Emerald Spectrum Advisory
Malissia Johnson, CFP®, AAMS, CMFC
5300 Maryland Way, Suite 303
Brentwood, TN 37027
615-369-0690
esateam@emeraldspectrum.com
www.emeraldspectrum.com

Pandemic Relief Measures and Your Tax Return

Two emergency relief bills passed in 2020 in response to the COVID-19 pandemic will make this an unusual tax season for many taxpayers. The Coronavirus Aid, Relief, and Economic Security (CARES) Act was passed in March, and a second relief package was attached to the Consolidated Appropriations Act, 2021, in December.

The federal government relied on the tax system to deliver financial lifelines to struggling households, boost consumer spending, and help speed the economic recovery.

The following provisions may affect many households when they file their personal tax returns for 2020. You might consult a tax professional who can further explain the relevant changes and recommend strategies to help reduce your tax liability for 2021.

Recovery Rebate Credit

Most U.S. households received two Economic Impact Payments (EIPs) from the federal government in 2020. They are not taxable because technically they are advances on a refundable credit against 2020 income taxes.

The CARES Act provided a Recovery Rebate Credit of $1,200 ($2,400 for married joint filers) plus $500 for each qualifying child under age 17. The second bill provided another $600 per eligible family member.

Any individual who has a Social Security number and is not a dependent generally qualifies for the payments, up to certain income limits. The amounts are reduced for those with adjusted gross incomes (AGIs) exceeding $75,000 ($150,000 for joint filers and $112,500 for heads of household) and phase out completely at AGIs of $99,000 ($198,000 for joint filer and $112,500 for heads of household).

In order for the money to be delivered quickly, eligibility was based on 2019 income tax returns (or 2018 if a 2019 return had not been filed). Eligible taxpayers who did not receive two full payments, possibly due to errors or processing delays, may claim the money as a Recovery Rebate Credit on their 2020 tax return. Households that reported a lower AGI in 2020 (or added a dependent) might be eligible for additional funds. To calculate the credit, filers will need to know the amounts of any payments they already received. The credit amount will increase the refund or decrease the tax owed, dollar for dollar.

Taxpayers who received two full payments don't need to fill out any additional information on their tax returns. The IRS will begin accepting 2020 tax returns on February 12, 2021; filing electronically usually results in a faster refund.

Coronavirus-related distributions

Another measure in the CARES Act allowed IRA owners and employer-plan participants who were adversely affected by COVID-19 to withdraw up to $100,000 of their vested account balance in 2020 without having to pay the 10% tax penalty (25% for SIMPLE IRAs) that normally applies prior to age 59½.

Still, withdrawals from tax-deferred retirement accounts are typically taxed as ordinary income in the year of the distribution. To help manage the tax liability, qualified individuals can choose to spread the income from a coronavirus-related distribution (CRD) equally over three years or report it in full for the 2020 tax year, with up to three years to reinvest the money in an eligible employer plan or an IRA.

Taxpayers who elect to report income over three years and then recontribute amounts greater than the amount reported in a given year may "carry forward" the excess contributions to next year's tax return. Taxpayers who recontribute amounts after paying taxes on reported CRD income can file amended returns to recoup the payments.

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Qualified individuals whose plans did not adopt CRD provisions may choose to categorize other types of distributions — including those normally considered required minimum distributions — as CRDs on their tax returns (up to the $100,000 limit).

Other notable changes

The special rules for charitable gift deductions enacted for 2020 have been extended through 2021. For those who itemize deductions, the limit on the charitable gift deduction increased to 100% of AGI for direct cash gifts to public charities. For nonitemizers, a new $300 charitable deduction for 2020 and 2021 direct cash gifts to public charities is available. For joint filers, this deduction increases to $600 for 2021 cash gifts to charitable organizations.

The floor for deducting medical expenses has been permanently lowered to 7.5% of AGI. (It was scheduled to increase to 10% in 2021.) And starting in 2021, there is no deduction for qualified tuition and related expenses. Instead, the modified adjusted gross income (MAGI) phaseout range for the Lifetime Learning credit was increased to be the same as the phaseout range for the American Opportunity credit ($80,000 to $90,000 for single filers; $160,000 to 180,000 for joint filers).

A temporary provision that allows taxpayers to exclude discharged debt for a qualified principal residence from gross income was extended through 2025, though the limit has been reduced from $2 million to $750,000. Also through 2025, employers can pay up to $5,250 annually toward employees' student loans as a tax-free employee benefit.

Yes, unemployment aid is taxable

The number of unemployed workers spiked above 22 million in March 2020, and more than 9 million people were still out of work at the end of the year.[1] Both relief bills expanded unemployment benefits and provided them to many workers who normally are not eligible (including the self-employed, independent contractors, and part-time workers).

Unemployment benefits, which sustained many families impacted by the pandemic, are considered taxable income, and many recipients may not have correctly withheld taxes from their 2020 payments. Avoiding a surprise tax bill typically requires opting into a 10% withholding rate and, in some cases, paying additional quarterly taxes during the year.

Last year was unpredictable, and your financial situation may have been far from normal. You should file your 2020 tax return by the April 15 deadline, even if you are worried that it's going to show a balance due. Being up-to-date on filing is generally required to pursue a payment agreement with the IRS. If you owe $50,000 or less, you may even be able to apply online for a short-term extension (up to 120 days) or a longer payment agreement. Paying as much as you can afford can help limit penalties and interest that accrue on unpaid amounts.

1) U.S. Bureau of Labor Statistics, 2021