ACCOUNTAX SCHOOL OF BUSINESS, INCORPORATED

Enrolled Agent Review Program
Part I Individual Taxation

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Introduction to Basic Individual Taxation

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Section 1: Preliminary Work and Taxpayer Data

1.1 Preliminary Work to Prepare Tax Returns
Use of Prior Year

1. Use of Prior Years returns for Comparison

Accuracy Carryovers for Current Year's Returns

Use of Prior Year Returns

Comparison

There are several reasons why current tax returns should be compared with those of a prior year. The comparison of tax returns from the prior year to the current year can prevent errors, the likelihood of misstatements, and help with the preparation using authentic data.

Suppose, for example, the current return reflects a significant reduction in dividend income. What has happened to the stock? Perhaps it was sold at a gain and such gain is not reflected on Schedule D? Perhaps it was gifted and such gift was not reported for Federal tax purposes?

Accuracy

Accurate and consistent reporting is important.

Consider the change from employed to self-employed status (e.g., a distribution from a qualified pension or profit-sharing plan not accounted for) or a change in marital status (e.g., alimony payments not being included in gross income or dependency exemptions being claimed incorrectly by an ex-spouse).

The presence of certain items in a return may increase the likelihood of audit.

Carryovers for Current Year Returns

Carryover items and amounts are very important to reflect the correct **amounts** of income and/or losses in the current year.

2. Taxpayer biographical information

The Taxpayer should be interviewed before a tax practitioner provides services or represents. Among the types of information requested is:

- The taxpayer's Name, social security number or ITIN
- The taxpayer's birthdate
- Number of dependents, ages of dependents, and if the social security numbers are available.
- Marital Status
- Other pertinent questions about the household.
- Verification that all appropriate returns were filed timely.

The tax practitioner should request a copy of the prior year tax return for accuracy, compliance, and consistency.

3. Residency Status and/or Citizenship

Joint return test and citizenship / residency test.

a. A married person cannot be claimed as a dependent if he or she files a joint return with his or her spouse.

b. A joint return is permissible if the filing was to recover withholdings, no tax liability would be due on separate returns, and neither spouse is required to file.

c. The dependent must be either a citizen or resident of the U.S.

d. An exception is made for residents of Canada and Mexico.

e. An exception is made for certain adopted children.

4. Filing Requirements for Tax Returns and Extensions

Filing Requirements

Individuals must file a return when gross income > (standard deduction + additional deductions for age + personal exemption)

There are 3 exceptions:

- Self-employment income exceeds $400
- MFS whose gross income exceeds $24,400
- Dependent with unearned income whose gross income exceeds $1,050

5. Taxpayer filing status
(e.g., single, MFJ, MFS, QW, HOH)

Determination of all five filing statuses

Tax law recognizes the difference in ability-to-pay by basing exemptions, standard deductions and tax rates on an individual's filing status.

Determination of all five filing statuses

There are 5 filing statuses

- Single
- Married, filing jointly
- Surviving spouse (qualifying widow or widower)
- Head of household
- Married, filing separately

Filing status affects tax rate brackets, standard deduction, and other amounts

1. Married filing jointly

Taxpayers must be legally married on the last day of their tax year

Spouse dies during taxable year

2. Surviving Spouse

Surviving Spouse may continue to use Married, Filing Jointly status

For two subsequent years

If at least 1 dependent child lives at home

If surviving spouse has not remarried

3. Married filing separately

Taxpayers married as of the last day of the year may choose to file separately. This does not include abandoned spouses.

4. Head of Household

Unmarried taxpayers qualify if they

Are legally unmarried or an "abandoned spouse" at end of tax year, **and**

Provide over 50% of the cost of a home for

Qualifying dependent**, <u>or</u>**

Qualifying child**, <u>or</u>**

Parent

Parent does not need to live with the taxpayer and must qualify as a dependent

5. Single

Taxpayers who are not legally married on the last day of the year and do not qualify as Head of Household or Surviving Spouse must file Single.

