2021 NC VITA TAX TRAINING
Part 2
December 9, 2021

Today's Topics

- Carryover 2020 issues
- UC Repayments
- VITA Scope of Service – What returns are "out-of-scope" as defined by the IRS?
- NC Part-Year Returns and Other State Tax Credits
- My Watch-Out List

2020 Carryover Items - What 2020 Changes Carry Over to 2021 and Which Do Not Plus Tax Extenders

- For the 2020 tax year, there were a number of tax changes from Coronavirus-relief legislation that only impacted 2020 tax returns. The changes that only applied to 2020 included:
    - The exclusion of up to $10,200 of unemployment compensation;
    - The waiver of the Required Minimum Distribution requirements for IRAs and qualified plans;
    - The Coronavirus-Related Distribution rules (but see the discussion of income inclusion and repayments below);
    - The waiver of PTC repayments; and
    - The deferral of a portion of the Self-Employment tax.
- There were a number of other changes in the COVID legislation that were permanent changes to the tax law. These include:
    - IRA contributions allowed after age 70½;
    - Penalty-free withdrawal of up to $5,000 from a 401(k) plan or IRA for the birth or adoption of a child;
    - Required Minimum Distribution requirement moved from age 70½ to age 72 for taxpayers who turn 70½ after 12/31/19; and
    - Changes to minimum distribution rules for non-spouse beneficiaries.
- Several other changes made in 2020 will continue to impact 2021 tax returns.
    - The credits for Sick Leave and Family Leave for self-employed taxpayers have been extended through September 30, 2021. Thus, qualifying days of sick leave or family leave will continue to qualify for these credits as long as the leave occurred by September 30, 2021. The American Rescue Plan also made some changes to the computation of the family leave credit for the period April 1 – September 30. TaxSlayer will require you to separate out the qualifying days of leave prior to April 1 and after March 30 in order to apply these changes.
    - The special rule allowing non-itemizers to deduct up to $300 in <u>cash</u> charitable contributions has been extended through 2021. In addition, the limit has been increased for 2021 to $600 for an MFJ return. In TaxSlayer, there is now a heading "Cares Act 2020" under Federal/Deductions where

    - this can be entered but it just takes you back to the Cash Charitable Contributions under Itemized Deductions where this was entered for 2020.
  - The increase in the AGI limit for charitable contributions from 60% to 100% for certain qualifying cash contributions has been extended for qualifying contributions through 2021.
- Coronavirus-Related Distributions
  - Although the Coronavirus-related Distribution (CRD) provision applied only to distributions made during 2020, there are two potential carryover effects of these distributions in 2021.
    - First, the taxpayer was allowed in 2020 to elect to spread the income from a CRD over three years. For these taxpayers, the 2021 tax year will be their second year to include 1/3 of the CRD in income. You will need to ask the taxpayer or look at the 2020 tax return to see if the CRD spread election was made in 2020.
    - Second, the law permits a taxpayer to repay a CRD anytime within 3 years of the distribution and receive a refund of the taxes paid in 2020 or 2021 on such distribution.
  - If a taxpayer makes a complete repayment in 2021, you will report the repayment in 2021 (which eliminates any income inclusion on the 2021 return) and will then have to file an amended return for 2020 to claim back the taxes paid in 2020 on the CRD.
  - If a taxpayer makes a partial repayment in 2021, the taxpayer reduces the 2021 income inclusion by the amount of the repayment. Any remaining repayment can either be carried forward to offset the 2022 inclusion or can be carried back to 2020 by filing an amended return or both.
  - Here is an example from Pub. 4012, p. D-43: **Example:** Joe is a qualified individual and treated his 2020 distribution as a coronavirus distribution. Joe includes the $30,000 distribution ratably over a 3-year period. Without any recontribution, Joe would include $10,000 in income on his 2020, 2021 and 2022 tax returns. In October 2021, Joe recontributes $12,000 to an IRA and makes no other recontribution in the 3-year period. Joe is permitted to do either of the following:
    - **Option 1.** Joe includes $0 in income with respect to the coronavirus distribution on the 2021 tax return. Joe carries forward the excess recontribution of $2,000 to 2022 and includes $8,000 in income with respect to the coronavirus distribution on his 2022 tax return.
    - **Option 2.** Joe includes $0 in income with respect to the coronavirus distribution on the 2021 tax return and $10,000 in income on the 2022 tax return. Joe files an amended return for 2020 to reduce the amount included in income as a result of the coronavirus distribution to $8,000.
  - TaxSlayer has not been updated yet to deal with CRDs.
  - TaxSlayer will add a new section to the 1099-R menu that will allow you to include one-third of the 2020 distribution in income with adjustments for repayments.
  - Will be part of the carryover.
  - Form 8915-F is the new form for reporting CRD repayments

- Although the Self-Employment Tax Deferral provision applied only to SE Tax owed in 2020, if the taxpayer elected this deferral, a payment of half the deferred amount was due by December 31. This is not done through the tax return, so it should have no impact on 2021 returns.
- Tax Extenders – Various tax extenders have been either extended or made permanent:
  - Medical Expense Floor – The 10% of AGI floor for itemized deductions of medical expenses has been changed to 7.5% permanently.
  - Employer payment of student loan debt up to $5,250 – extended through 2025.
  - Forgiveness of Principal Residence Indebtedness – extended through 2025. However, the maximum amount excludable was reduced from $2,000,000 to $750,000 ($375,000 on an MFS return).
  - Treatment of Primary Mortgage Insurance as mortgage interest – extended through 2021.
  - Nonbusiness energy property credit – extended through 2021.

