Quickfinder®

Individuals—Special Tax Situations Quickfinder® Handbook (2022 Tax Year)

Updates for December 2022 Legislation and Other Recent Guidance

Instructions: This packet contains "marked up" changes to the pages in the *Individuals—Special Tax Situations Quickfinder® Handbook* that were affected by December 2022 legislation, which was enacted after the *Handbook* was published. Additionally, changes were made based on other guidance issued after the *Handbook* was published. To update your *Handbook*, you can make the same changes in your *Handbook* or print the revised page and paste over the original page.

($159,177 × .9235 = $147,000). Reporting all of the earnings on just one of the spouse's Schedule SE may result in some of those earnings being taxed at the lower rate, while dividing them between two individuals may mean that all SE earnings are taxed at the 15.3% rate.

Observation: SE income may also be subject to the 0.9% additional Medicare tax (reported on Form 8959) on earned income if the combined earned income of the spouses exceeds $250,000.

Example: In 2022, Tom's income subject to SE tax is $180,000. Tom's wife Faye is involved in his direct selling business, but Tom has always filed his tax returns showing all the income on his Schedule C, along with a single Schedule SE for himself. The IRS examines their return and determines that Faye is actually Tom's equal partner. Thus, each of them will report half of the SE earnings on their own Schedule SE. The effect of this adjustment is as follows:

	All Income Reported by Tom	*Half Reported by Tom*	*Half Reported by Faye*
Income	$ 180,000	$ 90,000	$ 90,000
Tax on $159,177 at 15.3% after multiplying income by 92.35% (A)	$ 22,491	$ 12,717	$ 12,717
Income over $159,177	$ 20,823	$ 0	$ 0
Tax at 2.9% after multiplying income by 92.35% (B)	$ 558	$ 0	$ 0
Total Tax (A + B)	$ 23,049	$ 12,717	$ 12,717

The total SE tax under the IRS income allocation is $25,434 ($12,717 × 2). This is $2,385 ($25,434 – $23,049) more than if Tom reports all the SE income.

Formalizing the arrangement between the spouses can help prevent the IRS from successfully arguing that the business is a partnership and splitting the income between the spouses. For example, the less-involved spouse could sign an employment agreement as an employee of the more-involved spouse's business. It may also be advisable to ensure that the more-involved spouse is solely responsible for major business decisions.

Community Property States

If the spouses live in a community property state and any income derived from a trade or business is community income (under that state's community property laws), the SE income (or loss) from that business is treated as income of the spouse carrying on business. If only one spouse participates in the business, all of the income from that business is treated as that spouse's SE earnings. If both spouses operate the business, the SE income is allocated based on each spouse's participation in the business [IRC Sec. 1402(a)(5)(A)]. If the business is operated as a partnership, each partner reports his distributive share of income as SE income.

Determining whether a partnership exists is different for taxpayers in community property states than in separate property states. In community property states, the IRS will respect whichever treatment (sole proprietorship or partnership) the taxpayers use (as indicated by how they file their tax return) (Rev. Proc. 2002-69). Thus, the taxpayers can select the treatment they prefer. In separate property states, this determination is based on the facts and circumstances.

However, as is the case in separate property states, these rules for reporting trade or business income either as a partnership between the spouses or as a proprietorship do not apply if one spouse is a genuine employee of the other spouse's sole proprietorship.

Reporting Requirements

Form 1099

1099s issued. Direct sellers must file an information return if they make direct sales of at least $5,000 of consumer products to a buyer for resale anywhere other than a permanent retail establishment. The information return, Form 1099-MISC or Form 1099-NEC, must show the name, address, and identification number of the buyer (recipient). Check box 7 of Form 1099-MISC and box 2 of Form 1099-NEC to show these sales. Do not enter a dollar amount.

The direct seller must also provide a statement to the buyer by January 31 of the year following the calendar year for which the information return is filed, showing his name, address, phone number and identifying number. The statement given to the buyer for these direct sales may be in the form of a letter showing this information along with commissions, prizes, awards, etc.

Note: A Form 1099-NEC must also be issued to any noncorporate service providers to whom the direct seller pays $600 or more during the year.

1099s received. Direct sellers who purchase at least $5,000 of consumer products for resale during the year may receive a Form 1099-MISC or a Form 1099-NEC from the person who sold them the goods (often the company whose products they sell). They may also receive Form 1099-NEC if they are the recipients of commissions, prizes, awards, etc.