- Includes a taxpayer who is unmarried or separated from spouse by a divorce decree or separate maintenance agreement and does not qualify for another filing status
  - Marital status is determined as of the last day of the tax year
    - When a spouse dies during the year, marital status is determined as of the date of death.

Abandoned Spouse

Allows married taxpayer to file as Head of Household if the taxpayer:

- Does not file a joint return
- Paid more than half the cost of maintaining a home
- Spouse did not live in home during last 6 months of tax year
- Home was principal residence of taxpayer’s child for more than half the year
- Can claim child as a dependent

6. Sources of all world-wide taxable and non-taxable income (e.g., interest, wages, business, sales of property, dividends, rental income, flow-through entities, alimony received)

Income (broadly conceived). This includes all income of the taxpayer, both taxable and nontaxable.

a. This concept of income is essentially equivalent to gross receipts, but does not include a return of capital or a receipt of borrowed funds.

b. Many receipts (e.g., borrowed funds) are not reported on the tax return at all.

Gross Income

Section 61(a) of the Code defines gross income broadly as "all income from whatever source derived." Some examples of gross income items are listed below.

- Alimony
- Compensation for services
- Dividends
- Embezzled funds
- Gains from illegal activities
- Prizes
- Salaries
- Tips and gratuities

<u>Exclusions</u>. Congress has chosen to allow taxpayers to exclude certain items of income for various reasons). Some <u>examples</u> are listed

- Accident insurance proceeds
- Child support payments
- Gifts
- Inheritances
- Life insurance paid on death of insured
- Welfare payments
- Unemployment compensation (to a limited extent)

7. Sources of Applicable Exclusions and Adjustments to Gross Income

Deductions *for* AGI include:

- Ordinary and necessary expenses incurred in a trade or business
- Part of self-employment tax paid
- Alimony paid
- Certain payments to an IRA and Health Savings Accounts
- Unreimbursed moving expenses
- Fees for college tuition and related expenses
- Interest on student loans
- The capital loss deduction, and
- Moving Expense

8. Sources of Applicable Deductions Itemized, Standard

Itemized Deductions.

Included are medical expenses, various (but not all) state, local, and foreign taxes, home mortgage interest, investment interest, charitable contributions, and miscellaneous expenses.

A taxpayer should elect to itemize only if itemized deductions exceed the standard deduction.

The standard deduction is a dollar amount that reduces the amount of income on which you are taxed. In general, the standard deduction is adjusted each year for inflation and varies according to your filing status, whether you are 65 or older and/or blind, and whether another taxpayer can claim you as a dependent. The standard deduction is not available to certain taxpayers. You cannot take the standard deduction if you itemize your deductions.

9. Qualification of Dependency

The personal exemption for 2021 remains zero, as it was for 2020. This elimination of personal exemption was a provision in the Tax Cuts and Jobs Act. The standard deduction for married filing jointly rises to $25,100 for tax year 2021 up $700 from 2020.

A dependency exemption was available for one who is either a qualifying child or a qualifying relative

There were Two Types of Dependents:

Qualifying Child and Qualifying Relative.

Restrictions on Dependents

A person **claimed as a dependent** by another taxpayer may claim a standard deduction.

The standard deduction is limited to the larger of :

- Your standard deduction is limited to the greater of Amount of *earned income* plus $350 and the standard deduction amount of $1,100.
- **Net unearned income** of a child under the age of 18 or a full-time student under the age of 24 is taxed at the parent’s marginal tax rate.

