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Tax Planning For The Recovery Rebate Credit

Dave Bove

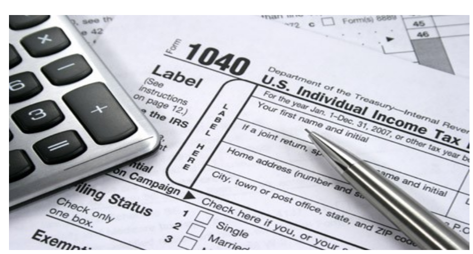
The Coronavirus Aid, Relief, and Economic Security (CARES) Act provides for a recovery rebate credit of $1,200 for individuals or $2,400 for couples and $500 per child against the tax imposed in the first tax year beginning in 2020. The amount of each rebate is phased out by $5 for every $100 in excess of a threshold amount. The threshold amount is based on adjusted gross income (AGI) and the phaseout begins at $75,000 for single filers, $112,500 for heads of households, and $150,000 for joint filers. Thus, the rebates are completely phased out for single filers with AGI over $99,000, heads of household with $136,500, and joint filers with $198,000.

An advanced refund was paid to help with the current COVID-19 crisis and expedite delivery of rebate credits to people. The advanced refund is calculated based on a taxpayer's AGI for 2019 or for 2018 if the 2019 return had yet been filed at that time. This prepaid amount is an estimate of the credit that the taxpayer should receive based on the 2020 tax year and does not necessarily reflect the actual amount of the credit.

Because a taxpayer's advanced refund is just an approximation of the credit to be received as part of the 2020 tax return, changes in the taxpayer's AGI in 2020 can make a significant difference in determining whether a taxpayer will ultimately qualify for the recovery rebate credit. Many taxpayers will have significant changes in income due to the economic uncertainty of 2020.

For example, if a married couple with two children receive the full advanced refund of $3,400 based on 2019's AGI, but their income increases to over $150,000 in 2020, they may be concerned that they will receive a surprise bill when filing their taxes next year, as the credit they already received begins to phase out. According to the IRS, the CARES Act does not require taxpayers to repay any advanced refund payments if their 2020 AGI exceeds the income limits for the refund credit as calculated on a 2020 return. Therefore, this couple would be allowed to keep the entire $3,400 refund without increasing their tax liability when filing their 2020 return. This also means people may benefit from delaying filing the 2019 return until after receiving the refund payment if their 2018 income was lower.

On the other hand, if the advanced credit is less than the actual credit, then taxpayers will be able to claim the difference (as an increased refund) on their 2020 income tax returns. For example, another married couple with two children may not receive an advanced refund at all if they had high income in 2018 or 2019. However, due to the current crisis, their income may be substantially lower in 2020, which would allow them to qualify for part or all of the credit on their 2020 return. Furthermore, if children are born or adopted in 2020 (and possibly 2019 if the recovery rebate is based on 2018), taxpayers will be eligible for an additional $500 for each new child, further increasing their credit. In that case, they may want to consider the increased credit when setting their withholding or making estimated payments. This is especially true if one spouse continues to work while the other has lost his or her job due to the crisis.



Since the tax credit is only valid for 2020, taxpayers have more of an incentive to push income to subsequent years, increase their 2020 deductions before AGI, or take advantage of other tax planning strategies to keep the recovery credit from being phased out in 2020. This could mean using the advanced refund to increase pretax retirement contributions, giving more to charity to take advantage of the AGI charitable contribution provision, or even choosing to file married filing separately to preserve the recovery rebate credit for at least one spouse.

One of the biggest opportunities for taxpayers to lower AGI is with 401(k) contributions. Most taxpayers are not able to max out their 401(k) contributions. However, taxpayers who are in jeopardy of losing part of their credit due to the phaseout might want to use any advanced refund received to increase their 401(k) contributions. Since 401(k) contributions are pretax contributions, taxpayers should be able to increase their 401(k) contribution more than the advanced refund amount without adjusting their personal budgets.

