advice, so the settlement was paid entirely out of her business income. The settlement is deductible as an ordinary and necessary business expense for Lacka.

Note. In *Comm'r v. Banks*,⁹⁰ the U.S. Supreme Court held that as a general rule the amount of an attorney's contingency fee is taxable to a successful plaintiff to the extent that the underlying award was includable in the plaintiff's gross income.

Discrimination and Whistleblowing Cases. For cases without contingent attorney fees, the prevailing party can deduct attorney fees under IRC §62(a)(20) for discrimination suits and under §62(a)(21) for attorney's fees associated with "whistleblower" cases.

Attorney fees and court costs for a claim of unlawful discrimination or for a claim under a whistleblower statute are deductible up to the amount of the judgment includable in the taxpayer's gross income.⁹¹ The amount of attorney fees for unlawful discrimination claims is reported on line 22 of Schedule 1 with "UDC" (unlawful discrimination claims) entered on the dotted line next to line 22. The amount of attorney fees for whistleblower claims is reported on line 22 of Schedule 1 with "WBF" (whistleblower fees) entered on the dotted line next to line 22.⁹²

Note. The effect is that taxpayers in these type of lawsuits are permitted to deduct the portion of the settlement that goes to the attorney and therefore only include in income the net result.

Example 12. Jacob Williams worked for ST Steel Inc. for many years. Jacob's managers had been pressuring him for several years to retire. Finally, for no apparent reason, Jacob was terminated in 2019. He filed a lawsuit for unlawful age discrimination and settled the lawsuit for \$250,000. His attorney received \$75,000 from the \$250,000 settlement. The \$250,000 is taxable income to Jacob, which is reported on Schedule 1 line 8, but he is permitted to deduct the attorney's fees on line 22 of Schedule 1 with "UDC" entered on the dotted line next to line 22. The result is that \$175,000 (\$250,000 – \$75,000 attorney's fees) is included in Jacob's AGI for 2019.

PRIZES AWARDED

Prizes and awards are generally included in gross income; scholarships usually are not.

Employee Recognition

An employee achievement award is not included in the employee's gross income as long as the amount of the award does not exceed the amount the employer may deduct for the cost of the award.⁹³ **Employee achievement award** is defined at IRC §274(j) as an item of tangible personal property that is:

- Transferred by an employer to an employee for an achievement related to length of service or safety,
- Awarded as part of a meaningful presentation, and
- Awarded under conditions and circumstances that do not create a significant likelihood of the payment of disguised compensation.

⁹⁰ *Comm'r v. Banks*, 543 U.S. 426 (2005).

⁹¹ IRC §62(a)(20) and (21).

⁹² Instructions for Form 1040 and 1040-SR.

⁹³ IRC §74(c).

The employer's deduction for such awards for each employee cannot exceed:

- \$400 per year if the award is not part of a qualified plan, or
- \$1,600 per year if the award is part of a qualified plan.⁹⁴

Scholarships

The amount of qualified scholarships received by a degree candidate at an educational organization qualifying under IRC §170(b)(1)(A)(ii) is generally excluded from gross income.⁹⁵ A **qualified scholarship** is defined as any amount received by an individual as a scholarship or fellowship grant to the extent that such amount was used for qualified tuition and related expenses not including room and board (e.g., fees, books, etc., as defined in IRC §117(b)(2)).⁹⁶

If an individual is allowed to study tuition-free or at a reduced rate of tuition, they may not have to pay tax on this benefit. This is called a tuition reduction. The individual does not have to include a qualified tuition reduction in their income. A tuition reduction is qualified only if the student receives it from, and uses it at, an eligible educational institution.⁹⁷

Note. For more information about tuition reductions and scholarships and how to report taxable scholarships, see IRS Pub. 970, *Tax Benefits for Education*, and the 2019 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 1: Individual Taxpayer Issues.

Other Prizes and Awards

As mentioned earlier, prizes and awards are usually included in gross income.⁹⁸ However, the value of any Olympic or Paralympic medal or prize money is exempt unless the taxpayer's AGI exceeds \$1 million.⁹⁹

In addition, gross income generally does not include amounts received as prizes and awards made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement. This exclusion from gross income only applies if the following conditions are satisfied.¹⁰⁰

- The recipient is selected without any action on their part to enter the contest.
- The recipient is not required to render substantial future services as a condition to receiving the prize or award.
- The prize or award is transferred by the payor to a governmental unit or organization described in §170(c) under a designation made by the recipient.

EXECUTOR FEES

Executor or personal representative (PR) fees are includable in gross income.¹⁰¹ An executor or PR is appointed by a court to administer an estate and is entitled to fees or commissions for the services provided. A trustee is appointed by the trust instrument or by a court.

If the taxpayer is not in the trade or business of being an executor, such fees are reported on Schedule 1, line 8. If the taxpayer is in the trade or business of being an executor, such fees are reported on Schedule C and represent SE income.¹⁰²

⁹⁴ IRC §74(j)(2).

⁹⁵ IRC §117.

⁹⁶ IRC §117(b).

⁹⁷ IRS Pub. 970, *Tax Benefits for Education*.

⁹⁸ IRC §74(a).

⁹⁹ IRC §74(d).

¹⁰⁰ IRC §74(b).

¹⁰¹ IRS Pub. 559, *Survivors, Executors, and Administrators*.

¹⁰² *Ibid.*

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HEALTH SAVINGS ACCOUNT INCOME

Distributions from a health savings account (HSA) are not taxable if:

1. Distributions are used for qualified medical expenses under §213, and
2. Any excess contributions are returned prior to the due date of the tax return.¹⁰³

Note. For detailed information about HSAs, see IRS Pub. 969, *Health Savings Accounts and Other Tax-Favored Health Plans*.

DEBT FORGIVENESS

For an individual, discharged debt is taxable **unless**:

1. The discharge occurs in a Title 11 bankruptcy,
2. The discharge occurs while the taxpayer is insolvent (and the amount of discharge is limited to the amount of insolvency¹⁰⁴),
3. The indebtedness discharged consists of qualified farm indebtedness,
4. The indebtedness discharged is qualified real property business debt for a taxpayer other than a C corporation, or
5. The indebtedness discharged is qualified principal residence debt that is either discharged or subject to a written agreement to discharge prior to January 1, 2021.¹⁰⁵



Practitioner Planning Tip

The receipt of either a Form 1099-C, *Cancellation of Debt*, or Form 1099-A, *Acquisition or Abandonment of Secured Property*, indicates that a taxpayer has debt forgiveness that needs to be addressed.

Note. For more information about the taxability of discharged debt, see **uofi.tax/20b7x1** [www.irs.gov/taxtopics/tc431] and the 2013 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 3: Financial Distress. The 2013 chapter can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

¹⁰³. IRC §223(f).

¹⁰⁴. IRC §108(a)(3).

¹⁰⁵. IRC §108(a)(1).

MEDICAID WAIVER PAYMENTS

Under a program described in §1915(c) of the Social Security Act, states enacted Medicaid waiver programs to encourage home and community-based services for patients who would otherwise require hospitalization or intermediate-level care. IRS Notice 2014-7 announced that payments received by caregivers for care provided in the caregiver's home under such waiver programs are excluded from gross income under IRC §131(c) as difficulty of care payments.¹⁰⁶ For purposes of the notice, qualified Medicaid waiver payments are payments by a state, a political subdivision of a state, or a certified Medicaid provider under a Medicaid waiver program to an individual care provider for nonmedical support services provided under a plan of care to an individual (whether related or unrelated) **living in the individual care provider's home.**¹⁰⁷

Note. A key factor for distinguishing whether Medicaid waiver payments are excludable from gross income is whether the caregiving services are provided in the **caregiver's residence**. Caregivers who travel to provide assistance, even if the patient is a relative, may not exclude the Medicaid waiver payments from gross income.¹⁰⁸

Although Medicaid waiver payments are excludable from gross income, these payments can be included in earned income for purposes of the earned income credit (EIC) or the additional child tax credit (ACTC).¹⁰⁹

Note. The Tax Court ruled that Medicaid waiver payments, even though excluded from income, may still be used in the calculation of earned income for purposes of refundable credits such as the EIC or the ACTC. The court reasoned that the IRS cannot remove a statutory benefit provided by Congress.¹¹⁰ The IRS has yet to update their frequently asked questions for this Tax Court result.¹¹¹

Example 13. Hunter Gather is an elderly widower. He lives with his son and daughter-in-law, Richard and Terri. Terri provides for Hunter's healthcare needs in their home because they do not want Hunter to have to live in a long-term care facility.

