Unemployment Benefits for 2020 - Taxation Under ARPA

On March 11, 2021, President Biden signed into law the American Rescue Plan Act (ARPA). This Act reportedly has a cost of $1.9 trillion, of which approximately $500 billion is for stimulus payments. There are a few tax related items in this Act. This email addresses only the unemployment compensation benefit (UC) change.

ARPA creates an exclusion from income for UC received in 2020. The exclusion only applies if the taxpayer's modified AGI (MAGI) is less than $150,000.

- There is not a phase out of this MAGI limitation. Either the taxpayer qualifies or the taxpayer does not qualify. A MAGI of $150,000 means the taxpayer is NOT eligible for the exclusion.

- The same MAGI limit of "less than $150,000" applies to all taxpayers regardless of their filing status. Therefore, taxpayers whose MFJ MAGI is $150,000 or more may want to consider filing MFS if their MAGI on MFS returns is less than $150,000.

- MAGI includes AGI as normally calculated by looking at the AGI on the tax return before excluding the UC, then subtracting ALL of the UC. For example, the amount of SS benefits subject to taxation are calculated by including the UC in the total income package to calculate the actual AGI. Then subtract ALL of the UC from this AGI to arrive at the taxpayer's MAGI – do not recalculate the taxable SS benefits. If this MAGI is below $150,000, the taxpayer is eligible for the exclusion.

The exclusion has a maximum of $10,200 per taxpayer. In the case of an MFJ return, the exclusion is limited to $10,200 for each spouse.

Example 1 – Taxpayer has $8,000 of UC. Spouse has $5,000 of UC. They can exclude $13,000 of UC.

Example 2 - Taxpayer has $18,000 of UC. Spouse has $15,000 of UC. They can exclude $10,200 of UC EACH, for a total exclusion of $20,400.

Example 3 - Taxpayer has $18,000 of UC. Spouse has $5,000 of UC. Taxpayer can exclude $10,200 of UC, Spouse can exclude $5,000 of UC, for a total exclusion of $15,200.

IRS released worksheet and updated program information to the software companies within a very short time. About a week later the worksheet was "corrected". The original worksheet included the UC in MAGI, while the corrected worksheet does not. The "corrected" worksheet makes more of the borderline people eligible for the exclusion.

Of course, as you already know, this change affects 2020 income tax returns. IRS had probably already received 75-100 million returns before this law change. Members of Congress directed IRS to find a way to fix these already filed returns without requiring taxpayers to amend their returns.

In News Release 2021-71 IRS announced it will "take steps to automatically refund money this spring and summer" to taxpayers who filed their returns with UC prior to the law change. Refunds will start coming out in May and will continue into the summer. The first refunds will be for those taxpayers who are able to exclude up to $10,200, then IRS will proceeds to those who are MFJ and able to exclude higher amounts.

The News Release also states IRS will recalculate other items on the return including credits claimed on the returns, although IRS cannot determine if taxpayers qualify for other credits as a result of the lower AGI. This is common to "math error corrections" IRS has done in the past.

Issues we see include:
- Did IRS correctly "fix" the return? The taxpayer will have recalculate the return using the exclusion to determine if the IRS "fix" was correct.

- A taxpayer will have to amend to claim any new credits. But to amend, the taxpayer will need to know the "original amounts, as adjusted by IRS." This means the taxpayer needs to receive the IRS paperwork explaining what IRS has changed on the return, then the taxpayer can file amended returns. The News Release states "There is no need for taxpayers to file an amended return unless the calculations make the taxpayer newly eligible for additional federal credits and deductions not already included on the original tax return." It does NOT say WHEN these special returns should be amended (i.e., before or after IRS does its correcting).

- IRS "fixing" these returns means the copy we provided to the taxpayer (or the copy they printed out when they prepared their own return) is NO LONGER the real final (or "superseded") return.

- Our tax preparation software has updated to claim this exclusion. When we pull up a client, the return we see now shows the exclusion, even though the original return we prepared did not have the exclusion. If we have not archived the original return, the only return we see is the one our software NOW displays. This also means amending the state return for any reason no longer can use the software's "original" return since the software now has the revised return as its base.

- The state return may have to be amended due to these changes on the Federal. Some states will accept the Federal change and some will not. Some states use the Federal adjusted gross income (AGI) or taxable income (TI) to calculate the state return, and therefore any change to the Federal may affect the already filed state returns.

Editorial comment – We feel Congress was irresponsible in making this change in the middle of tax season. We're not saying this exclusion is wrong or irresponsible, but we believe Congress making this change during tax season, especially after returns have already been filed, instead of last summer OR fall is irresponsible. IRS already has too much on their plate!

This text has been shared courtesy of: David & Mary Mellem, EAs & Ashwaubenon Tax Professionals, 920-496-1065 (920-496-9111).