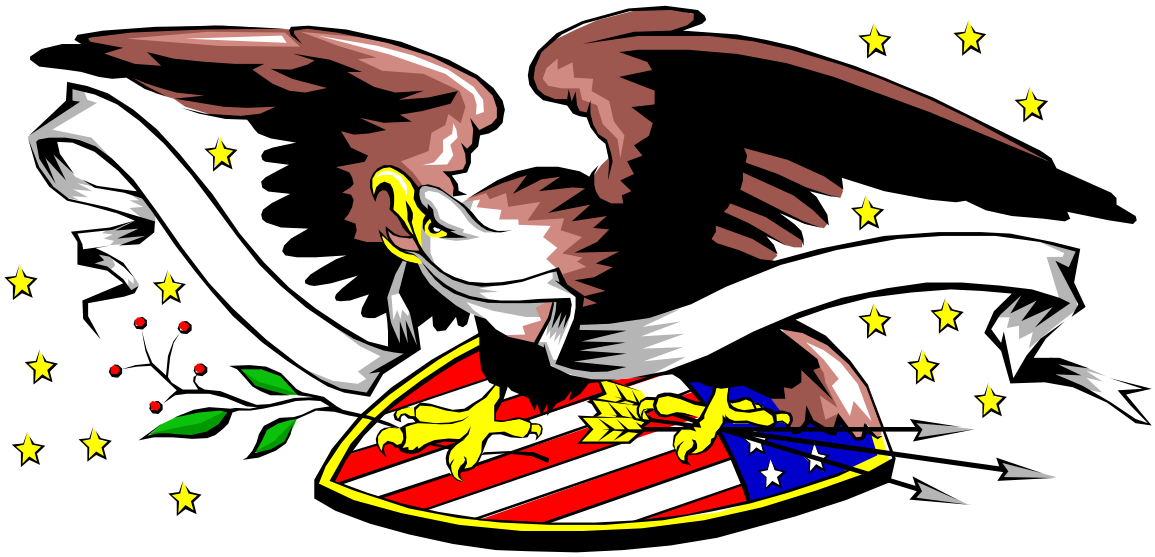

1040 Workshop

For 2025 Planning & 2024 Filings

By
Danny C. Santucci

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Learning Objectives

After reading Chapter 1, participants will be able to:

1. Identify federal revenue tax sources citing the definitive role of gross income and, determine a client's tax liability using current rates, tables, exemptions, statutory amounts, and their withholding and/or estimated tax responsibility.

2. Specify the various filing statuses and their filing requirements recognizing the advantages and disadvantages of each.

3. Determine what constitutes gross income under §61 stating the tax treatment of fringe benefits, rental income, prizes, and a child's income, and specify how debt discharge and foreclosure can result in taxable income.

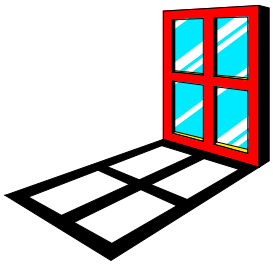
4. Identify the mechanics of income exclusions such as education-related exclusions, insurance, and personal injury awards.

5. Recognize income tax deductions and their use to reduce tax liability by identifying interest related to businesses, investments, qualified residences, and deductions for medical expenses, charitable contributions, casualty losses, and moving expenses.

6. Determine distinctions among several types of tax credits for children and education identifying amounts and eligibility requirements.

CHAPTER 1

Individual Tax Elements



Federal Income Taxes: A Description

The sources of federal tax revenue are individual income taxes; Social Security and other payroll taxes; corporate income taxes; excise taxes; and estate and gift taxes.

> **Note:** The individual income tax is the major source of federal revenues, followed closely by Social Security and other payroll taxes. As a revenue source, the corporate income tax is a distant third. Estate, gift, and excise taxes play only minor roles as revenue sources.

Application of U.S. Individual Income Tax

A United States citizen or resident alien generally is subject to the U.S. individual income tax on his or her worldwide taxable income. However, foreign tax credits are often available against U.S. income tax imposed on foreign source income to the extent of foreign income taxes paid on that income. A nonresident alien is subject to the U.S. individual income tax on income with a sufficient nexus to the United States.

Gross Income

Under the Internal Revenue Code, gross income means "income from whatever source derived" except for certain items specifically exempt or excluded by statute (§61).

> **Note:** Statutory exclusions from gross income include death benefits payable under a life insurance contract, interest on certain State and local bonds, the

receipt of property by gift or inheritance, employer-provided health insurance, employer-provided pension contributions, and certain other employer-provided benefits.

Sources of income include wages, salaries, tips, taxable interest and dividend income, business and farm income, realized net capital gains, income from rents, royalties, trusts, estates, partnerships, taxable pension and annuity income, and alimony received (before 2019).

Note: Wage income of employees is taxed, although most contributions to employee pension and health insurance plans and certain other employee benefits are not included in wages subject to income tax. Employer contributions to Social Security are also excluded from wages. When pensions are received, they are included in income to the extent that they represent contributions originally excluded. If the taxpayer has the same tax rate when contributions are made and when pensions are received, this treatment is equivalent to eliminating tax on the earnings of pension plans. Some Social Security benefits are also subject to tax.

Adjusted Gross Income (AGI)

The gross income is reduced by subtracting certain "*above-the-line*" deductions from gross income. These deductions include trade or business expenses, capital losses, contributions to a qualified retirement plan by a self-employed individual, contributions to individual retirement arrangements ("IRAs"), some interest paid on student loans, certain moving expenses, certain education-related expenses, and alimony payments (before 2019). This reduction produces adjusted gross income (AGI)

Taxable Income

Taxable income is the base on which federal income tax is assessed. Taxable income equals AGI reduced by either the *standard* deductions or *itemized* deductions *and* personal and dependent exemptions.

Standard Deduction

A taxpayer may reduce AGI by the amount of the applicable standard deduction. The basic standard deduction varies depending on a taxpayer's filing status. The elderly and blind are allowed an additional standard deduction. The amounts of the basic standard deduction and the additional standard deductions are indexed annually for inflation.

Itemized Deduction

In lieu of taking the applicable standard deductions, an individual may elect to itemize deductions. Itemized deductions include state and local income taxes, real property and certain personal property taxes, home mortgage interest, charitable contributions, certain investment interest, medical expenses (in excess of 7.5%), business (personal are suspended until 2026) casualty and theft losses, and certain miscellaneous expenses

(those subject to the 2% of AGI limit are suspended until 2026). From 2018 through 2025, the overall limitation on itemized deductions is suspended.

Personal Exemptions

Formerly, personal exemptions were allowed for a taxpayer, his or her spouse, and each dependent. However, from 2018 through 2025, personal (and dependency) exemptions and the personal exemption phase-out are suspended.

Filing Status

There are four main filing categories under the individual income tax: married filing jointly, married filing separately, head of household, and single individual.

Rates & Tax Liability

Graduated tax rates are applied to a taxpayer's taxable income to determine his or her individual income tax liability in the form of seven marginal income tax rates: 10%, 12%, 22%, 24%, 32%, 35%, and 37%. These marginal income tax rates are applied against taxable income to arrive at a taxpayer's gross income tax liability.

> **Note:** Long-term capital gains - that is, gain on the sale of assets held more than 12 months - and qualified dividend income are taxed at lower tax rates.

A taxpayer may face additional liability if the alternative minimum tax applies. However, a taxpayer may reduce his or her income tax liability by any applicable tax credits. Thus, a taxpayer's net income tax liability is the greater of the:

(1) regular individual income tax liability reduced by credits allowed against the regular tax, *or*

(2) tentative minimum tax reduced by credits allowed against the minimum tax.

Tax Credits

Tax credits are subtracted from gross tax liability to arrive at a final tax liability. They can be non-refundable, refundable, or partially refundable. Some tax credits reward people for installing solar panels, caring for children and dependents, education, and adoption. The major tax credits include the earned income tax credit, the child tax credit, the educational tax credits, the tax credit for the elderly and the disabled, and the credit for child and dependent care expenses.

> **Note:** Tax credits offset tax liability on a dollar-for-dollar basis and have become an increasingly popular method of providing tax relief and social benefits in general. If a tax credit is refundable and it exceeds tax liability, a tax-

payer receives a payment from the government. If credits are not refundable, then they provide no benefit to many lower income individuals who have no tax liability. The earned income credit is refundable, and the child tax credit is refundable for all but very low-income families. Many credits are phased out as income rises and thus do not benefit higher-income individuals; these phase-out points vary considerably.

Comment: It's important to determine eligibility for tax credits and deductions before filing. Deductions can reduce the amount of income before the tax owed is calculated. Credits reduce the amount of tax owed or increase a tax refund. Certain credits permit a refund even if no taxes are owed.

Rates, Tables, & Statutory Amounts

Income Tax Rates - §1

Under §1(f), tax rate schedules, exemption amounts, and the standard deduction are to be adjusted on a straight-line percentage by the increase in the Consumer Price Index for All Urban Consumers (CPI-U).

Note: Currently, a great site on the Internet to get updates on these amounts is http://www.smbiz.com.

The Tax Cuts & Jobs Act (TCJA) of 2017 created seven income tax brackets of 10%, 12%, 22%, 24%, 32%, 35%, and 37% for the taxable years 2018 through 2025.

These tax rate brackets for 2025, as adjusted for inflation, are:

Filing Status	Taxable Income	Rate
Single	$1 to $11,925	10%
	$11,925 to $48,475	12%
	$48,475 to $103,350	22%
	$103,350 to $197,300	24%
	$197,300 to $250,525	32%
	$250,525 to $626,350	35%
	Over $626,350	37%
Head of Household	$1 to $17,000	10%
	$17,000 to $64,850	12%
	$64,850 to $103,350	22%
	$103,350 to $197,350	24%
	$197,350 to $250,500	32%
	$250,500 to $626,350	35%
	Over $626,350	37%
Married, Joint	$1 to $23,850	10%
	$23,850 to $96,950	12%
	$96,950 to $206,700	22%

	$206,700 to $394,600	24%
	$394,600 to $501,050	32%
	$501,050 to $751,600	35%
	Over $751,600	37%
Married, Separate	$1 to $11,925	10%
	$11,925 to $48,475	12%
	$48,475 to $103,350	22%
	$103,350 to $197,300	24%
	$197,300 to $250,525	32%
	$250,525 to $375,800	35%
	Over $375,800	37%

These tax rate brackets for 2024, as adjusted for inflation, were:

Filing Status	**Taxable Income Rate**	
Single	$1 to $11,600	10%
	$11,600 to $47,150	12%
	$47,150 to $100,525	22%
	$100,525 to $191,950	24%
	$191,950 to $243,725	32%
	$243,725 to $609,350	35%
	Over $609,350	37%
Head of Household	$1 to $16,550	10%
	$16,550 to $63,100	12%
	$63,100 to $100,500	22%
	$100,500 to $191,950	24%
	$191,950 to $243,700	32%
	$243,700 to $609,350	35%
	Over $609,350	37%
Married, Joint	$1 to $23,200	10%
	$23,200 to $94,300	12%
	$94,300 to $201,050	22%
	$201,050 to $383,900	24%
	$383,900 to $487,450	32%
	$487,450 to $731,200	35%
	Over $731,200	37%
Married, Separate	$1 to $11,600	10%
	$11,600 to $47,150	12%
	$47,150 to $100,525	22%
	$100,525 to $191,950	24%
	$191,950 to $243,725	32%

$243,725 to $365,600	35%
Over $365,600	37%

Marriage Penalty - Mostly Gone

Tax law has long provided a lower combined income tax liability for an unmarried couple than that for a married couple filing jointly. This "marriage penalty" has been particularly true where both spouses have equal wage income and one or both dependent children.

Currently, the size of the regular income tax rate brackets for a married couple filing a joint return is generally twice the regular income tax rate brackets for an unmarried individual filing a single return.

For 2024 and 2025, the size of the various tax brackets for joint filers and qualified surviving spouses remains at 200% of the various tax brackets for individual filers (§1(i)(1)). In fact, for 2025, the married filing jointly income thresholds are exactly double the single thresholds for all but the two highest tax brackets. In other words, the marriage penalty has been effectively eliminated for everyone except married couples earning more than $501,050 ($487,450 in 2024).

> **Comment:** The TCJA, however, left (or increased) other marriage tax penalties such as (1) the tax advantage of head of household filing status, and (2) the impact of a married couple's combined income on SALT and mortgage interest limitations, and taxability of Social Security benefits.

Standard Deduction - §63

Many taxpayers choose to take the standard deduction rather than itemizing deductions such as mortgage interest and charitable contributions. The basic standard deduction varies depending upon a taxpayer's filing status - married filing separately, single, head of household (unmarried taxpayers can file as either single or head of household if qualified), married filing jointly, and surviving spouse. The standard deductions for 2025 and 2024 are:

Filing Status	2025	2024
Married Filing Separately	$15,000	$14,600
Single	$15,000	$14,600
Head of Household	$22,500	$21,900
Married Filing Jointly	$30,000	$29,200
Surviving Spouse	$30,000	$29,200

Note that the standard deduction amount for married filing jointly is twice the amount of those taxpayers filing as single or married filing separately. This marriage penalty relief in the standard deduction amounts is now permanent.

The additional standard deduction for the elderly and blind is increased as follows for 2025:

(1) Unmarried taxpayer: an additional $2,000 – up from $1,950 in 2024 ($4,000 for a taxpayer who is both elderly and blind); *and*

(2) Married taxpayer: an additional $1,600 – up from $1,550 in 2024 ($3,200 for a taxpayer who is both elderly and blind) (§63(f)).

Dependent Limit - §63(c)(5)

The basic standard deduction is limited for an individual taxpayer who *can* be claimed as a dependent by another taxpayer. In 2025, the standard deduction for such an individual (generally the deduction for a single taxpayer, which is $15,000 in 2025), cannot exceed the *greater* of:

(1) $1,350 (up from $1,300 in 2024), *or*

(2) the sum of $450 (up from $400 in 2023) and the individual's earned income (§63(c)(5) & R.P. 2024-40).

> **Note:** For the "kiddie tax" on a child's net unearned income, only the limited amount of basic standard deduction can be used to offset the child's unearned income. However, if the child is blind, the additional standard deduction for blindness can also be used to offset the child's unearned income.

Example

In 2025, Dan is age 17 and has $1,600 of earned income and $500 of interest income. Since his parents can claim him as a dependent, his standard deduction on his own return is $2,050 (the greater of $1,350, or $1,600 earned income plus $450).

Personal & Dependency Exemptions (Suspended) - §151

Formerly, taxpayers could take personal exemptions for themselves and an additional exemption for each eligible dependent. Personal exemptions were allowed for the taxpayer, his or her spouse, and any dependents. However, an individual who qualified as someone else's dependent could not claim a personal exemption. In addition, personal and dependency exemptions were phased out for higher-income taxpayers.

From 2018 through 2025, personal and dependency exemptions (including the exemption phase-out) are suspended (eliminated). Thus, for 2025, the personal exemption amount under §151(d) is $0.

Deemed Personal Exemption for Related Incorporating Provisions

In Notice 2018-70, the IRS announced that the suspension of personal exemptions for taxable years 2018-2025 will *not* be taken into account for purposes of:

(a) determining whether a person is a qualifying relative under §152(d)(1)(B),

(b) the $500 credit for other dependents under §24(h)(4), *and*

(c) head-of-household filing status under §2(b)

Thus, while the §151 dependency exemption deduction is zero from 2018 through 2025, this elimination is not taken into account for qualifying relatives, family credit, and eligibility for head-of-household status purposes. In 2025 for these purposes, the amount is $5,200 (up from $5,050 in 2024).

$500 (Family Tax) Credit for Certain Dependents - §24(h)(4)(A)

For 2018 through 2025, the TJCA creates a $500 nonrefundable credit for certain dependents of a taxpayer other than a qualifying child described in §24(c), for whom the child tax credit is allowed. The $500 credit applies to two categories of dependents:

(a) qualifying children for whom a child tax credit is *not* allowed, *and*

> **Note:** This definition of qualifying child has a number of requirements including age, residency, support, citizenship, joint return, and Social Security Number.

(b) qualifying relatives as defined in §152(d).

> **Note:** A qualifying relative has to meet somewhat similar requirements but, a nonrelative (living with you the entire year) can also qualify.

Taxpayers can claim this credit in addition to the child and dependent care and the earned income credits. However, the credit begins to phase out when the taxpayer's income is above $200,000 or $400,000 for married couples filing a joint tax return.

Limitation on Itemized Deductions (Suspended) - §68

In lieu of taking the applicable standard deductions, an individual may elect to itemize deductions. However, total itemized deductions otherwise allowable were formerly reduced under §68 by 3% of a taxpayer's AGI in excess of specified threshold amounts. For taxable years beginning after 2017 and before 2026, the TCJA suspends (eliminates) this overall limitation on itemized deductions.

Itemized Deductions Subject to 2% Floor (Suspended) - §62

Formerly, itemized deductions for certain miscellaneous expenses could not be deducted unless, in the aggregate, they exceeded 2% of the taxpayer's adjusted gross income (§§62, 67 & 212). However, as a result of the TCJA, all miscellaneous itemized deductions that are subject to the 2% floor are suspended from 2018 through 2025. Thus, taxpayers may not claim such items as itemized deductions for the affected taxable years. An individual also is unable to claim such deductions in calculating his or her AMT liability.

> **Note:** Miscellaneous itemized deductions subject to the 2% floor and now suspended include but, are not limited to (i) expenses for the production or collection of income, (ii) tax preparation expenses, (iii) unreimbursed expenses attributable to the trade or business of being an employee.

Comment: Taxpayers can deduct unreimbursed employee expenses only if they qualify as an Armed Forces reservist, a qualified performing artist, a fee-basis state or local government official, or an employee with impairment-related work expenses.

Earned Income Tax Credit - §32

An earned income tax credit is available to low-income workers who satisfy certain requirements. Many taxpayers claim the EITC, which, unlike most tax breaks, is refundable, meaning that individuals can get it even if they owe no tax and even if no tax is withheld from their paychecks. However, the amount of the EITC varies depending upon the taxpayer's earned income and whether the taxpayer has one, two, more than two, or no qualifying children.

The EITC generally equals a specified percentage of earned income up to a maximum dollar amount. The maximum amount applies over a certain income range and then diminishes to zero over a specified phaseout range.

For taxpayers with earned income (or adjusted gross income ("AGI"), if greater) in excess of the beginning of the phaseout range, the maximum EITC amount is reduced by the phaseout rate multiplied by the amount of earned income (or AGI, if greater) in excess of the beginning of the phaseout range. For taxpayers with earned income (or AGI, if greater) in excess of the end of the phaseout range, no credit is allowed.

In 2024, the earned income base amounts, credit percentages, and phase-out information for married filing jointly were as follows:

Type of Taxpayer	Credit Percentage	Earned Income Amount	Maximum Amount of Credit	Phaseout Percentage	Threshold Phaseout Amount	Completed Phaseout Amount
1 child	34	$12,390	$4,213	15.98	$29,640	$56,004
2 children	40	$17,400	$6,960	21.06	$26,640	$62,688
3+ children	45	$17,400	$7,830	21.06	$29,640	$66,819
No children	7.65	$8,260	$632	7.65	$17,250	$25,511

In 2025, the earned income base amounts, credit percentages, and phase-out information for married filing jointly are as follows:

Type of Taxpayer	Credit Percentage	Earned Income Amount	Maximum Amount of Credit	Phaseout Percentage	Threshold Phaseout Amount	Completed Phaseout Amount
1 child	34	$12,730	$4,328	15.98	$30,470	$57,554
2 children	40	$17,880	$7,152	21.06	$30,470	$64,430
3+ children	45	$17,880	$8,046	21.06	$30,470	$68,675
No children	7.65	$8,490	$649	7.65	$17,730	$26,214

The EITC is a refundable credit, thus if the amount of the credit exceeds the taxpayer's Federal income tax liability, the excess is payable to the taxpayer as a direct transfer payment.

Disqualified (Excessive Investment) Income - §32(i)

An individual is not eligible for the EITC if the aggregate amount of disqualified income of the taxpayer for the taxable year exceeds an indexed threshold. The amount of disqualified income (i.e., investment income) a taxpayer can have before losing the entire earned income tax credit is $11,950 in 2025 (up from $11,600 in 2024).

Means-Tested Programs

The refundable components of the EITC and the child tax credit (§24) do not make households ineligible for means-tested benefit programs and include provisions stating that these tax credits do not count as income in determining eligibility (and benefit levels) in means-tested benefit programs, and also do not count as assets for specified periods of time.

Social Security & Self-Employment Earnings Base

The social security contribution and benefit base for remuneration paid and self-employment income earned in tax years beginning in 2025 is $176,100 (up from $168,600 in 2024). There is no limit on the amount of wages subject to the Medicare tax.

> **Note:** For 2025, the domestic employee coverage threshold, as adjusted for inflation, is $2,800. This reflects an increase from $2,700 for 2024. Earnings below the domestic employee coverage threshold are not taxable under Social Security (§3121).

Standard Mileage Rate

The optional standard mileage rates used in computing the deductible costs paid or incurred, for operating a passenger automobile for business, charitable, medical, or Armed Forces member's moving purposes are:

Year	Business	Mail Carrier	Charitable	Medical/Moving
2025	70	47½	14	21
2024	67	47½	14	21
2023	65.5	47½	14	22
2022	58.5	47½	14	18

Qualified Transportation Fringes

Tax Year	Transit limitation	Parking limitation
2025	$325 ($0 deduction)	$325 ($0 deduction)
2024	$315 ($0 deduction)	$315 ($0 deduction)
2023	$300 ($0 deduction)	$300 ($0 deduction)
2022	$280 ($0 deduction)	$280 ($0 deduction)
2021	$270 ($0 deduction)	$270 ($0 deduction)

2020	$270 ($0 deduction)	$270 ($0 deduction)
2019	$265 ($0 deduction)	$265 ($0 deduction)

Passenger Automobile Depreciation Limits ("CAPS")

	2025	2024	2023	2022	2021	2019-20
1st Year	pending	$12,400	$12,200	$11,200	$10,200	$10,100
2nd Year	pending	$19,800	$19,500	$18,000	$16,400	$16,100
3rd Year	pending	$11,900	$11,700	$10,800	$9,800	$9,700
4th Year	pending	$7,160	$6,960	$6,460	$5,860	$5,600

Expensing Deduction - §179

2025	2024	2023	2022
$1,250,000	$1,220,000	$1,160,000	$1,080,000

Self-Employed Health Insurance Deduction

2003-25	2002	2001	2000	1999	1998	1997
100%	70%	60%	60%	60%	45%	40%

Corporate Income Tax Rates

1993 Through 2017:

Taxable Income Over	Not Over	Tax Rate
$0	$50,000	15%
$50,000	$75,000	25%
$75,000	$100,000	34%
$100,000	$335,000	39%
$335,000	$10,000,000	34%
$10,000,000	$15,000,000	35%
$15,000,000	$18,333,333	38%
$18,333,333	.....	35%

2018 & Later: 21%

Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regard to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

1. The federal tax revenue is comprised of a variety of taxes. However, which of the following is the greatest source of federal revenues?

a. corporate income taxes.

b. estate and gift taxes.

c. individual income taxes.

d. Social Security and other payroll taxes.

2. In 2025, Mary earned $50,000. What is Mary's marginal income tax rate if she files as head of household?

a. 12%.

b. 22%.

c. 24%.

d. 32%.

3. A taxpayer may lose their earned income tax credit if they have disqualified income. In 2025, what was the permissible limit of investment income?

a. $10,000.

b. $11,600.

c. $11,950.

d. $11,000.

4. The standard mileage rate is used to compute the deductible costs for operating the vehicle. For 2024, what mileage rate was used to compute such costs if the automobile was used for charitable purposes?

a. 14.

b. 19.

c. 47½.

d. 50.

Withholding & Estimated Tax

When a taxpayer is an employee, their employer withholds income tax from their pay. Tax may also be withheld from certain other income - including pensions, bonuses, commissions, and gambling winnings. In each case, the amount withheld is paid to the IRS in the taxpayer's name. The amount of income tax withheld depends on two things:

(1) Amount earned, *and*

(2) Information given to the employer on Form W-4.

Estimated tax is used to pay not only income tax but self-employment tax and alternative minimum tax as well.

Estimated Tax - §6654

Estimated tax is the method used to pay tax on income that is not subject to withholding. This includes income from:

(1) Self-employment,

(2) Unemployment compensation,

(3) Interest,

(4) Dividends,

(5) Alimony (before 2019),

(6) Rent,

(7) Gains from the sale of assets,

(8) Prizes, *and*

(9) Awards.

To the extent that tax is not collected through withholding, taxpayers are required to make quarterly estimated payments of tax, the amount of which is determined by reference to the required annual payment.

Taxpayers also may have to pay estimated tax if the amount of income tax being withheld from their salary, pension, or other income is not enough. Form 1040-ES, *Estimated Tax for Individuals,* is used to figure and pay estimated tax.

For 2024 and 2025, the required annual payment is the *lesser* of:

(1) 90% of the tax shown on the return (or 90% of the tax due for the year if no return is filed),

(2) 100% of the tax shown on the return for the prior taxable year (110% if the adjusted gross income for the preceding year exceeds $150,000), or

(3) the annualized income installment (§6654(d)(1)(A)).

> **Note:** If a taxpayer does not receive their income evenly throughout the year, they may be able to figure their estimated tax using the annualized income installment method. Under this method, the required installment for one or more payment periods may be less than one-fourth of the required annual payment.

However, when a taxpayer's adjusted gross income for the prior year exceeds $150,000 ($75,000 for married filing separately) the safe harbor percentage is the lesser of:

(1) 90% of the tax for the current year, *or*

(2) 110% of the tax shown on the return for the prior taxable year.

If an individual anticipates that income tax withheld during the year will be less than 90% of estimated tax liability, then he or she is required to make estimated tax payments equal to 25% of the shortfall by each of the following dates:

(1) April 15,
(2) June 15,
(3) September 15 of the current year, *and*
(4) January 15 of the following year (§6654(d)(1)(B)(i)).

Social Security, Medicare & FUTA (or Payroll) Taxes

Social Security benefits and certain Medicare benefits are financed primarily by payroll taxes on covered wages. These taxes are imposed on both the employer and employee. Sections 3101(a) and 3101(b) impose the *employee* portions of the social security tax and the Medicare tax, respectively. Sections 3111(a) and 3111(b) *impose* the employer portions of the social security tax and the Medicare tax, respectively.

> **Note**: Although the tax obligation is shared between employers and employees, employers have the responsibility for withholding the employee's share from wages and depositing such amounts under §3102 and §3121.

FICA - §3101, §3111 & §3121

The Federal Insurance Contributions Act ("FICA") imposes a tax on *employers* based on the amount of wages paid to an employee during the year (§3111). For 2025 and 2026, the tax *imposed* continued to be composed of two parts:

(1) the old age, survivors, and disability insurance ("OASDI") tax equal to 6.2% of covered wages up to the taxable wage base (§3111(a)); *and*

(2) the Medicare hospital insurance ("HI") tax amount equal to 1.45% of covered wages (§3111(b)).

> **Note:** The term "wages" is defined in §3121(a) for FICA purposes as all remuneration for employment, with certain specific exceptions. Section 3121(b) defines "employment" as any service, of whatever nature, performed by an employee for the person employing him, with certain specific exceptions.

In addition to the tax on employers, each *employee* is subject to FICA taxes *equal* to the amount of tax imposed on the employer (§3101(a) & (b)). The employee tax is collected by deducting the amount of the tax from wages and remitted to the Federal government by the employer (§3202(a)).

SECA - §1401

As a parallel to FICA taxes, the Self-Employment Contributions Act ("SECA") imposes taxes on the net income from self-employment of *self-employed* individuals. Thus, a sole proprietor has to pay self-employment tax (SECA) to cover Social Security and Medicare (§1401). In fact, they are liable for both the employer's and employee's shares of these taxes.

For 2025 and 2024, the rate of the OASDI portion of SECA taxes continued to be equal to the combined employee and employer OASDI FICA tax rates (i.e.,

12.4%) and applies to self-employment income up to the FICA taxable wage base. Similarly, the rate of the HI portion is the same as the combined employer and employee HI rates (i.e., 2.9%) and there is no cap on the amount of self-employment income to which the rate applies.

Wage Base

The social security contribution and benefit base for remuneration paid and self-employment income earned in tax years beginning in 2025 is $176,100 (up from $168,600 in 2024). There is no limit on the amount of wages subject to the Medicare tax.

Additional Hospital Insurance Tax On Certain High-Income Individuals

Because of health care legislation, the *employee* portion of the HI tax has been increased by an additional tax of 0.9% on wages received in excess of a specific threshold amount. However, unlike the general 1.45% HI tax on wages, this additional tax is on the *combined* wages of the employee and the employee's spouse, in the case of a joint return.

> **Note:** The threshold amount is $250,000 in the case of a joint return, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case (unmarried individual, head of household, or surviving spouse).

The increase in withholding starts on the first payroll where wages exceed $200,000. In addition, even if an individual knows they will be above the limit because of their spouse's wages, the additional tax cannot be withheld until their wages reach $200,000. Finally, the tax is imposed on combined wages for joint returns.

> **Note:** There is no employer match for this tax and the threshold is not indexed for inflation.

The same additional HI tax applies to the HI portion of the SECA tax on self-employment income in excess of the threshold amount. Thus, an additional tax of 0.9 percent is imposed on every self-employed individual on self-employment income in excess of the threshold amount.

FUTA - §3301 & §3306

The federal unemployment tax system, along with the state systems, provides unemployment payments to workers who have lost their jobs. Most employers pay both a state and federal unemployment tax. Self-employed persons are not subject to this tax.

For 2025 and 2024, in addition to FICA taxes, employers continue to be subject to a Federal unemployment insurance payroll tax (FUTA) equal to 6% of the total wages of each employee (up to $7,000) on covered employment. However, employers are eligible for a Federal credit equal to 5.4% for State unemployment taxes, yielding a 0.6% effective tax rate.

Employee Retention Credit Audits - §3111

CARES allowed eligible employers to claim a credit against employment taxes imposed on wages paid after March 12, 2020, and before January 1, 2021, to employees with respect to employment and include taxes levied under FICA, FUTA, Federal income tax, and RRTA.

However, amid rising concerns about a flood of improper employee retention credit claims, the IRS has announced moratoriums, withdrawal processes, and voluntary disclosure programs for claims under the pandemic-era relief provision to protect business owners from scams by aggressive promoters. In addition, the IRS has stated that hundreds of criminal cases were being worked, and thousands of ERC claims had been referred for audit.

> **Note:** Those who willfully filed a fraudulent claim, or those who assisted or conspired in such conduct, should be aware that withdrawing a fraudulent claim does not exempt them from potential criminal investigation and prosecution.

The first ERC Voluntary Disclosure Program ended on March 22, 2024 (Announcement 2024-3). Later, in Announcement 2024-30, the IRS announced a second ERC Voluntary Disclosure Program. This second ERC program also included the settlement of the ERC for purposes of a participant's employment tax obligations by eliminating their eligibility for the ERC. However, participants in this second ERC program were allowed to retain 15% of the claimed ERC amount. Participation in the second ERC program was limited to ERC claims filed for the 2021 tax period and for which a credit or refund was received prior to August 15, 2024. This second ERC program ran through November 22, 2024.

> **Note:** The IRS will continue to work on the denial of improper ERC claims pursuing civil and criminal investigations of potential fraud and abuse.

Filing Status

Filing status is a category that identifies a taxpayer based on their marital and family situation. A taxpayer's filing status is an important factor in determining whether they are required to file, the amount of their standard deduction, and the correct amount of tax. Filing status is also important in determining whether deductions and credits may be taken (§6012; §1; §63).

There are *five* basic filing statuses to choose from:

(1) Single,
(2) Married filing jointly,
(3) Married filing separately,
(4) Head of household, *and*
(5) Qualifying widow(er) with dependent child.

Note: There are different tax rates for different filing statuses. If more than one filing status applies, one should choose the status resulting in the lowest tax.

Marital Status

Filing status depends on whether the taxpayer is considered single or married.

Single Taxpayers

A taxpayer is considered single for the whole year if, on the last day of the tax year, they are unmarried or separated from their spouse by a divorce or a separate maintenance decree (Reg. §1.6013-4(a)). State law governs whether a taxpayer is married, divorced, or legally separated under a decree of divorce or separate maintenance.

Comment: Formerly, the Defense of Marriage Act required that for federal purposes a marriage had to be between a man and a woman. This Act was held to be unconstitutional.

Note: If a taxpayer is considered single, they may be able to file as single, head of household, or as a qualifying widow(er) with a dependent child.

Divorced Persons

State law governs whether you are married, divorced, or legally separated under a decree of separate maintenance. If you are divorced under a final decree by the last day of the year, you are considered unmarried for the whole year (Reg. §1.6013-4(a)).

Sham Divorce

If taxpayers obtain a divorce in one year for the sole purpose of filing tax returns as unmarried individuals, and at the time of divorce they intended to remarry and did remarry each other in the next tax year, the taxpayers must file as married individuals (R.R. 76-255).

Annulled Marriages

When a taxpayer obtains a court decree of annulment, which holds that no valid marriage ever existed, and the taxpayer does not remarry, they must file as single or head of household, whichever applies, for that tax year. They must also file amended returns claiming single or head of household status for all tax years affected by the annulment that are not closed by the statute of limitations for filing a tax return. The statute of limitations generally does not expire until 3 years after the original return was filed (Reg. §301.6501(a)-1; Reg. §301.6501(b)-1; R.R. 76-255).

Married Taxpayers

Married taxpayers may file a joint return or separate returns. Taxpayers are considered married for the whole year if on the last day of the tax year, they are either:

(1) Married and living together as husband and wife (Reg. §1.6013-4(a)),

(2) Living together in a common law marriage that is recognized in the state where they now live or in the state where the common law marriage began (R.R. 58-66),

(3) Married and living apart, but not legally separated under a decree of divorce or separate maintenance (§7703(a)(2)-1(a)), *or*

(4) Separated under an interlocutory (not final) decree of divorce (Reg. §1.6013-4(a); R.R. 57-368).

Spouse's Death

When a taxpayer's spouse dies during the year, the surviving taxpayer is considered married for the whole year for filing status purposes (§6013(d)). If the taxpayer has *not* remarried before the end of the tax year, they may file a joint return for themselves and their deceased spouse. In addition, for the next 2 years, the taxpayer may be entitled to the special benefits as a qualifying widow(er) with a dependent child (Reg. §1.2-2(a); Reg. §1.6013-1(d)).

If the taxpayer has remarried before the end of the tax year, they may file a joint return with their new spouse. The deceased spouse's filing status is married filing separately for that year (Reg. §1.6013-1(d)(2)).

Married Persons Living Apart

When a taxpayer lives apart from their spouse and meets certain tests, they may be considered unmarried. Thus, a taxpayer may file as head of household even though not divorced or legally separated. If a taxpayer qualifies to file as head of household instead of as married filing separately, their standard deduction will be higher. In addition, their tax may be lower, and they may be able to claim the earned income credit (§63(c)(2); §7703(b); §32(c); §32(d)).

Filing Jointly

A taxpayer may choose married filing jointly as a filing status if married and both the taxpayer and their spouse agree to file a joint return. On a joint return, married taxpayers report their combined income and deduct their combined allowable expenses (Reg. §1.6013-4(b)).

Note: Both married taxpayers must use the same accounting period, but may use different accounting methods (Reg. §1.6013-1(c)).

Joint Liability

A taxpayer may be held jointly and individually responsible for any tax, interest, and penalties due on a joint return filed before their divorce. This responsibility applies even if the divorce decree states that the former spouse will be responsible for any amounts due on previously filed joint returns (§6013(d); *Pesch*, 78 TC 100).

> **Note:** Under the new equitable relief exception, a factor to be taken into consideration is the written agreement of the parties.

One spouse may be held responsible for all the tax due even though all the income was earned by the other spouse (§6013(d)(3); Reg. §1.6013-4(b)).

> **Note: U**nder certain conditions, if a separate liability election is timely made, liability can be limited to taxes generated by income attributable to that spouse.