Direct sellers may also receive Form 1099-K if they use a payment settlement entity (PSE) to process credit card sales. The Form 1099-K will include the gross amount of the payment, including sales tax. The direct seller will need to maintain good records to determine what amounts may reduce gross sales. See *Form 1099-K Reporting* on Page 9-23 for additional information.

Law Change Alert: The American Rescue Plan Act of 2021 (ARPA) made significant changes to the reporting requirements for Form 1099-K, beginning with payment transactions settled after December 31, 2021. Prior to 2022, the reporting threshold requiring the issuance of a Form 1099-K was $20,000 in aggregate payments and 200 transactions. This reporting threshold is significantly modified ~~for 2022~~. ARPA made two significant changes to IRC Sec. 6050W. Section 9674(a) reduces the reporting threshold for Third Party Settlment Organizations (TPSOs) from $20,000 in aggregate payments and 200 transactions to solely a threshold of $600 in aggregate payments (with no minimum transaction requirement). This new rule is effective for transactions settled after December 31, 2022 (tax year 2022 is a transitional year—see Notice 2023-10). Therefore, a single transaction for $600 or more settled through a TPSO will now be reportable, as will multiple transactions with a payee that total more than $600. Section 9674(b) of ARPA clarifies the scope of TPSO reporting. A Form 1099-K is only required to be filed for transactions that are for goods or services. This means that transactions for personal gifts, charitable contributions, personal items sold at a loss, and reimbursements are not required to be reported on a Form 1099-K.

Schedule C

Unless the business is a partnership, income and expenses from direct selling are reported on Schedule C. The *Tax Organizer—Direct Sellers* on Page 3-25 can be used to gather the pertinent information.

When filing Schedule C, the direct seller should input a six-digit NAICS code. While there are several codes that relate to nonstore retailers, NAICS #454390 is generally the most appropriate code for direct selling businesses.

Qualified Business Income Deduction

From 2018 through 2025, direct sellers are eligible for the Section 199A deduction for qualified business income. The deduction is equal to 20% of the taxpayer's qualified business income but is subject to limits and phase-out when the taxpayer's taxable income exceeds certain thresholds, and different rules apply to service and non-service businesses. See *Qualified Business Income (QBI) Deduction* on Page 10-5 for coverage of the deduction.

Qualified Disaster Mitigation Payments

Qualified disaster mitigation payments are not included in gross income and do not increase the basis of the property for which the payments are made [IRC Sec. 139(g)(1)]. These are payments made pursuant to the Robert T. Stafford Disaster Relief and Emergency Assistance Act or the National Flood Insurance Act to or for the benefit of the owner of any property for hazard mitigation (for example, flood control) with respect to such property.

Qualified disaster mitigation payments are made under the following programs:

1) Flood Mitigation Assistance Program (FMA).
2) Pre-Disaster Mitigation Program (PDM).
3) Hazard Mitigation Grant Program (HMGP).
4) Building Resilient Infrastructure and Communities (BRIC).

Example: Alex received $53,000 as a qualified disaster mitigation payment to elevate her home in an area that frequently floods. Alex spends the entire $53,000 on elevation improvements. The $53,000 payment is excluded from income, so Alex is unable to increase the basis in her home by the amount of any repairs up to that amount. Any expenditure in excess of the $53,000 would increase basis.

FEMA "Individuals and Households Program" Payments

Under the Individuals and Households Program (IHP), FEMA provides grant payments to individuals for critical expenses and losses, not covered by insurance or other reimbursements that are incurred as a result of a federally declared disaster. FEMA makes the following types of payments under the program:

- *Temporary housing assistance.* To rent a different place to live or a government provided housing unit when rental properties are not available.
- *Repair assistance.* For homeowners to repair damage from the disaster to their primary residence that is not covered by insurance. The goal is to make the damaged home safe, sanitary, and functional.
- *Replacement assistance.* For homeowners to replace their primary residence destroyed in the disaster that is not covered by insurance.
- *Other needs assistance.* For necessary expenses and serious needs caused by the disaster, such as medical, dental, funeral, personal property, transportation, moving, and storage.
- *Hazard mitigation assistance.* For eligible homeowners to repair or rebuild stronger, more durable homes.