Dependency Requirements Qualifying Child Tests

5 tests must be met for Qualifying Child

- Age
- Non-support
- Relationship
- Principal residence
- Citizenship

Qualifying Child Tests

Age Test:

Must be

Younger than 19, **or**

A full-time student younger than 24, **or**

Permanently and totally disabled

Qualifying Child Tests

Non-Support Test:

Child may not

Supply more than 50% of their own support

Scholarships don’t count

Note: Taxpayer who claims the child does not have to provide more than 50% of the support

Qualifying Child Tests

Relationship Test:

Child must be taxpayer’s:

Child

Stepchild

Foster child

Sibling

Stepsibling

Descendant of any of the above

Qualifying Child Tests

Principal Residence Test:

Child must live with taxpayer more than 50% of the year

Absence due to illness, vacation, education, or military service does not cause failure of this test

Qualifying Child Tests

Citizen or Resident Test:

Child must be a U.S. citizen, or

Resident of the U.S., Canada, or Mexico

Dependency Requirements Qualifying Relative Tests

There are 5 tests for Qualifying Relative

Gross income

Support

Relationship

Citizenship

Joint-return

Qualifying Relative Tests

Gross Income Test

To be a dependent, an individual must have had a gross income less than the dependency exemption amount; $1,100.

Qualifying Relative Tests

Support Test

Taxpayers must provide more than 50% of a dependent's support for the year

Two exceptions apply:

Custodial parent may always claim a child

Multiple Support Agreement

Qualifying Relative Tests

Multiple Support Agreement

When two or more people together provide over half of another's support, anyone who contributes over 10% of the support may claim the exemption

Group must sign a support agreement

May rotate the exemption among the group

Multiple Support Agreement: Example

Allows children of elderly parent to claim exemption for parent when none of the individually meets the 50% support test

Children of Divorced Parents

Special rules apply if the parents meet the following conditions:

- They would have been entitled to the dependency exemption had they been married and filed a joint return
- They have custody (either jointly or singly) of the child for more than half of the year

Under the general rule, the parent having custody of the child for the greater part of the year (i.e., the custodial parent) is entitled to the dependency exemption

- General rule does not apply if
  - A multiple support agreement is in effect
  - Custodial parent issues a waiver in favor of the noncustodial parent

Qualifying Relative Tests

Relationship Test or Member of household test:

A dependent must be related to or reside with the taxpayer.

- Relatives - ancestors, descendants, and other blood or in-law relations siblings, aunts, uncles, nieces, nephews, and cousins don't count; but adopted children do
- Non-relatives must reside in the taxpayer's home for the entire year

Qualifying Relative Tests

Citizenship or Residency Test:

Dependent must be a U.S. citizen or a resident of a country contiguous to the U.S.

Qualifying Relative Tests

Joint Return Test

Dependent can not file a joint return

A Joint return may be filed simply to claim a refund of all withheld tax

10. Sources of Applicable Credits (Education, Foreign Tax, Retirement, Energy, Dependent Care)

Tax credits include:

child tax credit, additional child tax credit, education credits, earned income credit, credit for child and dependent care expenses, credit for the elderly or the disabled, adoption credit, and retirement savings contributions credit.

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11. Sources of Tax Payments and Refundable Credits (e.g., Withholding, Estimated Payments, Earned Income Tax Credit)

Withholding

Employees, who request employers to withhold income tax from their pay checks may also have certain other income withheld such as, pensions, bonuses, commissions, and gambling winnings. The amounts withheld are paid to the IRS in the employee's name.

Withholding

The amount of income tax the employer withholds from a regular pay depends on two things:

- The amount you earn.
- The information you give your employer on Form W-4.

Form W–4 includes three types of information that the employer will use to figure withholdings.

  - Whether to withhold at the single rate or at the lower How many withholding allowances are being claimed. (Each allowance reduces the amount withheld.)
  - Whether any additional amounts should be withheld.

Estimated tax

Taxpayers who you do not pay tax through withholding or do not pay enough tax may have to pay estimated tax.

Taxpayers who are in business for themselves generally will have to pay their tax this way. Estimated taxes should be made if income is received in the form dividends, interest, capital gains, rent, and royalties. Estimated tax is used to pay not only income tax, but self-employment tax and alternative minimum tax as well.