Innocent Spouse Exception

The RRA '98 made innocent spouse relief *easier* to obtain. The Act eliminated all understatement thresholds and requires only that the understatement of tax be attributable to an erroneous (and not just a grossly erroneous) item of the other spouse.

A *separate liability election* is provided for a taxpayer who, at the time of the election:

(1) Is *no longer married to*,

(2) Is *legally separated* from, *or*

(3) Has been *living apart for at least 12 months* from,

the person with whom the taxpayer originally filed a joint return (§6015(c)).

Such taxpayers may elect to have the liability for any deficiency limited to the portion of the deficiency that is attributable to items allocable to the taxpayer. The election is not available if the IRS demonstrates that assets were transferred between individuals filing a joint return as part of a fraudulent scheme of the individuals or if both individuals had actual knowledge of the understatement of tax.

Expanded innocent spouse relief and the separate liability election must be elected *no later than two years* after the date on which the IRS has begun collection activities with respect to the individual seeking the relief. The Tax Court has jurisdiction with respect to disputes about innocent spouse relief.

In addition, the IRS is authorized to relieve an individual of liability if relief is not available under the expanded innocent spouse rule or the separate liability election, but it is *inequitable* to hold the individual liable for any unpaid tax or any deficiency (§6015(f), §66(c)).

Innocent Spouse Guidelines

The IRS has issued permanent guidance (R.P. 2003-61) for individuals seeking equitable innocent spouse relief under §§6015(f) or 66(c) and applies to spouses requesting equitable relief for:

(1) Tax liabilities arising after July 22, 1998, *or*

(2) Any unpaid liability arising before that date.

R.P. 2003-61 provides:

(1) Threshold conditions for relief consideration;

(2) Circumstances under which relief will usually be granted; *and*

(3) A partial list of factors for determining whether it would be inequitable to hold an individual liable for a deficiency or unpaid liability.

Under the revenue procedure, the IRS will consider granting equitable relief under §6015(f) if the individual:

(1) Seeks relief for a tax year in which a joint return was filed;

(2) Is ineligible for relief under §§ 6015(b) or (c);

(3) Applies for relief no later than two years after the date the IRS initiates its first collection activity after July 22, 1998;

(4) Did not transfer assets to or receive assets from the nonrequesting spouse as part of a fraudulent scheme;

(5) Did not receive disqualified assets from the nonrequesting spouse; *and*

(6) Did not file the joint return with fraudulent intent.

Additionally, when the individual requests relief, the liability, with two exceptions, must be unpaid.

If the individual meets the threshold requirements, the IRS will ordinarily grant equitable relief under §6015(f) if:

(1) The liability reported on the joint return was unpaid when the return was filed;

(2) When the relief is requested, the individual is no longer married to, or is legally separated from the spouse with whom the joint return was filed;

(3) When the relief is requested, the individual hasn't shared a household with the nonrequesting spouse at any time during the 12-month period preceding their request;

(4) On filing the joint return, the individual didn't know and had no reason to know that the tax wouldn't be paid; *and*

(5) The individual would suffer economic hardship if relief were not granted.

Married individuals who file separate returns in community property states and request relief under §66(c) may qualify for relief, as well as persons who meet the threshold requirements for §6015(f) relief yet would not ordinarily be granted relief under the notice. In determining whether it is inequitable to hold those individuals liable for unpaid liability or deficiency, the IRS will take into account all the facts and circumstances. Factors that the IRS will consider include the individual's marital status; whether they will suffer hardship if relief isn't granted; whether they have suffered spousal abuse, not amounting to duress; and the nonrequesting spouse's legal obligations under a divorce decree or agreement.

The notice also provides factors that weigh against granting relief, including unpaid liability that is attributable to the requestor; the individual's knowledge or reason to know of an unpaid liability; whether the individual has significantly benefited from the unpaid liability; the individual's efforts to comply with federal income tax laws in the tax years following the tax year in which the relief request is made; and the individual's legal obligation to pay the deficiency under a divorce decree or agreement.

To apply for relief under the revenue procedure, interested individuals must file Form 8857, *Request for Innocent Spouse Relief (and Separation of Liability, and Equitable Relief)*. However, the IRS no longer applies the two-year limit on equitable relief requests (Notice 2011-70). Individuals who applied for relief under §§6015(b) or (c) need not file another application for relief under §§6015 or 66(c), as the IRS will review those applications for possible equitable relief.

Tax Court Jurisdiction

The Tax Court has jurisdiction to review the IRS's denial of equitable innocent spouse relief from joint liability even if no deficiency was asserted against the requestor of relief (§6015(e)(1)).

Nonresident Alien

A joint return generally cannot be made if either spouse is a nonresident alien at any time during the tax year. However, if at the end of the year one spouse was a nonresident alien or dual-status alien married to a U.S. citizen or resident, both spouses may choose to file a joint return (§6013(a)(1); §6013(g); §6013(h)).

Filing Separately

A taxpayer may choose married filing separately as a filing status if married. This method may benefit a taxpayer if they want to be responsible only for their own tax or if this method results in less tax than a joint return. If married taxpayers do not agree to file a joint return, they may have to use this filing status.

If a taxpayer lives apart from their spouse and meets certain tests, they may be considered unmarried and file as head of household. This is true even though the taxpayer is not divorced or legally separated. If a taxpayer qualifies to file as head of household, instead of as married filing separately, their tax may be lower, they may be able to claim the earned income credit, and their standard deduction will be higher. In addition, the head of household filing status allows a taxpayer to choose the standard deduction even if their spouse chooses to itemize deductions.

> **Note:** Taxpayers will generally pay more combined tax on separate returns than they would on a joint return because the tax rate is higher for married persons filing separately.

When a taxpayer files a separate return, they report only their own income, credits, and deductions.

> **Note:** Formerly, a taxpayer could file a separate return and claim an exemption for their spouse if the spouse had no gross income and was not a dependent of another person. However, if the spouse had any gross income or was the dependent of someone else, the taxpayer could not claim an exemption for him or her on their separate return (§151(b)). However, personal exemptions are now suspended.

Special Rules

If a taxpayer files a separate return:

(1) Their spouse should itemize deductions if the taxpayer itemized deductions because he or she cannot claim the standard deduction (§63(c)(6)(A));

(2) The taxpayer cannot take the credit for child and dependent care expenses in most instances (§21(e)(2), (4));

(3) The taxpayer cannot take the earned income credit (§32(d));

> **Note:** There are some exceptions to this rule. If you are a separated parent and your qualifying child lived with you for more than six months of the year, you may still qualify for the EITC.

(4) The taxpayer cannot exclude any interest income from series EE U.S. Savings Bonds that might be used for higher education expenses (§135(d)(2));

(5) The taxpayer cannot take the credit for the elderly or the disabled unless they lived apart from their spouse for all of the tax year (§22(e)(1)); *and*

(6) The taxpayer may have to include in income more of their social security benefits (or equivalent railroad retirement benefits) received than on a joint return (§86(c)(3))).

Joint Return after Separate Returns

If a taxpayer or their spouse files a separate return, the taxpayer may change to a joint return any time within 3 years from the due date of the separate return (§6013(b); Reg. §1.6013-2; R.R. 83-183). This does not include any extensions. A separate return includes a return filed by a taxpayer or their spouse claiming married filing separately, single, or head of household filing status. If the amount paid on the separate return is less than the total tax shown on the joint return, the taxpayer must pay the additional tax due on the joint return when filed.

Separate Returns after Joint Return

Once a joint return is filed, a taxpayer cannot choose to file a separate return for that year after the due date of the return (Reg. §1.6013-1(a)(1)).

Exception

A personal representative for a decedent may change from a joint return elected by the surviving spouse to a separate return for the decedent. The personal representative has one year from the due date of the return to make the change (§6013(a)(3); Reg. §1.6013-1(d)(5)).

Head of Household

A taxpayer is able to file as head of household if unmarried or considered unmarried on the last day of the year. In addition, the taxpayer must have paid more than half the cost of keeping up a home for themselves and a *qualifying person* for more than half the year (Reg. §1.2-2(b)(1); Reg. §1.2-2(c)).

Note: The head of household rules changed in 2005 as a result of the Working Family Relief Tax Act of 2004.

Advantages

Filing as head of household has the following advantages:

(1) a taxpayer can claim the standard deduction even if their spouse files a separate return and itemizes deductions;

(2) the standard deduction is higher than is allowed if the taxpayer claimed a filing status of single or married filing separately;

(3) the tax rate usually will be lower than it is if the taxpayer claimed a filing status of single or married filing separately;

(4) the taxpayer may be able to claim certain credits (such as the dependent care credit and the earned income credit) they cannot claim if their filing status were married filing separately; *and*

> **Note:** There are some exceptions to this rule. If you are a separated parent and your qualifying child lived with you for more than six months of the year, you may still qualify for the EITC.

(5) income limits that reduce your child tax credit, retirement savings contributions credit, itemized deductions, and the amount claimed for exemptions will be higher than the income limits if the taxpayer claimed a filing status of married filing separately.

Requirements of §2(b)

A taxpayer is able to file as head of household if he or she:

(1) is unmarried or "considered unmarried" on the last day of the year,

(2) paid more than half the cost of keeping up a home for the year, *and*

(3) had a "qualifying person" live with them in their home for more than half the year (except for temporary absences, such as school).

> **Note:** If the "qualifying person" is your dependent parent, he or she does not have to live with you.

Considered Unmarried

A taxpayer is considered unmarried on the last day of the tax year if they meet all of the following tests:

(1) The taxpayer files a separate return;

(2) The taxpayer paid more than half the cost of keeping up their home for the tax year;

(3) The taxpayer's spouse did not live in the taxpayer's home during the last 6 months of the tax year; *and*

(4) The taxpayer's home was, for more than half the year, the main home of their child, stepchild, adopted child, or foster child whom the taxpayer could claim as a dependent.

> **Note:** A taxpayer can still meet this last test if they *cannot* claim their child as a dependent because they state in writing to the noncustodial parent that he or she may claim an exemption for the child (§7703(b)).

Keeping Up a Home

A taxpayer is keeping up a home only if they pay more than half of the cost of its upkeep (Reg. §1.2-2(d)). Costs include rent, mortgage interest, taxes, insurance on the home, repairs, utilities, and food eaten in the home. Do not include the cost of clothing, education, medical treatment, vacations, life insurance, transportation, or the rental value

of a home. Also, do not include the value of the taxpayer's services or those of a member of the taxpayer's household.

Qualifying Person

A qualifying person can be a child, parent, or relative who meets certain conditions. Each of the following individuals is considered a qualifying person:

(1) a "qualifying child" such as a child (including legally adopted), stepchild, foster child, sibling, half-sibling, step-sibling, or a descendant of any of them under §152(c),

> **Note:** If the taxpayer is a noncustodial parent, the term "qualifying child" for head of household filing status does not include a child who is their qualifying child for exemption purposes only because the custodial parent signs a written declaration that he or she will not claim the child as a dependent for the year. If you are the custodial parent and those rules apply, the child is generally your qualifying child for head of household filing status even though the child is not a qualifying child for whom you can claim an exemption.

(2) a "qualifying relative" other than the taxpayer's mother or father who lives with the taxpayer for more than half the year, and is related in one of the following ways (§152(d)):

Son	Half brother
Daughter	Brother-in-law
Grandparent	Sister-in-law
Brother	Son-in-law
Sister	Daughter-in-law
Stepbrother	Stepsister
Stepmother	If related by blood:
Stepfather	Uncle
Mother-in-law	Aunt
Father-in-law	Nephew
Half-sister	Niece, *and*

> **Note:** Any of these relationships that were established by marriage are not ended by death or divorce.

(3) a "qualifying relative" who is the taxpayer's father or mother for whom an exemption may be claimed (§152(d)).

> **Note:** A taxpayer can be eligible to file as head of household even if their dependent parent does *not* live with them. The taxpayer must pay more than half the cost of keeping up a home that was the main home for the entire year for their father or mother. A taxpayer is keeping up a main home for their dependent father or mother if they pay more than half the cost of keeping their parent in a rest home or home for the elderly (§2(b)(1)(B); R.R. 70-279).

Summary

An individual is considered a head of household if such an individual is not married at the close of the taxable year, is not a surviving spouse, and *either*:

(1) maintains a household that constitutes for more than half of the taxable year the principal abode for:

(a) a "qualifying child" of the individual (under the new unified definition of a qualified child now contained in §152(c) but without regard to §152(e)), but *not* if such child:

(i) is married at the close of the taxpayer's taxable year, *and*

(ii) is not a dependent of such individual by reason of §152(b)(2) or §152(b)(3), or both, *or*

(b) any other person who is a dependent of the taxpayer, *or*

(2) maintains a household that constitutes for the taxable year the principal abode of the father or mother of the taxpayer.

Qualifying Widow(er) With Dependent Child

Taxpayers can be eligible to use qualifying widow(er) with dependent child as their filing status for 2 years following the year of death of their spouse. For example, if a taxpayer's spouse died in 2025, and the taxpayer has not remarried, they may be able to use this filing status for 2026 and 2027.

> **Note:** While this filing status entitles the taxpayer to use joint return tax rates and the highest standard deduction amount, it does not authorize the taxpayer to file a joint return.

To file as a qualifying widow(er) with a dependent child, a taxpayer must meet *all* of the following tests:

(a) The taxpayer was entitled to file a joint return with their spouse for the year their spouse died;

(b) The taxpayer did not remarry before the end of the tax year;

(c) The taxpayer had a child, stepchild, adopted child, or foster child who qualifies as their dependent for the year; *and*

(d) The taxpayer paid more than half the cost of keeping up a home that is the main home for the taxpayer and that child for the entire year, except for temporary absences (Reg. §1.2-2(c)(1)).

Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regard to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

5. Withholding applies to a variety of types of income including pensions, bonuses, and commissions. What other type of income is subject to withholding?

a. gambling winnings.

b. interest.

c. alimony.

d. prizes and awards.

6. Certain taxpayers are required to pay estimated tax on income that is excluded from withholding. How may a taxpayer calculate estimated tax when income is received at irregular intervals throughout the year?

a. using the annualized income installment method.

b. using the income averaging method.

c. using the accrual method.

d. using the seasonal business year method.

7. Based on marital and family factors, filing status determines which deductions and credits an individual may claim. What else is determined by an individual's filing status?

a. refundable child credit.

b. eligibility for Medicare.

c. earned income credit eligibility.

d. the standard deduction amount.

8. A person's filing requirement and correct tax are also determined by his or her filing status. What are the available federal filing statuses for an unmarried taxpayer?

a. separate or individual.

b. single or head of household.

c. single or domestic partner.

d. living together or head of household.

9. When a marriage is annulled, the marriage is held to never have existed. As a result, what must the parties file?

a. amended returns.

b. Form 8379 as injured spouses.

c. a request for innocent spouse relief.

d. a request for abandoned spouse status.

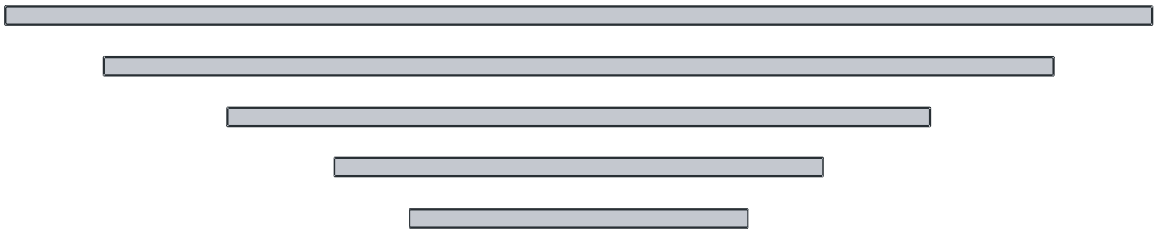
10. Taxpayers may find it desirable to file as head of household. What is an advantage of this filing status?

a. The IRS may not take the nondebtor's tax refunds for another's old debts.

b. The taxpayer may claim the standard deduction regardless of whether deductions are itemized by the spouse on a separate return.

c. The taxpayer takes the same standard deduction allowed on a single or married filing separate return.

d. This filing increases the allowable amount of childcare tax credit.



Gross Income

Section 61 requires that gross income include all income from whatever source derived unless "otherwise provided." The following is a list of items that are specifically included in gross income per §61:

(1) Compensation for services and other benefits,

(2) Gross income derived from business,

(3) Gains derived from dealing in property,

(4) Interest,

(5) Rents,
(6) Royalties,
(7) Dividends,
(8) Alimony and separate maintenance payments (before 2019),
(9) Annuities,
(10) Income from life insurance and endowment contracts,
(11) Pension,
(12) Income from discharge of indebtedness,
(13) Distributive share of partnership gross income,
(14) Income in respect of a decedent, *and*
(15) Income from an interest in an estate or trust.

Compensation

Employee compensation is includible in gross income whether it is cash or other assets. Compensation includes salary, commissions, bonuses, tips, vacation pay, and severance pay.

Note: Unemployment compensation is included in gross income.

Fringe Benefits

In addition to compensation, many employers provide fringe benefits to employees. Unless specifically exempted from taxation by law or the employee pays fair market value for them, the employer must include the value of these fringe benefits in the employee's gross income and withhold income taxes thereon.

The amount includible as compensation is based on the fair market value of the benefits. Reg. §1.61-21(b) requires that gross income include the fair market value of a fringe benefit, less any payments by or on behalf of the recipient and any statutory exclusion.

Rental Income

Rental income is any payment received for the use or occupation of property. Taxpayers must include in gross income all amounts received as rent. In addition to amounts received as normal rent payments, there are other amounts that may be rental income.

Advance Rent

Advance rent is any amount received before the period that it covers. Advance rent is included in income in the year received regardless of the period covered or the method of accounting used.

Example

Dan signs a 10-year lease to rent Ron's property. In the first year, Ron receives $5,000 for the first year's rent and $5,000 as rent for the last year of the lease. Ron must include $10,000 in his income in the first year.

Security Deposits

A security deposit is not included in income if the taxpayer plans to return it to the tenant at the end of the lease. However, if during any year, the taxpayer keeps part or all of the security deposit because their tenant does not live up to the terms of the lease, the amount kept is included in the income for that year.

> **Note:** If an amount called a security deposit is to be used as a final payment of rent, it is advance rent and includible in income when received.

Payment for Canceling a Lease

If a tenant pays a taxpayer to cancel a lease, the amount received is rent. The payment is included in income for the year received regardless of the taxpayer's method of accounting.

Social Security Benefits

A portion of Social Security benefits received *may* be taxable (§86). If the taxpayer's only income received in a tax year was their social security benefits, the benefits are not taxable. If the taxpayer received income other than the social security benefits, a portion of the benefits is taxable if provisional income, which is modified adjusted gross income plus one-half of the net benefits, is greater than a base amount.

> **Note:** Social Security benefits are included in gross income only if the recipient's provisional income exceeds a specified amount, referred to as the "base amount" or "adjusted base amount."

There are *two* tiers of benefit inclusion. A 50% rate is used to figure the taxable part of income that exceeds the base amount but does not exceed the higher adjusted basis amount. An 85% rate is used to figure the taxable part of income that exceeds the adjusted base amount.

Taxability of Benefits – Old & New Blended Application

Here is how this complicated two-tier benefit inclusion system came into being. Prior to 1994, up to 50% of Social Security benefits were subject to income tax when a taxpayer's modified adjusted gross income plus 50% of their social security benefits exceeded:

(1) $25,000 if the taxpayer filed as single, head of household, or qualifying widow(er) with a dependent child,

(2) $25,000 if the taxpayer was married, did not file a joint return, and did not live with their spouse at any time during the year,

(3) $32,000 if the taxpayer was married and filed a joint return, *or*

(4) $-0- if the taxpayer was married, did not file a joint return, and did live with their spouse at any time during the year.

"Modified adjusted gross income" is the *sum* of the taxpayer's adjusted gross income *plus* any tax-exempt interest received. "Adjusted gross income" is figured *without including* any of the taxpayer's social security or equivalent railroad retirement benefits and *without subtracting*:

(1) The interest exclusion for certain Series EE savings bonds redeemed for "qualified educational expenses,"

(2) The foreign earned income exclusion and foreign housing exclusion or deduction,

(3) The exclusion of income from U.S. possessions, *or*

(4) The exclusion of income from Puerto Rico by bona fide residents of Puerto Rico.

OBRA '93 made *up to 85%* of Social Security benefits subject to income tax for taxable years beginning *after December 1, 1993*. However, the *old law* continues to apply to a taxpayer whose modified adjusted gross income plus 50% of their social security benefits *does not exceed* $34,000 for unmarried individuals and $44,000 for married individuals filing joint returns.

For taxpayers whose modified adjusted gross income plus 50% of social security benefits *exceed* these thresholds, gross income includes the *lesser* of:

(l) 85% of the taxpayer's social security benefit, *or*

(2) The *sum* of:

(a) The smaller of

(i) The amount included under the old law; *or*

(ii) $4,500 (for unmarried taxpayers) or $6,000 for married taxpayers filing joint returns (one-half of the difference between the old and new threshold amounts),

Plus,

(b) 85% of the excess of the taxpayer's modified adjusted gross income plus 50% of their social security benefits over the applicable threshold amounts.

For married taxpayers filing separate returns, gross income includes the *lesser* of 85% of the taxpayer's social security benefits or 85% of the taxpayer's modified adjusted gross income plus 50% of their social security benefits.

Note: In addition to this increase in tax on Social Security benefits, Medicaid planning strategies were severely restricted. One of the most popular tools,

the so-called Medicaid Trust is now completely disallowed. Taxpayers who have done "Medicaid planning" now need to have their plans reviewed.

Taxpayers may use the following worksheet to compute the taxable portion of their social security benefits.

Social Security Worksheet

l. Modified adjusted gross income	$_____
2. Social security benefits	$_____
3. 85% of social security benefits	$_____
4. 50% of social security benefits	$_____
5. Sum of lines 1 and 4	$_____
6. Enter $25,000 unmarried, $32,000 married-joint, $0 married separate if living together	$_____
7. Subtract line 6 from line 5 (if $0, benefits are not taxable)	$_____
8. 50% of line 7	$_____
9. Lesser of line 4 or line 8	$_____
10. $4,500 unmarried, $6,000 married-joint	$_____
11. Lesser of lines 9 or 10	$_____
12. Enter $34,000 unmarried, $44,000 married-joint, $0 married separate if living together	$_____
13. Line 5 less line 12	$_____
14. 85% of line 13	$_____
15. Sum of lines 11 and 14	$_____
16. Taxable amount, lesser of lines 3 or 15	$_____

Example

Sharon and Danny, a married couple filing a joint return, have a modified adjusted gross income of $40,000 and receive social security benefits of $10,000. The taxable portion of their social security benefits is $5,850, calculated as follows:

l. Modified adjusted gross income	*$ 40,000*
2. Social security benefits	*$10,000*
3. 85% of social security benefits	*$8,500*
4. 50% of social security benefits	*$5,000*
5. Sum of lines 1 and 4	*$45,000*
6. Enter $25,000 unmarried, $32,000 married-joint, $0 married separate if living together	*$32,000*
7. Subtract line 6 from line 5 (if $0, benefits	

are not taxable)	*$13,000*
8. 50% of line 7	*$6,500*
9. Lesser of line 4 or line 8	*$5,000*
10. $4,500 unmarried, $6,000 married-joint	*$6,000*
11. Lesser of lines 9 or 10	*$5,000*
12. Enter $34,000 unmarried, $44,000 married-joint, $0 married separate if living together	*$44,000*
13. Line 5 less line 12	*$1,000*
14. 85% of line 13	*$850*
15. Sum of lines 11 and 14	*$5,850*
16. Taxable amount, lesser of lines 3 or 15	*$5,850*

Alimony & Spousal Support

The tax treatment of alimony is dependent upon the date of the divorce decree or separation instrument being either pre-2019 or 2019 and later.

For pre-2019 divorces, alimony (sometimes called "spousal support") payments by a separated or divorced spouse to the other spouse are fully deductible. Divorced taxpayers can deduct the cost of §71 qualified alimony payments above the line (§62(13)) while alimony recipients report such payments as taxable income (§71(a) & §215). Thus, alimony or separate maintenance payments are deductible by the payer spouse and includible in the recipient spouse's income if paid under a divorce or separation agreement executed before 2019.

For 2019 and later divorce or separation instruments executed or modified after 2018 (if the modification expressly provides TCJA amendments apply), the deduction for alimony (and separate maintenance) payments and the inclusion of such payments in gross income are repealed. Thus, taxpayers cannot deduct alimony or separate maintenance payments made under a divorce or separation agreement (i) executed after 2018, or (ii) executed before 2019 but later modified if the modification expressly states the repeal of the deduction for alimony payments applies to the modification. Alimony and separate maintenance payments received under such an agreement are not included in the recipient's gross income.

Alimony Restrictions & Requirements

Pre 2019 Decrees

Section 71 formerly provided rules regarding the tax treatment of alimony and separate maintenance payments but was repealed by the TCJA effective for any divorce or separation instrument executed after 2018. Thus, prior to 2019, to qualify as alimony under §71, payments to a

spouse or former spouse had to meet all of the restrictions and requirements:

1. The payment had to be required by a divorce or separation instrument (§71(b)(1)(A)).

> **Note:** An instrument is a judicial decree of divorce or separate maintenance or a decree of temporary support. An instrument also included a written agreement incident to a divorce or written separation agreement (§71(b)(2)).

2. A payment was not deductible to the payor or taxable to the payee if the parties were living together in the same household after being legally divorced (§71(b)(1)(C)).

3. Payments had to cease upon death, and there could not be any liability to make payments after the recipient's death as a substitute for payments stopped at death (§71(b)(1)(D)).

4. Payments had to be in cash (§71(b)(1)).

5. The divorce or separation instrument could not designate the payment as not alimony (§71(b)(1)(B).

6. The payment could not be treated as child support ((§71(c)(1))).

7. The spouses could not file a joint return ((§71(e)).

If all of the above criteria were met, the payments were considered alimony for federal purposes. For states that did not conform to the TCJA (which may still include California), the above §71 rules are still in effect.

2019 & Later Decrees

The TCJA makes the§71 list moot for federal purposes if the divorce or separation instrument was executed in 2019 or later. Alimony includes all payments made to a spouse or former spouse under a divorce decree, maintenance decree, or separation agreement whose purpose is to prevent a drastic decline in quality of living for a lower-earning spouse. Child support and property settlement payments continue not to be considered alimony.

Pre-2019 Recapture

Prior to 2019, if the amount of alimony paid in the first year exceeded the average of the second and third-year payments by more than $15,000, the excess was recaptured in the third year. Also, if second-year payments exceeded third-year payments by more than $15,000, the excess was recaptured in the third year. Recapture made the amount ordinary income to the payor and a deduction to the payee. However, for 2019 and later, recapture will ultimately disappear.

Example

A divorce decree requires Dan to make payments to Ann of $24,000 in 2016 and $1 per year in 2017 and 2018. Payments in year one exceed average payments in the second and third years by $23,999. The excess over $15,000 (i.e., $8,999) is recaptured as income in the third year (i.e., 2018). Thus, Dan has $8,999 of income in 2018, and Ann has an $8,999 deduction.

Child Support

Child support is not taxable to the recipient or the child and is not deductible by the payor. Normally, child support is clearly designated in the instrument as for the support of the child. However, any amount that is reduced upon the happening of a contingency related to the child is *deemed* to be child support.

> **Note:** Section 61(a) says that gross income covers all income from any source except "as otherwise provided." The IRS has stated that the "as otherwise provided" applies specifically to payments related to "the support of children" (PLR 201648001).

Prizes & Awards - §74 & §274

Prizes won through a quiz show, lucky number drawing, beauty contest, etc. must be included in taxable income. In addition, employee cash awards or bonuses given by an employer for good work or suggestions must be included in income when received.

Prizes and awards in goods or services must be included in income at their fair market value. If the taxpayer refuses to accept a prize, it is not included in their income (Reg. §1.74-1(a)(2); R.R. 57-374).

If a salesperson receives “prize points” redeemable for merchandise, which are awarded by a distributor to employees of dealers, they must include their fair market value in income. The “prize points” are taxable in the year they are paid or made available, rather than in the year the taxpayer redeems them for merchandise (R.R. 70-331).

Dividends & Distributions

Dividends are distributions of money, stock, or other property by a corporation. Dividends may also be received through a partnership, an estate, a trust, or an association that is taxed as a corporation. However, some amounts that are called dividends are actually interest income.

Most distributions are paid in cash or by check. However, distributions may be received as additional stock, stock rights, other property, or services.

Ordinary Dividends

Ordinary (taxable) dividends are the most common type of distribution from a corporation. They are paid out of the earnings and profits of a corporation and are ordinary income to the recipient. Most dividends, whether on common or preferred stock, are ordinary dividends unless the paying corporation states otherwise (§316; Reg. §1.316-1(a); §61(a)(7); Reg. §1.61-9).

> **Note:** Since 2003, corporate dividends (defined as "qualified dividends") paid to an individual are no longer taxed at ordinary income rates; rather, they are taxed at the top rates for capital gains.

Money Market Funds

Amounts received from money market funds are reported as dividend income. These amounts generally are not interest income and should not be reported as interest.

Dividends on Capital Stock

Dividends on the capital stock of organizations, such as savings and loan associations, are ordinary dividends. They are not interest (Reg. §1.116-(d)(1)).

Dividends Used to Buy More Stock

A corporation may have a dividend reinvestment plan. Such a plan permits the use of dividends to buy more shares of stock in the corporation instead of receiving the dividends in cash. Members of this type of plan, who use their dividends to buy additional stock at a price equal to its fair market value, must report dividends as income (R.R. 77-149).

Qualified Dividends

Qualified dividends receive special favorable tax treatment. Qualified dividend income received by an individual is taxed at rates substantially lower than ordinary income. Such dividends received by individuals, estates, or trusts are taxed at long-term capital gains rates (§1(h)(11)).

> **Note:** Dividends passed through to investors by a mutual fund or other regulated investment company (RIC), partnership, real estate investment trust (REIT), or held by a common trust fund are also eligible for the reduced rate assuming the distribution would otherwise be qualified dividend income

A 15% rate applies to qualified dividends of taxpayers who are above the 15% tax bracket. Taxpayers in the 10% and 15% tax brackets are subject to a 0% rate. However, for taxpayers in the 37% bracket, the rate on such items is 20% (§1(h)(1)).

"Qualified dividend income" is dividends received from a:

(1) domestic corporation, *or*

(2) qualified foreign corporation.

In the alternative, taxpayers may elect to treat qualified dividend income as investment income under §163(d)(4) (B). A taxpayer makes this election on Form 4952, *Investment Interest Expense Deduction*.

Capital Gain Distributions

Regulated investment companies, mutual funds, and real estate investment trusts pay these distributions or dividends from their net realized long-term capital gains. A Form 1099-DIV or the mutual fund statement will tell the amount recipients are to report as a capital gain distribution.

Capital gain distributions are reported as long-term capital gains regardless of how long the stock in the mutual fund has been owned. Those distributions that are not derived in the ordinary course of a trade or business are treated as portfolio income and are not considered income from a passive activity (§852(b)(3)(B); Reg. §1.852-4(b)(1); Reg. §1.852-4(C); §854(a); §469(e)(1)).

Undistributed Capital Gains

Taxpayers must report as long-term capital gain any amounts that the investment company or mutual fund credited to the taxpayer as capital gain distributions, even though the taxpayer did not actually receive them (Reg. §1.852-4(b)(2); §852(b)(3)(D)).

Form 2439

Taxpayers can take a credit on their return for any tax that the investment company or mutual fund has paid on the undistributed capital gains. The company or fund will send a Form 2439, Notice to Shareholder of Undistributed Long-Term Capital Gains, showing the amount of the undistributed long-term capital gain and the tax that was paid. Take this credit by entering the amount of tax paid and checking the box on line 59, Form 1040. Attach Copy B of Form 2439 to the return (§852(b)(3)(D)(ii); Reg. §1.852-9(c)(2)).

Basis Adjustment

Basis in the stock is increased by the difference between the amount of undistributed capital gain reported and the amount of the tax paid by the fund. Keep Copy C of Form 2439 as part of showing increases in the basis of stock (§852(b)(3)(D)(iii)).

Real Estate Investment Trusts (REITs)

Taxpayers will receive a Form 1099-DIV or similar statement from the REIT showing the capital gain distributions includable in income. Regardless of how long stock in the REIT has been owned, capital gain distribu-

tions are reported as long-term capital gain (§857(b)(3)(B); §857(b)(3)(C)).

Nontaxable Distributions

Taxpayers may receive a return of capital or a tax-free distribution of additional shares of stock or stock rights. These distributions are not treated the same as ordinary dividends or capital gain distributions.

Return of Capital

A return of capital is a distribution that is not paid out of the earnings and profits of a corporation. It is a return of the taxpayer's investment in the stock of the company. Taxpayers should receive a Form 1099-DIV or other statement from the corporation showing what part of the distribution is a return of capital (§301(c)(2); Reg. §1.3011(a)).

Basis Adjustment

A return of capital reduces stock basis and is not taxed until basis in the stock is fully recovered. If a taxpayer buys stock in a corporation in different lots at different times, reduce the basis of the earliest purchases first (Reg. §1.1012-1(c)(1); Reg. §1.1016-5(a)(1)).

When the stock basis has been reduced to zero, report any return of capital received as a capital gain. Whether the gain is reported as a long-term capital gain or short-term capital gain depends on how long the stock has been held (§301(c)(3)).

Example

You bought stock in 2020 for $100. In 2022, you received a return of capital of $80. You did not include this amount in your income, but you reduced the basis of your stock. Your stock now has an adjusted basis of $20. You receive a return of capital of $30 in 2025. You use $20 of this amount to reduce your basis to zero. You report the other $10 as a long-term capital gain for 2025. You must report as a long-term capital gain any return of capital you receive on this stock in later years.

Liquidating Distributions

Liquidating distributions, sometimes called liquidating dividends, are distributions received during a partial or complete liquidation of a corporation. These distributions are, at least in part, one form of a return of capital. They may be paid in one or more installments. Taxpayers will receive a Form 1099-DIV from the corporation showing the amount of the liquidating distribution (§331; Reg. §1.331-1).

Any liquidating distribution received is not taxable until the taxpayer has recovered the basis of their stock. After the stock basis has been reduced to zero, taxpayers must report the liquidating distribution as a capital gain (except in certain instances with regard to collapsible corporations under §341). Whether a taxpayer reports the gain as a long-term capital gain or short-term capital gain depends on how long the stock has been held (§341(a); *Ludorff*, 40 BTA 32).

Distributions of Stock and Stock Rights

Distributions by a corporation of its own stock are commonly known as stock dividends. Stock rights (also known as "stock options") are distributions by a corporation of rights to subscribe to the corporation's stock. Generally, stock dividends and stock rights are not taxable to the recipient and are not reported (§305(a); Reg. §1.305-1(a)).

Taxable Stock Dividends and Stock Rights

Distributions of stock dividends and stock rights are taxable if:

(1) Taxpayer or any other shareholder has the choice to receive cash or other property instead of stock or stock rights (§305(b)(1)),

(2) The distribution gives cash or other property to some shareholders and an increase in the percentage interest in the corporation's assets or earnings and profits to other shareholders (§305(b)(2)),

(3) The distribution is in convertible preferred stock and has the same result as in (2), (§305(b)(5)),

(4) The distribution gives preferred stock to some common stock shareholders and gives common stock to other common stock shareholders (§305(b)(3)), or

(5) The distribution is on preferred stock (§305(b)(4); Reg. §1.305-5(a)).

Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive

any credit you may be seeking with regard to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

11. When a tenant pays a landlord to use or occupy a property, the landlord receives rental income. For income tax purposes, what is the tax treatment of an amount paid by a tenant to a landlord to terminate a lease?

a. a security deposit.

b. advance rent.

c. excludable income.

d. rent.

12. Divorce or separation instruments may define child support payments as being for the support of a child. However, when does federal tax law deem payments to constitute child support?

a. if other payments are patently insufficient to support the child.

b. if they are decreased upon a contingency related to the child**.**

c. if the other spouse waives spousal support.

d. if the spouses execute Form 8332.

