Year-end Wrap-up

Highlights of the 2021 income tax year

By Sheri Fronsee, CPA

As we prepare for tax season, let's review the 2021 tax rates and highlight the impact that major tax law changes have on the year.

2021 tax rates

There are seven federal individual income tax rates for tax year 2021: 10%, 12%, 22%, 24%, 32%, 35% and 37%. The tax rates are dependent upon taxable income and filing status.

Capital gains and qualified dividends tax rates unchanged

The capital gains and qualified dividends rates will remain unchanged at 0%, 15% and 20%, with an additional Medicare rate of 3.8% for taxpayers who meet the threshold requirements. Maximum unrecaptured §1250 gain due to depreciation remains at 25%, and collectible and antique capital gain remains at 28%.

Personal exemption and standard deduction

A key provision of the 2017 *Tax Cuts and Jobs Act* (TCJA) eliminated the personal exemption. Standard deductions essentially doubled by encompassing the old standard deduction and adding the personal exemption, allowing for a larger standard deduction for each filing status (see Table 1 below).

While the dependency exemption deduction under §151 is reduced to zero from 2018 through 2025, this reduction isn't taken into account for other purposes of the Internal Revenue Code, such as who is a qualifying relative for family credit purposes and eligibility for head-of-household status. This amount is $4,300 for 2021.

Child tax credit

The child tax credit has been expanded and increased. For 2021 only, the *American Rescue Plan Act* (ARP Act) expanded the child tax credit (CTC) to include children under the age of 18 and for taxpayers with a certain AGI. The act increased the CTC from $2,000 per eligible child to:

- $3,600 for each child under age 6
- $3,000 for each child age 6 to 17

The increased credit amount begins to phase out when the taxpayer's AGI is:

- $75,000 (Single)
- $112,500 (HOH)
- $150,000 (MFJ and QW)

Table 1: Standard deduction

Filing Status	2021
Married filing jointly (MFJ)	$25,100
Married filing separately (MFS)	$12,550
Head of household	$18,800
Single	$12,550
65+/ blind additional standard deduction (MFJ)	$1,350
65+/ blind additional standard deduction (Single)	$1,700
Dependent personal exemption	$1,100 or $350 + earned income

Once the increased credit amount is reduced to $2,000, the regular $2,000 credit begins to phase out at:

- $400,000 (MFJ)
- $200,000 (all others)

If the taxpayer lived in the U.S. for more than half the year, the credit is fully refundable for 2021. In addition, advance payments of the 2021 CTC will be made monthly from July through December 2021. Generally, they will be 50% of the taxpayer's estimated 2021 CTC based on their 2020 return (or 2019 return if the 2020 return has not been filed). Taxpayers may receive up to $300 per month for each child under age 6 and up to $250 per month for each child age 6 to 17.

Taxpayers may use the IRS Child Tax Credit Update Portal at irs.gov to check the status of their advance CTC payments and/or update their personal information.

Taxpayers must reconcile these advance payments with the CTC actually allowed on their 2021 return. If taxpayers received excess advance CTC payments, they may have to repay some or all of them depending on their MAGI.

The IRS sent Letters 6416 and 6416-A to taxpayers who may be eligible for advance CTC payments. Taxpayers also received a second, personalized letter listing an estimate of their monthly payment. If they wanted to receive these payments, they did not need to take action. On the other hand, the taxpayer had to unenroll or opt out using the online Child Tax Credit Update Portal if they did not want to receive them. The portal also allows the taxpayer to check on the status of their payments and make updates to their information to ensure they are receiving the right amount as quickly as possible.

Remember, this credit also falls under the due diligence requirements for filing Form 8867, *Paid Preparer's Due Diligence Checklist*, each year.

Advanced child tax credit payments (ACTC)

For 2021 only, the CTC is fully refundable and replaces the ACTC. See Table 2 below.

