Chapter 4
Individual Tax Matters

Key Issue 4A: Rollback of Kiddie Tax Rules

Background

Under pre-2017 Tax Cuts and Jobs Act (TCJA) law, pursuant to the "kiddie tax" provisions, the net unearned income of a child was taxed at the parents' tax rates if the parents' tax rates were higher than the tax rates of the child. The remainder of the child's taxable income [that is, earned income, plus unearned income up to a certain amount ($2,100 for 2017), less the child's standard deduction] was taxed at the child's rates.

For 2018–2025, the TCJA changed this by subjecting a portion of the child's unearned income to the trust and estate income tax rates (which can be as high as 37% or 20% for long-term capital gains and qualified dividends).

Belatedly, Congress became concerned that the TCJA kiddie tax rate change unfairly increased the federal income tax bills of affected children, including survivors of deceased military personnel, first responders, and emergency medical workers.

New Development

The Setting Every Community Up for Retirement Enhancement (SECURE) Act repealed the kiddie tax changes added by the TCJA, effective for tax years beginning after December 31, 2019, but the repeal may be applied retroactively to tax years that began in 2018 or 2019.

Under the kiddie tax rules, a portion of a child's net *unearned income* for 2018 and 2019 can be taxed at (1) the federal income tax rates for trusts and estates or (2) the parent's marginal rate (if elected). For 2020 and beyond, the parent's marginal rate will be used. Note that the kiddie tax rules can cause a portion of an affected child's net unearned income to be taxed at higher rates than would otherwise apply. [See IRC Sec. 1(g) and former IRC Sec. 1(j)(4).]

Only the portion of taxable income that consists of net unearned income and that exceeds the annual unearned income threshold ($2,100 for 2018; $2,200 for 2019, 2020, and 2021) is subject to the kiddie tax. If the child's net unearned income for the year does not exceed the annual threshold, the kiddie tax is not applicable. If the child's net unearned income exceeds the threshold, only the excess is hit with the kiddie tax. [See IRC Sec. 1(g) and Rev. Procs. 2017-58, 2018-57, 2019-44, and 2020-45.]

Calculating the kiddie tax. In calculating the federal income tax bill for a child under the kiddie tax rules, first add up the child's net earned income and net unearned income. Then, subtract the child's standard deduction to arrive at taxable income. For 2018, the standard deduction for a child for whom a dependent exemption deduction would have been allowed before the TCJA is the greater of (1) $1,050 or (2) earned income + $350, not to exceed $12,000. For 2019, the standard deduction is the greater of (1) $1,100 or (2) earned income + $350, not to exceed $12,200. For 2020, the standard deduction is the greater of (1) $1,100 or (2) earned income + $350, not to exceed $12,400. For 2021, the standard deduction is the greater of (1) $1,100 or (2) earned income + $350, not to exceed $12,550. (See Rev. Procs. 2017-58, 2018-57, 2019-44, and 2020-45.)

The portion of taxable income that consists of net earned income is taxed at the regular rates for a single taxpayer. The portion of taxable income that consists of net unearned income and that exceeds the annual unearned income threshold ($2,100 for 2018; $2,200 for 2019, 2020, and 2021) is subject to the kiddie tax. For 2018 and 2019, the kiddie tax can be calculated using the trust and estate rates or the parent's marginal rate if the parental rate option is elected. Electing to use the parent's marginal rate can result in a lower kiddie tax bill, especially if the child has substantial unearned income. For 2020 and beyond, the kiddie tax is always calculated using the parent's marginal rate, thanks to the SECURE Act.

Example #1: In 2019, Fritz (age 17) earned $2,000 from delivering newspapers. He also had $1,300 of net unearned ordinary interest income from his custodial account. The kiddie tax does not apply for 2019 because Fritz's $1,300 of unearned income is less than the $2,200 threshold for 2019.

Fritz's taxable income for 2019 is $950 ($3,300 − $2,350 standard deduction based on his $2,000 of earned income + $350). The $950 is taxed at 10% under the regular rates for single taxpayers. Therefore, Fritz's 2019 federal income tax bill is only $95 (10% × $950).

Variation: Now assume that all of Fritz's $1,300 of net unearned income is from long-term capital gains. His $2,000 of earned income and the first $350 of his long-term capital gains is offset by his $2,350 standard deduction. The last $950 of his long-term capital gains is taxed at 0% under the regular preferential capital gains rates for single taxpayers. Therefore, Fritz's 2019 federal income tax bill is $0.

Example #2: For 2019, Gina (age 17) had $2,000 of earned income and $25,000 of unearned interest and short-term capital gains from her custodial account. All the unearned income is taxed at ordinary rates. Gina's standard deduction is $2,350 ($2,000 earned income + $350). Gina's taxable income is $24,650 ($2,000 + $25,000 − $2,350 standard deduction).