In 2019, Terri received \$33,000 from a certified Medicaid provider under a Medicaid Waiver Program for nonmedical support. This amount qualifies as a "difficulty of care" payment under §131.

Because Terri received a 1099-MISC, *Miscellaneous Income*, she must report the income on Schedule C. However, she is permitted a deduction under IRS Notice 2014-7.

¹⁰⁶ IRS Notice 2014-7, 2014-4 IRB 445.

¹⁰⁷ *Certain Medicaid Waiver Payments May Be Excludable from Income*. May 8, 2020. IRS. [www.irs.gov/individuals/certain-medicaid-waiver-payments-may-be-excludable-from-income] Accessed on Aug. 10, 2020.

¹⁰⁸ Ibid.

¹⁰⁹ *Certain Medicaid Waiver Payments May Be Excludable from Income*. Q&A 9. May 8, 2020. IRS. [irs.gov/individuals/certain-medicaid-waiver-payments-may-be-excludable-from-income] Accessed on Jun. 22, 2020.

¹¹⁰ *Mary and Edward Feigh v. Comm'r*, 152 TC No. 15 (2019).

¹¹¹ *Certain Medicaid Waiver Payments May Be Excludable from Income*. Q&A 9. May 8, 2020. IRS. [irs.gov/individuals/certain-medicaid-waiver-payments-may-be-excludable-from-income] Accessed on Jul. 29, 2020.

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For Example 13

CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no. All Care Home Health, Inc. 10127 Manchester Rd, Ste 206 St. Louis, MO 63122		1 Rents \$	OMB No. 1545-0115 2019 Form 1099-MISC	Miscellaneous Income
		2 Royalties \$	3 Other income \$	
PAYER'S TIN xx-xxxxxxx		RECIPIENT'S TIN xxx-xx-1234	4 Federal income tax withheld \$	Copy B For Recipient
		5 Fishing boat proceeds \$	6 Medical and health care payments \$	
RECIPIENT'S name Terri Gather Street address (including apt. no.) 810 Main Lane City or town, state or province, country, and ZIP or foreign postal code St. Louis, MO 63136		7 Nonemployee compensation \$ 33,000.00	8 Substitute payments in lieu of dividends or interest \$	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.
		9 Payer made direct sales of \$5,000 or more of consumer products to a buyer (recipient) for resale <input type="checkbox"/>	10 Crop insurance proceeds \$	
Account number (see instructions)		FATCA filing requirement <input type="checkbox"/>	11	
		13 Excess golden parachute payments \$	14 Gross proceeds paid to an attorney \$	
15a Section 409A deferrals \$	15b Section 409A income \$	16 State tax withheld \$	17 State/Payer's state no.	18 State income \$

Form **1099-MISC** (keep for your records) www.irs.gov/Form1099MISC Department of the Treasury - Internal Revenue Service

Note. If Terri received the Medicaid waiver payments in 2020 instead of 2019, they would be reported on Form 1099-NEC, *Nonemployee Compensation*. Beginning with tax year 2020, nonemployee compensation is reported on Form 1099-NEC, rather than in box 7 of Form 1099-MISC.¹¹²

¹¹² Instructions for Forms 1099-MISC and 1099-NEC.

2020 Workbook

For Example 13

SCHEDULE C (Form 1040 or 1040-SR)

Department of the Treasury
Internal Revenue Service (99)

Profit or Loss From Business (Sole Proprietorship)

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

Attach to Form 1040, 1040-SR, 1040-NR, or 1041; partnerships generally must file Form 1065.

OMB No. 1545-0074

2019
Attachment
Sequence No. **09**

2

Name of proprietor Terri Gather		Social security number (SSN) xxx-xx-1234
A Principal business or profession, including product or service (see instructions) Home Health Care Services		B Enter code from instructions 621610
C Business name. If no separate business name, leave blank.		D Employer ID number (EIN) (see instr.)
E Business address (including suite or room no.) 810 Main Lane City, town or post office, state, and ZIP code St. Louis, MO 63136		
F Accounting method: (1) <input checked="" type="checkbox"/> Cash (2) <input type="checkbox"/> Accrual (3) <input type="checkbox"/> Other (specify) _____		
G Did you "materially participate" in the operation of this business during 2019? If "No," see instructions for limit on losses		<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
H If you started or acquired this business during 2019, check here		<input type="checkbox"/>
I Did you make any payments in 2019 that would require you to file Form(s) 1099? (see instructions)		<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
J If "Yes," did you or will you file required Forms 1099?		<input type="checkbox"/> Yes <input type="checkbox"/> No

Part I Income

1	Gross receipts or sales. See instructions for line 1 and check the box if this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked	1	33,000
2	Returns and allowances	2	
3	Subtract line 2 from line 1	3	33,000
4	Cost of goods sold (from line 42)	4	
5	Gross profit. Subtract line 4 from line 3	5	33,000
6	Other income, including federal and state gasoline or fuel tax credit or refund (see instructions)	6	
7	Gross income. Add lines 5 and 6	7	33,000

Part II Expenses. Enter expenses for business use of your home only on line 30.

8	Advertising	8		18	Office expense (see instructions)	18	
9	Car and truck expenses (see instructions)	9		19	Pension and profit-sharing plans	19	
10	Commissions and fees	10		20	Rent or lease (see instructions):		
11	Contract labor (see instructions)	11		20a	a Vehicles, machinery, and equipment	20a	
12	Depreciation	12		20b	b Other business property	20b	
13	Depreciation and section 179 expense deduction (not included in Part III) (see instructions)	13		21	Repairs and maintenance	21	
14	Employee benefit programs (other than on line 19)	14		22	Supplies (not included in Part III)	22	
15	Insurance (other than health)	15		23	Taxes and licenses	23	
16	Interest (see instructions):			24	Travel and meals:		
a	Mortgage (paid to banks, etc.)	16a		24a	a Travel	24a	
b	Other	16b		24b	b Deductible meals (see instructions)	24b	
17	Legal and professional services	17		25	Utilities	25	
				26	Wages (less employment credits)	26	
				27a	Other expenses (from line 48)	27a	33,000
				27b	b Reserved for future use	27b	
28	Total expenses before expenses for business use of home. Add lines 8 through 27a	28	33,000				
29	Tentative profit or (loss). Subtract line 28 from line 7	29	0				

30 Expenses for business use of your home. Do not report these expenses elsewhere. Attach Form 8829 unless using the simplified method (see instructions).
Simplified method filers only: enter the total square footage of: (a) your home: _____ and (b) the part of your home used for business: _____. Use the Simplified Method Worksheet in the instructions to figure the amount to enter on line 30

31 **Net profit or (loss).** Subtract line 30 from line 29.

- If a profit, enter on both **Schedule 1 (Form 1040 or 1040-SR), line 3** (or **Form 1040-NR, line 13**) and on **Schedule SE, line 2**. (If you checked the box on line 1, see instructions). Estates and trusts, enter on **Form 1041, line 3**.
- If a loss, you **must** go to line 32.

32 If you have a loss, check the box that describes your investment in this activity (see instructions).

- If you checked 32a, enter the loss on both **Schedule 1 (Form 1040 or 1040-SR), line 3** (or **Form 1040-NR, line 13**) and on **Schedule SE, line 2**. (If you checked the box on line 1, see the line 31 instructions). Estates and trusts, enter on **Form 1041, line 3**.
- If you checked 32b, you **must** attach **Form 6198**. Your loss may be limited.

31 **0**

32a All investment is at risk.
 32b Some investment is not at risk.

For Paperwork Reduction Act Notice, see the separate instructions.

Cat. No. 11334P

Schedule C (Form 1040 or 1040-SR) 2019

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For Example 13

b If "Yes," is the evidence written? Yes No

Part V Other Expenses. List below business expenses not included on lines 8–26 or line 30.	
Nontaxable Medicaid waiver payments received pursuant to Notice 2014-7	33,000
48 Total other expenses. Enter here and on line 27a	48 33,000

Schedule C (Form 1040 or 1040-SR) 2019

If Terri had received a Form W-2 for \$33,000 (instead of a Form 1099-MISC), she would deduct the \$33,000 on line 8 of Schedule 1 of Form 1040.