Generally, FEMA IHP payments are excluded from gross income to the extent that the expenses compensated for by the IHP payments are not compensated for by insurance or other reimbursement (ITA 200114044 and 200114045; IRS website—*FAQs for Disaster Victims—Mitigation Payments*). The recipient of a FEMA IHP repair or replacement assistance payment must reduce the amount of any casualty loss attributable to the damaged or destroyed residence by the amount of the payment and must reduce his tax basis in the residence by the amount of the payment, as well as by the amount of the allowable casualty loss deduction attributable to the damaged or destroyed residence. If the recipient repairs a damaged residence, the cost of repairs ordinarily is capitalized and added to the recipient's tax basis in the damaged residence.

Other Disaster-Related Rules

Proof of Loss

To deduct a casualty loss, the taxpayer must be able to show that there was a casualty and be able to support the amount of the deduction.

Casualty—must be able to show:

- Type of casualty.
- When the casualty occurred.
- That the loss was a direct result of the casualty.
- That the taxpayer was the owner of the property (or was contractually liable for damage to leased property.
- Whether a claim for reimbursement (for example insurance) exists for which there is a reasonable expectation of recovery.

Documentation. It is important to have records and other documentation to prove a loss deduction. This documentation should be retained in case the IRS questions the deduction but it does not need to be attached to the tax return. If actual records do not exist, the loss deduction can be supported by photographs of the property, appraisals, etc. If records have been destroyed or lost, the taxpayer may need to re-create them. Information about reconstructing records is available at **www.irs.gov.** Search for "record reconstruction."

Observation: Newspaper stories and pictures of the disaster should be saved and kept with the taxpayer's copy of the return. These items will make it easier to prove a casualty loss from a local disaster to an IRS agent who has no first-hand knowledge of the disaster.

Note: The IRS has indicated that it recognizes the extraordinary damage that can be caused by disasters and urges taxpayers and tax professionals to act in good faith in making reasonable estimations based on all information available. When records documenting valuation are not available or it is not feasible to obtain documentation sufficient to re-create records, the IRS will consider documentation requirements satisfied by the best reasonably available information presented in good faith. The IRS will generally consider each situation on a case-by-case basis. (Search for "FAQs for Disaster Victims" at **www.irs.gov.**)

Related Expenses

Expenses related to a casualty or theft are generally not deductible as casualty losses. However, they may be deductible under other provisions of the Code.

Retirement Plan Issues

Taxpayers who live or work in disaster areas may be eligible to take hardship distributions or retirement plan loans under liberalized procedures. While the procedures are relaxed to allow the taxpayer to access the funds more quickly, the tax treatment of the distributions remain unchanged unless special legislation is passed specifically for the applicable disaster (see *2019 Disaster Act Victims* on Page 4-21 and *TCDTRA Victims* on Page 4-21).

Hardship distributions. A taxpayer who receives a distribution from an employer's retirement plan prior to attaining the age of 59½ is subject to a 10% additional tax on the earnings distributed [IRC Sec. 72(t)]. This additional tax will apply to hardship distributions as well unless specifically exempted by legislation. Also, the distribution will be subject to 20% withholding. The retirement plan must specifically allow for hardship distributions. In addition, 401(k) plans and 403(b) plans must normally restrict any elective contributions to the plan within six months after the hardship distribution is made. However, disaster-related hardship distributions are not subject to this six-month ban. In addition, the disaster-related hardship distribution may be made before the plan is formally amended to provide for the hardship distribution.

Law Change Alert: The Consolidated Appropriations Act, 2023, exempts from the 10% additional tax on early distributions from qualified plans and IRAs up to $22,000 for *qualified disaster recovery distributions* made within 180 days of a federally declared disaster occurring on or after January 26, 2021 [IRC Sec. 72(t)(2)(M) and (t)(11)]. Distributions are included in income ratably over a three-year period, but can be repaid within three years and not included in income.

IRS examiners are directed to determine whether any funds remaining in the trust account at year end represent fees that have been earned on settled cases but not yet recognized as income because the fees are retained within the trust account.

Client Expense Advances By Attorneys

Attorneys often pay litigation expenses on behalf of their clients. These costs are typically recovered when the settlement or court award is received. This practice is often used by lawyers that accept cases on a contingency basis.

Loan or Expense?

Whether these advances are currently deductible depends on if the advance is a loan to the client. If the attorney expects that the client will repay the amounts advanced, they are not deductible when advanced.

Net fee billing. Under this arrangement, the proceeds of a lawsuit are first applied to reimburse the lawyer for any expenses advanced. The firm then receives a percentage of the remaining proceeds.