Assume that Gina makes the election to use the parental tax rate. Of the $24,650 of taxable income, $22,800 ($25,000 unearned income − $2,200 unearned income threshold) is taxed at her parent's marginal rate under the kiddie tax rules. Assume that rate is 24%. The kiddie tax hit is $5,472 ($22,800 × 24%). The remaining $1,850 of Gina's taxable income ($24,650 − $22,800) is taxed at the 10% regular rate for a single taxpayer, resulting in $185 of tax ($1,850 × 10%). So, Gina's federal income tax bill is $5,657 ($5,472 + $185).

Variation: Same facts, but this time Gina does not elect to use the parental tax rate to calculate her kiddie tax bill. Of Gina's $24,650 of taxable income, $22,800 ($25,000 unearned income − $2,200 unearned income threshold) is taxed at the rates for trusts and estates. The kiddie tax hit is $6,794 [($2,600 × 10%) + ($6,700 × 24%) + ($3,450 × 35%) + ($10,050 × 37%)]. The remaining $1,850 of Gina's taxable income ($24,650 − $22,800) is taxed at the 10% regular rate for a single taxpayer, resulting in $185 of tax ($1,850 × 10%). So, Gina's federal income tax bill is $6,979 ($6,794 + $185). Obviously, Gina would benefit from making the election to use the parental tax rate to calculate her kiddie tax bill.

Key Issue 4B: Extended Tax Relief for Certain Students Whose Education Loans Were Discharged

Background

Generally, a borrower must include in gross income any amount of a loan that is canceled or forgiven [IRC Sec. 61(a)(12)].

Student loan discharges by the Department of Education (ED). There are two procedures under which the ED discharges student loans:

1) *Closed School procedure.* The ED can discharge a federal student loan when the student was attending a school at the time it closed or if the student withdrew within a certain period before the closing date. Federal student loans include federal Family Education Loans, federal Perkins Loans, and federal Direct Loans.
2) *Defense to Repayment procedure.* The ED is required to discharge a federal Direct Loan if a student (borrower) establishes, as a defense against repayment, that the school's actions would give rise to a cause of action against the school under applicable state law. Federal Family Education Loans can also be discharged under this procedure if certain requirements are met.

There are statutory exclusions from taxable gross income for cancelation of debt (COD) income from federal student loans that are discharged under the Closed School discharge procedure. Therefore, a taxpayer whose loan is discharged under this procedure should not report the related COD income as taxable gross income on his federal income tax return. While there is no statutory gross income exclusion for COD income from loans that are discharged under the Defense to Repayment procedure, a taxpayer (student loan borrower) may be able to exclude COD amounts under other tax-law exceptions (such as the insolvency exception or bankruptcy exception) or under an IRS provided non-statutory exception.

In Rev. Procs. 2015-57, 2017-24, and 2018-39, the IRS announced that taxpayers, who took out federal and private student loans to finance attendance at schools owned by Corinthian College, Inc. (CCI) and American Career Institutes, Inc. (ACI) and whose loans were discharged, didn't have to recognize gross income as a result of the debt discharge.

New Development

In a 2020 revenue procedure, the IRS extended this relief to all taxpayers who took out federal or private student loans to attend nonprofit or for-profit schools and whose federal loans were discharged under the Department of Education's Defense to Repayment or Closed School discharge processes or where private loans were discharged based on settlements of certain types of legal causes of action. These taxpayers will not be required to increase taxes for prior claimed credits or deductions attributable to the loans, and creditors will not be required to file information returns for the discharged debt (Rev. Proc. 2020-11).

Key Issue 4C: Changes to Charitable Contributions

Background

Tax reform in 2017, more commonly referred to as the 2017 Tax Cuts and Jobs Act (TCJA), changed the charitable giving landscape by increasing the standard deduction, making it less likely that individual taxpayers would itemize deductions. This created concern for many charities that believed there was a strong tie between donations and tax deductions.

Under pre-TCJA law, the deduction for *cash* contributions to public charities and certain private foundations was limited to 50% of adjusted gross income (AGI).

The TCJA increased the 50% AGI limit for *cash* contributions to public charities and certain private foundations to 60% for 2018–2025 [IRC Sec. 170(b)(1)(G)].

New Developments

Taxpayer Certainty and Disaster Tax Relief Act of 2019 (Disaster Act). IRC Sec. 170(b)(1) limits an individual's charitable contribution deduction based on AGI, while IRC Sec. 170(b)(2) limits charitable deductions for corporations based on their taxable income. The Disaster Act suspended these limitations for contributions made for relief efforts in 2018–2019 qualified disaster areas (meaning such contributions are allowed up to 100% of the taxpayer's contribution base). To qualify as a *2018–2019 qualified disaster contribution*, four requirements must be met (Disaster Act Sec. 204):

1) The contribution is paid during the period beginning January 1, 2018 through February 18, 2020 in cash to a 50% charity;
2) The contribution is made for relief efforts in a qualified disaster area;
3) The taxpayer obtains from the donee organization a contemporaneous written acknowledgment that the contribution was used for relief efforts in the qualified disaster area; and
4) The taxpayer elects to treat the contribution as a 2018–2019 qualified disaster contribution.