Discharge of Debt Income

If a taxpayer's debt is canceled or forgiven, other than as a gift, the taxpayer must include the canceled amount in their gross income (§61(a)(12). A debt includes any indebtedness for which the taxpayer is liable or which attaches to property held by the taxpayer (§108(d)(1); §108(e)(1); §61(a)(12)).

Example

Dan obtained a mortgage loan on his personal residence several years ago at a relatively low rate of interest This year, in return for Dan paying off the loan early, the lending institution cancels a part of the remaining principal. Dan must include the amount canceled in his gross income (R.R. 82-202)

Exceptions from Income Inclusion

Despite the general rule requiring inclusion of canceled debt in gross income, taxpayers do not include a canceled debt in gross income if any of the following situations apply:

1. The cancellation takes place in a bankruptcy case under title 11 of the United States Code (§108(a)(1)(A)).

> **Note:** Income from debt discharged prior to the filing of a bankruptcy does not qualify for this exclusion (and may not be entitled to either the insolvency or farm debt exclusion). Thus, for tax planning purposes, it is important for a debtor who will be involved in bankruptcy to discharge all the debt inside of the bankruptcy proceedings.

2. The cancellation takes place when the taxpayer is insolvent. Here, the amount excluded is not more than the amount by which the taxpayer is insolvent at the moment immediately prior to discharge (§108(a)(1)(B)).

> **Note:** If the taxpayer is insolvent before the cancellation but solvent after the cancellation, income is realized to the extent the transaction makes the taxpayer solvent. The amount of income realized would be equal to the amount by which the fair market value of the taxpayer's assets is more than the liabilities after the cancellation. If the taxpayer is insolvent before the cancellation, and remains insolvent or has no excess of assets over liabilities after the cancellation, no income is realized.

3. The cancellation is a qualified farm debt discharged by an unrelated lender (§108(a)(1)(C)).

4. The cancellation is real property business debt (§108(a)(1)(D)).

5. The debt arises from certain student loans (§108(f)).

> **Note:** For loans discharged after 2020 and before 2026, ARPA excludes from income student loan amounts forgiven for any reason (§108). This exclusion applies to both Federally backed student debt, as well as private student loans provided no services are required.

6. Other circumstances enumerated in §108(e) such as purchase-money debt reduction and cancellation of deductible debt.

Reduction of Tax Attributes

The amount of canceled debt that does not create income must reduce tax attributes by the amount of such canceled debt. Tax attributes include the "basis" of certain assets, net operating losses, general business credit carryovers, minimum tax credits, capital losses, passive activity losses and credits, and foreign tax credit carryovers. Reducing the tax attributes effectively defers the realization of the canceled debt instead of excluding it.

> **Note:** A bankrupt taxpayer may exclude the amount of discharge of indebtedness income that exceeds their tax attributes.

Order of Reductions

Generally, the order for reducing tax attributes is:

(1) Net operating losses,

(2) General business credit carryover,

(3) Alternative minimum tax credits,

(4) Capital losses,

(5) Property basis,

(6) Passive activity loss and credit carryovers, and then

(7) Foreign tax credit carryovers.

The taxpayer may elect to reduce the basis of depreciable property before reducing other tax attributes.

Foreclosure

If the borrower (buyer) of property does not make payments due on a loan secured by property, the lender (mortgagee or creditor) may foreclose on the mortgage or repossess the property. The foreclosure or repossession is treated as a sale or exchange from which the borrower may realize gain or loss. This is true even if the property is voluntarily conveyed to the lender.

The borrower's gain or loss from the foreclosure or repossession is generally figured and reported in the same way as gain or loss from sales or exchanges. The gain or loss is the difference between the borrower's adjusted basis of the transferred property and the amount realized.

> **Note:** The amount realized from a sale or other property disposition includes liabilities "discharged" in the sale or disposition (Reg. §1.1001-2(a)).

Nonrecourse Indebtedness

This rule applies to nonrecourse (i.e. the borrower is not personally liable) debt *regardless* of the fair market value of the property transferred. Thus, even if the property's fair market value at the time of transfer is less than the nonrecourse debt, the total amount of such debt is included in the amount realized when determining the transferor's gain or loss (*Commissioner v. Tufts*, 461 U.S. 300 (1983)).

When the amount realized exceeds the mortgagor's adjusted basis, the taxpayer will recognize gain. If the adjusted basis exceeds the amount realized, then a loss will be recognized.

Example

Dan purchased a new residence for $150,000. He paid $20,000 down and borrowed the remaining $130,000 from the bank. Under state law, Dan is not personally liable for the loan (nonrecourse), but the loan is secured by the home.

Years later, the bank foreclosed on the home because he stopped making loan payments. The balance due after taking into account the payments Dan made was $100,000. The home's fair market value when foreclosed was $90,000. The amount Dan realized on the foreclosure is $100,000. That amount is the debt canceled by the foreclosure, even though he is not personally liable for the loan and the home's fair market value is less than $100,000. Dan figures his gain or loss on the foreclosure by comparing the amount realized ($100,000) with his adjusted basis ($150,000). He, therefore, has a $50,000 nondeductible loss.

Typically, the borrower receives no consideration from the mortgagee other than the application of the proceeds toward the amount of the debt. In such a case, the amount realized by the mortgagor will only include the amount of debt satisfied by the foreclosure.

Note: In a nonrecourse debt, the lending institution only looks to the property for recovery of the mortgage, and cannot additionally look to the borrower's other assets. In effect, the investor never owes more than the fair market value of the asset securing the loan. Therefore, the sales price is the entire nonrecourse debt, even if the fair market value is less than the amount of the loan. The result is there will never be a cancellation of indebtedness income in a nonrecourse debt.

Recourse Indebtedness

If the underlying indebtedness is *recourse* (i.e. the borrower is personally liable), Reg. §1.1001-2(a), Example 8 provides for a different result.

If the fair market value of the property transferred is less than the canceled debt, the amount realized by the owner includes the canceled debt up to the fair market value of the property. The owner is treated as receiving ordinary income from the canceled debt for that part of the canceled debt not included in the amount realized. Such income may be realized, but not recognized by reason of the §108 bankruptcy, insolvency, or qualified farm debt exclusions.

Example

Dan purchases the same new residence (see earlier example) for $150,000, paying $20,000 down and borrowing the remaining $130,000 from the bank. This time Dan is personally liable for the loan (recourse). Years later, when the bank foreclosed, Dan still owed $100,000, but the home was only worth $90,000.

In this case, the amount he realizes is $90,000. This is the amount of the canceled debt ($100,000) up to the home's fair market value ($90,000). He is also treated as receiving ordi-

nary income from cancellation of debt. That income is $10,000 ($100,000 minus $90,000). This is the part of the canceled debt not included in the amount realized. Dan figures his gain or loss on the foreclosure by comparing the amount realized ($90,000) with his adjusted basis ($150,000). He, therefore, has a $60,000 nondeductible loss.

The income from a cancellation of debt is in addition to the gain or loss from the sale or exchange (transfer of property). This ordinary income from the cancellation of debt may arise if:

(1) The borrower is personally liable for repayment of the debt secured by the property transferred to satisfy the debt, *and*

(2) The fair market value (FMV) of the transferred property is less than the amount of canceled debt.

Residential Mortgage Debt Relief - §108

Under §61(a)(12), taxpayers who have mortgage debt canceled or forgiven can be required to pay taxes on that amount as taxable income. However, the Mortgage Debt Relief Act of 2007 (as amended) prevents the taxation of such so-called "shadow income" from foreclosures and canceled debts on qualified principal residence indebtedness by making up to $750,000 of forgiven debt eligible to be excluded from income ($350,000 if married filing separately) (§108(a)(1)(E)) for discharges of indebtedness *before January 1, 2026*.

Qualified principal residence indebtedness is acquisition indebtedness under §163(h)(3)(B) with respect to the taxpayer's principal residence but with a $750,000 limit (down from $2 million) and $375,000 limit (down from $1 million) for married filing separately on taxpayer's principal residence (§108(h)(2)).

Acquisition indebtedness with respect to a principal residence is indebtedness incurred in the acquisition, construction, or substantial improvement of the principal residence of the individual and is secured by the residence. It also includes refinancing of such indebtedness to the extent the amount of the indebtedness resulting from such refinancing does not exceed the amount of the refinanced indebtedness. However, the basis of the individual's principal residence is reduced by the amount excluded from income under the provision.

Note: The exclusion does not apply to the discharge of a loan if the discharge is on account of services performed for the lender or any other factor not directly related to a decline in the value of the residence or to the financial condition of the taxpayer.

Bartering

Bartering is an exchange of property or services. Taxpayers must include in income, at the time received, the fair market value of property or services received in bartering.

If services are exchanged with another person and there is an agreement ahead of time as to the value of the services, that value will be accepted as fair market value unless the value can be shown to be otherwise.

Example

Dan is a self-employed attorney who performs legal services for a client, a small corporation. The corporation gives Dan shares of its stock as payment for his services. Dan must include the fair market value of the shares in income on Schedule C (Form 1040) in the year he received them.

Example

Ralph is a self-employed accountant. Both Ralph and a house painter are members of a barter club. The organization each year gives its members a directory of members and the services each member provides. Members get in touch with each other directly and bargain for the value of the services to be performed. In return for accounting services Ralph provided, the house painter painted his home. Ralph must report as income on Schedule C (Form 1040) the fair market value of the house painting services he received, and the house painter must include in income the fair market value of the accounting services Ralph provided.

Example

Dan is a member of a barter club. The club uses "credit units" as a means of exchange. It adds credit units to his account for goods or services he provides to members, which Dan can use to purchase goods or services offered by other members of the barter club. The club subtracts credit units from Dan's account when he receives goods or services from other members. Dan must include in income the value of credit units that are added to his account, even though Dan may not actually receive goods or services from other members until a later tax year.

Example

Dan owns an apartment building and an artist gives Dan a work of art the artist created in return for 6 months' rent-free use of an apartment. Dan must report as rental income on Schedule E (Form 1040) the fair market value of the artwork, and the artist must report as income on Schedule C (Form 1040) the fair rental value of the apartment.

Barter Exchange

If property or services are exchanged through a barter exchange, taxpayers should receive Form 1099-B, *Statement for Recipients of Proceeds from Broker and Barter Exchange Transactions*, or a similar statement from the barter exchange. The statement should be received by January 31, and it should show the value of cash, property, services, credits, or scrip received from exchanges during the year. The IRS will get a copy of Form 1099-B.

Backup Withholding

Income received from bartering is generally not subject to regular income tax withholding. However, backup withholding will apply in certain circumstances to ensure that income tax is collected on this income (§3406(b)(3)(C).

Under backup withholding, the barter exchange must withhold, as income tax, 24% of the income if:

(i) The taxpayer does not give the barter exchange their identification number (either a social security number or an employer identification number), or

(ii) The IRS notifies the barter exchange that the taxpayer gave it an incorrect identification number.

> **Note:** If a taxpayer joins a barter exchange, they must certify under penalties of perjury that their social security or employer identification number is correct and that they are not subject to backup withholding. If a taxpayer does not make this certification, backup withholding may begin immediately. The barter exchange will give a Form W-9, *Payer's Request for Taxpayer Identification Number and Certification*, or a similar form, to make this certification.

Review Questions

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benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regard to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

13. When must canceled debt be included in a taxpayer's gross income?

a. if the debt is discharged before filing for bankruptcy.

b. if the cancellation is a qualified farm debt by an unrelated lender.

c. if the cancellation is real property business debt.

d. if the debt arises from certain student loans.

14. There are many exceptions to the discharge of indebtedness inclusion rule. However, the use of most of these exceptions requires that the taxpayer:

a. use the amount of the canceled debt to reduce tax attributes.

b. did not file for bankruptcy.

c. is solvent at the time of the cancellation.

d. receive cash management and debt counseling.

15. The reduction of tax attributes must follow a specific order. What should be reduced first when there is nonrecognition of debt discharge income?

a. alternative minimum tax credits.

b. passive activity losses.

c. general business credit carryovers.

d. net operating loss.

16. The foreclosure rules vary for nonrecourse debt and recourse debt. Upon the foreclosure of property subject to a recourse loan, how does the borrower treat the canceled debt?

a. as an amount realized regardless of the property's fair market value.

b. as ordinary income.

c. as an amount realized up to the fair market value of the property.

d. as fully protected by §121.

Recoveries

Recovery is a return of an amount the taxpayer deducted or took a credit for in an earlier year. Generally, part or all of the recovered amounts must be included in income in the year the recovery is received.

The most common recoveries are refunds, reimbursements, and rebates of deductions itemized on Schedule A (Form 1040). Non-itemized deduction recover-

ies include such items as payments received on previously deducted bad debts and recoveries on items previously claimed as a tax credit.

If amounts are recovered that were deducted in a previous year that are attributable to itemized deductions and to non-itemized deductions, recompute taxable income first as shown in the section below on *Non-Itemized Deduction Recoveries* before determining the amount to include in income as shown in the section below on *Itemized Deduction Recoveries*.

> **Note:** Interest on any of the amounts recovered must be reported as interest income in the year received.

Recovery & Expense—Same Year: If the refund or other recovery and the deductible expense occur in the same year, the recovery reduces the deduction and is not reported as income.

> **Note:** Refunds of federal income taxes are not included in income because they are never allowed as a deduction from income.

Recovery Attributable to 2 or More Years: If a refund or other recovery is for amounts paid in 2 or more separate years, the taxpayer must allocate, on a pro-rata basis, the recovered amount between the years in which it was paid.

This allocation is necessary to determine the amount of recovery attributable to any earlier years and to determine the amount, if any, of allowable deduction for this item for the current year.

Example

Dan paid a 2024 estimated state income tax liability of $4,000 in four equal payments. He made his fourth payment in January 2025. Dan had no state income tax withheld during 2024. In 2025, Dan received a $400 tax refund based on his 2024 state income tax return. Dan claimed itemized deductions each year on his federal income tax return.

Dan must allocate the $400 refund between 2024 and 2025, the years in which he paid the tax on which the refund is based. Since Dan paid 75% ($3,000 divided by $4,000) of the estimated tax in 2024, 75% of the $400 refund, or $300, is for amounts Dan paid in 2024 and is a recovery item. If all of the $300 is a taxable recovery item, Dan will include $300 on Form 1040, for 2025, and attach a copy of his computation showing why the amount is less than the amount shown on Form 1099-G, Statement for Recipients of Certain Government Payments, Dan received from the state.

The balance ($100) of the $400 refund is for his January 2025 estimated tax payment. When Dan figures his deduction for state and local income taxes paid during 2025, he will reduce the $1,000 paid in January by $100. His deduction for state and local income taxes paid during 2025 will include the January net amount of $900 ($1,000 minus $100), plus any estimated state income taxes paid in 2024 for 2025, any state income tax withheld during 2025, and any tax paid with his state income tax return filed in 2025.

Itemized Deduction Recoveries

If any amount is recovered that was deducted in an earlier year on Schedule A (Form 1040), the taxpayer must determine how much, if any, of the recovery to include in income[1]. To determine if amounts deducted in 2024 and recovered in 2025 must be included in income, the taxpayer must know the standard deduction for their filing status in 2024.

> **Note:** If a state or local income tax refund (or credit or offset) is received in 2024, the taxpayer may receive Form 1099-G from the payer of the refund by January 31, 2025. The IRS will receive a copy of Form 1099-G.

Example

In 2024, Dan filed his income tax return on Form 1040. In 2025, Dan received a refund from his 2024 state income tax. Dan does not report any of the refund as income because he did not itemize deductions in 2024.

Recovery Limited to Deduction

The amount included in income is limited to the *lesser* of:

(i) the amount deducted on Schedule A (Form 1040), or

(ii) the amount recovered.

Thus, any recovery amount that exceeds the amount deducted in the earlier year is not included in income.

Example

In 2024, you paid $1,200 for medical expenses. From this amount, you subtracted $1,000, which was 7.5% of your adjusted gross income. Your taxable income for 2024 was $79,000. Your actual medical expense deduction was $200. In 2025, you receive a $500 reimbursement from your medical insurance for your 2024 expenses. The only amount of the $500 reimbursement that must be included in your income in 2025 is $200 - the amount actually deducted.

Recoveries Included in Income

Amounts deducted will be included in income if:

[1] If the taxpayer did not itemize deductions in the year for which they received the recovery, they do not include any of the recovery amount in income.

(i) The recoveries are equal to or less than the amount by which itemized deductions exceeded the standard deduction for the filing status in the earlier year, *and*

(ii) Taxable income in the earlier year was zero or more[2].

However, under the tax benefit rule, recoveries included in income will not be more than the amount deducted.

Non-Itemized Deduction Recoveries

If amounts recovered are due to both itemized deductions and non-itemized deductions taken in the same year, the taxpayer must determine the amounts to include in income as follows:

(a) Figure the non-itemized recoveries,

(b) Add the non-itemized recoveries to taxable income, *and then*

(c) Figure itemized recoveries.

This order is required because taxable income will change and the taxpayer must use taxable income to figure their itemized recoveries.

Amounts Recovered for Credits

If a recovery is received in the current tax year for an item claimed as a tax credit in an earlier year, the current tax year's tax must be increased to the extent the credit reduced tax in the earlier year. There is a recovery if there is a downward price adjustment or similar adjustment on the item for which a credit was claimed.

Tax Benefit Rule

If an amount is recovered that the taxpayer deducted or took a credit for in an earlier year, include the recovery in income only to the extent the deduction or credit reduced tax in the earlier year.

If a deduction reduced taxable income but did not reduce tax because the taxpayer either was subject to the alternative minimum tax or had tax credits that reduced tax to zero, they will need to recompute the earlier year's tax to determine whether they can exclude the recovery amount from income.

Children's Income - §63, §73 & §6012

Children have the same return-filing obligations as any other individual and must file a return if their income exceeds certain threshold amounts for earned and/or unearned income (§6012(a)(1)(C)). Thus, a child with sufficient income must file a return (or a parent or guardian must do so on the child's behalf) and pay the tax liability (Reg. §1.6012-1(a)(4)).

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[2] If taxable income was a negative amount, reduce the includable recovery by the negative amount.

Note: While a child is responsible for filing his or her own tax return, the parent or guardian must file a required return if the minor fails to do so (§6201(c)).

Threshold amounts: A dependent must file a return if he or she has either:

(1) *unearned* income exceeding $1,350 in 2025 (up from $1,300 in 2024) plus any additional standard deduction allowed to the blind, *or*

(2) *gross* income exceeding the basic standard deduction applicable under §63(c)(5).

Under §63(c)(5), a dependent's standard deduction cannot exceed the *greater* of:

(1) $1,350 in 2025 ($1,300 in 2024) plus any additional standard deduction allowed to blind; *or*

(2) the sum of their earned income plus $450 (in 2024 & 2025) but not more than the regular standard deduction amount §63(c)(5)).

Earned Income - §73

A child with earned income in excess of the filing threshold is a separate taxpayer who must file an individual return and is generally taxed as a single taxpayer (§73). Earned income includes wages, salaries, fees, and other compensation for personal services (§911(d)(2)).

A child is generally taxed as a single person on earned income, and the amounts earned are reported on the child's tax return (Reg. §1.73-1(c)). A child's *earned* income is not treated as the parent's income and is not part of the parent's gross income (Reg. §1.73-1(a)). However, any business expenditures made by a parent or child attributable to the child's personal service income are considered paid by the child (§73(b)).

This is true even though the income is paid to the parent rather than the child, and even if under state law such income may be the property of the parent rather than the child. However, if a parent agrees to do a job, and puts the child to work on the job but does not pay the child a salary, the income is taxed to the parent, not to the child. The rationale is that the third party contracted with the parent, not the child to do the work.

While a child can itemize, if they can be claimed as a dependent on another taxpayer's return, their standard deduction cannot exceed the *greater* of (i) $1,350 in 2025 ($1,300 in 2024) plus any additional standard deduction allowed to blind; or (ii) the sum of their earned income plus $450 in 2024 and 2025 (§63(c)(5)).

Unearned Income

A child with *unearned* income exceeding $1,350 in 2025 (up from $1,300 in 2024) plus any additional standard deduction allowed to blind is typically required to file a tax return (§6012(a)(1)(A) & §63(c)(5)(A)). Unearned income includes investment-type income, such as taxable interest, ordinary

dividends, capital gain distributions, and cancellation of indebtedness income.

"Kiddie" Tax - §1(g)

A child's *net* unearned income (commonly called investment income) is taxed at the *greater* of the child's normal tax rate or the parents' tax rate (§1(g)). Form 8615 is used to figure this "kiddie" tax.

> **Child's Normal Tax Rate:** Formerly, the TCJA applied ordinary and capital gains rates applicable to trusts and estates to the net unearned income of a child. However, the Secure Act retroactively repealed this TCJA Kiddie Tax rate change and reinstated the pre-TCJA kiddie tax calculation.

A child's net unearned income under the kiddie tax is that part of AGI not attributable to earned income, reduced by:

(1) $1,350 in 2025 (up from $1,300 in 2024) - the amount of a dependent's basic standard deduction (§63(c)(5)); *plus*

(2) the *greater* of:

(a) the dependent's basic standard deduction ($1,350 in 2025), or

(b) the child's allowable itemized deductions connected to the production of the unearned income (§1(g)(4)(A)).

A child who reports the kiddie tax on his or her own return calculates the tax on Form 8615, *Tax for Certain Children Who Have Unearned Income* and attaches it to Form 1040.

When the kiddie tax applies, the child's tax is the *greater* of:

(1) the tax on all of the child's income, *or*

(2) the sum of:

(a) the tax imposed on the child's taxable income reduced by net unearned income, plus

(b) the child's share of the allocable parental tax (§1(g)(1)).

> **Note:** The allocable parental tax is the increase in the parent's tax liability resulting from adding to the parent's taxable income the net unearned income of the child (§1(g)(3)(A) & §1(g)(2)).

Application, Threshold & Impact

The "kiddie" tax will tax a portion of a child's normal investment income at the parent's rate when the child:

(1) has *not* attained age 18 before the close of the taxable year;

(2) has attained age 18 (but not 19) before the close of the taxable year and does not have earned income that was more than half of the child's support, or

(3) is a full-time student over age 18 and under age 24 at the end of the year and does not have earned income that is more than half of the child's support (§1(g)(2)).

For 2025, the standard deduction for a dependent cannot exceed the greater of $1,350 ($1,300 in 2024), or the sum of $450 and the dependent's earned income. This impacts the application of the "kiddie" tax and the result is that the unearned income of a child is taxed in three tiers:

(1) first, up to $1,350 ($1,300 in 2024) is not taxed because of the child's allowed standard deduction;

(2) next, amounts in excess of $1,350 ($1,300 in 2024) up to twice that amount ($2,700 in 2025) are taxed at the child's own normal rate (application of capital gains rates applicable to trusts and estates to child's normal rate was repealed by SECURE Act); *and*

> **Note:** As a result, the "kiddie" tax is said to have an application threshold of twice the dependent standard limitation of $1,350 (in 2025), or $2,700 (in 2025).

(3) finally, what remained is taxed at the parent's allocable rate.

Example

In 2025, Dan's daughter, Ann, was 18 and had $6,000 unearned income, no earned income, and no itemized deductions. Her allowable standard deduction would be $1,350, which when applied against her unearned income, brought it to $4,650. The next $1,350 of unearned income was taxed at Ann's individual tax rate. The remaining $3,300 of her unearned income was subject to the kiddie tax and, taxed at Dan's tax rate.

Election to Report on Parents' Return - §1(g)(7)(A) [Form 8814]

Parents can elect, by attaching Form 8814 to their return, to include a child's unearned income in their return and the child will *not* be required to file a separate return if:

(1) The child is under age 19 (or under age 24 if a full-time student) at the end of the year;

(2) The child's gross income for the tax year is more than $1,350 and less than 13,500 in 2025 (up from $1,300 and $13,000 in 2024);

(3) The child's income consists solely of interest and dividends;

(4) The child is required to file a return unless this election was made;

(5) The child does not file a joint return for the year;

(6) No estimated tax payments were made for the year in the name and TIN of the child; *and*

(7) No backup withholding has been made (§1(g)(7)(A)).

While the election simplifies filing, it results in a higher tax for the family unit. Since the electing parents increased their income by the amount of the child's investment income above $2,700 in 2025 (up from $2,600 in 2024) (§1(g)(7)(B)(i)), their adjusted gross income is increased affecting such other tax items as:

(1) The amount of permissible deductions above the floor on deductible medical expenses,

(2) The former 2% floor on miscellaneous itemized deductions,

(3) The former 10% floor on non-business casualty losses,

(4) The phase-out of the deduction for former personal exemptions,

(5) The reduction of allowable itemized deductions, *and*

(6) Eligibility to make deductible IRA contributions.

Election Situations

1. Filing status of parents

a. If parents file a *joint* return for the year, the tentative tax is computed using the *total* taxable income for both parents.

b. If parents are married and file *separate* returns, the tentative tax is computed using the return of the parent with the *greater* income.

c. If parents are divorced, the tentative tax is computed using the income of the parent who has *custody* of the child.

Example

Peter is twelve years old and last year his uncle Dan gave him bonds that generated interest income of $5,000 in 2025. Peter's parents are divorced and he lives with his mother, Pat. Pat must pay income tax on $2,300 ($5,000 minus $2,700) of the interest income.

d. If the parent who has custody of the child remarried, the tentative tax is computed using the *total* income of that parent *and* his or her new spouse.

2. More than one child

a. Net investment income for all children is added together to compute the tentative tax at the parents' rate.

b. The tentative tax is then allocated to each child based on the ratio of each child's net investment income to net investment income for all the children.

3. Recomputation of Tax

The child's tax liability has to be re-computed if:

(i) The parent's taxable income is subsequently adjusted, or

(ii) More than one child used the parent's taxable income and a subsequent adjustment is made to any child's net investment income.

4. Information to compute tentative tax

If the child (or the child's representative) is unable to obtain the necessary information directly from the parent, the child can, upon written request to the IRS, obtain sufficient information regarding the parent's return to properly prepare the child's tax return.

5. Capital Losses

A child's capital losses are taken into account in determining the child's investment income. Capital losses are first applied against capital gains; if the capital losses are more than the capital gains, the difference is a net capital loss. Net capital losses (up to $3,000) were then subtracted.

6. Alternative Minimum Tax

The net unearned income of a child that is taxed at the parent's rate is subject to alternative minimum tax in an amount no less than the minimum tax that the parents would have paid on the income.

In the following examples, assume that the child was 18 and had at least one parent alive at the end of 2025.

Example 1

The child has the following income:

Dividends	*600*
Wages	*2,300*
Taxable interest income	*1,200*
Tax-exempt interest income	*100*
Net capital gains	*300*

Investment income would be $2,100, which is the total of the dividends ($600), taxable interest income ($1,200), and net capital gains ($300).

Example 2

The child has investment income of $16,000 and an early withdrawal penalty of $100. Itemized deductions of $1,100 (net of the former 2% floor) are directly connected with the production of her investment income. The net investment income is $13,550 determined as follows:

Total investment income	*16,000*
Less:	
Adjustments to income attributable	

to investment income	*(100)*
$1,100 deduction	*(1,100)*
Greater of $1,350 or itemized deductions directly connected with the production of investment income	*(1,350)*
Net investment income	*13,450*

Definitions

Child - The term "child" includes a legally adopted child or stepchild, regardless of whether the child is a dependent. A child is considered to be 19 on the day *before* his or her 20th birthday.

Student - A student is a child who during any part of 5 calendar months of the year is enrolled as a full-time student at a school, or took a full-time, on-farm training course given by a school or a state, county, or local government agency. A school includes a technical, trade, or mechanical school. It does not include an on-the-job training course, correspondence school, or school offering courses only through the Internet.

Investment Income - Investment income includes all taxable income other than salaries, wages, professional fees, and amounts received as pay for work actually done. A child's investment income includes investment income produced by property given as gifts to the child under the Uniform Gifts to Minors Act or Uniform Transfers to Minors Act.

Examples of investment income include:

(1) Interest, dividend, and capital gains,

(2) Income from property received as gifts or inheritances,

(3) Certain distributions from trusts, *and*

(4) The taxable portion of social security benefits.

Net Investment Income - Net investment income is the total investment income reduced by the sum of the following items:

(1) Adjustments to income attributable to investment income (such as a penalty for early withdrawal of savings),

(2) $1,350 in 2025 (up from $1,300 in 2024), *and*

(3) The greater of $1,350 in 2025 (up from $1,300 in 2024) or the child's itemized deductions that were directly connected with the production of investment income (§1(g)).

Directly-Connected Itemized Deductions - Directly-connected itemized deductions are those expenses paid to produce or collect income or to manage, conserve, or maintain income producing property that are in excess of the 2% limit on miscellaneous itemized deductions. These expenses include cus-

todial fees, service charges, and investment counsel fees. However, from 2018 through 2025 itemized deductions are suspended.

AMT Exemption for Children - §59(j)

A child whose tax is figured on Form 8615 can be subject to the alternative minimum tax if he or she has certain items given preferential treatment under the tax law. These items include accelerated depreciation and certain tax-exempt interest income. The AMT can also apply if the child has passive activity losses or certain distributions from estates or trusts.

For taxable years beginning in 2025, for a child to whom the §1(g) "kiddie tax" applied, the exemption amount under §§55 and 59(j) for purposes of the alternative minimum tax under § 55 may not exceed the sum of:

(1) the child's earned income for the taxable year, *plus*

(2) $9,550 – up from $9,250 in 2024 (R.P. 2024-40).

Exclusions from Income

Many exclusions are provided in §101 through §137, in addition to other sections scattered throughout the Code. Often, there is a reason for each exclusion. Some prevent double taxation, others provide incentives for certain activities, and others provide indirect welfare payments.

Educational Savings Bonds - §135

A tax exemption is provided for interest on U.S. savings bonds used to finance the higher education of taxpayers, their spouses, or their dependents (§135). If the redemption proceeds (principal and interest) exceed the educational expenses, only a prorata portion of the interest will qualify.

Income Exclusion

Section 135 allows a taxpayer to exclude from gross income the interest earned on certain Series EE U.S. savings bonds that are redeemed to pay qualified higher education expenses. The interest exclusion does not apply to married taxpayers filing separately. The exclusion only applies to bonds issued:

(i) After December 31, 1989, *and*

(ii) To an individual who is at least 24 years old.

> **Comment:** The exclusion is only available to a purchaser who is also the owner of the bonds. The only exception is for bonds owned jointly with a spouse or bonds purchased by one spouse and owned by the other. Thus, bonds purchased by a parent and put in the child's name don't qualify nor do bonds bought by a grandparent even if put in the parent's name.

Phase Out Limitation

For 2025, the amount of the interest exclusion is phased out (gradually reduced) if your filing status is married filing jointly or qualifying widow(er) and your modified adjusted gross income (MAGI) is between $149,250 (up from $145,200 in 2024) and $179,250 (up from $175,200 in 2024). You cannot take the deduction if your MAGI is $179,250 or more in 2025.

For all other filing statuses in 2025, the interest exclusion is phased out if your MAGI is between $99,500 (up from $96,800 in 2024) and $114,500 (up from $111,800 in 2024). You cannot take a deduction if your MAGI is $114,500 in 2025 or more (R.P. 2024-40).

MAGI

Modified adjusted gross income is adjusted gross income without regard to the income earned abroad exclusion (§911) and the §931 and §933 exclusions, but after the application of the partial inclusion of Social Security benefits under §86, the limitation of passive activity losses and credits, and adjustments for contributions to retirement savings (§219).

Notice 90-7

In Notice 90-7, the IRS issued guidance on educational savings bonds. To be eligible for the exclusion, the bonds must be issued in the name of the taxpayer or in the names of the taxpayer and his or her spouse. A taxpayer who buys a qualified bond may designate any individual, including a child, as a beneficiary of the bond payable on death.

Education Expenses

Qualified higher education expenses are limited to tuition and required fees at eligible educational institutions, not including room and board. The amount of qualified expenses must be reduced by scholarships, fellowships, veteran benefits, and other tax-exempt educational benefits.

Excludable Interest

The amount of *excludable interest* is proportionate to the part of the redemption proceeds used to pay qualified expenses during the same tax year as the redemption.

Forms 8818 & 8815

Form 8818 is used to record the serial number, date of issue, face value, cost, and redemption proceeds when the bonds are redeemed. Taxpayers will need the information in Form 8818 to fill out Form 8815, which is used to figure the amount of interest that can be excluded from income.

Scholarships & Fellowships - §117

An amount received as a qualified scholarship is not included in gross income if it is granted to a degree candidate at an "educational organization." Only a candidate for a degree may exclude amounts received as a qualified scholarship from income (§117).

Definitions

Scholarship - A scholarship is an amount to aid a student at an educational institution in the pursuit of studies.

Educational institution - An educational institution is one that normally maintains a regular faculty and course of study and has a regularly enrolled body of students in attendance.

Fellowship grant - A fellowship grant is an amount to aid a person in the pursuit of study or research.

Qualified scholarship- A qualified scholarship is any amount received that is used according to the conditions of the grant for:

(a) Tuition to enroll in or attend an educational institution, *and*

(b) Fees, books, supplies, and equipment required for courses at the educational institution.

Note: Amounts used for room and board do not qualify.

Work Learning Service Programs - §117(c)(2)(C)

Section 117 now exempts from gross income any payments from a comprehensive student work-learning-service program (as defined in §448(e) of the Higher Education Act of 1965) operated by a work college. Specifically, a work college must require resident students to participate in a work-learning-service program that is an integral and stated part of the institution's educational philosophy and program.

Scholarship Prizes

Scholarship prizes won in a contest are not scholarships or fellowships if the recipient does not have to use the prizes for educational purposes. Recipients must include these amounts in their gross income whether or not used for educational purposes (R.R. 65-58; R.R. 68-20).

Education Expenses

*Where education expenses are those of a qualified performing artist or are reimbursed by the employer, deductible education expenses are fully deducted as an adjustment to gross income. Otherwise, education expenses would be itemized deductions that (except for impairment-related work expenses) are miscellaneous itemized deductions subject to the 2% AGI limitation and disallowed under the TCJA through 2025.

Education Assistance Programs - §127

When certain requirements are satisfied, up to $5,250 (this amount has remained unchanged since 2002) annually of educational assistance provided by an employer to an employee is excludable from gross income for income tax purposes and from wages for employment tax purposes (§127 & §3121(a)(18)). This exclusion applies to both graduate and undergraduate courses.

> **Note:** CARES temporarily added to the educational payments excluded from employee gross income, "eligible student loan repayments." However, CAA extended the exclusion for loan repayments through 2025.

Employer Educational Trusts - §83

Where an employer contributes to a trust for the purpose of paying the expenses of the employees' children attending school, the employee includes this benefit in income under the restricted property rules. Thus, the amount would be taxable to the employee when it is either transferable by the employee or not subject to a substantial risk of forfeiture.

Qualified Tuition Programs (QTP) - §529

A qualified tuition program (QTP), also referred to as a §529 plan, is a program established and maintained by a state, or an agency or instrumentality of a state. This program allows a contributor to either prepay a beneficiary's qualified higher education expenses at an eligible educational institution or to contribute to an account for paying those expenses. While contributions to a QTP are not deductible, a distribution from a QTP can be excluded from income if the amount distributed is used for higher education.

The TCJA modified §529 plans to allow such plans to distribute not more than $10,000 in expenses for tuition incurred during the taxable year in connection with the enrollment or attendance of the designated beneficiary at a public, private, or religious *elementary or secondary school*. This limitation applies on a per-student basis, rather than a per-account basis.

> **Note:** Thus, under the provision, although an individual may be the designated beneficiary of multiple accounts, that individual may receive a maximum of $10,000 in distributions free of tax, regardless of whether the funds are distributed from multiple accounts.

Any excess distributions received by the individual are treated as a distribution subject to tax under the general rules of §529. The TCJA also modified the definition of higher education expenses to include certain expenses incurred in connection with registered apprenticeships, homeschooling, and up to $10,000 of qualified student loan repayments (including those for siblings).