Estimated tax

If you did not pay enough tax throughout the year, either through withholding or by making estimated tax payments, you may have to pay a penalty for underpayment of estimated tax. Generally, most taxpayers will avoid this penalty if they owe less than $1,000 in tax after subtracting their withholdings and credits, or if they paid at least 90% of the tax for the current year, or 100% of the tax shown on the return for the prior year, whichever is smaller. There are special rules for farmers and fishermen.

Effect of Prepayments and Credits. After the tax liability is computed, prepayments and credits are subtracted to arrive at the amount of tax owed or refund due.

a. Common prepayments include taxes withheld by the employer and estimated payments made by the taxpayer.

b. Common credits include the earned income credit, credit for child and dependent care expenses, credit for the elderly, child tax credit, and foreign tax credit.

12. Previous IRS Correspondence with the Taxpayer

If taxpayers receive a letter or notice from the IRS, it will explain the reason for the correspondence and provide instructions. Many of these letters and notices can be dealt with simply, without having to call or visit an IRS office.

The notice you receive covers a very specific issue about your account or tax return. Generally, the IRS will send a notice if it believes you owe additional tax, are due a larger refund, if there is a question about your tax return or a need for additional information

13. Additional required returns filed and taxes paid (e.g., employment, gifts, and information returns)

Additional required returns can include:

Deposits for Withholding Taxes
Form W-2 used to Report Wages Tips, and Other Compensation paid to employees
Self- Employment Tax
FUTA Tax
The Nanny Tax

14. Special filing requirements (e.g., foreign income, presidentially declared disaster areas, Form 1040-NR)

Many United States (U.S.) citizens and resident aliens receive income from foreign sources. There have been recent reports about the interest of the Internal Revenue Service (IRS) in taxpayers with accounts in Liechtenstein. The interest of the IRS, however, extends beyond accounts in Liechtenstein to accounts anywhere in the world. Consequently, the IRS reminds you to report your worldwide income on your U.S. tax return.

Special filing requirements (e.g., foreign income, presidentially declared disaster areas, Form 1040-NR)

A U.S. citizen or resident alien must report income from all sources within and outside of the U.S. This is true whether or not you receive a Form W-2 Wage and Tax Statement, a Form 1099 (Information Return) or the foreign equivalents. See Publication 525, Taxable and Nontaxable Income for more information. Additionally, a U.S. citizen or resident alien, the rules for filing income, estate and gift tax returns and for paying estimated tax are generally the same whether you are living in the U.S. or abroad.

Presidentially Declared Disaster Areas

(This applies to disaster area relief articles that link to this page. Those articles list the places included in each disaster area, the specific FTD Penalty Waiver Period, Extension Period and Disaster Designation. The articles are in the individual state news pages.)

Affected Taxpayers

For the purposes of this tax relief, affected taxpayers include individuals and businesses located in the disaster area, those whose tax records are located in the disaster area, and relief workers. The same relief will also apply to any places added to the disaster area.

Taxation of Nonresident Aliens- Form 1040 –NR

An alien is any individual who is not a U.S. citizen or U.S. national. A nonresident alien is an alien who has not passed the green card test or the substantial presence test.

15. Foreign Account and Asset Reporting (FBAR. Form 8938)

Schedule B, Part III Foreign Accounts and Trusts

In general, the U.S. owner of a foreign trust is taxed on the income of that trust.

A U.S. person is treated as the owner of a foreign trust under the grantor trust rules of Internal Revenue Code sections 671-679, which includes someone who transfers assets to a foreign trust which has a U.S. beneficiary of any portion of the trust. *Each U.S. owner should receive a Foreign Grantor Trust Owner Statement (Form 3520-A, page 3), which includes information about the foreign trust income they must report.