Unemployment Compensation

2020 FEDERAL EXCLUSION

- First $10,200 of unemployment compensation (UC) received was exempt from income if the return showed modified AGI of less than $150,000. Modified AGI is AGI less the total UC received. Passed in March 2021.
- If the 2020 return was filed including all UC received (generally because it was filed prior to enactment of the provision or implementation in the software), the IRS was supposed to "fix" the $10,200 exclusion and issue a refund to the taxpayer.

IRS FIX & THE NEED FOR AMENDED RETURNS

- The IRS has announced that they will fix any credit or deduction that changes due to the exclusion of UC so long as the credit or deduction was claimed on the original return or if the exclusion now qualifies the taxpayer for the Recovery Rebate Credit, the Earned Income Credit with no qualifying dependents, or the Advance Premium Tax Credit.
- If the credit or deduction was not claimed on the original return, but the taxpayer now qualifies for the credit or deduction (other than the 3 credits mentioned above), an amended return will be required to claim the credit or deduction.

WHAT DO WE NEED TO DO?

- The taxpayer is supposed to receive a letter from the IRS detailing the corrections made by the IRS.
- You will need a copy of that letter to determine whether an amended return is required for the taxpayer.
- When you open the 2020 return in TaxSlayer (even if it was filed before the change in law), the return will update to reflect the UC exclusion, as well as any other changes resulting from the change in income.
- If what you see in TaxSlayer does not reconcile with the IRS letter, you will need to understand why and then file an amended return if necessary to claim a credit or deduction not allowed by the IRS.

- An example of an issue the IRS has highlighted is a return where the taxpayer originally did not qualify for the EIC, but following the UC exclusion, the taxpayer now qualifies.
    - In this situation, since the EIC did not appear on the original return, it is possible that the IRS fix will not reflect that the taxpayer now qualifies for the EIC.
    - An amended return would be required in this situation to claim the EIC.
    - When you open this return in TaxSlayer, the software will have already added the EIC to the return.

REPAYMENT OF UC

- If a repayment of UC occurs in the year the payment was received, you can reduce the UC reported on the return by the amount repaid.
- If, however, the repayment occurs in a later tax year, things get much more complicated. We'll focus on UC received in 2020 that is repaid in 2021.
- The other problem is that the 2021 return MAY become out of scope for VITA.
- If the repayment is for UC received in 2020, the first question is how the repayment relates to the $10,200 exclusion.
- First, if the total UC received by the taxpayer in 2020 was less than $10,200, there will be no tax benefit for the repayment as there was no tax cost to the amount received in 2020.
- If the amount received in 2020 was more than $10,200, does the repayment go first against the $10,200 of nontaxable UC (and thus there is no benefit) or does it first reduce the taxable portion of the UC received in 2020? The answer <u>should</u> be the latter – the repayment should first go against any taxable amount.
- The reason for this is had the taxpayer received the correct amount in 2020, the first $10,200 received would have been tax-free so only any remaining amount received (net of the repayment amount) would have been taxable.
- For example, TP received $14,000 in UC in 2020 and reported $3,800 as UC income on her 2020 return. In 2021, she was required to repay $5,000 of the UC received in 2020. Thus, the amount she should have received in 2020 was $9,000, which is less than the $10,200 exclusion. So, when we test the repayment in 2021 (since we can't file an amended return), because the repayment ($5,000) exceeds the taxable portion of the UC in 2020 ($3,800), we would use the $3,800 as the amount of UC repaid in 2021 that she could receive a benefit for repaying in 2021.

REPAYMENT OF UC ≤ $3,000

- If the amount repaid (up to the taxable portion for 2020) is $3,000 or less, prior to 2018 you could deduct the amount repaid on the return for the year of the repayment as a miscellaneous itemized deduction subject to the 2% floor. But this, along with most other miscellaneous itemized deductions, were repealed for the years 2018-2025 and therefore there is NO Federal relief for the repayment of UC received in 2020 but repaid in 2021 if the amount of the repayment is less than $3,000.
- A return for a taxpayer with $3,000 or less in UC repayment remains in scope.

REPAYMENT OF UC > $3,000

- If the amount of UC repaid (up to the taxable portion for 2020) in 2021 is greater than $3,000, the taxpayer may generally either take an itemized deduction for the repayment or take a tax credit on the 2021 tax return. You <u>cannot</u> file an amended 2020 tax return to reflect the repayment.

- Unfortunately, both of these options are out of scope for VITA. I'm still going to explain the calculation of the deduction and credit so that you can aid the taxpayer in determining whether it is worth going to a paid preparer (which absent really big repayments will not be the case).
- Claiming a deduction or credit on the 2021 tax return is only available if the original amount was received under a "claim of right." This means at the time the taxpayer received the UC it appeared that the taxpayer had an unrestricted right to the income. If, for example, the taxpayer filed a fraudulent claim for UC, this would not have been received under a "claim of right" and no relief is afforded for the repayment.
- You will need to calculate the tax benefit from the itemized deduction (which will often be $0) and the credit and then choose the better of the two.

ITEMIZED DEDUCTION FOR REPAID UC > $3,000

- In TaxSlayer, go to Deductions/Itemized Deductions/Miscellaneous Deductions and go to the box labeled "Repayment under claim of right" and enter the amount repaid in 2021 (but not in excess of the amount of UC included in income in 2020).
- Complete any remaining sections of Itemized Deductions applicable to the taxpayer.
- As an itemized deduction, a benefit will be derived only if the total itemized deductions are in excess of the standard deduction.
- In order to compare the tax result of the itemized deduction versus taking a tax credit, note the total Federal and NC tax owed or amount of refunds.