Gift & Inheritance Exclusion - §2503

Gifts and inheritances are generally excluded from the gross income of the recipient (§102(a)). The donor's motive determines whether a gift has been made. The motive must be of "detached and disinterested generosity" and the gift must be made "out of affection, respect, admiration, charity or like impulses" (*Commissioner v Duberstein* (1960) 363 US 278).

The gift transfer must have the following elements:

(i) A donor who is competent to make the gift,

(ii) A donee that is able to receive the gift,

(iii) A clear intent by the donor to make the gift, *and*

(iv) A vesting of legal title in the donee, without the donor's power of revocation.

> **Note:** However, federal gift tax applies when a taxpayer gives more than the annual exclusion amount ($19,000 in 2025) to a single recipient in a year or when cumulative gifts exceed the lifetime estate and gift exemption ($13.99 in 2025). If you exceed the annual exclusion amount, you must file Form 709 to report the gift, but you won't owe gift tax unless you've also exceeded your lifetime exemption.

The exclusion for inheritances applies to property actually received under a will or through intestate succession as well as any other property received that is referable to such inheritance. Will contest settlements are excluded inheritances. A bequest in consideration of *past services*, however, is taxable income. Executor's fees are income, but an executor who waives his fees is not taxed on the value of his services even though he is also a legatee (R.R. 66-167).

> **Note:** However, inheritances are subject to federal estate tax when the total value of the deceased person's estate exceeds the applicable exclusion ($13.99 in 2025).

Subsequent Income - §61

Although property transferred as a gift or inheritance is excluded from gross income, the income subsequently earned by the property is includible in the recipient's gross income (§102(b)(1)). When a gift or inheritance is merely of future income, then all such income is taxable to the recipient (§102(b)(2)).

Divorce - §1041

A transfer of property incident to a divorce to a spouse or former spouse is treated as a tax-free gift. The transfer is incident to a divorce if it occurs within one year after the parties cease to be married or if it is related to the divorce (§1041(c)).

Business Gifts - §274(b)(1)

The deduction for business gifts is limited to $25 per person per year. This does not include advertising gifts each costing $4 or less with the taxpayer's

name on them or any promotional material used in the recipient's place of business (§274(b)(1) & Reg. §1.274-3).

Nominal Transfers to Employees - §132(e)

Transfers of property by an employer to an employee rarely qualify as gifts. However, §132(e) permits holiday gifts to employees where the property is of low fair market value. This would include the cost of turkeys, hams, or other merchandise of nominal value distributed on holidays in order to promote employee goodwill.

Insurance - §101(a)

Amounts paid under an insurance contract by reason of an insured's death are excluded from gross income (§101(a)). Life insurance proceeds are excluded regardless of who paid the premiums. Moreover, the exclusion applies regardless of whether the proceeds are paid to the insured's estate, family, creditors, or to the partnership or corporation of which the insured was a member (Reg. §1.101(a)).

The Code does not define life insurance, however, the Supreme Court has indicated that life insurance involves "risk-shifting and risk-distributing" (*Helvering v. Le Gierse*, 312 U.S. 531 (1941)). Thus, when a contract does not shift any risk of premature death to the insurance company, it is not life insurance (R.R. 65-57).

Exceptions

Purchase for Value Inclusion - §101(a)(2)

The exclusion for life insurance does not cover the purchase of an existing policy for consideration (§101(a)(2)). However, this exception does not apply if the purchaser is the insured himself or herself, his or her partner or partnership, or a corporation in which the insured is a member or officer.

Example

Dan owns a policy on his own life and sells it to Bambi, the gold digger. Bambi pays the future premium payments. Dan now dies. The proceeds are taxed to Bambi, except Bambi can recover her basis in the policy - i.e., the purchase price plus subsequent premiums (§101(a)(2)).

Installment Payments - §61

When the death benefits are payable by the insurer in installments, and the unpaid balance bears interest, that portion of the installment representing interest is taxable. The balance is exempt (§101(c) & (d)).

To determine the excluded part, divide the amount held by the insurance company (generally the total lump sum payable at the death of the insured person) by the number of installments to be paid. Include anything over this excluded part in income as interest.

Specified Number of Installments

If a taxpayer is entitled to receive a specified number of installments under the insurance contract, figure the excluded part of each installment by dividing the amount held by the insurance company by the number of installments to which the taxpayer is entitled[3].

Example

The face amount of the policy is $75,000, and as beneficiary, Dan chooses to receive 120 monthly installments of $1,000 each. The excluded part of each installment is $625 a month ($75,000 divided by 120) or $7,500 for an entire year. The rest of each payment, $375 a month (or $4,500 for an entire year), is interest income.

Specified Amount Payable

If each installment received under the insurance contract is a specific amount, figure the excluded part of each installment by dividing the amount held by the insurance company by the number of installments necessary to use up the principal and guaranteed interest in the contract.

Example

As beneficiary, Dan chooses to receive $40,000 of proceeds in 10 annual installments of $4,000 plus $400 of guaranteed interest each year. During the year Dan receives $4,400. He can exclude from gross income $4,000 ($40,000 divided by 10) as a return of principal. The rest of the installment, $400, is taxable as interest income.

Installments for Life

If, as the beneficiary under an insurance contract, a taxpayer is entitled to receive the proceeds in installments for the rest of their life without a refund or period-certain guarantee, figure the excluded part of each installment by dividing the amount held by the insurance company by

[3] A secondary beneficiary is entitled to the same exclusion.

the taxpayer's life expectancy. If there is a refund or period-certain guarantee, the amount held by the insurance company for this purpose is reduced by the actuarial value of the guarantee.

Personal Injury Awards - §104

Damages received on account of personal injury or illness are tax-free under §104. Damages received because of a physical injury or sickness, or in an action based on a claim that is attributable to a physical injury or sickness, are treated as payments for physical injury or sickness under §104.

> **Note:** Those damages are excluded from income even if the person receiving the damages is not the person injured.
>
> **Comment:** The facts and circumstances surrounding each settlement payment must be considered to determine the purpose for which the money was received because not all amounts received from a settlement are exempt from taxes. In short, what was the settlement (and its corresponding payments) intended to replace?

There are three main categories of damages related to personal injuries:

(1) Damages on account of personal injury or illness,

(2) Punitive damages, *and*

(3) Interest on a personal injury award.

Personal Injury

If you receive a settlement for personal physical injuries or physical sickness and did not take an itemized deduction for medical expenses related to the injury or sickness in prior years, the full amount is non-taxable. However, the exclusion under §104 is available only if there is physical injury or illness. Damage recoveries for *nonphysical* injuries are included in income.

> **Comment:** The statute does not define the term "personal injury," so much controversy surrounds the taxation of this type of compensation.
>
> **Note:** Taxpayers must include in income that portion of a settlement that is for medical expenses they deducted in any prior year(s) to the extent the deduction(s) provided a tax benefit.

Emotional Distress or Mental Anguish

The proceeds received for emotional distress or mental anguish attributable to a physical injury or physical sickness are treated as excludable from income under §104. However, when the proceeds received for emotional distress or mental anguish do not originate from a personal physical injury or physical sickness, they must be included in income.

> **Comment:** The amount included in income is reduced by (i) amounts paid for medical expenses attributable to emotional distress or mental anguish not previously deducted and (ii) previously deducted medical expenses for such distress and anguish that did not provide a tax benefit.

In short, emotional distress by itself is not considered a physical injury or physical sickness. However, damages awarded for a claim of emotional distress that results from a physical injury are excluded from income.

Lost Wages or Lost Profits

If a taxpayer receives a settlement in an employment-related lawsuit, the portion of the proceeds that is for lost wages (i.e., severance pay, back pay, front pay) is taxable wages and subject to the social security wage base and social security and Medicare tax rates in effect in the year paid.

Likewise, if a taxpayer receives a settlement for lost profits from their trade or business, the portion of the proceeds attributable to the carrying on of your trade or business is net earnings subject to self-employment tax. These proceeds are taxable and should be included in business income.

Punitive Damages

Punitive damages are meant to punish the defendant for their actions and deter them from engaging in similar conduct again and may be awarded in a personal injury lawsuit. However, all punitive damages for personal injury or sickness are *includable* income, whether or not related to a physical injury or physical sickness.

Interest on a Personal Injury Award

Interest on a personal injury award is taxable. This includes interest added by the court onto a judgment, as well as interest accrued when the defendant delays payment. This is true even if the award itself is tax-free, interest on it is viewed as income and taxed.

Tax Benefit Rule - §111

Income attributable to the recovery of an amount deducted in a prior year is not included in gross income to the extent such amount did not reduce the tax owed by the taxpayer (§111). The recovery is included in gross income only to the extent that the taxpayer received a tax benefit.

Interest on State & Local Obligations - §103

Section 103, enables the federal government to subsidize state and local governments by excluding interest earned on the state and local obligations from tax. Thus, state and local governments can offer a lower interest rate, since investors require a lower yield on tax-free investments than they do on taxable investments.

Foreign Earned Income Exclusion - §911

Worldwide income of a U.S. citizen is subject to U.S. tax. In addition, a foreign country can tax foreign income. Without any relief, the income could be subjected to double taxation. The Code provides two relief provisions:

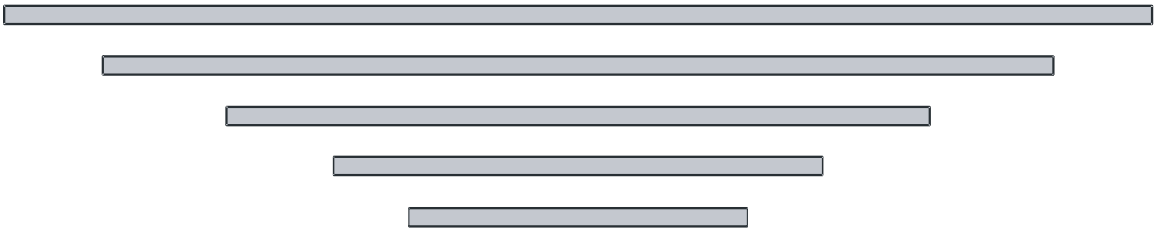
(1) The *foreign tax credit*, which allows a taxpayer to claim a credit against U.S. taxes for foreign taxes paid, *and*

(2) The *foreign-earned income exclusion*, which allows a taxpayer to exclude foreign-earned income.

Foreign earned income is compensation from personal services rendered in a foreign country during periods while the bona fide residence or 330-day test is satisfied. Section 911 requires that the bona fide resident status must be for an uninterrupted period that includes a full year.

For 2025, this foreign earned income exclusion amount under §911 is $130,000 (up from $126,500 in 2024) or $356 per day (R.P. 2024-40). A foreign housing exclusion is allowed in addition to the foreign-earned income exclusion. This foreign housing cost exclusion is 16% (but, for most locations, not to exceed 30%) of the maximum exclusion amount (i.e., $130,000 in 2025) divided by 365 (366 if a leap year), then multiplied by the number of days in the qualifying period that fall within the tax year (R.P. 2024-40).

> **Note:** If the foreign-earned income exclusion is elected, the foreign tax credit cannot be claimed for the foreign tax allocated to the excluded income.



Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regard to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions

and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

17. Deductions for items taken in earlier years but later recovered typically must be included in income in the year of the recovery. However, the required recomputation of income is complex and must be ordered based upon:

a. the filing status of the taxpayer.

b. the regular and alternative minimum tax.

c. the reduction in tax attribute rules.

d. whether the deductions were itemized or non-itemized.

18. As a result of the "kiddie" tax, parents will likely shift fewer income-producing assets to their children. The reasoning for this is that their children's net unearned income can be taxed at the greater of:

a. the child's highest tax rate or the parents' lowest tax rate.

b. the child's alternative minimum tax rate or the parents' regular tax rate.

c. the normal tax rate for the child or the tax rate of the parents.

d. the child's tax rate for the previous year or the parents' tax rate for the current year.

19. Section 117 scholarships granted to qualified students are tax-free to the extent they are used to cover qualified expenses. For example, scholarship income could be used to pay for:

a. required books.

b. research or clerical help.

c. room and board.

d. travel.

20. A §529 qualified tuition program is an investment vehicle allowing individuals to make contributions to accounts for a beneficiary's qualified educational expenses. What rule applies when qualified higher education expenses are paid using a distribution from a qualified tuition program?

a. The contributions are deductible to the contributor at that time.

b. The distribution is free from income tax.

c. The earnings portion is subject to a 10% additional tax.

d. The entire distribution is includible in the beneficiary's income.

21. A number of items are identified in the course material as exclusions from income. Which of the following is one such item?

a. wages and salary.

b. inheritances.

c. IRA distributions.

d. royalties.

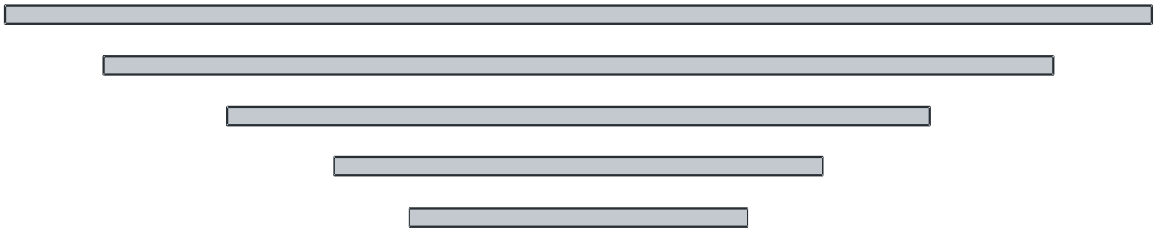
22. Section 104 covers the tax treatment of personal injury awards. Regardless of the recovery method, how are damages for personal injuries treated?

a. They are included in taxable income.

b. They are entitled to installment reporting and treatment.

c. They are excluded from gross income.

d. They are subjected to the alternative minimum tax.



Nonbusiness & Personal Deductions

The income tax is a tax on *net* rather than gross income. Thus, after gross income is determined deductions from income must be calculated.

There are three categories of deductions:

(1) Deductions related to a *trade or business*, including an employee's business-related expenses (§162);

(2) *Nonbusiness* deductions related to investments and to the production of nonbusiness income (§212); *and*

(3) *Personal* deductions specifically provided for by the Code.

> **Note:** Nonbusiness and personal deductions are deductible even though they have no connection to a trade or business.

Deductions are either:

(1) "Above the line" deductions, which are deducted from gross income, *or*

(2) "Below the line" deductions, which are deducted from adjusted gross income (AGI).

Section 62 lists the following "above the line" deductions available to arrive at AGI:

(1) Trade and business deductions;

(2) Reimbursed employee deductions and certain expenses of performing artists;

(3) Losses from the sale or exchange of property;

(4) Deduction attributable to rents and royalties;

(5) Certain deduction of life tenants and income beneficiaries of property;

(6) Pension, profit-sharing, and annuity plans of self-employed individuals;

(7) Retirement savings;

(8) Certain portion of lump-sum distributions from pension plans taxed under §402(e);

(9) Penalties forfeited because of premature withdrawal of funds from time-saving accounts or deposits;

(10) Alimony (prior to 2019);

(11) Reforestation expenses;

(12) Certain required repayments of supplemental unemployment compensation benefits;

(13) Jury duty pay remitted to an employer;

(14) Deduction for clean-fuel vehicles and certain refueling property; *and*

(15) Moving expenses (now suspended from 2018 through 2025) allowed as a deduction under §217.

Itemized Deductions

Taxpayers may choose to claim itemized deductions or the standard deduction. If total itemized deductions are more than the standard deduction, itemize deductions. Taxpayers can benefit from itemizing deductions on Schedule A of Form 1040 if they:

(1) Do not qualify for the standard deduction, or the amount they can claim is limited,

(2) Had large (i.e., in excess of 7.5% of AGI) uninsured medical and dental expenses during the year,

(3) Paid interest and taxes on their home,

(4) Had large unreimbursed employee business expenses or other miscellaneous deductions,

> **Note:** Unreimbursed employee business expenses, even if they exceed 2% of AGI, are disallowed (suspended) until 2026.

(5) Had large casualty or theft losses not covered by insurance,

> **Note:** From 2018 through 2025, the deduction for personal casualty losses is suspended (repealed).

(6) Had large moving expenses,

> **Note:** From 2018 through 2025, the deduction for moving expenses for taxable years is suspended (repealed).

(7) Made large contributions to qualified charities, *or*

(8) Have total itemized deductions that are more than the highest standard deduction to which they otherwise are entitled.

> **Note:** From 2018 through 2025, all miscellaneous itemized deductions that are subject to the 2% floor of §67 are suspended.

Limitation on Itemized Deductions Suspended - §68

In lieu of taking the applicable standard deductions, an individual may elect to itemize deductions. However, total itemized deductions otherwise allowable were formerly reduced under §68 by 3% of a taxpayer's AGI in excess of specified threshold amounts. For taxable years beginning after 2017 and before 2026, the TCJA suspends (eliminates) this overall limitation on itemized deductions.

Personal & Dependency Exemptions Suspended - §151

Formerly, taxpayers could take personal exemptions for themselves and an additional exemption for each eligible dependent. Personal exemptions were allowed for the taxpayer, his or her spouse, and any dependents. However, an individual who qualified as someone else's dependent could not claim a personal exemption. In addition, personal and dependency exemptions were phased out for higher-income taxpayers.

From 2018 through 2025, personal and dependency exemptions (including the exemption phase-out) are suspended (eliminated). Thus, for 2025, the personal exemption amount under §151(d) is $0.

> **Comment:** In Notice 2018-70, the IRS held that the suspension of personal exemptions will *not* be taken into account for purposes of (i) determining whether a person is a qualifying relative under §152(d)(1)(B), (ii) the $500 credit for other dependents under §24(h)(4), *and* (iii) head-of-household filing status under §2(b). In 2025 for these purposes, the amount is $5,200 (up from $5,050 in 2024).

Former Personal Exemptions

Taxpayers were allowed one exemption for themselves (unless they could be claimed as a dependent by another taxpayer) and, if married, one exemption for their spouse (§151(d)(2)). These were called personal exemptions.

If another was entitled to claim the taxpayer as a dependent, the taxpayer could not take an exemption for himself or herself. This was true even if the other taxpayer did not actually claim the exemption (§151(d)(2)).

Former Dependency Exemptions

Taxpayers were allowed one exemption for each person they could claim as a *dependent* (§151(c)). A dependent was defined as any person who met all the dependency tests. These tests varied over the years, at first emphasizing

support and later principal place of abode. However, with the current suspension of dependency exemptions such tests have become moot.

Former Phaseout of Exemptions

In the past, personal and dependency exemptions were phased out for higher-income taxpayers. However, from 2018 through 2025, the TCJA now suspends (eliminates) the personal exemption phase-out.

Interest Expense - §163

The tax law creates several categories of interest expense including:

1. *Personal interest* - Personal interest is nondeductible and thus, the least desirable type of interest.

2. *Investment interest expense* - Deductions for investment interest are limited to net investment income. However, amounts disallowed are carried forward to future years.

3. *Interest expense attributable to passive activities* - Deductions related to passive activities are limited by complex passive loss rules. However, amounts disallowed are carried forward to future years (§469).

4. *Qualified residence interest* - Home mortgage interest is one of the most popular types of interest. In general, it is fully deductible subject to certain ceiling limitations.

5. *Business interest* - Business interest is attributable to a trade or business and is generally deductible(§162).

Personal Interest - §163(h)(1)

Definition

Personal interest is all interest *other* than:

(a) Interest on trade or business debt (other than the trade or business of being an employee),

(b) Qualified residence interest,

(c) Investment interest,

(d) Interest considered in computing income or loss from a passive activity, *and*

(e) Interest on estate tax payments deferred because reversionary interest or closely held business interest is included in the estate.

Deductibility

Personal interest is not deductible. Examples of personal interest include:

(a) interest on a loan to purchase a car for personal use,

(b) interest on individual income taxes, *and*

Note: Personal interest is also not deductible for alternative minimum tax purposes.

(c**)** interest on credit cards used for personal expenses

Comment: There are a few situations where personal interest is tax-deductible, including if the taxpayer uses the loan for qualified educational costs or an eligible mortgage.

Investment Interest - §163(d)

If a taxpayer borrows money to buy property for investment purposes, any interest paid on that borrowed money becomes investment interest. A noncorporate taxpayer can deduct investment interest to the extent of net investment income (§163(d)).

Note: This is despite the suspension, from 2018 through 2025, of all miscellaneous itemized deductions (including investment fees and expenses) subject to the 2% AGI limit of §67.

However, interest incurred for an investment in a §469 passive activity (i.e., one in which the taxpayer is deemed not to materially participate) does not qualify for the investment interest deduction unless, in some cases, the activity generates portfolio income (e.g., interest or dividends).

Definitions

Investment interest includes**:**

(1) Interest expense incurred on indebtedness to purchase or carry property held for investment, including any amount allowable as a deduction in connection with personal property used in a short sale,

(2) Interest allocable to portfolio income under the passive loss rules, and

(3) Interest allocable to an activity involving a trade or business, in which the taxpayer does not materially participate, if not treated as passive under the passive loss rule.

Note: Investment interest does not include qualified residence interest or interest taken into account in applying the passive activity loss rules.

Net investment income is the excess of investment income over investment expenses.

Investment income is the gross income from property held for investment, including any gain attributable to the disposition of property held for investment, but only to the extent the gross income is not derived from the conduct of a trade or business.

Investment income also includes gross portfolio income under the passive loss rule and income from trade or business activities in which the taxpayer does not materially participate if the activities are not treated as passive under the passive loss rule.

Note: The amount of passive loss allowed for rental real estate activity in which the taxpayer actively participates does not reduce investment income.

Investment expenses are deductible expenses, other than interest, directly connected with the production of investment income.

Net Investment Income Limitation

Investment interest is deductible to the extent of net investment income. Investment interest expense disallowed is carried forward to subsequent years. However, investment interest expense carried forward can be deducted only against net investment income.

Note: Formerly, investment interest expense was deductible to the extent of net investment income plus $10,000 ($5,000 for marrieds filing separately). This additional $10,000 allowance has been phased out.

For purposes of the alternative minimum tax, investment interest expense is also deductible only to the extent of net investment income.

Qualified Residence (or Mortgage) Interest - §163(h)(3) [Form 8598]

Qualified residence (or mortgage) interest includes interest and points paid on a loan secured by the taxpayer's main home or a second home. A main home is where a taxpayer lives most of the time. A second home can include any other residence taxpayer owns and chooses to treat as a second home.

Over the years, Congress created (and modified) numerous rules dealing with interest expense paid on personal residences. Nevertheless, qualified residence interest is exempt from the limitations on personal, investment, and passive activity interest and is deductible as an itemized deduction subject to certain restrictions (§163(h)).

Definitions

A *qualified residence* is the taxpayer's principal residence and/or a second residence selected by the taxpayer for the taxable year. The taxpayer must own the home in order for it to qualify. A home can include a house, cooperative apartment, condominium, house trailer, or boat, provided it includes basic living accommodations, including sleeping space, toilet, and cooking facilities.

A *principal residence* is a residence that would qualify for nonrecognition of gain on an old rollover sale (§1034 - now repealed). The taxpayer cannot have more than one principal residence at one time.

A *second residence* is one that is not occupied, occupied part of the year, or rented out during the year. If the home was rented out during the year, it may qualify if the taxpayer uses the home the greater of 14 days or 10% of the number of days during the year that it was rented at a fair rental. If the home was not rented out during the year, there is no usage requirement and the home can be considered a second residence.

If the taxpayer has more than one residence that would qualify as a second residence, the taxpayer can select which home will be a qualified second residence. This selection is made each year without regard to the home selected as a second residence in prior years. Generally, a taxpayer cannot elect different residences as the second residence at different times of the same tax year.

Qualified residence interest is interest on debt that is secured by the taxpayer's principal residence or second residence subject to certain limitations. In most states, the security must be recorded.

Limitations

Qualified residence interest includes *acquisition* indebtedness on a taxpayer's principal and second residences. It can also include home *equity* indebtedness but only if the proceeds are used to buy, build, or substantially improve the taxpayer's qualified home and do not exceed the permissible aggregate acquisition indebtedness.

Note: Amounts not deductible as qualified residence interest due to the limitations imposed are generally treated as personal interest. Form 8598 is used to calculate amounts deductible as qualified residence interest.

Acquisition Indebtedness Modified

Acquisition indebtedness is debt incurred in acquiring, constructing, or substantially improving principal or second residences. For 2018 through 2025, aggregate acquisition indebtedness cannot exceed $750,000 ($375,000 for marrieds filing separately). Acquisition indebtedness is reduced as payments of principal are made and cannot be increased by refinancing. However, if a taxpayer refinances the acquisition indebtedness, the new debt is considered acquisition indebtedness to the extent of the old debt immediately before refinancing.

Comment: In the case of acquisition indebtedness incurred before December 15, 2017, this limitation is $1,000,000 ($500,000 in the case of married taxpayers filing separately). However, this limit is reduced (but not below zero) by the amount of any grandfathered debt. Debt over this limit may qualify as home equity debt. For taxable years beginning after 2026, a taxpayer may again treat up to $1,000,000 ($500,000 in the case of married taxpayers filing separately) of indebtedness as acquisition indebtedness, regardless of when the indebtedness was incurred.

Home Equity Loan

A home equity loan is a loan that allows a taxpayer to borrow against the equity in their residence. The taxpayer typically receives a lump-sum payment and repays the loan with interest over a predetermined term.

Comment: Formally, if a loan was taken out for reasons other than to buy, build, or substantially improve a home, it might have qualified as home equity debt. Home equity indebtedness was debt other than acquisition indebtedness secured by a qualified residence. Interest on home equity indebtedness was deductible regardless of the use of the proceeds. The aggregate amount of debt treated as home equity indebtedness could not exceed $100,000 ($50,000 for marrieds filing separately).

From 2018 through 2025, a taxpayer may not claim a deduction for interest on a home equity loan *unless* it is used to buy, build, or substantially improve the taxpayer's qualified home that secures the loan. However, even if the loan is used to build or improve a qualified home, it cannot exceed the $750,000 limit when aggregated with other such loans or acquisition debt.

Example

In January 2024, a taxpayer takes out a $500,000 mortgage to purchase a main home with a fair market value of $800,000. In February 2025, the taxpayer took out a $250,000 home equity loan to put an addition on the main home. Both loans are secured by the main home and the total does not exceed the cost of the home. Because the total amount of both loans does not exceed $750,000, all of the interest paid on the loans is deductible. However, if the taxpayer used the home equity loan proceeds for personal expenses, such as paying off student loans and credit cards, then the interest on the home equity loan would not be deductible.

Refinancing

If a taxpayer takes out a loan that qualifies as acquisition debt and, subsequently, takes out a second loan, which is used to refinance the first loan, the second loan will qualify as acquisition indebtedness up to the amount of the first loan.

Home Improvements

Expenses that qualify as home improvements can be used to determine the amount of interest deductible as acquisition indebtedness. Generally, an improvement to the home adds to the value of the home, prolongs its useful life, or adapts it to new uses.

Examples of Improvements*:*

(1) Putting a recreation room in an unfinished basement,

(2) Paneling a den,

(3) Adding a bathroom or bedroom,

(4) Putting decorative grillwork on a balcony,

(5) Putting up a fence,
(6) Putting in new plumbing or wiring,
(7) Putting in new cabinets,
(8) Putting on a new roof, *and*
(9) Paving a driveway.

The taxpayer should save all receipts and other records for any improvements, additions, and other items that affect the basis of the home for at least three years after the home is sold or disposed of. In fact, it is a wise practice to permanently retain records dealing with a property's basis.

Timing – 24 Months or 90 Days

Debt incurred before the date the improvement is completed may be treated as acquisition indebtedness for the amount of expenditures for the improvements that are made not more than twenty-four months after the date of the debt.

Debt incurred after the improvement is completed may be treated as acquisition indebtedness if it is taken out within ninety days after completion. Additionally, the debt can only be for improvement costs that are made within twenty-four months before the completion of the improvement. Debt is generally considered incurred on the date that loan proceeds are disbursed.

Example

Over a period of four months, you make a substantial improvement to your residence, paying cash. Within ninety days after completion, you take out a mortgage loan in the amount of the cost of the improvement. The loan qualifies as acquisition indebtedness.

Example

You begin building a home using $150,000 of your own funds. Prior to the completion of construction, you take out a mortgage loan of $150,000 and keep the money. The loan is treated as incurred to construct a residence and qualifies for treatment as acquisition indebtedness.

Alternative Minimum Tax Co-ordination - §55

For alternative minimum tax purposes, the term "qualified housing interest" is substituted for "qualified residence interest." Qualifying housing

interest is interest on a secured debt that is incurred for the purpose of acquiring, constructing, or substantially rehabilitating the taxpayer's residence or a qualified second residence. The qualified second residence must be used as a dwelling by the taxpayer or a member of the taxpayer's family.

Points - §461

Points that are in the nature of an additional interest charge constitute prepaid interest. As such, they must be capitalized by a cash-basis taxpayer and deducted ratably over the term of the loan if incurred in a business transaction, the same as if the taxpayer were on the accrual basis (§461(g)(1)).

Points charged for specific services by the lender for the borrower's account are *not* interest. Examples of fees for services *not* considered interest are:

(i) Lender's appraisal fee,

(ii) Preparation costs for the mortgage note or deed of trust,

(iii) Settlement fees, *and*

(iv) Notary fees.

Points charged for services for getting a Department of Veterans Affairs (VA) or Federal Housing Administration (FHA) loan are not interest.

> **Note:** The term "points" is also used to describe loan placement fees that the seller may have to pay to the lender to arrange financing for the buyer. The seller may not deduct these amounts as interest. However, these charges are a selling expense that reduces the amount realized.

Home Purchase & Improvement Exception

Points can be currently deductible as home mortgage interest if paid on indebtedness incurred in connection with the purchase or improvement of the taxpayer's principal residence, provided the indebtedness is secured by the residence and meets certain criteria (tests).

> **Note:** Points paid to refinance an existing home mortgage are incurred for the purpose of repaying an existing indebtedness, not to purchase or improve a home. Such points do not qualify.

To meet this exception taxpayer must meet all of the following tests:

(1) The loan must be secured by taxpayer's main home (i.e., the one lived in most of the time);

(2) Paying points is an established business practice in the area where the loan was made;

(3) The points paid were not more than the points generally charged in that area;

(4) Taxpayer uses the cash method of accounting;

(5) The points were not paid in place of amounts that ordinarily are stated separately on the settlement statement, such as appraisal fees, inspection fees, title fees, attorneys fees, and property taxes;

(6) The funds provided by taxpayer at or before closing, plus any points the seller paid, were at least as much as the points charged;

(7) The loan proceeds are used to buy or build the taxpayer's main home;

(8) The points were computed as a percentage of the principal amount of the mortgage; *and*

(9) The amount is clearly shown on the settlement statement as points for the mortgage.

If a taxpayer meets all of these tests, they can choose to either fully deduct the points in the year paid, or deduct them over the life of the loan.

Refinancing

Generally, points paid to refinance a mortgage are not deductible in full in the year paid. This is true even if the new mortgage is secured by the main home.

However, if the taxpayer uses part of the refinance mortgage proceeds to improve their main home and meet the first six tests set forth above, they can fully deduct the part of the points related to the improvement in the year they paid them with their own funds. The rest of the points can be deducted over the life of the loan.

Huntsman Case

In *Huntsman*, 905 F. 2d 1182 (8th Cir. 1990), the Eighth Circuit held that points on an acquisition-related home *refinance* loan, obtained three years after the purchase of the home, could be deducted.

Note: In February 1991, the IRS issued an action on decision stating that because an inter-circuit conflict did not exist it would not appeal Huntsman. However, the Service also said it won't follow the holding outside of the Eighth Circuit (which covers Arkansas, Iowa, Minnesota, Missouri, Nebraska, and North, and South Dakota).

Mortgage Interest Statement – Form 1098

If a taxpayer paid $600 or more of mortgage interest (including certain points) during the year on any one mortgage, they generally will receive a Form 1098**,** *Mortgage Interest Statement,* or a similar statement from the mortgage holder. A taxpayer will receive the statement if they paid interest to a person (including a financial institution or a cooperative housing corporation) in the course of that person's trade or business. A governmental unit is a person for purposes of furnishing the statement.

Note: The statement should be received for each year by January 31 of the following year. A copy of this form will also be sent to the IRS. This statement will show the total interest paid during the year. If a main home was purchased during the year, it will also show the deductible points paid during the year, including seller-paid points.

Business Interest - §163(j)

Business interest generally is allowed as a deduction in the taxable year in which the interest is paid or accrued, subject to a number of limitations. For example, limitations on interest expense exist for certain amounts paid in connection with insurance and annuity contracts, while other disallowances exist with respect to interest payments between related taxpayers. Other limitations on the deductibility of interest expense, in general, exist to disallow certain amounts of interest paid in connection with tax-exempt interest, passive interest, investment interest, and qualified residence interest.

For 2018 and later, in the case of any taxpayer for any taxable year, the deduction for business interest is limited to the sum of:

(1) business interest income;

(2) 30% of the adjusted taxable income of the taxpayer for the taxable year; *and*

(3) the floor plan financing interest of the taxpayer for the taxable year (§163(j)).

The amount of any business interest not allowed as a deduction for any taxable year may be carried forward indefinitely, treating business interest as allowed as a deduction on a first-in, first-out basis.

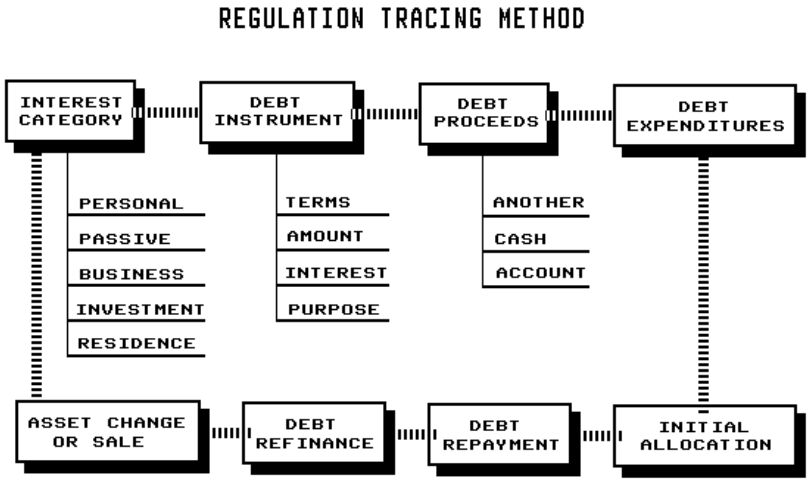
The limitation in §163(j) applies to all taxpayers, *except* for certain taxpayers that meet the gross receipts test in §448(c), and to all trades or businesses, except certain trades or businesses listed in §163(j)(7).

Allocation of Interest Expense

Generally, debt is allocated to the proper category of interest incurred by the taxpayer by tracing disbursements of the debt proceeds to specific expenditures. The type of property that secures the debt doesn't matter unless it is a home mortgage or is tax exempt. Due to the variety of limits imposed on interest deductions, the IRS has provided special allocation rules to be used to determine the proper category of interest.

All taxpayers other than non-closely held regular (subchapter C) corporations must allocate interest. In addition, the interest allocation rules apply for the purpose of applying limitations for passive losses, investment interest, and personal interest.

Under the interest allocation rules, accrued interest is treated as a debt until it is paid. Compound interest accruing on such debt may be allocated between the original expenditure and the new expenditure on a straight-line basis (i.e., by allocating an equal amount of such interest expense to each day during the taxable year). In addition, a taxpayer may treat a year as consisting of twelve 30-day months for purposes of allocating interest on a straight-line basis.



Allocation starts when the taxpayer uses the proceeds and ends when the debt is repaid or reallocated, whichever is earlier.

Example

On January 1, the taxpayer borrows $1,000 and uses the money to buy an investment security. On July 1, the taxpayer sells the security for $41,000 and buys shoes with the money. On December 31, the taxpayer pays $140 of accrued interest on the $1,000 debt for the entire year.

Interest expense is allocated to investment expenditures from January 1 to June 30 and to personal expenditures from July 1 to December 31. The taxpayer would, therefore, have $70 of investment interest expense and $70 of personal interest expense.

