

Chapter 9: Individual Taxpayer Issues

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Note. Corrections were made to this workbook through January of 2024. No subsequent modifications were made. For terms used in this chapter, see the **Acronyms and Abbreviations** section following the index.

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

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ESTIMATED TAX PAYMENTS

BASICS

To avoid penalties, taxpayers should have sufficient withholding or make timely estimated tax payments. Income taxes are a pay-as-you-go system which means that either an employer or the taxpayer is required to withhold tax on income as earned or received. For taxpayers receiving income not associated with or in addition to a Form W-2, *Wage and Tax Statement*, this income may trigger the requirement to submit estimated tax payments separate from traditional wage withholding.¹ Income that is subject to tax but not typically subject to withholding includes, but is not limited to, the following.

- Self-employment (SE) income
- Interest
- Dividends
- Capital gains
- Prizes
- Rental income
- Gig economy income

Generally, taxpayers expecting to owe at least \$1,000 in tax after subtracting withholding and credits are required to make estimated payments.² The general safe harbor is to timely pay either:

1. 90% of the tax to be shown on the current year return, or
2. 100% of the tax shown on the previous year tax return, which must cover all 12 months.

Taxpayers with adjusted gross income (AGI) in the prior year higher than \$150,000 (\$75,000 for individuals married filing separately (MFS)) must substitute 110% for the 100% withholding.³

Note. Individuals need to consider any liability for SE taxes,⁴ the 3.8% net investment income tax (NIIT),⁵ the 0.9% additional Medicare tax,⁶ and any pass-through income from partnerships, trusts, estates, and S corporations, in addition to federal income tax liabilities when calculating their estimated tax liabilities.

Note. Certain taxpayers are subject to modified rules. For example, individuals who derive two-thirds of their annual gross income from fishing or farming qualify for special exceptions to the general requirements for estimated tax payments. Such taxpayers may avoid penalties by paying 66.67% of their liability in January or filing and paying 100% of the tax due by March 1 of the following year. Details on what is considered income is available in IRS Publication 505, *Tax Withholding and Estimated Tax*.

¹. IRS Pub. 505, *Tax Withholding and Estimated Tax*.

². IRC §6654.

³. Ibid.

⁴. IRC §7701(b)(1)(A).

⁵. IRC §1411.

⁶. IRC §1401(b)(2).

Married Individuals⁷

Married taxpayers can make joint estimated tax payments even if they are not living together. However, spouses cannot make joint estimated tax payments if they meet any of the following criteria.

- The couple is legally separated under a decree of divorce or separate maintenance
- The spouses have different tax years
- Either spouse is a nonresident alien

Note. Couples who cannot make joint estimated tax payments apply the general rules to their separate estimated income.

Allocating Joint Estimated Payments on Separate Returns. Spouses who make joint estimated tax payments but subsequently file separate tax returns can claim their individual payments or divide the payments in any manner in which they both agree. If they cannot agree, each can only claim the estimated payment resulting from the following calculation.

$$\text{Individual's share of joint estimated payment} = \frac{\text{Joint estimated payment}}{\text{Total tax liability of both individuals}} \times \text{Individual tax liability on separate return}$$

Caution. A difficult challenge occurs when one spouse is not willing to share their tax liability.

Taxpayers claiming any portion of a joint estimated tax payment should attach an explanation how they divided the payments and list the spouse's or ex-spouse's tax identification number (TIN) on the tax return. If divorced and remarried during the year, enter the current spouse's TIN on the return and the former spouse's tax TIN, followed by "DIV" on line 26 of Form 1040, *U.S. Individual Income Tax Return*.⁸

Prior Year Separate Returns and Current Year Joint Return. If a couple plans to file a joint return in the current year and filed separate returns in the prior year, for purposes of estimated tax, the prior year tax is the sum of the total tax shown on the separate returns.

Prior Year Joint Return and Current Year Separate Returns. If a couple plans to file separate returns in the current year and filed a joint return for the prior year, for purposes of estimated tax, the prior year tax is the amount of tax for the individual spouse.

The individual's share of tax on a joint return is calculated as follows, using the same filing status as the current year.

$$\text{Individual's share of tax on joint return} = \text{Tax on joint return} \times \frac{\text{Tax individual would have paid if filing separate returns}}{\text{Total tax spouses would have paid if filing separate returns}}$$

⁷ IRS Pub. 505, *Tax Withholding and Estimated Tax*.

⁸ IRS Pub. 504, *Divorced or Separated Individuals*.

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Estates and Trusts

Estates and trusts generally must also pay estimated tax.⁹ However, estates and certain grantor trusts that receive the residue of the decedent's estate under the decedent's will are exempt from making estimated tax payments for the first two years after the decedent's death.

Due Dates

For calendar year individual taxpayers, quarterly tax payment due dates are **typically** as follows.

- April 15
- June 15
- September 15
- January 15

Note. A 1st quarter payment can be made with an extension payment to create an overpayment that carries over to the following tax year.

CALCULATING ESTIMATES ON FORM W-4

Taxpayers complete Form W-4, *Employee's Withholding Certificate*, to calculate the withholdings their employer should withdraw from their payments to cover the individual's income tax liability. Appropriately withheld tax helps individuals prevent underpayment penalties (covered later).

In 2020, the IRS redesigned the form to reduce the form's complexity and increase the transparency and accuracy of the withholding system. The worksheets on the previous form are replaced with questions in an attempt to simplify the process.¹⁰ An example of a blank 2023 Form W-4 follows.

⁹ IRC §6654.

¹⁰ *FAQs on the 2020 Form W-4*. Jan. 24, 2023. IRS. [www.irs.gov/newsroom/faqs-on-the-2020-form-w-4] Accessed on Jun. 8, 2023.

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Form **W-4**
Department of the Treasury
Internal Revenue Service

Employee's Withholding Certificate

Complete Form W-4 so that your employer can withhold the correct federal income tax from your pay.
Give Form W-4 to your employer.
Your withholding is subject to review by the IRS.

OMB No. 1545-0074

2023

Step 1: Enter Personal Information	(a) First name and middle initial	Last name	(b) Social security number
	Address		Does your name match the name on your social security card? If not, to ensure you get credit for your earnings, contact SSA at 800-772-1213 or go to www.ssa.gov .
	City or town, state, and ZIP code		
	(c) ☐ Single or Married filing separately ☐ Married filing jointly or Qualifying surviving spouse ☐ Head of household (Check only if you're unmarried and pay more than half the costs of keeping up a home for yourself and a qualifying individual.)		

Complete Steps 2–4 ONLY if they apply to you; otherwise, skip to Step 5. See page 2 for more information on each step, who can claim exemption from withholding, other details, and privacy.

Step 2:
Multiple Jobs or Spouse Works

Complete this step if you (1) hold more than one job at a time, or (2) are married filing jointly and your spouse also works. The correct amount of withholding depends on income earned from all of these jobs.

Do **only one** of the following.

(a) Reserved for future use.

(b) Use the Multiple Jobs Worksheet on page 3 and enter the result in Step 4(c) below; **or**

(c) If there are only two jobs total, you may check this box. Do the same on Form W-4 for the other job. This option is generally more accurate than (b) if pay at the lower paying job is more than half of the pay at the higher paying job. Otherwise, (b) is more accurate ☐

TIP: If you have self-employment income, see page 2.

Complete Steps 3–4(b) on Form W-4 for only ONE of these jobs. Leave those steps blank for the other jobs. (Your withholding will be most accurate if you complete Steps 3–4(b) on the Form W-4 for the highest paying job.)

Step 3: Claim Dependent and Other Credits	If your total income will be \$200,000 or less (\$400,000 or less if married filing jointly): Multiply the number of qualifying children under age 17 by \$2,000 \$ _____ Multiply the number of other dependents by \$500 \$ _____ Add the amounts above for qualifying children and other dependents. You may add to this the amount of any other credits. Enter the total here	3	\$		
	Step 4 (optional): Other Adjustments (a) Other income (not from jobs). If you want tax withheld for other income you expect this year that won't have withholding, enter the amount of other income here. This may include interest, dividends, and retirement income			4(a)	\$
	(b) Deductions. If you expect to claim deductions other than the standard deduction and want to reduce your withholding, use the Deductions Worksheet on page 3 and enter the result here			4(b)	\$
	(c) Extra withholding. Enter any additional tax you want withheld each pay period . .	4(c)	\$		

Step 5: Sign Here	Under penalties of perjury, I declare that this certificate, to the best of my knowledge and belief, is true, correct, and complete.		
	Employee's signature (This form is not valid unless you sign it.)		Date
Employers Only	Employer's name and address	First date of employment	Employer identification number (EIN)

For Privacy Act and Paperwork Reduction Act Notice, see page 3.

Cat. No. 10220Q

Form **W-4** (2023)

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Note. The IRS provides an online tool for calculating estimated tax withholding at [uofi.tax/23x9x8](https://www.irs.gov/individuals/tax-withholding-estimator) [www.irs.gov/individuals/tax-withholding-estimator]. The tool estimates federal tax withholding, shows how a taxpayer's refund, take-home pay, or tax due are impacted by the withholding amount, and helps the taxpayer select an appropriate estimated withholding amount. See IRS Pub. 15-T, *Federal Income Tax Withholding Methods*.

Taxpayers should check their withholding amounts annually. Additionally, any time an individual has a **major life event**, such as a change in employment, major shift in income, a change in marital status or dependents, or alters their home ownership status, they should check their withholdings.¹¹

PENALTIES

Penalties are based on the amount and timing of the underpayment. The IRS may also charge interest on the penalty itself.¹² The IRS publishes interest rates quarterly.¹³

Taxpayers can avoid penalties by making appropriate and timely payments. Withholding from Forms W-2, 1099s, and other forms applicable to line 25c of the Form 1040, as shown next, are considered to have been paid one-fourth on each payment due date.¹⁴

24	Add lines 22 and 23. This is your total tax.	24
Payments 25	Federal income tax withheld from:	
a	Form(s) W-2	25a
b	Form(s) 1099	25b
c	Other forms (see instructions)	25c
d	Add lines 25a through 25c	25d
26	2022 estimated tax payments and amount applied from 2021 return	26
	Earned income credit (EIC)	27

There are limited circumstances in which the IRS may remove or reduce a penalty. The following are some circumstances where the IRS would consider abating a penalty.¹⁵

- The taxpayer, or their spouse if married filing jointly (MFJ), retired in the previous two years after turning age 62 or became disabled, **and** have **reasonable cause** for underpaying the estimated tax or paying late.
- Most of the taxpayer's income tax was withheld early in the year instead of spread evenly throughout the year.
- The taxpayer's income varies during the year.

¹¹ *Tax Withholding Estimator*. Apr. 13, 2023. IRS. [www.irs.gov/individuals/tax-withholding-estimator] Accessed on Jun. 8, 2023.

¹² *Underpayment of Estimated Tax by Individuals Penalty*. May 16, 2023. IRS. [www.irs.gov/payments/underpayment-of-estimated-tax-by-individuals-penalty] Accessed on Jun. 8, 2023.

¹³ For current year interest rates, see *Quarterly Interest Rates*. May 1, 2023. IRS. [www.irs.gov/payments/quarterly-interest-rates] Accessed on Jun. 9, 2023.

¹⁴ Instructions for Form 2210.

¹⁵ *Underpayment of Estimated Tax by Individuals Penalty*. May 16, 2023. IRS. [www.irs.gov/payments/underpayment-of-estimated-tax-by-individuals-penalty] Accessed on Jun. 8, 2023.

Figuring the Penalty¹⁶

Generally, the IRS figures any underpayment penalties and sends a bill to the taxpayer. However, taxpayers must compute their penalty for any of the following reasons.

- The taxpayer is requesting a waiver of part of their penalty.
- The taxpayer's income varied throughout the year and their penalty is reduced or eliminated when applying the annualized income installment method (explained later).
- The taxpayer's penalty is lower when treating the federal income tax withheld from their income as paid on the dates it was actually withheld, rather than in equal amounts on the payment due dates.

Taxpayers who file their return by the due date of the Form 1040, without extension, are not charged interest on the penalty if they pay the penalty by the date shown on the bill. If taxpayers would rather have the IRS figure the penalty, **they should not file Form 2210, *Underpayment of Estimated Tax by Individuals, Estates, and Trusts***, and leave the penalty line on their return blank.

The required installment deficiencies are calculated using a daily penalty rate based on **the number of days** the balance is due, resulting in the net underpayment penalty. Taxpayers calculate the number of days their installment payment is delinquent and apply the applicable penalty rate of between 4% and 7%. The Worksheet for Form 2210, Part III, Section B — Figure the Penalty (Penalty Worksheet) guides taxpayers in calculating their quarterly penalties.



Practitioner Planning Tip

It is advisable to pay a late estimated payment as soon as possible to minimize penalties and interest.

There are two acceptable methods for calculating the estimated tax penalty: the regular method and the annualized income installment method.

Regular Method. Under the regular method, taxpayers must pay 25% of their required annual payment on each of the four installment payment due dates. If the taxpayer's estimated taxes and withholdings are equal to or more than their required annual payments for all payment periods, they do not owe a penalty. The withholding may consist of any prior year overpayments, specific payments, and withholdings. A taxpayer does not need to file a Form 2210 if their withholdings and estimated taxes exceed their required annual payment.

Note. Any prior year overpayment of tax is typically applied to the first quarterly installment.¹⁷

¹⁶ IRC §6654(d)(2) and Instructions for Form 2210.

¹⁷ See Instructions for Form 2210.

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Example 1. Ricky and Julie are Florida residents who file MFJ. Their income consists of Form W-2 wages of \$100,000 with \$10,000 in withholdings. Their maximum required annual payment is \$35,000 based on their prior year's tax.

In 2022, Julie became the beneficiary of a trust from her great uncle, Jim. The trust reported \$500,000 in portfolio income which was paid to Julie in November. There were no additional withholdings, and the wage withholdings are assumed to have been paid evenly throughout the year.

Part I Required Annual Payment

1 Enter your 2022 tax after credits from Form 1040, 1040-SR, or 1040-NR, line 22. (See the instructions if not filing Form 1040.)	1	148,438
2 Other taxes, including self-employment tax and, if applicable, Additional Medicare Tax and/or Net Investment Income Tax (see instructions)	2	13,300
3 Other payments and refundable credits (see instructions)	3	()
4 Current year tax. Combine lines 1, 2, and 3. If less than \$1,000, stop ; you don't owe a penalty. Don't file Form 2210	4	161,738
5 Multiply line 4 by 90% (0.90)	5	145,564
6 Withholding taxes. Don't include estimated tax payments. See instructions	6	10,000
7 Subtract line 6 from line 4. If less than \$1,000, stop ; you don't owe a penalty. Don't file Form 2210	7	151,738
8 Maximum required annual payment based on prior year's tax (see instructions)	8	35,000
9 Required annual payment. Enter the smaller of line 5 or line 8	9	35,000

Next: Is line 9 more than line 6?

☐ **No.** You **don't** owe a penalty. **Don't** file Form 2210 unless box **E** below applies.

☒ **Yes.** You may owe a penalty, but **don't** file Form 2210 unless one or more boxes in Part II below applies.

• If box **B**, **C**, or **D** applies, you must figure your penalty and file Form 2210.

• If box **A** or **E** applies (but not **B**, **C**, or **D**), file only page 1 of Form 2210. You **aren't** required to figure your penalty; the IRS will figure it and send you a bill for any unpaid amount. If you want to figure your penalty, you may use Part III as a worksheet and enter your penalty on your tax return, but **file only page 1 of Form 2210**.

Part II Penalties for Filing. Check applicable boxes. If **no**, **don't** file Form 2210.

Line 5 shows the current year safe harbor is \$145,564. The required annual payment is limited to the lesser of the safe harbor (\$145,564) or the prior year maximum required annual payment based on prior year's tax (\$35,000). For the regular method, the \$35,000 will be divided equally over the four quarterly payment due dates, along with the wage withholdings of \$10,000.

If Rick and Julie use the regular method, their net penalty due is \$1,002, as shown on the following Form 2210.

Note. Interest of 0.5% (0.25% for months covered by an installment agreement) of the tax due for each month or part of a month a payment is late would likely be applied.¹⁸ Interest has not been taken into account for this example.

¹⁸ Notice 433-Interest and Penalty Information. Jul. 2006. IRS. [www.irs.gov/pub/irs-pdf/n433.pdf] Accessed on Jul. 17, 2023.

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For Example 1

Form 2210 (2022)

Page **2**

Part III Penalty Computation (See the instructions if you're filing Form 1040-NR.)

Section A—Figure Your Underpayment		Payment Due Dates				
		(a) 4/15/22	(b) 6/15/22	(c) 9/15/22	(d) 1/15/23	
10	Required installments. If box C in Part II applies, enter the amounts from Schedule AI, line 27. Otherwise, enter 25% (0.25) of line 9, Form 2210, in each column. For fiscal year filers, see instructions	10	8,750	8,750	8,750	8,750
11	Estimated tax paid and tax withheld (see the instructions). For column (a) only, also enter the amount from line 11 on line 15, column (a). If line 11 is equal to or more than line 10 for all payment periods, stop here; you don't owe a penalty. Don't file Form 2210 unless you checked a box in Part II	11	2,500	2,500	2,500	2,500
Complete lines 12 through 18 of one column before going to line 12 of the next column.						
12	Enter the amount, if any, from line 18 in the previous column	12				
13	Add lines 11 and 12	13		2,500	2,500	2,500
14	Add the amounts on lines 16 and 17 in the previous column	14		6,250	12,500	18,750
15	Subtract line 14 from line 13. If zero or less, enter -0-. For column (a) only, enter the amount from line 11	15	2,500	0	0	0
16	If line 15 is zero, subtract line 13 from line 14. Otherwise, enter -0-	16		3,750	10,000	
17	Underpayment. If line 10 is equal to or more than line 15, subtract line 15 from line 10. Then go to line 12 of the next column. Otherwise, go to line 18	17	6,250	8,750	8,750	8,750
18	Overpayment. If line 15 is more than line 10, subtract line 10 from line 15. Then go to line 12 of the next column	18				

Section B—Figure the Penalty (Use the Worksheet for Form 2210, Part III, Section B—Figure the Penalty in the instructions.)

19	Penalty. Enter the total penalty from line 14 of the Worksheet for Form 2210, Part III, Section B—Figure the Penalty. Also include this amount on Form 1040, 1040-SR, or 1040-NR, line 38; or Form 1041, line 27. Don't file Form 2210 unless you checked a box in Part II	19	1,002
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Form **2210** (2022)

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2023 Workbook

For Example 1

2022 Underpayment Penalty Worksheet								
Client RICKY			Ricky and Julie Star			123-12-1234		
Required Installment	Payment			Penalty				
	Date	Type *	Amount	Underpayment	Days Late	Rate	Amount of Penalty **	Penalty per Period
First Qtr	4/15/22	2	2,500.	6,250.	61	0.040	41.78	
8,750.	6/15/22	2	2,500.	3,750.	15	0.040	6.16	
Total								47.94
Rate Change	6/30/22			3,750.	77	0.050	39.55	
	9/15/22	2	2,500.	1,250.	15	0.050	2.57	
Total								42.12
Rate Change	9/30/22			1,250.	92	0.060	18.90	
Total								18.90
Rate Change	12/31/22			1,250.	15	0.070	3.60	
	1/15/23	2	1,250.					
Total								3.60
Second Qtr	6/15/22			8,750.	15	0.040	14.38	
8,750.								
Total								14.38
Rate Change	6/30/22			8,750.	92	0.050	110.27	
Total								110.27
Rate Change	9/30/22			8,750.	92	0.060	132.33	
Total								132.33
Rate Change	12/31/22			8,750.	15	0.070	25.17	
	1/15/23	2	1,250.	7,500.	90	0.070	129.45	
	4/15/23	5	7,500.					
Total								154.62
Third Qtr	9/15/22			8,750.	15	0.050	17.98	
8,750.								
Total								17.98
Rate Change	9/30/22			8,750.	92	0.060	132.33	
Total								132.33
Rate Change	12/31/22			8,750.	105	0.070	176.20	
	4/15/23	5	8,750.					
Total								176.20
Fourth Qtr	1/15/23			8,750.	90	0.070	151.03	
8,750.	4/15/23	5	8,750.					
Total								151.03
TOTAL UNDERPAYMENT PENALTY								1,002.
* 1 = Overpayment 2 = Withholding 3 = Estimate 4 = Extension 5 = Paid with return ** Underpayment $\times \frac{\text{Days Late}}{365} \times \text{Rate}$								

FDIL1601L 01/06/23

Annualized Income Installment Method. For taxpayers with inconsistent yearly earnings (such as portfolio income, bonuses, capital dispositions, or seasonal business income), equal quarterly payments may not be sufficient to reduce or eliminate the underpayment penalty. Taxpayers who do not receive income evenly throughout the year are allowed to use **the annualized income installment method** to reflect the income earned in the period immediately before the installment due date. The annualized income installment method may result in estimated tax payments which differ from the traditional equal installments in an attempt to match prepayments to earnings.

Taxpayers using the annualized income installment method figure the required installments to enter on Form 2210 on Schedule AI, *Annualized Income Installment Method*. Schedule AI modifies a taxpayer's AGI and uses the annualization amounts to reflect the periods in which the income was earned. If a taxpayer uses Schedule AI for any payment due date, they must use it for all payment due dates. A taxpayer using the annualized income installment method must complete all the following steps.

1. Compute annualized income on part I of Schedule AI and part II if the taxpayer has SE income
2. Figure the penalty on part III of Form 2210
3. Select box C on part II of Form 2210, reflecting the taxpayer is using the annualized income installment method
4. Calculate income and deductions based on the taxpayer's method of accounting for each period on Schedule AI (cash method taxpayers must include all their income actually or constructively received and all deductions actually paid during the period)
5. Attach all parts of Form 2210 and Schedule AI to the taxpayer's return



Practitioner Planning Tip

If a taxpayer receives additional income later in the year, penalties can usually be reduced by using the annualized income installment method.

Example 2. Use the same facts as **Example 1**, except Ricky and Julie use the annualized income installment method. They allocate the \$500,000 lump sum to the 4th quarter and allocate wage income evenly throughout the year.

The couple adjusts their penalty computation to reflect the tax withholding to be remitted during the period in which the income was earned. The total amount of tax to be withheld via the required installments does not change between **Example 1** and **Example 2**, just the timing on when the tax should have been remitted.

The net penalty due is \$694 due as shown on the following Form 2210 and associated statement. This is a reduction in the penalty of \$308 over the regular method (\$1,002 – \$694).