> **Court Case:** The lawyer represented clients in personal injury lawsuits on a contingent fee basis. The lawyer paid many of the expenses of the litigation, which would be reimbursed out of any settlement or award. The lawyer then received a percentage of the remaining settlement (net fee billing). However, if nothing was recovered, the lawyer would receive nothing. The lawyer screened prospective clients and accepted cases only when there was a good prospect of recovery. The court found that the expenses that the lawyer paid on the clients' behalf were loans because the lawyer expected that they would be reimbursed, even though there was a possibility that the lawyer could receive nothing [*Canelo*, 53 TC 217 (1969)].

Lawyers using a net fee arrangement should treat the client expense advances as loans until the costs are recovered. If the law firm is not eventually reimbursed by the client, or the amount reimbursed is less than the amount advanced, the lawyer can deduct the unreimbursed expenses as a bad debt. The bad debt deduction is claimed in the year the taxpayer determines that the loan has become worthless [Reg. 1.166-2(b)].

Hourly billing. Client expense advances are nondeductible when the lawyer bills the clients for the costs advanced on their behalf.

> **Court Case:** A law firm billed its clients based on a standard hourly rate. In addition, the firm billed clients (sometimes on a separate bill and sometimes along with the bill for services rendered) for the litigation costs it incurred on the case. The expense advances were loans to the client, not deductible expenses, because the firm was reimbursed dollar-for-dollar (*Pelton & Gunther, P.C.*, TC Memo 1999-339).

Gross fee billing. Under this contractual arrangement, the lawyer receives a flat percentage of the settlement or award. Expenses are not specifically repaid before the percentage is applied.

> **Court Case:** The lawyer represented clients in personal injury lawsuits on a contingent fee basis. The lawyer paid many of the expenses of the litigation. If the case was successful, the lawyer received a percentage of the proceeds, before any repayment of expenses (gross fee billing). If there was no recovery, the lawyer received nothing. The court found that since the expenses were not specifically reimbursed out of the settlement, they were more like the normal overhead any business incurs to make a profit. Therefore, even though the lawyer recovered approximately 90% of the expenses advanced, the court found that the advances were not loans to clients. The lawyer could deduct them in the year paid [*Boccardo*, 75 AFTR 2d 95-2244 (9th Cir. 1995)].

Reporting Payments to Attorneys

Anyone engaged in a trade or business who, in the course of that activity, makes payments totaling at least $600 for legal services to attorneys must report the amount paid on Form 1099-NEC or Form 1099-MISC unless payment was made by credit card, in which case, Form 1099-K may be issued by the payment settlement entity [IRC Sec. 6045(f)]. Reporting is required regardless of whether the legal practice operates as a proprietorship, partnership, LLC or corporation.

Law Change Alert: The American Rescue Plan Act (ARPA) lowered the reporting threshold for Form 1099-K for 2023 (tax year 2022 is a transitional year—see Notice 2023-10). From 2010 through 2021, Form 1099-K was only required to be issued if gross payments exceeded $20,000 or there were more than 200 transactions during the year. ARPA reduces the payment threshold to $600 and eliminates the transaction threshold entirely. Therefore, any taxpayer who receives $600 or more from a third-party settlement organization in 2023 must be issued a Form 1099-K.

Note: Non-employee compensation is reported on Form 1099-NEC.

Observation: Form 1099-MISC is generally not required when the payee is a corporation. However, payments to attorneys is an exception to this general rule, therefore, Form 1099-MISC must be filed even if the legal practice operates as a corporation.

Gross proceeds of $600 or more paid to an attorney in connection with legal services (regardless of whether the services are performed for the payer), but not for the lawyer's services, are reported on Form 1099-MISC, box 10. Attorneys' fees of $600 or more paid in the course of trade or business are reportable in box 1 of Form 1099-NEC.

Caution: A payer must report payments to an attorney even if the services are not performed for the payer. Thus, insurance companies paying a settlement on behalf of an insured are required to report the payment.

Often, an attorney will receive a check, some of which will be paid to other attorneys or to the attorney's client. The payer reports the entire amount to the first attorney listed on the check. If that attorney then makes a payment of $600 or more to another attorney, he must report that payment to the second attorney on Form 1099-NEC, under the same rules for payments to attorneys discussed in this section.