Schedule B, Part III Foreign Accounts and Trusts

Form orm 1040, Schedule B, Part III, Foreign Accounts and Trusts, must be completed if you receive a distribution from, or were grantor of, or a transferor to a foreign trust. If you have a financial interest in or signature authority over a foreign financial account, including a bank account, brokerage account, mutual fund, trust, or other type of foreign financial account, the Bank Secrecy Act may require you to report the account yearly to the U.S. Internal Revenue Service (IRS) by filing FinCEN Form 114 (formerly TD F 90-22.1), Report of Foreign Bank and Financial Accounts ("FBAR").

International Tax Gap Series

Although there are legitimate reasons why a U.S. person might create a foreign trust, or have transactions with a foreign trust, they can have tax consequences and result in filing responsibilities as well. Regardless of your motivation, failure to meet these reporting and filing requirements can result in very significant penalties.

General Rules:

In general, the reporting rules apply to a U.S. person who creates a foreign trust, transfers any money or property to a foreign trust, receives a distribution from a foreign trust, or is treated as the U.S. owner of a foreign trust.

Information Returns

Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts, and Instructions.

Who must file Form 3520? There are several situations in which a Form 3520 (or statement with similar information) is required to be filed. The most common circumstances are where a U.S. person:

Creates or transfers money or property to a foreign trust, receives (directly or indirectly) any distributions from a foreign trust, receives certain gifts or bequests from foreign entities,

The Instructions for Form 3520 include more detailed information about who must file a Form 3520; when, where, and possible penalties for late or incomplete filing.

Information Returns

Form 3520-A, Annual Information Return of Foreign Trust with a U.S. Owner, and Instructions. This form provides information about the foreign trust, its U.S. beneficiaries, and any U.S. person who is treated as an owner of any portion of the foreign trust.

Who Must File Form 3520-A? Each U.S. person treated as an owner of any portion of a foreign trust under the grantor trust rules is responsible for ensuring that the foreign trust files Form 3520-A and furnishes the required annual statements to its U.S. owners and U.S. beneficiaries.

The Instructions for Form 3520-A include more detailed information about who must file a Form 3520-A; when, where, and possible penalties for late or incomplete filing.

Other Reporting Requirement:

Form 1040, Schedule B, Part III, Foreign Accounts and Trusts, must be completed if you receive a distribution from, or were grantor of, or a transferor to a foreign trust.

If you have a financial interest in or signature authority over a foreign financial account, including a bank account, brokerage account, mutual fund, trust, or other type of foreign financial account, the Bank Secrecy Act may require you to report the account yearly to the U.S. Internal Revenue Service (IRS) by filing FinCEN Form 114 (formerly TD F 90-22.1), Report of Foreign Bank and Financial Accounts ("FBAR").

Other Reporting Requirement:

U.S. beneficiary of a foreign trust – In general, the U.S. beneficiary of a foreign trust will report their share of foreign trust income to the extent it is not reported by the transferors to the trust under the grantor trust rules. The U.S. beneficiary should receive a Foreign Grantor Trust Beneficiary Statement (Form 3520-A, or a Foreign Non Grantor Trust Beneficiary Statement which includes information about the taxability of distributions they have received and foreign trust income they must report.

U.S. transferor of assets to a non grantor foreign trust - Internal Revenue Code section 684 requires the recognition of gain on certain transfers of appreciated assets to a foreign trust. See the Instructions for Form 3520-A for additional information.

16. Minor Children's Unearned Income (Kiddie Tax)

Certain Minor Children Taxed at Parents' Rate (Kiddie Tax).

Unearned income of children under age 19 or a student under age 24 is taxed at the parents' rate. For 2022, the first $1,150 of a child's unearned income qualifies for the standard deduction, the next $1,150 is taxes at the child's income tax rate and unearned income above $23,000 is taxed at the parent's marginal income tax rate.

b. The <u>child's rate applies</u> to the child's taxable income less the amount of net unearned income taxed at the parents' rate.

Certain Minor Children Taxed at Parents' Rate (Kiddie Tax).

c. A return must be filed if a child received gross income, unearned income from interest and dividends, of more than $1,150.

