Individual Tax Provisions of the New Appropriations Act

On 12/27/20, the massive Consolidated Appropriations Act, 2021 (CAA, 2021) was signed into law. Before the CAA, 2021 hit the books, a bevy of federal income tax breaks were set to expire on 12/31/20. The tax changes explained in this letter are found in the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (TCDTR) and the COVID-related Tax Relief Act of 2020 (COVIDTRA). Both of these Acts are folded into the CAA, 2021.

This letter explains what the TCDTR has to say about so-called *tax extenders* that benefit individuals. These extenders are tax breaks that Congress has repeatedly allowed to expire before restoring them, often retroactively. This letter also covers some other important tax changes included in the COVIDTRA that benefit individuals.

College Tuition Deduction Replaced by Liberalized Education Credit

For 2020, the college tuition deduction can be up to $4,000 at lower income levels or up to $2,000 at middle income levels. Taxpayers with Modified Adjusted Gross Income (MAGI) up to $65,000, or up to $130,000 for married joint-filers, can deduct qualified expenses up to $4,000. Taxpayers with MAGI between $65,001 and $80,000, or between $130,001 and $160,000 for married joint-filers, can deduct up to $2,000. The allowable 2020 deduction is zero if MAGI is more than $80,000, or more than $160,000 for married joint-filers.

If your 2020 income allows you to be eligible for the deduction, you can claim it whether you itemize or not.

New Law: The TCDTR repeals the college tuition write-off for 2021 and beyond. Also, starting in 2021, the new law aligns the phase-out rule for the Lifetime Learning credit, which can be worth up to $2,000 annually, with the more favorable phase-out rule for the American Opportunity credit, which can be worth up to $2,500 per student. In effect, the TCDTR trades the old-law write-off for the more favorable new-law Lifetime Learning credit phase-out rule.

Key Point: After this TCDTR change, both education tax credits are phased out for 2021 and beyond between MAGI of $80,001 and $90,000 for unmarried individuals and between $160,001 and $180,000 for married joint-filing couples. Before the TCDTR, the Lifetime Learning credit was phased out for 2020 between MAGI of $59,001 and $69,000 for unmarried individuals and between $118,001 and $138,000 for married joint-filing couples.

Tax-free Treatment of Employer Payments of Student Loans Extended

The Coronavirus Aid, Relief, and Economic Security (CARES) Act allowed federal-income-tax-free treatment for payments made by employer-sponsored educational assistance plans towards student loan debts of participating employees. Between 3/28/20 and 12/31/20, up to $5,250 per employee could be paid out (towards principal or interest) with no federal income tax hit for the employee. Also, employers could deduct these payments.

New Law: The TCDTR extends this break to cover qualifying student loan debt payments made through 12/31/25.

Intersection of Emergency College Financial Aid Grants and Higher Education Tax Credits

Eligible individuals can claim the American Opportunity credit (worth up to $2,500 per student) or the Lifetime Learning credit (worth up to $2,000) for qualifying higher education expenses.

However, expenses paid from federal-income-tax-free sources generally can’t be used to claim these credits.

New Law: The COVIDTRA grants federal-income-tax-free treatment to certain CARES Act emergency financial aid grants to college students. Under an exception, expenses paid with these tax-free grants can be used to claim the two higher education tax credits. The exception applies to qualified emergency financial aid grants made after 3/26/20 pursuant to the CARES Act.

Lower Itemized Medical Expense Deduction Threshold Made Permanent

The Tax Cuts and Jobs Act (TCJA) set the threshold for itemized medical expense deductions at 7.5% of Adjusted Gross Income (AGI). The threshold was scheduled to increase to a daunting 10% of AGI for 2021 and beyond.

New Law: The TCDTR makes the 7.5%-of-AGI threshold permanent for 2021 and beyond.

Tax-free Treatment of Forgiven Principal Residence Mortgage Debt Extended with Lower Limits

For federal income tax purposes, a forgiven debt generally counts as taxable Cancellation of Debt (COD) income. However, an exception applies to COD income from cancelled mortgage debt that was used to acquire a principal residence. Under the exception, up to $2 million ($1 million for married individuals who filed separately) of COD income from principal residence acquisition debt that was cancelled in 2007–2020 qualified as a federal-income-tax-free item.

New Law: The TCDTR extends this break to cover principal residence mortgage debt that’s forgiven in 2021–2025. However, the maximum amount of forgiven debt that can be treated as tax-free for those years is reduced to only $750,000 ($375,000 for married individuals who file separately).

Mortgage Insurance Premium Write-off Extended

Premiums for qualified mortgage insurance on debt to acquire, construct, or improve a first or second residence can potentially be treated as deductible qualified residence interest. The deduction is phased out for higher-income individuals.

New Law: The TCDTR extends this break through 2021.

$500 Credit for Energy-efficient Home Improvements Extended

This break allows you to claim a federal income tax credit of up to $500 for the installation of certain energy-saving improvements to a principal residence. However, the $500 maximum allowance must be reduced by any credits claimed in earlier years. In other words, the $500 amount is a lifetime limitation.

New Law: The TCDTR extends this break to cover qualifying improvements placed in service in 2021. However, if you’ve already claimed the credit for an earlier year, you may be ineligible for any additional credit.