> **Example:** Fellows Corporation settles a suit brought by Matt Grayson by paying a check for $1 million to Matt's three attorneys, Adam, Zeke and Charles. (Zeke and Charles worked for Adam as outside legal consultants.) The check is delivered to Adam, who deposits it into a trust account and writes separate checks to Zeke for $100,000 and to Charles for $50,000 for their share of the attorney fees. Adam also makes a payment of $550,000 to his client, Matt.
>
> Because it does not know how much of the $1 million represents attorney's fees, Fellows reports the $1 million paid to Adam in box 10 of Form 1099-MISC. Adam then files Form 1099-NECs reporting $100,000 paid to Zeke and $50,000 paid to Charles. Adam reports the amounts paid to Adam and Charles in box 1 of Form 1099-NEC (since he knows that is the amount of their fees).

Planning Tip: In many cases, attorneys will receive Forms 1099 and 1099-NEC reporting gross payments, not all of which are taxable to them. These attorneys should be able to document the difference between the amounts reported to them on Form 1099 and the fees they report as income. Generally, the difference will consist of amounts paid to other attorneys, amounts paid to clients and amounts used to reimburse the attorney for advanced expenses (see *Attorney's Trust Accounts* on Page 8-20).

All documents presented to the employer must be originals. The employer should make a copy of these documents to be retained in its files with the completed Form I-9.

Affordable Care Act

Employers with at least 50 full-time equivalent employees are subject to employer shared responsibility provisions, under which employers who do not offer affordable health coverage that provides a minimum level of coverage to their full-time employees (and their dependents) may be subject to an employer shared responsibility payment. This could occur if at least one of their full-time employees receives a premium tax credit for purchasing individual coverage on one of the Affordable Insurance Exchanges (also called a Health Insurance Marketplace) (IRC Sec. 4980H).

Note: Employers with fewer than 50 full-time equivalent employees and who provide health insurance to their employees may qualify for a tax credit. See *Small Employer Health Insurance Credit* on Page 9-23.

Form 1099-K Reporting

Payment settlement entities must report debit and credit card sales to the IRS and merchants receiving payments. These payments are reported on Form 1099-K.

A payment settlement entity is a bank or other organization that has the contractual obligation to make payment to participating payees in settlement of payment card transactions or third party network transactions. A participating payee is anyone who accepts a payment card (or account number associated with a card) as payment or accepts payments from a Third Party Settlement Organization (TPSO) in settlement of a third party network transaction.

Until recently, a TPSO was only required to issue a Form 1099-K to a payee when the total number of transactions during the calendar year exceeded 200 and the dollar amount of those transactions exceeded $20,000. This *de minimis* exception only applied to third party network transactions (not payment card transactions). However, the American Rescue Plan Act (ARPA) brought about changes to these rules.

Law Change Alert: Beginning in 2023, the *de minimis* exception for TPSOs is significantly reduced to $600 per year with no minimum transaction requirement. This means a single transaction for $600 or more settled through a TPSO is now reportable. These new requirements apply to payments made beginning in 2023 (tax year 2022 is a transitional year—see Notice 2023-10), which will be reported on 2023 Form 1099-K issued in January 2024.

Practice Tip: Because many restaurants accept debit and credit cards, it is likely that they will receive one or more Form 1099-K. The amount reported to the payee and the IRS is the total reportable payment card/third-party network transactions for the year, without any adjustments for credits, discounts, refunded amounts or any other amounts. It could also include tips added to the total by customers. The amount reported on Form 1099-K is not reported on a specific line on the restaurant's tax return. However, any taxable amount should be included in the proper line on the return. The IRS does not match amounts reported on the Form 1099-K to the taxpayer's return. However, it could use the information reported on the Form 1099-K to identify potential under-reported income. So, taxpayers who receive Form 1099-K reporting information they believe is incorrect should contact the issuer to obtain a corrected Form 1099-K.

Tax Credits

Work Opportunity Tax Credit (WOTC)

The WOTC is available through December 31, 2025.

To be eligible for the WOTC, a new employee must be certified as a member of a targeted group by a state workforce agency (SWA). An employee is a member of a targeted group if he began working for the employer before 2026 and is a (IRC Sec. 51):

- Long-term family assistance recipient,
- Qualified recipient of Temporary Assistance for Needy Families (TANF),
- Qualified veteran,
- Qualified ex-felon,
- Designated community resident,
- Vocational rehabilitation referral,
- Summer youth employee,
- Supplemental Nutrition Assistance Program (SNAP) benefits (food stamps) recipient,
- SSI recipient, or
- Qualified long-term unemployment recipient (those who have been unemployed for at least 27 consecutive weeks).