Note. No interest has been included in these calculations.

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For Example 2

Form 2210 (2022)

Page **3**

Schedule AI—Annualized Income Installment Method (See the instructions.)

Estates and trusts, **don't** use the period ending dates shown to the right. Instead, use the following: 2/28/22, 4/30/22, 7/31/22, and 11/30/22.

	(a) 1/1/22–3/31/22	(b) 1/1/22–5/31/22	(c) 1/1/22–8/31/22	(d) 1/1/22–12/31/22
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Part I Annualized Income Installments

1 Enter your adjusted gross income for each period. See instructions. (Estates and trusts, enter your taxable income without your exemption for each period.) . . .	1	25,000	50,000	75,000	600,000
2 Annualization amounts. (Estates and trusts, see instructions.)	2	4	2.4	1.5	1
3 Annualized income. Multiply line 1 by line 2	3	100,000	120,000	112,500	600,000
4 If you itemize, enter itemized deductions for the period shown in each column. All others, enter -0-, and skip to line 7. Exception: Estates and trusts, skip to line 9 .	4				
5 Annualization amounts	5	4	2.4	1.5	1
6 Multiply line 4 by line 5	6				
7 In each column, enter the sum of your standard deduction and line 12b from Form 1040 or 1040-SR. (Form 1040-NR filers, enter -0-. Exception: Indian students and business apprentices, see instructions.)	7	25,900	25,900	25,900	25,900
8 Enter the larger of line 6 or line 7	8	25,900	25,900	25,900	25,900
9 Deduction for qualified business income. Estates and trusts: Subtract this amount from the amount on line 3, skip line 10, and enter the result on line 11	9				
10 Add lines 8 and 9	10	25,900	25,900	25,900	25,900
11 Subtract line 10 from line 3	11	74,100	94,100	86,600	574,100
12 Form 1040, 1040-SR, or 1040-NR filers, enter -0- in each column. (Estates and trusts, see instructions.)	12	0	0	0	0
13 Subtract line 12 from line 11. If zero or less, enter -0-	13	74,100	94,100	86,600	574,100
14 Figure your tax on the amount on line 13. See instructions	14	8,484	11,942	10,292	148,441
15 Self-employment tax from line 36 (complete Part II below)	15				
16 Enter other taxes for each payment period including, if applicable, Additional Medicare Tax and/or Net Investment Income Tax. See instructions	16	13,330	13,330	13,330	13,300
17 Total tax. Add lines 14, 15, and 16	17	21,784	25,242	23,592	161,741
18 For each period, enter the same type of credits as allowed on Form 2210, Part I, lines 1 and 3. See instructions . .	18				
19 Subtract line 18 from line 17. If zero or less, enter -0-	19	21,784	25,242	23,592	161,741
20 Applicable percentage	20	22.5%	45%	67.5%	90%
21 Multiply line 19 by line 20	21	4,901	11,359	15,925	145,567

Complete lines 22–27 of one column before going to line 22 of the next column.

22 Enter the total of the amounts in all previous columns of line 27	22	4,901	11,359	15,925
23 Subtract line 22 from line 21. If zero or less, enter -0-	23	4,901	6,458	4,566
24 Enter 25% (0.25) of line 9 on page 1 of Form 2210 in each column	24	8,750	8,750	8,750
25 Subtract line 27 of the previous column from line 26 of that column	25	3,849	6,141	10,325
26 Add lines 24 and 25	26	8,750	12,599	19,075
27 Enter the smaller of line 23 or line 26 here and on Form 2210, Part III, line 10	27	4,901	6,458	4,566

Part II Annualized Self-Employment Tax (Form 1040, 1040-SR, or 1040-NR filers only)

28 Net earnings from self-employment for the period (see instructions)	28			
29 Prorated social security tax limit	29	\$36,750	\$61,250	\$98,000
30 Enter actual wages for the period subject to social security tax or the 6.2% portion of the 7.65% railroad retirement (tier 1) tax. Exception: If you filed Form 4137 or Form 8919, see instructions	30			
31 Subtract line 30 from line 29. If zero or less, enter -0-	31			
32 Annualization amounts	32	0.496	0.2976	0.186
33 Multiply line 32 by the smaller of line 28 or line 31	33			
34 Annualization amounts	34	0.116	0.0696	0.0435
35 Multiply line 28 by line 34	35			
36 Add lines 33 and 35. Enter here and on line 15 above	36			

Form **2210** (2022)

2023 Workbook

For Example 2

Form 2210 (2022)

Page **2**

Part III Penalty Computation (See the instructions if you're filing Form 1040-NR.)

Section A—Figure Your Underpayment		Payment Due Dates				
		(a) 4/15/22	(b) 6/15/22	(c) 9/15/22	(d) 1/15/23	
10	Required installments. If box C in Part II applies, enter the amounts from Schedule AI, line 27. Otherwise, enter 25% (0.25) of line 9, Form 2210, in each column. For fiscal year filers, see instructions	10	4,901	6,458	4,566	19,075
11	Estimated tax paid and tax withheld (see the instructions). For column (a) only, also enter the amount from line 11 on line 15, column (a). If line 11 is equal to or more than line 10 for all payment periods, stop here; you don't owe a penalty. Don't file Form 2210 unless you checked a box in Part II	11	2,500	2,500	2,500	2,500
Complete lines 12 through 18 of one column before going to line 12 of the next column.						
12	Enter the amount, if any, from line 18 in the previous column	12				
13	Add lines 11 and 12	13		2,500	2,500	2,500
14	Add the amounts on lines 16 and 17 in the previous column	14		2,401	6,359	8,425
15	Subtract line 14 from line 13. If zero or less, enter -0-. For column (a) only, enter the amount from line 11	15	2,500	99	0	0
16	If line 15 is zero, subtract line 13 from line 14. Otherwise, enter -0-	16		0	3,859	
17	Underpayment. If line 10 is equal to or more than line 15, subtract line 15 from line 10. Then go to line 12 of the next column. Otherwise, go to line 18	17	2,401	6,359	4,566	19,075
18	Overpayment. If line 15 is more than line 10, subtract line 10 from line 15. Then go to line 12 of the next column	18				

Section B—Figure the Penalty (Use the Worksheet for Form 2210, Part III, Section B—Figure the Penalty in the instructions.)

19	Penalty. Enter the total penalty from line 14 of the Worksheet for Form 2210, Part III, Section B—Figure the Penalty. Also include this amount on Form 1040, 1040-SR, or 1040-NR, line 38; or Form 1041, line 27. Don't file Form 2210 unless you checked a box in Part II	19	694
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Form **2210** (2022)

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2023 Workbook

For Example 2

2022 Underpayment Penalty Worksheet								
Client RICKY			Ricky and Julie Star			123-12-1234		
Required Installment	Payment			Penalty				
	Date	Type *	Amount	Underpayment	Days Late	Rate	Amount of Penalty **	Penalty per Period
First Qtr	4/15/22	2	2,500.	2,401.	61	0.040	16.05	
4,901.	6/15/22	2	2,401.					
Total								16.05
Second Qtr	6/15/22	2	99.	6,359.	15	0.040	10.45	
6,458.								
Total								10.45
Rate Change	6/30/22			6,359.	77	0.050	67.07	
	9/15/22	2	2,500.	3,859.	15	0.050	7.93	
Total								75.00
Rate Change	9/30/22			3,859.	92	0.060	58.36	
Total								58.36
Rate Change	12/31/22			3,859.	15	0.070	11.10	
	1/15/23	2	2,500.	1,359.	90	0.070	23.46	
	4/15/23	5	1,359.					
Total								34.56
Third Qtr	9/15/22			4,566.	15	0.050	9.38	
4,566.								
Total								9.38
Rate Change	9/30/22			4,566.	92	0.060	69.05	
Total								69.05
Rate Change	12/31/22			4,566.	105	0.070	91.95	
	4/15/23	5	4,566.					
Total								91.95
Fourth Qtr	1/15/23			19,075.	90	0.070	329.24	
19,075.	4/15/23	5	19,075.					
Total								329.24
TOTAL UNDERPAYMENT PENALTY.....								694.
* 1 = Overpayment 2 = Withholding 3 = Estimate 4 = Extension 5 = Paid with return ** Underpayment $\times \frac{\text{Days Late}}{365} \times \text{Rate}$								

FDIL1601L 01/06/23

WITHHOLDING STRATEGIES

A taxpayer can implement a variety of withholding strategies to minimize or eliminate any estimated payment penalties. Available strategies depend on how the taxpayer is earning their money (a salaried job, a passthrough entity, etc.) and how much flexibility the taxpayer has in adjusting the timing of various payments.

Form W-4, Individual Estimates and Withholding Planning¹⁹

A carefully prepared Form W-4 is the first step to helping a wage-earning client plan for their payment of taxes because wage income and earnings are assumed to be evenly received throughout the year. As mentioned previously, taxpayers with wage withholding should regularly update their wage withholding via Form W-4 as income tax rates automatically change, as Congress enacts new legislation, or as their personal situations change. Form W-4 is typically submitted to an employee's payroll or human resources department.

Multiple Jobs. Taxpayers filing as MFJ or single taxpayers who hold at least two jobs should use the Multiple Jobs Worksheet (reproduced next) included with Form W-4 to project the proper withholding. For households with two or more jobs, the form guides taxpayers to an indexed worksheet where the sum of the higher paying and lower paying job withholdings are allocated throughout the number of pay periods. The calculated withholding amount is most accurate if the taxpayer inputs the data for the highest paying job on the Form W-4.

Form W-4 (2023)

Page **3**

Step 2(b)—Multiple Jobs Worksheet (Keep for your records.)



If you choose the option in Step 2(b) on Form W-4, complete this worksheet (which calculates the total extra tax for all jobs) on **only ONE** Form W-4. Withholding will be most accurate if you complete the worksheet and enter the result on the Form W-4 for the highest paying job. To be accurate, submit a new Form W-4 for all other jobs if you have not updated your withholding since 2019.

Note: If more than one job has annual wages of more than \$120,000 or there are more than three jobs, see Pub. 505 for additional tables.

- 1 Two jobs.** If you have two jobs or you're married filing jointly and you and your spouse each have one job, find the amount from the appropriate table on page 4. Using the "Higher Paying Job" row and the "Lower Paying Job" column, find the value at the intersection of the two household salaries and enter that value on line 1. Then, **skip** to line 3 **1** \$ _____
- 2 Three jobs.** If you and/or your spouse have three jobs at the same time, complete lines 2a, 2b, and 2c below. Otherwise, skip to line 3.
 - a** Find the amount from the appropriate table on page 4 using the annual wages from the highest paying job in the "Higher Paying Job" row and the annual wages for your next highest paying job in the "Lower Paying Job" column. Find the value at the intersection of the two household salaries and enter that value on line 2a **2a** \$ _____
 - b** Add the annual wages of the two highest paying jobs from line 2a together and use the total as the wages in the "Higher Paying Job" row and use the annual wages for your third job in the "Lower Paying Job" column to find the amount from the appropriate table on page 4 and enter this amount on line 2b **2b** \$ _____
 - c** Add the amounts from lines 2a and 2b and enter the result on line 2c **2c** \$ _____
- 3** Enter the number of pay periods per year for the highest paying job. For example, if that job pays weekly, enter 52; if it pays every other week, enter 26; if it pays monthly, enter 12, etc. **3** _____
- 4 Divide** the annual amount on line 1 or line 2c by the number of pay periods on line 3. Enter this amount here and in **Step 4(c)** of Form W-4 for the highest paying job (along with any other additional amount you want withheld) **4** \$ _____

¹⁹ See Form W-4 and Instructions.



Practitioner Planning Tip

An employee may not wish to disclose other jobs to their current employer, in which case it would likely be in their best interest to use the tax withholding calculator discussed earlier.

Dependents and Other Credits. Taxpayers should consider any child tax or other dependent credits available if that may impact their estimated tax payments. Taxpayers with total income of \$200,000 or less (\$400,000 or less if MFJ) may be eligible for child and dependent care credits.²⁰

In 2023, to qualify for the child tax credit, the taxpayer must have a child under age 17 as of December 31 who qualifies as a dependent. The child must live with the taxpayer for more than half of the year and must have a social security number (SSN).²¹

Note. For more information on qualifications for the child tax credit, see IRC §24. Additionally, the IRS provides guidance at **uofi.tax/23x9x9** [www.irs.gov/credits-deductions/individuals/child-tax-credit].

When calculating withholding, taxpayers should also consider whether they are eligible to claim other dependents for whom they could claim a child tax credit. This would include an older child or a qualifying relative.²²

Note. For more information on the eligibility requirements for other dependents, see IRS Pub. 501, *Dependents, Standard Deduction, and Filing Information*.

Taxpayers should estimate any additional credits for which they are eligible when estimating their withholding amount. This may include the foreign tax credits and education tax credits.



Practitioner Planning Tip

Taxpayers who include these credits in their withholding calculation will increase their paycheck amounts, but this will likely reduce the amount of any refund they receive. Tax practitioners should have conversations with their clients and document answers as to whether their preference is higher paychecks throughout the year or a larger refund at the end of the year.

²⁰ IRC §24.

²¹ Ibid.

²² Ibid.

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Impact of Deductions. Currently, taxpayers are allowed either the standard or itemized deduction in computing taxable income and income tax. Unless the taxpayer expects to use the standard deduction on their income tax return, they should use the Form W-4 Deductions Worksheet under Step 4(b) to project the itemized deductions which would be reported on Form 1040, Schedule A, *Itemized Deductions*. This includes such itemized deductions as qualifying home mortgage interest, charitable deductions, state and local taxes (up to \$10,000) and medical expenses (subject to limitations). Additionally, taxpayers should consider other deductions such as student loan interest and traditional individual retirement arrangement (IRA) contributions.

Step 4(b)—Deductions Worksheet (Keep for your records.)



1	Enter an estimate of your 2023 itemized deductions (from Schedule A (Form 1040)). Such deductions may include qualifying home mortgage interest, charitable contributions, state and local taxes (up to \$10,000), and medical expenses in excess of 7.5% of your income	1	\$										
2	Enter: <table border="0"><tr><td rowspan="3">{</td><td>• \$27,700 if you're married filing jointly or a qualifying surviving spouse</td><td rowspan="3">}</td><td rowspan="3">.</td><td rowspan="3">2</td><td rowspan="3">\$</td><td rowspan="3"></td></tr><tr><td>• \$20,800 if you're head of household</td></tr><tr><td>• \$13,850 if you're single or married filing separately</td></tr></table>	{	• \$27,700 if you're married filing jointly or a qualifying surviving spouse	}		2	\$		• \$20,800 if you're head of household	• \$13,850 if you're single or married filing separately			
{	• \$27,700 if you're married filing jointly or a qualifying surviving spouse		}							2	\$		
	• \$20,800 if you're head of household												
	• \$13,850 if you're single or married filing separately												
3	If line 1 is greater than line 2, subtract line 2 from line 1 and enter the result here. If line 2 is greater than line 1, enter "0"	3	\$										
4	Enter an estimate of your student loan interest, deductible IRA contributions, and certain other adjustments (from Part II of Schedule 1 (Form 1040)). See Pub. 505 for more information	4	\$										
5	Add lines 3 and 4. Enter the result here and in Step 4(b) of Form W-4	5	\$										

Shareholders and Partners²³

Shareholders and partners include in their taxable income any share of the partnership or S corporation's income or loss for the months ending before the due date of the installment payment. This also includes distributive shares of partnership items, guaranteed payments, and gains/losses on partnership property distributions.

Tax withheld on Forms W-2, 1099s, and other forms as referenced on Form 1040, line 25c are assumed to have been paid evenly throughout the year.

Caution. If the taxpayer's year differs from the S corporation or partnership, the taxpayer's distributive share must be considered for the months in the entity's tax year ending within the tax year of the individual which precede the month in which the estimated tax installment date falls.

Withholding from Retirement Plan Withdrawals²⁴

When taxpayers take a withdrawal from a retirement plan, including required minimum distributions (RMDs), they should calculate any estimated tax payments and appropriately withhold taxes from the distribution. Taxpayers must include the tax and any penalties from early withdrawals from an IRA or other retirement plan in their calculation of estimated tax payments.²⁵

Taxpayers can choose not to withhold tax on a withdrawal unless they are **eligible rollover distributions**. Eligible rollover distributions are distributions eligible to be rolled over tax-free into a qualified retirement or annuity plan. Generally, 20% of an eligible rollover distribution is withheld for income tax. For example, an IRC §401(k) distribution paid directly to the taxpayer instead of a trustee-to-trustee transfer remains eligible for a taxfree rollover for 60 days.²⁶

²³ Treas. Reg. §1.6654-2.

²⁴ IRS Pub. 505, *Tax Withholding and Estimated Tax*; IRS Pub. 575, *Pension and Annuity Income*.

²⁵ See IRC §72(t).

²⁶ *Rollovers of Retirement Plan and IRA Distributions*. Jun. 5, 2023. IRS. [www.irs.gov/retirement-plans/plan-participant-employee/rollovers-of-retirement-plan-and-ira-distributions] Accessed on Aug. 21, 2023.

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There is no withholding on any part of a distribution if it is reasonable for a taxpayer to believe that the distribution will not be included in gross income. A taxpayer choosing not to have income tax withheld from retirement plan payments completes either Form W-4P, *Withholding Certificate for Periodic Pension or Annuity Payments*, or Form W-4R, *Withholding Certificate for Nonperiodic Payments and Eligible Rollover Distributions*. This determination remains in effect until the taxpayer revokes it.

Note. A payor may ignore a taxpayer's choice not to have tax withheld under specific situations that are described in IRS Pub. 575, *Pension and Annuity Income*. These include a taxpayer who does not give the payor their SSN or the IRS notifies the payor, prior to them making the payment, that the taxpayer provided an incorrect SSN.

Periodic payments (amounts paid at regular intervals (weekly, monthly, or yearly) for longer than one year) are treated as wages for withholding purposes. **Taxpayers who do not complete a Form W-4P or similar form will have tax withheld as if they are married and claiming three withholding allowances.**

Nonperiodic payments are all amounts a taxpayer receives that are not an annuity. This includes cash withdrawals, distributions of current earnings on investments, certain loans, etc. The withholding rate for nonperiodic distributions is **10%**, assuming it is not an eligible rollover distribution, and the taxpayer chooses to have no withholding. A taxpayer can request the payor withhold additional amounts on Form W-4R. Up to 100% can be withheld. Therefore, a taxpayer could take a withdrawal at the end of the year and withhold the entire amount to cover their estimated taxes during the year.

Form W-4R		Withholding Certificate for Nonperiodic Payments and Eligible Rollover Distributions Give Form W-4R to the payer of your retirement payments. OMB No. 1545-0074 2023	
Department of the Treasury Internal Revenue Service			
1a First name and middle initial		Last name	
Address		1b Social security number	
City or town, state, and ZIP code			
Your withholding rate is determined by the type of payment you will receive. - For nonperiodic payments, the default withholding rate is 10%. You can choose to have a different rate by entering a rate between 0% and 100% on line 2. Generally, you can't choose less than 10% for payments to be delivered outside the United States and its territories. - For an eligible rollover distribution, the default withholding rate is 20%. You can choose a rate greater than 20% by entering the rate on line 2. You may not choose a rate less than 20%. See page 2 for more information.			
2 Complete this line if you would like a rate of withholding that is different from the default withholding rate. See the instructions on page 2 and the Marginal Rate Tables below for additional information. Enter the rate as a whole number (no decimals)		2	%
Sign Here Your signature (This form is not valid unless you sign it.) Date			

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Example 3. Jane calls her tax return preparer, Frank, in December of 2023 to inform him that she has just received an IRA distribution from her mother's estate. There were no taxes withheld on the distribution. Frank asks Jane about her other income, expenses, and life events for the year, and Jane tells him that "everything else is about the same as 2022."

Frank uses the information he has on hand to calculate a projection for 2023.

Total projected 2023 tax liability	\$9,000
2023 tax withholding	(6,500)
Projected balance due	\$2,500

Because Jane's projected balance due is over \$1,000, she may need to make an estimated tax payment. In 2022, Jane's total tax liability was \$6,000. Frank compares her actual 2022 and projected 2023 taxes to the amount of 2023 withholding to see if she meets one of the safe harbor exceptions.

	2022 Actual Taxes	2023 Projected
Total tax liability	\$6,000	\$9,000
Applicable percentage	$\times 100\%$	$\times 90\%$
Safe harbor threshold	\$6,000	\$8,100
Lower of two above thresholds	\$6,000	
2023 withholding	\$6,500	

Because Jane's 2023 withholding is greater than 100% of her 2022 taxes, she is not required to make an estimated tax payment for 2023.

RMDs. Retirement plan participants must begin taking RMDs starting at age 73 (if that individual reaches age 72 after December 31, 2022).²⁷ As a nonperiodic payment, RMDs are subject to the 10% withholding, as described previously. The IRS treats amounts withheld from IRA distributions, including RMDs, as paid evenly throughout the year, including lump-sum payments at the end of the year.²⁸

Example 4. Phillip made wise investing decisions during his working career and does not require his RMDs to support himself. Based on his 2022 tax liability, Phillip must make estimated tax payments in 2023 of \$15,000. His RMD for 2023 is also \$15,000. Phillip waits until December to take his RMD and requests that 100% of the distribution be withheld to cover his tax estimate for the year. By using this strategy, Phillip avoids making quarterly estimates and avoids any underpayment penalties, while keeping his money in his IRA for most of the year.

Caution. Although the strategy of using withholding from an RMD works on federal tax liabilities, it may not work on state tax liabilities. Individuals should check with their IRA sponsors to ensure that their plan allows for state-tax withholding.

²⁷ IRC §401(a)(9).

²⁸ *The RMD Solution to the Hassle of Filing Estimated Taxes in Retirement*. McCormally, Kevin and Mengle, Rocky. Sep. 14, 2021. Kiplinger. [www.kiplinger.com/retirement/retirement-plans/required-minimum-distributions-rmds/603438/rmd-solution-for-estimated-taxes] Accessed on Jun. 26, 2023.

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End-of-Year Bonuses

A bonus paid at the end of the year is considered supplemental wages.²⁹ Individuals can treat such payments as if paid evenly throughout the year.³⁰

Generally, bonuses that are less than \$1 million are subject to 22% withholding for income taxes.³¹

Withholding for Roth Conversions or High-Income Bonuses³²

Generally, the conversion of a retirement plan into a Roth IRA is a taxable event. Therefore, a plan participant may need to increase their withholding or make an estimated tax payment to avoid an underpayment penalty. A taxpayer should also consider whether the taxable income from the Roth conversion puts them into a higher tax bracket. This may also require additional withholding or estimates.