Table 2: CTC and ACTC repayment protection MAGI phase-out ranges

MFJ, QW	$60,001-$120,000
HOH	$50,001-$100,000
S, MFS	$40,001-$80,000

Itemized deductions

Medical expenses. Medical expenses are subject to 7.5% of AGI. This was made permanent under the *Consolidated Appropriations Act 2021* (CAA) [§213(a)].

State and local income tax deductions (SALT). The SALT deduction for state and local income tax or sales tax, real estate taxes and personal property taxes is limited to a total of $10,000 ($5,000 MFS).

Mortgage interest. The TCJA reduced the allowable ceiling for qualified mortgage interest on a taxpayer's residence from $1 million of acquisition indebtedness to $750,000 ($375,000 MFS), unless the mortgage was incurred on or before Dec. 15, 2017. Mortgages obtained prior to this date are considered grandfathered debt under the $1 million indebtedness limit. The deduction for home equity debt is also suspended for tax years 2018-2025. Because of this suspension, the only way for home equity indebtedness to be qualified debt is for it to meet the definition of qualified mortgage debt, be secured by the home, be used to improve the property and be included in the acquisition debt limitations.

Charitable contribution deduction. Beginning with the 2021 tax year, eligible individuals who do not itemize may deduct up to $300 ($600 MFJ) in qualified charitable contributions made to qualified charitable organizations. Any amount that exceeds the limit may not be carried forward to future tax years or claimed as an itemized deduction.

The 100% of AGI contribution limit applies only to gifts of cash directly to charities (not including family-funded private foundations). An affirmative election on Schedule A (Form 1040), Line 11, must be made to claim the charitable deduction for the enhanced (100%) AGI limit. Also, TCJA eliminates a charitable deduction for payments made to colleges or universities for the right to purchase tickets or seats at athletic events.

Casualty and theft loss. Personal casualty and theft losses of an individual, sustained in a tax year beginning after 2017, are deductible only to the extent that the losses are attributable to a federally declared disaster.

For casualty losses in a federally declared disaster that occurred in an area warranting public or individual assistance (or both), taxpayers can choose to treat the casualty loss as having occurred in the year immediately preceding the tax year in which the disaster loss was sustained, and the loss can be claimed as a deduction on the return or amended return for that preceding tax year.

If the loss deduction is more than the taxpayer's income, the result may be a net operating loss (NOL).

Employee business expenses. Taxpayers who have filed Form 2106, *Employee Business Expenses*, to claim a deduction for unreimbursed employee expenses are no longer eligible for this deduction under the TCJA. There are a few taxpayers who may still qualify to claim their unreimbursed expenses on Form 2106. These taxpayers include Armed Forces reservists, qualified performing artists, fee-basis state or local government officials, and employees with impairment-related work expenses.

Gambling losses and expenses. Gambling losses remain deductible on Schedule A (Form 1040), but only to the extent of winnings, which are included in taxable income. The IRS requires taxpayers to maintain a log of winnings and losses as documentation.

Moving expenses

The moving expense deduction has been eliminated for all taxpayers except active members of the Armed Forces who move due to a change in military orders. The TCJA suspends the exclusion from gross income for any other taxpayers receiving reimbursement for what otherwise would have been qualified moving expenses.

Alimony

Congress has eliminated the deduction for alimony paid, thereby making alimony received nontaxable. This is effective for any divorce or separation instrument executed after Dec. 31, 2018. This does not apply to previously agreed upon prenuptial agreements. This elimination will also apply to pre-2019 divorce decrees that are amended after Dec. 31, 2018, if the new agreement expressly provides that TCJA rules apply.

AMT

Exemption amounts and phase-out limitations increase for tax years 2018–2025. The amounts are shown in Table 3 below.

§529 plan distributions

Taxpayers may receive distributions up to $10,000 each year from §529 plans to pay for education costs, such as tuition and related fees paid to a public, private, or religious elementary or secondary educational institution. This distribution allowance will not sunset in tax year 2025.