Note. In-depth questions and answers on Medicaid waivers can be found at [uofi.tax/20b7x2 \[www.irs.gov/individuals/certain-medicaid-waiver-payments-may-be-excludable-from-income\]](https://www.irs.gov/individuals/certain-medicaid-waiver-payments-may-be-excludable-from-income).

ALIMONY

The TCJA made changes to the rules for alimony payments.¹¹³ Divorce or separation agreements executed **prior to January 1, 2019**, follow the pre-TCJA rules whereby alimony is deductible by the paying spouse and taxable to the receiving spouse.¹¹⁴

Divorce or separation agreements executed **after December 31, 2018**, follow the TCJA rules whereby alimony is **not deductible** by the paying spouse and is **not taxable** to the receiving spouse. Parties may modify their older agreements. However, provisions from the older agreements are grandfathered by the TCJA, unless the modification made after December 31, 2018, expressly agrees to follow the new law.¹¹⁵

IRC §121(d)(3)(C), which was added by the TCJA, defines a **divorce or separation instrument** as:

- i. *A decree of divorce or separate maintenance or a written instrument incident to such a decree,*
- ii. *A written separation agreement, or*
- iii. *A decree (not described in clause (i)) requiring a spouse to make payments for the support or maintenance of the other spouse.*

Note. An older divorce or separation agreement, as well as an older prenuptial or post-marital agreement, may not comport with the definition of “divorce or separation agreement” in §121(d)(3)(C).

¹¹³. TCJA, §11051.
¹¹⁴. TCJA, §11051(c).
¹¹⁵. TCJA, §11051(c)(2).

Once the practitioner has identified receipts that are includable in income for the tax year, the next step is to identify any deductions or adjustments (e.g., exclusions, offsets) applicable to the benefit to then arrive at the taxable income amount.

ITEMIZED DEDUCTIONS

Itemized deductions are allowed under §212, which applies to non-trade or business activity and allows for a deduction of all ordinary and necessary expenses paid or incurred during the tax year:

1. For the production or collection of income;
2. For the management, conservation, or maintenance of property held for the production of income; or
3. In connection with the determination, collection, or refund of any tax.¹¹⁶

Because these expenses are not associated with the taxpayer's trade or business, they are usually deducted on Schedule A.

TCJA Suspension of Miscellaneous Itemized Deductions

Prior to the TCJA, a taxpayer could aggregate and take miscellaneous itemized deductions, subject to a floor of 2% of AGI. However, the TCJA suspended miscellaneous itemized deductions from January 1, 2018, through December 31, 2025, for the following expenses.¹¹⁷

- Unreimbursed employee expenses
- Expenses for the determination of any tax for which a deduction is allowable under §212(3), such as tax counsel and appraisal fees
- Expenses for the production and collection of income deductible under §§212(1) and (2), such as investment advisory fees, safe deposit boxes, and certain attorneys' fees
- Expenses associated with an activity not engaged in for profit deductible under IRC §183

The TCJA did not suspend or amend §212. Through the 2025 tax year, though, adjustments to taxable income must be authorized by other Code sections. For example,

Section 62(a)(2)(A), however, allows an employee to deduct business expenses the employee pays or incurs in performing services as an employee under a reimbursement or other expense allowance arrangement with a payor. ...The expenses paid or incurred by the taxpayer that are deductible under § 62(a)(1) or (a)(2) in computing adjusted gross income are not miscellaneous itemized deductions as described in § 67.¹¹⁸

ACTIVITIES NOT ENGAGED IN FOR PROFIT

Under IRC §183, gross income from a not-for-profit (hobby) activity includes the total of all gains from the sale, exchange, or other disposition of property, and all other gross receipts derived from the activity. Gross income from a not-for-profit activity can be determined by subtracting the cost of goods sold (COGS) from the gross receipts as long as this is done in a consistent manner and using generally accepted methods of accounting.¹¹⁹

¹¹⁶ IRC §212.

¹¹⁷ The TCJA, PL 115-97, added IRC §67(g); Temp. Treas. Reg. §1.67-1T(a)(1).

¹¹⁸ Rev. Proc. 2019-46, 2019-49 IRB 1301.

¹¹⁹ IRS Pub. 535, *Business Expenses*.

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Income from a not-for-profit activity is entered on Schedule 1, line 8. Deductions for such activities cannot exceed the income reported for the activity and can be taken only if the taxpayer itemizes deductions on Schedule A.¹²⁰

Note. For a detailed explanation of hobby activities, see the *2020 University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Small Business Issues.

GAMBLING INCOME/LOSS

Gambling winnings of more than \$5,000 from the following sources are subject to income tax withholding at a flat 24% rate.¹²¹

- Sweepstakes, wagering pools (including payments made to winners of poker tournaments), and lotteries
- Any other wager if the payoff is at least 300 times the amount of the bet

Gambling winnings from bingo, keno, and slot machines are generally **not** subject to income tax withholding.¹²²

If a payor withholds income tax from gambling winnings, they should report the amounts won and the amount withheld on Form W-2G, *Certain Gambling Winnings*.¹²³ The taxpayer then reports the tax withheld on their tax return.

Casual Gamblers

A gambler should keep an accurate diary or other record of their losses and winnings. The diary should contain the following information.¹²⁴

- Date and type of specific wager or wagering activity
- Name and address of gambling establishment
- Names of other persons (if any) present with taxpayer at gambling establishment
- Amount(s) won or lost

Note. This type of recordkeeping is burdensome for people playing slot machines. Thus, IRS Notice 2015-21 proposed a safe harbor taxpayers can use to track their winnings and losses by sessions.¹²⁵ In addition, Treas. Reg. §1.6041-10 contains reporting requirements by payors to complement the reporting requirements for taxpayers.

IRS Pub. 529, *Miscellaneous Deductions*, provides suggestions to help the taxpayer establish their winnings and losses for various types of gambling transactions.

Casual gamblers must report the full amount of their gambling winnings for the year on Schedule 1. They can deduct their **gambling losses** for the year on Schedule A as miscellaneous itemized deductions not subject to the 2% of AGI limitation. Gambling losses include the actual cost of wagers plus expenses incurred in connection with the conduct of the gambling activity (e.g., travel to and from a casino). The taxpayer cannot deduct gambling losses that are more than their winnings.¹²⁶

Caution. Gambling winnings and losses should not be netted. If a casual gambler does not itemize deductions, they cannot claim gambling losses.

¹²⁰ IRS Pub. 525, *Taxable and Nontaxable Income*.

¹²¹ IRS Pub. 505, *Tax Withholding and Estimated Tax*.

¹²² *Ibid.*

¹²³ *Ibid.*

¹²⁴ IRS Pub. 529, *Miscellaneous Deductions*.

¹²⁵ IRS Notice 2015-21, 2015-12 IRB 765.

¹²⁶ IRS Pub. 529, *Miscellaneous Deductions*; Instructions for Schedule A.

Professional Gamblers

Initially, professional gamblers (i.e., those for whom gambling constitutes a trade or business) netted their losses and business expenses against their winnings on Schedule C.¹²⁷ IRC §165(d) provides that losses from wagering transactions are allowed only to the extent of the gains from such transactions.

In 1987, the U.S. Supreme Court held in *Comm'r v. Groetzinger* that wagering losses under §165 are distinct from business expenses under §162.¹²⁸ An Office of Chief Counsel Memorandum in 2008 concluded that:

*The limitation in §165(d) applies only to wagering losses, not to expenses incurred to engage in the business of gambling. Those business expenses are subject to the ordinary rules governing deductibility under §162(a).*¹²⁹

The court in *Mayo v. Comm'r*¹³⁰ held that gambling expenses other than wagering losses were not subject to the restriction that limited wagering losses to the amount of wagering gains. Consequently, gambling expenses other than wagering losses were deductible if the taxpayer was a professional gambler.