Bigger Credit for Residential Solar Energy Equipment Extended

There's a generous federal income tax credit for qualifying solar energy equipment expenditures for your home. For equipment placed in service in 2020, the credit rate is 26%. The rate was scheduled to drop to 22% for equipment placed in service in 2021 before vanishing entirely for 2022 and beyond.

New Law: The TCDTR extends the 26% credit rate to cover equipment placed in service in 2021 and 2022 and extends the 22% rate to cover equipment placed in service in 2023. For 2024 and beyond, the credit is scheduled to expire.

Credit for Fuel Cell Vehicles Extended

You can claim a federal income tax credit for vehicles propelled by chemically combining oxygen with hydrogen to create electricity. The base credit is $4,000 for vehicles weighing 8,500 pounds or less. Heavier vehicles can qualify for credits of up to $40,000. An additional $1,000 to $4,000 credit is available to cars and light trucks to the extent their fuel economy meets federal standards.

New Law: The TCDTR extends this break to cover qualifying 2021 purchases.

Credit for Electric Motorcycles Extended

The 10% federal income tax credit for the purchase of qualifying electric-powered two-wheeled vehicles manufactured primarily for use on public thoroughfares and capable of at least 45 miles per hour (i.e., electric-powered motorcycles) can be worth up to $2,500.

New Law: The TCDTR extends this break to cover qualifying 2021 purchases.

Credit for Alternative Fuel Vehicle Refueling Equipment Extended

There's a personal and business federal income tax credit for up to 30% of the cost of installing nonhydrogen alternative fuel vehicle refueling equipment (for example, for your Tesla or other electric vehicle).

New Law: The TCDTR extends this break to cover qualifying 2021 expenditures.

Charitable Deductions for Nonitemizers Extended and Expanded

For 2020, individuals who don't itemize deductions can claim a federal income tax write-off for up to $300 of cash contributions to IRS-approved charities. The same $300 limit applies to both unmarried taxpayers and married joint-filing couples.

New Law: The TCDTR extends the $300 break to cover cash contributions made in 2021. It also doubles the deduction limit to $600 for married joint-filing couples for cash contributions made in 2021.

Bigger Charitable Deduction Limit for Generous Donors Extended

Before 2020, individuals could not claim an itemized charitable deduction for cash contributions to IRS-approved charities that exceeded 60% of AGI.

New Law: The Cares Act suspended the AGI limit for qualifying charitable contributions made in 2020. The TCDTR extends this taxpayer-friendly suspension into 2021. In other words, you can deduct up to 100% of AGI for qualifying charitable contributions made in those years.

Liberalized Rule for Calculating 2020 Refundable Child Credit and Earned Income Credit

You can collect refundable tax credits even if you have no federal income tax liability. Eligible taxpayers can claim a refundable Child Tax Credit (CTC) equal to 15% of earned income in excess of $2,500. The refundable Earned Income Tax Credit (EITC) equals the applicable percentage of an eligible taxpayer's earned income. *Earned income* means wages, salaries, tips, other taxable employee compensation, and self-employment income. More earned income can translate into bigger refundable credits, and less earned income can translate into smaller refundable credits. You may have had lower earned income in 2020 due to the COVID-19 economic fallout, which could result in lower refundable credits.

New Law: For purposes of calculating allowable CTCs and EITCs for the 2020 tax year, the TCDTR allows taxpayers to use either their 2020 earned income or their 2019 earned income amount if that's more than the 2020 figure.

Liberalized Rules for Flexible Spending Account (FSA) Balances

An employer-sponsored health FSA can allow an employee to carry over up to $550 of his or her unused FSA balance into the following plan year. This rule is called the *carryover rule*. At the employer's option, a separate *grace period rule* can be offered to give you up to 2½ months after the plan's year-end to submit qualifying expenses for reimbursement and thereby use up your FSA balance. Health FSAs can offer either the carryover rule or the grace period rule, but not both.

For dependent care FSAs, employers cannot offer the carryover rule, but they can offer the grace period rule.

New Law: For plan years ending in 2020 and 2021, the TCDTR allows employers to extend health FSA and dependent care FSA grace periods for up to 12 months into the following plan year. Also, for these plan years, both types of FSA plans can *apparently* allow the carryover rule in addition to the grace period rule. The employer also can allow an employee who ceases to participate in an FSA plan during calendar year 2020 or 2021 to continue to receive reimbursements from unused balances through the end of the plan year in which the employee's participation ceased, including any grace period.

Liberalized Rule for Educator Expense Deduction

Eligible K–12 teachers and instructors are entitled to a $250 annual above-the-line deduction for certain school-related expenses paid out of their own pockets.

New Law: The COVIDTRA stipulates that by no later than 2/28/21, the IRS must issue official guidance to clarify that the costs of Personal Protective Equipment (PPE), disinfectant, and other supplies used to prevent the spread of COVID-19 count as allowable expenses for the $250 educator expense deduction. This guidance will apply to such expenses paid or incurred after 3/12/20.

Conclusion

You now have updated information on the status of tax extenders and other important tax changes that benefit individuals. Please contact us if you have questions or want more information.