Caution. Taxpayers who move into a higher tax bracket because of a Roth conversion or other bonus should also consider the impact of their higher modified adjusted gross income (MAGI) on Medicare premiums and NIIT. A taxpayer who is suddenly subjected to those additional taxes may require estimated tax payments to cover their increased liability.



Practitioner Planning Tip

It is essential for a practitioner to advise their client to appropriately tax plan and mitigate any potential penalties or interest assessments. While it may not be possible to know every detail about a client's current year tax situation, additional confidence could be found in setting up mid-summer tax planning appointments or requesting information from the client's investment advisor or attorney.

²⁹ Treas. Reg. §31.3402(g)-1(a)(1)(i).

³⁰ Treas. Reg. §31.3402(g)-1; IRS Pub. 15, (*Circular E*), *Employer's Tax Guide*.

³¹ IRS Pub. 15, (*Circular E*), *Employer's Tax Guide*.

³² *Retirement Plans FAQs on Designated Roth Accounts*. Nov. 1, 2022. IRS. [www.irs.gov/retirement-plans/retirement-plans-faqs-on-designated-roth-accounts] Accessed on Jun. 27, 2023.

COLLEGE COST PLANNING

Higher education costs can represent a significant expense, making it important to plan years in advance. The government and many state agencies have programs to subsidize a portion of higher education costs by leveraging tax-free growth within certain accounts designated for college savings.

Taxpayers should evaluate the different college cost-planning resources available to maximize earnings potential and tax-free growth. This section covers different college cost-planning strategies, associated potential tax implications, and ways to optimize education cost assistance through government and state-sponsored programs.

ACCOUNT OPTIONS

IRC §529 accounts are a common strategy for college planning. Other options also come with tax advantages, including standard brokerage accounts, educational savings accounts, retirement account funds, and insurance policies.

IRC §529 Accounts

IRC §529 accounts, also known as **qualified tuition plans** or **qualified savings plans**, are tax-advantaged accounts designed to encourage saving for education costs.³³ These accounts are commonly sponsored and run by state agencies and educational institutions.

IRC §529 accounts grow tax-free, and distributions from them are tax-free, provided the account holder uses the funds for qualifying education expenses. There may be situations where account holders withdraw funds from the account and do not use them for qualifying education expenses. In such cases, the portion of the withdrawal attributable to account growth is subject to ordinary income taxation and a 10% penalty.³⁴

Qualifying education expenses include elementary, secondary, and higher education expenses. Common expenses include room and board, tuition and fees, books and supplies, special needs service expenses, and up to \$10,000 of payments on qualified student loans.³⁵

Caution. Not all states allow §529 funds to be used for elementary and secondary expenses. Allowed distributions may also vary by state.³⁶

Contributions to §529 accounts are not deductible for federal tax purposes but may have state tax ramifications. Over 30 states, including the District of Columbia, offer a tax credit for qualifying contributions.³⁷

Putting money into a §529 account may affect a college's judgment in awarding financial aid. The student **must disclose** the existence of any §529 accounts. Thus, it is important to consider the trade-off between potentially tax-free account growth and financial aid awards.³⁸

³³ *An Introduction to 529 Plans*. May 29, 2018. U.S. Securities and Exchange Commission. [www.sec.gov/about/reports-publications/investor-publications/introduction-529-plans] Accessed on May 31, 2023.

³⁴ IRC §529(e); IRS Pub. 970, *Tax Benefits for Education*.

³⁵ IRC §529(e)(3); IRS Pub. 970, *Tax Benefits for Education*.

³⁶ *Using Your 529 Funds*. 2023. NEST 529 College Savings Plan. [nest529.com/use-of-funds] Accessed on Aug. 2, 2023.

³⁷ *State Section 529 Deductions*. 2023. Finaid. [finaid.org/savings/state529deductions] Accessed on May 28, 2023.

³⁸ *How do 529 plans Affect Financial Aid?* Jul. 28, 2022. Saving For College. [www.savingforcollege.com/intro-to-529s/does-a-529-plan-affect-financial-aid] Accessed on Jun. 13, 2023.

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Brokerage Accounts

A brokerage account's design is to buy and sell investments. Funds in a brokerage account will continue to accumulate through interest, dividends, capital gain proceeds, and market appreciation.

Brokerage accounts under the name of a taxpayer's child may be subject to the **Kiddie Tax**. Under IRC §1(g), a child's unearned income is taxed at the parent's tax rate to avoid exploiting tax loopholes by placing assets and income in the child's name. Tax rates assessed on dependent returns can be significantly lower than those of the parents. The Kiddie Tax prohibits parents from taking advantage of the lower tax rates by requiring them to pay income tax at a rate equal to that of the parents. Dependents are subject to the Kiddie Tax when their situation meets the following criteria for 2023.³⁹

- The child's unearned income is more than \$2,500.
- The child is under the age of 18 and pays less than half of their support **or** was a full-time student between ages 19 and 24.
- The child has at least one parent alive at the end of the tax year.
- The child must file a tax return for the current tax year.
- The child does not file a joint return for the current tax year.

A child who meets these criteria must file an individual income tax return and attach Form 8615, *Tax for Certain Children Who Have Unearned Income*. Alternatively, parents can elect to report and pay taxes on the child's income by filing Form 8814, *Parents' Election to Report Child's Interest and Dividends*.⁴⁰

Note. For 2023, parents can elect to pay taxes on the child's income that exceeds \$2,500 but is less than \$11,500. Income from interest, dividends, and capital gain distributions exceeding \$11,500 will require the child to file an individual income tax return.⁴¹ If the child has capital gains or losses from sales they will need to file their own return.⁴²

Educational Savings Account

Educational savings accounts (ESAs), **also known as Coverdell Accounts**, work similarly to §529 accounts, where earnings within the account grow tax-free. However, ESAs have income phaseout thresholds and limit the contribution amount.⁴³

Taxpayers can set up multiple accounts for the same beneficiary, but the total contribution to all accounts must aggregate to \$2,000 or less.⁴⁴ Single taxpayers contributing to ESAs must have a MAGI under \$110,000 or \$220,000 if MFJ.⁴⁵

³⁹ IRC §1(g); *Topic Number 533 — Tax on a Child's Investment and Other Unearned Income (Kiddie Tax)*. Mar. 30, 2023. IRS. [www.irs.gov/taxtopics/tc553] Accessed on May 30, 2023.

⁴⁰ Ibid.

⁴¹ Ibid.

⁴² *Topic Number 553 — Tax on a Child's Investment and Other Unearned Income (Kiddie Tax)*. Mar. 30, 2023. IRS. [www.irs.gov/taxtopics/tc553] Accessed on Aug. 21, 2023; Instructions for Form 8814.

⁴³ IRC §530(c); IRS Pub. 970, *Tax Benefits for Education*.

⁴⁴ IRC §530(b); IRS Pub. 970, *Tax Benefits for Education*.

⁴⁵ IRS Pub. 970, *Tax Benefits for Education*, p. 38 (2022).

Similar to §529 accounts, account holders can use funds in ESAs for elementary and secondary education expenses. ESAs are also subject to a 10% penalty and ordinary income taxation on fund growth if the account beneficiary does not use the funds to pay for qualifying education expenses.⁴⁶ However, the additional 10% penalty **does not apply** in the following circumstances.⁴⁷

- The distribution was a payment to a beneficiary or the designated beneficiary's estate following the death of a designated beneficiary.
- The purpose of the distribution was attributable to the designated beneficiary being disabled.
- The designated beneficiary received tax-free educational assistance. The distribution is exempt from the 10% penalty up to the amount of the aid.
- The designated beneficiary attends a military academy, including the United States Military Academy, the United States Naval Academy, the United States Air Force Academy, the United States Coast Guard Academy, and the United States Merchant Marine Academy. The distribution is exempt from the 10% penalty up to the amount of higher education costs for enrollment in such military academy.

Example 5. Barney and Betty anticipate sending their children to private elementary and secondary schools, even though their daughters are only a few months old. Their MAGI is under \$200,000. Because Barney and Betty expect high educational costs, they establish an ESA for each child, listing them as beneficiaries. Because of a fortunate financial situation, their two daughters did not need to use these funds until college. As a result, the growth in their ESAs enables their children to attend college without incurring student loan debt.

Calculating the Taxable Portion of a Distribution. The taxable portion of a distribution is the amount of the excess distribution (distributions in excess of adjusted qualified education expenses (AQEE), discussed later) that represents earnings that have accumulated tax free in the account. The taxable portion is calculated as follows.⁴⁸

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

AQEE is calculated by reducing qualified education expenses by any tax-free educational assistance, including the following.⁴⁹

- Tax-free part of any scholarship or fellowship grant (including Pell grants)
- Tax-free part of any employer-provided educational assistance
- Veterans' educational assistance
- Any other educational assistance that is excludable from gross income, other than as a gift, bequest, devise, or inheritance)

⁴⁶ IRC §530(d); IRS Pub. 970, *Tax Benefits for Education*.

⁴⁷ Ibid.

⁴⁸ IRS Pub. 970, *Tax Benefits for Education*.

⁴⁹ Instructions for Form 8863; IRS Pub. 970, *Tax Benefits for Education*.

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Funds in Retirement Accounts or Insurance Policies

Taxpayers can withdraw funds penalty-free from an IRA or take a §401(k) loan to pay for higher education expenses.⁵⁰ Higher education expenses include tuition, books, supplies, and equipment necessary to attend an educational institution.⁵¹ Special-needs equipment and expenses also constitute a qualified higher education expense.⁵²

Insurance policies can also offer a flexible approach to higher education expenses. Funds from universal or whole life policies can pay for higher education expenses, including tuition.⁵³ Life insurance loans and proceeds generally do not have any tax implications on the individual income tax return.

Disclosure of retirement funds and insurance policies is generally not includable on the Free Application for Federal Student Aid (FAFSA) (explained later). However, they are includable on a student's College Scholarship Service (CSS) profile. The College Board maintains CSS profiles for students which includes information that extends beyond that required of the FAFSA. A CSS profile is a single common application that students and families can use to reduce the number of times they enter financial data to apply for scholarships. A student's ability to obtain nonfederal scholarships and other aid may be impacted by any funds in retirement or insurance accounts.⁵⁴ Thus, a deliberate shift to these accounts might not affect an applicant's FAFSA report and aid package, but can impact a potential student's CSS profile.

FEDERAL STUDENT AID TAX STRATEGIES

Federal Student Aid (FSA) helps students receive federal funding for higher education expenses through grants, scholarships, and loans. The U.S. Department of Education oversees the FSA, which manages the FAFSA under *Title IV* of the *Higher Education Act of 1965*. The FSA reviews applications, develops the FAFSA forms, reconciles federal student aid, monitors assistance, and manages the federal student loan portfolio.⁵⁵

The FAFSA is a detailed form requesting financial information from students and parents. It was announced that a new FAFSA application will be launched in December 2023, for the 2024–2025 academic year.⁵⁶ It should have fewer questions and provide a more streamlined experience than the current form. A mandatory IRS Direct Data Exchange will replace the current IRS Data Retrieval Tool.

⁵⁰ IRC §72(t)(2)(E); IRS Pub. 590-B, *Distributions from Individual Retirement Arrangements (IRAs)*.

⁵¹ IRC §529(e)(3); IRS Pub. 590-B, *Distributions from Individual Retirement Arrangements (IRAs)*.

⁵² *Ibid.*

⁵³ *Using Your Life Insurance to Help Pay for a Child's College*. Sep. 18, 2018. Next Avenue. [www.nextavenue.org/life-insurance-pay-childs-college] Accessed on May 28, 2023.

⁵⁴ *How to Complete the CSS Profile*. Sep. 27, 2022. U.S. News and World Report. [www.usnews.com/education/best-colleges/paying-for-college/articles/everything-you-need-to-know-to-complete-the-css-profile] Accessed on May 28, 2023.

⁵⁵ *About Us*. May 13, 2023. Federal Student Aid. [www.studentaid.gov/about] Accessed on May 28, 2023.

⁵⁶ *2024–2025 FAFSA Roadmap*. Apr. 12, 2023. U.S. Department of Education. [fsapartners.ed.gov/knowledge-center/topics/fafsa-simplification-information/2024-25-fafsa-roadmap]. Accessed on Aug. 2, 2023.

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There are strategies students can use to obtain higher funds from FSA, including the following.

- **Filing Early.** The FAFSA generally opens in the fall and closes on June 30, before the end of the school year for which the student is seeking assistance. This window allows students to receive financial aid at any point in the school year. However, FAFSA works based on a first-come, first-serve model. Each state has its own priority deadline.⁵⁷
- **Reduce Reportable Assets.** Because financial aid depends on an applicant's financial position, among other criteria, legally reducing reportable assets can result in higher scholarships, grants, and loans from the FSA. Strategies include using assets to pay down debt, leveraging reportable and non-reportable asset classes, and moving assets from the parent's name into the student's name. Larger assets reported on the FAFSA reduce a student's eligibility for need-based financial aid, regardless of whether their parents assist with higher education expenses.⁵⁸
- **Reduce Income in the FAFSA Base Year.** For the 2023-2024 school year, the FAFSA uses income reported on the 2021 individual income tax return as the base year for calculating financial aid packages.⁵⁹ Reducing the base year income helps prospective students applying for financial aid in future years. Strategies to reduce the base year for the application include using capital losses to lower income and postponing bonuses and other large income payments until the following year.
- **Coordinate with the American Opportunity Tax Credit (AOC).** Taxpayers eligible for the AOC could allocate up to \$4,000 of qualifying expenses to maximize this credit. The IRS prohibits double-dipping, where taxpayers cannot use the same qualifying expenses for tax-free distributions from §529 accounts and to claim the AOC.⁶⁰ The AOC is covered later in this section.

EARNINGS ON FORM 1099-Q⁶¹

Individuals receive a Form 1099-Q, *Payments From Qualified Education Programs (Under Sections 529 and 530)*, when they receive distributions from a §529 account, which is a qualified tuition program (QTP). The form identifies the recipient's information, gross distribution, earnings within the account, and the individual's basis in those earnings.

☐ CORRECTED (if checked)

PAYER'S/TRUSTEE'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.		1 Gross distribution \$	OMB No. 1545-1760 Form 1099-Q (Rev. November 2019) For calendar year 20__	Payments From Qualified Education Programs (Under Sections 529 and 530)	
		2 Earnings \$			
PAYER'S/TRUSTEE'S TIN	RECIPIENT'S TIN	3 Basis \$	4 Trustee-to-trustee transfer ☐		Copy B For Recipient This is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
RECIPIENT'S name Street address (including apt. no.) City or town, state or province, country, and ZIP or foreign postal code Account number (see instructions)		5 Distribution is from: • Qualified tuition program— Private ☐ or State ☐ • Coverdell ESA ☐ If the fair market value (FMV) is shown below, see Pub. 970 , Tax Benefits for Education, for how to figure earnings.			

Form **1099-Q** (Rev. 11-2019) (keep for your records)
www.irs.gov/Form1099Q
Department of the Treasury - Internal Revenue Service

- ^{57.} *FAFSA Deadlines.* May 13, 2023. Federal Student Aid. [www.studentaid.gov/apply-for-aid/fafsa/fafsa-deadlines] Accessed on May 28, 2023.
- ^{58.} *How to Shelter Assets on the FAFSA.* Kantrowitz, Mark. May 16, 2022. Saving for College. [www.savingforcollege.com/article/how-to-shelter-assets-on-the-fafsa] Accessed on May 28, 2023.
- ^{59.} *Federal Student Aid Handbook.* 2023. Federal Student Aid. [fsapartners.ed.gov/sites/default/files/2023-2024/2023-2024_Federal_Student_Aid_Handbook/_knowledge-center_fsa-handbook_2023-2024_application-and-verification-guide.pdf] Accessed on Jun. 2, 2023.
- ^{60.} *File the FAFSA to Get More Money In College.* Kantrowitz, Mark. Oct. 3, 2022. College Ave. Student Loans. [www.collegeavestudentloans.com/blog/file-the-fafsa-to-get-more-money-in-college] Accessed on Jan. 30, 2023.
- ^{61.} Instructions for Form 1099-Q.

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The reported gross distribution includes the portion of the earnings within the account. If the distribution equals or exceeds the qualified educational expenses incurred, taxpayers do not report the earnings as taxable income on their return.

However, if any portion of the distribution reported in box 1 is taxable, then the earnings in box 2 will be used to calculate the taxable portion of the distribution by applying an **earnings ratio**. The earnings ratio consists of earnings allocable in the account as of the distribution date multiplied by the percentage of the distribution the taxpayer used for noneducation expenditures.⁶² Additionally, only accounts with the same tuition program, account holder, and designated beneficiary are aggregated to calculate earnings on distributions.⁶³

Example 6. Noah and Alex are sending their daughter to college in the fall. They have not yet received an expected cost breakdown for the year, so they decided to pull out \$50,000 from their daughter's §529 account. This distribution consists of \$40,000 of contributions and \$10,000 of earnings. Their daughter's actual qualifying expenses total only \$45,000. Because they used 10% of the withdrawn funds for noneducational purposes ($(\$50,000 - \$45,000) \div \$50,000$), Noah and Alex are subject to income tax on \$1,000 of earnings ($\$10,000 \times 10\%$).

Caution. To eliminate any potential timing issues, taxpayers should take the distribution prior to making the payment in the same tax year.

Reporting Requirements

The responsible party for reporting Form 1099-Q earnings depends on the recipient's TIN, which is generally the beneficiary. Sometimes, Form 1099-Q lists a parent's TIN. Consequently, the parent would report the information from Form 1099-Q on their income tax return.⁶⁴ Usually, Form 1099-Q lists the designated beneficiary as the recipient for distributions made directly to the designated beneficiary or an educational institution on behalf of the designated beneficiary. If these two situations are not applicable, Form 1099-Q lists the account owner as the recipient of the distribution.

Note. If parents claim the AOC, but the student reports earnings from a Form 1099-Q on their income tax return, it is important to avoid double-dipping on qualified education expenses. The parents would not include the costs the Form 1099-Q covered on their return when calculating the AOC. Instead, the student should claim the expenses on their income tax return to offset the Form 1099-Q distribution or choose to include the taxable distribution in income.

PREPAID TUITION OR SAVINGS PLANS

IRC §529 accounts are segregated into two separate categories: prepaid tuition plans, and savings account plans. Contributors to either type of §529 accounts are not limited by AGI constraints as they would be for ESAs. This section highlights the nuances of each category.

⁶² IRS Notice 2001-81, 2001-52 IRB 617.

⁶³ IRS Notice 2016-13, 2016-7 IRB 314.

⁶⁴ Instructions for Form 1099-Q.

Prepaid Tuition Plans⁶⁵

Prepaid tuition plans generally limit coverage to only tuition and fees in higher education. Many other expenses, such as room, board, and supplies, are not eligible. State-sponsored prepaid tuition plans provide credits for institutions within the states. Additionally, there are private tuition plans for participating college programs.

Prepaid tuition plans are limited to higher education institutions that participants may use the credits toward. For instance, specific prepaid plans apply to 2-year programs, while others only apply to 4-year programs. Depending on the specifics of the contract, certain graduate school tuition could be covered under the plan. Furthermore, the participant has no control over the funds' investments, as contributions go into the general fund to purchase future tuition credits. However, prepaid tuition plans can lock in tuition prices.

Caution. Prepaid tuition plans generally require the taxpayer or their child to be a resident of the state sponsoring the plan.

Note. If the beneficiary does not attend a college that is a part of the plan, the remaining prepaid tuition plan funds can be transferred to a new beneficiary, such as a sibling. Age restrictions might impact the transferability depending on the state sponsoring the plan. When the funds go unused for qualified tuition or the account holder cancels the plan, the account holder only receives the amount they contributed, less a potential cancellation fee.

Savings Account Plans⁶⁶

A state or an agency of the state establishes savings account plans. IRC §529 savings plans are more flexible than prepaid tuition plans, applying to prospective students of all ages. Funds within savings account plans are available for a broader set of expenses, including textbooks, tuition, room, board, equipment, and computers. These plans also have provisions that apply to elementary and secondary education expenses.

Unlike prepaid tuition plans, savings account plans apply to universities across the country and some overseas programs. These provisions allow more flexibility in the use of the funds. Additionally, the investment mix within the account can be changed up to two times per year, giving taxpayers more control over how they invest their money.

Example 7. John and Carla are saving for their child, Joe, who wants to attend college in California. Their current home location is in Maine. However, John and Carla like a Montana §529 program. They decide to establish a §529 savings plan in Montana, even though they live in Maine and Joe wants to attend college in California. John and Carla can use these funds for tuition in California under a savings account plan, whereas they may face restrictions if they use a prepaid tuition plan.

Note. Although individuals can contribute to plans outside their resident state, this can hinder state tax credits. Many states only offer credits for contributions to plans within that state. Therefore, state taxation laws are an important income tax consideration when deciding to contribute to out-of-state education savings programs.

⁶⁵. 529 Plans. 2023. FINRA. [www.finra.org/investors/investing/investment-accounts/college-savings-accounts/529-plans] Accessed on May 29, 2023.

⁶⁶. Ibid.

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SAVINGS BONDS⁶⁷

Savings bonds are another method available to pay for higher education expenses. A qualified U.S. savings bond is one issued after December 31, 1989, to an individual who attained age 24 before the date of issuance at a discount under 31 USC §3105. To the extent that the holder uses proceeds from the savings bonds to pay qualifying higher education costs, the interest they receive from the bond is tax-free. Room and board and other recreational activities are **excluded** from qualifying education costs. However, students can use savings bonds for graduate or undergraduate studies.

This treatment is limited to individuals whose MAGI does not exceed an income threshold, despite being indexed for inflation. For 2023, the phaseouts are as follows.⁶⁸

- \$91,850 to \$106,850 for single and head of household filers
- \$137,800 to \$167,800 for MFJ and qualifying surviving spouse filers

Individuals who exceed the phaseout amounts cannot exclude interest income from savings bonds. Individuals filing as MFS also cannot exclude savings bond interest, regardless of their AGI.

Example 8. Sarah's grandpa, Randy, buys a \$15,000 savings bond in 2010 when he is 70 years old which he plans to use to pay for Sarah's eventual college expenses. When Sarah starts college in 2023, Randy cashes in the bond and uses the proceeds to pay her tuition. There is no tax liability on the bond proceeds because he meets the income and age requirements.