The credit is claimed on Form 5884.

Credit for Employer Social Security and Medicare Taxes Paid on Certain Employee Tips

Restaurant employers are allowed a credit (claimed on Form 8846) for the social security and Medicare (FICA) taxes they pay on their employees' tip income. However, no credit is given to the extent the tips are needed to bring an employee's compensation up to $5.15 per hour (IRC Sec. 45B).

Example: An employee is paid $3.75 per hour and tips of $1.40 per hour were applied to reach $5.15. The $1.40 per hour in tips cannot be used towards the credit. If, however, the employee was paid an amount equal to or more than $5.15 per hour without including tips, then the credit is computed on all reported tips.

Other rules:

- Only tips received at establishments where tipping is a common practice qualify for the credit.
- No deduction is allowed for any amounts used in computing the credit.
- Since the credit is part of the general business credit, any unused credits can be carried back one year and forward 20 years.

Example: Tres Bon Chow offers both on-premises dining and take-out service, and encourages customers to tip employees and delivery personnel. During the year, Tres Bon Chow employees received $60,000 in tips from customers eating at the restaurant and $38,000 in tips from the delivery of food. Since tipping is customary at the establishment, both the tips from customers dining at the restaurant and the tips from food deliveries are included in the credit calculation.

Small Employer Health Insurance Credit

Qualified small employers that purchase health insurance coverage for their employees are eligible for a tax credit (IRC Sec. 45R). The credit (claimed on Form 8941) is a specified general business credit, and is available to use against regular tax and AMT. Any unused credit can be carried back one year and carried forward 20 years.

Amount of the credit. The credit generally is only available for premiums paid on behalf of employees enrolled in a qualified health plan offered through a Small Business Health Options Program (SHOP) Marketplace. The credit equals 50% of of the lesser of (1) premiums paid or (2) the amount that would have been contributed for employees if the premium equaled the small business benchmark premium for the employer's state. The credit is available to eligible small employers for a consecutive two-year

The income exclusion also applies to emergency financial aid grants that are used to discharge a student's overdue balance for tuition and fees.

Student Loans—Interest Deduction

Taxpayers can deduct up to $2,500 of interest paid on qualified education loans for college or vocational school expenses as an adjustment to income (above-the-line) (IRC Sec. 221). The deduction is available on qualifying loans for the benefit of the taxpayer or the taxpayer's spouse or dependent at the time that the debt was incurred.

Student Loan Interest Deduction—Quick Glance

Feature	Description
Benefit	Up to $2,500 tax deduction (above-the-line).
Qualified Loan	• Must have been taken out solely to pay qualified education expenses. • Cannot be from a related person or a qualified employer retirement plan.
Qualified Student	• Taxpayer, spouse or dependent. • Enrolled at least half-time in a degree program.
Phase-out	The ability to claim the deduction is phased out between $145,000 and $175,000 for MFJ, and between $70,000 and $85,000 for other qualified taxpayers.

COVID-19 Tax Alert: The Coronavirus Aid, Relief, and Economic Security Act (CARES Act) temporarily suspended the requirement to make payments on federal student loans through September 30, 2020. The suspension of principal and interest payments only applies to student loans owned by the Department of Education, which includes Direct Loans, some Federal Perkins Loans, and some Federal Family Education Loan Program loans. The payment pause and interest waiver have been extended through June 30, 2023 as of the date of publication. However, tax professionals should continue to watch for further developments.

Qualified loans. Qualified education loans are loans used solely for qualified education expenses, including tuition, fees, room and board, books, equipment and transportation for an eligible student to attend an eligible institution.

Coordination with other education benefits. Qualified education expenses do not include amounts paid with nontaxable education benefits received, such as employer-provided educational assistance, nontaxable distributions from an ESA or QTP, U.S. savings bond interest excluded from income or veteran's educational benefits.

Note: QTP distributions are allowed for up to $10,000 of student loan repayments (both principal and interest) for either the designated beneficiary of the QTP or a sibling of the designated beneficiary.

Student loan payments by employers. Employers may provide a student loan repayment benefit to employees on a tax-free basis. An employer may contribute up to $5,250 annually toward an employee's student loans, and the payment will be excluded from the employee's income. The $5,250 cap applies to both the new student loan repayment benefit as well as other educational assistance (such as tuition, fees, and books) provided by the employer under current law. (See IRC Sec. 127.) The provision applies to any student loan payments made by an employer on behalf of an employee, whether paid to a lender or to the employee through December 31, 2025. To prevent a double benefit, student loan repayments for which the exclusion is allowable cannot be deducted under IRC Sec. 221 (CARES Act Sec. 2206).