For retired individuals, the CARES Act eliminated the required minimum distribution requirements for 2020. Taxpayers who have the resources to forgo IRA and 401(k) distributions this year could lower their AGI to increase or preserve the recovery rebate if they did not receive the entire advanced refund due to the phaseout. This strategy would be an added benefit to those individuals who are heavily invested in securities that may have declined in value due to the crisis.

The CARES Act also provides an increased charitable deduction that allows taxpayers to claim up to $300 as an above-the-line deduction enabling charitable deductions to be subtracted from gross income and further lowering AGI. Even though the amount of the above-the-line deduction is not high, it does help increase the recovery rebate.

It is better, in most situations, for a married couple to file a joint return rather than file separately. However, the phaseout of the recovery rebates credit may make it beneficial to file separately. For married taxpayers whose AGI causes them to lose over half the credit and where one spouse makes disproportionately more than the other, it may be better to file separately, allowing the spouse with lower income to receive part or even all of the credit that the couple would not have been eligible for had they filed married filing jointly.

Qualified children over the age of 17 and qualified relatives that are claimed on another taxpayer's tax return as a dependent are not eligible for the recovery rebates and will not receive advanced refunds. Because they are not qualifying children under age 17, a taxpayer claiming them as a dependent is also not entitled to an additional $500 recovery rebate credit for these individuals. If those children and qualified relatives are not claimed as dependents in 2020, each one is eligible for the $1,200 credit. While they will not receive the advanced refund if they were dependents in 2019 (or 2018, if a 2019 return has not been filed at the time the advanced refund is issued), they are eligible for the recovery credit. The credit is refundable and does not have a minimum income requirement. Therefore, in most instances, it will overall be more beneficial for children over the age of 17 and qualified relatives not to be claimed as a dependent in 2020.

Taxpayers might choose to use their IRAs to get money during the crisis. The good news is that, if the taxpayer is affected by COVID-19, he or she can take a coronavirus distribution up to $100,000 from his or her IRA and have three years to repay the amount, without recognizing it as income. However, a taxpayer who does not pay the coronavirus distribution back is required to recognize the amount in income ratably over the three-year period. The taxpayer would not be subject to the 10% early-withdrawal additional tax. The amount included in income in 2020 may reduce the amount of the recovery rebate the taxpayer receives if he or she did not receive the entire advanced refund. That should be considered before taking a coronavirus distribution from an IRA as other than a loan. Also, while the valuations of investments are low, taxpayers might take the opportunity to convert a traditional IRA to a Roth IRA. However, the conversion will increase taxable income which may cause either part or all of the recovery rebate credit to be phased out. Taxpayers should consider these additional costs before making such a conversion.

Advanced refunds of the recovery rebates helped taxpayers meet economic needs during the current crisis. However, those rebates are only estimates of the recovery rebate credit on the 2020 tax return. Taxpayers need to be aware of the available opportunities to increase and/or preserve those amounts through proactive tax planning.

IT’S TIME FOR SOME GOOD NEWS

Kathy Tushaus

Want some good news from the Internal Revenue Service (IRS)? The odds of being audited by the IRS has dropped over 50% from 2011 to 2018. This percentage drop is large, but when we look at the actual numbers, the odds appear to be even lower. In 2011, 1 in 90 or .0111% of returns were audited. In 2018, 1 in 160 or .00625% of returns were audited. The reasons for the low audit rates relate mostly to budget cuts so we can expect an even larger reduction in audits now that we are experiencing the economical effects of COVID-19.

Did you know that 25% of all Americans say they are afraid about being audited and men are 12% more fearful than women? It has been shown that taxpayers making over $1 million have the greatest chance of being selected for an audit. For example, 1 in 35 taxpayers with income between $1 million and $5 million get audited. Those between $5 million and $10 million are getting audited in 1 of 17 cases and above $10 million comes in at 1 in 8 chances. The IRS targets the wealthy because they are more likely to just write a check and be over with the audit. Other statistics show that in 2016, paper filers of tax returns were audited more than electronically filed returns. 1 in 5 vs 1 in 200.