TAX CREDIT FOR REPAID UC > $3,000

- The tax credit available for a repayment of previously-included income is basically the reduction in the taxpayer's 2020 Federal tax owed if the repayment had occurred in 2020. Obviously, this will interact with the $10,200 exclusion.
- If the taxpayer's total UC shown on the 2020 return was no greater than $10,200, there will be no credit since none of the UC was taxed in 2020. So, if the amount of the repayment is less than $10,200, there is no need to analyze the tax credit as it will be zero.
- You must have the 2020 return in the system to be able to determine the tax credit amount. If you do not have it in your system, you will need to input the 2020 return in TaxSlayer (you can use the Practice Lab for this purpose) in order to compute the credit. This is a lot to ask for a potentially out-of-scope return.
- First, you must take out the deduction under the claim of right previously entered in TaxSlayer from the prior page for the 2021 return.
- In the 2020 return, first note the amount of Federal tax due prior to making any changes.
- Go into the 2020 return and reduce the amount of UC entered into TaxSlayer (which is the gross amount received before the $10,200 exclusion) by the amount of the repayment.
- Note the Federal tax due and compute the difference from the tax shown on the original return.
- This amount is entered into TaxSlayer on the 2021 return under Federal/ Payments & Estimates/IRC 1341 Repayment Amount.

- Be sure to go back and correct the 2020 return so that it reflects the UC received in 2020 before the repayment.

REPAYMENT TAX BENEFIT

- Compare the 2021 Federal and NC tax owed/refund due under the itemized deduction and credit scenarios and choose the more beneficial one, which for most of our taxpayers will be the tax credit since they can't itemize even with the repayment.
- If you determine there is a benefit from either the itemized deduction or the tax credit, the return is out-of-scope if you claim the deduction or credit.
- If you go through the steps I have given you, you should be able to determine the tax savings available to the taxpayer by claiming the deduction or credit so that the taxpayer can decide whether it is worth going to a paid preparer to claim the repayment benefit.
- My guess is for most of our clients, unless the repayment amount is substantial, it will not be worth going to a paid preparer.

NC TREATMENT OF A UC REPAYMENT

- For NC purposes, an itemized deduction is allowed that is the same as the Federal itemized deduction (assuming the taxpayer elects to use the Federal itemized deduction rather than a credit). TaxSlayer will compute this for you automatically.
- If the tax credit is used for Federal purposes, there is no NC tax benefit available.
- If the amount repaid is less than $3,000, NC still allows an itemized deduction for the amount of the repayment but only in excess of 2% of AGI. This is entered in TaxSlayer in NC/Itemized Deductions/Repayment of Claim of Right Income. However, when I have tested this in TaxSlayer, it has not worked. Since any benefit would be quite small, this is probably not worth the effort.

Out of Scope

- The primary source for whether an item is out of scope (OOS) is pages 5-16 in Pub. 4012. This is a list by form number.
- Additional details can normally be found in the sections of the 4012 and Pub. 4491 that discuss the topic.
- The following is an overview of the primary items seen at VITA sites but is not a comprehensive listing of all OOS issues.
- I will not deal with whether an item requires Basic vs. Advanced, but I will highlight some of the issues where Military or International certification is required.

INCOME

- Salary & Wages
    - The following Form W-2 Box 12 codes are out of scope:
        - Q (Nontaxable Military Pay, unless Military certification).
        - R (Employer Contributions to an Archer MSA).
        - T (Adoption Benefits).
        - FF (Permitted Benefits under a Qualified Small Employer Health Reimbursement Arrangement) and the employee has a Marketplace policy and is otherwise eligible for the PTC.

    - Income of Ministers or other members of the clergy who present issues such as: parsonage/housing allowance, whether earnings are covered under FICA or Self-Employed Contributions Act (SECA) or rules for determining exemption from coverage.
- Interest
    - Form 1099-INT with any of the following boxes completed:
        - Box 9 (Private Activity Bonds) if the TP owes Alternative Minimum Tax.
        - Box 11 (Bond Premium) if the amount exceeds the amount of interest shown in Box 1.
        - Box 12 (Bond Premium on Treasury Obligations) if the amount exceeds the amount of interest on U.S. obligations shown in Box 3.
        - Box 13 (Bond Premium on Tax-Exempt Bonds) if the amount exceeds the amount of tax-exempt interest shown in Box 8.
        - FATCA Filing Requirement box is checked.
    - Form 1099-OID with Box 6 (Acquisition Premium) or with the FATCA Filing Requirement box checked.
    - Exclusion of Savings Bond interest to fund educational expenses (Form 8815).
    - Reporting savings bond interest as it accrues other than for U.S. Savings Bonds.
    - A bond is sold between interest payment dates other than for U.S. Savings Bonds.
- Dividends
    - Form 1099-DIV with any of the following boxes completed:
        - Box 2b (Unrecaptured Section 1250 Gain).
        - Box 2c (Section 1202 Gain).
        - Box 2d (Collectibles (28%) gain).
        - Box 8 (Cash Liquidation Distributions).
        - Box 9 (Noncash Liquidating Distributions).
- State Tax Refunds/Form 1099-G
    - State Tax Refunds received during the year for a year other than the previous tax year.
- Capital Gains & Losses
    - Sale of any asset other than stocks, bonds, mutual funds, or a personal residence.
    - Transactions involving digital currency, such as Bitcoin. Note that a return is in scope if the taxpayer merely purchased virtual currency using real currency or held an investment in Bitcoin.
    - Taxpayers who trade in options, futures, or other commodities whether or not they disposed of them during the year.
    - Worthless securities.
    - Decreases to basis, including from casualty losses, gains a taxpayer postponed from the sale of a previous home before May 7, 1997, and depreciation during the time the home was used for business or as a rental property.
    - Schedule D where the basis of property is determined by means other than a purchase or inheritance (such as by gift or stock options) unless the taxpayer provides the basis of the property.