However, the TCJA amended §165(d). For tax years beginning after December 31, 2017, and before January 1, 2026, “the term ‘losses from wagering transactions’ includes any deduction otherwise allowable under this chapter incurred in carrying on any wagering transaction.”¹³¹ This means that the loss limitation applies not only to the actual costs of wagers incurred by an individual but also to other expenses incurred in connection with the conduct of that individual’s gambling activity. For example, an individual’s otherwise deductible expenses in traveling to and from a casino are subject to this limitation.

ILLEGAL ACTIVITIES

Gross income includes income from “whatever source derived,” which includes illegal activities.¹³² Marijuana is an example of an activity that:

- Is illegal at the federal level but legal in some states;
- Can encompass production as well as retail, which affects how COGS is calculated; and
- May be conducted in conjunction with legal activities.

Presently, marijuana is a Schedule I controlled substance at the federal level even though some states allow for medicinal and/or recreational marijuana sales.¹³³ IRC §280E prohibits trades or businesses engaged in illegal activities from taking any deductions or credits.

Cost of Goods Sold

COGS is not a deduction or a credit; rather it is subtracted from the amount of gross sales in order to calculate gross income for an activity.¹³⁴ COGS may not include amounts disallowed as a deduction under IRC §§162(c), (f), or (g) (i.e., illegal bribes, kickbacks, fines, penalties, or treble damage payments under antitrust laws) or amounts not ordinarily used to compute COGS.¹³⁵

¹²⁷ *Offutt v. Comm'r*, 16 TC 1214 (1951).

¹²⁸ *Comm'r v. Groetzinger*, 480 U.S. 23 (1987).

¹²⁹ Chief Counsel Memorandum AM2008-013 (Dec. 10, 2008).

¹³⁰ *Mayo v. Comm'r*, 136 TC 81 (2011).

¹³¹ IRC §165(d).

¹³² IRC §61.

¹³³ *Drug Scheduling*. DEA. [www.dea.gov/drug-scheduling] Accessed on Jun. 24, 2020.

¹³⁴ Treas. Reg. §1.61-3(a).

¹³⁵ *Ibid.*

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In general, COGS may be computed based on IRC §§471 or 263A. Under IRC §471, COGS is determined as follows.

- COGS for **resellers** is the cost of the inventory plus transportation and other direct acquisition costs.¹³⁶
- COGS for **producers** includes direct costs (e.g., raw materials, direct labor) and indirect costs of production (and allocation of management expenses).¹³⁷

The business then recovers its inventory costs as the inventory is sold.¹³⁸

The uniform capitalization (UNICAP) rules under §263A require the capitalization of direct costs and an allocable share of certain indirect costs incurred to the extent they are properly allocable to real or tangible personal property produced by the taxpayer or real or personal property acquired for resale to customers.¹³⁹

Direct costs that must be capitalized under §263A include direct material costs, direct labor costs, and acquisition costs.¹⁴⁰ **Indirect costs** include all costs other than direct costs of property purchased for resale. Indirect costs may be allocable to both production and resale activities, as well as other activities not subject to §263A.¹⁴¹

Note. For more information about the capitalization of costs under §263A, see the 2019 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 3: Small Business Issues.

Marijuana businesses have litigated to be able to use the broader definition of inventory costs available under IRC §§263 or 263A. This litigation is summarized below.

1. In *Californians Helping to Alleviate Med. Problems, Inc. v. Comm’r* (CHAMP), the Tax Court found that CHAMP was not engaged in a single business activity.¹⁴² The business expenses associated with CHAMP’s legal activities of providing counseling and caregiving services were deductible. Only CHAMP’s deductions associated with its provision of medical marijuana — even when provided on the basis of a physician’s recommendation and legal under state law — were disallowed under §280E.
2. In *Olive v. Comm’r*, the Tax Court found that marijuana sales were the sole source of revenue for the dispensary and therefore declined to recognize free community outreach as a second trade or business.¹⁴³
3. In *Canna Care, Inc. v. Comm’r*, the parties stipulated that Canna Care was in the business of distributing medical marijuana.¹⁴⁴ Thus, the Tax Court relied on the stipulation and found “that the sale of medical marijuana was petitioner’s primary source of income and that the sale of any other item was an activity incident to its business of distributing medical marijuana.”
4. In *Harborside Health Center v. Comm’r*, the medical marijuana dispensary in California derived only 0.5% of its revenue from products that did not contain marijuana, took §162 deductions for all of its business expenses, and adjusted its COGS under the §263A rules for producers.¹⁴⁵ The Tax Court held that Harborside was engaged in a single business activity and did not have an ownership interest in the marijuana plants it chose to buy. Thus, Harborside was a reseller and had to follow the rules under §471 for its COGS.

¹³⁶ Treas. Reg. §1.471-3(b).

¹³⁷ Treas. Regs. §§ 1.471-3(c) and 1.471-11.

¹³⁸ See Treas. Reg. §§1.471-3(a), (b), and (c) for inventory on hand at the start of the tax year, purchased during the tax year, and produced during the tax year, respectively.

¹³⁹ IRC §263A(b).

¹⁴⁰ Treas. Reg. §1.263A-1(e)(2).

¹⁴¹ Treas. Reg. §1.263A-1(e)(3)(i).

¹⁴² *Californians Helping to Alleviate Med. Problems, Inc. v. Comm’r*, 128 TC 173 (2007).

¹⁴³ *Olive v. Comm’r*, 139 TC 19, 39 (2012), *aff’d* 792 F.3d 1146 (9th Cir. 2015).

¹⁴⁴ *Canna Care, Inc. v. Comm’r*, TC Memo 2015-206 (Oct. 22, 2015), *aff’d* 694 F. Appx 570 (9th Cir. 2017).

¹⁴⁵ *Harborside Health Center v. Comm’r*, 151 TC No. 11 (2018).

In summary, illegal activities are denied §162 deductions pursuant to §280E, and COGS is calculated under the provisions of §471.

Note. For more information about the issues relevant to the sale of marijuana, see the 2019 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 3: Small Business Issues.

EDUCATION DEDUCTION

An eligible taxpayer may **either** take a deduction or a credit for qualified tuition and fees.

Form 1098-T

The taxpayer should receive a Form 1098-T, *Tuition Statement*, for qualified tuition and fees paid to eligible educational institutions.¹⁴⁶

- Box 1 of Form 1098-T shows payments received for qualified tuition and related expenses.
- Other boxes on the Form 1098-T show adjustments, scholarships and grants,¹⁴⁷ and the student's status (i.e., graduate student or at least half-time student).

Tuition and Fees Deduction

A taxpayer is eligible to take a deduction for tuition and fees if the taxpayer meets the following requirements.¹⁴⁸

1. The taxpayer pays qualified education expenses of higher education.
2. The taxpayer pays the education expenses for an eligible student (i.e., a student who is enrolled in at least one course at an eligible educational institution).
3. The eligible student is the taxpayer, the taxpayer's spouse, or a dependent the taxpayer can claim on their tax return.

Qualified education expenses are tuition and certain related expenses required for enrollment or attendance at an eligible educational institution. An **eligible educational institution** is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the U.S. Department of Education.¹⁴⁹

The tuition and fees deduction is set to expire on December 31, 2020.¹⁵⁰

Amount and Limits of Deduction. An eligible taxpayer may deduct up to \$4,000 of qualified tuition and fees on Form 8917, *Tuition and Fees Deduction*.

The dollar limit on the tuition and fees deduction is:

- \$4,000 for a single taxpayer with an AGI less than or equal to \$65,000 (\$130,000 for married filing jointly (MFJ) taxpayers);
- \$2,000 for a single taxpayer with an AGI greater than \$65,000 but less than or equal to \$80,000 (greater than \$130,000 and less than or equal to \$160,000 for MFJ); and
- \$0 for a single taxpayer with an AGI greater than \$80,000 (greater than \$160,000 for MFJ).¹⁵¹

Note. Expenses used for this deduction cannot be used again to qualify for an education credit. For a detailed explanation of education credits, see the 2019 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 1: Individual Taxpayer Issues and IRS Pub. 970, *Tax Benefits for Education*.

¹⁴⁶ *What is an Eligible Education Institution?* Mar. 4, 2020. IRS. [www.irs.gov/credits-deductions/individuals/earned-income-tax-credit/eligible-educational-inst] Accessed on Jun. 25, 2020. Contains links to the U.S. Department of Education's database of accredited post-secondary institutions and programs and the federal student loan program list.