Interest on a debt may accrue before the taxpayer actually receives the debt proceeds, or before the taxpayer uses the debt proceeds to make an expenditure. During this pre-receipt (or pre-use) period, the debt is allocated to an investment expenditure.

Debt proceeds that are deposited into a depositor's account that contains unborrowed funds are treated as being withdrawn first when expenditures are made.

Example

David borrows $1,000 and puts the money in his checking account, which already contains $740, money that David has saved. The next day, David withdraws $75 cash. The day after that, David uses $1,000 from the account to buy a bond. The $75 cash withdrawal would be treated as an expenditure of the debt proceeds.

Generally, if the proceeds of two or more loans are deposited into the same account, subsequent expenditures are treated as coming from the borrowed funds in the order in which they were deposited.

> **Note:** A borrower may elect to treat any expenditure made within 15 days after loan proceeds are deposited into the account as having been made from the proceeds of that loan.

In an account containing only the proceeds of a debt and the interest earned on those proceeds, the taxpayer may treat expenditures from the account as being made first from the interest earned. Debt proceeds deposited into an account are treated as investment property until those funds are expended.

> **Note:** The rules for the allocation of debt apply separately to each account of the taxpayer.

In general, the re-allocation of expenditures occurs on the date of the expenditure but the taxpayer may elect:

(1) To re-allocate the debt as of the first day of the month in which the expenditure occurs, *or*

> **Note:** A taxpayer may use the first-day-of-the-month convention only if all other expenditures from the account during the month are similarly treated.

(2) To re-allocate the debt as of the day on which the debt proceeds are deposited in the account if later.

Debt proceeds received in cash are treated as if they were used to make personal expenditures. Debt proceeds are "received in cash" if cash is withdrawn from an account containing debt proceeds.

> **Exception:** As with debt proceeds deposited into an account, there is a special 15-day rule (90 days for residences) that allows a taxpayer to treat any cash expenditure he or she makes within 15 days of receiving the cash as an expenditure made from the debt proceeds

If at any time any portion of a debt is repaid and such debt is allocated to more than one expenditure, the debt is treated as repaid in the following order:

(1) Amounts allocated to personal expenditures.

(2) Amounts allocated to investment expenditures and passive activity expenditures.

(3) Amounts allocated to passive activity expenditures in connection with a rental real estate activity in which the taxpayer actively participates.

(4) Amounts allocated to former passive activity expenditures.

(5) Amounts allocated to active trade or business expenditures.

Example

Taxpayer B borrows $100,000 ("Debt A") on July 12, immediately deposits the proceeds in an account, and uses the debt proceeds to make the following expenditures on the following dates:

August 31 $40,000 passive activity expenditure #1

October 5 $20,000 passive activity expenditure #2

December 24 $40,000 personal expenditure

On January 19 of the following year, B repays $90,000 of Debt A (leaving $10,000 of Debt A outstanding). The $40,000 of Debt A allocated to the personal expenditure, the $40,000 allocated to passive activity expenditure#1, and $10,000 of the $20,000, allocated to passive activity expenditure #2 are treated as repaid.

Amounts allocated to two or more expenditures that fall in the same classification (e.g., amounts allocated to different personal expenditures) are treated as repaid in the order in which the amounts were allocated to such expenditures.

In the case of borrowings pursuant to a line of credit or similar account that allows a taxpayer to borrow funds periodically under a single loan agreement:

(1) All borrowings on which interest accrues at the same rate are treated as a *single* debt; *and*

(2) Borrowings on which interest accrues at *different* rates are treated as different debts, and such debts are treated as repaid in the order such debts are treated as repaid under the loan agreement.

Example

Taxpayer A obtains a line of credit. Interest on any borrowing on the line of credit accrues at the lender's "prime lending rate" on the date of the borrowing plus two percentage points. The loan documents provide that borrowings on the line of credit are treated as repaid in the order the borrowings were made. A borrows $30,000 ("Borrowing #1") on the line of credit and immediately uses $20,000 of the debt proceeds to make a personal expenditure ("personal expenditure #1") and $10,000 to make a trade or business expendi-

ture ("trade or business expenditure #1"). A subsequently borrows another $20,000 ("Borrowing #2") on the line of credit and immediately uses $15,000 of the debt proceeds to make a personal expenditure ("personal expenditure #2") and $5,000 to make a trade or business expenditure ("trade or business expenditure #2"). A then repays $40,000 of the borrowings.

If the prime lending rate plus two percentage points was the same on both the date of Borrowing #1 and the date of Borrowing #2, the borrowings are treated for purposes of this paragraph as a single debt, and A is treated as having repaid $35,000 of debt allocated to personal expenditure #1 and personal expenditure #2, and $5,000 of debt allocated to trade or business expenditure #1.

If the prime lending rate plus two percentage points were different on the date of Borrowing #1 and Borrowing #2, the borrowings are treated as two debts, and, in accordance with the loan agreement, the $40,000 repaid amount is treated as a repayment of Borrowing #1 and $10,000 of Borrowing #2. Accordingly, A is treated as having repaid $20,000 of debt allocated to personal expenditure #1, $10,000 of debt allocated to trade or business expenditure #1, and $10,000 of debt allocated to personal expenditure #2.

With some exceptions, reallocation of debt allocated to an expenditure properly chargeable to capital account with respect to an asset (the "first expenditure") is reallocated to another expenditure on the earlier of:

(1) The date on which proceeds from a disposition of such asset are used for another expenditure; *or*

(2) The date on which the character of the first expenditure changes (e.g., from a passive activity expenditure to an expenditure that is not a passive activity expenditure) by reason of a change in the use of the asset with respect to which the first expenditure was capitalized.

Education Expenses

Work-Related Education

For 2018 through 2025, as a result of the TCJA, employee expenses are not deductible unless you are a self-employed individual, Armed Forces reservist, qualified performing artist, fee-basis state or local government official, or an employee with impairment-related work expenses.

> **Note:** Prior to the TCJA, educational expenses were deductible if the education (i) was required by the taxpayer's employer or the law to keep the taxpayer's salary, status, or job (and served a business purpose of the employer), *or* (ii) maintained or improved skills required in the taxpayer's present work. Employees itemized their unreimbursed work-related education expenses as miscellaneous expenses subject to the 2% AGI limit (§67).

A business owner who typically files a Schedule C is not affected by the elimination of employee expense deductions but the rules prior to the TCJA apply.

Educator Expenses - §62

Under §62, certain expenses of eligible educators are allowed as an above-the-line deduction (§62). Specifically, educators who work at least 900 hours during a school year as a teacher, instructor, counselor, principal, or aide, can deduct up to $300 (in 2025 & 2024) of qualified out-of-pocket expenses for books and classroom supplies. The deduction is available for those in public or private elementary or secondary schools (including kindergarten).

> **Comment:** Educators can claim this deduction only for expenses that weren't reimbursed by their employer, a grant, or other sources.

Qualifying expenses include books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment, and supplementary materials used by the eligible educator in the classroom (§62(a)(2)(D)).

The maximum amount that an eligible educator may deduct under §62 for expenses is $300 in 2025 and 2024 (up from $250 in 2021).

Medical Expense Deductions - §213 [Schedule A]

Section 213 allows taxpayers to deduct their total qualified unreimbursed medical care expenses that exceed 7.5% of their adjusted gross income when the taxpayer uses Schedule A (Form 1040) to itemize their deductions. Taxpayers can generally include medical expenses paid for themselves, as well as their spouse or dependent. This threshold applies for purposes of the AMT in addition to the regular tax.

Medical care means amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, and for treatments affecting any part or function of the body. The medical care expenses must be primarily to alleviate or prevent a physical or mental defect or illness.

Items Deductible

To the extent a taxpayer is not reimbursed, they may deduct what they paid for:

1. Prescription medicines and drugs, or insulin.

2. Medical doctors, dentists, eye doctors, chiropractors, osteopaths, podiatrists, psychiatrists, psychologists, physical therapists, acupuncturists, and psychoanalysts (medical care only).

3. Medical examinations, X-ray and laboratory services, insulin treatment, and whirlpool baths which are doctor-ordered.

4. If a taxpayer pays someone to do both nursing and housework, they may deduct only the cost of the nursing help.

5. Hospital care (including meals and lodging), clinic costs, and lab fees.

6. Medical treatment at a center for drug addicts or alcoholics.

7. Medical aids such as hearing aid batteries, contact lenses, braces, crutches, wheelchairs, guide dogs, and the cost of maintaining them.

8. Costs of a mentally or physically handicapped person at a special school, including tuition, meals, and lodging.

9. Cost of an individual at a nursing home or home for the aged.

10. Amounts paid for inpatient treatment at a therapeutic center for alcohol addiction.

Items Not Deductible

The following medical costs are not deductible:

1. The basic cost of Medicare insurance (Medicare A).

> **Comment:** If you are sixty-five or over and not entitled to Social Security benefits, you may deduct premiums you voluntarily paid for Medicare A coverage.

2. Life insurance or income protection policies.

3. The 1.45% Medicare (hospital insurance benefits) tax withheld from your pay as part of the Social Security tax or the Medicare tax paid as part of the social security self-employment tax.

4. Nursing care for a healthy baby (except perhaps under §21).

5. Illegal operations or drugs.

6. Nonprescription medicines or drugs.

7. Travel for rest or change which a doctor ordered.

8. Funeral, burial, or cremation costs.

Medical Insurance Premiums

A taxpayer can include in medical expenses insurance premiums they pay for policies that cover medical care. Policies can provide payment for:

(1) Hospitalization, surgical fees, X-rays, etc.,

(2) Prescription drugs,

(3) Replacement of lost or damaged contact lenses,

(4) Qualified long-term care insurance contracts, *or*

(5) Membership in an association that gives cooperative or so-called free choice medical service, or group hospitalization and clinical care.

> **Note:** Taxpayers cannot deduct insurance premiums paid with pretax dollars because the premiums are not included in box 1 of Form W-2.

If a taxpayer has a policy that provides more than one kind of payment, they can include the premiums for the medical care part of the policy if the charge for the medical part is reasonable. The cost of the medical portion must be separately stated in the insurance contract or given to the taxpayer in a separate statement.

Medicare Part A

If a taxpayer is covered under Social Security (or if they are a government employee who paid Medicare tax), they are enrolled in Medicare A. The payroll tax paid for Medicare A is not a medical expense. If a taxpayer is not covered under Social Security (or was not a government employee who paid Medicare tax), they can voluntarily enroll in Medicare A. In this situation, the premiums paid for Medicare A can be included as a medical expense on their tax return.

Medicare Part B

Medicare B is supplemental medical insurance. Premiums paid for Medicare B are a medical expense. If a taxpayer applied for it at age 65 or after they became disabled, they can deduct the monthly premiums they paid. If a taxpayer was over age 65 or disabled when they first enrolled, check the information received from the Social Security Administration to find out the premium.

Medicare Part D

Medicare Part D is a federal program to subsidize the costs of prescription drugs for Medicare beneficiaries in the United States. It was enacted as part of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (MMA).

The drug benefit is not part of the 'original' Medicare program, which includes Part A for hospital care and Part B for physician, outpatient care, and durable medical equipment. Rather, it is being administered by private insurance plans that are reimbursed by the Centers for Medicare and Medicaid Services (CMS).

Self-Employed

Self-employed individuals can deduct "above-the-line" Medicare premiums on their federal tax returns. This deduction applies to premiums for Medicare Part A, B, C, and D, as well as Medicare Advantage and Medigap policies.

Prepaid Insurance Premiums

Insurance premiums a taxpayer pays before they are age 65 for medical care after they reach age 65 for themselves, their spouse, or their dependents, are medical care expenses in the year paid if they are:

(a) Payable in equal yearly installments, or more often, *and*

(b) Payable for at least 10 years, or until the taxpayer reaches 65 (but not for less than 5 years).

Meals & Lodging

A taxpayer can deduct as a medical expense amounts paid for lodging (but not meals) while away from home to receive medical care in a hospital or a medical care facility that is related to a hospital. Do not include more than $50 a night for each eligible person. Meals included in the cost of care in a hospital or other institution are deductible.

Transportation Expenses

Costs of gas, oil, parking fees, taxi, train, plane and bus fares, ambulance service, and lodging expenses while en-route to the place of medical treatment are deductible. If a taxpayer uses their own car, they may claim what they spent for gas and oil to go to and from the place they received the care; or they may claim 21 cents a mile in 2025 and 2024. Add parking and tolls to the amount a taxpayer claims under either method.

Permanent Improvements

Elevators, swimming pools, and other permanent improvements to taxpayer's property (including capital expenditures to accommodate a residence to a physically handicapped individual) qualify as a medical expense only to the extent the total expense *exceeds* the amount by which the improvement increases the value of the property.

Example

A taxpayer spends $5,000 to put in a central air conditioning system after their daughter's allergist recommends the installation to alleviate an asthmatic condition. If that boosts the value of the taxpayer's home by $4,500, the allowable deduction shrinks to only $500, the amount by which the cost exceeds the increase in value. A renter could claim the entire cost because the improvement adds nothing to the value of his or her property.

A written opinion from a competent real estate appraiser detailing how little or how much the installation raised the value of the property is recommend-

able. The appraisal fee does not count under the percentage AGI limit for medical expenses. Taxpayers could count them with other miscellaneous deductions, such as return preparation fees, which were allowable, prior to 2018, to the extent they exceeded 2% of AGI.

Whether the taxpayer is an owner or a renter, deductible items include the entire cost of detachable equipment - e.g., a window air conditioner that relieves a medical problem. In addition, remember to include as part of the medical deduction amounts spent for such operating and maintenance expenses as electricity, repairs, or a service contract.

> **Comment:** Some expenses incurred by a physically handicapped individual to remove structural barriers in their residence in order to accommodate their physical condition such as constructing access ramps, widening doorways, and installing special support bars are presumed not to increase the value of the residence and are deductible in full.

Spouses, Dependents & Others

An individual may deduct (subject to §213 limits) the medical expenses of his or her spouse, his or her dependent children, and any other person who meets the definition of dependent under §152.

> **Note:** Business owners may be able to deduct 100% of the amount paid for medical and dental insurance and qualified long-term care insurance for themselves, their spouses, and their dependents

Reimbursement of Expenses

Medical expenses compensated for by insurance are reduced by the amount so compensated. No reduction is required for amounts received as compensation for loss of earnings or damages for personal injuries.

Long-Term Care Provisions

A qualified long-term care insurance contract generally is treated as an accident and health plan. This allows long-term care insurance contracts to receive the same tax benefits as other health insurance plans.

Long-Term Care Payments - §7702B(d)(4)

The limit on the exclusion (as to amounts received for personal injuries and sickness) for payments made on a per diem or other periodic basis under a long-term care insurance contract is $420 for 2025 (up from $410 in 2024) per day (R.P. 2024-40). The limit applies to the total of these payments and any accelerated death benefits made on a per diem or other periodic basis under a life insurance contract because the insured is chronically ill.

Under this limit, the excludable amount for any period is figured by subtracting any reimbursement received (through insurance or otherwise)

for the cost of qualified long-term care services during the period from the *larger* of the following amounts:

(1) the cost of qualified long-term care services during the period, *and*

(2) the dollar amount for the period ($420 per day for any period in 2025).

Long-Term Care Premiums - §213(d)(10)

Premiums for long-term care insurance and long-term care services are treated as medical expenses for purposes of the itemized deduction for medical expenses and the exclusion of employer-provided health benefits.

For 2024, taxpayers could include qualified long-term care premiums, up to the amounts shown below, as medical expenses on Schedule A (Form 1040).

Age 40 or under – $470.

Age 41 to 50 – $880.

Age 51 to 60 – $1,760.

Age 61 to 70 – $4,710.

Age 71 or over – $5,880 (R.P. 2023-34).

For 2025, taxpayers can include qualified long-term care premiums, up to the amounts shown below, as medical expenses on Schedule A (Form 1040).

Age 40 or under – $480.

Age 41 to 50 – $900.

Age 51 to 60 – $1,800.

Age 61 to 70 – $4,810.

Age 71 or over – $6,020 (R.P. 2024-40).

This limitation is for each person.

Note: Long-term care insurance will not be permitted to be offered under a cafeteria plan or to be covered under flexible spending arrangements.

IRA Withdrawals for Certain Medical Expenses – 72(t)(2)(B)

A 10% early withdrawal penalty applies to distributions from an individual retirement account (IRA) prior to age 59½. This penalty is in addition to the income tax owed on the amount withdrawn. However, there are exceptions to this rule where the 10% penalty does not apply.

One such exception to the 10% penalty tax on early withdrawals from an IRA is for out-of-pocket medical expenses in excess of 7.5% of adjusted gross income. In addition, the 10% tax does not apply to distributions for medical insurance (without regard to the 7.5% floor) if the individual has received unemployment compensation under federal or state law for at least 12 weeks.

ABLE Accounts - §529A

Section 529A provides rules for a type of tax-advantaged savings program known as a qualified ABLE program. A qualified ABLE program is a program established and maintained by a State or agency or instrumentality thereof. A qualified ABLE program is generally exempt from income tax but is subject to the unrelated business income provisions. Contributions accumulate on a tax-deferred basis.

The §529A program is designed to permit an individual to contribute cash to an ABLE account, invest the money, and later take tax-free distributions for disability expenses. Section 529A allows a state or state agency to establish and maintain a tax-advantaged savings program for the qualified disability expenses of a "designated beneficiary" of the account (ABLE account). The term "designated beneficiary" means the eligible individual who establishes an ABLE account and is the owner of such an account.

> **Comment:** Each eligible person may have only one ABLE account and except for rollovers, once an ABLE account has been established, no account subsequently established for the same designated beneficiary may qualify.

ABLE programs use Form 1099-QA, *Distributions from ABLE Accounts*, and Form 5498-QA, *ABLE Account Contribution Information*, to report relevant account information annually to designated beneficiaries and the IRS.

Eligible Individual

Under §529A(e)(1), an individual is an eligible individual for a tax year if they are either:

(1) entitled during that year to benefits based on blindness or disability under title II or XVI of the Social Security Act, provided that such blindness or disability occurred before the date on which the individual attained age 26, or

> **Note:** The standard of disability is applied without regard to either the individual's age or whether the individual is engaged in substantial gainful activity (Reg §1.529A-2(e)(2)).

(2) the subject of a disability certification filed with the Treasury Secretary or his delegate for that year.

The determination that an individual is an eligible individual is made each tax year and applies for the entire year (Reg §1.529A-2(d)(1)(i)).

Qualified ABLE Program

A qualified ABLE program must meet certain conditions including the following:

(1) be a program established and maintained by a State;

(2) under the provisions of the program, contributions are made to an account (an "ABLE account"), established for the purpose of meeting

the qualified disability expenses of the designated beneficiary of the account; *and*

(3) the program must limit a designated beneficiary to one ABLE account.

Contributions

All contributions to an ABLE account must be made in cash and are not deductible. An ABLE account must provide that it may not receive aggregate contributions during a taxable year in excess of the annual gift tax exclusion amount ($19,000 in 2025; $18,000 in 2024).

For tax years 2018 through 2025, after the overall limitation on contributions is reached, an ABLE account's designated beneficiary may contribute an additional amount, up to the lesser of:

(1) the Federal poverty line for a one-person household; *or*

(2) the individual's compensation for the taxable year (§529A(b)(2)(B)).

> **Note:** The TCJA temporarily (tax years 2018 through 2025) allows a designated beneficiary of an ABLE account to claim the saver's credit for contributions made to his or her ABLE account.

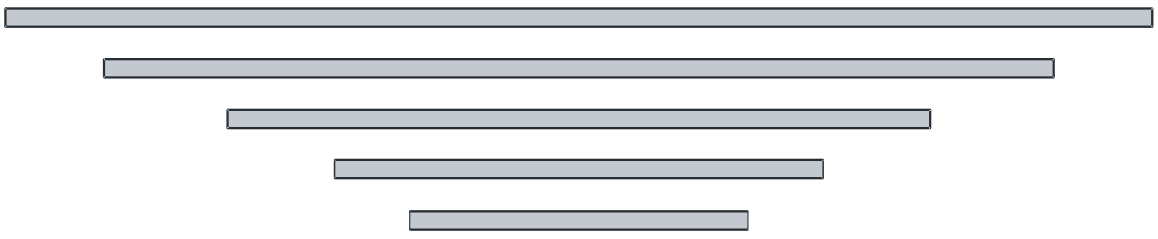
Investment Direction

A qualified ABLE program may not allow the designated beneficiary to direct, either directly or indirectly, the investment of any contributions to his or her account (or any earnings thereon) more often than twice in any calendar year. In addition, no interest in an ABLE account may be used as security for a loan.

Distributions

Distributions are tax-free if used for qualified disability expenses. However, the earnings portion of distributions from an ABLE account in excess of the qualified disability expenses is generally included in the gross income of the designated beneficiary.

> **Note:** The portion of any distribution that is includible in gross income is subject to an additional 10% tax unless made after the death of the beneficiary.



Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regard to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

23. Under §163, there are several types of interest expense. Which type of interest is defined as interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for purposes of making a profit?

a. investment interest.

b. trade interest.

c. qualified residence interest.

d. prepaid interest.

24. Points are considered a type of interest expense. Under §461(g)(1), what is a characteristic of points that have features of an additional interest charge?

a. They are fully deductible when paid on a refinance of a home purchase.

b. They constitute personal interest.

c. If incurred in a business deal, they are deducted ratably over the loan's term.

d. They must be capitalized by an accrual-basis taxpayer.

25. The author lists ten deductible medical items under §213 to the extent the taxpayer is not reimbursed for such expenses. What is one of these items that taxpayers may deduct?

a. expenses of a funeral, burial, or cremation.

b. costs for cosmetic surgery.

c. expenses for medical treatment at a drug addiction center.

d. over-the-counter medicines or drugs.

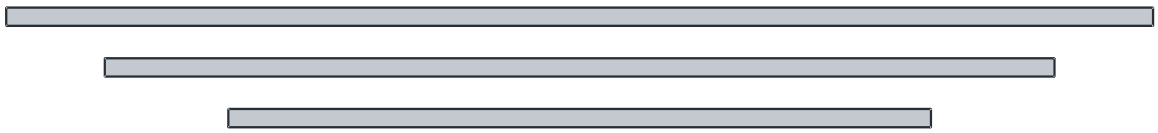
26. Under §213, physically handicapped individuals may deduct certain expenses incurred to modify their primary residence. However, which expense is nondeductible as such a medical expense?

a. amounts spent building access ramps and putting in special support bars.

b. amounts spent for operating and maintaining residential accommodations.

c. appraisal fees for getting a written, detailed opinion of a home's increased value.

d. the entire cost spent on purchasing detachable equipment.



Charitable Contributions - §170 [Schedule A]

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization. The amount of deduction generally equals the fair market value of the contributed property on the date of the contribution. Charitable deductions are provided for income, estate, and gift tax purposes.

Charitable contributions are deductible only as an itemized deduction on Schedule A. If the taxpayer does not itemize, or cannot itemize, there is no deduction for charitable contributions.

Requirements for Deductibility

To be deductible charitable contributions must meet the following requirements:

1. Contributions must be to or for the use of qualifying organizations;

2. Generally, they must be paid within the year, even if the taxpayer is on the accrual basis;

3. They cannot exceed certain statutory limits; *and*

4. They must be itemized deductions for individuals.

> **Comment:** A contribution made to an individual is not deductible unless he or she is acting as an agent for a qualified organization, even though he or she may be in need.

Qualified Organizations

A state, a U.S. possession (including Puerto Rico), a political subdivision of a state or possession, the United States, or the District of Columbia is a qualified organization if the contribution is made only for public purposes. An Indian tribal government and any of its subdivisions that are recognized by the Secretary of the Treasury as performing substantial government functions will be treated as a state for purposes of the charitable contributions deduction.

In addition, a qualified organization is a community chest, corporation, trust, fund, or foundation organized or created in, or under the laws of, the United States, any state, the District of Columbia, or any possession of the United States. The organization must be organized and operated only for charitable, religious, educational, scientific, or literary purposes. It may also be for the prevention of cruelty to children or animals.

Limitations on Contributions

If contributions are all to 50% charities, the deduction for contributions is limited to 50% (60% for cash contributions made to public charities and certain private foundations from 2018 through 2025) of adjusted gross income before any net operating loss carryback. There is an exception for appreciated capital gain property.

Charities that are 50% organizations include:

(1) Churches,

(2) Tax-exempt educational organizations,

(3) Tax-exempt hospitals and certain medical research organizations,

(4) Certain organizations holding property for state and local colleges and universities,

(5) A state, a possession of the U.S., or any political subdivision of any of the foregoing, or the U.S. or the District of Columbia, if the contribution is for exclusively public purposes,

(6) An organization organized and operated exclusively for charitable, religious, educational, scientific, or literary purposes or for the prevention of cruelty to children or animals or to foster national or international amateur sports competition if it normally gets a substantial part of its support from the government or the general public,

(7) Limited private foundations, *and*

(8) Certain membership organizations more than one-third of whose support comes from the public (§170(b)(1)).

Contributions to charities *other* than 50% (or 60%) charities *and* contributions for the use of any charity are limited to 30% of the donor's adjusted gross income before any net operating loss carrybacks. Additionally, any contribution of appreciated capital gain property to a 50% charity is subject to the 30% ceiling unless an election is made.

Contributions of appreciated capital gain property to 30% charities are deductible only up to 20% of adjusted gross income before any net operating loss carrybacks.

Five-year Carryover

If the 50% (60% for cash to certain entities), 30% or 20% ceilings limit the contributions, the amount not deductible in the year contributed may be carried forward for up to five years and deducted on a future return. The carryover amounts are subject to the same ceilings the original contributions were subject to.

Contributions of Cash

Generally, cash contributions to qualified organizations are deductible. However, there are some exceptions:

Benefits Received

If a taxpayer contributes to a charitable organization and also receives a benefit from it, they may deduct only the amount that is more than the value of the benefit they received.

Examples of charitable contributions that are not deductible because of benefits received include:

(1) tuition, even for children attending parochial school, and

(2) payments in connection with an aged person's admission to a home operated by a charity, to the extent allocable to care to be given or the privilege of being admitted.

Note: Some of the expense may be deductible as a medical expense.

Benefit Performances

If a taxpayer pays *more* than the fair market value to qualified organizations for charity balls, banquets, shows, etc., the amount that is more than the value of the privileges or other benefits received is deductible as a contribution.

The presumption here is that the payment is not a gift. The taxpayer must show that a clearly identifiable part of the payment is a gift. Only that part

of the payment made with the intention of making a gift and for which the taxpayer received no consideration qualifies as a contribution.

Athletic Event Seating Rights

Formerly, a taxpayer who made a charitable contribution to or for a college or university and was thereby entitled to purchase tickets to athletic events was allowed to deduct 80% of the payment as a charitable contribution. However, any amount that was for the tickets themselves was not considered part of the contribution.

Effective 2018 and later, this special rule providing a charitable deduction of 80% of the amount paid for the right to purchase tickets for athletic events is repealed.

Raffle Tickets, Bingo, Etc.

Amounts paid for raffle tickets, bingo, and prizes are not contributions. They are gambling losses, deductible only to the extent of winnings.

Dues, Fees, or Assessments

Dues, fees, or assessments may be deductible to the extent the amount paid exceeds benefits received if paid to qualified organizations. Amounts paid to country clubs, lodges, other social organizations, and homeowners associations are not deductible.

Contribution of Property

The tax treatment of charitable contributions varies based on the type of property given.

Clothing & Household Goods

No deduction is allowed for a charitable contribution of clothing or household items unless the clothing or household item is in good used condition or better. Household items include furniture, furnishings, electronics, appliances, linens, and other similar items. Food, paintings, antiques, and other objects of art, jewelry, gems, and collections are excluded from the provision.

The Treasury Secretary is authorized to deny by regulation a deduction for any contribution of clothing or a household item that has minimal monetary value, such as used socks and used undergarments.

Note: Tax law does not define "good condition." It is expected that the Secretary, in consultation with affected charities, will exercise assiduously the authority to disallow a deduction for some items of low value, consistent with the goals of improving tax administration and ensure that donated clothing and household items are of meaningful use to charitable organizations.

However, a deduction may be allowed for a charitable contribution of an item of clothing or a household item not in good used condition or better if the amount claimed for the item is more than $500 and the taxpayer includes with the taxpayer's return a qualified appraisal with respect to the property.

Ordinary Income or Short-Term Capital Gain Type Property

Contributions of property that would have resulted in ordinary income or generated short-term capital gain if sold at its fair market value on the date contributed have a special rule. The amount deductible as a contribution is the fair market value minus the amount that would have been ordinary or short-term capital gain (i.e., adjusted basis).

Example

Stock held for five months is donated to a church. The value of the stock is $1,000 and the amount paid for the stock was $800. The amount deductible would be $800 ($1,000 minus $200) because the $200 of appreciation would have been short-term capital gain.

Exception

A corporation other than an "S" corporation is allowed a deduction for the basis plus one-half of the appreciation of ordinary income property, such as inventory. The property must be for use by the donee to care for the ill, needy, or infants or it must be a qualified research contribution, the deduction can't exceed twice the basis of the donated property, and other tests must be met.

Capital Gain Type Property

Contributions of property that would have resulted in capital gain are generally deductible at their fair market value on the date of contribution. Nevertheless, contributions of capital gain type property to 50% charities are limited to the 30% ceiling for deductible contributions. However, a taxpayer can elect to have the 50% ceiling applied by reducing the amount of the contribution by the capital gain.

Note: Contributions of capital gain property to 30% charities are limited to the 20% ceiling for deductible contributions. There is no election available to have another ceiling apply.

Exceptions

Tangible personal property that is unrelated to the donee charity's exempt function (e.g. art to a church that then sells it) is deductible as a

contribution only to the extent of the donor's basis. In addition, capital gain property (except for publicly traded stock) given to a private foundation that is not an operating foundation or community foundation and that does not make timely qualifying distributions is deductible as a contribution only to the extent of the donor's basis.

Conservation Easements - §170(b)

A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as:

(1) the entire interest of the donor other than a qualified mineral interest:

(2) a remainder interest: or

(3) a restriction (granted in perpetuity) on the use that may be made of the real property.

Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations. Conservation purposes include:

(1) the preservation of land areas for outdoor recreation by, or for the education of, the general public;

(2) the protection of a relatively natural habitat of fish, wildlife, plants, or similar ecosystem:

(3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal. State, or local governmental conservation policy: and

(4) the preservation of a historically important land area or a certified historic structure (§170(b)(1)(A)).

Qualified conservation contributions of capital gain property are subject to the same limitations and carryover rules of other charitable contributions of capital gain property.

For contributions of appreciated capital gain real property (including partial interests) to qualified charities for conservation purposes, the 30% contribution base limitation on contributions of capital gain property by individuals does not apply to qualified conservation contributions (as defined under present law). Instead, individuals may deduct the fair market value of any qualified conservation contribution to an organization described in §170(b)(1)(A) to the extent of the excess of 50% of the contribution base over the amount of all other allowable charitable contributions. These contributions are not taken into ac-

count in determining the amount of other allowable charitable contributions.

Individuals are allowed to carry over any qualified conservation contributions that exceed the 50-percent limitation for up to 15 years.

> **Note:** The IRS issued final regulations (T.D. 9999) that provide guidance on the application of a rule enacted by the SECURE 2.0 Act of 2022, which disallows deductions for certain qualified conservation contributions by partnerships or S corporations after Dec. 29, 2022.

Loss Type Property

Property contributed to a charity that, if sold, would have created a *loss*, is deductible at its fair market value. However, the ideal thing to do when this situation exists is to sell the property, recognize the loss on the tax return, and donate the cash to the charity.

Vehicle Donations

Contemporaneous (30 days) written acknowledgment is required for any "qualified vehicle" donation exceeding $500. If the charity sells the vehicle without any significant intervening use or material improvement, the amount of the deduction will be limited to the gross sales price received by the charity. Thus, the actual fair market value of the vehicle may be meaningless.

Taxpayers are not entitled to any deduction unless they receive this acknowledgment from the charity containing the donor's name, taxpayer identification number, and vehicle identification number. If the charity sells the property without significant intervening use the acknowledgment must also:

(1) certify that the asset was sold in an arm's length transaction between unrelated parties;

(2) certify the amount of the gross sales proceeds; *and*

(3) include a warning that the donor's deduction is limited to the sales proceeds.

Fractional Interests

No deduction is allowed for a contribution of an undivided portion of a taxpayer's entire interest in tangible personal property unless, immediately before the contribution, all interests in the property are held by:

(1) the taxpayer; *or*

(2) the taxpayer and the donee. (§170(o)(1)(A))

Under (1), if a taxpayer who is the sole owner of an item of tangible personal property (e.g., a painting) contributes a portion of his or her undivided interest in the property to charity (e.g., a museum), he or she is allowed a charitable deduction if the contribution otherwise qualifies. Un-

der (2), a taxpayer who owns only a partial undivided interest in property is allowed a charitable contribution for a gift of that interest to charity only if the donee charity already owned the remaining interest in the property (and then only to the extent of his or her partial interest). As a result, a taxpayer who donates a portion of his or her undivided interest in an item of tangible personal property to charity gets a charitable deduction for that "initial" gift (assuming it otherwise qualifies). Then, if he or she later gives any portion of his or her remaining undivided interest in that property to the same charity, he or she gets a charitable deduction for that "additional" contribution.

Other Types of Contributions

Unreimbursed out-of-pocket expenses in performing services free for a qualified charity can be deductible. However, travel expenses, including meals, lodging, and transportation while away from home are not deductible as a contribution unless there is no significant element of personal pleasure, recreation, or vacation in the travel.

> **Note:** Even if the travel expense test is met, only 50% of the meal expenditures can be deducted and the deduction is allowed only for meals and lodging necessarily incurred while away from home overnight in rendering the services.

For auto expenses, a taxpayer may deduct the actual unreimbursed expenses for gas and oil or take the standard mileage rate of 14 cents (in 2024 & 2025) per mile. Regardless of whether the standard mileage rate or the actual expense method is used, the taxpayer may also deduct parking fees and tolls. Depreciation, insurance, and repairs are not deductible.

Qualified Charitable Distributions from IRAs - §408(d)(8)(A)

If an amount withdrawn from a traditional individual retirement arrangement ("IRA") or a Roth IRA is donated to a charitable organization, the rules relating to the tax treatment of withdrawals from IRAs apply to the amount withdrawn and the charitable contribution is subject to the normally applicable limitations on the deductibility of such contributions.

Each year, a traditional or Roth IRA owner, age 70½ or over, can *directly* transfer tax-free, up to $108,000 per year in 2025 (up from $105,000 in 2024) from all IRAs to an eligible charitable organization (§408(d)(8)). Thus, otherwise taxable IRA distributions from a traditional or Roth IRA are excluded from gross income to the extent they are qualified charitable distributions(§408(d)(8)). The exclusion may not exceed $108,000 per taxpayer per taxable year.

> **Note:** Special rules apply in determining the amount of an IRA distribution that is otherwise taxable. The otherwise applicable rules regarding taxation of IRA distributions and the deduction of charitable contributions continue

to apply to distributions from an IRA that are not qualified charitable distributions.

A qualified charitable distribution (QCD) is taken into account for purposes of the minimum distribution rules applicable to traditional IRAs to the same extent the distribution would have been taken into account under such rules had the distribution not been directly distributed under the qualified charitable distribution provision.

Comment: The QCD option is available regardless of whether an eligible IRA owner itemizes deductions on Schedule A. Transferred amounts are not taxable, but no deduction is available for the transfer

A qualified distribution must be made *directly* from the IRA by the trustee to a charitable organization when the taxpayer has attained age 70½. Eligible IRA owners can take advantage of this provision, regardless of whether they itemize their deductions.

Note: Distributions that are excluded from gross income by reason of the qualified charitable distribution provision are not taken into account in determining the deduction for charitable contributions under §170.

Substantiation - §170

Section 170 outlines the rules and requirements for substantiating charitable contributions. The kinds of records that must be kept for charitable contributions depend on the amount of the contribution, whether the contribution was cash or property, and whether a benefit was derived from the contribution.

Cash Contributions

Cash contributions include those paid by cash, check, credit card, or payroll deduction. They also include out-of-pocket expenses when donating services.