- Schedule D where the property was acquired by inheritance from a decedent whose date of death was during 2010.
- Schedule D where the basis of inherited property is determined by a method other than FMV of the property on the date of the decedent's death, unless the taxpayer provides the basis and holding period.
- <u>Form 1099-B, Proceeds From Broker and Barter Exchange Transactions, where any of the following boxes has an entry:</u>
  - Box 1f (Accrued Market Discount).
  - Box 7 (Loss Not Allowed).
  - Box 8 (Profit or (Loss) Realized on Closed Contracts).
  - Boxes 9 & 10 (Unrealized Profit or (Loss) on Open Contracts).
  - Box 11 (Aggregate Profit or (Loss) on Contracts.
  - Box 13 (Bartering).
  - The FATCA Filing Requirement is checked.
- <u>Any of the following adjustments to basis:</u>
  - Taxpayers who disposed of collectibles (Adjustment code C).
  - Taxpayers who received a Form 1099-B or 1099-S as a nominee (Adjustment code N).
  - Taxpayers who sold qualified small business stock and can exclude part of the gain (Adjustment code Q).
  - Taxpayers who are electing to postpone all or part of their gain for any rollover of gain (Adjustment code R).
  - Taxpayers who have a loss from the sale, exchange, or worthlessness of small business stock and the total loss is more than the maximum amount that can be treated as an ordinary loss (Adjustment code S).
- The following sales of a personal residence:
  - <u>Taxpayers who inherited a home or received the home as a gift where the taxpayer does not use the home as a personal residence.</u>
  - <u>Taxpayers claiming a reduced exclusion for the sale of a home owned and used for less than 2 years.</u>
  - Married taxpayers claiming an exclusion for gain on the sale of a home where both spouses do not satisfy all the requirements for married taxpayers to claim this exclusion.
  - Taxpayers claiming an exclusion for the sale of a home and who received the first-time homebuyer credit and are required to repay the credit in the year of sale.
  - Taxpayers who sold a home and had days of nonqualified use after 2008 when the Taxpayer owned the home but didn't use it as a main home.
  - <u>Taxpayers who sold a home previously used for business purposes or as rental property.</u>
  - <u>Taxpayers who sold a home that was previously depreciated.</u>

- Retirement Income
  - <u>Form 1099-R –</u>
    - The following Box 7 Distribution Codes are out of scope: 5, 6, 8, 9, A, E, J, K, N, P, R, T, U, or W.

        - Box 7 Code B (Designated Roth account distribution) is in scope only if the taxable amount has been determined.
        - Box 7, Code D (certain Annuity payments) is in scope only if AGI is < $200,000 for Single or Head of Household, $250,000 if MFJ, or $125,000 if MFS.
        - Code 2 (Early distribution, exception applies (under age 59½)) is not in scope if the IRA/SEP/SIMPLE box is checked and there were nondeductible contributions.
    - Additional Taxes on Qualified Plans and Other Tax-Favored Accounts (Form 5329) – Only Part I (Additional Tax on Early Distributions) is in scope. All other parts of Form 5329 are out of scope.
    - Nondeductible IRA contributions other than Roth.
    - Taxable or partially taxable Roth distributions unless the taxable amount has been determined.
    - IRA rollovers that do not meet the tax-free requirements.
    - A distribution from an ABLE Account that exceeds the qualified disability expenses of the beneficiary.
    - More than one rollover from an IRA in a 12-month period.
    - The general rule was used to determine the amount of the pension that was taxable in a prior year (generally taxpayers who retired prior to July 2, 1986 and did not use the 3-year rule).
    - Withdrawals from a retirement plan where the taxpayer is claiming any of the special provisions for victims of specified disaster losses other than COVID-related distributions.
    - Partially taxable distribution from an IRA/SEP/SIMPLE.
    - Social Security – Foreign social security from Canada or Germany that is treated as U.S. Social Security under the applicable treaties.
- Rental Income
    - Rental Real Estate – in scope only for Military families renting their personal residence – requires Military Certification. Any other rental arrangement, including renting out a room or Airbnb/VRBO, is out of scope. But note there is an exception – if you rent out your personal residence for less than 15 days, you do NOT have to report the income as rental income and therefore the return would still be in scope.
    - Depreciation and Amortization that must be claimed on Form 4562.
    - Depreciation on property placed in service during 2021.
    - Taxpayers who are unable to provide an amount for depreciation.
- Royalties
    - Royalty Income only if shown on Form 1099-MISC, Box 2 or Schedule K-1 and only if there are no associated expenses.
- Schedule K-1
    - Income other than (box numbers shown are for Form 1065, Schedule K-1):
        - Interest income (Box 5)
        - Dividend income (Box 6a)
        - Qualified dividend income (Box 6b)
        - Net Short-term Capital gains and losses (Box 8)
        - Net Long-term Capital gains and losses (Box 9a)