LOANS

Outside loans through public and private institutions can be used to pay for qualifying higher education expenses.⁶⁹ These loans are unsecured, recourse loans that require repayment. However, interest on loans tied to educational purposes can be taken as an adjustment on the federal tax return of up to \$2,500 if certain circumstances apply.⁷⁰ The loan must solely pay higher education expenses on behalf of the taxpayer, the taxpayer's spouse, or a dependent. Additionally, the borrower must incur the educational costs within a reasonable timeframe from the loan date.⁷¹

Student loan interest is an above-the-line adjustment, altering a taxpayer's AGI, provided that the taxpayer does not exceed the MAGI limits. The MAGI limits for 2023 are as follows.⁷²

- \$90,000 for single, head of household, and qualifying surviving spouse filers
- \$180,000 for MFJ filers

Taxpayers report their student loan interest deduction on part II of Schedule 1, *Additional Income and Adjustments to Income*, of the Form 1040. This deduction, along with taxpayers' other income and adjustments, flows through on the adjustments to the income line on Form 1040. Similar to savings bonds, taxpayers who file as MFS are excluded from taking the \$2,500 adjustment.⁷³ Additionally, dependents may not take this deduction on their return.

⁶⁷ IRC §135.

⁶⁸ Rev. Proc. 2022-38, 2022-45 IRB 445.

⁶⁹ IRC §221(d)(2).

⁷⁰ IRC §221(b)(1).

⁷¹ IRC §221(d)(1).

⁷² IRC §221; Rev. Proc. 2022-38, 2022-45 IRB 445.

⁷³ IRC §221(e)(2).

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Example 9. Martha reports her total income of \$50,000 on her 2022 Form 1040. She took out a loan to pay for her daughter's tuition. Interest on the loan totaled \$2,000, and Martha used the entire amount toward tuition at an eligible institution. Martha enters \$2,000 on line 21 of Schedule 1, which flows through to line 10 on Form 1040. Martha can thereby deduct \$2,000 from her total income to generate an AGI of \$48,000.

Schedule 1 (Form 1040) 2022

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Part II Adjustments to Income

11	Educator expenses	11	
12	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106	12	
13	Health savings account deduction. Attach Form 8889	13	
14	Moving expenses for members of the Armed Forces. Attach Form 3903	14	
15	Deductible part of self-employment tax. Attach Schedule SE	15	
16	Self-employed SEP, SIMPLE, and qualified plans	16	
17	Self-employed health insurance deduction	17	
18	Penalty on early withdrawal of savings	18	
19a	Alimony paid	19a	
b	Recipient's SSN		
c	Date of original divorce or separation agreement (see instructions):		
20	IRA deduction	20	
21	Student loan interest deduction	21	2,000
22	Reserved for future use	22	
23	Archer MSA deduction	23	
24	Other adjustments:		
a	Jury duty pay (see instructions)	24a	
b	Deductible expenses related to income reported on line 8i from the rental of personal property engaged in for profit	24b	
c	Nontaxable amount of the value of Olympic and Paralympic medals and USOC prize money reported on line 8m	24c	
d	Reforestation amortization and expenses	24d	
e	Repayment of supplemental unemployment benefits under the Trade Act of 1974	24e	
f	Contributions to section 501(c)(18)(D) pension plans	24f	
g	Contributions by certain chaplains to section 403(b) plans	24g	
h	Attorney fees and court costs for actions involving certain unlawful discrimination claims (see instructions)	24h	
i	Attorney fees and court costs you paid in connection with an award from the IRS for information you provided that helped the IRS detect tax law violations	24i	
j	Housing deduction from Form 2555	24j	
k	Excess deductions of section 67(e) expenses from Schedule K-1 (Form 1041)	24k	
z	Other adjustments. List type and amount:	24z	
25	Total other adjustments. Add lines 24a through 24z	25	
26	Add lines 11 through 23 and 25. These are your adjustments to income . Enter here and on Form 1040 or 1040-SR, line 10, or Form 1040-NR, line 10a	26	2,000

Schedule 1 (Form 1040) 2022

Income		1a	Total amount from Form(s) W-2, box 1 (see instructions)	1a	50,000
b		1b	Household employee wages not reported on Form(s) W-2	1b	
c		1c	Tip income not reported on line 1a (see instructions)	1c	
d		1d	Medicaid waiver payments not reported on Form(s) W-2 (see instructions)	1d	
e		1e	Taxable dependent care benefits from Form 2441, line 26	1e	
f		1f	Employer-provided adoption benefits from Form 8839, line 29	1f	
g		1g	Wages from Form 8919, line 6	1g	
h		1h	Other earned income (see instructions)	1h	
i		1i	Nontaxable combat pay election (see instructions)	1i	
z		1z	Add lines 1a through 1h	1z	50,000
2a		2a	Tax-exempt interest	2a	
3a		3a	Qualified dividends	3a	
4a		4a	IRA distributions	4a	
5a		5a	Pensions and annuities	5a	
6a		6a	Social security benefits	6a	
c			If you elect to use the lump-sum election method, check here (see instructions) ☐		
7		7	Capital gain or (loss). Attach Schedule D if required. If not required, check here ☐	7	
8		8	Other income from Schedule 1, line 10	8	
9		9	Add lines 1z, 2b, 3b, 4b, 5b, 6b, 7, and 8. This is your total income	9	
10		10	Adjustments to income from Schedule 1, line 26	10	2,000
11		11	Subtract line 10 from line 9. This is your adjusted gross income	11	48,000

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EDUCATION CREDITS

Two credits are available to reduce the cost of higher education for taxpayers, their spouses, and their dependents: the AOC and the lifetime learning credit. The following table compares the two credits.

	American Opportunity Credit	Lifetime Learning Credit
Refundable	40% of the credit may be refundable (limited to \$1,000 per student).	Nonrefundable
Annual limit	\$2,500 credit per student (100% of the first \$2,000 qualifying expenses, plus 25% of the next \$2,000)	\$2,000 credit per tax return
Qualified expenses	Tuition, books, supplies, equipment needed for a course of study, required enrollment or admission fees	Tuition and fees required for enrollment or admission
Qualifying expenses	Undergraduate	Undergraduate, graduate, and professional courses to acquire or improve job skills
Felony drug conviction restriction	Yes	No
Degree or certificate requirement	Yes: degree or other recognized credential	No requirement
Enrollment requirement	Yes, at least half-time for at least one academic period in tax year	One or more courses
MAGI phaseout for MFJ filers	\$160,000–\$180,000	\$160,000–\$180,000
MAGI phaseout for single, head of household, qualifying surviving spouse	\$80,000–\$90,000	\$80,000–\$90,000

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

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

Note. For more information on qualifications and calculations for the lifetime learning credit and the AOC, see the 2019 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 1: Individual Taxpayer Issues. This can be found at [uofi.tax/arc](https://taxschool.illinois.edu/taxbookarchive) [taxschool.illinois.edu/taxbookarchive].



Practitioner Planning Tip

The AOC is more beneficial than a tax-free §529 distribution, but additional qualifying educational expenses can be allocated to other sources such as §529 plans.

Coordination of Credits and Deductions

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

Example 10. Tara incurs \$8,500 of qualified education expenses, receives \$3,500 in tax-free scholarships, and takes a \$5,000 distribution from a §529 plan, of which \$800 represents earnings.

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

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

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

Example 11. Use the same facts as **Example 10**, except Tara's AQEE is reduced by \$4,000 to claim the AOC (assuming she meets all requirements to claim this credit).

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

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

\$800 earnings – \$160 tax-free earnings = \$640 taxable earnings (not subject to a 10% penalty).⁷⁴

If Tara is in the 22% tax bracket, she incurs \$141 of tax on the \$640 of taxable earnings. However, if she qualifies, she can take a maximum \$2,500 AOC.⁷⁵

⁷⁴ IRS Pub. 970, *Tax Benefits for Education*.

⁷⁵ Ibid.

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ALTERNATIVES

There are many alternatives for education cost-saving strategies, including those earned through military service and scholarships. The following are some alternative strategies for college cost planning.

GI Bill⁷⁶

The GI Bill aims to help veterans and their families pay for higher education, including college, graduate school, and training programs. Recipients can use GI Bill funds to pay for tuition, supplies, and textbooks. Recipients may also use funds for monthly housing subject to certain criteria and limitations, such as how long the veteran served in active duty, how many credit hours the student is enrolled in, and the campus location. Funds are paid directly to the institution of attendance.

Employer Funding

Some employers are willing to invest in the education of employees if it results in more value for the company. Employers can take a qualifying business deduction on their tax return for payments made toward continuing education.⁷⁷ Although the employee has no income tax benefit, it can reduce the out-of-pocket costs associated with attending higher education institutions.

Scholarships

Scholarships are another option for funding higher education. Unlike loans, students are not required to repay funds from scholarships to the issuer. Instead, scholarship recipients obtain the award from community involvement, contests, applications, academic achievement, merit, or financial need. Both public and private institutions offer a variety of scholarship programs for current and prospective students.

Note. Taxpayers can use scholarships in conjunction with other education savings programs. However, it is critical to offset education expenses with any awarded scholarships when calculating qualifying education expenses for tax credits to avoid inflated education credits and double-dipping expenses.

Scholarships are generally excluded from taxable income if a student actively participates in a degree program at an educational institution and spends the awarded funds on qualifying education expenses. These expenses include tuition, fees, supplies, books, and equipment.⁷⁸ In cases where services are furnished in exchange for a scholarship or the recipient uses the awarded funds for incidental expenses, such as travel or optional equipment, the taxpayer must include the funds as taxable gross income.⁷⁹

ROTC

Army Reserve Officers' Training Corps (ROTC) programs also offer higher education benefits. ROTC members develop technical skills and receive a structured path to a career in the military after college. Additionally, ROTC members may apply for scholarships and monetary support from the United States Army. In addition to tuition, scholarship recipients receive a monthly stipend for housing expenses and an annual stipend for books.⁸⁰ Stipends are reported as pay excluded from gross income on Form W-2, similar to a reimbursement.⁸¹ Accordingly, a recipient would not include the stipend as taxable income on their tax return.

⁷⁶ *About GI Bill Benefits*. Feb.14, 2023. U.S. Department of Veteran Affairs. [www.va.gov/education/about-gi-bill-benefits] Accessed on May 29, 2023.

⁷⁷ Treas. Reg. §1.162-5(a).

⁷⁸ IRC §117(b).

⁷⁹ *Topic Number 421 — Scholarships, Fellowships Grants, and Other Grants*. Apr. 4, 2023. IRS. [www.irs.gov/taxtopics/tc421] Accessed on Jun. 12, 2023.

⁸⁰ *Army ROTC Scholarships*. May 30, 2023. U.S. Army. [www.goarmy.com/careers-and-jobs/find-your-path/army-officers/rotc/scholarships.html] Accessed on Jun. 5, 2023.

⁸¹ IRS Pub. 3, *Armed Forces' Tax Guide*, p. 8 (2022).

SETTLING A TAXPAYER'S ESTATE

Tax practitioners find themselves in a position of being sought for advice on a myriad of tax topics. It is not uncommon for a tax practitioner to have a client come to them and say, “I have recently had a passing in the family. Now what do I do?” In addition to mourning the passing of a loved one, surviving friends and family members are also often overwhelmed with settling the affairs of the decedent and are unfamiliar with or unsure of what steps they need to take in meeting their fiduciary responsibilities. Tax practitioners can provide an invaluable service to such clients by helping them navigate this process, but attorneys also need to be involved.

This section covers the processes and steps for settling the affairs of a deceased taxpayer. This section flows similarly to how a practitioner would walk through the steps with their client. Unless specifically stated, the client is assumed to be an executor of an estate for purposes of this section.

KEY DOCUMENTS FOR MAPPING THE SETTLEMENT PROCESS

When first discussing the issue of estates with clients, tax practitioners should request a copy of important documents that will direct the conversation and provide a roadmap of instructions on how to proceed with settling the decedent's affairs. The decedent may have a will, trust, both, or neither.

Last Will and Testament

A last will and testament (will) is a legal document providing instructions on what to do with a decedent's property upon death. The document names the executor charged with carrying out the stipulations listed in the will. Additionally, the will lists the estate beneficiaries who will inherit the property. As such, a decedent's will is often the primary document for settling an estate, as it details what to do with the property, who should receive the property, and who will distribute the property.⁸²



Practitioner Planning Tip

As a first step, practitioners should begin any estate discussions with executors by **reading and developing an understanding** of the decedent's will. This step is critical in all cases, as each decedent's will differs from another's, and practitioners should not rely solely on an executor's interpretation or belief of a decedent's wishes. Legal advice should be sought to best understand these documents and the laws of applicable states.

Additionally, because individuals can amend their wills during their lifetime at any point, practitioners should request copies of any amendments or codicils to a will to ensure they are privy to the most current and complete provisions of a decedent's estate plan.

⁸² *Will*. ALM Global, LLC. [dictionary.law.com/Default.aspx?selected=2248] Accessed on Jul. 17, 2023.

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Trust Instrument⁸³

A common tool for estate planning, trusts are contractual arrangements under which an individual transfers legal property ownership to another party. Trusts are favored vehicles for managing and transferring property, as they offer flexibility in establishing criteria and timing provisions for handling assets and any income they generate.⁸⁴ When settling an estate, it is necessary to determine if the decedent established any trusts to ensure the assets placed in trust are distributed and handled in accordance with the trust provisions. Differentiating the assets by specific ownership will come into play when inventorying assets and assessing probate. This section discusses both topics later.

Note. For an in-depth analysis of the fundamentals of trusts, see the 2020 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 3: Trust Essentials. This can be found at uofi.tax/arc [taxschool.illinois.edu/taxbookarchive].

Like a will for an estate, a trust instrument governs what property is held in the trust and who the property will go to, known as **beneficiaries**. Additionally, the trust instrument identifies who will manage and distribute the property, known as the **trustee**.

Living Trusts. A living (or inter vivos) trust is an entity an individual (grantor) creates during their lifetime. The trust may be **revocable**, where the grantor retains the right to change or amend the trust. The trust instrument will contain language identifying whether the grantor has or maintains these rights. Alternatively, the trust can be **irrevocable**, where the grantor is unable to change or modify the trust. Upon the death of the grantor, any revocable trusts will become irrevocable by nature, as the grantor is no longer living and cannot exercise any right to change or modify the trust.⁸⁵

For state law purposes, when a grantor transfers assets to a trust, they should title the assets in the name of the trust, a process known as **funding the trust**. Failure to transfer titled assets, such as real estate and brokerage accounts, to the trust may result in those assets being subject to probate,⁸⁶ discussed later, unless the grantor employs a different method, such as payable on death (POD) or transfer on death (TOD).⁸⁷



Practitioner Planning Tip

Due to the complexity of the tax preparation process, it would be beneficial for practitioners to alert their clients to pay special attention to the titles of specific trust accounts.

⁸³ See Treas. Reg. §301.7701-4.

⁸⁴ *Trusts and estates: Uses and tax considerations*. Pippin, Sonja E. Feb. 2017. Journal of Accountancy. [www.journalofaccountancy.com/issues/2017/feb/trusts-and-estates-uses-tax-considerations.html] Accessed on Jul. 17, 2023.

⁸⁵ *Trusts: Common Law and IRC 501(c)(3) and 4947*. Thomas, Ward L. and Henzke, Jr., Leonard J. 2003. IRS. [www.irs.gov/pub/irs-tege/eotopica03.pdf] Accessed on Jul. 17, 2023.

⁸⁶ *The Probate Process*. American Bar Association. [www.americanbar.org/groups/real_property_trust_estate/resources/estate_planning/the_probate_process] Accessed on Jul. 18, 2023.

⁸⁷ POD (bypasses the probate process and for the funds to go directly to the beneficiary) and TOD (automatically transfers assets to a named beneficiary when the holder dies) are defined at *Pros and Cons: Payable on Death (POD) Accounts*. Lake, Rebecca. May 27, 2023. SmartAsset. [smartasset.com/estate-planning/payable-on-death] Accessed on Jul. 18, 2023.

Testamentary Trusts. When a grantor creates a trust under the provisions of their will, the trust is known as a testamentary trust. Unlike living trusts, testamentary trusts can only be irrevocable, as the trust is established after the grantor's death. The trust instrument for a testamentary trust is not a separate document, but is rather created within the provisions of the grantor's will.⁸⁸

Simple and Complex Trusts.⁸⁹ The status of a trust as a simple or complex trust is determined annually. A trust is designated as a simple trust if **all** the following are true for the tax year.

1. The trust instrument **requires** that all income must be distributed currently (regardless of whether or not the income is actually distributed);
2. The trust instrument does **not** provide that any amounts are to be paid, permanently set aside, or otherwise used for charitable purposes; and
3. The trust does not distribute amounts allocated to the corpus of the trust.

Any trust that does not qualify as a simple trust is a complex trust.

IDENTIFYING ESTATE BENEFICIARIES

A fundamental step in settling a taxpayer's estate is first identifying the beneficiaries and whether there is a surviving spouse. Additionally, practitioners should investigate the role that attorneys can play and consider executing a power of attorney (POA).

Caution. Tax practitioners should exercise extreme caution before advising a client that they may not need an attorney.

Surviving Spouse as Sole Beneficiary

When reviewing the will and trust documents, the practitioner should identify if the surviving spouse is the sole beneficiary of the decedent's estate. If that is the case, settling the estate can be much simpler and less involved than estates with multiple beneficiaries. With fewer parties involved, the identification of assets and who the title should transfer to is one person compared to multiple people. As such, administrative time for tracking down beneficiaries and having them sign documents to transfer the title of assets is limited to one person. Additionally, if the decedent's assets were jointly owned with the surviving spouse, transferring those assets directly to the spouse is simpler, generally requiring notification of the decedent's death to the broker or account manager instead of obtaining signatures for signing documents and providing evidence to support the transfer of title of an asset to a non-joint owner.

No Surviving Spouse or Multiple Non-Spouse Beneficiaries

For estates with no surviving spouse or multiple non-spouse beneficiaries, it may behoove the executor to involve an attorney and grant a practitioner with powers of attorney to help facilitate the settlement of the estate due to higher complexity. When a surviving spouse inherits all or the majority of a decedent's assets, the administrative process of distributing assets primarily consists of transferring title of those assets to the spouse. When multiple parties are beneficiaries, there is more involvement in the administrative process of transferring assets. Additionally, there is a higher risk of conflicting interests among multiple beneficiaries which could potentially result in litigation. Involving an attorney to aid in the administration, legal interpretation, and beneficiary communication involved in settling an estate early in the process can help reduce the burden of stress arising from such fiduciary responsibilities.

⁸⁸ *Trusts: Common Law and IRC 501(c)(3) and 4947*. Thomas, Ward L. and Henzke, Jr., Leonard J. 2003. [www.irs.gov/pub/irs-tege/eotopica03.pdf] Accessed on Jul. 17, 2023.

⁸⁹ IRC §651; Treas. Reg. §§1.1471-1(b)(22) and (118); see also Instructions for Form 1041.

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Role of an Attorney

Credentials and qualifications for tax return preparers **do not extend to the practice of law or legal interpretation**. Therefore, particularly in situations where a decedent's estate is complex, involves beneficiaries who disagree with each other, or the provisions of a will or trust instrument are difficult to interpret, an attorney may be needed to assist with the interpretation of the estate documents and the settlement of the estate. Tax practitioners can provide guidance on tax considerations for estate matters and serve as a translator between the executor and the attorney. There may be cases where the executor may feel more comfortable talking to their tax practitioner due to a longstanding and more familiar relationship with them compared to their attorney. Practitioners can provide value in multiple facets of these interactions with multiple parties. Practitioners and their clients should seek competent legal advice.

Authorization Forms

An executor may not have access to all pertinent tax documents and records needed while settling an estate. They must notify the IRS of their fiduciary relationship on behalf of the decedent, their estate, and any trusts. The executor can also grant the practitioner authorization to act as a representative on their behalf. In some cases, an executor may grant a practitioner with a POA, which authorizes the practitioner to perform "certain specified acts" on behalf of the taxpayer.⁹⁰ To initiate and establish these relationships and authorizations, the executor and practitioner must complete and submit the applicable forms.

Form 56.⁹¹ Fiduciaries file Form 56, *Notice Concerning Fiduciary Relationship*, with the IRS to notify the agency of a fiduciary relationship for which the filer is engaged. A **fiduciary** is a person acting on behalf of another living person or entity to assume the person or entity's powers, rights, duties, and privileges. Therefore, an executor of an estate would file Form 56 with the IRS to notify the agency that the executor has the rights and duties of the estate. Form 56 does not grant any powers or rights to the fiduciary. Instead, the form informs the IRS of the established relationship.

If there is no surviving spouse, or if the executor instead of the surviving spouse is responsible for filing the decedent's final Form 1040, the executor would also file a separate Form 56 to notify the IRS that the executor has the rights and duties of the decedent.⁹² These rights include receiving correspondence and obtaining information from the IRS. Duties include filing tax returns and paying any tax due on behalf of the taxpayer. A fiduciary also uses Form 56 to notify the IRS of the termination of their fiduciary relationship.

⁹⁰ IRM 4.11.55.1.6 (2018).

⁹¹ Instructions for Form 56.

⁹² IRC §6903.

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Example 12. Miranda passed away on June 12, 2023. She was widowed at the time of her passing, having been married to Stuart for 50 years before his passing on August 8, 2020. Miranda had two children living at the time of her death. In her will, she named Lydia, her eldest daughter, as the executor of her estate. In preparation for handling her mother's estate and expecting to have correspondence with the IRS, Lydia prepares and files the following Forms 56 with the IRS for both her mother and her mother's estate.