So, don’t concern yourself too much with the chance of getting audited. Take a deep breath as the 2019 tax season winds down and be happy for some good news.

TEN WEEKS OF QUARANTINE

Rick Vernal

Week 1 - Washed hands so much that my exam notes from 1995 resurfaced

Week 2 – Ran out of toilet paper and started using old newspapers – Times are rough

Week 3 – If I keep eating at this level, the buttons on my shirt will start to socially distance from each other

Week 4 – My car is getting three weeks to the gallon

Week 5 – The dog is looking at me like, “See? This is why I chew the furniture!”

Week 6 – I never thought that my hands would consume more alcohol than my mouth

Week 7 – They said a mask and gloves were enough to go to the supermarket. Not true, everyone else had clothes on

Week 8 – I’m getting very sad watching my spouse stand at the living room window and gaze aimlessly into space. I totally empathize, and often consider letting them inside - but rules are rules

Week 9 – Today’s weather – room temperature

Week 10 – It’s looking like Las Vegas in my house: we’re losing money by the minute, cocktails are acceptable at any hour, and nobody knows what time it is

A NEW FORM TO FILL OUT FOR NONEMPLOYEE COMPENSATION

Dawn M. Lopez

There's a new IRS form for business taxpayers that pay or receive nonemployee compensation.

Beginning with tax year 2020, payers must complete Form 1099-NEC, Nonemployee Compensation, to report any payment of $600 or more to a payee.

Why the new form?

Prior to 2020, Form 1099-MISC was filed to report payments totaling at least $600 in a calendar year for services performed in a trade or business by someone who isn't treated as an employee. These payments are referred to as nonemployee compensation (NEC) and the payment amount was reported in box 7.

Form 1099-NEC was reintroduced to alleviate the confusion caused by separate deadlines for Form 1099-MISC that report NEC in box 7 and all other Form 1099-MISC for paper filers and electronic filers. The IRS announced in July 2019 that, for 2020 and thereafter, it will reintroduce the previously retired Form 1099-NEC, which was last used in the 1980s.

What businesses will file?

Payers of nonemployee compensation will now use Form 1099-NEC to report those payments.

Generally, payers must file Form 1099-NEC by January 31. For 2020 tax returns, the due date will be February 1, 2021, because January 31, 2021, is on a Sunday. There's no automatic 30-day extension to file Form 1099-NEC. However, an extension to file may be available under certain hardship conditions.

Can a business get an extension?

Form 8809 is used to file for an extension for all types of Forms 1099, as well as for other forms. The IRS recently released a draft of Form 8809. The instructions note that there are no automatic extension requests for Form 1099-NEC. Instead, the IRS will grant only one 30-day extension, and only for certain reasons.

Requests must be submitted on paper. Line 7 lists reasons for requesting an extension. The reasons that an extension to file a Form 1099-NEC (and also a Form W-2, Wage and Tax Statement) will be granted are:

- The filer suffered a catastrophic event in a federally declared disaster area that made the filer unable to resume operations or made necessary records unavailable.
- A filer's operation was affected by the death, serious illness or unavoidable absence of the individual responsible for filing information returns.
- The operation of the filer was affected by fire, casualty or natural disaster.
- The filer was "in the first year of establishment."
- The filer didn't receive data on a payee statement such as Schedule K-1, Form 1042-S, or the statement of sick pay required under IRS regulations in time to prepare an accurate information return.

Link for further instruction can be found at: https://www.irs.gov/instructions/i1099msc

CARES Act Special Tax Relief Provisions for Distribution and Loans from Retirement Funds

Lise Seedroff

The Coronavirus Aid, Relief, and Economic Security Act (CARES Act) was enacted on March 27, 2020. The goal as suggested by the title was to provide economic relief through various avenues in response to the unprecedented impact of the coronavirus commonly referred to as COVID-19 on the U. S. economy beginning in early 2020.