        - Tax-exempt interest (Box 14)
        - Royalty income (Box 18) with no associated expenses
        - Section 199A dividends (Box 20, Code Z)
        - Foreign Tax (Box 21)
    - All other items of income, deduction, credit or other items shown on a K-1 are out of scope.
- Cancellation of Debt
    - Cancellation of Indebtedness income other than: (1) income from the cancellation of nonbusiness credit card debt so long as the taxpayer was not insolvent or in bankruptcy at the time of the cancellation; (2) income from the cancellation of Qualified Principal Residence Indebtedness so long as the taxpayer was not bankrupt or insolvent and the home was never used for business or rental; or (3) discharge of certain student loan debt in 2021 through 2025.
    - Form 1099-C with an entry in Box 3 (Interest) unless the cancellation was of nonbusiness credit card debt and the taxpayer was solvent.
- Education Savings Accounts
    - Distributions from Education Savings Accounts, Qualified Tuition Plans (section 529 Plans), or ABLE accounts reported on Form 1099-Q in which the funds were not used for qualified education expenses or the distributions exceeds the amount of qualified expenses.
- Business Income
    - Business that operates at a loss.
    - Business with expenses of more than $35,000.
    - Business use of a home.
    - Schedule C – The following items are out of scope:
        - Part I, Lines 2 (returns and allowances), 4 (cost of goods sold), or 6 (other income).
        - Part II, Lines 9 (car expenses based on actual expenses rather than the standard mileage allowance), 11 (contract labor), 12 (depletion), 13 (depreciation or if Form 4562 is required), 14 (employee benefit programs), 16a (mortgage interest), 19 (pension and profit-sharing plans), 20 (rental or lease of more than 30 days), 26 (wages), 27a (other expenses), or 30 (business use of home).
        - Part III, Cost of goods sold.
    - Other gains or losses (Form 4797 – Sales of Business Property).
    - Farm Income or income that must be reported on Schedule F.
    - Activities not entered into for profit (Hobby Losses).
    - Income from the manufacture, distribution, or trafficking of controlled substances.
- Miscellaneous Income
    - Alimony received if the divorce or separation was prior to 1985.
    - 1099-MISC with entries in Boxes 5 and 7-14.
    - Net Operating Losses.

ADJUSTMENTS TO INCOME
- Employee expenses other than certain expenses of reservists and U.S. Armed Forces members who were provided a commuter highway vehicle by their employer (requires Military Certification).
- Moving Expenses – Taxpayer must be active-duty military (requires Military Certification).
- Self-employed SEP, SIMPLE, and Qualified Plans.
- Self-employed Health Insurance Deduction if the taxpayer purchased Marketplace insurance and was eligible for the Premium Tax Credit.
- Alimony paid from pre-1985 divorce.
- Archer Medical Saving Accounts (MSA).
- Medicare Advantage MSA.

ITEMIZED DEDUCTIONS
- Casualty and theft losses.
- Repayment of an item previously included in income of more than $3,000.
- Charitable contributions – The following topics are out of scope:
    - Noncash contributions of more than $500 except for active-duty Military taxpayers and requires Military certification.
    - Form 1098-C, Contributions of Motor Vehicles, Boats, and Airplanes if the value is more than $500.
    - Taxpayers affected by limits on charitable deductions, including charitable contribution carryovers.
    - Contributions of property that was previously depreciated.
    - Donations of capital gain property.

TAX CREDITS
- Premium Tax Credit – Marketplace insurance subject to a Shared Policy Allocations (Form 8962, Part IV) or the Alternative Calculation for Year of Marriage (Form 8962, Part V).
- Education Credits – Taxpayers who claimed an education credit in a prior year and they were refunded part or all of the expenses used to claim the education credit.
- Education - Form 1098-T with Boxes 4 or 6 (both relating to prior year adjustments) completed.
- Foreign Tax Credit – Requires International Certification if Form 1116 is required (Form 1116 is not required if all foreign taxes were paid with respect to passive income reported on a 1099-DIV, 1099-INT, or Schedule K-1 and the total is less than $300/$600 MFJ).
- Residential Energy Credits Part I.
- Form 8839 – Qualified Adoption Expenses.

SPECIAL TAX SITUATIONS
- Kiddie Tax (Form 8615) other than for Native Americans receiving per capita payments or certain Alaska residents.
- Alternative Minimum Tax.
- Household Employment Taxes.
- Estimated Tax Penalty (the IRS will compute the penalty due).
- Parent's Election to Report Child's Interest and Dividends (Form 8814).

- Qualified Adoption Expenses (Form 8839).
- Request for Innocent Spouse Relief (but Injured Spouse relief is in scope).
- Uncollected Social Security and Medicare Tax on Wages, for taxpayers contesting status as a non-employee (Form 8919).
- Form 1040NR unless International certification.
- Dual Status taxpayers (both a resident and nonresident in the same year).
- Taxpayers with a F, J, M, or Q visa require Foreign Student certification.
- Taxpayers wanting to file Form 8840, Closer Connection Exception Statement for Aliens.
- Resident aliens treated as nonresident aliens under an income tax treaty.
- Nonresident aliens who do not meet the green card or substantial presence test and are not married to a US citizen or resident alien.
- Election to treat a nonresident alien spouse as a resident alien. Note that this return is in scope for subsequent years, just not in scope for the year the election is first made.