The parent(s) may <u>elect to report</u> the child's unearned income on the parent's tax return (Form 8814).

Making the election may result in slightly more tax than if the child's income is reported separately on Form 8615.

All dependent children must file a return if they receive earned income of than $12,550 of income in 2021 This is income form wages and salraies.

17. Affordable Care Act (ACA) Provisions Introduction

One of the most sweeping Federal laws enacted in the last decade is known as the Affordable Care Act, or “Obama Care.” The Affordable Care Act (ACA) was enacted in March 2010 to increase the quality and affordability of health insurance, reduce the number of uninsured individuals in the United States by expanding public and private insurance coverage, and lower health care costs for individuals and the government.

Affordable Care Act (ACA) Provisions Reconciliation of the advanced Premium Tax Credit

In order to reconcile The Advance Credit Payments of the Premium Tax Credit taxpayers must file a tax return to reconcile any advance credit payments received in 2021 and to maintain your eligibility for future premium assistance. If you do not file, you will not be eligible for advance payments of the premium tax credit In 2022.

Affordable Care Act (ACA) Provisions
Reconciliation of the advanced Premium Tax Credit

Individuals and families whose household incomes are at least 100 percent but no more than 400 percent of the Federal poverty level (also called the Federal poverty line, or FPL) may be eligible to receive a Federal subsidy (the premium tax credit, or PTC) if they purchase insurance via the Health Insurance Marketplace (the Marketplace).

Affordable Care Act (ACA) Provisions
Individual Shard Responsibility Payment

The ACA's "individual mandate"—which has been deemed a "tax" by the U.S. Supreme Court2—requires a taxpayer and members of the taxpayer's family to have minimum

essential coverage (MEC) or an exemption from MEC. Individuals not covered by an employer-sponsored health plan, Medicare, Medicaid, or other public insurance program must secure a private insurance policy or pay a penalty for each month they do not have health coverage or meet an exemption. The penalty is called the individual

shared responsibility payment (ISR).

What Employers Need to Know

- Fewer than 50 full-time employees (including full-time equivalent employees) – §4980H does not apply
- Applicable Large Employer (ALE) status
  - Employer tax provisions for ALEs: Employer Shared Responsibility Provisions (§4980H)
  - Information Reporting (§6056)
  - Employers that offer self-insured plans: Information Reporting (§6055)

Affordable Care Act (ACA) Provisions
Understanding Reporting for Forms 1095A, 1095 B, 1095C

Form 1095 A is a Health Insurance Marketplace Statement.

Included in this information statement are the actual monthly health insurance premium payments, the monthly second lowest cost Silver plan (SLCSP) premiums for

the individual(s), and any PTC received in advance. This information also is reported to the IRS.

Affordable Care Act (ACA) Provisions
Understanding Reporting for Forms 1095A, 1095 B, 1095C

Form 1095-B

This form is used to report certain information to the IRS and to taxpayers about individuals who are covered by minimum essential coverage and therefore aren't liable for the individual shared responsibility payment. Minimum essential coverage includes government-sponsored programs, eligible employer-sponsored plans, individual market plans, and other coverage the Department of Health and Human Services designates as minimum essential coverage.

Affordable Care Act (ACA) Provisions
Understanding Reporting for Forms 1095-A, 1095-B 1095-C

Form 1095-C

Businesses that employ 50 or more full-time employees (or a combination of fulltime and part-time employees that equate to 50 full-time employees) but do not offer health insurance to their full-time employees (and their dependents up to age 26) will pay a tax penalty if the government has subsidized a full-time employee's

health care through a PTC. This penalty commonly is known as the employer mandate [or the employer shared responsibility payment (ESRP)

Form 1095-C

These employers, referred to as “applicable large employers” must also file Form 1095–C (Employer-

Provided Health Insurance Offer and Coverage) with each full-time employee and the IRS. The forms are due to the employees by January 31 of the next year.