¹⁴⁷ See IRC §117 for qualified scholarships and for qualified tuition reductions, neither of which is included in gross income.

¹⁴⁸ IRS Pub. 970, *Tax Benefits for Education*.

¹⁴⁹ *Ibid.*

¹⁵⁰ IRC §222(e).

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REPAYMENT OF UNEMPLOYMENT BENEFITS

Taxpayers may be eligible to receive state unemployment benefits as well as supplemental unemployment benefits (SUB) if the employer offers such a plan.

SUBs are tax benefits paid out to terminated employees due to a plant closing, layoff, or reduction in workforce. Supplemental unemployment compensation is taxable as wages, subject to withholding, and reported on line 1 of Form 1040. However, these benefits are supplemental income to state unemployment benefits, are exempt from payroll taxes (FICA, FUTA, SUTA), and are offered in lieu of traditional severance pay.¹⁵²

Note. Laid-off employees are required to file a claim with the unemployment insurance office in the state where they worked. Many states have other specific requirements, including requirements relating to eligibility and frequency of payments under a SUB plan. In most states, SUB amounts do not affect eligibility for, or the amount of, state unemployment benefits.

Repaid in Same Year Received

If the taxpayer repays any of the SUB or state unemployment benefits in the same year they are received, the total amount of benefits, which are included in line 1 on Form 1040 or line 7 on Schedule 1, should be reduced by the amount of the repayment.¹⁵³

Form	1040	Department of the Treasury—Internal Revenue Service (99)	2019	OMB No. 1545-0074	IRS Use Only—Do not write or staple in this space.
U.S. Individual Income Tax Return					
Filing Status <input type="checkbox"/> Single <input type="checkbox"/> Married filing jointly <input type="checkbox"/> Married filing separately (MFS) <input type="checkbox"/> Head of household (HOH) <input type="checkbox"/> Qualifying widow(er) (QW)					
Check only one box. If you checked the MFS box, enter the name of spouse. If you checked the HOH or QW box, enter the child's name if the qualifying person is a child but not your dependent. ▶					
Your first name and middle initial			Last name		Your social security number
If joint return, spouse's first name and middle initial			Last name		Spouse's social security number
Home address (number and street). If you have a P.O. box, see instructions.				Apt. no.	Presidential Election Campaign
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions).				Check here if you, or your spouse if filing jointly, want \$3 to go to this fund. Checking a box below will not change your tax or refund. <input type="checkbox"/> You <input type="checkbox"/> Spouse	
Foreign country name		Foreign province/state/county		Foreign postal code	
If more than four dependents, see instructions and ✓ here ▶ <input type="checkbox"/>					
Standard Deduction Someone can claim: <input type="checkbox"/> You as a dependent <input type="checkbox"/> Your spouse as a dependent					
<input type="checkbox"/> Spouse itemizes on a separate return or you were a dual-status alien					
Age/Blindness You: <input type="checkbox"/> Were born before January 2, 1955 <input type="checkbox"/> Are blind Spouse: <input type="checkbox"/> Was born before January 2, 1955 <input type="checkbox"/> Is blind					
Dependents (see instructions):					
(1) First name	Last name	(2) Social security number	(3) Relationship to you	(4) ✓ if qualifies for (see instructions):	
				Child tax credit	Credit for other dependents
				<input type="checkbox"/>	<input type="checkbox"/>
				<input type="checkbox"/>	<input type="checkbox"/>
				<input type="checkbox"/>	<input type="checkbox"/>
				<input type="checkbox"/>	<input type="checkbox"/>
1 Wages, salaries, tips, etc. Attach Form(s) W-2					
2a Tax-exempt interest		2a		b Taxable interest. Attach Sch. B if required	
2a		3a		b Ordinary dividends. Attach Sch. B if required	
2a		3a		b	

¹⁵¹. IRC §222(b)(2)(B).

¹⁵². IRS Pub. 15-A, *Employer's Supplemental Tax Guide*; IRC §3402(o); and IRS Pub. 525, *Taxable and Nontaxable Income*.

¹⁵³. IRS Pub. 525, *Taxable and Nontaxable Income*.

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SCHEDULE 1
(Form 1040 or 1040-SR)

Department of the Treasury
Internal Revenue Service

Additional Income and Adjustments to Income

▶ Attach to Form 1040 or 1040-SR.
▶ Go to www.irs.gov/Form1040 for instructions and the latest information.

OMB No. 1545-0074

2019
Attachment
Sequence No. **01**

Name(s) shown on Form 1040 or 1040-SR

Your social security number

At any time during 2019, did you receive, sell, send, exchange, or otherwise acquire any financial interest in any virtual currency? Yes No

Part I Additional Income		
1	Taxable refunds, credits, or offsets of state and local income taxes	1
2a	Alimony received	2a
b	Date of original divorce or separation agreement (see instructions) ▶	
3	Business income or (loss). Attach Schedule C	3
4	Other gains or (losses). Attach Form 4797	4
5	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	5
6	Farm income or (loss). Attach Schedule F	6
7	Unemployment compensation	7
8	Other income. List type and amount ▶	8
9	Combine lines 1 through 8. Enter here and on Form 1040 or 1040-SR, line 7a	9

Part II Adjustments to Income

Repaid in Subsequent Years

If any of the supplemental unemployment benefits are repaid in later years, the repayment amount is deducted as an adjustment to gross income by including it on line 22 of Schedule 1. “Sub-Pay TRA” should be noted on the dotted line next to line 22 (“TRA” refers to the Trade Act of 1974).¹⁵⁴

If the amount of repayment in a subsequent year exceeds \$3,000, the taxpayer should use whichever of the following methods results in the lower tax liability.¹⁵⁵

- Method 1.** Report the repayment amount as an itemized deduction on line 16 (other itemized deductions) of Schedule A if the taxpayer included the income under a claim of right. This means that at the time the taxpayer reported the income, it appeared that the taxpayer had an unrestricted right to it.¹⁵⁶
- Method 2.** Calculate the tax for the year of repayment and claim a credit for the repaid amount by following these steps.
 - a.** Calculate the tax for the year of repayment without deducting the repaid amount.
 - b.** Recalculate the tax from the earlier year without including the amount repaid in income.
 - c.** Subtract the tax in (b) from the tax shown on the return for the earlier year. This is the credit, which is reported on line 13 of Schedule 3, *Additional Credits and Payments*.
 - d.** Subtract the amount in (c) from the amount in (a).

¹⁵⁴. Ibid.

¹⁵⁵. Ibid.

¹⁵⁶. See IRC §1341.

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Example 14. Jobie is a single, cash-basis taxpayer. In 2018, he received \$5,000 in state-issued unemployment benefits. In 2019, he was determined to be ineligible for the unemployment benefits and was required to repay the entire \$5,000. His income and tax for 2018 and 2019 are as follows.

Method 1

2018	With \$5,000 Included	Without \$5,000 Included
Taxable income	\$15,000	\$10,000
Tax liability	1,613	1,013

2019	With \$1341 Credit	\$5,000 Included and Jobie Itemizes	Without \$5,000 and Jobie Itemizes
Taxable income	\$49,950	\$49,950	\$44,950
Tax liability	\$ 6,853	\$ 6,853	\$ 5,753
Less: credit	(600)	0	0
Net tax liability	\$ 6,253	\$ 6,853	\$ 5,753

Jobie's tax under **method 1** is **\$5,753**. His tax under **method 2** is **\$6,253**, which is calculated as follows.

Method 2

Tax previously calculated for 2018	\$1,613
Less: tax as recalculated	(1,013)
Decrease in 2018 tax	\$ 600
Regular tax liability for 2019	\$6,853
Less: decrease in 2018 tax	(600)
Recalculated tax for 2019	\$ 6,253

Jobie pays less tax using method 1. Therefore, he should take a deduction for the repayment in 2019.¹⁵⁷

Note. For more information about the repayment of supplemental unemployment benefits, see IRS Pub. 525.

EMPLOYEE BUSINESS EXPENSES

Relatively few taxpayers can use Form 2106, *Employee Business Expenses*, to claim employee business expenses unless they are Armed Forces reservists, qualified performing artists, fee-basis state or local government officials, and employees with impairment-related work expenses. The amount from Form 2106 is an adjustment on line 11 of Schedule 1.¹⁵⁸

^{157.} Adapted from an example in IRS Pub. 525, *Taxable and Nontaxable Income*.