Section 2202 of the CARES Act provides special tax relief provisions for distributions, loans and rollover or repayment options from certain retirement plans. The CARES Act relaxes early distribution rules and plan loan standards for qualified individuals (participants) with a valid COVID-19 reason for early access to retirement funds.

Qualified individuals are those who meet one of the following requirements:

- Are diagnosed with COVID-19
- Have a spouse or dependent diagnosed with COVID-19
- Experience a layoff, furlough, reduction in hours, or inability to work due to COVID-19 or lack of childcare because of COVID-19
- Had a job offer rescinded or delayed starting date due to COVID-19
- Experience adverse financial consequences due the effect of COVID-19 on the individual or their spouse
- Closing or reduced hours of a business owned by the individual or their spouse

Eligible tax-advantaged retirement plans include workplace retirement programs like 401(k)s, 403(b)s and 457 plans, as well as traditional individual retirement accounts (IRAs).

Relaxed early distribution rules offer the following benefits for early distributions to qualified individuals in 2020:

Up to an aggregate limit of $100,000 per qualified individual from all eligible plans

Waiver of the 10% additional tax (penalty) on otherwise non-qualified early distributions

Elimination of the mandatory 20% withholding requirement that normally applies to early distributions from workplace retirement plans

The option to recognize the 2020 distribution as income ratably over a three-year period on federal tax returns for 2020, 2021 and 2022

The 2020 distribution can also be recognized in total on the 2020 federal tax return, allowing flexibility if total income for the year (and thus the tax rate) is much lower

The three-year period also applies to repayment of the distribution, which will then be treated as a non-taxable rollover, an amended return would be required to claim a refund for any income recognized in a year prior to the repayment

Plan loan relief applies to eligible retirement plans <u>not including IRAs</u>:

<u>Certain loan payments may be delayed for one year</u>; any loan outstanding on or after March 20, 2020 and any repayment due from March 20, 2020 to December 31, 2020 may have the due date delayed under the plan for up to one year.

<u>The CARES Act also permits employers to increase the maximum loan amount</u> available to qualified participants from March 20, 2020 to September 22, 2020 up to the lesser of $100,000 (including any other outstanding plan loans to the participant), or the participant's vested benefit under the plan.

It is optional for employers to adopt the distribution and loan rules of the CARES Act. An employer may choose whether, and to what extent, to amend its plan to provide for COVID-19 related distributions or loans. A plan administrator may rely on an individual's certification that they satisfy the requirements to be treated as a qualified individual. The distribution must be reported by the retirement plan in 2020 on Form 1099-R even if the qualified individual repays the distribution in the same year.

Even if an employer does not treat a distribution as coronavirus related, a qualified individual may treat a distribution that meets the requirements of the CARES Act as COVID-19 related on their personal 2020 federal tax return. The distribution must be reported in 2020 and a minimum of one-third of the distribution recognized as 2020 income using Form 8915-E.

The CARES Act also suspended required minimum distributions (RMDs) for 2020. If you've already taken your 2020 RMD a recent adjustment allows you to return the funds to your account by August 31, 2020.

The changes regarding rules for 2020 retirement plan early distributions and loans provide unusual financial flexibility for people when they may need it most due to extraordinary circumstances beyond their control. The usual advice to avoid taking funds from your retirement accounts still applies so it is wise to limit use of these provisions to the minimum needed to weather the storm.

Closing Entries

ANNIVERSARIES

The following Dwight Darby & Company employment anniversaries will be occurring this Fall.

Karen Sellars – 19 years in September

Margaret McDeed – 14 years in September

Rick Vernal – 4 years in October

Leslie Hamilton – 2 years in December

Lise Seedroff – 1 year in September

"Of all the seasons, autumn offers the most to man and requires the least of him."

- Hal Borland

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