For a contribution made in cash, the records a taxpayer must keep depend on whether the contribution is:

(a) Less than $250, *or*

(b) $250 or more.

Contributions Less Than $250 - §170

For each cash contribution that is less than $250, one of the following must be kept:

(1) A canceled check or a legible and readable account statement that shows:

(a) If payment was by check - the check number, amount, date posted, and to whom paid,

(b) If payment was by electronic funds transfer - the amount, date posted, and to whom paid,

(c) If payment was charged to a credit card - the amount, transaction date, and to who paid,

(2) A receipt (or a letter or other written communication) from the charitable organization showing the name of the organization, the date of the contribution, and the amount of the contribution, *or*

(3) Other reliable written records that include the information described in (2).

> **Note:** Records may be considered reliable if they were made at or near the time of the contribution, were regularly kept, or if, in the case of small donations, the taxpayer has buttons, emblems, or other tokens, that are regularly given to persons making small cash contributions.

Contributions of $250 or More - §170(f)(8)(A)

In addition to the above recordkeeping requirements, special substantiation requirements apply in the case of charitable contributions with a value of $250 or more. No charitable deduction is allowed for contributions of $250 or more unless the taxpayer has written acknowledgment of the contribution from the donee organization or adequate payroll records.

In figuring whether the contribution is $250 or more, separate contributions are not combined. However, two checks written on the same date to the same qualified organization may be considered one contribution (§170(f)(8)).

> **Note:** If contributions are made by payroll deduction, the deduction from each paycheck is treated as a separate contribution.

The acknowledgment must:

(1) Be written;

(2) Include:

(a) The amount of cash contributed,

(b) Whether the qualified organization gave the taxpayer any goods or services (other than token items of little value) as a result of the contribution, *and*

(c) A description and good faith estimate of the value of any goods or services described in (b), *and*

> **Note:** If the only benefit received was an intangible religious benefit (such as admission to a religious ceremony) that generally is not sold in a commercial transaction outside the donative context, the acknowledgment must say so and does not need to describe or estimate the value of the benefit.

(3) Be received on or before the *earlier* of:

(a) The date the return is filed for the year of the contribution, *or*

(b) The due date, including extensions, for filing the return.

Payroll Deduction Records

If a contribution is made by payroll deduction, an acknowledgment from the qualified organization is not needed. But if an employer deducted $250 or more from a single paycheck, the taxpayer must keep:

(a) A pay stub, Form W-2, or other document furnished by the employer that proves the amount withheld, *and*

(b) A pledge card or other document from the qualified organization that states the organization does not provide goods or services in return for any contribution made to it by payroll deduction.

Noncash Contributions

For a contribution not made in cash, the records a taxpayer must keep depend on whether their deduction for the contribution is:

(1) Less than $250,

(2) At least $250 but not more than $500,

(3) Over $500 but not more than $5,000, *or*

(4) Over $5,000.

Deductions of Less Than $250

If any noncash contribution is made, the taxpayer must get and keep a receipt from the charitable organization showing:

(1) The name of the charitable organization,

(2) The date and location of the charitable contribution, *and*

(3) A reasonably detailed description of the property.

A letter or other written communication from the charitable organization acknowledging receipt of the contribution and containing the information in (1), (2), and (3) will serve as a receipt.

> **Note:** Taxpayers are not required to have a receipt where it is impractical to get one (for example, if property is left at a charity's unattended drop site).

Additional Records

Taxpayers must also keep reliable written records for each item of donated property. Such written records must include the following:

(1) The name and address of the organization to which the taxpayer contributed,

(2) The date and location of the contribution,

(3) A description of the property in detail reasonable under the circumstances,

> **Note:** For security, keep the name of the issuer, the type of security, and whether it is regularly traded on a stock exchange or in an over-the-counter market.

(4) The fair market value of the property at the time of the contribution and how the fair market value was figured,

> **Note:** If it was determined by appraisal, keep a signed copy of the appraisal.

(5) The cost or other basis of the property if the taxpayer must reduce its fair market value by appreciation,

(6) The amount claimed as a deduction for the tax year as a result of the contribution if the taxpayer contributes less than their entire interest in the property during the tax year, *and*

(7) The terms of any conditions attached to the gift of property.

Deductions of At Least $250 But Not More Than $500

If a deduction of at least $250 but not more than $500 for a noncash charitable contribution is claimed, a taxpayer must get and keep an acknowledgment of their contribution from the qualified organization. This acknowledgment must contain the information in items (1) through (3) listed under Deductions of Less Than $250, earlier, and the taxpayer's written records must include the information listed in that discussion under Additional Records.

The acknowledgment must:

(1) Be written;

(2) Include:

(a) A description (but not the value) of any property contributed,

(b) Whether the qualified organization gave the taxpayer any goods or services (other than token items of little value) as a result of the contribution, *and*

(c) A description and good faith estimate of the value of any goods or services described in (b); *and*

> **Note:** If the only benefit received was an intangible religious benefit (such as admission to a religious ceremony) that generally is not sold in a commercial transaction outside the donative context, the acknowledgment must say so and does not need to describe or estimate the value of the benefit.

(3) Be received on or before the earlier of:

(a) The date the return is filed for the year of the contribution, *or*

(b) The due date, including extensions, for filing the return.

Deductions Over $500 But Not Over $5,000

If a deduction over $500 but not over $5,000 for a noncash charitable contribution is claimed, the taxpayer must have the acknowledgment and written records described under Deductions of At Least $250 But Not More Than $500.

In addition, the taxpayer's records must include:

(1) How the taxpayer got the property, for example, by purchase, gift, bequest, inheritance, or exchange;

(2) The approximate date the taxpayer got the property or, if created, produced, or manufactured by or for the taxpayer, the approximate date the property was substantially completed; *and*

(3) The cost or other basis, and any adjustments to the basis, of property held less than 12 months and, if available, the cost or other basis of property held 12 months or more.

Note: This requirement, however, does not apply to publicly traded securities.

If a taxpayer is not able to provide information on either the date they got the property or the cost basis of the property and they have a reasonable cause for not being able to provide this information, attach a statement of explanation to the return.

Deductions over $5,000

If a deduction of over $5,000 for a charitable contribution of one property item or a group of similar property items is claimed, the taxpayer must have the acknowledgment and the written records described under Deductions Over $500 But Not Over $5,000. In figuring whether the deduction is over $5,000, combine all claimed deductions for similar items donated to any charitable organization during the year.

Generally, if the claimed deduction for an item or group of similar items of donated property is more than $5,000, other than money and publicly traded securities, the taxpayer must get a qualified appraisal made by a qualified appraiser and must attach an appraisal summary (Section B of Form 8283) to their tax return.

Contributions over $75 Made Partly for Goods or Services

Charities that receive payments made partly as a gift and partly for goods or services must inform the donor that the charitable deduction is limited to the excess of the contribution over the value of the goods or services where the donor makes a payment of more than $75. In addition, the

charity must provide the donor with a good-faith estimate of the value of those goods or services.

Example #1

In a weak moment, Dan contributes $100 to liberal dominated Public Television while watching a special on the new lawyers' weasel petting zoo in San Diego. In return he receives their number one premium, "Pavarotti Does Country Western," valued at $40. Public Television would have to inform Dan that only $60 of his hard-earned Republican dollars are deductible.

Example #2

However, if Dan only contributed $35.00 to Public TV and received a baseball cap emblazoned with PTV on it, PTV does not have to inform Dan of anything, because the donation is less than $75.

There is a penalty of $10 per contribution (up to a limit of $5,000 per fundraising event or mailing) for failure to comply with this rule.

State and Local Tax (SALT) Deduction - §164 [Schedule A]

Section 164 allows taxpayers who itemize deductions on their federal income tax returns to deduct certain taxes paid to state and local governments. This can include real estate and personal property taxes, as well as either income taxes or general sales taxes.

> **Comment:** Taxpayers cannot deduct both state income and sales tax. However, they can combine property and sales taxes or property and income taxes, but not all three.

However, the TCJA capped the total state and local tax deduction at $10,000 for tax years 2018 through 2025. Thus, a taxpayer may only claim an itemized deduction of up to $10,000 ($5,000 for a married taxpayer filing a separate return) for the *aggregate* of:

(1) State and local property taxes not paid or accrued in carrying on a trade or business, or an activity described in §212, *and*

(2) State and local income, war profits, and excess profits taxes (or sales taxes in lieu of income, etc. taxes) paid or accrued in the taxable year.

Foreign real property taxes may not be deducted under this $10,000 provision.

Income Taxes

Taxpayers may**:**

1. Deduct up to $10,000 of state and local income taxes withheld from salary;

> **Note:** A taxpayer may claim an itemized deduction of up to $10,000 ($5,000 for a married taxpayer filing a separate return) for the aggregate of state and local property taxes.

2. Deduct payments made on taxes for an earlier year in the year they were withheld or paid; *and*

3. Deduct estimated payments (including any credits for an overpayment applied to estimated taxes) made under a scheduled payment plan of a state or local government.

> **Note:** However, taxpayers must have a reasonable basis for making the estimated state tax payments. In other words, if the income does not justify the estimated tax payment the payment is not deductible.

Real Property Tax

A taxpayer may deduct, up to $10,000, any real estate taxes for any state or local taxes on real property levied for the general public welfare. Do not deduct taxes charged for local benefits and improvements that increase the value of the property.

If a taxpayer bought or sold real estate during the tax year, the real estate taxes must be divided between the buyer and the seller. The buyer and the seller must divide the real estate taxes according to the number of days in the real property tax year (the period to which the tax imposed relates) that each owned the property. The seller pays the taxes up to the date of the sale, and the buyer pays the taxes beginning with the date of the sale.

Accrual Method Taxpayers

Regulations require accrual method taxpayers to delay property tax deductions until actually paid. This applies to both state and local property taxes. Deductions for property taxes can no longer be accrued when the tax lien attaches to the property.

State & Local Sales Tax Deduction - §164

At the election of the taxpayer, an itemized deduction, up to $10,000, can be taken for State and local general sales taxes in lieu of the itemized deduction for State and local income taxes.

Taxpayers are able to deduct general State and local sales taxes paid by accumulating receipts showing general sales taxes paid. Alternatively, taxpayers can use optional sales tax tables created by the IRS (see Pub. 600). Taxpayers also can add to the table any sales taxes paid on:

(1) a motor vehicle, but only up to the amount of tax paid at the general sales tax rate;

(2) an aircraft, boat, home (including mobile or prefabricated); or

(3) home building materials, if the tax rate was the same as the general sales tax rate.

As is the case for State and local income taxes, the itemized deduction for state and local general sales taxes is not permitted for purposes of determining a taxpayer's alternative minimum taxable income.

Personal Property Tax

To deduct up to $10,000 of personal property tax, a state or local tax must meet the following three tests:

(1) The tax must be based only on the value of the personal property;

Example

Assume your state charges a yearly motor vehicle registration tax of 2% of value plus twenty-five cents per one hundred pounds. You paid $69 based on the value of $3,000 and a weight of 3600 pounds for your car. You may deduct $60 as a personal property tax since the tax is based on the value. However, the remaining $9 is based on weight and is not deductible.

(2) The tax must be charged on a yearly basis, even if it is collected more than or less than once a year; *and*

(3) The tax must be charged on personal property.

Note: A tax is considered charged on personal property even if it is for the exercise of a privilege. For example, a yearly tax based on value qualifies as a personal property tax although it is called a registration fee that is for the privilege of registering motor vehicles or using them on the highways.

Other Deductible Taxes

Other taxes may be deductible if they are ordinary and necessary expenses. Generally, these taxes must be paid during the tax year. The following are examples of deductible income producing taxes that are ordinary and necessary:

(1) One-half of the self-employment tax;

(2) Taxes attributable to property producing rent or royalty income (generally deductible on Schedule E, Form 1040);

(3) Foreign income taxes a taxpayer pays to a foreign country or U.S. possession; *and*

Note: Location of the deduction is at the discretion of the tax preparer. The preparer may choose to deduct the taxes on Schedule A, Form 1040 as an itemized deduction, or claim a credit against U.S. income tax (see Publication 514, Foreign Tax Credit for U.S. Citizens and Resident Aliens).

(4) Taxes that a taxpayer pays in operating their business, or on their property used in their business (usually deductible on Schedule C or Schedule F, Form 1040).

Examples of Non-Deductible Taxes

Nondeductible *federal* taxes include:

(1) Federal income taxes, including those withheld from pay or paid as estimated tax payments,

(2) Social security or railroad retirement taxes withheld from pay,

(3) Social security and other employment taxes paid on the wages of a taxpayer's employee who performed domestic or other personal services,

(4) Federal excise taxes or customs duties, unless they are connected with your business or income-producing activity, *and*

(5) Federal estate and gift taxes.

> **Note:** However, if a taxpayer must include in gross income an amount of income in respect of a decedent, the tax may be deductible as a miscellaneous deduction.

The following *state* or *local* taxes are not deductible:

(1) General sales taxes (temporary legislation permitted the deduction through 2011),

(2) Motor vehicle sales tax (see *Personal Property Tax*, earlier),

(3) Inheritance, legacy, succession, or estate taxes,

(4) Gift taxes,

(5) Per capita or poll taxes, *and*

(6) Cigarette, tobacco, liquor, beer, wine, etc., taxes.

Fees and charges such as the following are not deductible:

(1) Driver's licenses, car inspection fees, license plates (see *Personal Property Tax*, earlier),

(2) Dog tags, hunting licenses,

(3) Marriage licenses,

(4) Tolls for bridges and roads, parking meter deposits (unless business related),

(5) Fines (such as for parking or speeding) and collateral deposits,

(6) Water bills, sewer, utility, and other service charges.

(7) Postage (unless business related), etc,

(8) State and local taxes on gasoline, diesel, and other motor fuels are not deductible unless the vehicles are used for business.

(9) Taxes for improvements to property are not deductible.

> **Note:** These include assessments for streets, sidewalks, water mains, sewer lines, public parking facilities, and similar improvements. A taxpayer should increase the basis of their property by the amount of the assessment.

(10) Transfer taxes (or stamp taxes) and other taxes and charges on the sale of a personal home are not deductible.

> **Note:** However, if the seller pays them, they are expenses of the sale and reduce the amount realized on the sale. If paid by the buyer, they are included in the cost basis of the property.

(11) Utility taxes charged under state or local law are not deductible if the rate differs from that of the general sales tax,

(12) A fuel adjustment charge by a municipally owned electric utility company that is charged to residents is a nondeductible personal expense, *and*

(13) Employment taxes for household workers.

> **Note:** A taxpayer may not deduct the social security or other employment taxes they pay on the wages of a household worker. However, they may be able to include their share of social security and other employment taxes they pay as part of medical or childcare expenses.

Casualty & Theft Losses - §165 [Schedule A]

Personal casualty and theft losses of an individual, sustained in a tax year beginning after 2017, are deductible only to the extent that the losses are attributable to a federally declared disaster. Personal casualty and theft losses attributable to a federally declared disaster are subject to the $100 per casualty and 10% of adjusted gross income (AGI) reductions unless they are attributable to a *qualified* disaster loss (i.e., a disaster declared by the President under §401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act). Personal casualty and theft losses attributable to a qualified disaster loss are *not* subject to the 10% of the AGI reduction and the $100 reduction is increased to $500.

> **Comment:** Formerly, a personal deduction was allowed for all or part of each loss caused by theft or casualty. However, personal casualty or theft losses were deductible only if they exceeded $100 per casualty or theft. In addition, aggregate net casualty and theft losses were deductible only to the extent they exceed 10% of an individual taxpayer's adjusted gross income (§165).

Business casualty and theft losses generally are fully deductible, regardless of whether the damage occurred in a federal disaster area. While such losses are not subject to the $100-per-event reduction or the 10%-of-adjusted gross income threshold, they are subject to other restrictions, such as those related to salvage value and insurance reimbursements.

Definitions

Casualty - A casualty is the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual. There is no casualty loss if the damage is caused by progressive deterioration of property caused by termites, moths, drought, disease, or rust.

Theft - A theft is the unlawful taking and removing of money or property with the intent to deprive the owner of it. Lost or mislaid money or property does not qualify for the casualty loss deduction.

Proof of Loss

To take a deduction for a casualty or theft loss, a taxpayer has to be able to show that there was a casualty or theft. Taxpayers also have to support the amount taken as a deduction and show that they owned the property.

Amount of Loss

The amount of a casualty or theft loss is generally the *lesser* of:

(1) The decrease in the fair market value of the property as a result of the casualty or theft, *or*

(2) The taxpayer's adjusted basis in the property before the casualty or theft.

Taxpayers can use the cost of replacing or repairing property after a casualty as a measure of the decrease in fair market value if the value of the repaired or replaced property does not exceed the value of the property before the casualty.

Insurance & Other Reimbursements

Any insurance reimbursement has to be subtracted from the amount of the loss when the deduction is figured. If the reimbursement exceeds the taxpayer's basis in the property there is a casualty gain. If the personal casualty gains for any tax year exceed the personal casualty loss for that year all the gains and losses are treated as capital gains and losses. In that event, the losses are not subject to the 10% floor.

For casualty and theft losses sustained by individuals, and not attributable to a business or a for-profit transaction, a loss covered by insurance is taken into account only if the taxpayer filed a timely claim.

Limitations

Nonbusiness casualty and theft losses can be deducted only to the extent that the amount of each separate casualty or theft loss exceeded $100, and the total amount of all losses during the year exceeded 10% of the taxpayer's adjusted gross income. Nonbusiness casualty and theft losses in excess of this 10% floor are deducted as itemized deductions on Schedule A of Form 1040.

There are no limitations on casualty or theft losses on property used in a trade or business. If business casualty losses exceed business casualty gains they are deductible as ordinary losses on Form 4797.

Casualty or Theft Loss Deduction

Part A: Loss Arising From a Single Casualty

1. Fair market value of property immediately *before* the casualty or theft	$_____	
2. Fair market value of property immediately *after* the casualty or theft	$_____	
3. Line 1 minus Line 2 (but not less than zero)[4]	$_____	
4. Adjusted basis of property destroyed by casualty or lost by theft[5]	$_____	
5. Loss - before limitations (lower of Lines 3 or 4)		$_____
6. Insurance proceeds received by taxpayer[6]	$_____	
7. Nonbusiness property limitation	$100	
8. Total of Lines 6 and 7		$_____
9. Casualty or theft loss from that property (Line 5 minus Line 8)		$_____

Part B: Total Casualty or Theft Loss for the Year

10. Enter amount on Line 9 (if there is more than one casualty, theft, or disaster loss, combine the amounts on Line 9 from the schedules prepared for each casualty)		$_____
11. Adjusted gross income	$_____	
12. Enter 10% of Line 11		$_____
13. Deductible casualty or theft loss for the year (Line 10 minus Line 12)		$_____

Allocation for Mixed Use Property

When a casualty involves both real and personal property, the taxpayer has to figure the amount of the loss separately for each type of property, as discussed above. However, the taxpayer applies a single $100 reduction to the total loss. Then they apply the 10% rule.

When property is owned partly for personal use and partly for business or income-producing purposes, the casualty or theft loss deduction must be figured as though there were two separate casualties or thefts - one affecting the nonbusiness property and the other affecting the business or income-producing property. The $100 rule and the 10% rule apply only to the casualty or theft of nonbusiness property.

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[4] The cost of repairing damaged property is evidence of the loss in its value if (i) the repairs are necessary to restore the property to its former condition, (ii) the amount spent for repairs is not excessive, (iii) the repairs are restricted to the damage suffered in the casualty, and (iv) the repairs do not increase the value of the property beyond it former fair market value.

[5] In the case of property that is converted from personal use in a trade or business or for the production of income, use fair market value on the date of the conversion if the property's value on that date was less than adjusted basis.

[6] If the loss is insured, a timely insurance claim must be filed with respect to damages to the property or the casualty loss will be disallowed (§165(h)(3)(E)).

2% Itemized Deductions Suspended - §67 [Schedule A]

Formerly, itemized deductions for certain miscellaneous expenses could not be deducted unless, in the aggregate, they exceeded 2% of the taxpayer's adjusted gross income (§§62, 67 & 212). However, as a result of the TCJA, all miscellaneous itemized deductions that are subject to the 2% floor are suspended from 2018 through 2025. Thus, taxpayers may not claim such items as itemized deductions for the affected taxable years. An individual also is unable to claim such deductions in calculating his or her AMT liability.

> **Note:** Miscellaneous itemized deductions subject to the 2% floor and now suspended include but, are not limited to (i) expenses for the production or collection of income, (ii) tax preparation expenses, (iii) unreimbursed expenses attributable to the trade or business of being an employee.

Moving Expenses - §217

Formerly, a taxpayer could claim a deduction for moving expenses incurred in connection with starting a new job, regardless of whether or not the taxpayer itemizes his deductions. To qualify, the new workplace generally had to be at least 50 miles farther from the former residence than the former place of work or, if the taxpayer had no former workplace, at least 50 miles from the former residence (§217). In addition, employer-provided qualified moving expense reimbursements are excluded from an employee's gross income.

From 2018 through 2025, the deduction for moving expenses for taxable years is suspended. However, during that suspension period, the provision retains the deduction for moving expenses and the rules providing for exclusions of amounts attributable to in-kind moving and storage expenses (and reimbursements or allowances for these expenses) of members of the Armed Forces (or their spouse or dependents) on active duty that move pursuant to a military order and incident to a permanent change of station.

> **Note:** The exclusion of employer-provided qualified moving expense reimbursements is also suspended for tax years 2018 through 2025.

Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regard to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

27. According to the author, four requirements must be met for most §170 charitable contributions. What is one of these four basic requirements?

a. Individual taxpayers cannot itemize contributions.

b. Taxpayers must abide by statutory limits.

c. Only taxpayers who use cash basis accounting must make contributions during the tax year.

d. Taxpayers must make contributions to or for the benefit of individuals.

28. Charities often conduct games, events, and activities at which participants transfer funds. However, which of the following payments to charity is most likely deductible outside of the §170 charitable provisions?

a. payments made for raffle tickets or bingo.

b. contributions of cash

c. amounts paid for tickets to charity balls, banquets, or shows.

d. dues, fees, or assessments.

29. The type of property contributed to a charity determines the tax treatment of the contribution. With regard to charitable contributions of clothing and household items, what is required?

a. Paintings and antiques are included in the categorization.

b. Used donated clothing or household items must be in good condition.

c. A $500 deduction may be claimed for any item not in good used condition.

d. Used socks and used undergarments can qualify for a deduction.

30. Taxpayers may be able to deduct certain automobile expenses as a charitable contribution. Which of these expenses may taxpayers deduct whether they use the standard mileage rate or the actual expense method?

a. depreciation, insurance, and repairs.

b. parking fees and tolls.

c. the value of transportation services.

d. any travel expenses.

31. The author lists several miscellaneous itemized deductions subject to the 2% of adjusted gross income (AGI) limitation of §67 that are now suspended. Which of the following is such an item?

a. the deduction for taxes under §164.

b. casualty losses deductible under §165.

c. the deduction for an amortizable bond premium under §171.

d. unreimbursed employee business expenses.

32. The deduction for moving expenses is currently suspended. Nevertheless, during this suspension period, the deduction is retained for:

a. disaster area residents.

b. certain members of the Armed Forces.

c. first-time job seekers.

d. veterans.

Credits

A *deduction* is subtracted either from gross income or from AGI. In either case, the deduction reduces taxable income. A *credit*, on the other hand, reduces tax on a dollar-for-dollar basis.

Child or Dependent Care Tax Credit - §21 [Form 2441]

Employment-related expenses for child or dependent care can qualify for a credit. The credit is up to 35% of eligible childcare expenses ($3,000 for one child and $6,000 for two or more children) for children under 13 and disabled dependents (§21). The 35% credit rate is reduced, but not below 20%, by one per-

centage point for each $2,000 (or fraction thereof) of adjusted gross income ("AGI") above $15,000. Therefore, the credit percentage is reduced to 20% for taxpayers with AGI over $43,000.

AGI in Excess of:	Credit Percent:
15,000	34%
17,000	33%
19,000	32%
21,000	31%
23,000	30%
25,000	29%
27,000	28%
29,000	27%
31,000	26%
33,000	25%
35,000	24%
37,000	23%
39,000	22%
41,000	21%
43,000	20%

Comment: The child and dependent care credit (§21) should not be confused with the child tax credit of $2,000 for each qualifying child under the age of 17 at the end of the calendar year (§24). The child tax credit is refundable for some taxpayers, but it is phased out for high-income taxpayers.

Eligibility

A qualifying individual must furnish more than half the cost of maintaining a household for either:

(1) A dependent under age 13, *or*

(2) A dependent or spouse who is physically or mentally incapacitated.

Employment Related Expenses

Expenses qualifying for the credit include expenses for household services and for the care of qualifying individuals that are incurred to enable the taxpayer to be employed.

Qualifying Out-of-the-home Expenses

Qualifying out-of-the-home expenses include those for a dependent under age 13 and for an older dependent or spouse who is incapacitated as long as he or she regularly spends at least eight hours each day in the taxpayer's household.

Payments to Relatives

Childcare payments to relatives are eligible for the credit unless the relative is a dependent of the taxpayer or the taxpayer's spouse or is a child (under age 19) of the taxpayer.

Allowable Amount

The amount of employment-related expenses that may be used to compute the credit is $3,000 if the expenses are incurred for one qualifying individual and $6,000 if they are incurred for two or more qualifying individuals.

Dependent Care Assistance - §129

The dollar amount of expenses eligible for the credit is reduced, dollar for dollar, by the aggregate amount excludable from gross income under §129 dependent care assistance exclusion.

Reporting

The credit is not allowable unless the taxpayer reports the correct name, address, and tax identification number of the care provider. The credit is claimed by completing and filing Form 2441, *Credit for Child and Dependent Care Expenses*.

Earned Income Tax Credit - §32 [Form 1040]

As previously discussed, the earned income tax credit is a special credit allowable for persons who work and meet certain criteria established by law. The credit reduces the amount of tax owed and may qualify taxpayers for a refund even if they do not owe any tax, or earned enough money to file a return. The credit is intended to offset some of the increases in living expenses and social security taxes for taxpayers with limited incomes (see earlier discussion for more details).

Adoption Credit - §23 & §137

Taxpayers that adopt children can receive a refundable tax credit for qualified adoption expenses (§23). A taxpayer may also exclude from income adoption expenses paid by an employer (§137).

For 2025, the maximum adoption credit is $17,280 (up from $16,810 in 2024). Also, the maximum exclusion from income for benefits under your employer's adoption assistance program is $17,280. These amounts are phased out if your modified AGI is between $259,190 and $299,190 in 2025 ($252,150 and $292,150 in 2024). You cannot claim the credit or exclusion if your modified AGI is $299,190 or more in 2025 ($292,150 or more in 2024) (R.P. 2024-40).

> **Note:** Modified adjusted gross income is the sum of the taxpayer's adjusted gross income plus amounts excluded from income under §911, §931, and

§933 (relating to the exclusion of income of U.S. citizens or residents living abroad; residents of Guam, American Samoa, and the Northern Mariana Islands; and residents of Puerto Rico, respectively).

Qualified Adoption Expenses

Qualified adoption expenses are reasonable and necessary adoption fees, court costs, attorney's fees, and other expenses that are:

(1) Directly related to, and the principal purpose of which is for, the legal adoption of an eligible child by the taxpayer;

(2) Not incurred in violation of State or Federal law, or in carrying out any surrogate parenting arrangement;

(3) Not for the adoption of the child of the taxpayer's spouse; *and*

(4) Not reimbursed (e.g., by an employer).

Exclusion from Income for Employer Reimbursements - §137

A maximum $17,280 (up from $16,810 in 2024) *exclusion* in 2025 from the gross income of an employee is allowed for qualified adoption expenses paid or reimbursed by an employer under an adoption assistance program. The exclusion is also phased out ratably for taxpayers with modified adjusted gross income between $259,190 and $299,190 in 2025 ($252,150 and $292,150 in 2024) (§137). These amounts are adjusted annually for inflation.

The exclusion does not apply for purposes of payroll taxes. Adoption expenses paid or reimbursed by the employer under an adoption assistance program are not eligible for the adoption credit. A taxpayer may be eligible for the adoption credit (with respect to qualified adoption expenses he or she incurs) and also for the exclusion (with respect to different qualified adoption expenses paid or reimbursed by his or her employer).

You cannot claim the credit or exclusion if your modified AGI is $299,190 in 2025 (up from $292,150 in 2024) or more.

Child Tax Credit - §24

Credit Amount

Under §24, an individual may claim a tax credit for each qualifying child *under* the age of 17. A child who is not a citizen, national, or resident of the United States cannot be a qualifying child. The maximum amount of the credit per child is $2,000 for 2024 and 2025 and is usable against the regular income tax and AMT. Thus, in the case of a taxpayer with qualifying children, the amount of the child credit equals the amount of the credit times the number of qualifying children.

Qualifying Child

To be a qualifying child for the tax year, the child must:

(1) be under age 17 at the end of the year;

(2) be taxpayer's son, daughter, stepchild, eligible foster child, brother, sister, stepbrother, stepsister, half-brother, half-sister, or a descendant of one of these (for example, a grandchild, niece or nephew);

(3) provide no more than half of their own financial support during the year;

(4) have lived with the taxpayer for more than half the year;

(5) be properly claimed as taxpayer's dependent on taxpayer's tax return;

(6) not file a joint return with their spouse for the tax year or file it only to claim a refund of withheld income tax or estimated tax paid; *and*

(7) have been a U.S. citizen, U.S. national, or U.S. resident alien.

Phase-out

The aggregate amount of child credits that may be claimed is phased out for individuals with income over certain threshold amounts. The otherwise allowable child tax credit is reduced by $50 for each $1,000 (or fraction thereof) of modified adjusted gross income over $200,000 for single individuals or heads of households, $400,000 for married individuals filing joint returns, and $200,000 for married individuals filing separate returns (§24(h)). These thresholds are *not* adjusted for inflation.

Refundable Child Care Credit Amount

The child credit is *refundable* to the extent of the greater of:

(1) 15% of earned income above $2,500 *or*

> **Note:** Earned income is defined as the sum of wages, salaries, tips, and other taxable employee compensation plus net self-employment earnings.

(2) for taxpayers with three or more qualifying children, the excess of the taxpayer's social security taxes for the tax year over his or her earned income tax credit for the year (§24(d)).

The refundable portion of the credit is limited to $1,700 in 2024 and 2025 (up from $1,600 in 2023) per qualifying child but is indexed for inflation (§24(d)(1)(A).

AMT & Child Tax Credit

The refundable child tax credit is not reduced by the amount of the alternative minimum tax. The child tax credit is allowed to the extent of the full amount of the individual's regular income tax and alternative minimum tax.

$500 Credit for Certain Dependents - §24(h)(4)(A)

The $500 credit for dependents, also known as the Family Tax Credit, is a non-refundable credit that taxpayers may be able to claim for dependents who don't qualify for the child tax credit. It can be claimed for dependents of any age, including those who are age 18 or older.

> **Comment:** The credit can be claimed for dependent parents or other qualifying relatives supported by the taxpayer. In fact, the credit even apples to It also applies to dependents living with the taxpayer who are not related to the taxpayer.

The $500 credit applies to two categories of dependents:

(a) qualifying children for whom a child tax credit is not allowed, *and*

(b) qualifying relatives as defined in §152(d).

This dependent must also be a U.S. citizen, national, or resident of the United States and not a resident of a contiguous country (i.e., Mexico and Canada).

A taxpayer can claim this credit if:

(a) they claim the person as a dependent on the taxpayer's return,

(b) they cannot use the dependent to claim the child tax credit or additional child tax credit, *and*

(c) the dependent is a U.S. citizen, national, or resident alien.

The credit begins to phase out when the taxpayer's income is more than $200,000. This phaseout begins for married couples filing a joint tax return at $400,000.

American Opportunity Tax (former Hope) & Lifetime Learning Credits - §25A

The Hope (or American Opportunity) tax credit is available for up to four taxable years for students enrolled at least half-time who are pursuing a degree or credential and has a maximum value of $2,500 per student per year (up to $10,000 in tax relief over four years). In contrast, the lifetime learning tax credit is available for an unlimited number of years of education, does not require that the qualifying students be pursuing a degree or credential, and has a maximum value of $2,000 per tax return. Both credits phase out for taxpayers with modified adjusted gross income between $80,000 and $90,000 (between $160,000 and $180,000 for joint filers).

American Opportunity Tax Credit - §25A(b)(1)

Over the years, the original Hope credit has been permanently modified by provisions referred to as the "American Opportunity Tax" credit (§25A(1)).

Note: As a result, the credit is now referred to as the "American Opportunity Tax Credit".

The allowable credit is $2,500 (in 2024 & 2025) per eligible student per year for qualified tuition and related expenses paid for each of the first four years of the student's post-secondary education in a degree or certificate program.

The amount of credit for each eligible student is the sum of:

(1) 100% on the first $2,000 of qualified tuition and related expenses paid for the eligible student, *and*

(2) 25% on the next $2,000 of qualified tuition and related expenses (maximum credit $2,500) paid for that student.

Note: The definition of qualified tuition and related expenses includes course materials. However, the inclusion of course materials applies only to the American Opportunity Tax Credit (i.e., Hope) and not to the Lifetime Learning Credit.

Accordingly, the maximum American Opportunity Tax Credit allowable under §25A(b)(1) is $2,500 for 2024 and 2025.

Phase Out - §25A(d)(2)

The credit is phased out ratably for taxpayers with modified adjusted gross income between $80,000 and $90,000 ($160,000 and $180,000 for married taxpayers filing a joint return) in 2024 and 2025. The credit can be claimed against a taxpayer's alternative minimum tax liability. These income phaseouts are not adjusted for inflation.

Refundable Portion

Forty percent of a taxpayer's otherwise allowable American opportunity credit is refundable for most taxpayers. Thus, if the credit brings the amount of tax owed to zero, 40 percent of any remaining amount of the credit (up to $1,000 – i.e., 40% x $2,500) is refundable.

Note: No portion of the modified credit is refundable if the taxpayer claiming the credit was a child to whom §1(g) applies for such taxable year (generally, any child under age 18 or any child under age 24 who is a student providing less than one-half of his or her own support, who has at least one living parent and does not file a joint return).

Lifetime Learning Credit - §25A(a)(1)

In 2024 and 2025, the maximum amount of Lifetime Learning credit you can claim is $2,000 (i.e., 20% of the first $10,000 of qualified education expenses) per taxpayer return (§25A(c)(1)). The credit applies to all years (not just the first four years of post-secondary education) in which the taxpayer pays qualified expenses.

Phase Out - §25A(d)(2)

For 2024 and 2025, the Lifetime Learning credit amount is phased out ratably for taxpayers with modified adjusted gross income between $80,000 and $90,000 ($160,000 and $180,000 for married taxpayers filing a joint return). The income phaseouts for the lifetime learning tax credit are not adjusted for inflation. These phaseout amounts are the same as the American Opportunity Tax Credit.

Ministers & Military - §107

Clergy

Members of the clergy must include in income the amounts received from offerings and fees for marriages, baptisms, funerals, masses, etc., in addition to their salary. However, if the offering is made to a religious institution, it is not taxable to the clergy member.

Members of religious organizations, who turn over their outside earnings to the organization, must still include the earnings in their income. However, they may be entitled to a charitable contribution deduction for the amount paid to the organization.

Rental Value of a Home

If clergy members are provided a home as part of their pay for carrying out their duties as ordained, licensed, or commissioned ministers, the rental value of the home and the utility expenses paid for them are not income to them. However, clergy must include the rental value of the home, and related allowances, as earnings from self-employment on Schedule SE (Form 1040) for the purpose of the Social Security Self-employment tax.

> **Comment:** Expenses of providing a home include rent, house payments, furniture payments, and utilities. They do not include the cost of food or servants.

Similarly, housing allowances paid to clergy as part of their salary to the extent they use it to provide a home or to pay utilities are not taxable.

Members of Religious Orders

A member of a religious order, who has taken a *vow of poverty*, excludes from income the amounts earned for services performed as an agent of the order that are renounced and turned over to the order.