North Carolina

NC PART-YEAR RETURNS

- The key to completing a NC part-year return is properly allocating the items of income, as well as state additions and subtractions to income, between the amounts that occurred while the taxpayer was a NC resident and those that occurred outside of NC.
- A pro rata allocation based on the number of months in NC and out of NC is usually not the right answer. You should look at the date the taxpayer received the income (or the adjustment occurred) to properly allocate these items.
- Items of income are generally taxable when received by the taxpayer or the event that gives rise to the income occurred (such as a capital gains transaction).
    - Form W-2 wages should reflect this allocation, as the employer is supposed to split wages received during the year on between those earned in NC and outside NC (and reflect the related state tax withheld).
    - Capital gains are generally taxed to the state where the taxpayer resided when the transaction giving rise to the capital gain occurred (for example, the date of sale of stock). However, real estate transactions are generally taxable in the state where the real estate was located and will create a double tax situation if the taxpayer resides in a different state (see the discussion of credits for taxes paid to another state below).
    - Passive income like interest and dividends should be allocated based on when the taxpayer received the income (for example, the date the interest or dividend was paid).
    - Pension distributions and Social Security income are taxed to the state where the taxpayer resided when the income was received by the taxpayer.
- I find it very helpful to create a table that reconciles the total Federal income and the NC additions and subtractions from income between NC and the other state. This is, in fact, what NC Form D-400, Schedule PN does.

NC PY RETURNS- TAXSLAYER

- TaxSlayer sets up the state return automatically as a full-year resident return. In order to create a part-year (or nonresident) return, you must delete the NC return and start a new NC return, choosing part-year as the type of return.
- In *Basic Information*, you must input the date the taxpayer (and spouse) became residents of NC and the date the residency ended for that tax year (December 31, 2021, if the taxpayer is a resident of NC at year end).
- <u>Income Subject to Tax</u>
    - In *Income Subject to Tax – Federal Income Subject to NC Tax*, you must input the portion of the taxpayer's income that relates to NC from the table you created. W-2 information automatically carries over and TaxSlayer tells you what other income appears on the Federal return that has to be allocated between NC and the other state. For SS, you only want to allocate the <u>taxable</u> portion of the income item between NC and the other state (so for NC (and most other states) leave SS blank since it is not taxable in NC). Allocations for pensions and SS would be based on the relative percentage of pension and SS payments received while a resident of each state.
    - In *Income Subject to Tax – Additions to Federal Taxable Income & Subtractions to Federal Taxable Income*, you will need to enter the adjustments that would be made to the return for the portion of the year the taxpayer was a resident of NC. So, for example, if a pension distribution qualifies for Bailey, you would enter the amount of the pension distribution received <u>as a resident of NC</u> as a subtraction here.
- After entering the items in the *Income Subject to Tax* section, click Back to take you back to the NC menu.
- <u>Additions to Income and in Subtractions to Income</u>
    - In this section, you enter the NC adjustments as if the taxpayer had been a full-year NC resident. So, for example, if the taxpayer received a taxable pension distribution of $10,000, with $4,000 received while a resident of NC, and the pension distribution would qualify for the NC Bailey subtraction if received as a resident of NC, you would have entered $4,000 in the prior section (Income Subject to Tax – Subtractions to Federal Taxable Income) as the amount of the subtraction (i.e., the amount of the taxable pension attributable to NC residency). In this section (Subtractions to Income), you would enter the entire amount of the taxable pension, or $10,000.
    - You do not need to enter anything for taxable SS in this section, as TaxSlayer does this adjustment for you.
- After completing this section, go back to the NC menu to see if you have any other entries to make (not typical).
- After exiting the NC return, you will want to go to a print set to see the NC tax return to be sure you captured everything correctly.
- When you open the NC return, go to Schedule PN to make sure the entries are consistent with the table you created to allocate income between the states. The numbers in Column A should be exactly the same as the numbers on the Federal Form 1040. The remaining numbers in Column A should be the amount of the NC additions and subtractions as if the taxpayer were a full-year NC resident.

- The numbers in Column B should be the same as your NC allocated income and adjustment items.

NC CREDIT FOR OTHER STATE TAXES

- NC allows residents of NC to claim a credit for income taxes paid to another state (not including taxes paid to local municipalities) or foreign country when the income taxed by the other jurisdiction is also subject to tax in NC due to the taxpayer's resident status in NC.
- This most frequently occurs in the state context when someone is a resident of NC but works in another state. The state where the person works will tax the income arising out of services performed in the state and NC will tax the same income since a NC resident is generally taxed on all of her income earned while a resident of NC without regard to where the income is earned.
- Another common example would be a sale of real estate situated in another state. In this case, the state where the real estate was located generally will tax any gain. In addition, NC will also tax this gain if the taxpayer is a resident of NC.
- One point of confusion is when someone moves to NC and must file a part-year return. A state tax credit <u>cannot</u> be claimed for the period the person was a nonresident of NC. Instead, it only applies if income received during the period of residency in NC is also taxed on the same income by another state.
- For example, if an employee in Georgia retires and moves to NC during the year but receives a bonus from her work in Georgia after she has established residency in NC, both Georgia and NC will tax the bonus. In this situation, NC would allow a credit for the taxes paid to Georgia on the bonus income.
- If you do both the NC return and the other state's return in TaxSlayer, TaxSlayer will generally do the state tax credit computation for you in the event that income is taxed in both states.
- For example, Jim lives in NC, but works part of the year in SC. He receives a W-2 showing wages of $25,000 from SC and another W-2 showing wages of $15,000 from NC. You will input each W-2 including the appropriate state for each W-2. TaxSlayer will tax the entire $40,000 to NC. If you then create a Non-Resident Return for SC, TaxSlayer will automatically do the SC return and will then automatically compute the credit on the NC return for the taxes paid to SC on the $25,000 in wages taxed to both states.
- For double-taxed income other than wages, you will need to know the amount of the double-taxed income and the state tax paid on the income to the other state.
- This credit is claimed in the State section of TaxSlayer under Credits – Credit for Taxes Paid to Another State.
- If, however, you are not doing the other state's return in TaxSlayer, you must have a copy of the other state's return before you can complete an accurate NC return.
- The taxpayer must also attach to the NC return a copy of the other state return in order to claim the credit.
- The credit is determined using the actual tax paid to the other state, as shown on the tax return, not the amount of income tax withholding.