^{158.} Instructions for Form 1040 and 1040-SR.

Employee business expenses may be reimbursed through accountable or nonaccountable plans.¹⁵⁹

- **Accountable plans** provide allowances for, or reimbursement of, expenses associated with the conduct of the business, are substantiated, and require the employee to return any excess reimbursement to the employer within a reasonable time.¹⁶⁰ Payments made to employees under accountable plans are excluded from the employee's gross income and are exempt from withholding.¹⁶¹
- **Nonaccountable plans** do not satisfy one or more of the criteria (i.e., business purpose, substantiation, and requirement to return excess payments) that accountable plans contain.¹⁶² Payments made to employees under nonaccountable plans are included in the employee's gross income. Such amounts are reported as wages or other compensation on the employee's Form W-2 and are subject to withholding. Prior to the passage of the TCJA, certain payments made under nonaccountable plans could be deducted as miscellaneous itemized deductions subject to the 2% floor.¹⁶³ However, as mentioned earlier, the TCJA suspended such deductions for the 2018 through 2025 tax years.

Note. For more information about the treatment of payments under accountable and nonaccountable plans, see Treas. Reg. §1.62-2.

PARTICIPATION: LEVELS AND APPLICABILITY

Income, and the associated expenses from activities that generate gross receipts, may be classified as passive or active, similar to the concepts of unearned or earned income.

- The sources of **passive income** (by individuals, estates, trusts, closely held C corporations, and personal services corporations)¹⁶⁴ are:
 - ♦ Investment of capital in a trade or business in which the investor does not materially participate,¹⁶⁵ and
 - ♦ Interest, dividends, gains, and losses from investments other than in trades or businesses.¹⁶⁶
- The sources of **active income** are the following.
 - ♦ A trade or business¹⁶⁷
 - ♦ Activity carried on for the production of income¹⁶⁸

This section discusses the taxpayer's participation in a trade or business, or in an activity to produce income, to determine whether the taxpayer's level of participation is passive, material, significant, or active.

The characterization of the taxpayer's participation using these terms — passive, material, significant, and active — affects whether the taxpayer is liable for the net investment income tax (NIIT) on passive income. The NIIT is covered in the next section.

¹⁵⁹ Treas. Reg. §§1.62-2(c)(2) and (3).

¹⁶⁰ Treas. Reg. §§1.62-2(d), (e), and (f).

¹⁶¹ Treas. Reg. §1.62-2(c)(4).

¹⁶² Treas. Reg. §1.62-2(c)(3).

¹⁶³ Treas. Reg. §1.62-2(c)(5).

¹⁶⁴ IRC §469(a)(2).

¹⁶⁵ IRC §469(c)(1).

¹⁶⁶ IRC §469(e)(1).

¹⁶⁷ IRC §§62 and 162.

¹⁶⁸ IRC §212.

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PASSIVE ACTIVITY AND IRC §469

IRC §469 was added by the Tax Reform Act of 1986 (TRA), which, in part, targeted abusive tax shelters.¹⁶⁹ The purpose of the Code section was to end the unlimited use of deductions and credits from one business activity to offset income from other activities.¹⁷⁰ A Senate amendment outlined the general rule that deductions and credits from passive activities would be allowed only up to the amount of income from passive activities, and the disallowed losses and credits could be carried forward to future tax years.¹⁷¹

Note. IRC §469 has a straightforward objective: identify and isolate the realization of tax events associated with passive activities. Distinguishing passive activities from other activities, though, depends heavily on the facts and circumstances of each activity in which the taxpayer is involved. The practitioner's interviews, site visits, and reviews of current documentation as well as prior year's reporting all contribute to justifying the characterization of the client's activities and associated tax events.

Structure of IRC §469

IRC §469 takes a deductive approach (i.e., from general to specific) to identify and isolate passive activities, and consistently provides specific references for trades or businesses (versus production of income), real property rentals, and oil and gas working interests.

A passive activity is defined to include any activity that involves the conduct of any trade or business in which the taxpayer does not materially participate,¹⁷² including research and experimental activities for which expenses may be deducted under IRC §174.¹⁷³

DEFINITION OF PARTICIPATION

IRC §469 defines “material participation”¹⁷⁴ for all activities, and “active participation” for rental activities¹⁷⁵ but defers to the regulations for more specificity in these definitions to carry out the provisions of §469.¹⁷⁶ Treas. Reg. §1.469-5(f)(1) fills in the gaps with the following definition of “participation.”

Except as otherwise provided. . . any work done by an individual (without regard to the capacity in which the individual does the work) in connection with an activity in which the individual owns an interest at the time the work is done shall be treated for purposes of this section as participation of the individual in the activity.

¹⁶⁹ PL 99-514.

¹⁷⁰ Tax Reform Act of 1986–Conference Report to Accompany H.R. 3838, H.R. Conf. Rep. No. 99-841, II-137.

¹⁷¹ Ibid; disallowed losses, but not credits, are allowed in full upon disposition of the taxpayer's entire interest.

¹⁷² IRC §469(c)(1).

¹⁷³ IRC §469(c)(5).

¹⁷⁴ See IRC §469(h).

¹⁷⁵ IRC §469(i)(6)(A).

¹⁷⁶ IRC §469(l).

Exceptions to the Definition of Participation

The definition of **participation** excludes the following.

1. Work not customarily performed by owners is excluded if the following conditions are met.¹⁷⁷
 - ♦ The work is not of a type that is customarily done by an owner of such an activity.
 - ♦ One of the principal purposes for the performance of such work is to avoid the disallowance under §469 of any loss or credit from such activity.
2. Work performed by an individual in their capacity as an investor is not treated as participation in the activity unless the individual is directly involved in the day-to-day management or operations of the activity. Work done by an individual in the individual's capacity as an investor in an activity includes the following.¹⁷⁸
 - ♦ Studying and reviewing financial statements or reports on operations of the activity
 - ♦ Preparing or compiling summaries or analyses of the finances or operations of the activity for the individual's own use
 - ♦ Monitoring the finances or operations of the activity in a nonmanagerial capacity

Note. IRC §469 addresses passive activities. The definition of “participation” emphasizes work of a managerial or operational capacity being done by a party with an ownership interest, for a trade or business, or for other production of income. In addition, the work has an impact beyond merely informing the individual owner of the historical performance of the trade, business, or activity.

Levels of Participation

Participation may be classified as material, significant, or active; otherwise, the level of participation is characterized as passive. Rental activities are **per se** passive. However, there is an exception for real estate professionals (discussed later).

Practitioner Planning Tip

It is important for the practitioner to interview the client to understand whether the client has an ownership interest in the activity and **how** the client participates in each activity.

Client efforts to improve the financial performance of the trade, business, or activity by attracting customers, increasing sales, lowering costs, improving efficiency, lowering defects/returns, etc., are likely to be nonpassive because they have measurable outcomes.

Client efforts that are reflective in nature, or that have a tenuous link with performance metrics, are likely to be passive because they are not pursuing profit or income.

¹⁷⁷. Temp. Treas. Reg. §1.469-5T(f)(2)(i).

¹⁷⁸. Temp. Treas. Reg. §1.469-5T(f)(2)(ii).

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Material Participation. Material participation requires the individual to have **regular, continuous, and substantial involvement** in the operations of the activity.¹⁷⁹

Under Temp. Treas. Reg. §1.469-5T(a), an individual is treated as materially participating in an activity for the tax year if they meet **one** of the following seven tests for material participation.

1. The individual participates in the activity for more than 500 hours during the year.
2. The individual's participation in the activity for the tax year constitutes substantially all of the participation in the activity of all individuals for the year.
3. The individual participates in the activity for more than 100 hours during the tax year, and such individual's participation in the activity for the tax year is not less than the participation in the activity of any other individual for the year.
4. The activity is a significant participation activity for the tax year, and the individual's aggregate participation in all significant participation activities during the year exceeds 500 hours.
5. The individual materially participated in the activity for any five tax years (whether or not consecutive) during the 10 tax years that immediately precede the tax year.
6. The activity is a personal service activity, and the individual materially participated in the activity for any three tax years (whether or not consecutive) preceding the tax year.
7. Based on all of the facts and circumstances, the individual participates in the activity on a regular, continuous, and substantial basis during the year.