If the member is directed to take employment outside the order, the employment will not constitute the exercise of duties required by the order unless the services are:

(a) The kind that are ordinarily the duties of members of the order, *and*

(b) A part of the duties that are required to be exercised for, or on behalf of, the religious order as its agent.

Ordinarily, services will not be considered directed or required by the order if the legal relationship of employer and employee exists between the member and a third party for whom the services are performed. When services are not considered to be directed or required by the order, the amounts received for the services are includable in the member's gross income. This is true even if the member has taken a vow of poverty.

Example

Mark Brown is a member of a religious order and has taken a vow of poverty. All claims to his earnings are renounced and belong to the order.

Mark is a schoolteacher. He was instructed by the superiors of the order to get a job with a private tax-exempt school, and as he requested, the school made the salary payments directly to the order. Because Mark is an employee of the school, he is performing services as the school's agent rather than as an agent of the order through whom the order performs services for the school. Therefore, the wages Mark earns working for the school are included in his gross income.

Military & Veterans

Payments received as a member of a military service generally are taxable except for certain allowances (Reg. §1.61-2(a)(1)). They are reported as wages. However, veterans' benefits generally are not taxable.

Wages - §61

Military pay taxable as wages includes:

(a) Active duty pay,

(b) Reserve training pay,

(c) Reenlistment bonus,

(d) Armed Services Academy pay,

(e) Amounts received by retired personnel serving as instructors in junior ROTC programs, *and*

(f) Lump-sum payments upon separation or release to inactive duty.

Military retirement pay based on age or length of service is taxable and must be included on line 16, Form 1040.

Nontaxable Income - §134

Military benefits *not* taxable as wages include:

(1) Annual round trip for dependent students

(2) Burial and death services (internal allowances)
(3) Combat zone compensation and benefits
(4) Death gratuities
(5) Defense counseling
(6) Dental care for military dependents
(7) Dependent education
(8) Disability benefits
(9) Educational assistance
(10) Emergency assistance
(11) Evacuation allowances
(12) Family counseling
(13) Family separation allowances
(14) Forfeited pay
(15) Group term life insurance
(16) Housing allowances
(17) Medical benefits
(18) Moving and storage
(19) Mustering out payments (payments on discharge)
(20) Overseas cost-of-living allowances
(21) Premiums for survivor & retirement protection plans
(22) Professional education
(23) Quarters allowances
(24) Subsistence allowances
(25) Temporary lodging in conjunction with certain orders
(26) Travel for consecutive overseas tours
(27) Travel for consecutive overseas tours for dependents
(28) Travel in lieu of moving dependents during ship overhaul or inactivation
(29) Travel of dependents to a burial site
(30) Travel to a designated place in conjunction with reassignment in a dependent-restricted status
(31) Uniform allowance

Veterans' Benefits - §134

Veterans' benefits under any law administered by the Veterans Administration are not included in gross income. The following amounts paid to veterans or their families are not taxable:

(a) Education, training, or subsistence allowances,
(b) Disability compensation and pension payments for disabilities
(c) Grants for homes designed for wheelchair living

(e) Grants for motor vehicles for veterans who lost their sight or the use of their limbs, *and*

(f) Veterans' pensions paid either to the veterans or to their families.

Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regard to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

33. Which of the following credits was created by §32 to provide relief for lower-income taxpayers?

a. Making Work Pay credit.

b. child care credit.

c. first-time homebuyer credit.

d. earned income tax credit.

34. Section 23 provides an individual credit for qualified adoption expenses. Such expenses must meet four general requirements. For example, such adoption fees and related expenses:

a. must not be incurred in breach of an arrangement for surrogate parenting of a child.

b. must be directly or indirectly related to the adoption.

c. can be incurred in the process of adopting a spouse's child.

d. can be reimbursed by an employer.

35. Parents can take advantage of several child-related credits. Which credit is available to certain taxpayers based on having a qualifying child under age 17?

a. lifetime learning credit.

b. child tax credit.

c. Hope credit.

d. adoption credit.

36. Under §24, an individual may claim a tax credit for each qualifying child. This credit:

a. can be used against the regular income tax but, not the AMT.

b. is not subject to phase-out.

c. can be refundable.

d. is reduced by the AMT.

37. The American Opportunity Education Tax Credit is available to qualified individuals for qualified tuition and related expenses. What does this tax credit include in the definition of qualified tuition and related expenses?

a. costs for course materials.

b. costs for lodging.

c. costs for meals.

d. costs for sports.

38. Which payments received for military service are taxable as wages?

a. annual round trip for dependent students.

b. armed services academy pay.

c. combat zone compensation and benefits.

d. death gratuities.

Learning Objectives

After reading Chapter 2, participants will be able to:

1. Recognize the tax treatment of rental property expenses specifying their impact on landlords and tenants taking into consideration the tax differences given to rent, insurance, tax preparation fees, property taxes, and purchased leases.

2. Identify the application of the hobby loss rules to a business, determine deductible expenses, recognize the requirements of the home-office deduction, and specify self-employment taxes.

3. Determine how to properly deduct travel by identifying deductible domestic and foreign business travel expenses, a taxpayer's tax home, if any, and work locations; specify the "away from home" and convention rules; and define the adequate substantiation methods.

4. Differentiate accountable and nonaccountable plans including the requirements for an accountable plan particularly adequate accounting using per diem rates for non-related employees.

5. Determine what constitutes local personal commuting and deductible travel to temporary work sites.

6. Identify the apportionment of automobile expenses between personal and business use, the actual cost and standard mileage methods, medical & charitable mileage, and depreciation.

7. Specify the various types of excluded fringe benefits that can increase employers' deductions and incentive-based compensation of employee.

8. Recognize the cash, accrual, and other methods of accounting, select available accounting periods specifying their impact on income and expenses, and identify expensing and amortization.

CHAPTER 2

Expenses, Deductions & Accounting

Landlord Rental Expenses - Schedule E

Repairs and certain other expenses of renting property can be deducted from gross rental income. Rental expenses are normally deducted in the year they are paid or incurred.

If a taxpayer holds property for rental purposes, in addition to depreciation, taxes, and utilities, they may be able to deduct ordinary and necessary expenses for managing, conserving, or maintaining the property while the property is vacant. However, they cannot deduct any loss of rental income for the period the property is vacant.

> **Note:** A taxpayer can deduct their ordinary and necessary expenses for managing, conserving, or maintaining rental property from the time they make it available for rent. Likewise, if a taxpayer sells property they held for rental purposes, they can deduct the ordinary and necessary expenses for managing, conserving, or maintaining the property until it is sold.

Examples of expenses that landlords may deduct from their total rental income include:

Depreciation – Allowances for exhaustion, wear and tear (including obsolescence) of property. Landlords begin to depreciate their rental property when it is placed in service. They can recover some or all of their original ac-

quisition cost and the cost of improvements by using Form 4562, *Depreciation and Amortization* beginning in the year the rental property is first placed in service, and beginning in any year they make improvements or add furnishings.

Repair Costs – Expenses to keep property in good working condition but that do not add to the value of the property.

Operating Expenses – Other expenses necessary for the operation of the rental property, such as the salaries of employees or fees charged by independent contractors (groundkeepers, bookkeepers, accountants, attorneys, etc.) for services provided.

Deductions for rental expenses are taken in full in computing AGI and are not subject to the former 2% floor of §67 applicable to miscellaneous itemized deductions (§62(a)(4)). Moreover, since such deductions are "above the line", they may be deducted whether or not the taxpayer itemizes deductions.

Repairs Versus Improvements

There is an important distinction between repairs and improvements. A taxpayer can deduct the cost of repairs they make to their rental property. However, the cost of improvements is not deductible. Improvements are recovered by taking depreciation.

> **Note:** Taxpayers should separate the costs of repairs and improvements, and keep accurate records. Taxpayers need to know the cost of improvements when they sell or depreciate the property.

Repairs - §162

A repair keeps a property in good operating condition. It does not materially add to the value of the property or substantially prolong its life. Regulation §1.162-4 provides that the cost of incidental repairs that neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted.

Repainting property inside or out, fixing gutters or floors, fixing leaks, plastering, repairing an air conditioner, maintaining appliances, and replacing broken windows are examples of repairs.

> **Note:** If a taxpayer makes repairs as part of an extensive remodeling or restoration of a property, the whole job could be labeled an improvement.

Improvements - §263(a)(1)

Section 263(a)(1) provides that no deduction shall be allowed for any amounts paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. In short, an improvement adds to the value of a property, prolongs its useful life, or adapts it to new uses. Such costs must be capitalized and Improvements must

be depreciated over an extended (up to 27.5 years for residential properties) period (§263(a)).

> **Note:** While an increase in value is indicative of a capital expenditure, the term value is not defined in the Code, regulations, or by case law. There is no bright line test.

Putting a recreation room in an unfinished basement, paneling a den, adding a bathroom or bedroom, putting decorative grillwork on a balcony, putting up a fence, putting in new plumbing or wiring, putting in new cabinets, putting on a new roof, upgrading appliances, and paving a driveway are examples of improvements.

> **Note:** If a taxpayer makes an improvement to property before renting it, the cost of the improvement is added to the basis of the property.

Final Repair Regulations - Reg. §1.263(a)-3

Tax law has long required taxpayers to determine whether expenditures related to tangible property are currently deductible business expenses or nondeductible capital expenditures. Before the issuance of the final tangible property regulations (TD 9636), such decisions were guided by decades of often conflicting case law and rulings.

The "final regulations" attempt to combine this case law and other authorities into a framework to determine whether certain costs are currently deductible or must be capitalized.

> **Note:** The regulations also contain several simplifying provisions that are elective and prospective in application (e.g., the election to apply the de minimis safe harbor, the election to utilize the safe harbor for small taxpayers, and the election to capitalize repair and maintenance costs in accordance with books and records).

Application

The final regulations apply to anyone who pays or incurs amounts to acquire, produce, or improve tangible real or personal property. These regulations apply to corporations, S corporations, partnerships, LLCs, and individuals filing a Form 1040 with Schedule C, E, or F.

> **Note:** The rules are most significant for those that regularly incur large capital expenditures, e.g., electric utilities, telecommunications companies, and businesses with substantial real estate holdings.

De Minimis Safe Harbor Election

Under the final regulations, you may elect to apply a de minimis safe harbor to amounts paid to acquire or produce tangible property to the extent such amounts are deducted by you for financial accounting purposes or in keeping your books and records. If you have an applicable financial statement (AFS), you may use this safe harbor to deduct amounts paid for

tangible property up to $5,000 per invoice or item. If you don't have an AFS, you may use the safe harbor to deduct amounts up to $2,500 per item or invoice.

Note: Notice 2015-82 increased the de minimis safe harbor limit from $500 to $2,500 for taxpayers without an applicable financial statement (AFS). In addition, the IRS provided audit protection to eligible businesses by not challenging the use of the $2,500 threshold for tax years ending before 2016.

If an amount doesn't qualify under the de minimis safe harbor, you can treat such amount under the normal rules that apply, i.e., currently deductible if paid for incidental materials and supplies or for repair and maintenance. Thus, the safe harbor is a rule of administrative convenience allowing you to elect to deduct small-dollar expenditures for the acquisition or production of property that otherwise must be capitalized under the general rules.

Note: R.P. 2015-56 established a safe harbor method for qualified taxpayers in the restaurant business or retail trades under which 75% of costs paid or incurred to refresh or remodel a qualified building can be deducted immediately and 25% are to be capitalized as improvements.

Making the Safe Harbor Election

You should attach a statement titled "Section 1.263(a)-1(f) de minimis safe harbor election" to the timely filed original federal tax return including extensions for the taxable year in which the de minimis amounts are paid. The statement should include your name, address, and Taxpayer Identification Number, as well as a statement that you are making the de minimis safe harbor election. An election is not a change in the method of accounting requiring the filing of Form 3115.

Analytical Framework for Repairs vs. Improvement

The final regulations attempt to synthesize existing tax law into a “clarified” fact and circumstances analysis employing the following steps/questions:

Step 1 – What is the unit of property to which you should apply the improvement rules? A unit of property is variously defined for buildings, non-buildings, plant property (e.g., manufacturing plant, generation plant, etc.), and network assets (e.g., railroad track, oil & gas pipelines, etc.).

Step 2 – Is there an improvement to the unit of property, or in the case of a building, the building structure, or any key building system, identified in Step 1? A unit of tangible property is improved only if the amounts paid are (1) for a betterment to the unit of property, (2) to restore the unit of property, or (3) to adapt the unit of property to a new or different use.

Alternatives To The Facts & Circumstances Analysis

The simplifying alternatives to the facts and circumstances analysis are the (1) safe harbor election for small taxpayers, (2) safe harbor for routine maintenance, and (3) election to capitalize repair and maintenance costs.

Safe Harbor Election For Small Taxpayers

Taxpayers are not required to capitalize as an improvement and therefore may deduct, the costs of work performed on owned or leased buildings, e.g., repairs, maintenance, improvements, or similar costs, that fall into the safe harbor election for certain electing small taxpayers with average annual gross receipts less than $31 million in 2025 ($30 million in 2024).

Safe Harbor For Routine Maintenance

You are not required to capitalize as an improvement and therefore may deduct, certain amounts paid for recurring activities that you expect to perform as a result of your use of the property in your trade or business.

Election To Capitalize Repair & Maintenance Costs

The final regulations include an election to capitalize repair and maintenance expenses as improvements if you treat such costs as capital expenditures for financial accounting purposes.

Salaries & Wages - §162

Wages and salaries can be considered rental expenses. If a taxpayer employs individuals such as superintendents, maintenance personnel, and others to take care of their rental property, the amounts paid or payable to them can be deducted. They can also deduct bonuses paid to employees if, when added to their regular salaries or wages, the total is not more than reasonable pay. However, taxpayers cannot deduct the value of their own services

> **Note:** A taxpayer can also deduct reasonable wages paid to their dependent child if the child is a bona fide employee. However, a taxpayer cannot deduct the cost of meals and lodging for the child.

Rental Payments for Property & Equipment - §162

A taxpayer can deduct the rent they pay for property that is used for rental purposes (§162). If a taxpayer buys a leasehold for rental purposes, they can deduct an equal part of the cost each year over the term of the lease.

Rent paid for equipment used for rental purposes can also be deducted. However, in some cases, lease contracts are actually purchase contracts. If so, these

payments cannot be deducted. The cost of *purchased* equipment is recovered through depreciation.

Insurance Premiums

Insurance premiums paid for rental purposes are deductible. If the premiums are paid for more than one year in advance, each year the taxpayer can only deduct the part of the premium payment that will apply to that year.

Local Benefit Taxes & Service Charges

Generally, charges for local benefits cannot be deducted if they increase the value of the property, such as for putting in streets, sidewalks, or water and sewer systems. These charges are nondepreciable capital expenditures. They must be added to the basis of the property. Local benefit taxes are deductible if they are for maintaining, repairing, or paying interest charges for the benefits.

A taxpayer can deduct charges paid for services provided for their rental property, such as water, sewer, and trash collection.

Travel & Local Transportation Expenses

Ordinary and necessary costs of traveling away from home, if the primary purpose of the trip was to collect rental income or to manage, conserve, or maintain rental property, are deductible. Local transportation expenses are also deductible if incurred to collect rental income or to manage, conserve, or maintain rental property.

In addition, if a taxpayer uses their personal car, pickup truck, or light van for rental activities, they can deduct local transportation expenses using one of two methods: actual expenses or the standard mileage rate.

Tax Return Preparation

Taxpayers can deduct, as a rental expense, the part of tax return preparation fees paid to prepare Part I of Schedule E. Taxpayers can also deduct, as a rental expense, any expense paid to resolve a tax underpayment related to their rental activities.

Other Expenses

Other expenses a taxpayer can deduct from their gross rental income include:

(1) Advertising,
(2) Janitor and maid service,
(3) Utilities,
(4) Fire and liability insurance,
(5) Taxes,
(6) Interest,

(7) Commissions for the collection of rent, *and*
(8) Ordinary & necessary travel and transportation.

Tenant Rental Expense - §162

When business property is leased, the rent paid can be deducted. Rent is the amount paid for the use of property not owned. In general, rent is deductible as an expense only if the rent is for property that is used in a trade or business. If the taxpayer will receive equity in or title to the property, the rent is not deductible.

> **Note:** If a taxpayer rents rather than owns a home and uses part of the home as their place of business, the rent paid for that part of the home is deductible, if the requirements for business use of a home are met.

Rent Paid in Advance

If rent is paid in advance, only the amount that applies to the use of the rented property during the tax year in which payment was made can be deducted. The balance of the payment must be deducted over the period to which it applies.

Example

In May 2025, Dan leased a building for 5 years beginning July 1, 2025, and ending June 30, 2030. According to the terms of the lease, the rent is $12,000 per year. Dan paid the first year's rent ($12,000) on June 2, 2025. On his income tax return for calendar year 2025, Dan can deduct only $6,000 (6/12 x $12,000) for the rent applicable to 2025.

Example

In January 2025, Dan leased property for 3 years for $6,000 a year. Dan paid the full $18,000 (3 x $6,000) during the first year of the lease. For 2025, Dan can deduct only $6,000, the part of the rent that applies to 2025. Dan can deduct the balance ($12,000) over the remaining 2-year term of the lease at $6,000 for each year.

Lease or Purchase

To determine if payments are rent, there must first be a determination of whether the agreement is a lease or a conditional sales contract. If under the agreement, the taxpayer acquired or will acquire title to or equity in the property, the

agreement should be treated as a conditional sales contract. Payments made under a conditional sales contract are not deductible as rent expense.

Whether the agreement is a lease or a conditional sales contract depends upon the intent of the parties. Intent is determined based on the facts and circumstances existing at the time the agreement is made.

Determining the Intent

In general, an agreement can be considered a conditional sales contract rather than a lease if any of the following is true:

1. The agreement applies part of each "rent" payment toward an equity interest that will be received.

2. Title to the property is transferred after making all the required payments.

3. The payments are over a short period of time compared to the useful life of the property and in an amount that is close to the price of the property and the taxpayer can continue to use the property for periods approximating its useful life for nominal payments even if title does not pass.

4. The "rent" paid is much more than the current fair rental value for the property.

5. There is an option to buy the property at a price that is small compared to the value of the property at the time the option may be exercised. This value is determined at the time of the agreement.

6. There is an option to buy the property at a price that is small compared to the total amount required to be paid under the lease.

7. The lease designates some part of the "rent" payments as interest or part of the "rent" payments are easy to recognize as interest.

Taxes on Leased Property

When business property is leased, any taxes that have to be paid to or for the lessor can be deducted as additional rent. The timing of this deduction for additional rent depends on the taxpayer's accounting method.

Cash Method

If a taxpayer uses the cash method of accounting, they can only deduct the taxes as additional rent for the tax year in which they pay them.

Accrual Method

If a taxpayer uses the accrual method of accounting, they can deduct taxes as additional rent for the tax year in which they can determine:

(1) That they have a liability for taxes on the leased property,

(2) How much the liability is, *and*

(3) That economic performance occurred.

The liability and amount of taxes are determined by state or local law and also by the lease agreement. Economic performance occurs as the property is used.

Example

Oak Corporation is a calendar year taxpayer that uses the accrual method of accounting. Oak leases land for use in its business. Under local law, owners of real property become liable (it becomes a lien on the property) for real estate taxes for the year on January 1 of that year, but do not have to pay these taxes until June 1 of the next year (18 months later). This means that property owners become liable for 2024 real estate taxes on January 1, 2024, but do not have to pay them until June 1, 2025.

Under the terms of the lease, Oak becomes liable for the real estate taxes when the tax bills are issued on June 1, 2025. Oak cannot deduct the real estate taxes for 2024 as additional rent until June 1, 2025. This is when Oak's liability under the lease becomes fixed.

If according to the terms of the lease, Oak is liable for the real estate taxes when the owner of the property becomes liable for them, on January 1, 2024, but does not have to pay them until June 1, 2025, Oak will deduct the lessor's real estate taxes as additional rent on its 2024 tax return. This is the year in which Oak's liability under the lease becomes fixed.

Cost of Acquiring a Lease

Taxpayers may either enter into a new lease with the lessor of the property or acquire an existing lease from another lessee. Very often when an existing lease is acquired from another lessee, in addition to paying the rent on the lease, the taxpayer must pay the previous lessee a sum of money to acquire that lease.

If an existing lease is acquired on property or equipment for use in a business, any amount paid to acquire that lease must be deducted over the remaining term of the lease.

Example

If a taxpayer pays $10,000 for an existing lease on a machine and there are 10 years remaining on the lease with no option to renew, $1,000 can be deducted each year.

Option to Renew - 75% Rule

The term of the lease for amortization purposes will include all renewal options, as well as any period for which the lessee and lessor reasonably expect the lease to be renewed if less than 75% of the cost is attributable to the term of the lease remaining on the purchase date. In determining the term of the lease remaining on the purchase date, do not include any period for which the lease may be renewed, extended, or continued under an option exercisable by the lessee.

Example

Dan paid $10,000 to acquire a lease with 20 years remaining on it and two options to renew for 5 years each. Of this cost, $7,000 was paid for the original lease and $3,000 was applied to the renewal options. Since $7,000 is less than 75% of the total cost of the lease of $10,000, Dan must amortize the $10,000 over 30 years, the remaining life of the present lease plus the periods for renewal.

Example

If in the above example, the amount applicable to the original lease had been $8,000, then Dan would have been allowed to amortize the entire $10,000 over the 20-year remaining life of the original lease because the $8,000 cost of acquiring the original lease was not less than 75% of the total cost of the lease.

Cost of a Modification Agreement

If a taxpayer has to pay an additional "rent" amount over part of the lease period in order to change certain provisions in a lease, these payments must be capitalized and then amortized over the remaining period of the lease. Such payments cannot be deducted as additional rent, even if they are described as rent in the agreement.

Example

Dan is a calendar year taxpayer and signed a 20-year lease to rent part of a building starting on January 1. However, before Dan occupies it, he decides that he really needs less space. The lessor agrees to reduce Dan's rent from $7,000 to $6,000 per year and to release the excess space from the original lease. In exchange, Dan agrees to pay an additional rent amount of $3,000, payable in 60 monthly installments of $50 each.

Dan must capitalize the $3,000 and amortize it over the 20-year term of the lease. His amortization deduction each year will be $150 ($3,000/20). Dan cannot deduct the $600 actually paid during each of the first 5 years as rent.

Commissions, Bonuses, & Fees

Commissions, bonuses, fees, and other amounts paid to obtain a lease on property used in a business are capital costs. These costs must be amortized over the term of the lease.

Loss on Merchandise & Fixtures

If merchandise and fixtures bought solely to acquire a lease are sold at a loss, the loss is a cost of acquiring the lease. The loss must be capitalized and then amortized over the remaining term of the lease.

Improved Leased Property

If property is leased with a building or other improvement already on it, a depreciation deduction for such building or other improvements is not allowed.

Construction Allowances Provided To Lessees - §110

Gross income of a lessee does not include amounts received in cash (or treated as a rent reduction) from a lessor under a short-term lease of retail space for the purpose of the lessee's construction or improvement of qualified long-term real property for use in the lessee's trade or business at such retail space (§110).

A short-term lease is a lease (or other agreement for occupancy or use) of retail space for 15 years or less. The following rules apply in determining whether the lease is for 15 years or less:

1. Take into account options to renew when figuring whether the lease is for 15 years or less. However, do not take into account any option to renew at fair market value determined at the time of renewal.

2. Two or more successive leases that are part of the same transaction (or a series of related transactions) for the same or substantially similar retail space are treated as one lease.

Retail space is real property leased, occupied, or otherwise used by lessee in their business of selling tangible personal property or services to the general public.

Qualified long-term real property is nonresidential real property that is part of, or otherwise present at, the retail space and that reverts to the landlord when the lease ends.

Assignment of a Lease

If a long-term lessee makes permanent improvements to leased land and later assigns all lease rights to a taxpayer for money, and the taxpayer pays the rent required by the lease, the amount the taxpayer pays for the assignment is a capital investment. If the rental value of the unimproved land increased since the lease began, part of the taxpayer's capital investment is for that increase in the rental value, and the balance is for the taxpayer's investment in the permanent improvements.

The part that is for the increased rental value of the leased land is a cost of acquiring a lease and can only be amortized over the remaining term of the lease. The part that is for the taxpayer's investment in the building can be depreciated.

Example

In 2024, Frank leased unimproved land for 99 years and built a warehouse on it. In January 2025, immediately after the building was completed, Frank assigned all his rights in the lease to Dan. Dan paid Frank $100,000 for the assignment and also agreed to pay the rent for the unimproved land under the lease. The $100,000 Dan paid Frank is considered paid for the warehouse, which Dan can capitalize and depreciate.

Example

Assume that in the above example, Frank had leased the property, built the warehouse in 1993, and used it in his business until he assigned the lease to Dan in January 2025. The rental value of the unimproved land for the remaining period of the lease increased $40,000 since the time the lease was entered into in 1994. Of the $100,000 that Dan paid to Frank, $40,000 is considered to have been paid for the lease. Treat the balance of $60,000 as having been paid for the warehouse, which Dan must capitalize and depreciate.

Capitalizing Rent Expenses

Under the uniform capitalization rules, taxpayers must capitalize or include in inventory all costs (direct and indirect) of producing real or tangible personal property or acquiring tangible or intangible property for resale. Indirect costs include amounts incurred for the rent of equipment, facilities, or land.

Example

Dan rents construction equipment to build a storage facility. The rent Dan paid for the equipment must be capitalized as part of the cost of the building. Dan recovers his cost by claiming a deduction for depreciation on the building.

Example

Dan rents space in a facility to conduct his business of manufacturing tools. The rent Dan paid to occupy the facility must be included in the cost of the tools he produces.

Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regard to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

39. Which costs are nondeductible when a taxpayer holds property for rental purposes?

a. costs for improvements.

b. maintenance costs.

c. management costs.

d. costs of repairs.

40. Landlords may deduct employee expenses related to renting property. However, which of the following employee costs are nondeductible by landlords?

a. employee bonuses if, when added to their usual salaries or wages, the aggregate is less than reasonable pay.

b. reasonable salaries and wages paid to employees who are not relatives.

c. reasonable wages paid to an employee who is also a dependent child.

d. meals and lodging expenses for a bona fide employee who is also a dependent child.

41. Rent paid for business property is deductible under §162. However, under which circumstance will an agreement be deemed a conditional sale contract, instead of a lease, and thus be nondeductible as rent?

a. The agreement does not designate part of the payments as interest.

b. The amount paid is a large portion of what the taxpayer would pay to take title to the property.

c. The taxpayer has an option to buy the property at its actual price.

d. The taxpayer pays less than the property's current fair rental value.

Health Insurance Costs of Self-Employed Persons - §162(l) [Schedule C]

Health insurance for self-employed persons is tax-deductible. Qualifying self-employed individuals can deduct the amount they spend on health care coverage from their net income. They can also deduct the health care premium costs for their spouse, dependents, and children 26 years of age or younger. However, no deduction is allowed to the extent the deduction exceeds the individual's earned income derived from the trade or business.

> **Note:** When a self-employed individual is allowed a business deduction for amounts paid for medical insurance, those amounts are not taken into account in computing the medical expense deduction.

Requirements for Eligibility

For purposes of determining eligibility the following rules apply:

(1) the taxpayer and their spouse must not be eligible to participate in any subsidized health plan maintained by their employers,

(2) if the taxpayer has employees, they may not take the deduction unless they provide nondiscriminatory health insurance coverage to all employees, *and*

(3) the taxpayer must have net earnings from self-employment.

Amount Deductible

The amount of medical insurance paid which is deductible as a business expense deduction is limited to the net profit from self-employment. Thus, the deduction cannot exceed the earned income collected from the taxpayer's business. If the taxpayer's business earns no money, they cannot take the deduction, and the deduction cannot create a net loss for the year.

Note: Actually, the deduction cannot exceed your business's net income minus the deductions for one-half of self-employment tax and qualified retirement plan contributions.

Hobby Loss Rules - §183 [Schedule C]

Activities that are "not engaged in for profit" are considered to be hobbies. Taxpayers must include on their return income from an activity not for profit. An example of this type of activity would be a hobby or a farm operated mostly for recreation and pleasure. Deductions for expenses related to the activity are limited, cannot total more than the income reported, and can be taken only if the taxpayer itemizes deductions on Schedule A (Form 1040).

Note: The limit on not-for-profit losses applies to individuals, partnerships, estates, trusts, and S corporations. It does not apply to corporations other than S corporations (§ 183(a); R.R. 77-320; Reg. §1.1831(a)).

Allowable Deductions

Interest, state and local property taxes, and other items that are deductible as an itemized deduction are deductible without regard to a profit motive.

Limited Deductions

If an activity is considered a hobby, deductions for depreciation, insurance, and other expenses not allowed under the allowable deductions listed above, may be deducted only to the extent gross income exceeds the allowable deductions.

Deductions are allowable in the following order and only to the following extent:

1. Amounts deductible without regard to whether the activity giving rise to such amounts was engaged in for profit are allowable in full (e.g., interest under §163, real property taxes under §164, etc.).

2. Amounts deductible if the activity had been engaged in for profit, but only if the deduction does not result in an adjustment to the basis of property. Such deductions are allowed only to the extent the gross income of the activity exceeds the deductions under (1).

3. Amounts that result in an adjustment to the basis of property are deductible only to the extent that income exceeds the deductions allowed under (1) and (2). Deductions falling within this subdivision include such items as depreciation, partial losses with respect to property, partially worthless debts, amortization, and amortizable bond premiums.

Example

Assume an activity with the following tax items:		
Gross income		*$1,000*
Interest expense		*225*
Property taxes		*125*
Depreciation		*500*
Insurance		*200*
The total deductions for this activity would be as follows:		
Allowable deductions		
Interest expense	*225*	
Property taxes	*125*	
Total allowable deductions	*350*	
Limited deductions		
Gross income	*1,000*	
Total allowable deductions	*(350)*	
	650	
Depreciation		*500*
Insurance[1]		*200*
		700
Total limited deduction	*650*	
Total deductions	*1,000*	

Profit Motive Presumptions

An activity is *presumed* to be engaged in for profit if it shows a profit for any *three* or more years out of *five* consecutive years. A taxpayer can elect on Form 5213 to have the IRS wait until after the first five years (i.e., close of the 4th tax year) before making the determination as to whether this presumption applies. The Form should be filed within three years of the due date of the return for the first year in business.

[1] Insurance is deductible in full with a portion of the depreciation deductible.

Comment: Filing Form 5213 is a bad idea. Normally there is a 3-year statute of limitations for audits. Form 5213 gives the IRS 5 years to audit.

Special Rule for Horse Breeding

Horse breeding is presumed to be engaged in for profit if it shows a profit for any *two* or more years out of seven consecutive years. A taxpayer who has not engaged in an activity for more than seven years can elect on Form 5213 to have the determination as to whether this presumption applies not be made before the close of the *sixth* tax year.

Other Factors

The three out of five-year profit presumption can be rebutted by using all the facts and circumstances of the activity (Reg. §1.183-2(b)). Among the factors to be considered are:

(1) Whether the taxpayer carries on the activity in a businesslike manner (Reg. §1.183-2(b)(1));

(2) Whether the time and effort the taxpayer puts into the activity indicates the intent to make it profitable (Reg. §1.183-2(b)(3));

(3) Whether the taxpayer is depending on income from the activity for their livelihood (Reg. §1.183-2(b)(8));

(4) Whether taxpayer's losses from the activity are due to circumstances beyond their control or are normal in the start-up phase of taxpayer's type of business (Reg. §1.183-2(b)(6));

(5) Whether the taxpayer changes methods of operation in an attempt to improve the profitability of the activity (Reg. §1.183-2(b)(1));

(6) Whether the taxpayer or their advisors have the knowledge needed to carry on the activity as a successful business (Reg. §1.183-2(b)(2));

(7) Whether the taxpayer has been successful in making a profit in similar activities in the past (Reg. §1.183-2(b)(5));

(8) Whether the activity makes a profit in some years, and how much profit it makes (Reg. §1.183-2(b)(7)); *and*

(9) Whether the taxpayer can expect to make a future profit from the appreciation of the assets used in the activity (Reg. §1.183-2(b)(4)).

Self-Employment Taxes - §3111 & §3121

Self-employed individuals are subject to SECA just like employees are subject to FICA. If a taxpayer is a sole proprietor, they have to pay self-employment tax (SECA) to cover Social Security and Medicare (§1401). In fact, they are liable for both the employer's and employee's shares of these taxes, meaning a combined rate of 15.3% on the first $176,100 (up from $168,600 in 2024) of income in 2025.

In 2024 and 2025, this 15.3% rate is a total of 12.4% for social security (old-age, survivors, and disability insurance or OASDI) and 2.9% for Medicare (hospital insurance or HI).

Home Office Deduction - §280A [Schedule C]

A taxpayer's business use of his or her home may give rise to a deduction for the business portion of expenses related to operating the home (e.g., a portion of rent, depreciation, and repairs). This includes houses, apartments, condos, or similar properties. It can also include structures on the property like an unattached garage, studio, barn, or greenhouse.

> **Comment:** Congress adopted §280A, in order to provide a narrow scope for the home office deduction. These home office rules were designed to prevent the perceived abuse of writing off personal expenses as deductible business expense.

The deduction is available for both homeowners and renters. Taxpayers may be able to deduct expenses such as mortgage interest, insurance, utilities, repairs, and depreciation for that area. Taxpayers need to figure out the percentage of their home devoted to business activities to calculate these deductions.

Requirements

The basic requirements of the home office deduction are:

1. There must be a specific room or area that is set aside for and used *exclusively* on a *regular* basis as:

(a) the principal place for one or more of taxpayer's businesses, *or*

> **Note:** A taxpayer can use their home office for more than one trade or business activity, but they cannot use it for any activities that are not related to a trade or business.

(b) a place where the taxpayer meets with patients, clients, or customers in the normal course of their trade or business, *or*

(c) a separate structure that is used in the taxpayer's trade or business and is not attached to their house or residence (§280A(c)(1)).

2. An employee can take a home office deduction if he or she meets the regular and exclusive use test and the use is for the convenience of the employer. This test is rarely met.

> **Note:** The exclusive use requirement does not apply when use of the home is for daycare of children, the handicapped, or the elderly. In addition, the storage of inventory at home, if the taxpayer is engaged in the business of selling goods, is considered business use provided the home is the only place of that business. In such a case, the exclusive use rule also doesn't apply (§280A(c)(2)).

3. No deduction is allowed unless there is a trade or business involved. Managing investments or rental property (unless there are a number of units) is not considered a trade or business and therefore no home office expense can be deducted related to such activity.

> **Comment:** To the extent that an individual is considered to be conducting a trade or business in the ownership of rental property, the taint of dealer status is a problem. A dealer in real estate is precluded from using §1031 exchanges, installment sales, and depreciation (on his or her "inventory") along with the prohibition of capital gain benefits. Dealer status may be applied to a taxpayer as a whole or to an individual property.

Deductible Expenses

Deductible expenses are the business portions of:

(1) Mortgage interest,

(2) Property taxes,

> **Comment:** The unused portion of home mortgage interest and property taxes should be deducted in the usual places in Schedule A.

(3) Depreciation - using 39-year MACRS,

(4) Repairs and maintenance to the overall home that help the business use area,

(5) Janitorial services or maid,

(6) Utilities,

> **Note:** Individuals may no longer deduct any charge (including taxes) for local phone service for the *first* phone line provided to any residence (whether or not their principal residence).

(7) Insurance, *and*

(8) Other expenses directly related to operating the remainder of the home.

Under IRS rulings, the deductibility of expenses incurred for local transportation between a taxpayer's home and a work location also depends on whether the taxpayer's home office qualifies under §280A(c)(1) as a principal place of business (R.R. 94–47). Thus, when a taxpayer's residence is their principal place of business, the taxpayer may deduct daily transportation expenses incurred in going between the residence and another work location. This converts nondeductible commuting expenses into deductible transportation expenses, which could be more valuable to the taxpayer than the home office deduction.

Employee's Home Leased To Employer

No deduction is allowed for expenses attributable to the rental by an employee of all or part of their home to their employer if the employee uses the rented portion to perform services as an employee of the employer (§280A(c)(6).