Eligible educational institutions include colleges, vocational schools and other post-secondary institutions that are eligible to participate in DOE student aid programs.

Eligible student. Students must take at least one half the normal full-time load in a degree, certificate or other qualified program at an eligible institution.

Restrictions

1) Not available to a taxpayer when that person is claimed as a dependent by another taxpayer. Another taxpayer is claiming the taxpayer as a dependent if he lists the taxpayer's name and other required information in the Dependents section of his Form 1040.

   Note: Even though there is no exemption deduction for tax years 2018–2025, taxpayers will still claim dependents for other tax purposes (such as the child tax credit, credit for other dependents, or education tax credits) and doing so will prevent a claimed dependent from deducting student loan interest expense.
2) Not available to married taxpayers filing separately.
3) A taxpayer must have the primary obligation to repay the loan in order to deduct the interest and he must actually pay the interest during the tax year.
4) Interest on a loan from a related person does not qualify. Related persons include: siblings, spouses, ancestors and lineal descendants, as well as certain corporations, partnerships, trusts and exempt organizations.
5) Interest on loans from a qualified employer retirement plan do not qualify for the deduction.

Observation: Because of restrictions 1 and 3, a student loan interest deduction often will not be allowed when the student takes out the loan and his parents claim the student/child as a dependent. *Reason:* If the student has the primary obligation to repay, his parents cannot deduct any interest they pay. Alternatively, if the student pays interest on the loan, he cannot deduct the interest if his parents claim him as a dependent. A couple of points to consider in this situation:

1) If parents do not actually claim the student as a dependent on their return, the student can deduct interest he pays on his own student loan.
2) Even if the parents claim the student as a dependent, it may make sense for the student/child to take out the loan when payments will not be due until after graduation, at which point the child will likely no longer be a dependent and can therefore, deduct the interest he pays on his return.

Example #1: Edgar pays $750 of interest on qualified education loans during the year. Only Edgar has the legal obligation to make the payments. Edgar's his parents claim him as a dependent on their tax return. Edgar cannot deduct the $750 of interest paid because he is a claimed dependent. Because Edgar's parents were not legally obligated to make the loan payments, they too cannot deduct the interest.

Example #2: Alicia pays $750 of interest on a qualified education loan during the year. Alicia's parents do not claim her as a dependent. Assuming fulfillment of all other relevant requirements, Alicia may deduct the $750 of interest paid.

What's Deductible as Interest?

In addition to simple interest on the loan, if all other requirements are met, the items discussed below can be student loan interest.

Loan origination fee. In general, this is a one-time fee charged by the lender when a loan is made. To be deductible as interest, a loan origination fee must be for the use of money rather than for property or services (such as commitment fees or processing costs) provided by the lender [Reg. 1.221-1(f)]. A loan origination fee is treated as interest that accrues over the term of the loan.

If loan origination fees are not included in the amount reported on Form 1098-E (Student Loan Interest Statement) (box 2 is checked) the taxpayer can use any reasonable method to allocate the loan origination fees over the term of the loan. If loan payments are constant, allocating the fees to a tax year based on the number of payments made that year relative to the total number of payments to be made over the life of the loan would be reasonable.

Practice Tip: Lenders are required to include the amount of the loan origination fee and capitalized interest paid during the year in the interest reported in box 1 of Form 1098-E.

Capitalized interest. This is unpaid interest on a student loan that is added by the lender to the outstanding principal balance of the loan. Capitalized interest is deductible as principal payments are made on the loan.

Interest on revolving lines of credit. This interest, which includes interest on credit card debt, is student loan interest if the borrower uses the line of credit (credit card) *only* to pay qualified education expenses.

Interest on refinanced student loans. This includes interest on both:

- *Consolidated loans*—loans used to refinance more than one student loan of the same borrower.
- *Collapsed loans*—two or more loans of the same borrower that are treated by both the lender and the borrower as one loan.

Caution: If a taxpayer refinances a qualified student loan for more than the original loan and uses the additional amount for any purpose other than qualified education expenses, the taxpayer cannot deduct any interest paid on the refinanced loan.

Voluntary interest payments. These are payments made on a qualified student loan during a period when interest payments are not required, such as when the borrower has been granted a deferment or the loan has not yet entered repayment status.