Rise to the Level of Material Participation. The gradations in the levels of participation and in the types of activities involved lend themselves to consideration of whether a taxpayer's level of participation "rises to the level of" material participation or to a trade or business. The analysis is important for the characterization of passive activity losses and the NIIT.

Material participation requires substantiation for which the taxpayer bears the burden of proof.¹⁸⁰ A taxpayer can establish the extent of their participation in a particular activity by any reasonable means.¹⁸¹ In *Tolin v. Comm'r*,¹⁸² the Tax Court found that the nature and extent of the activities described by the taxpayer were corroborated by phone records, third-party witness testimony, the party's comprehensive stipulations of fact, and other contemporaneous materials. The court noted that this was in contrast to the taxpayer in *Bartlett v. Comm'r*,¹⁸³ in which the taxpayer's "credible narrative summary" was not sufficient to establish material participation without corroborating evidence such as phone records or other contemporaneous documentation of participation.

In *Mordkin v. Comm'r*,¹⁸⁴ an attorney whose legal practice was his primary source of income, but who served on the board of the condominium association for his rental property, did not rise to the level of material participation for the rental activity in part because:

- He had not delivered personal services,
- He had compensated others to manage the property, and
- The average period of customer use of the condominium was less than seven days and thus did not constitute rental activity.

¹⁷⁹ IRC §469(h)(1).

¹⁸⁰ Tax Court Rule 142A.

¹⁸¹ Temp. Treas. Reg. §1.469-5T(f)(4).

¹⁸² *Tolin v. Comm'r*, TC Memo 2014-65 (Apr. 9, 2014).

¹⁸³ *Bartlett v. Comm'r*, TC Memo 2013-182 (Aug. 8, 2013).

¹⁸⁴ *Mordkin v. Comm'r*, TC Memo 1996-187 (Apr. 17, 1996).

In *Groetzinger*,¹⁸⁵ the U.S. Supreme Court considered whether the taxpayer's activity as a professional gambler rose to the level of a trade or business.

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

Note. Continuity, regularity, and substantiation are key for justifying that a taxpayer's efforts rise to the level of material participation, or an activity rises to the level of a trade or business.

Significant Participation. Under Temp. Treas. Reg. §1.469-5T(c)(2), a taxpayer is treated as significantly participating in an activity if the taxpayer participates in the activity for more than 100 hours during the tax year.

Losses from a significant participation activity are passive activity losses.¹⁸⁶

Some income from significant participation activity may be recharacterized as nonpassive income, and thus excluded from the NIIT, if gross income from all significant participation activities exceeds passive activity deductions from the same activities for the same tax year.¹⁸⁷

A taxpayer may materially participate in a significant participation activity if the taxpayer's aggregate participation in all significant participation activities during the year exceeds 500 hours.¹⁸⁸

Active Participation. Active participants with at least a 10% ownership share may offset up to \$25,000 of losses from the rental activities (\$12,500 for MFS taxpayers who lived apart all year). The \$25,000 allowance begins to be phased out for taxpayers whose modified adjusted gross income (MAGI) exceeds \$100,000 (\$50,000 for MFS taxpayers).¹⁸⁹

Active participation is the minimal level of participation by an owner. Citing the Senate Report for the 1986 TRA, the Tax Court observed in evaluating a rental real estate activity:

*The difference between active participation and material participation is that the former can be satisfied without regular, continuous, and substantial involvement in operations, so long as the taxpayer participates, e.g., in the making of management decisions or arranging for others to provide services (such as repairs), in a significant and bona fide sense. Management decisions that are relevant in this context include approving new tenants, deciding on rental terms, approving capital or repair expenditures, and other similar decisions.*¹⁹⁰

In determining whether a taxpayer actively participates, participation by the owner's spouse is considered in conjunction with that of the owner, regardless of whether the spouse owns an interest in the activity.¹⁹¹

Because participation requires that decisions be made in a managerial or operational capacity, limited partners in a partnership are generally not treated as actively participating.¹⁹²

^{185.} *Comm'r v. Groetzinger*, 480 U.S. 23, 35 (1987).

^{186.} Temp. Treas. Reg. §1.469-2T(f)(2).

^{187.} Temp. Treas. Reg. §1.469-2T(f)(2)(i).

^{188.} Temp. Treas. Reg. §1.469-5T(a)(4).

^{189.} IRC §§469(i)(1)–(3); Treas. Reg. §1.469-9(j); IRS Pub. 925, *Passive Activity and At-Risk Rules*.

^{190.} *Madler v. Comm'r*, TC Memo 1998-112 (Mar. 18, 1998), citing S. Rept. 99-313 (1986), 1986-3 CB 1.

^{191.} IRC §469(i)(6)(D).

^{192.} IRC §469(i)(6)(C); Treas. Reg. §1.469-4(d)(3)(i).

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Example 15. Joe Ross has an idea for a new business but no resources to invest in a business. He asks his father, William Ross, to either lend Joe the money he needs or to be an investor in his business. After consultation with William's attorney, Joe and William established an S corporation as equal shareholders. Joe handles the day-to-day operation of the business. William is not involved except to occasionally ask his son how the business is progressing or to review the Schedule K-1 from the S corporation before he gives it to his accountant. William's participation in this activity is passive.

Example 16. Use the same facts as **Example 15**. After several years of receiving Schedules K-1 from the S corporation showing dismal results, William tells Joe he needs to protect the investment he made and decides to take over the financial operation of the business. William's participation has now likely risen to the level of active or material participation. Therefore, based on facts and circumstances, William's participation in the S corporation is no longer passive.

Rental and Real Estate Activities

A rental activity is considered a passive activity.¹⁹³ An exception exists for real estate professionals who materially participate in rental real estate activities.¹⁹⁴

The definition of a real property trade or business includes any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.¹⁹⁵

Qualifying as a Real Estate Professional. To qualify as a real estate professional, the taxpayer must meet the following requirements.¹⁹⁶

1. The taxpayer performs at least 750 hours of services during the tax year in real property trades or business in which they materially participate.
2. The 750 hours (or more) must account for more than half of the personal services the taxpayer performs in trades or businesses for the tax year.

A closely held C corporation satisfies the above two requirements if more than 50% of the corporation's gross receipts for the tax year are derived from real property trades or businesses in which the corporation materially participates.¹⁹⁷

For married taxpayers filing a joint return, either spouse separately must meet the two requirements to qualify as a real estate professional.

Personal services are those performed by an individual. Personal services performed by an employee are not counted toward the hours performed in real property trades or businesses.¹⁹⁸

Self-Employed Taxpayers. Treas. Reg. §1.1402(a)-3 directs individuals with earnings from self-employment to calculate net earnings pursuant to Treas. Regs. §§1.1402(a)-4 through 1.1402(a)-(17). The most relevant rules are under Treas. Reg. §1.1402(a)-4, addressing rentals from real estate.

Rental income from real estate is passive income and therefore is not subject to SE tax under IRC §1401.¹⁹⁹

¹⁹³. IRC §469(c)(2).

¹⁹⁴. IRC §§469(c)(7)(A) and (C).

¹⁹⁵. IRC §469(c)(7)(C).

¹⁹⁶. IRC §469(c)(7)(B).

¹⁹⁷. IRC §469(c)(7)(D)(i).

¹⁹⁸. IRC §469(c)(7)(D)(ii).

¹⁹⁹. IRC §469(c)(2).

There are exceptions for:

- Real estate dealers,²⁰⁰
- Owners of real estate who also provide personal services to tenants,²⁰¹ and
- Owners or tenants who materially participate in the production or management of commodities.²⁰²

NET INVESTMENT INCOME TAX

NIIT was introduced as part of the Health Care and Education Reconciliation Act of 2010 (the Reconciliation Act)²⁰³ as an amendment to the Patient Protection and Affordable Care Act (ACA) of 2010.²⁰⁴

Passive activity income from a trade or business and other income not derived from the ordinary course of a trade or business is subject to the NIIT.²⁰⁵ Because passive income is subject to the NIIT, taxpayers may want to avoid any classification of their income and associated expenses as passive if possible.