Form 56 (Rev. November 2022) Department of the Treasury Internal Revenue Service	Notice Concerning Fiduciary Relationship (Internal Revenue Code Sections 6036 and 6903) Go to www.irs.gov/Form56 for instructions and the latest information.	OMB No. 1545-0013
Part I Identification		
Name of person for whom you are acting (as shown on the tax return) Miranda Dunmeyer		Identifying number ***-**-6789
Address of person for whom you are acting (number, street, and room or suite no.) 2640 Steiner St		
City or town, state, and ZIP code (If a foreign address, see instructions.) San Francisco, CA 94115		
Fiduciary's name Lydia Hillard		
Address of fiduciary (number, street, and room or suite no.) 2640 Steiner St		
City or town, state, and ZIP code San Francisco, CA 94115		Telephone number (optional) ()
Section A. Authority		
1 Authority for fiduciary relationship. Check applicable box: a ☒ Court appointment of testate estate (valid will exists) b ☐ Court appointment of intestate estate (no valid will exists) c ☐ Court appointment as guardian or conservator d ☐ Fiduciary of intestate estate e ☐ Valid trust instrument and amendments f ☐ Bankruptcy or assignment for the benefit of creditors g ☐ Other. Describe: _____		
2a If box 1a, 1b, or 1d is checked, enter the date of death: 6/12/2023		
b If box 1c, 1e, 1f, or 1g is checked, enter the date of appointment, taking office, or assignment or transfer of assets: _____		
Section B. Nature of Liability and Tax Notices		
3 Type of taxes (check all that apply): ☒ Income ☐ Gift ☒ Estate ☐ Generation-skipping transfer ☐ Employment ☐ Excise ☐ Other (describe): _____		
4 Federal tax form number (check all that apply): a ☒ 706 series b ☐ 709 c ☐ 940 d ☐ 941, 943, 944 e ☒ 1040 or 1040-SR f ☐ 1041 g ☐ 1120 h ☐ Other (list): _____		
5 If your authority as a fiduciary does not cover all years or tax periods, check here ☐ and list the specific years or periods within your authority: _____		
For Paperwork Reduction Act and Privacy Act Notice, see separate instructions.		
Cat. No. 16375I		Form 56 (Rev. 11-2022)

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For Example 12

Form 56 (Rev. November 2022) Department of the Treasury Internal Revenue Service	Notice Concerning Fiduciary Relationship (Internal Revenue Code Sections 6036 and 6903) Go to www.irs.gov/Form56 for instructions and the latest information.	OMB No. 1545-0013
Part I Identification		
Name of person for whom you are acting (as shown on the tax return) Miranda Dunmeyer Estate		Identifying number 98-7654321
Decedent's social security no.		
Address of person for whom you are acting (number, street, and room or suite no.) 2640 Steiner St		
City or town, state, and ZIP code (If a foreign address, see instructions.) San Francisco, CA 94115		
Fiduciary's name Lydia Hillard		
Address of fiduciary (number, street, and room or suite no.) 2640 Steiner St		
City or town, state, and ZIP code San Francisco, CA 94115		Telephone number (optional) ()
Section A. Authority		
1 Authority for fiduciary relationship. Check applicable box: a ☒ Court appointment of testate estate (valid will exists) b ☐ Court appointment of intestate estate (no valid will exists) c ☐ Court appointment as guardian or conservator d ☐ Fiduciary of intestate estate e ☐ Valid trust instrument and amendments f ☐ Bankruptcy or assignment for the benefit of creditors g ☐ Other. Describe: _____		
2a If box 1a, 1b, or 1d is checked, enter the date of death: 6/12/2023		
b If box 1c, 1e, 1f, or 1g is checked, enter the date of appointment, taking office, or assignment or transfer of assets: _____		
Section B. Nature of Liability and Tax Notices		
3 Type of taxes (check all that apply): ☒ Income ☐ Gift ☐ Estate ☐ Generation-skipping transfer ☐ Employment ☐ Excise ☐ Other (describe): _____		
4 Federal tax form number (check all that apply): a ☒ 706 series b ☐ 709 c ☐ 940 d ☐ 941, 943, 944 e ☐ 1040 or 1040-SR f ☒ 1041 g ☐ 1120 h ☐ Other (list): _____		
5 If your authority as a fiduciary does not cover all years or tax periods, check here ☐ and list the specific years or periods within your authority: _____		
For Paperwork Reduction Act and Privacy Act Notice, see separate instructions.		
Cat. No. 16375I		Form 56 (Rev. 11-2022)

Form 2848.⁹³ Taxpayers file Form 2848, *Power of Attorney and Declaration of Representative*, with the IRS to notify the agency that the taxpayer is authorizing an individual to represent them before the IRS. The taxpayer further uses the form to describe the specific matters, tax forms, and years or periods they authorize the individual to represent them. In the case of an estate, an executor, having filed Form 56 notifying the IRS of their fiduciary relationship to the estate, may file Form 2848, giving authority to their tax practitioner to represent the estate in income tax matters. This authorization would pertain to Form 1041, *U.S. Income Tax Return for Estates and Trusts*, and the executor would list the tax years for which they authorize the practitioner to represent the estate.

⁹³ Instructions for Form 2848.

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Example 13. Use the same facts as **Example 12**. Lydia, as executor, wishes to have her attorney, Juliette, and her accountant, Drew, represent her mother's estate before the IRS. She prepares and files the following Form 2848 with the IRS to grant this authorization.

Form 2848 (Rev. January 2021) Department of the Treasury Internal Revenue Service	Power of Attorney and Declaration of Representative ► Go to www.irs.gov/Form2848 for instructions and the latest information.	OMB No. 1545-0150 For IRS Use Only Received by: _____ Name _____ Telephone _____ Function _____ Date ____/____/____
Part I Power of Attorney Caution: A separate Form 2848 must be completed for each taxpayer. Form 2848 will not be honored for any purpose other than representation before the IRS.		
1 Taxpayer information. Taxpayer must sign and date this form on page 2, line 7.		
Taxpayer name and address Miranda Dunmeyer Estate 2640 Steiner St, San Francisco, CA 94115		Taxpayer identification number(s) 98-7654321 Daytime telephone number 415-555-8268
hereby appoints the following representative(s) as attorney(s)-in-fact:		
2 Representative(s) must sign and date this form on page 2, line II.		
Name and address Juliette Marshall 1200 Market St, San Francisco, CA 94115 Check if to be sent copies of notices and communications ☐	CAF No. 9007-16078R PTIN _____ Telephone No. 415-555-7238 Fax No. _____ Check if new: Address ☐ Telephone No. ☐ Fax No. ☐	
Name and address Drew Letchworth 30 Pacific Ave Ste 203, San Francisco, CA 94115 Check if to be sent copies of notices and communications ☒	CAF No. 4006-16038R PTIN P03422666 Telephone No. 415-555-6496 Fax No. _____ Check if new: Address ☐ Telephone No. ☐ Fax No. ☐	
Name and address _____ (Note: IRS sends notices and communications to only two representatives.)	CAF No. _____ PTIN _____ Telephone No. _____ Fax No. _____ Check if new: Address ☐ Telephone No. ☐ Fax No. ☐	
Name and address _____ (Note: IRS sends notices and communications to only two representatives.)	CAF No. _____ PTIN _____ Telephone No. _____ Fax No. _____ Check if new: Address ☐ Telephone No. ☐ Fax No. ☐	
to represent the taxpayer before the Internal Revenue Service and perform the following acts:		
3 Acts authorized (you are required to complete line 3). Except for the acts described in line 5b, I authorize my representative(s) to receive and inspect my confidential tax information and to perform acts I can perform with respect to the tax matters described below. For example, my representative(s) shall have the authority to sign any agreements, consents, or similar documents (see instructions for line 5a for authorizing a representative to sign a return).		
Description of Matter (Income, Employment, Payroll, Excise, Estate, Gift, Whistleblower, Practitioner Discipline, PLR, FOIA, Civil Penalty, Sec. 4980H Shared Responsibility Payment, etc.) (see instructions)	Tax Form Number (1040, 941, 720, etc.) (if applicable)	Year(s) or Period(s) (if applicable) (see instructions)
Income	1041	2023 - 2026

Form 8821.⁹⁴ Taxpayers file Form 8821, *Tax Information Authorization*, with the IRS to notify the agency of an individual or entity the taxpayer authorizes to inspect and receive tax information. Like Form 2848, the taxpayer identifies the specific tax matter, form, and years or periods for which they authorize the designee to inspect and receive information. However, Form 8821 differs from Form 2848 in that the scope of the authorization is **substantially limited**. Form 8821 does not authorize a designee to represent the taxpayer before the IRS but provides authorization for the designee to obtain specific tax information. An executor may use Form 8821 to authorize their tax practitioner to receive tax information from the IRS if the executor does not want their practitioner to represent the estate before the IRS. Instead, the executor may wish to have their attorney or another tax specialist represent the estate before the IRS while authorizing their tax practitioner to obtain the estate's tax information from the IRS.

⁹⁴ Instructions for Form 8821.

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Example 14. Use the same facts as **Example 12**. Miranda's youngest daughter, Natalie, is a beneficiary of her mother's estate. Her accountant, Robert Lundy, would like access to Miranda's estate income tax returns to obtain detailed information regarding a net operating loss on Natalie's Schedule K-1 (Form 1041), *Beneficiary's Share of Income, Deductions, Credits, etc.* Believing it may be more convenient for him to obtain this information directly from the IRS, Robert suggests Lydia grant him authority to receive information regarding current and future Form 1041 filings. After discussing the matter with her attorney, Lydia agrees. She prepares and files the following Form 8821 to notify the IRS of this authorization.

Form 8821 (Rev. January 2021) Department of the Treasury Internal Revenue Service	Tax Information Authorization ► Go to www.irs.gov/Form8821 for instructions and the latest information. ► Don't sign this form unless all applicable lines have been completed. ► Don't use Form 8821 to request copies of your tax returns or to authorize someone to represent you. See instructions.	OMB No. 1545-1165 For IRS Use Only Received by: Name _____ Telephone _____ Function _____ Date _____	
1 Taxpayer information. Taxpayer must sign and date this form on line 6.			
Taxpayer name and address Miranda Dunmeyer Estate 2640 Steiner St, San Francisco, CA 94115		Taxpayer identification number(s) 98-7654321 Daytime telephone number _____ Plan number (if applicable) _____	
2 Designee(s). If you wish to name more than two designees, attach a list to this form. Check here if a list of additional designees is attached ☐			
Name and address Robert Lundy 44 Church St, Danville, CA 94526		CAF No. 5007-16056R PTIN P01234567 Telephone No. 925-555-7200 Fax No. _____	
Check if to be sent copies of notices and communications ☒		Check if new: Address ☐ Telephone No. ☐ Fax No. ☐	
Name and address		CAF No. _____ PTIN _____ Telephone No. _____ Fax No. _____	
Check if to be sent copies of notices and communications ☐		Check if new: Address ☐ Telephone No. ☐ Fax No. ☐	
3 Tax information. Each designee is authorized to inspect and/or receive confidential tax information for the type of tax, forms, periods, and specific matters you list below. See the line 3 instructions. ☐ By checking here, I authorize access to my IRS records via an Intermediate Service Provider.			
(a) Type of Tax Information (Income, Employment, Payroll, Excise, Estate, Gift, Civil Penalty, Sec. 4980H Payments, etc.)	(b) Tax Form Number (1040, 941, 720, etc.)	(c) Year(s) or Period(s)	(d) Specific Tax Matters
Income	1041	2023 - 2026	
4 Specific use not recorded on the Centralized Authorization File (CAF). If the tax information authorization is for a specific use not recorded on CAF, check this box. See the instructions. If you check this box, skip line 5 ☐			
5 Retention/revocation of prior tax information authorizations. If the line 4 box is checked, skip this line. If the line 4 box isn't checked, the IRS will automatically revoke all prior tax information authorizations on file unless you check the line 5 box and attach a copy of the tax information authorization(s) that you want to retain ☐ To revoke a prior tax information authorization(s) without submitting a new authorization, see the line 5 instructions.			
6 Taxpayer signature. If signed by a corporate officer, partner, guardian, partnership representative (or designated individual, if applicable), executor, receiver, administrator, trustee, or individual other than the taxpayer, I certify that I have the legal authority to execute this form with respect to the tax matters and tax periods shown on line 3 above. ► IF NOT COMPLETED, SIGNED, AND DATED, THIS TAX INFORMATION AUTHORIZATION WILL BE RETURNED. ► DON'T SIGN THIS FORM IF IT IS BLANK OR INCOMPLETE.			
Signature _____		Date _____	
Print Name _____		Title (if applicable) _____	

For Privacy Act and Paperwork Reduction Act Notice, see the instructions.

Cat. No. 11596P

Form **8821** (Rev. 01-2021)

Kovel Agreements⁹⁵

Due to the nature of settling an estate, it is not uncommon for executors to work with both an attorney and an accountant. For example, an attorney may have sufficient knowledge of settling an estate but may not be knowledgeable regarding the associated accounting procedures and ramifications. Therefore, attorneys may work with an executor's accountant to consider and address the accounting aspects of settling the estate. However, while confidential communications between an attorney and a client have protection from disclosure under an attorney-client privilege, such protection does not generally extend between clients and their accountants. While IRC §7525 describes certain confidentiality privileges in taxpayer communications, they are limited in scope to noncriminal tax matters and proceedings brought before the IRS and United States Government. Furthermore, protection under §7525 relates to tax advice only, and does not cover compliance or business advice.

A **Kovel agreement**, coined after an appellate court decision,⁹⁶ is an agreement between a client's legal counsel and accountant, describing the services the accountant will provide at the attorney's discretion. The attorney will usually draft this letter for the accountant to sign. The client may also sign the draft letter, especially in cases where the client is responsible for paying the accountant's fees, which the agreement specifies. By establishing the relationship between the client's attorney and their accountant, the accountant's discussions, workpapers, and advice become protected under the attorney-client privilege. This extended privileged communication may be valuable when a tax controversy exists or occurs.

Note. A Kovel agreement is similar to a tax practitioner's engagement letter with a client, where the document describes the scope of the work, responsibility, and payment terms. As with other binding agreements, it is important for an accountant and potentially their own legal counsel to review the agreement before signing it and retaining a copy for their records.

PROBATE PROCESS

Probate is a legal process requiring the court to ensure a decedent's will is valid, an executor is appointed, and all debts of the estate are paid. Potential issues associated with probate include the following.⁹⁷

- Attorney's fees and other costs
- Delays in transferring property to the intended beneficiaries
- A less private process

Probate is a public process where documents such as the decedent's will and list of probate assets are filed with the court and become public records. Consequently, the public may view the documents in their entirety, perhaps virtually.

⁹⁵ See *Kovel agreement basics for you and your client*. Nakamura, Karen. Jul. 1, 2022. Journal of Accountancy. [www.journalofaccountancy.com/issues/2022/jul/kovel-agreement-basics.html] Accessed on Jun. 20, 2023.

⁹⁶ *U.S. v. Kovel*, 296 F.2d 918 (2nd Cir. 1961).

⁹⁷ *The Probate Process*. American Bar Association. [www.americanbar.org/groups/real_property_trust_estate/resources/estate_planning/the_probate_process] Accessed on Jul. 18, 2023.

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State law governs the probate process. As such, executors need to be conscientious about where the estate needs to enter probate and assess the specific requirements and adhere to the governing laws of the state. In instances where a decedent owned property in different states, multiple probate proceedings may be necessary, which increases expenses and further complicates the probate process. Other rules potentially differing among states include the claims period and process for the estate's debts.⁹⁸ Using the state of Illinois as an example, an executor must inform creditors of a probate case.⁹⁹ For creditors who are known to the executor, the executor must notify the creditors directly. For creditors unknown to the executor, the executor must publish a public notice of the probate case. Creditors have six months from the date the executor published a notice to submit any claim against the estate, otherwise any such claim would be barred.¹⁰⁰

Probate Requirement

Not all estates are subject to probate. While most estates where a decedent did not create a will **must** go through probate, some exceptions may apply. Some states have applicable thresholds, where estates with total assets valued below a specified threshold are not subject to the state's probate. Using the state of Illinois as an example, executors may file a small estate affidavit exempting the estate from probate if the gross estate's probate assets are under \$100,000.¹⁰¹

Additionally, not all assets of an estate are subject to probate. Assets are not subject to probate if they are scheduled to pass to a survivor under a contract or by operation of property law rather than through the decedent's will. Examples of nonprobate assets include the following.¹⁰²

- Retirement plans, such as IRAs and §401(k) plans, with named beneficiaries that are not the estate
- Life insurance proceeds, with named beneficiaries that are not the estate
- Real estate owned by joint tenants with rights of survivorship
- Joint bank accounts with rights of survivorship
- Any assets that would pass to the surviving spouse under the statutory right of the surviving spouse
- Grantor trust assets
- Assets that are POD
- Assets that are TOD



Practitioner Planning Tip

While probate is often viewed as a process to avoid due to the cost and prolonged timing, there may be benefits for an estate going through probate. Using Illinois as an example, notifying creditors of a probate case results in a 6-month claims period from the date the executor provided notice, whereas the default claims period against estates is two years after the decedent's death.¹⁰³ Tax practitioners should work with attorneys familiar with the applicable state's probate rules.

⁹⁸ See, *Ancillary Probate: Probate in Another State*. Randolph, Mary, JD. Nolo. [www.nolo.com/legal-encyclopedia/ancillary-probate-probate-another-state.html] Accessed on Jul. 18, 2023.

⁹⁹ 755 ILCS 5/18-3.

¹⁰⁰ Ibid.

¹⁰¹ 755 ILCS 5/24-22.

¹⁰² See, *Probate v. Non-Probate: What Is the Difference?* Dec. 9, 2022. ElderLawNet, Inc. [www.elderlawanswers.com/probate-v-non-probate-what-is-the-difference-14411] Accessed on Jul. 17, 2023.

¹⁰³ 755 ILCS 5/18-12.

IDENTIFYING APPLICABLE TAX RETURNS

A critical step for an executor to settle an estate is determining which tax returns the estate will need to file. This concept can be difficult to explain due to the niche nature of fiduciary taxation and the multiple tax returns that may necessitate filing. Tax practitioners should discuss and explain the multiple tax returns an estate may need to file and assist the executor with identifying which returns apply to the estate.

Decedent's Final Form 1040¹⁰⁴

Death does not exempt taxpayers from income tax filing and payment requirements for the year of death. Therefore, an executor may need to file a final Form 1040 for the deceased taxpayer to report and pay tax on income in the tax year of their death. There are not many differences in filing a final Form 1040 compared to a non-final return. For example, the due date of a final tax return is the same as all other Form 1040 calendar year filings (April 15). However, there are some considerations practitioners should discuss with the executor.

Requirements to File. A final Form 1040 is subject to the same filing requirements as a non-final Form 1040, where gross income and the filing status generally dictate when a filing requirement is present. There may be situations, particularly when the taxpayer's death occurred early in the tax year, where there is little to no income. Consequently, a final Form 1040 for the tax year of the taxpayer's death would not require filing.

If a final Form 1040 is required, the tax preparer must write "DECEASED," following the taxpayer's name and the date of their death at the top of the tax return. If there is a surviving spouse, they will sign the final return writing "Filing as surviving spouse" next to their signature. If the estate has an appointed personal representative, they will sign the tax return on behalf of the deceased taxpayer, while the surviving spouse will also sign their name on the return if filing jointly.

Income to Report. While the nature and type of income to report on a final Form 1040 is consistent with other Form 1040 requirements, the difference lies in when the income was earned and received. In general, income the decedent accounted for under the **cash method** is includable on their final Form 1040 if the decedent received it before their death. Accordingly, income the decedent accounted for under the **accrual method** is includable on the final Form 1040 if the decedent had earned it before their death.

While the general rule of income reporting appears simple, complexities can arise from the timing of receipt relative to the taxpayer's passing. **Constructive receipt of income** refers to taxpayers having income available for use without restriction. Using dividend income as an example, the following three dates are important when determining whether to report the dividend income on the decedent's final income tax return.

1. The declaration date when the dividend is declared
2. The record date where the issuer identifies the shareholders eligible to receive the dividend
3. The date when the issuer pays the dividend to the shareholders on record

If the taxpayer died after the declaration date, but before the record date, the final Form 1040 should not include the dividend income. If the taxpayer died after the record date, but before the payment date, the final Form 1040 should include the dividend as a constructive receipt of income.

Available Deductions. Final Form 1040 returns generally have the same deductions as non-final Form 1040 returns, including the full standard deduction if the taxpayer is not itemizing deductions. There are no special or unique deductions available to deceased taxpayers on their final income tax returns. For example, funeral and burial expenses are not deductible on the decedent's final Form 1040.

¹⁰⁴ IRS Pub. 559, *Survivors, Executors, and Administrators*.

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Medical expenses are one type of deduction where practitioners and executors have some discretion on which tax return to report them. Executors can elect to treat all medical expenses of the decedent that were not paid before the decedent's passing but were paid within a year after the decedent's passing as paid by the decedent when incurred. This treatment enables them to be deducted on the final Form 1040, if itemized, subject to the regular medical expense limitations. If the executor does not make this election or the expenses were paid after one year from the decedent's date of death, they could report these unpaid medical expenses on Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*, discussed later.

Form 1310.¹⁰⁵ If a decedent's final Form 1040 results in a refund due for an overpayment of income tax, an executor may need to file Form 1310, *Statement of Person Claiming Refund Due a Deceased Taxpayer*. The form contains fields requesting information to identify the name, SSN, and address of the individual claiming the refund. When a Form 1310 must accompany the tax return, electronic filing may not be available.

Form 1041¹⁰⁶

Because estates and trusts are separate entities from taxpayers, they have income tax return filing and payment requirements if there is reportable income. The income of an estate or trust is reported on Form 1041. While the nature and format of Form 1041 are similar to Form 1040, Form 1041 has unique attributes.

Income reported on Form 1041 may be either taxed at the entity level or passed through to beneficiaries and taxed at their level. Like partnerships and S corporations, trusts and estates may prepare a Schedule K-1 (Form 1041) for each beneficiary of the entity to report their share of income they will include on their tax return. The executor or trustee is responsible for filing Forms 1041 for the estate and the decedent's trusts if they meet the applicable filing requirements.

Requirements to File. Estates with gross income equaling or exceeding \$600 during a tax year must file Form 1041. Simple trusts must file Form 1041 if gross income during a tax year exceeds \$300.¹⁰⁷ Complex trusts must file Form 1041 if gross income during a tax year exceeds \$100.¹⁰⁸

Tax Year Determination. Estates can adopt either a fiscal or calendar year to report income and file income tax returns. If the estate adopts a **calendar year** and the initial filing is for the tax year of the decedent's death, the tax preparer files a short tax year return, with the beginning month being the month of the taxpayer's death and the ending month being December. Subsequent Form 1041 filings are full tax year returns unless the executor files the final Form 1041 early because they settled the estate before the end of a year. In that situation, the tax preparer would file a final short year Form 1041.

If the executor wishes to adopt a **fiscal year**, they may elect any yearend provided it ends on the last day of the month and the initial year does not exceed 12 months. The executor makes this election by **filing an initial Form 1041** (regardless of the yearend selected on the federal employer identification number (FEIN) application).

Caution. After an FEIN is assigned, the IRS issues the taxpayer a notice with the due dates for required returns based on the information provided on the application. The due date for Form 1041 may not be correct as shown because the yearend election is not made until the first return is filed.

The due date of Form 1041 is the 15th day of the 4th month following the close of the tax year. Filers can apply for an automatic 5½-month extension using Form 7004, *Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns*.¹⁰⁹

¹⁰⁵. Instructions for Form 1310.