Coronavirus Aid, Relief, and Economic Security (CARES) Act:

- *Charitable contributions above-the-line deduction.* A new paragraph (22) is added to IRC Sec. 62(a) to encourage taxpayers who do not itemize deductions to contribute to churches and other charitable organizations (generally public charities) in 2020. This provision permits nonitemizers to deduct up to $300 of cash contributions (CARES Act Sec. 2204).
- *Charitable contributions limitation.* The limitation on deductions for charitable contributions by individuals who itemize is increased from 60% to 100% of modified income for cash contributions, generally to public charities, made in 2020 (CARES Act Sec. 2205). This applies, at the taxpayer's election, to donations to charitable organizations other than donor advised funds, supporting organizations, or private foundations. The intent of this restriction is to get cash in the hands of charities that will use the funds now, rather than pool or defer giving.

Key Issue 4D: Proposed Regulations on Nondeductible Fines and Penalties

Background

Subject to an exception for restitution or remediation payments, the 2017 Tax Cuts and Jobs Act (TCJA) expanded the scope of nondeductible fines and penalties under IRC Sec. 162(f). The TCJA also added IRC Sec. 6050X, which generally requires government officials to report to the IRS and each party to a settlement the amount and nature of any payments made under an agreement (if at least $600).

New Developments

The IRS has issued proposed regulations (REG-104591-18; Prop. Regs. 1.162-21 and 1.6050X-1) that (1) describe how taxpayers may meet the requirements of IRC Sec. 162(f) and (2) define key terms and phrases, such as *restitution*, *remediation*, and *paid to come into compliance with a law*. The proposed rules also provide guidance to governments related to Section 6050X reporting requirements (for orders and agreements that become binding under applicable law on or after January 1, 2022). The regulations are generally proposed to apply to tax years beginning on or after the date they are adopted as final (News Release IR-2020-94).

Key Issue 4E: Alternative Health Coverage Arrangements

Background

In response to rising health care costs (and other aspects of the health care system), President Trump issued Executive Order 13877 on June 24, 2019. The Order directed the IRS to propose regulations (to the extent consistent with law) to treat expenses related to certain types of arrangements, potentially including Direct Primary Care (DPC) arrangements and Health Care Sharing Ministries (HCSMs), as eligible medical expenses under IRC Sec. 213(d). The IRS has fulfilled its directive, and the resulting proposed regulations (REG-109755-19; Prop. Reg. 1.213-1) are by and large taxpayer-friendly.

Expenses for medical care, dental care, and health insurance premiums that exceed 7.5% of AGI (for tax years beginning before January 1, 2021) are deductible on Schedule A of Form 1040 for taxpayers who itemize deductions [IRC Sec. 213(f)]. Generally, *medical care* is defined as an amount paid for (1) the diagnosis, cure, mitigation, treatment, or prevention of disease, or for a purpose affecting the body's structure or function; (2) transportation primarily for and essential to medical care; (3) qualified long-term care services; and (4) insurance for medical care or any qualified long-term care insurance contract [IRC Sec. 213(d)(1)]. An expenditure that's merely beneficial to the general health of an individual isn't an expenditure for medical care [Reg. 1.213-1(e)(1)(ii)].

New Developments

DPC arrangements. Since the mid-2000s, DPC arrangements have been marketed as a way to afford *basic* medical care. Under this option, a patient contracts with his doctor for the provision of typical primary care services (such as preventative care, annual checkups, laboratory tests, etc.). Fees are usually fixed and paid on an annual or monthly basis. (A typical monthly fee for a DPC arrangement is around $100.) In some cases, doctors may charge an additional visit fee when services are performed.

Since the contract is directly between the patient and the doctor, there's no need to file health insurance claims. This appeals to many patients who find it frustrating to deal with insurance providers. DPC arrangements cut out the need for monthly health insurance premiums or copays. However, many patients who pursue DPC arrangements also enroll in a High Deductible Health Plan (HDHP) to cover visits to specialists, urgent care, or hospitals.

Under the proposed regulations, the IRS sets some additional parameters around the definition of a *DPC arrangement*. According to Prop. Reg. 1.213-1(e)(1)(v)(A), a DPC arrangement is a contract between an individual and one or more primary care physicians under which the physician or physicians agree to provide medical care for a fixed annual or periodic fee without billing a third party. A *primary care physician* is one who has a