Note. Although the NIIT was introduced in conjunction with health care reform, nothing in the initial legislation dedicates collection of the NIIT to Medicare. Because the NIIT is presently a general funding mechanism for the federal government, changes to the NIIT could be introduced independent of future health care reform.

The Supreme Court has agreed to consider the case of *State of California et al. v. State of Texas et al.*²⁰⁶ A potential outcome of this case could be to determine that the ACA²⁰⁷ is unconstitutional. This would potentially render taxes associated with the ACA (such as the NIIT) unconstitutional as well. The Supreme Court typically does not release its rulings until June. Therefore, tax professionals with clients who were subject to the NIIT on 2017 returns, for example, may recommend to clients the filing of a protective claim prior to April 16, 2021, when the 3-year statute of limitations for filing amended returns for 2017 will end (unless a valid extension was filed for the 2017 tax year). A protective claim in this case could be filed to extend the statute of limitations for taxpayers to potentially amend their returns to recover NIIT calculated on a 2017 return.

For more information regarding the process of filing a protective claim, see the 2016 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 3: Amending Returns. This can be found at uofi.tax/arc [taxschool.illinois.edu/taxbookarchive].

²⁰⁰ IRC §1402(a)(1).

²⁰¹ *Hopper v. Comm'r*, 94 TC 542, 545 (1990) applying Treas. Reg. §1.1402(a)-4(c)(2).

²⁰² Treas. Reg. §1.1402(a)-4(b)(4).

²⁰³ PL 111-152.

²⁰⁴ PL 111-148.

²⁰⁵ IRC §1411.

²⁰⁶ *State of California et al. v. State of Texas et al.*, No. 19-840; No. 19-1019 (Cert. granted Mar. 2, 2020).

²⁰⁷ PL 111-148.

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APPLICABILITY

The NIIT imposes a 3.8% tax on unearned income of individuals, estates, and trusts for tax years beginning after 2012.²⁰⁸

The NIIT does not apply to the following.

- Nonresident alien²⁰⁹
- Dual-resident individual claiming benefit of a tax treaty between the United States and the other country of residence²¹⁰
- Dual-status individual who resides in the United States for part of the year and in another country for part of the year²¹¹
- The following types of trusts²¹²
 - ♦ Charitable trusts and qualified retirement plan trusts exempt from tax under IRC §501
 - ♦ Charitable remainder trusts exempt from tax under IRC §664
 - ♦ A trust for which all unexpired interests are devoted to one or more of the following purposes under IRC §170(c)(2)(B): religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals
 - ♦ Grantor trusts under IRC §§671–679
 - ♦ Trusts not classified as trusts for federal income tax purposes (e.g., real estate investment trusts, common trust funds)
 - ♦ Electing Alaska native settlement trusts described in IRC §646
 - ♦ Perpetual care (cemetery) trust described in IRC §642(i)

CALCULATING THE NIIT

Individual Taxpayers

The NIIT for an individual is 3.8% of the lesser of:

- Net investment income (NII) for the tax year, or
- The excess of MAGI over the threshold amount.²¹³

MAGI for this purpose is defined as AGI without regard to the impact of the foreign earned income exclusion (FEIE) or the amount of deductions or exclusions that might otherwise be claimed for the FEIE.²¹⁴

²⁰⁸. IRC §1411(a).

²⁰⁹. IRC §1411(e)(1).

²¹⁰. Treas. Regs. §§301.7701(b)-7(a)(1) and 1.1411-2(a)(2)(i).

²¹¹. Treas. Reg. §1.1411-2(a)(2)(ii).

²¹². Instructions for Form 8960.

²¹³. IRC §1411(a)(1).

²¹⁴. IRC §1411(d).

The threshold amounts depend on the individual taxpayer's filing status, as follows.²¹⁵

- \$250,000 for MFJ taxpayers, a surviving spouse, or a qualifying widow(er) with a dependent child²¹⁶
- \$125,000 for MFS taxpayers
- \$200,000 for single and head of household taxpayers²¹⁷

The threshold amounts are not indexed for inflation.

Example 17. Micah is a single individual with a 2020 MAGI of \$210,000, which includes NII of \$40,000.

Of the \$40,000 of NII Micah received in 2020, the \$10,000 of NII that is over the \$200,000 threshold amount is subject to the NIIT.

I. Net investment income for the year		\$40,000
MAGI	\$210,000	
Less: applicable threshold for filing status	(200,000)	
II. MAGI in excess of threshold	\$ 10,000	\$10,000
Lesser of I or II		\$10,000

Micah's 2020 NIIT liability is \$380 ($\$10,000 \times 3.8\%$).

Net Investment Income

NII for an individual, trust, or estate taxpayer subject to the NII rules includes some forms of **income** and **capital gains** the taxpayer receives during the year. However, not all income or capital gains become part of NII for the taxpayer. Both the income and capital gain components have some exceptions that are not subject to the 3.8% NIIT.

Generally, NII includes the following types of income.²¹⁸

1. Gross interest, dividends, annuities, royalties, rents, and substitute interest or dividends
2. Other income from certain trades or businesses (i.e., a passive activity or a trade or business of trading in financial instruments or commodities)
3. Net capital gains attributable to the disposition of property other than property held in a trade or business

The following types of income are **not** included in NII.²¹⁹

- Wages
- Unemployment benefits
- Social security benefits
- Alimony
- Tax-exempt interest

²¹⁵ *Questions and Answers on the Net Investment Income Tax*. Apr. 3, 2020. IRS. [www.irs.gov/newsroom/questions-and-answers-on-the-net-investment-income-tax] Accessed on Jul. 19, 2020; IRC §1411(d).

²¹⁶ Treas. Reg. §1.1411-2(d)(1).

²¹⁷ IRC §1411(b).

²¹⁸ IRC §1411(c)(1)(A).

²¹⁹ *Questions and Answers on the Net Investment Income Tax*. Apr. 3, 2020. IRS. [www.irs.gov/newsroom/questions-and-answers-on-the-net-investment-income-tax] Accessed on Jul. 28, 2020.

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- SE income
- Alaska permanent fund dividends
- Qualified plan distributions (IRC §§401(a), 403(a), 403(b), 408, 408A, 457(b))
- The gain on the sale of a personal residence excluded under IRC §121
- Net income from a nonpassive business

Example 18. Use the same facts as **Example 15**, except William received positive net income (instead of a loss) from his son's S corporation activity. This income could be subject to the NIIT.

Example 19. Use the same fact as **Example 16**. When William's participation in the S corporation ceased to be passive, any net income William reports will be nonpassive and therefore not subject to the NIIT.

Self-Rental. A taxpayer who owns rental property directly or via a pass-through entity and who rents the property for use in a business in which the taxpayer materially participates is engaged in self-rental. The net rental income from a self-rental is excluded from NII.²²⁰

Kiddie Tax Gains. The "kiddie tax" applies to unearned income of a child who has not yet attained 18 years of age, or who has attained 18 years of age during the tax year and is still a qualifying child under IRC §152(c)(3).²²¹

A parent can elect to report their child's income on the parent's return if the child meets certain conditions.²²² The parent makes this election by filing Form 8814, *Parent's Election to Report Child's Interest and Dividends*. The amount of the child's income included in the parent's NII equals those amounts that are reported on Form 8814. However, the following amounts are excluded from the calculation of the NII.²²³

- Amounts excluded from Form 1040 due to the threshold amounts on Form 8814
- Amounts attributable to Alaska permanent fund dividends

FORMS AND REPORTING

The NIIT is calculated on Form 8960, *Net Investment Income Tax – Individuals, Estates, and Trusts*. Individuals report the NIIT from Form 8960 on line 8 of Schedule 2, *Additional Taxes*.

Note. For more information about the NIIT, see the 2013 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 2: Affordable Care Act Update. This can be found at uofi.tax/arc [taxschool.illinois.edu/taxbookarchive].

²²⁰ Treas. Regs. §§1.469-2(f)(6) and 1.1411-5(b)(2)(i).

²²¹ IRC §1(g).

²²² See the Instructions for Form 8814.

²²³ *Questions and Answers on the Net Investment Income Tax*. Apr. 3, 2020. IRS. [www.irs.gov/newsroom/questions-and-answers-on-the-net-investment-income-tax] Accessed on Jul. 19, 2020.