Additionally, taxpayers may roll over within 60 days funds from a §529 plan to an Achieving a Better Life Experience (ABLE) account without penalties. This rollover must be made to an ABLE account that is owned by the designated beneficiary of the §529 plan or to a member of the designated beneficiary's family.

Discharge student loan debt

For 2018–2025, student loan debt that is discharged due to total and permanent disability or death of a student is excludable from income.

The ARP Act added a special rule for student loan discharges in 2021 through 2025. Under §108(f)(5), gross income does not include any amount that would be cancellation of debt income from the discharge of certain student loans.

Student loan forgiveness

From March 13, 2020, through Jan. 31, 2022, the interest rate is 0% and payments are suspended on federal student loans owned by the federal government. In addition, tax refund and/or wage garnishment was suspended from March 13, 2020, through Jan. 31, 2022, for those who have defaulted on federal student loan debt. Student loan borrowers who made student loan payments, had refunds taken or had wages garnished after March 13, 2020, can have those payments refunded if they notify their loan servicer.

Roth IRA recharacterization

The TCJA repealed the law that allowed a taxpayer to recharacterize a Roth conversion back to a traditional IRA. The law is effective Jan. 1, 2018, and forward. Taxpayers can recharacterize Roth contributions to a traditional IRA if the recharacterization takes place before the due date of the taxpayer's income tax return.

Table 3: AMT exemption amounts and phase-out limitations

Filing Status	Exemption Amount	Phase-out Limitations
MFJ, QW	$114,600	$1,047,200
S, HOH	$73,600	$523,600
MFS	$57,300	$523,600

Estate tax exclusion

For tax year 2021, the exclusion for decedents is $11.7 million. The FMV date of death basis rules remain in effect.

Section 199A

The §199A deduction is the lesser of (1) the combined qualified business income (QBI amount) or (2) an amount equal to 20% of the excess (if any) of taxable income of the taxpayer for the tax year over the net capital gain of the taxpayer for the tax year.

Except as provided below, the deduction cannot exceed the greater of:

1. 50% of the W-2 wages with respect to the qualified trade or business (W-2 wage limit), or
2. The sum of 25% of the W-2 wages paid with respect to the qualified trade or business plus 2.5% of the unadjusted basis, immediately after acquisition, of all qualified property

For 2021, the above limit does not apply for taxpayers with taxable income below the threshold amounts of $329,800 MFJ, $164,925 MFS and $164,900 for all other individuals.

Taxpayers meeting the limitations may be allowed the full 20% deduction. A partial deduction is allowed for taxpayers falling within the phase-out range. However, the deduction is eliminated for those taxpayers exceeding the top of the phase-out range. These phase-out ranges are shown in Table 4 below.

Table 4: QBI deduction phase-out

Filing Status	Phase-out
MFJ	$329,800–$429,800 ($100,000)
MFS	$164,925–$214,925 ($50,000)
S, HOH, QW	$164,900–$214,900 ($50,000)

Stay vigilant against scams

The IRS urges taxpayers to be on the lookout for unexpected scam phone calls from anyone claiming to be collecting on behalf of the IRS. Recent news about tax scams and consumer alerts are available at www.irs.gov/uac/tax-scams-consumer-alerts.

Due to the continuation of scams involving callers who impersonate IRS agents and request immediate payment, the IRS will do everything it can to help taxpayers avoid confusion and ensure they understand their rights and tax responsibilities, especially when it assigns cases to a private collection agency.

Even with private debt collection, taxpayers shouldn't receive unexpected phone calls from the IRS demanding payment. When taxpayers owe tax, the IRS always sends several collection notices through the mail before making phone calls.

CAA, ARP Act and other new rules

Mortgage forgiveness debt relief. The maximum amount of discharged debt on a principal residence through foreclosure or debt restructuring that may be excluded from income under §108(a)(1)(E) was lowered from $2 million to $750,000 ($375,000 MFS). This new limit applies after Dec. 31, 2020, through tax year 2025.