¹⁰⁶. IRS Pub. 559, *Survivors, Executors, and Administrators*.

¹⁰⁷. Instructions for Form 1041.

¹⁰⁸. Ibid.

¹⁰⁹. Ibid.



Practitioner Planning Tip

Reasons an executor may wish to adopt a fiscal year for an estate may include the following.

- The estate's cash flow and ability to pay tax obligations, particularly if the estate will be open over a longer period, may be delayed by adopting a fiscal year that ends later than an initial calendar year.
- A fiscal year adoption may minimize the number of returns the executor must file if the estate is open for multiple calendar years but is expected to be closed within 12 months.

An executor may wish to adopt a calendar yearend in the following situation.

- Estates with income primarily from investment accounts may benefit from a calendar yearend so that income reported on the return matches the amounts reported on Forms 1099. Therefore, a breakout of income and associated reconciliation to Forms 1099 is not needed, and the tax return preparation time and accounting fees may be significantly reduced.

IRC §645 Election. A trust must generally use a December 31 yearend. However, a qualified revocable trust (QRT) can make an election per IRC §645, under which the trust is treated and taxed as if it were part of the estate. A QRT is any revocable trust owned by a deceased grantor that is includable in their taxable estate.¹¹⁰ An executor may wish to make this election to simplify and reduce the number of filings they are responsible for, which generally results in reduced filing fees. Additionally, adopting a fiscal year generally allows the executor and tax practitioner more time to prepare and file the return, particularly when they use an extension. The due date is the 15th day of the 4th month following the close of the tax year.



Practitioner Planning Tip

Use of a fiscal year may defer income tax liability to a later year. It may allow beneficiaries more time to plan for the inclusion of taxable income allocated to them from an estate or trust. A trust with a calendar year ending December 31, 2022, results in the allocation of income to beneficiaries on their 2022 returns. Beneficiaries may not receive this unexpected Schedule K-1 until late in the filing season, which does not allow much time for planning. Conversely, a trust with a fiscal year ending March 31, 2023, results in the allocation of income to beneficiaries on their 2023 return, with beneficiaries receiving their Schedule K-1 well before the filing season.

¹¹⁰ IRC §645(b)(1).

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To make the §645 election, filers use Form 8855, *Election to Treat a Qualified Revocable Trust as Part of an Estate*. By making the election, the estate and trust can file using a fiscal year if the fiscal yearend is not later than the end of the month before the month of death. For example, if the date of the decedent's death is June 12, 2023, the fiscal year must end by May 31, 2024. By filing a timely extension for the estate (or trust if no probate estate exists), Form 8855 receives an extended due date, thereby also extending the due date for the trust.¹¹¹ The fiscal yearend is established when the first Form 1041 is filed. The election period begins on the date of the decedent's death and ends two years after the decedent's death if Form 706 is not required. If Form 706 is required, the election period ends at the later of the following.¹¹²

- Two years after the date of the decedent's death, or
- Six months after the final determination of liability for estate tax.

Example 15. Use the same facts as **Example 12**. Because Miranda had established a QRT during her lifetime, Lydia thought it best to elect §645 treatment to reduce the number of tax return filings. Because Miranda's date of death was June 12, 2023, the fiscal yearend must end by May 31, 2024. Lydia chooses the May 31 yearend, resulting in a due date for the estate's first Form 1041 of September 15, 2024.

Income to Report. Form 1041 includes all items of income the estate or trust receives during the tax year, including dividends, interest, rents, capital gains, and business income. The income is reported on the respective Form 1099 under the estate or trust's TIN. Because Forms 1099 report income based on a calendar year, estates and §645 QRTs adopting a fiscal year need to reconcile the income they report on their Form 1041 filings to the issued Forms 1099.

In addition to reporting income the estate or trust receives, Form 1041 may need to include **income in respect of a decedent (IRD)**. IRD is income for which a decedent would have received if they had not passed away and the income was not properly includable on the decedent's final Form 1040.¹¹³ If the estate or trust has the right to receive this income, it must be included on the entity's Form 1041. However, if a beneficiary of the entity or other individual has the right to receive the income, they would report that income on their individual tax return instead of on the estate or trust Form 1041.

As mentioned previously, for cash basis income the decedent earned before their death but had not yet received at the time of their death, the income would not be properly includable on the final Form 1041. For accrual basis income the decedent earned before their death but did not receive at the time of their death, the income would be includable on the decedent's final Form 1041.

Example 16. Use the same facts as **Example 12**. Before her death, Miranda earned \$1,400 of income from consulting services she provided. At the time of her death, Miranda had not yet received the payment from the client. Miranda historically reported income from consulting on her Schedule C, *Profit or Loss From Business*, using the cash accounting method. When preparing Miranda's final Form 1040 after her death, Lydia properly does not report the \$1,400 on the return. Instead, Lydia reports the \$1,400 on Form 1041 when Miranda's estate received the payment from the client.

Example 17. Assume the same facts as **Example 16**, except Miranda historically reported her consulting income using the accrual method of accounting. Lydia must include the \$1,400 of consulting income on Schedule C for Miranda's final Form 1040.

Example 18. Assume the same facts as **Example 16**, except Lydia's sister, Natalie, has the right to receive the \$1,400 of consulting income. Lydia would not include the consulting income on her mother's final Form 1040 or her estate tax return. When Natalie receives the \$1,400 payment in 2024, she must include the income on her 2024 Form 1040.

¹¹¹. Instructions for Form 8855.

¹¹². IRC §645(b)(2).

¹¹³. IRC §691(a)(1).



Practitioner Planning Tip

These examples illustrate the importance of the executor providing current Forms W-9, *Request for Taxpayer Identification Number and Certification*, to payors so they can timely issue Forms 1099 to the estate.

Available Deductions.¹¹⁴ Generally, estates and trusts may deduct the same expenses as individuals, including ordinary and necessary expenses paid or incurred in a trade or business¹¹⁵ and expenses incurred in connection with the production or collection of income. Additionally, estates and trusts may deduct expenses incurred for the management, conservation, or maintenance of property used in producing income.¹¹⁶ Business expenses are reported on the schedule corresponding to the reporting of that business's income, such as Schedule C.

The following are specific deductions the estate or trust may take on Form 1041.

- Investment interest, mortgage interest for qualified principal or secondary residence of a beneficiary, and interest on underpayment or nonpayment of tax
- State and local income or sales tax, real estate tax, and personal property tax
- Foreign or U.S. possession income taxes and generation-skipping transfer (GST) tax
- Fiduciary fees, such as probate court fees, legal publication costs of notices, printing costs for certified copies of the death certificate, and fiduciary accounts costs
- Attorney, accountant, and return preparer fees, including fees for filing a decedent's final Form 1040 (costs associated with preparing Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return*, are not deductible, as they are a common and customary expense for individuals and not necessitated by cause of death)
- Appraisal fees are deductible if they are not included on the estate's Form 706
- Investment advisory fees, but only for the portion above what an individual would normally incur because of the advice pertaining specifically to an estate or trust

Due to the ability for income to pass through to beneficiaries of an estate and trust for taxation at the beneficiary level, an **income distribution deduction** is available on Form 1041. For estates, when an executor distributes income to the estate beneficiaries, each beneficiary will receive a Schedule K-1 (Form 1041) reporting their share of the income. This form is prepared and filed with the estate's Form 1041. The income distribution deduction is calculated on Form 1041 Schedule B, *Income Distribution Deduction*. The deduction is then reported on page 1 of Form 1041, reducing the adjusted total income to reflect the amount the beneficiaries will report on their respective tax returns. Trusts operate similarly, except for simple trusts that have an income distribution deduction regardless of whether the trustee made distributions to the beneficiaries in the taxable year.

¹¹⁴. Instructions for Form 1041.

¹¹⁵. IRC §162.

¹¹⁶. IRC §212.

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Form 706¹¹⁷

As discussed earlier, an estate is subject to taxation on its income, filing Form 1041 to report **income** and calculate federal income tax. However, estates may also be subject to taxation on the value of **assets** the estate holds.¹¹⁸ Form 706 reports the estate's assets and calculates any associated federal estate tax.



Practitioner Planning Tip

In communication with clients regarding estate taxation, it may be helpful for practitioners to distinguish between the two types of estate tax returns by referring to Form 1041 as an estate's **income** tax return during a period of time after death (similar to the income statement) and Form 706 as an estate's **asset value** return at one moment in time (similar to the balance sheet) to avoid confusion.

Requirement to File. An executor for a U.S. citizen or resident's estate must file Form 706 for estates whose gross estate plus adjusted taxable gifts is more than the unified credit against the estate tax. A taxpayer's gross estate encompasses all property, both domestic and foreign, the decedent held an interest in at the time of their death. However, the gross estate also includes certain asset transfers the decedent made during their lifetime, certain life insurance proceeds, even if paid directly to estate beneficiaries, and digital assets.

When assessing whether Form 706 is required, it is critical to review the **unified credit against estate tax** and taxable gifts. The unified credit against estate tax, often referred to as a taxpayer's **lifetime exemption**, represents the tax credit every decedent is entitled to use in offsetting both estate value and gift taxation.¹¹⁹ The amount of the basic exclusion for decedents who die between 2017 and 2025 is \$10 million.¹²⁰ The basic exclusion is \$5 million for tax years after 2025.¹²¹ The exclusion is adjusted each year for inflation, with the resulting exclusion for decedents who die in 2023 being \$12.92 million.¹²²

A taxpayer's lifetime exemption is reduced by the amount of taxable gifts the taxpayer makes during their lifetime. When a taxpayer makes **taxable gifts** (gifts whose value exceeds the annual gift tax exclusion¹²³) in a tax year, they report the taxable gifts on Form 709, which includes a schedule with the history of all taxable gifts the taxpayer made during their lifetime up until that tax year. Therefore, executors and tax practitioners must know all the taxable gifts a decedent made during their lifetime to determine how much of the decedent's lifetime exemption is available and to assess a filing requirement for Form 706.

Executors must file Form 706 within nine months after the decedent's date of death. However, executors may file for an extension using Form 4768, *Application for Extension of Time To File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes*, which grants an automatic 6-month extension.

¹¹⁷. Instructions for Form 706.

¹¹⁸. IRC §2001(a).

¹¹⁹. IRC §2010(a).

¹²⁰. IRC §2010(c)(3).

¹²¹. Ibid.

¹²². Rev. Proc. 2022-38, 2022-45 IRB 445.

¹²³. For 2023, the annual gift exclusion is \$17,000. This amount is adjusted annually. See, *What's New — Estate and Gift Tax*. Jun. 13, 2023. IRS. [www.irs.gov/businesses/small-businesses-self-employed/whats-new-estate-and-gift-tax] Accessed on Jul. 13, 2023.

Example 19. Use the same facts as **Example 12**. Form 706 is due March 12, 2024, which is nine months after Miranda’s date of death (June 12, 2023). However, Lydia is unable to gather all the necessary records by March and files an extension. Lydia now has until September 12, 2024, to file the Form 706.

Benefits to Filing if Form 706 is Not Required. An executor may wish to file Form 706 in situations where the form would not otherwise require filing. Executors and their practitioners should explore these reasons to determine whether there is a benefit to filing the tax form.

Portability. An executor can make an election where the amount of a **deceased spouse’s unused exclusion (DSUE)** is available for use by the surviving spouse’s estate.¹²⁴ The process of “porting” this unused exclusion is known as “portability.” The DSUE amount is available to the surviving spouse as of the date of the deceased spouse’s death. The surviving spouse may apply it to gifts and their estate before using their own exemption. Accordingly, the surviving spouse may use the DSUE amount to shelter lifetime gifts from gift tax or to reduce their estate tax liability at the time of their death.¹²⁵

A surviving spouse makes the portability election on a timely filed Form 706 for their spouse who preceded them in death.¹²⁶ However, the IRS allows estates to request late portability election relief by filing Form 706 up to five years after the first spouse’s date of death.¹²⁷ This relief is available for decedents who were U.S. citizens or residents at the time of their death, whose date of death was after December 31, 2010, were survived by a spouse, and whose estate did not otherwise require filing Form 706.¹²⁸

Part 6 of Form 706 is entirely dedicated to the portability election, the DSUE calculation, and the roll forward of the DSUE amount. Per the description of the section, “a decedent with a surviving spouse elects portability of the DSUE amount, if any, by completing and timely filing this return. No further action is required to elect portability...”¹²⁹ Therefore, the filer makes the election by default if there is a DSUE amount and they file Form 706. This is the case as long as the filer **does not check** the box in Form 706 part 6 section A. By checking the box, the filer **elects out** of portability.

Caution. If a surviving spouse who elected portability on their deceased spouse’s Form 706 remarries and their subsequent spouse predeceases them, the surviving spouse loses the amount of DSUE from their prior marriage.¹³⁰ To receive any DSUE, the surviving spouse would need to file Form 706 for their remarried spouse, if the remarried spouse has any of their exemption left to port over.

Establishing Stepped-Up Basis in Assets. A decedent’s eligible assets receive a basis adjustment to their fair market value at the decedent’s date of death.¹³¹ A beneficiary may benefit from a step-up in basis when selling inherited assets which significantly appreciated in value from the time the decedent acquired the asset until their date of death. While this step-up in basis applies to estate assets regardless of whether an estate files Form 706, there may be a benefit in filing to have an easy reference for the estate’s asset values. Having this information may be highly beneficial for future transactions, such as selling the assets and needing to determine the gain on the sale. If a dispute arises regarding the basis of inherited property, a beneficiary may use Form 706 to substantiate their claim of the basis amount, as the form clearly indicates its value the IRS accepted with its filing.

¹²⁴ IRC §2010(c)(4); Treas. Reg. §20.2010-2.

¹²⁵ Treas. Reg. §20.2010-3(b)(ii).

¹²⁶ IRC §2010(c)(5)(A); Treas. Reg. §20.2010-2(a)(1).

¹²⁷ Rev. Proc. 2022-32, 2022-30 IRB 101.

¹²⁸ Ibid.

¹²⁹ See Form 706.

¹³⁰ Treas. Reg. §20.2010-3(a).

¹³¹ IRC §1014(a)(1).

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Alternate Valuation.¹³² The executor can make an election to value the estate within six months after the decedent's death if the value of the property in the gross estate and the estate's federal estate tax liability are both reduced by making the election.¹³³ This is known as an **alternate valuation election**. The election results in the estate's property being valued at six months after death or earlier if the property is disposed of before the end of the 6-month period.

Caution. Because the alternative valuation election is only permissible if it reduces both the gross estate and the federal estate tax liability, the election is only available to estates that must file Form 706. An estate that is not required to file Form 706 has zero federal estate tax liability, meaning an alternative valuation could not lower the estate tax liability.¹³⁴

Need for an Appraisal. While determining the value of some assets is straightforward, such as cash or investment accounts, other asset values are not as easily determinable. For those assets, executors may need to hire an appraiser to assign a value to them. Real estate is a common asset an executor would normally need an appraisal to report the value on Form 706. If the executor uses any appraisals in determining the value of reported assets, they must include copies of those appraisals with the filed form.¹³⁵

State Filings

Some states impose a tax on estates of decedents who were residents of or held property in those states. States may impose two types of taxes, consisting of an estate tax and an inheritance tax.

State Estate Tax. Similar to the federal estate tax, some states impose an estate tax based on the value of an estate's assets. The taxes, forms, and filing thresholds differ among the states. Therefore, it is important for executors and their practitioners to familiarize themselves with the requirements of the states the decedent was a resident of or in which they held property. The following table sets forth the various state estate tax exemptions and tax rates as of May 3, 2023.¹³⁶

State	Exemption Amount	Maximum Tax Rate
CT	\$12,920,000	12%
DC	4,528,800	16%
HI	5,490,000	20%
IL	4,000,000	16%
ME	6,410,000	12%
MD	5,000,000	16%
MA	1,000,000	16%
MN	3,000,000	16%
NY	6,580,000	16%
OR	1,000,000	16%
RI	1,733,264	16%
VT	5,000,000	16%
WA	2,193,000	20%

¹³². IRC §2032.

¹³³. CCA 201926013 (May 30, 2019).

¹³⁴. For more information regarding the alternative valuation election, see *Alternate Valuation — Useful Estate Tax Valuation Provision*. McEowen, Roger. Mar. 17, 2020. Law Professors Blog, LLC. [lawprofessors.typepad.com/agriculturallaw/2020/03/alternate-valuation-useful-estate-tax-valuation-provision.html] Accessed on Aug. 21, 2023.

¹³⁵. Instructions for Form 706.

¹³⁶. *State Death Tax Chart*. May 3, 2023. American College of Trust and Estate Counsel. [www.actec.org/resources/state-death-tax-chart] Accessed on Jun. 25, 2023; *Where Not To Die in 2022*. Ebeling, Ashlea. May 13, 2022. Forbes. [www.forbes.com/sites/ashleaebeling/2022/05/13/where-not-to-die-in-2022-the-greediest-death-tax-states] Accessed on Jun. 25, 2023.

Caution. While the federal estate tax exemption results in estates being subject to taxation for values above the exemption, some states treat their exemption as a filing threshold. For example, the Illinois exemption is \$4 million, where estates with assets below the threshold are not required to file or pay estate tax. However, if an Illinois estate had \$5 million of assets, the estate would be subject to estate taxation on the full amount, not just the \$1 million over the exemption (\$5 million – \$4 million). The tax computation is only done via the online calculator provided by the Attorney General website and uses a graduated range of tax brackets from 0% to 16%.¹³⁷

Connecticut is the only state to impose its own gift tax on its residents.¹³⁸ The Connecticut annual gift exemption is equal to the federal gift exemption, where taxpayers who make gifts in excess of this amount must file a Connecticut gift tax return. Therefore, executors of estates where the decedent was a resident of or held property in Connecticut must obtain copies of filed state gift tax returns to determine the amount of state estate tax exemption the decedent used to offset gift tax.

Inheritance Tax. Some states impose an inheritance tax on the beneficiaries of an estate. This differs from an estate tax, where the estate files a return and pays a tax on its assets. Instead, beneficiaries subject to this form of tax must file and pay tax on the amount of **assets they inherited**. The following table sets forth the various state inheritance tax exemptions and tax rates as of May 3, 2023.¹³⁹

State	Exemption Amount	Maximum Tax Rate
IA	\$ 0	15%
KY	500	16%
MD	0	10%
NE	25,000	15%
NJ	0	16%
PA	0	15%

Iowa began reducing its inheritance tax by 20% each year since 2021, which will result in repealing the tax beginning January 1, 2025.¹⁴⁰ Maryland is the only state imposing **both** an estate tax and an inheritance tax.

APPLYING FOR APPLICABLE FEINS

After determining which forms an estate or trust must file, executors and trustees are next responsible for applying for and obtaining an FEIN for each applicable entity. An FEIN is necessary to issue Forms 1099 and file tax returns. There are two ways a domestic applicant may apply for an FEIN, either mailing or faxing Form SS-4, *Application for Employer Identification Number*, or applying online at IRS.gov. Applying online via the proper IRS website (not a fake or pay-to-use site) is the preferred method.

¹³⁷. 2013-2022 Decedents Estate Tax Calculator. Aug. 2, 2022. Illinois Attorney General. [ag.state.il.us/publications/calculator/2013calc/calculator2013.html] Accessed on Jul. 7, 2023.

¹³⁸. Estate and Gift Tax Information. 2023. Connecticut State Department of Revenue Services. [portal.ct.gov/DRS/Individuals/Individual-Income-Tax-Portal/Estate-and-Gift-Taxes/Tax-Information#overview] Accessed on Jun. 25, 2023.

¹³⁹. State Death Tax Chart. May 3, 2023. American College of Trust and Estate Counsel. [www.actec.org/resources/state-death-tax-chart] Accessed on Jun. 25, 2023; Where Not To Die in 2022. Ebeling, Ashlea. May 13, 2022. Forbes. [www.forbes.com/sites/ashleaebeling/2022/05/13/where-not-to-die-in-2022-the-greediest-death-tax-states] Accessed on Jun. 25, 2023; Legislature of Nebraska 2022 LB310 §4(b).

¹⁴⁰. State Death Tax Chart. May 3, 2023. American College of Trust and Estate Counsel. [www.actec.org/resources/state-death-tax-chart] Accessed on Jun. 25, 2023.

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Applying for an FEIN Online

An applicant can obtain an FEIN immediately upon completing the online application and save a pdf copy of the confirmation page with the FEIN to distribute to their attorney and practitioner as needed. The online application mirrors the questions on Form SS-4.

Note. The online FEIN application is only available Monday through Friday from 7AM to 10PM Eastern Standard Time.

Form SS-4¹⁴¹

Form SS-4 requests the entity's legal name that must match the one the IRS has on record. The form also requests the name and address of the responsible party (executor or trustee), the type of entity for which the responsible party applies, and the reason for the application.

Form SS-4 also asks for the date the entity started. For estates, this date is the decedent's date of death. For trusts, the date is when the trust began its taxable activity as its own entity. For disregarded grantor trusts, this date is the grantor's date of death, as any income-generating activity during the grantor's lifetime would be included in the grantor's tax return under their SSN. Non-grantor trusts should use the date the trust began earning income. The IRS will use this date with the closing month of the accounting year the applicant selects to initially determine what periods the entity should file.

If an applicant uses an incorrect starting date and the IRS notifies the applicant of the need to file tax returns for prior periods that are not applicable due to the entity not having taxable income, the applicant may notify the IRS of this situation and would not be bound to file the returns.

The responsible party may identify a third-party designee they would like the IRS to provide the FEIN to and direct any questions regarding the application. The applicant could list their tax preparer or other party who assisted them with preparing and mailing a Form SS-4. The IRS estimates it usually takes four weeks to mail the FEIN to the applicant or third-party designee. This timeframe differs significantly compared to the online option providing the FEIN immediately.

¹⁴¹. Instructions for Form SS-4.

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Example 20. Use the same facts as **Example 12**. Lydia needed an FEIN for her mother's estate. Lydia completed the following Form SS-4 for the estate and used this information to file for the FEIN online.