Interest paid by third party. If someone other than the person legally obligated to make interest payments makes a payment of interest on the borrower's behalf, the borrower is treated as receiving the payments from the other person and, in turn, paying the interest [Reg. 1.221-1(b)(4)].

Example: Ethan obtained a qualified student loan to attend college. After graduating from college, the first monthly payment on his loan was due in December. As a gift, Ethan's mother made this payment for him. No one is claiming Ethan as a dependent. Assuming all other qualifications are met, Ethan can deduct the interest paid by his mother on his tax return.

Student Loan Interest Deduction Worksheet

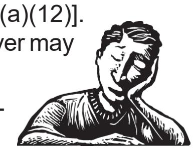
If filing Form 2555, or 4563 or excluding income from sources within Puerto Rico, use the worksheet in IRS Pub. 970.

1) Enter the total interest paid in 2022 on qualified student loans. Do not enter more than $2,500 .... 1) $_______
2) Enter total income from Form 1040, line 9 ...... 2) $_______
3) Enter the total of amounts from Form 1040, Schedule 1, lines 11 through 20, and 23 and 25 .... 3) $_______
4) Subtract line 3 from line 2 .... 4) $_______
5) Enter the amount shown below based on filing status:
   - Single, head of household, or qualifying widow(er)—$70,000
   - Married filing jointly—$145,000................. 5) $_______
6) Is the amount on line 4 more than the amount on line 5?
   ☐ No. Skip line 6 and 7, enter -0- on line 8 and go to line 9
   ☐ Yes. Subtract line 5 from line 4. .... 6) $_______
7) Divide line 6 by $15,000 ($30,000 if married filing jointly). Enter the result as a decimal (rounded to at least three places). If the result is 1.000 or more, enter 1.000 .... 7) $_______
8) Multiply line 1 by line 7 .... 8) $_______
9) Student loan interest deduction. Subtract line 8 from line 1. Enter the result here and on Form 1040, Schedule 1, line 21. Do not include this amount in figuring any other deduction on the return (such as on Schedule A, C, E, etc.) .... 9) $_______

Student Loans—Cancellations and Repayment Assistance

Student Loan Cancellation

Generally, a borrower must include in gross income any amount of a loan that is canceled or forgiven [IRC Sec. 61(a)(12)]. However, if a student loan is canceled, the taxpayer may not have to include any amount in income.



Law Change Alert: President Biden announced a plan addressing student loan debt. The plan would allow $20,000 in debt forgiveness if a taxpayer went to college on a Pell Grant, or $10,000 for non-Pell Grant recipients. Debt forgiveness applies only to those with "adjusted gross income" of less than $125,000 (single or MFS) or $250,000 (MFJ, HOH, or QW) in 2020 or 2021. The Biden administration also said that those with undergraduate degrees and a Pell Grant would have their repayments capped at 5% of monthly income. At the time of publication, the student loan payment pause is extended until the U.S. Department of Education is permitted to implement the debt relief program or certain litigation is resolved. Payments will restart 60 days later. For more information, go to **https://studentaid.gov/debt-relief-announcement**. Expanded details on the debt forgiveness part of the plan are available at **https://studentaid.gov/debt-relief-announcement/one-time-cancellation**.

Qualifying loans. To qualify for tax-free treatment, a student loan must contain a provision stating that all or part of the debt will be canceled if the taxpayer works [IRC Sec. 108(f)(1)]:

1) For a certain period of time,
2) In certain professions, and
3) For any of a broad class of employers.

Example: Ellen received $80,000 under a medical educational loan program. Under the terms of the program, one-fourth of the loan (or $20,000) is canceled each year she practices medicine in a qualifying state hospital. These amounts can be excluded if forgiven under the terms of the program.

Qualified lenders. The loan must be made by a qualified lender to assist the borrower in attending an eligible educational institution. Qualified lenders include [IRC Sec. 108(f)(2)]:

1) Federal, state or local government or an instrumentality, agency or subdivision thereof.
2) A tax-exempt public benefit corporation that has assumed control of a state, county or municipal hospital and whose employees are considered public employees under state law.
3) An eligible educational institution, if the loan is made:
   a) As part of an agreement with an entity described in items 1 or 2 under which the funds to make the loan were provided to the educational institution or
   b) Under a program of the educational institution that is designed to encourage its students to serve in occupations with unmet needs or in areas with unmet needs where the