Changes to education credits. The CAA repealed the §222 deduction for qualified tuition and related expenses. Instead, it increases the phase-out limits on the lifetime learning credit (LLC) to match the phase-out limits for the American opportunity tax credit (AOTC) of $80,000 ($160,000 MFJ) effective for tax years beginning after Dec. 31, 2020.

Minimum age for retirement distributions. The CAA modified §401(a) to allow certain qualified pensions to make distributions to workers who are age 59½ or older and who are still working. For certain construction and building trades workers, the age is lowered to age 55.

2021 recovery rebate and credit. A 2021 advance recovery rebate or a third economic impact payment (EIP3) of $1,400 ($2,800 MFJ) was issued to each eligible individual, plus $1,400 to each dependent (including adult dependents).

The payment will fully phase out when income reaches $80,000 for single filers, $120,000 for heads of household with one child, and $160,000 for joint filers or surviving spouse.

– *continued on page 8*

Eligible taxpayers are those who:

- Are U.S. citizens or U.S. resident aliens (and their spouse, if MFJ)
- Are not a dependent of another taxpayer
- Have a valid SSN

Ineligible individuals are:

- Any nonresident alien individual
- Any individual who is a dependent of another taxpayer at the beginning of the calendar year
- An estate or trust

The recovery rebate credit (RRC) is based on the 2019 or 2020 tax return and will be reconciled on the 2021 tax return.

For payments based on the 2019 return, the ARP Act contains a provision that allows for a plus-up or additional payment if the advance recovery rebate is greater based on the taxpayer's 2020 return.

EIC without children. For 2021, the minimum age to claim the EIC for taxpayers without children (childless EIC) generally is reduced from age 25 to age 19 (except full-time students). The maximum age limit of 65 for claiming the childless EIC has been eliminated.

The credit and phase-out percentage increases from 7.65% to 15.3% for an individual with no qualifying children. Taxpayers may use their earned income from the 2019 tax year to determine their EIC for the 2021 tax year if the 2021 earned income was less than the 2019 earned income. See Table 5 below.

Table 5: EIC maximum AGI for 2021

Qualifying Children	Single, HOH, QW, MFS*	MFJ
0	$21,430	$27,380
1	$42,158	$48,108
2	$47,915	$53,865
3	$51,464	$57,414

Investment income limit: $10,000 or less

Maximum credit amounts:

- No qualifying children: $1,502
- 1 qualifying child: $3,618
- 2 qualifying children: $5,980
- 3 or more qualifying children: $6,728

* Taxpayers claiming the EITC who file married filing separately must meet the eligibility requirements under the special rule in the *American Rescue Plan Act* (ARPA) of 2021.

The disqualified investment income limit also increases from $3,650 (2020) to $10,000.

Child and dependent credit. For 2021, the credit is fully refundable and the dollar limit for eligible expenses increases from $3,000 to $8,000 for one eligible child, and from $6,000 to $16,000 for two or more eligible children.

The maximum credit rate increased from 35% to 50% and the AGI limitation increases from $15,000 to $125,000. Taxpayers with an AGI of $125,000 to $400,000 will receive a partial credit.

The exclusion for employer-provided dependent care assistance increases from $5,000 to $10,500 ($5,250 for MFS).

Flexible spending accounts (FSA). Unused balances in flexible spending accounts for health care and dependent care expenses may be carried over from 2020 into 2021, and again from 2021 into 2022, if the employer allows. A special carryforward rule applies to children who turned age 13 during the pandemic.

Closing

The coronavirus continues to impact most taxpayers and businesses, and that means tax preparers will need to stay updated now more than ever.

Finish the year off on a great note by completing your CPE, enjoying the holidays with family and friends, and thoroughly preparing to spring into action when tax season begins.