Form SS-4 (Rev. December 2019) Department of the Treasury Internal Revenue Service		Application for Employer Identification Number (For use by employers, corporations, partnerships, trusts, estates, churches, government agencies, Indian tribal entities, certain individuals, and others.) ▶ Go to www.irs.gov/FormSS4 for instructions and the latest information. ▶ See separate instructions for each line. ▶ Keep a copy for your records.		OMB No. 1545-0003		
1 Legal name of entity (or individual) for whom the EIN is being requested Miranda Dunmeyer Estate		EIN				
Type or print clearly.	2 Trade name of business (if different from name on line 1)	3 Executor, administrator, trustee, "care of" name Lydia Hillard				
	4a Mailing address (room, apt., suite no. and street, or P.O. box) 2640 Steiner St	5a Street address (if different) (Don't enter a P.O. box.)				
	4b City, state, and ZIP code (if foreign, see instructions) San Francisco, CA 94115	5b City, state, and ZIP code (if foreign, see instructions)				
	6 County and state where principal business is located San Francisco CA					
	7a Name of responsible party Lydia Hillard	7b SSN, ITIN, or EIN ***-**-3333				
8a Is this application for a limited liability company (LLC) (or a foreign equivalent)? ☐ Yes ☒ No		8b If 8a is "Yes," enter the number of LLC members ☐ Yes ☐ No				
8c If 8a is "Yes," was the LLC organized in the United States? ☐ Yes ☐ No						
9a Type of entity (check only one box). Caution: If 8a is "Yes," see the instructions for the correct box to check. ☐ Sole proprietor (SSN) ☒ Estate (SSN of decedent) ***-**-6789 ☐ Partnership ☐ Plan administrator (TIN) ☐ Corporation (enter form number to be filed) ▶ ☐ Trust (TIN of grantor) ☐ Personal service corporation ☐ Military/National Guard ☐ State/local government ☐ Church or church-controlled organization ☐ Farmers' cooperative ☐ Federal government ☐ Other nonprofit organization (specify) ▶ ☐ REMIC ☐ Indian tribal governments/enterprises ☐ Other (specify) ▶ ☐ Group Exemption Number (GEN) if any ▶						
9b If a corporation, name the state or foreign country (if applicable) where incorporated		State	Foreign country			
10 Reason for applying (check only one box) ☐ Started new business (specify type) ▶ ☐ Banking purpose (specify purpose) ▶ ☐ Hired employees (Check the box and see line 13.) ☐ Changed type of organization (specify new type) ▶ ☐ Compliance with IRS withholding regulations ☐ Purchased going business ☒ Other (specify) ▶ Estate created due to taxpayer's death ☐ Created a trust (specify type) ▶ ☐ Created a pension plan (specify type) ▶						
11 Date business started or acquired (month, day, year). See instructions. 06/12/2023		12 Closing month of accounting year May				
13 Highest number of employees expected in the next 12 months (enter -0- if none). If no employees expected, skip line 14. <table border="1"><tr><td>Agricultural</td><td>Household</td><td>Other</td></tr></table>		Agricultural	Household	Other	14 If you expect your employment tax liability to be \$1,000 or less in a full calendar year and want to file Form 944 annually instead of Forms 941 quarterly, check here. (Your employment tax liability generally will be \$1,000 or less if you expect to pay \$5,000 or less in total wages.) If you don't check this box, you must file Form 941 for every quarter. ☐	
Agricultural	Household	Other				
15 First date wages or annuities were paid (month, day, year). Note: If applicant is a withholding agent, enter date income will first be paid to nonresident alien (month, day, year) ▶						
16 Check one box that best describes the principal activity of your business. ☐ Health care & social assistance ☐ Wholesale-agent/broker ☐ Construction ☐ Rental & leasing ☐ Transportation & warehousing ☐ Accommodation & food service ☐ Wholesale-other ☐ Retail ☐ Real estate ☐ Manufacturing ☐ Finance & insurance ☐ Other (specify) ▶						
17 Indicate principal line of merchandise sold, specific construction work done, products produced, or services provided.						
18 Has the applicant entity shown on line 1 ever applied for and received an EIN? ☐ Yes ☒ No If "Yes," write previous EIN here ▶						
Third Party Designee	Complete this section only if you want to authorize the named individual to receive the entity's EIN and answer questions about the completion of this form.					
	Designee's name		Designee's telephone number (include area code)			
	Address and ZIP code		Designee's fax number (include area code)			
Under penalties of perjury, I declare that I have examined this application, and to the best of my knowledge and belief, it is true, correct, and complete.			Applicant's telephone number (include area code)			
Name and title (type or print clearly) ▶			Applicant's fax number (include area code)			
Signature ▶		Date ▶				

For Privacy Act and Paperwork Reduction Act Notice, see separate instructions.

Cat. No. 16055N

Form **SS-4** (Rev. 12-2019)

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FEINs For §645 Election¹⁴²

When an executor elects the §645 election to treat a QRT as part of an estate, they normally must obtain an FEIN for both the electing QRT and the related estate. However, if an estate does not have an executor and one is not expected to be appointed, then the trustee only needs to obtain an FEIN for the QRT.

NOTIFICATION OF KEY PARTIES

Individuals who find themselves in the role of an executor of an estate must notify several parties of the decedent's death to facilitate the settlement of the estate. Some of this communication will come into play when preparing and filing necessary income and estate tax forms and assisting with the transfer or title of assets to beneficiaries.

Financial Advisors and Brokers

Executors should notify all financial advisors and brokers who worked with the decedent in handling their investments and accounts as soon as possible. The urgency of this communication is caused by the need for the advisors to assign the account in the name of the estate or joint owner with the right of survivorship. Additionally, the broker needs to know the date of death to begin separating investment activity between pre- and post-death. This communication should result in the brokerage firm issuing Forms 1099 to the correct party covering the correct reporting period. For example, brokers should issue Forms 1099 under the decedent's SSN for pre-death activity while issuing Forms 1099 under the estate's FEIN or joint owner's SSN for post-death activity.

Brokers also need to know the decedent's date of death so they may begin tracking basis accordingly. Because assets receive a step-up in basis at the time of the decedent's death, the broker **should** calculate the basis of each investment to report the correct basis on Forms 1099 for any investment sold within the reporting period.

Social Security Administration

If the decedent was receiving social security benefits at the time of their death, the Social Security Administration (SSA) will generally be automatically notified of the benefit holder's death. Individuals are no longer entitled to social security benefits once they die. However, surviving spouses or other family members may be eligible for the decedent's benefits based on the decedent's earnings and how long the decedent paid into social security.¹⁴³ Funeral directors may contact the SSA notifying them of the benefit holder's death, but executors should ensure this communication occurs. If a decedent receives social security benefits after their death they were not entitled to, the executor must pay back the excess benefits to the SSA.

Banks and Financial Institutions

Banks and financial institutions must know when an account holder dies to retitle any accounts to the estate or joint party. It may be best for the executor to wait until pending payments for the decedent go through processing before notifying the bank to prevent the transactions payable to the decedent from being rejected due to the name change on the account to the estate or other party.

Life Insurance Agents and Brokers

If a decedent held any life insurance policies, the agents and brokers of those policies should receive notification of the decedent's death to begin processing and fulfilling payments to the named beneficiaries. The life insurance agents will issue a Form 712, *Life Insurance Statement*, to the decedent, which provides information about a policy and its value. The executor will need this form to determine the values of the decedent's policies when compiling assets to determine if probate applies and if an estate tax form is necessary. If an estate with life insurance policies files Form 706, they must provide a copy of Form 712 for each policy with the filed return.¹⁴⁴

¹⁴². Treas. Reg. §1.645-1(d).

¹⁴³. *Survivors Benefits*. Nov. 25, 2019. Social Security Administration. [www.ssa.gov/benefits/survivors] Accessed on Jun. 25, 2023.

¹⁴⁴. Instructions for Form 706.

DISTRIBUTION OF ASSETS TO BENEFICIARIES

Part of the fiduciary duties an executor is responsible for includes distributing estate assets to beneficiaries. Generally, it is beneficial for an executor to make these distributions as a final step in the settlement process after all expenses, creditor claims, and taxes have been paid. An executor may be held liable for an estate's unpaid debts, and in some cases, beneficiaries may be held liable as well.¹⁴⁵

SCHEDULE H¹⁴⁶

Note. The majority of the information in this section is derived from IRS Pub. 926, *Household Employer's Tax Guide*.

People who hire individuals to provide services in their homes may be required to file Schedule H, *Household Employment Taxes*, with their Form 1040. Babysitters, butlers, caretakers, cleaning people, cooks, drivers, health aides, housekeepers, maids, nannies, private nurses, yard workers, and similar laborers are all potential household employees.

Taxpayers often ask their tax advisors what they should do when they are paying someone “on the side” to work in their homes. For 2020, nearly 180,000 Schedules H were filed reporting \$1.2 million in employment taxes.¹⁴⁷ If everyone understood their obligations, the number of filings would be significantly higher. Fortunately, many common situations are **not subject to the household employer requirements**. Individuals do not have to report payments to the following.

- Their underage children (discussed later)
- Other people's underage children, except in rare circumstances
- Their parents, except in rare circumstances
- Businesses that are providing services in their home, including businesses operated as sole proprietorships (employees of such businesses are not employees of the payor.)

EMPLOYEE OR INDEPENDENT CONTRACTOR

When someone is providing a service regularly in the home **and** is being paid directly by the person receiving the service (or their agent,) the payments made to them might be considered wages. The payor must determine if they are paying a sole proprietor or an employee for the services.

If the recipient is an independent contractor, payments are not wages. The payor is not required to report the payments or assume any other employer obligations. Because the services are not being provided to a business, the payor is not required to file a Form 1099-NEC, *Nonemployee Compensation*, either.¹⁴⁸

Example 21. Rosemary loves helping people with little tasks around their homes. She puts out the word at her favorite beauty shop and now spends a few hours every week with some of her favorite people for a little cash on the side. She charges each person \$100 per week per visit.

Violet has agoraphobia. She does not mind paying Rosemary for her regular help. Because Rosemary offers her services to the public, Violet is not an employer.

¹⁴⁵. *Estate of Kwang Lee v. Comm'r*, No. 21-2921 (3d Cir. 2022), aff'g TC No. 20531-18L.

¹⁴⁶. IRS Pub. 926, *Household Employer's Tax Guide*; Schedule H Instructions; See also *Topic No. 756, Employment Taxes for Household Employees*. Apr. 7, 2023. IRS. [www.irs.gov/taxtopics/tc756] Accessed on Jun. 30, 2023.

¹⁴⁷. IRS Pub. 4801, *Individual Income Tax Returns Line Item Estimates*.

¹⁴⁸. *General Instructions for Certain Information Returns*. Mar. 27, 2023. IRS. [www.irs.gov/pub/irs-pdf/i1099gi.pdf] Accessed on Jul. 5, 2023.

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Sometimes it is not obvious to the people involved if they are entering into a “business relationship” or an “employer-employee relationship.” Questions they should ask include the following.

- Does the service provider have a bona fide trade or business? (A self-employed worker usually provides their own tools and offers services to the general public in an independent business.) If so, they are an independent contractor.
- Does the recipient of the services have the right to control the way the services are provided, such as the timing and other details? If so, the provider is an employee.

It is not necessary for the employer to actually exercise control as long as the employer has the **right to control**. It also does not matter whether the work is full-time or part-time or how the pay is structured.¹⁴⁹ The employee determination is made by looking at all the facts and circumstances of the situation.¹⁵⁰

Example 22. Kendra’s mother, Nan, is ailing. Rather than have Nan move into a private care facility, Kendra quits her job and starts caring for her mother in Nan’s home. Kendra is an adult, and, therefore, not exempt from being treated as an employee, even though she is Nan’s child. Nan plans to pay Kendra \$500 a week for helping her.

Nan wants to know if she will have to report these payments as wages. It is clear that Kendra is not a sole proprietor, but Nan has the right to control how the services are provided. Nonetheless, because the payments are intended to compensate Kendra for services provided in the home, they are wages subject to reporting and tax requirements.

Note. For more information on factors indicating an employee or independent contractor relationship, see the 2023 *University of Illinois Federal Tax Workbook*, Chapter 3: Independent Contractors.

OTHER PAYMENT TRANSACTIONS

Some individuals might want to treat the payments as some other type of transaction to avoid these and other employment-related obligations. However, they must be careful that their circumstances match their claims about the nature of the payments. The different options have various factors that should be considered. A few are discussed next.

- **Gifts** — Under basic contract law, a gift is a voluntary and gratuitous transfer of property without obligation or expectation of favor. However, if the intent of a payment is to reward the recipient for performing as expected, the payment is compensation rather than a gift.
- **Virtual currencies** — Payments in virtual money, such as Bitcoin, are included as cash wages.¹⁵¹
- **Bequest for services** — Payment made from an estate as compensation for services provided while the decedent was alive is taxable income to the recipient.¹⁵²
- **Benefits of being treated as an employee for the worker** — A person treated as an independent contractor instead of as an employee takes responsibility for all the related tax obligations. Failure to report earnings subject to the Federal Insurance Contributions Act (FICA) and the Self-Employed Contributions Act (SECA) might reduce the amount of retirement or disability benefits the laborer qualifies to receive in the future.

Note. SSA Pub. 05-10021, *Household Workers*, has information on how household work is credited to an employee’s social security record. This can be found at [uofi.tax/23x9x1 \[www.ssa.gov/pubs/EN-05-10021.pdf\]](https://www.ssa.gov/pubs/EN-05-10021.pdf).

¹⁴⁹. *Hiring Household Employees*. Feb. 7, 2023. IRS. [www.irs.gov/businesses/small-businesses-self-employed/hiring-household-employees] Accessed on Apr. 21, 2023.

¹⁵⁰. Treas. Reg. §§31.3401(c)-1(b), (d), and (h).

¹⁵¹. IRS Pub. 525, *Taxable and Nontaxable Income*; See also IRS Notice 2014-21, 2014-16 IRB 938.

¹⁵². IRS Pub. 525, *Taxable and Nontaxable Income*, p. 35 (2022).

- **Exchange for rent** — FICA taxes are **only** due on **cash** wages paid to service providers. Cash wages typically do not include the value of food and lodging. However, if the agreement between the employer and the employee is such that there is a direct offset in pay relative to the fair market value of the food or lodgings, the arrangement might be a disguised cash transaction.
- **Clothing, transit passes, and other noncash items given to household employees** — These items are generally excluded from cash wages for employment tax purposes. However, the value of these types of items is not excludable if they are just money in disguise.

Example 23. Peg overhears another practitioner at a Tax Pro convention say, “And then my aunt said to me, I just buy all of her groceries and clothes, so we don’t have to include her as an employee.” Peg politely taps the other practitioner on the shoulder and explains that the groceries and clothes are just like money, and therefore, the aunt must report the income paid.

Caution. Although noncash wages are not subject to FICA taxes, they are typically included in wages subject to income tax withholding unless a specific exclusion applies. See IRS Pub. 15, (*Circular E*), *Employer’s Tax Guide*, and IRS Pub. 15-B, *Employer’s Tax Guide to Fringe Benefits*, for more information on cash and noncash wages and fringe benefits.

Caution. Although IRS Pub. 15 states that “Payments for the services of a child of any age who works for their parent are not subject to income tax withholding if paid for domestic work in the parent’s home,” this exception is actually very narrow. As explained in the publication and later in this section, under the Code, this **only** applies in very rare circumstances.¹⁵³

EMPLOYER TAX RESPONSIBILITIES

Once a person determines that they are an employer, they must file for an FEIN. This is done by filing Form SS-4 on paper or by completing an interview-style online FEIN application, as discussed previously.¹⁵⁴ An individual’s SSN can only be associated with one FEIN. Thus, a household employer should not file for a new FEIN if they previously were a household employer, operated a sole proprietorship, or applied for an FEIN for banking purposes.

If the payor and the person receiving the service are not the same person, it might be necessary to evaluate who in fact should file as the employer. This complication is covered later in this chapter under the heading “Rare Circumstances.”

¹⁵³. IRC §3121(b)(3)(B).

¹⁵⁴. *Employer ID Numbers*. Jun. 12, 2023. IRS. [www.irs.gov/businesses/small-businesses-self-employed/employer-id-numbers] Accessed Jun. 26, 2023.

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Each time a person hires someone to work as a household employee, they are required to obtain certain paperwork.¹⁵⁵

1. Every household employee and their employer must complete the U.S. Citizenship and Immigration Services (USCIS) **Form I-9, Employment Eligibility Verification**. As part of this process, the employee must provide the employer with certain documents and proof of eligibility to work in the United States.

Note. Form I-9 and the USCIS Handbook for Employers is available at **USCIS.gov/I-9-Central**. If the employer agrees to withhold federal income taxes, the employee must submit Form W-4 to their employer to request that federal income taxes be withheld. The Form W-4 is covered in more detail earlier in this chapter.

Note. An in-home care service recipient may request that the IRS authorize their agent¹⁵⁶ to report, file, and pay **most** federal employment taxes on their behalf. See Form 2678, *Employer/Payer Appointment of Agent*, for more information. In addition, an individual who receives such home care services through a program administered by a federal, state, or local government agency may assign their federal unemployment taxes (FUTA) responsibilities to an agent.¹⁵⁷ Other individuals cannot assign their FUTA responsibilities.

2. It is advisable to have the employee sign appropriate paperwork documenting the terms of their employment.

Once the employee is hired, the payor **may be**:

- Allowed to withhold **federal income taxes** on behalf of the employee;
- Required to pay **FUTA** on the wages;
- Required to collect **social security and Medicare taxes (FICA)** on behalf of the employee and pay the employer's share of the taxes;
- Required to issue a **Form W-2** to the employee;
- Required to file **Schedule H and submit payments** to the IRS; and
- Required to withhold state and local taxes, pay state unemployment taxes, pay workers' compensation insurance, and/or be subject to **other rules** and regulations specific to their situation. (Links to common resources for these items are provided later in this material.)

Note. Homeowners may also want to re-evaluate their homeowner liability insurance coverage in the event of an injury to a household employee on the premises.

Voluntary Withholding

Once the parties agree that they have an employment relationship, the payor is **allowed** to **withhold federal income taxes** at the employee's request upon receipt of Form W-4. However, the payor is **not required** to take on the liability of withholding income taxes. Once the payor withholds federal income taxes, they are obligated to file a Form W-2 and Schedule H.

¹⁵⁵. *Hiring Employees*. May 17, 2023. IRS. [www.irs.gov/businesses/small-businesses-self-employed/hiring-employees] Accessed on Jun. 30, 2023.

¹⁵⁶. Under IRC §3504.

¹⁵⁷. See Rev. Proc. 2013-39, 2013-52 IRB 830, for more details.

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FUTA

In 2023, the wage threshold is **\$1,000** total in any calendar quarter paid to all employees of the household. Once this level is met, the payor is obligated to pay **federal unemployment tax** on covered employees.

Example 24. Skip enjoys helping people by paying them to help him around his house. In the 1st quarter of 2023, he pays the following amounts to individuals for their services as employees.

Howie	\$ 300
Pat	400
Sidney	<u>500</u>
Total	\$1,200

Skip is now obligated to pay FUTA on these payments. He must file a Schedule H to report the tax. The FUTA tax obligation does not require Skip to file Forms W-2 (explained in more detail later).

Note. The FUTA rate is based on the state in which the employee works and the unemployment tax liabilities of the employer in that state. Schedule H instructions provide guidance for determining the proper rate for the employer each year by state.

FICA

It is possible to be subject to FUTA tax and not be subject to the **FICA requirements**. FICA is activated when cash wages of **\$2,600** or more are paid to **any one person** during the year.¹⁵⁸ This is a per person test, unlike the FUTA test, which is per quarter.

Example 25. Use the same facts as **Example 24**. Skip continues to pay his helpers throughout the year. For 2023, total payments to each person are as follows.

Howie	\$1,200
Pat	1,600
Sidney	<u>2,000</u>
Total	\$4,800

No one person was paid \$2,600 or more, so Skip's only federal requirement is to pay FUTA tax by filing Schedule H for 2023.

Note. For more information on the definition of cash wages, see the instructions for Schedule H.

The \$2,600 threshold sets in motion responsibility for FICA taxes and for filing Form W-2 and Schedule H (assuming the payor had not already volunteered for income tax withholding). With regard to the FICA taxes, payors have the option to:

- Withhold the employee's portion of FICA taxes (6.2% of social security and 1.45% of Medicare taxes for a total of 7.65%¹⁵⁹); **or**
- Pay the employee portion on the employee's behalf, which becomes income subject to income tax withholding on the employee's Form W-2.

¹⁵⁸. *Household Workers*. Jan. 2023. Social Security Administration. [www.ssa.gov/pubs/EN-05-10021.pdf] Accessed on Jul. 2, 2023.

¹⁵⁹. *Topic No. 756, Employment Taxes for Household Employees*. Apr. 7, 2023. IRS. [www.irs.gov/taxtopics/tc756] Accessed on Jul. 18, 2023.

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If the employer pays the employee portion from the employer's own funds, the FICA taxes paid to cover the employee's share must be included in the employee's wages for income tax purposes. However, they are not counted as FICA wages or as FUTA wages. The social security and Medicare taxes paid by the employer are reported in boxes 4 and 6 of the employee's Form W-2. The taxes are also added to the employee's wages reported in box 1 of Form W-2.¹⁶⁰

Example 26. Bob pays Karry for help around the house. After the end of the year, he tells his accountant, Zach, that he paid Karry \$3,000 "pretty evenly" over the course of the year. He mentions that Karry does not work for anyone else and that Karry asked him not to withhold any taxes. Bob agreed to pay any extra taxes due, and he asks Zach to make sure that all of the right taxes are paid and forms filed.

Zach determines that the employee portion of FICA taxes on \$3,000 in wages is \$229.50 ($7.65\% \times \$3,000$). As the employer, Bob must match these taxes. In box 1 of Karry's Form W-2 (shown next), \$3,229.50 reflects the total net pay (\$3,000 wages + \$229.50 FICA paid on her behalf). Boxes 3 and 5 reflect the net wages of \$3,000. Boxes 4 and 6 reflect the allocation of the \$229.50 withheld from her wages between her social security taxes (6.2%) and Medicare taxes (1.45%).

a Employee's social security number ***-**-0926		OMB No. 1545-0008		Safe, accurate, FAST! Use				Visit the IRS website at www.irs.gov/efile	
b Employer identification number (EIN) 86-3229500				1 Wages, tips, other compensation 3229.50		2 Federal income tax withheld			
c Employer's name, address, and ZIP code Bob Rainley 1500 Main St., Apt. 1 Your Town, WA 98052				3 Social security wages 3000.00		4 Social security tax withheld 186.00			
				5 Medicare wages and tips 3000.00		6 Medicare tax withheld 43.50			
				7 Social security tips		8 Allocated tips			
d Control number				9		10 Dependent care benefits			
e Employee's first name and initial Last name Suff. Karry Z. Betreuerin 1500 Main St., Apt. 1 Your Town, WA 98052				11 Nonqualified plans		12a See instructions for box 12			
				13 Statutory employee Retirement plan Third-party sick pay ☐ ☐ ☐		12b			
				14 Other		12c			
						12d			
f Employee's address and ZIP code									
15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name			

Form **W-2** Wage and Tax Statement

2023

Department of the Treasury—Internal Revenue Service

Copy B—To Be Filed With Employee's FEDERAL Tax Return.
This information is being furnished to the Internal Revenue Service.