OTHER STATE RETURNS

- If you do tax returns for other states, the biggest issue is understanding the tax system of the other state.

- There can be complex state rules on filing status, particularly if the taxpayers want to claim a different filing status for state than for Federal.
- Itemized deductions rules also vary widely from state to state.
- Wage income and normal interest and dividends are typically fully taxed. But there can be wide variations on how other types of income are taxed.
- The biggest watchouts for other states are:
  - How do they tax Social Security income?
  - How do they tax pension income? Many states provide a partial or complete exemption for pension income and sometimes, like in NC for Bailey, there are complex rules that apply.
  - How do they tax unemployment compensation? Many states exempt unemployment compensation from state taxation.
  - How do they tax military or reserve income, including military pensions? There is a wide array of exceptions to the taxation of this income at the state level.
  - How do they tax capital gains and losses, including from the sale of a personal residence? Some states tax these differently than the Federal rules.
- My recommendation is to find the other state's instructions to their tax form to see how unusual items are taxed and to answer other issues such as filing status, available tax state credits, etc.

TOP 10 WATCH-OUT LIST

The following is my list of some of the more frequent issues that preparers tend to miss or that generate confusion for preparers. This is obviously not a comprehensive listing but is designed to help preparers and reviewers watch out for some of the more common issues that tend to arise at VITA sites.

1. IS THE TAXPAYER MARRIED?

- Seems like a simple question, but nothing is simple in tax law.
- Bottom line is once married always married unless death <u>or a court</u> do us part.
- Just because you haven't spoken to your spouse in 20 years and have no idea where he/she is, you are still married so long as you are both alive until you go to court.
- VOLUNTARY SEPARATIONS UNDER NC LAW DO NOT COUNT!
- You must either have a divorce decree or a decree of "separate maintenance" <u>issued by a court</u>.
- Here is how the NC Department of Revenue describes the requirement that you must go to court:

  > Under the Internal Revenue Code, Section 2(b)(2), an individual who is legally separated from his/her spouse under a decree of divorce or of separate maintenance shall not be considered as married. North Carolina law, G.S. 52-10.1, authorizes a married couple to enter into a legal separation agreement. Although an agreement pursuant to G.S. 52-10.1 is a legal contract without being sanctioned by a court, it does not constitute a legal separation under a decree of divorce or of separate maintenance within the meaning of the Internal Revenue Code. Therefore, a separation agreement must be sanctioned by a court in the form of a decree or judgment for parties to be considered unmarried for purposes of filing status.

https://www.ncdor.gov/taxes-forms/individual-income-tax/your-filing-status

2. DEPENDENCY IS NOT A CHOICE

- Whether another person is a dependent, qualifying child or qualifying relative of another person is a legal test based on the actual facts.
- Taxpayers do not get to pick and choose who they will claim – instead the various tests must be satisfied for the taxpayer to claim a person.
- This has been further complicated by the various stimulus payments. But fortunately, the third stimulus payment that was made during 2021 provides the same amount for a dependent as for the taxpayer, so this should have no bearing on whether someone is a dependent.
- The issue usually comes down to support and we will never have all the facts to make a true determination but use your common sense.
- Remember, the support test is different for a Qualifying Child versus a Qualifying Relative. For a Qualifying Child, the question is whether the person who the taxpayer is attempting to claim provided more than half of his/her own support. This is generally the test we are applying for college kids and younger, so college kids are generally going to be a dependent unless they provided more than half of their own support (and remember scholarships are ignored if the student's parent is attempting to claim the student). So, they usually would have to have sources of funds (such as wages or loans where they were the responsible party) that supplied more than half of the money they spent during the year that was not covered by scholarships.
- For Qualifying Relatives, the test flips to a determination of whether the taxpayer provided more than half of the person's support.
- Be extra careful with college kids or younger trying to claim themselves or taxpayers claiming parents.
- Use the Colorado TaxAide tool to help with difficult dependency issues: https://cotaxaide.org/tools/Dependent%20Qualification%20Calculator.html

3. HEAD OF HOUSEHOLD QUALIFYING PERSON

- The ability to claim Head of Household is dependent on the taxpayer having a Qualifying Person live with them in the home for more than half the year (although the taxpayer's parents do not have to live with the taxpayer to qualify).
- A Qualifying Person for these purposes is generally the same as the tests for a Qualifying Child or a Qualifying Relative but with one major difference – the person must be related to the taxpayer to be a Qualifying Person for this purpose.
- Thus, an unrelated person who the taxpayer claims for the Other Dependent credit is NOT a Qualifying Person for Head of Household purposes.
- See Pub. 4012, p. B-10 for a good summary of these rules.
- And remember that the rules for being a Qualifying Person for an unmarried person to qualify for HoH status (the rules discussed above) are different from the rules for being a "child" of a married taxpayer who qualifies the taxpayer as "considered unmarried" for HoH status.
- For the "considered unmarried" rules, the person who lives with the taxpayer for more than half the year must be a child, adopted child, stepchild, or foster child of the taxpayer. A grandchild does not satisfy this test.

4. OUT-OF-SCOPE ISSUES

- We've already discussed this topic, but I'll point out a few of the bigger scope issues:
- Selling property other than stocks, bonds, mutual funds or a personal residence.
- Rental Income unless it's an Active-Duty member of the Military renting their personal residence and you are Military certified.
- Schedule K-1 with ordinary income or loss or other non-investment income.
- The Kiddie Tax. A big issue if there is a student with scholarships or a child of a member of the Military receiving survivor benefits.

5. HSAs – Code W on Form W-2

- Code W in Box 12 of a Form W-2 shows contributions made to the employee's Health Savings Account during the year. The contributions shown are either contributions made by the Employer or contributions made by the Employee on a <u>pre-tax</u> basis.
- Contributions made by an Employee on a pre-tax basis are treated as Employer contributions and not as Employee contributions (despite what the taxpayer may argue) for purposes of determining whether the contributions qualify for the adjustment to income for HSA contributions, and thus do NOT qualify for the adjustment.
- Only after-tax contributions to the HSA qualify for the adjustment.

6. PREMIUM TAX CREDIT – EXCEPTION FOR TAXPAYERS WITH INCOME BELOW THE FPL

- I have discussed this in detail in prior years. Any time you see a taxpayer with relatively low income having to repay any Advance Premium Tax Credit, you should be analyzing this issue.
- Basically, our taxpayers who have income below the Federal Poverty Line should almost always qualify for the exception for taxpayers with income below 100% of the FPL and therefore are still entitled to the Premium Tax Credit.
- TaxSlayer has always provided a default answer of No to this question, when the answer should almost always be Yes.
- The failure to correct this makes the taxpayer ineligible for the PTC and usually requires a repayment of some or all of the Advance PTC received by the taxpayer.
- The good news is that TaxSlayer has promised to remove the default answer of No, so that the preparer needs to answer the question (but not so far).
- If you answer Yes and the taxpayer ends up having income in excess of 100% of the FPL, answering Yes is meaningless.
- So basically, answer YES to this question in TaxSlayer:
- And one other PTC point – <u>Never</u> override the number of family members on the page entitled "Verify Your Household Members."

7. EDUCATION CREDITS

- Whenever we have a return with a student who received a scholarship, ALWAYS look for an opportunity to include all or part of the scholarship in the student's income to generate or increase the amount of qualifying expenses for an education credit.
- There will be a separate presentation on this topic on January 6th that will explore this opportunity in detail.

8. SELF-EMPLOYED HEALTH INSURANCE DEDUCTION

- With every self-employed taxpayer filing a Schedule C, you should always think about the Self-Employed Health Insurance (SEHI) deduction.

- Self-employed individuals are allowed to deduct as an adjustment to income the amount paid for health insurance that covers the self-employed individual, spouse, Dependents or non-dependent children under the age of 27. This includes amounts shown on the Form SSA-1099 for Medicare payments and any supplemental health insurance costs for retired persons.
- No deduction is allowable for any month when the taxpayer who was self-employed was eligible to be covered by a health plan sponsored by the taxpayer's or spouse's or Dependent's employer.
- The use of Marketplace insurance premiums to claim the Self-Employed Health Insurance deduction is out-of-scope.

9. SELF-EMPLOYED CAR EXPENSES

- Self-employed taxpayers often attempt to claim expenses for a car or truck used in their business.
- VITA sites are limited to using cents per mile – actual expenses are not allowed.
- The cents-per-mile charge includes the following (and are therefore not separately deductible): gas, oil, depreciation, repairs and maintenance, parking tickets, traffic fines, car registration fees (not including the property tax piece), lease payments, insurance, and car washes.
- Amounts that can be deducted are parking, tolls, property tax on the car, and interest on a car loan. The amount deductible for the last two is based on the business use vs. personal use of the car.
- In computing the allowable mileage, the biggest issue is commuting. Basically, unless you have a qualifying home office (which is out of scope for VITA), the trip from your home to the first job site and from your last job site to your home is commuting and is NOT includable in the allowable mileage.
- The only mileage that can be taken is miles driven between job sites.
- A great example is Uber drivers. They cannot include the first trip of the day from home to their first pickup, nor can they count the miles from the last drop-off to home, but everything in between generally counts (except for personal time like driving to get lunch).
- See the chart on p. D-21 of Pub, 4012 for a great summary of these rules.

10. NC BAILEY EXEMPTION

- The Bailey exemption exempts from NC income distributions from certain Federal and NC retirement plans if the taxpayer was vested in the plan as of August 12, 1989.
- Preparers often forget to ask the right questions to determine if this might apply. You should inquire whenever you see a Federal retirement benefit, including from the Military, or a retirement benefit from NC or one of its localities.
- But, if you see one from a NC plan (such as the NC Teachers' and State Employees' Retirement Plan or NC Local Government Employees' Retirement Plan), look for "Vested as of August 12, 1989" on the 1099-R. If it's not there, it almost certainly does not qualify.

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