¹⁶⁰ IRS Pub. 926, *Household Employer's Tax Guide*.

Filing Forms W-2¹⁶¹

For tax year 2023 forms filed in 2024, any filers of 10 or more withholding tax returns¹⁶² (e.g., Form W-2) in a calendar year are generally required to file the forms electronically. Employers with fewer than 10 Forms W-2 to file may still file printed copies by mail.¹⁶³

Although the procedures for completing Form W-2 and its companion Form W-3, *Transmittal of Income and Tax Statements*, is beyond the scope of this material, filers may be interested to know that when tax software asks which type of payer a household employer is, the proper response is “941” if household employer is not an option.

The SSA offers employers the option of electronically filing Forms W-2 and W-3 via its Business Services Online (BSO) portal. The full-service online filing option is generally only available to taxpayers with Login.gov or ID.me credentials. Others may take advantage of limited online services.¹⁶⁴

Note. The BSO portal at www.ssa.gov/bso provides various types of information for employers, including forms and instructions. A brief online tutorial regarding BSO services may be found at uofi.tax/23x9x2 [www.SSA.gov/employer/bsotut.htm].

Some standard rules apply to all Form W-2 filers, including household employers, such as the following.

- Employers must notify certain employees about the earned income credit (EIC). The notice must be given to all employees who have no income tax withheld even though they requested withholding. This notice must be similar to the one on the official IRS version of Form W-2, on the reverse side of Copy B.¹⁶⁵ Household employers who are not required to issue their employee a Form W-2 must nonetheless provide this EIC notice.¹⁶⁶
- The due date for filing and mailing 2023 Forms W-2 is January 31, 2024.
- The IRS will only grant extensions of time to file Form W-2 with the SSA in extraordinary circumstances.
- Extensions of time to furnish Forms W-2 to employees are also not automatic and only granted in extenuating circumstances.

Filing Schedule H and Submitting Payments to the IRS

To encourage payors to participate in the system, household employers are allowed to forgo quarterly filing of employer wage activity on the usual business forms.¹⁶⁷ Instead, they are allowed to file Schedule H with their annual income tax return.¹⁶⁸ On this form, they report total wages, withholding, and employment taxes due as a result of paying any household employees.

¹⁶¹. IRS *General Instructions for Forms W-2 and W-3*. Dec. 29, 2022. IRS. [www.irs.gov/pub/irs-pdf/iw2w3.pdf] Accessed on Jul. 18, 2023.

¹⁶². TD 9972, 2023-31 IRB 530. Note that the 10-return threshold applies to the aggregate number of information return types covered by the regulation. Earlier regulations applied the 250-return threshold separately to each type of applicable information return.

¹⁶³. The IRS provides printable copies at www.irs.gov, but the copies to submit to the SSA must be printed on machine readable paper approved by the SSA. Approved forms may be purchased from office supply stores.

¹⁶⁴. *Business Services Online (BSO)*. 2023. Social Security Administration. [www.ssa.gov/bso/bsowelcome.htm] Accessed on Jul. 2, 2023.

¹⁶⁵. Providing the employee with Notice 797, *Possible Federal Tax Refund Due to the Earned Income Credit (EIC)*, is also an allowable way to inform them about EIC.

¹⁶⁶. Instructions for Schedule H.

¹⁶⁷. Such as Form 941, *Employer's QUARTERLY Federal Tax Return*; Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return*; Form 943, *Employer's Annual Federal Tax Return for Agricultural Employees*; or Form 944, *Employer's ANNUAL Federal Tax Return*. Household employers who also have employees of their sole proprietorships may elect to include the household wages with the business wages on the employer filings instead of filing Schedule H.

¹⁶⁸. Form 1040, *U.S. Individual Income Tax Return* or Form 1041, *U.S. Income Tax Return for Estates and Trusts*, as applicable.

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Example 27. Use the same facts as **Example 26.** Bob files the following Schedule H with his 2023 Form 1040. The total taxes due from employing Karry are \$459, as shown on line 8d. Because the \$3,000 was spread evenly throughout the year, Bob did not pay more than \$1,000 in any quarter to his household employee in 2023. Therefore, he does not owe any FUTA taxes. If he were subject to FUTA, the taxes would have been calculated on page 2 (not shown). The total of the taxes due calculated on this form are transferred to Schedule 2 (Form 1040), *Additional Taxes*, line 9, (not shown).

SCHEDULE H (Form 1040)

Department of the Treasury
Internal Revenue Service

Household Employment Taxes

(For Social Security, Medicare, Withheld Income, and Federal Unemployment (FUTA) Taxes)

Attach to Form 1040, 1040-SR, 1040-NR, 1040-SS, or 1041.

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

OMB No. 1545-0074

2023
Attachment
Sequence No. **44**

Name of employer

Bob Rainley

Social security number

***-**-0607

Employer identification number

8 6 3 2 2 9 5 0 0

Calendar year taxpayers having no household employees in 2023 don't have to complete this form for 2023.

- A** Did you pay **any one** household employee cash wages of \$2,600 or more in 2023? (If any household employee was your spouse, your child under age 21, your parent, or anyone under age 18, see the line A instructions before you answer this question.)
☒ **Yes.** Skip lines B and C and go to line 1a.
☐ **No.** Go to line B.
- B** Did you withhold federal income tax during 2023 for any household employee?
☐ **Yes.** Skip line C and go to line 7.
☐ **No.** Go to line C.
- C** Did you pay **total** cash wages of \$1,000 or more in **any** calendar **quarter** of 2022 or 2023 to **all** household employees? (Don't count cash wages paid in 2022 or 2023 to your spouse, your child under age 21, or your parent.)
☐ **No. Stop.** Don't file this schedule.
☐ **Yes.** Skip lines 1a-9 and go to line 10.

Part I Social Security, Medicare, and Federal Income Taxes

1a Total cash wages subject to social security tax	1a	3,000	
b Qualified sick and family leave wages paid in 2023 for leave taken after March 31, 2020, and before April 1, 2021, included on line 1a	1b		
2a Social security tax. Multiply line 1a by 12.4% (0.124)	2a		372
b Employer share of social security tax on qualified sick and family leave wages paid in 2023 for leave taken after March 31, 2020, and before April 1, 2021. Multiply line 1b by 6.2% (0.062)	2b		
c Total social security tax. Subtract line 2b from line 2a	2c		372
3 Total cash wages subject to Medicare tax	3	3,000	
4 Medicare tax. Multiply line 3 by 2.9% (0.029)	4		87
5 Total cash wages subject to Additional Medicare Tax withholding	5		
6 Additional Medicare Tax withholding. Multiply line 5 by 0.9% (0.009)	6		
7 Federal income tax withheld, if any	7		
8a Total social security, Medicare, and federal income taxes. Add lines 2c, 4, 6, and 7.	8a		459
b Nonrefundable portion of credit for qualified sick and family leave wages for leave taken before April 1, 2021	8b		
c Nonrefundable portion of credit for qualified sick and family leave wages for leave taken after March 31, 2021, and before October 1, 2021	8c		
d Total social security, Medicare, and federal income taxes after nonrefundable credits. Add lines 8b and 8c and then subtract that total from line 8a	8d		459
e Refundable portion of credit for qualified sick and family leave wages for leave taken before April 1, 2021	8e		
f Refundable portion of credit for qualified sick and family leave wages for leave taken after March 31, 2021, and before October 1, 2021	8f		
g Qualified sick leave wages for leave taken before April 1, 2021	8g		
h Qualified health plan expenses allocable to qualified sick leave wages reported on line 8g	8h		
i Qualified family leave wages for leave taken before April 1, 2021	8i		
j Qualified health plan expenses allocable to qualified family leave wages reported on line 8i	8j		
k Qualified sick leave wages for leave taken after March 31, 2021, and before October 1, 2021	8k		
l Qualified health plan expenses allocable to qualified sick leave wages reported on line 8k	8l		
m Qualified family leave wages for leave taken after March 31, 2021, and before October 1, 2021	8m		
n Qualified health plan expenses allocable to qualified family leave wages reported on line 8m	8n		
9 Did you pay total cash wages of \$1,000 or more in any calendar quarter of 2022 or 2023 to all household employees? (Don't count cash wages paid in 2022 or 2023 to your spouse, your child under age 21, or your parent.) ☐ No. Stop. Include the amount from line 8d above on Schedule 2 (Form 1040), line 9. Include the amounts, if any, from lines 8e and 8f on Schedule 3 (Form 1040), line 13z. If you're not required to file Form 1040, see the line 9 instructions. ☐ Yes. Go to line 10.			

For Privacy Act and Paperwork Reduction Act Notice, see the instructions.

Cat. No. 12187K

Schedule H (Form 1040) 2023

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The total amount due shown on Schedule H is included as part of the taxpayer's total tax liability for the year. An individual who does not have an income tax filing obligation must file the Schedule H by itself. An extension for filing the income tax return also applies to Schedule H.

Generally, the employer must include the household taxes as part of **their total tax liability for estimated tax purposes**. To avoid estimated tax penalties, they may need to increase their federal income tax withholding from their wages, pension, annuity, etc., or increase their estimated tax payments.¹⁶⁹

Note. Estimated tax payments are covered in detail earlier in this chapter.

Example 28. Prior to 2022, Willie's normal income tax liability was around \$2,000 each year. She covered this liability by withholding \$200 a month from her social security benefits (\$2,400 per year). In 2022, she also owed \$3,000 in taxes because she paid her niece to work around the house. Thus, her total 2022 tax liability was \$5,000 and she had to pay the balance of \$2,600 (\$5,000 total tax liability – \$2,400 withholding from social security benefits) in April 2023.

Willie anticipates that her household employer taxes will increase to \$4,000 in 2023. Her income tax will be the usual \$2,000, which brings her total tax liability to \$6,000 for the year.

The minimum amount she must pay in estimated taxes for 2023 is \$5,000.¹⁷⁰ If she changes nothing, she will owe \$3,600 in April 2024 (\$6,000 total tax liability – \$2,400 tax withheld from social security benefits) and she will be subject to estimated tax penalties. She may make up the shortfall by increasing her withholding, making estimated tax payments, or a combination of both.

Note. If the amount of wages paid varies each month, it may be wise for household employers to make monthly estimated tax payments based on the prior month's pay **instead** of including the employer tax liability in the estimated payments that the taxpayer bases on income tax liability.

Household employers will not be penalized for failure to make estimated tax payments if **both** of the following apply for the year.

1. They will not have federal income tax withheld from wages, pensions, or any other payments they receive.
2. Their income taxes, excluding the household employment taxes, are not high enough to require payment of estimated taxes.

¹⁶⁹. For more information, see IRS Pub. 505, *Tax Withholding and Estimated Tax*.

¹⁷⁰. Per IRS Pub. 505, the minimum due is the lesser of 100% of prior year taxes (\$5,000) or 90% of current year projected taxes (\$6,000 x 90% = \$5,400).

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RARE CIRCUMSTANCES

There are a few exceptions and special rules that are important. For example, as shown in Table 1 from IRS Pub. 926 (2023), there are exceptions to the exclusions for FICA taxes.

Table 1. **Do You Need To Pay Employment Taxes?**

IF you ...		THEN you need to ...
A	Pay cash wages of \$2,600 or more in 2023 to any one household employee. Don't count wages you pay to: • Your spouse, • Your child under the age of 21, • Your parent (see <i>Wages not counted</i>, later, for an exception), or • Any employee under the age of 18 at any time in 2023 (see <i>Wages not counted</i>, later, for an exception).	Withhold and pay social security and Medicare taxes. • The taxes are 15.3%¹ of cash wages. • Your employee's share is 7.65%.¹ (You can choose to pay it yourself and not withhold it.) • Your share is 7.65%.
B	Pay total cash wages of \$1,000 or more in any calendar quarter of 2022 or 2023 to household employees. Don't count wages you pay to: • Your spouse, • Your child under the age of 21, or • Your parent.	Pay FUTA tax. • The tax is 6% of cash wages. • Wages over \$7,000 a year per employee aren't taxed. • You may also owe state unemployment tax.
¹ In addition to withholding Medicare tax at 1.45%, you must withhold a 0.9% Additional Medicare Tax from wages you pay to an employee in excess of \$200,000 in a calendar year. You're required to begin withholding Additional Medicare Tax in the pay period in which you pay wages in excess of \$200,000 to an employee and continue to withhold it each pay period until the end of the calendar year. Additional Medicare Tax is only imposed on the employee. There is no employer share of Additional Medicare Tax. All wages that are subject to Medicare tax are subject to Additional Medicare Tax withholding if paid in excess of the \$200,000 withholding threshold.		
Note. If neither A nor B above applies, you don't need to pay any federal employment taxes. But you may still need to pay state employment taxes.		

Wages paid to **unrelated children** are **taxable** if working for the payor is the child's **principal occupation**. Any employee who was under age 18 at any time during the year is considered a child for these purposes. If the child is a student, that is considered their principal occupation.

Example 29. Chris, age 17, graduates from high school in the spring of 2023. In the fall, Chris becomes the full-time nanny for a neighborhood family. Even though she is under 18 years old, the wages the family pays Chris after she graduates are counted as FICA wages when the job becomes Chris's principal occupation.

According to the Code, a payor who has **never been married** is **not** required to report their **parent's** earnings in FICA wages. Only a person who was married, has not remarried, and who is without their spouse due to death or divorce is required to include their parent's earnings in FICA wages. Furthermore, only wages paid for services related to the grandparent's care of an underage or impaired child are included in FICA wages.¹⁷¹

Example 30. Tobias and Rachel are married. In 2022, they welcome their first child. When Rachel and Tobias return to work, Rachel's mother watches the baby. They pay her \$100 per week. Rachel and Tobias do not need to count the wages they pay to Rachel's mother in 2022 as FICA wages because they are married, and neither is incapacitated.

Example 31. In 2023, Rachel and Tobias from **Example 30** divorce. Following their divorce, Rachel does not remarry, and her mother continues to care for the baby while Rachel works. The wages paid to Rachel's mother are included in FICA wages.

Example 32. Use the same facts as **Example 31**, except Rachel and Tobias were never married. None of the wages paid to Rachel's mother in 2022 or 2023 must be treated as FICA wages.

Example 33. Use the same facts as **Example 31**, except Rachel and Tobias paid Rachel's mother to watch their beloved pets. None of the wages paid to Rachel's mother in 2022 or 2023 must be treated as FICA wages.

¹⁷¹. IRC §3121(b)(3)(B).

Any person who is divorced, widowed, or whose spouse is incapacitated is without their spouse. In this context, incapacitations and impairments must last at least four continuous weeks during the calendar quarter in which the child's grandparent performs the services.

Identity of Employer Unclear

Generally, the employer is the person who receives the services **and** pays the employee.¹⁷² However, if the service recipient does not control the payment of compensation to the household employee, then the employer is the person who controls compensation payments.¹⁷³ When it is unclear who the employer is, an examination of the facts and circumstances may be necessary to determine the identity of the employer.¹⁷⁴

Observation. Particularly in family situations, it is essential for the tax practitioner to clearly identify who the employer is, because it is the employer who has reporting and withholding obligations for the household employee.¹⁷⁵ Issuing a hiring letter that makes it clear who the employer is and making compensation payments consistently from an appropriate account belonging to the employer helps eliminate issues that could arise because of a lack of clarity regarding the identity of the employer.

Wages Paid to Employee but Form W-2 Reporting Not Required

A taxpayer may not know how to report income they receive from an employer when they do not receive a Form W-2. A household employee is more likely than other types of employees to legitimately receive wages and no Form W-2.

Example 34. Skip's friends in **Example 25** are employees. However, because they earned less than \$2,600 total from him for the year, they do not receive Forms W-2. As such, they incorrectly assume they have no filing obligation.

On the 2022 Form 1040, the IRS introduced **line 1b, "Household employee wages not reported on Form(s) W-2,"** for this situation. This line gives the employee a place to report their wages for income tax purposes and other potential issues, such as the EIC.

Note. An employee who should have received a Form W-2, but has not, may file Form 4852, *Substitute for Form W-2, Wage and Tax Statement, or Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, if they do not receive the Form W-2 in time to timely file their income tax return.

POTENTIAL PENALTIES¹⁷⁶

At one time, hiring undocumented workers and paying for household help off the books were commonplace practices. Then, in 1993, several political nominations were derailed when it became public that they had employed undocumented immigrants and/or not paid social security taxes on the wages.¹⁷⁷

In addition to reputational consequences, there can be financial penalties imposed on taxpayers who fail to meet certain requirements related to their employees. Most of these penalty amounts have increased for returns required to be filed after December 31, 2023.

¹⁷². IRC §3401(d).

¹⁷³. IRC §3401(d)(1); and Treas. Reg. §31.3401(d)-1(f).

¹⁷⁴. Treas. Reg. §31.3401(c)-1(d).

¹⁷⁵. Treas. Reg. §31.3401(d)-1(h).

¹⁷⁶. *General Instructions for Certain Information Returns*. Mar. 27, 2023. IRS. [www.irs.gov/pub/irs-pdf/i1099gi.pdf] Accessed on Jul. 5, 2023.

¹⁷⁷. See, e.g., *Nannygate*. Apr. 21, 2023. Wikipedia. [en.wikipedia.org/wiki/Nannygate] Accessed on Jul. 5, 2023.

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Penalties for Failure to Timely File Correct Information Returns¹⁷⁸

Penalties for not filing accurate and timely returns vary depending on when the correct Form W-2 is filed. Penalties currently range from \$60 to \$310 per Form W-2. Reasonable cause exceptions may apply, but the penalties for intentional disregard of the rules is \$630 per Form W-2.¹⁷⁹

The penalty may be assessed against employers who:

- Fail to timely file,
- Fail to include all information required to be shown on Form W-2,
- Include incorrect information on Form W-2,
- File on paper forms when required to file electronically,
- Report an incorrect TIN,
- Fail to report a TIN, or
- Fail to file paper Forms W-2 that are machine readable.

Penalties for Failure to Furnish Correct Payee Statements¹⁸⁰

The employee's Form W-2 copies for 2023 must be mailed or provided by January 31, 2024. Penalties for failing to do so are similar to the penalties related to filing Form W-2 copies with the IRS as discussed previously, except that the penalties apply to the employee's copy rather than the government's copy.

Penalties for Failure to Withhold and Pay FICA, FUTA, and Federal Income Tax¹⁸¹

Failures involving withholding and reporting payroll taxes can result in both civil and criminal penalties, depending upon the circumstances. These penalties can potentially be as high as 100% of the tax due. However, for household employers, the penalties for late payments are under the rules applicable to estimated tax rules for the payor's Form 1040 or Form 1041 (as opposed to the rules for payments due with the Form 940 series.)

Failure to File Accurate Schedule H

There does not appear to be a specific penalty for filing an inaccurate Schedule H or failing to file one. However, penalties for accuracy and timeliness related to Form 1040 filings apply because the form is due as part of the Form 1040 filing.

If an employer files information with the IRS and the SSA that is not consistent between the agencies, they will likely receive correspondence from one or both asking for clarification and informing the taxpayer of the consequences for not providing the information.

¹⁷⁸. IRC §6721.

¹⁷⁹. *General Instructions for Certain Information Returns*. Mar. 27, 2023. IRS. [www.irs.gov/pub/irs-pdf/i1099gi.pdf] Accessed on Jul. 5, 2023.

¹⁸⁰. IRC §6722.

¹⁸¹. IRS Pub. 15, (*Circular E*), *Employer's Tax Guide*.

TANGENTIAL OBSERVATIONS

Household Employees

Although the focus of this material is on the employer, tax practitioners may also have clients who are household workers. If a service provider receives a Form 1099-NEC for payments related to providing personal services in a home, it is more than likely someone has misunderstood the rules pertaining to their engagement.

In this situation, the practitioner should verify that their client **is or is not** in the business of providing services to the public such as those for which these payments were received. If the client received the funds in the course of their trade or business, the income is includable with the amounts for other gross receipts.

If the client is not operating a trade or business, the payor is probably skirting their duties as an employer. A person who is being misclassified for employment purposes may file Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*. The worker files Form SS-8 if they want the IRS to make a determination of their status as an independent contractor or an employee. Filing Form SS-8 is the only way a person can initiate getting approval to file Form 8919, *Uncollected Social Security and Medicare Tax on Wages*, with their individual income tax return. This form is used to take responsibility for the unpaid employee portion of the FICA tax due on the wages received. It is typically used when a taxpayer is trying to document why they are not reporting income as subject to SE tax, which is twice the employee portion of FICA.

Note. There are circumstances when a person gets paid for services that were neither in the course of a trade or business nor in the traditional sense of employment. For more information about reporting income from such activities, see the 2020 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Small Business Issues. This can be found at [uofi.tax/arc](https://taxschool.illinois.edu/taxbookarchive) [taxschool.illinois.edu/taxbookarchive].

Medical Deductions

Wages reported on Schedule H may be deductible on Schedule A if they were made for qualified medical purposes. A person who needs substantial supervision or help with at least two activities of daily living may be allowed to deduct up to 100% of the wages and related taxes they pay for household employees. See IRS Pub. 502, *Medical and Dental Expenses*, for more information on the deductibility of qualified long-term care services and nursing services.

ADDITIONAL RESOURCES

For additional information, the following links and recommendations may be helpful.

- Social Security Number Verification Service: uofi.tax/23x9x3 [SSA.gov/employer/ssnv.htm]
- USCIS Central: uofi.tax/23x9x4 [www.uscis.gov/i-9-central]
- USCIS online services for registered employers to confirm employment eligibility of newly hired employees: **E-Verify.gov**
- IRS webpage listing state government links: uofi.tax/23x9x5 [www.irs.gov/businesses/small-businesses-self-employed/state-government-websites]
- U.S. Department of Labor list of state unemployment tax agencies: uofi.tax/23x9x6 [oui.doleta.gov/unemploy/agencies.asp]
- U.S. Department of Labor list of labor laws applicable to **live-in** domestic workers: uofi.tax/23x9x7 [www.dol.gov/agencies/whd/fact-sheets/79b-flsa-live-in-domestic-workers]
- For questions about the employment eligibility verification process or other immigration-related employment matters, contact the USCIS Office of Business Liaison at 800-357-2099

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