Calculation

Taxpayers can choose one of two methods to calculate their home office expense deduction:

(1) a simplified option where a rate of $5 a square foot for business use of the home is applied (R.P.2013-13), *or*

> **Note:** This option's deduction is capped at $1,500 per year based on $5 a square foot for up to 300 square feet. Though homeowners using this option cannot depreciate the portion of their home used in a trade or business, they can claim allowable mortgage interest, real estate taxes, and casualty losses on the home as itemized deductions on Schedule A. These deductions need not be allocated between personal and business use, as is required under the regular method.
>
> **Comment:** Restrictions on the home office deduction, such as the requirement that a home office must be used regularly and exclusively for business and the limit tied to the income derived from the particular business, still apply under this option.

(2) the regular method where deductions for a home office are based on the percentage of the home devoted to business use.

Business expenses unrelated to the home, such as advertising, supplies, and wages paid to employees are still fully deductible.

Allocation

Taxpayers must divide the expenses of operating their home between personal and business use and direct and indirect. Direct expenses for only the business part of the home, such as painting or repairs only in the area used for business, are generally fully deductible. Indirect expenses are expenses for keeping up and running the entire home. Such expenses include (i) real estate taxes. (ii) home mortgage interest, (iii) depreciation, (iv) utilities, and (v) casualty losses attributable to a federally declared disaster. Here, taxpayers use the business percentage of these expenses to figure how much to include in their total business-use-of-the-home deduction.

Depreciation

To figure the depreciation deduction, you must first figure the part of the cost of your home that can be depreciated (depreciable basis). The depreciable basis is figured by multiplying the percentage of your home used for business by the smaller of the following:

(1) the adjusted basis of your home (excluding land) on the date you began using your home for business, *or*

(2) the fair market value of your home (excluding land) on the date you began using your home for business.

This amount is then depreciated using the 39-year nonresidential real property method.

Limitations

The deduction limitation for the business use of a home is limited to the gross income from the business use. Home office deductions may not be claimed if they create (or increase) a net loss from a business activity, although such deductions may be carried over to subsequent taxable years (§280A(c)(5)).

Under the regular method, business deductions for the business use of a home are deducted in this order:

(1) the business percentage of the expenses that would otherwise be allowable as a deduction, that is, mortgage interest, real estate taxes, and deductible casualty losses;

(2) the direct expenses for the business in the home, such as expenses for supplies and compensation, but not the other expenses of the office in the home (such as those listed in item (3) below); *and*

(3) the other business expenses for the business use of the home such as maintenance, utilities, insurance, and depreciation. Deductions that adjust the basis in the home are taken last.

Thus, deductions for the business use of the home will not create a business loss or increase a net loss from the taxpayer's business.

Taxpayers are allowed to carry forward any deductions suspended by the gross income limit. Deductions carried over continue to be allowable only up to the income from the business from which they arose, whether or not the dwelling unit is used as a residence during the year. This limit also applies to rental activities, as well as trade or business activities.

Example

Under the regular method, Joe uses 15% of his home as his principal place of business for a landscape service he operates as a sideline to his regular job. His gross income, expenses, and computation of deductible business use of his home are as follows:

Gross income from business		*10,500*	
Minus:			
Business % (15%) of mortgage interest and real estate taxes	*2,000*		
Other business expenses (labor, supplies, etc.	*7,500*	*9,500*	
Modified net income		*1,000*	
Business use of home expense			
Maintenance, utilities, insurance, etc. (15%)			*700*
Depreciation on business portion			*900*

	1,600
Deduction limited to modified net income	*1,000*
Carryforward to next year (subject to the same limitations)	*600*

The remaining interest and taxes will be deducted on Schedule A. If Joe were an employee, the same computation of the limitation would apply. Both portions of taxes and interest would be deducted on Schedule A, and the remaining allowable expenses would formerly go to line 4, Form 2106. However, with the suspension of itemized employee business expenses from 2018 through 2025, Form 2106 can not be used by most employees and the remaining expenses would not be deductible.

Principal Place of Business

A taxpayer can have more than one business location, including their home, for a single trade or business. However, to qualify to deduct the expenses for the business use of their home it must be the principal place of business for their trade or business. Determining whether a home is a principal place of business involves consideration of:

(a) the relative importance of the activities performed at each place where you conduct business, *and*

(b) the amount of time spent at each place where you conduct business.

The definition of "principal place of business" includes a home office that is used by the taxpayer to conduct *administrative* or *management activities* of the business.

Administrative or Management Activities

Section 280A specifically provides that a home office qualifies as the ''principal place of business'' if:

(i) the office is used by the taxpayer to conduct *administrative* or *management activities* of a trade or business, *and*

(ii) there is no other fixed location of the trade or business where the taxpayer conducts substantial administrative or management activities of the trade or business.

Example

Doctor Dan consults with patients at local hospitals and uses a portion of his home exclusively and regularly to conduct administrative or management activities. Dan does not conduct any other significant administrative or management function at another fixed location. Dan qualifies for the home office deduction.

A&M Activities Performed at Other Locations

The following activities performed by the taxpayer or others will not disqualify the taxpayer's home office from being their principal place of business:

(1) taxpayer has others conduct their administrative or management activities at locations other than their home (e.g., another company does taxpayer's billing from its place of business),

(2) taxpayer conducts administrative or management activities at places that are not fixed locations of their business, such as in a car or a hotel room,

(3) taxpayer occasionally conducts minimal administrative or management activities at a fixed location outside their home,

(4) taxpayer conducts substantial nonadministrative or nonmanagement business activities at a fixed location outside their home (e.g., taxpayer meets with or provides services to customers, clients, or patients at a fixed location of the business outside their home), *and*

(5) taxpayer has suitable space to conduct administrative or management activities outside their home but chooses to use their home office for those activities instead.

A&M Definition

Many activities are administrative or managerial in nature. Here are a few examples:

(1) billing customers, clients, or patients,

(2) keeping books and records,

(3) ordering supplies,

(4) setting up appointments, and

(5) forwarding orders or writing reports.

Place To Meet Patients, Clients, or Customers

If a taxpayer meets or deals with patients, clients, or customers in their home in the normal course of their business, even though they also carry on business at another location, they can deduct their expenses for the part of the home used exclusively and regularly for business if they meet both the following tests:

(a) taxpayer physically meets with patients, clients, or customers on your premises.

(b) their use of the home is substantial and integral to the conduct of their business.

Example

Dan, a self-employed attorney, works 3 days a week in his office, then works 2 days a week at home, in a home office used only for business. Dan regularly meets clients there. The home office qualifies for a business deduction because Dan meets clients there in the normal course of his business.

Separate Structure

Taxpayers can deduct expenses for a separate free-standing structure, such as a studio, workshop, garage, or barn if they use it exclusively and regularly for their business. The structure does not have to be the taxpayer's principal place of business or a place where they meet patients, clients, or customers

Storage of inventory or product samples.

If a taxpayer uses part of their home for storage of inventory or product samples, they can deduct expenses for the business use of the home without meeting the exclusive use test. However, they must meet all the following tests:

(1) they sell products at wholesale or retail as their business,

(2) they keep the inventory or product samples in their home for use in their business,

(3) taxpayer's home is the only fixed location of their business,

(4) taxpayer uses the storage space on a regular basis, *and*

(5) the space used is a separately identifiable space suitable for storage.

Office in Home Worksheet – Regular Method

1. Home office square footage:

a. Office area	_____ sq ft
b. Storage area	_____ sq ft
c. Meeting area	_____ sq ft
d. Other	_____ sq ft
Business square footage	_____ sq ft

2. Total square footage of house _____ sq ft

3. Home office percentage _____ %

4. Office expenses:

a. Mortgage interest $ _____
b. Property taxes $ _____
c. Depreciation $ _____
d. Repairs $ _____
e. Utilities $ _____
f. Insurance $ _____
g. Trash Removal $ _____

5. Home office deduction
(line 4 times line 3) $_____

6. Gross income limit $ _____

Business & Investment Credits

The Code provides for certain credits against tax with respect to business activities and investments. These credits generally cannot exceed the amount of tax. Examples of such credits include:

(1) Testing for rare diseases (§45C),

> **Note:** The orphan drug tax credit allows drug manufacturers to claim a tax credit of 50% of the qualified costs of clinical research and drug testing of orphan drugs (i.e., those affecting 200,000 or fewer)

(2) Producing nonconventional fuels (§45K),

> **Note:** The nonconventional source production credit, is a tax credit available to taxpayers who sell certain types of fuel.

(3) Credit for federal tax on fuels (§6427(e)), *and*

> **Note:** The Credit for Federal Tax Paid on Fuels is a tax credit that allows some businesses to reduce their taxable income based on specific types of fuel costs.

(4) General business credit (§38).

The general business credit is a nonrefundable credit comprised of a number of individual business credits including:

(1) Alcohol used as fuel (§40),
(2) Research credit (§41),

> **Note:** A taxpayer can claim a tax credit of 20% of the amount of qualified research expenses that exceed the average amount of the research expenses in a base period.

(3) Low-income housing credit (§42),
(4) Rehabilitation credit (§46),
(5) Energy investment tax credits (§48), *and*

(6) Work opportunity tax credit (§51)).

The aggregate of the credits described above cannot exceed the excess of the taxpayer's net income tax over the greater of (a) 25% times the excess of the net income tax over $25,000 or (b) the tentative AMT (§38; §39).

Taxpayers file Form 3800 to claim any of the general business credits.

Business Credit Carryback & Carryforward Rules - §39(a)

If in any taxable year, the general business credit (the sum of the business credit carryforwards to the current year plus the current year business credit) exceeds tax liability, the excess business credit may be carried back and carried forward until it is exhausted (§39(a)). The carryback period is *one* year and the carryforward period is 20 years.

NOL Comparison - §172

A net operating loss (NOL) generally is the amount by which a taxpayer's current-year business deductions exceed its current-year gross income. For 2018 and later, NOLs are generally not allowed to be carried back (i.e., the 2-year carryback period and the longer carryback periods for special types of losses, are eliminated), but may only be carried forward indefinitely. Exceptions are provided for farming and insurance companies. In addition, for 2018 and later, taxpayers can only deduct an NOL carryover or carryback (in the case of farms and insurance companies) to the extent of 80% of the taxpayer's taxable income (determined without regard to the NOL deduction).

> **Note:** Formerly, NOLs while not deductible in the year generated could be carried back two years and carried forward 20 years to offset taxable income in such years.

Review Questions

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42. The author lists three requirements for the health insurance cost deduction for self-employed individuals. Which of the following rules apply for purposes of determining eligibility?

a. The taxpayer must provide health insurance coverage to key employees.

b. The taxpayer must be eligible to take part in a subsidized health plan.

c. The taxpayer must have a net loss from self-employment.

d. The taxpayer's spouse must not be eligible to take part in a subsidized health plan.

43. Under §183, deductions for expenses associated with a not-for-profit business:

a. are disallowed for state and local property taxes.

b. are deductible without restriction.

c.. can be taken only if the taxpayer itemizes deductions.

d. must total more than the income reported.

44. If an individual operates a business out of their home, three requirements must be met to allocate a portion of the expenses of the residence to business. What is one of these requirements?

a. A specific area is used at least occasionally as a place where the taxpayer meets with patients.

b. A portion of a specific room or area is used as the principal place of business.

c. The individual must be self-employed and cannot be an employee.

d. A trade or a business must be involved to be allowed a deduction.

45. Taxpayers must claim business deductions for the business use of a home in a specific order. Which business deductions must be deducted first?

a. business expenses for the business use of the home such as maintenance, utilities, insurance, and depreciation.

b. business percentage of the costs that would otherwise be claimed as a deduction.

c. deductions that adjust the basis in the home.

d. direct expenses for the business in the home.

Travel & Entertainment

Travel away from home, local transportation, and entertainment expenses probably cause more controversy than any other item on a tax return. This controversy can be over the question of whether a particular expense is deductible, the amount of the allowable deduction, the proof of the deduction, or all of these. For this reason, it is essential to know which expenses are deductible and which are not. In addition, the rules on record-keeping and other requirements for proving these expenses are of critical importance.

Travel Expenses

A deduction is allowed for ordinary and necessary traveling expenses incurred by a taxpayer while away from home in the conduct of a trade or business.

Examples of ordinary and necessary travel expenses include:

(1) Meals (but only 50%) and lodging, both enroute and at the destination,

(2) Cost of transportation from the place where the taxpayer eats and sleeps to their temporary work assignment,

(3) Air, rail, ship, bus, and baggage charges,

(4) Telephone and telegraph expenses,

(5) Cost of operating and maintaining a car,

(6) Cost of transportation by taxi, etc. from the airport or station to the hotel, from the hotel to the airport or station, from one customer or place of work to another,

(7) Laundry, cleaning, and clothes pressing costs,

(8) Transportation costs for sample and display material, *and*

(9) Reasonable tips to the extent incident to any of the above expenses.

Determining a Tax Home

To deduct expenses for travel "away from home," the taxpayer must first determine where their home is. Normally this determination is not a problem. However, for those who travel, keep two homes or places of business, or have no definite home, it can be hard to decide where "home" is for tax purposes.

Normally, a taxpayer's tax home is:

a. The taxpayer's principal place of business

b. If the taxpayer has no principal or regular place of business, their tax home is their regular place of abode in a real and substantial sense (see discussion below).

c. If the taxpayer fails to fall within the above two categories, they are considered an itinerant - i.e., one who has their home wherever they happen to be working -and, thus, is never "away from home." As such, this taxpayer cannot have any deductible travel expenses.

Regular Place of Abode in a Real & Substantial Sense

The IRS holds that a taxpayer whose work site constantly changes only has a "regular place of abode in a real substantial sense" if he or she meets *two* of the following three requirements:

a. The taxpayer performs a portion of their business in the vicinity of this claimed abode and uses such abode (for purposes of their lodging) while performing such business there.

b. The taxpayer's living expenses incurred at their claimed abode are duplicated because their business requires them to be away therefrom.

c. The taxpayer either:

(1) Hasn't abandoned the vicinity in which their historical place of lodging and their claimed abode are both located; *or*

(2) Has a member or members of their family (marital or lineal only) currently residing at their claimed abode; *or*

(3) Uses their claimed abode frequently for purposes of their lodging.

If the taxpayer meets all three factors, the taxpayer is temporarily away from home for travel expense deduction purposes. If the taxpayer meets only two of the factors, the taxpayer may be temporarily away from home depending on the facts and circumstances. If the taxpayer meets only one factor, he was not temporarily away from home and cannot deduct travel expenses.

Two Work Locations

If a taxpayer works at two or more separate locations, his or her tax home is where his or her principal employment or business is located.

Under R.R. 54-147, the factors considered in determining the principal location are:

(1) Total time ordinarily spent performing duties in each area

(2) Degree of business activity in each area, *and*

(3) Relative significance of the financial return from each area

The last factor is given substantial weight when services are performed as an employee.

Temporary Assignment

If a taxpayer engages in temporary work away from their "tax home," their "tax home" does not shift, and they are deemed away from home for the entire temporary period. As such, all expenses for traveling, meals, and lodging are deductible as travel "away from home."

If, however, the change is indefinite (i.e., if its termination cannot be foreseen within a fixed and reasonably short period), the "tax home" is considered to move with the taxpayer and no deduction for travel, meals, and lodging will be allowed.

One-Year Expectation Rule

Determining whether a job assignment is temporary or indefinite is based on the expected duration of the assignment at the time it begins (§162(a)). If the taxpayer expects an assignment or job to last for 1 year or less, it is considered temporary meaning that the taxpayer's tax home does not change.

Example 1 from Pub. 463 (Rev. '23)

You are a construction worker. You live and regularly work in Los Angeles. You are a member of a trade union in Los Angeles that helps you get work in the Los Angeles area. Your tax home is Los Angeles. Because of a shortage of work, you took a job on a construction project in Fresno. Your job was scheduled to end in 8 months. The job actually lasted 10 months.

You realistically expected the job in Fresno to last 8 months. The job actually did last less than 1 year. The job is temporary and your tax home is still in Los Angeles.

Any work assignment that is expected to last for more than one year is considered indefinite and the location of the assignment is considered to be the taxpayer's new tax home, and they cannot deduct expenses as if they were away from home.

Example 2 from Pub. 463 (Rev. '23)

The facts are the same as in Example 1, except that you realistically expected the work in Fresno to last 18 months. The job was actually completed in 10 months.

Your job in Fresno is indefinite because you realistically expected the work to last longer than 1 year, even though it actually lasted less than 1 year. You can't deduct any travel expenses you had in Fresno because Fresno became your tax home

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If a job is initially temporary and then becomes indefinite due to a change in circumstances, a taxpayer may no longer deduct job-related expenses.

Example 3 from Pub. 463 (Rev. '23)

The facts are the same as in Example 1, except that you realistically expected the work in Fresno to last 9 months. After 8 months, however, you were asked to remain for 7 more months (for a total actual stay of 15 months).

Initially, you realistically expected the job in Fresno to last for only 9 months. However, due to changed circumstances occurring after 8 months, it was no longer realistic for you to expect that the job in Fresno would last for 1 year or less. You can deduct only your travel expenses for the first 8 months. You can't deduct any travel expenses you had after that time because Fresno became your tax home when the job became indefinite

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Away From Home - Travel Expenses

While transportation can be deductible whether or not the trip takes the taxpayer away from home, meals and lodging are deductible only if the taxpayer is "away from home." The IRS has adopted the so-called "sleep or rest" rule as a requirement in determining if the taxpayer is away from their tax home. Thus, a taxpayer is traveling away from home if:

(1) taxpayer's duties require them to be away from the general area of their tax home substantially longer than an ordinary day's work, *and*

(2) taxpayer needs to sleep or rest to meet the demands of their work while away from home.

Sleep or Rest

The sleep or rest rule requires the taxpayer to prove that it is reasonable to need sleep or rest during release time to meet the demands of their employment. In other words, the taxpayer's duties require them to be away from the general area of their tax home for a period that is substantially longer than an ordinary day's work and, during release time while away, it is reasonable for the taxpayer to sleep or rest to meet the needs of their employment or business.

> **Note:** The "sleep and rest" rule was adopted in *United States v. Correll*, 389 U.S. 299 (1967), which denied an expense deduction to a traveling salesman for breakfasts and lunches eaten on the road because he returned home each day for dinner.

Substantial Period

An employee's absence cannot be considered "overnight" unless the taxpayer could not reasonably be expected to travel home without substantial sleep or rest. The absence need *not* be for a full twenty-four hour period, or from dusk to dawn, but it must be *substantial*.

A "substantial" period is one that is of such duration that the taxpayer could not reasonably be expected to complete the round trip without stopping regular duties for sufficient time to obtain sleep or rest.

Example from Pub. 463 (Rev. '23)

You are a railroad conductor. You leave your home terminal on a regularly scheduled round-trip run between two cities and return home 16 hours later.

During the run, you have 6 hours off at your turnaround point where you eat two meals and rent a hotel room to get necessary sleep before starting the return trip. You are considered to be away from home.

Example from Pub. 463 (Rev. '23)

You are a truck driver. You leave your terminal and return later the same day. You get an hour off at your turnaround point to eat. Because you are not off to get necessary sleep and the brief time off is not an adequate rest period, you are not away from home.

Business Purpose - Travel & At Destination Expenses

Even when a taxpayer is determined to be traveling away from their tax home and their expenses are ordinary (not lavish or extravagant) and necessary, further distinctions must be made as to the purpose of the trip and the categories of expenditures.

Categories of Expense

All travel expenses must be divided into two categories:

(i) Travel costs to and from the destination, *and*

(ii) Expenses incurred while at the destination.

Travel Costs to and from the Destination

If a trip is undertaken primarily for personal purposes, travel costs are nondeductible personal expenses, and meals and lodging are nondeductible living expenses, even though the taxpayer engages in business activi-

ties while away from home (Reg. 1.162-2; 262). If the trip is primarily for business, travel expenses are deductible.

> **Comment:** Travel expenses while away from home include, but aren't limited to, the costs of travel by airplane, train, bus, or car between a taxpayer's tax home and their business destination.

Costs at Destination

Expenses incurred at the destination must always be allocated between business and personal pleasure. Thus, even if a trip is primarily personal, expenses incurred while *at the destination* are deductible if related to taxpayer's trade or business, even though the *travel* expenses to and from the destinations might not be deductible (Reg. §1.162-2).

> **Comment:** Deductible at-destination expenses include but aren't limited to fares for taxis or other types of transportation between a taxpayer's hotel and the work location of their customers or clients, their business meeting place, or their temporary work location.

All or Nothing

Travel costs are, therefore, an "all or nothing" proposition depending on the primary business nature of the trip. On the other hand, the business-related portion of costs at the destination is always deductible, even if the majority of expenses were personal.

Time

Whether a trip is related primarily to a taxpayer's trade or business or is essentially personal in nature depends on the facts and circumstances of each case. While at a minimum the trip must have a business reason, the most important factor is the amount of time the taxpayer spends on personal activities in relation to the length of the trip.

51/49 Rule for Domestic Travel

The number of days spent on business vs. pleasure is critical. As a general rule, a trip is primarily for business if bona fide business is conducted on over 50% of the trip days.

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46. The author lists nine examples of deductible travel expenses undertaken for business. What is included as an example?

a. tips paid for services provided.

b. expenses for business gifts.

c. laundry, cleaning, and clothes pressing costs.

d. transportation expenses within the general geographical work area.

47. The Service uses a number of factors and requirements to determine a taxpayer's regular place of abode. However, which of the following items does the Service disregard in making this determination?

a. whether part of the taxpayer's business is performed in the area of the abode.

b. duplication of living expenses.

c. the taxpayer's business plan.

d. the presence of family members at the claimed abode.

48. Under Reg. §1.162-2, deductible travel costs must be primarily for business. When are domestic travel costs deemed primarily for business?

a. If more than half the trip days are spent on business.

b. The expenses are incurred at a vacation resort.

c. A taxpayer who had control over planning the trip incurs the expenses.

d. The travel is related to investigating new or different business opportunities.

49. A taxpayer may travel to a foreign country primarily for business purposes. If this taxpayer also engages in some personal activities, how is the travel cost treated?

a. It is disallowed.

b. It is subject to the 50% reduction rule.

c. It is still allowed in full.

d. It has to be allocated between business and personal.

Foreign Business Travel

Personal Pleasure

If a taxpayer travels outside the U.S. primarily for personal pleasure or for vacation, travel costs to and from the destination are not allowed but business expenses at the destination are allowed.

Comment: For this purpose, the U.S. includes the 50 states and the District of Columbia.

Primarily Business

If the trip outside the U.S. is primarily for business (e.g., more than 50%) but there were some nonbusiness activities, not all of the travel cost from home to the business destination and back may be deductible by an individual. The cost will have to be allocated between business and nonbusiness activities.

Counting Business Days

In such situations, taxpayers must allocate their travel time on a day-to-day basis between business days and nonbusiness days. Business days include transportation days (i.e., days taxpayer departs from and returns to the U.S.), days taxpayer's presence was required, days taxpayer spent on business, and weekends, holidays, and necessary standby days if they fall between business days.

Calculation of Deductible Amount

To figure the deductible amount of a taxpayer's round-trip travel expenses use a fraction where the numerator is the total number of business days outside the U.S. and the denominator is the total number of business and nonbusiness days of travel.

Travel Considered Entirely for Business

There is an exception that provides a full deduction under these circumstances provided certain conditions are met. To be fully deductible, foreign travel must be primarily for business (e.g., more than 50%) *and* meet at least *one* of the following conditions:

(1) The taxpayer is an employee who is not related to his or her employer;

> **Comment:** An employee is related to their employer if the employee owns, directly or indirectly, more than 10% of the employer.

(2) The trip lasts less than eight days (including the return travel day, but excluding the departure day);

(3) Less than 25% of the total number of days on the trip is nonbusiness days;

(4) Taxpayer had little control over arranging the business trip; *and*

(5) Personal vacation or holiday was not a major consideration in making the trip.

Limitations - Travel Expenses

The travel expense area has many special rules, limitations, and requirements:

Meals & Lodging

While the TCJA eliminated the deduction for entertainment expenses, Congress did not amend the provisions relating to the deductibility of business meals. Thus, taxpayers generally may continue to deduct 50 percent of the food and beverage expenses associated with operating their trade or business, including meals consumed by employees on work travel - see H.R. Rep. No. 115-466, at 407 (2017) (Conf. Rep.).

Lodging while on business travel away from the taxpayer's tax home is also a deductible travel deduction. However, the IRS does not set a standard amount that can be deducted for lodging expenses. The allowable lodging expense deduction is the taxpayer's actual cost.

Meal and lodging expenses must be incurred while away from the tax home. Taxpayers cannot deduct the cost of meals and lodging while at their tax home. In addition, meals must not be lavish or extravagant under the circumstances.

Domestic Conventions & Meetings

Expenses for attending domestic conventions and meetings are deductible if attendance primarily benefits or advances the taxpayer's trade or business. If the agenda of the convention or meeting is so related to the conduct of the taxpayer's trade or business that attendance was predominantly for a business purpose, the primarily business test is met (R.R. 59-316).

Factors to determine if the agenda of the convention or meeting is related to the conduct of the taxpayer's trade or business include:

(1) The amount of time devoted to business compared to recreational and social activities;

(2) If the location is related to the operation of the taxpayer's trade or business;

(3) The attitude of the organization sponsoring the convention; *and*

(4) Whether attendance is mandatory.

Foreign Conventions & Meetings

No deduction is allowed for a convention, seminar, or similar meeting held outside the North American area unless the meeting is *directly related* to the taxpayer's trade or business, *and* it is as reasonable for the meeting to be held outside as within the North American area.

The North American area means the U.S., its possessions (including Puerto Rico, Virgin Islands, Guam, and American Samoa), the Trust Territory of the Pacific Islands, Canada, and Mexico. Certain Caribbean countries and Bermuda are included if the country:

(1) Is a "beneficiary country;"

(2) Has entered into an agreement with the U.S. for the exchange of tax information; *and*

(3) Has no tax laws discriminating against conventions held in the U.S.

Factors determining reasonableness are:

(1) The purpose of the meeting and the activities taking place at the meeting,

(2) The purposes and activities of the sponsoring organization or group,

(3) The residences of the active members of the sponsoring organization,

(4) The places at which other meetings of the sponsoring organization or group have been held or will be held, *and*

(5) Such other relevant factors as the taxpayer may present.

Cruise Ship Convention

Cruise ship conventions have a deduction limited to $2,000 per individual per year. Married filing jointly taxpayers can deduct $4,000 if each spouse spent at least $2,000 for attending a business-related cruise ship convention. In addition, the cruise ship must be registered in the U.S. and all ports of call must be located in the U.S. or its possessions.

Two written statements must be attached to a taxpayer's tax return:

(1) A *taxpayer's statement,* signed by the individual attending the meeting and including information with respect to:

(i) The total days of the trip (excluding the days of transportation to and from the cruise ship port)

(ii) The number of hours of each day of the trip that the individual devoted to scheduled business activity,

(iii) The program of the scheduled business activity of the meeting, *and*

(iv) Such other information as may be required by the IRS.

(2) A *sponsor's statement*, signed by an officer of the sponsoring organization or group, including:

(i) A schedule of the business activity of each day of the meeting

(ii) The number of hours during which the individual attending the meeting attended such scheduled business activities, *and*

(iii) Such other information as may be required by regulations.

Entertainment Activities & Facilities Deduction Repealed - §274

Section 274(a)(1)(A) generally disallows a deduction for any item with respect to an activity of a type considered to constitute entertainment, amusement, or recreation (entertainment expenditures). Thus, no deduction is allowed with respect to:

(1) an activity generally considered to be entertainment, amusement, or recreation,

(2) membership dues with respect to any club organized for business, pleasure, recreation, or other social purposes, *or*

(3) a facility or portion thereof used in connection with any of the above items (§274(a)(1)).

However, prior to the amendment by the TCJA, §274(a)(1)(A) provided exceptions to that disallowance if the taxpayer established that:

(1) the item was directly related to the active conduct of the taxpayer's trade or business (directly related exception); *or*

> **Note:** An item was considered directly related if it is associated with a substantial and bona fide business discussion.

(2) in the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), the item was associated with the active conduct of the taxpayer's trade or business (business discussion exception).

Section 274(n)(1) generally limited the deduction of food or beverage expenses and entertainment expenditures to 50 percent of the amount that otherwise would have been allowable. Thus, under prior law, taxpayers could deduct 50 percent of meal expenses and 50 percent of entertainment expenditures that met the directly related or business discussion exception.

> **Note:** The IRS has issued final regulations (TD 9925) that provide guidance under §274 regarding the elimination of the deduction under §274 for expenditures related to entertainment, amusement, or recreation activities, and provide guidance to determine whether an activity is of a type generally considered to be entertainment.

Facilities

Section 274(a)(1)(B) disallows a deduction for any item with respect to a facility used in connection with an activity referred to in §274(a)(1)(A). Section 274(a)(2) provides that, for purposes of applying §274(a)(1), dues or fees to any social, athletic, or sporting club or organization shall be treated as items with respect to facilities. Section 274(a)(3) disallows a deduction for amounts paid or incurred for membership in any club organized for business, pleasure, recreation, or other social purpose.

Final Regulations on Meal & Entertainment Deductions - TD 9925

On September 30, 2020, final regulations addressed the limitation on the deduction of food and beverage expenses under §274(k) and (n), including the applicability of the exceptions under §274(e)(2), (3), (4), (7), (8), and (9). The final regulations affect taxpayers who pay or incur expenses for meals.

Exceptions to Disallowance - §274(e)

Sections 274(e)(1) through (9) provide exceptions to the rule in §274(a) that disallows a deduction for entertainment expenditures. The TCJA did not change the application of the §274(e) exceptions to entertainment expenditures.

The entertainment expenses that remain deductible under one of the *nine* exceptions are:

(1) Food and beverages for employees furnished on the taxpayer's business premises (§274(e)(1));

> **Note:** Also deductible is the cost of maintaining the facilities for furnishing the food and beverages (Reg. §1.274-2(f)(2)(ii)).

(2) Expenses treated as compensation to an employee subject to withholding (§274(e)(2));

(3) Reimbursed expenses that the employee provides adequate accounting for (§274(e)(3));

(4) Recreational, social, or similar activity expenses for employees (other than highly compensated employees) (§274(e)(4));

> **Note:** Expenses under this exception are not subject to the 50% limitation.

(5) Expenses directly related to business meetings of a firm's employees, partners, stockholders, agents, or directors (§274(e)(5));

> **Note:** However, if the primary purpose of the meeting was social, this exception doesn't apply.

(6) Expenses directly related to business meetings or conventions of exempt organizations (§274(e)(6));

(7) The ordinary and necessary cost of providing entertainment or recreational facilities to the general public as a means of advertising or promoting goodwill in the community (§274(e)(7));

> **Note:** The 50% limitation doesn't apply to this exception.

(8) Entertainment sold to customers in a bona fide transaction for adequate and full consideration (§274(e)(8)); *and*

> **Note:** This is a normal business expense not subject to the 50% limitation.

(9) Expenses includable in the income of a non-employee (§274(e)(9)).

Business Meals

Taxpayers may still deduct 50% of the food and beverage expenses associated with operating their trade or business (e.g., meals consumed by employees on work travel) - see H.R. Rep. No. 115-466, at 407 (2017) (Conf. Rep.). Thus, taxpayers can continue to deduct 50% of the cost of business meals if the taxpayer (or an employee of the taxpayer) is present and the food or beverages are not considered lavish or extravagant.

The meals may be provided to a current or potential business customer, client, consultant, or similar business contact. If provided during or at an entertainment activity, the food and beverages must be purchased separately from the entertainment, or the cost of the food or beverages must be stated separately from the cost of the entertainment on one or more bills, invoices, or receipts (Notice 2018-76).

Percentage Reduction for Meals - §274(n)(1)

Deductions for meals (and formerly for entertainment) are reduced by 50%. Specifically, under §274(n)(1), this reduction applies to any expense for food or beverages (and formerly any cost for an entertainment activity). The percentage reduction is applied to the amount "allowable" as a deduction (§274(n)(1)).

Note: Travel and transportation expenses are not affected by this reduction rule, only meals (including meals while in travel status).

The percentage reduction rule also applies to related expenses, for example, taxes and tips relating to a meal.

Note: A temporary exception allowed a 100% deduction for food or beverages from restaurants, as long as the expense was paid or incurred in 2021 or 2022 (§274(n)(2)(D)).

Eating Facilities

For amounts incurred and paid after 2017 and before 2025, this 50% limitation is expanded to include expenses of the employer associated with providing food and beverages to employees through an eating facility that meets requirements for de minimis fringes and for the convenience of the employer. However, such amounts incurred and paid after 2025 are not deductible.

Exceptions

Exceptions *not* subject to the 50% reduction include:

(1) Expenses treated as compensation (§274(e)(2); §274(n)(2)),

(2) Reimbursed expenses (§274(e)(3) and §274(n)(2)(A)),

Note: However, the 50% limitation will apply to the person making the reimbursement (S Rept No. 99-313 (PL 99-514) p. 71),

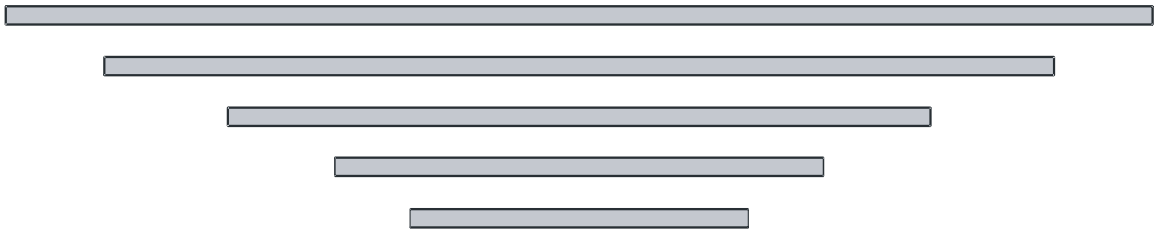
(3) Recreational expenses for employees (§274(e)(4); §274(n)(2)(A)),

(4) Items available to the public (§274(e)(7) and §274(n)(2)(A)),

(5) Entertainment sold to customers (§274(e)(8) and §274(n)(2)(A)),

(6) Expenses includible in the income of persons who are not employees (§274(e)(9) and §274(n)(2)(A)), *and*

(7) Expenses for food or beverages provided by a restaurant and paid or incurred before January 1, 2023 (§274(n)(2)(D)).



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50. There are five circumstances that can avoid the mixed-use allocation rule for primarily business foreign travel. What is one of these conditions?

a. More than half of the days on the trip are business days.

b. The employee owns, directly or indirectly, more than 10%.

c. The business trip was arranged by someone other than the taxpayer.

d. To foreign travel must be to a single foreign destination.

51. Convention expenses can be deductible if attendance primarily benefits the taxpayer's business. To determine whether it is beneficial, what is compared with an individual's business duties?

a. the purposes set forth in its registration with the IRS.

b. the purposes in the program or agenda.

c. the purposes provided in the sponsor's statement.

d. the purposes stated in the sponsor's tax opinion.

52. The “North American area” encompasses some Caribbean countries and Bermuda. When are the costs of attending a convention in such a country deductible?

a. if the country is a member of the North Atlantic Treaty Organization.

b. if the country maintains diplomatic relations with the United States.

c. if the country agrees to exchange tax information with the United States.

d. if the country has been deemed a "friendly" nation by the State Department.

53. When a convention is held outside the North American area, a deduction is permitted so long as the meeting directly relates to the business, and holding said meeting outside the area is deemed to be reasonable. Which of the following factors listed below is disregarded when determining this reasonableness?

a. The purposes of the sponsor.

b. The times at which the lectures are given.

c. Where the sponsoring organization’s members live.

d. Where other meetings have taken place.

54. If a cruise ship convention otherwise qualifies for deduction, a taxpayer's statement must be attached to the tax return. This statement requires detailed information about the convention. However, which of the following information items can be omitted from the taxpayer’s statement?

a. the number of trip days.

b. a tally of business hours for each day.

c. a convention program.

d. the names of other participants.

55. The reduction limitation for meals is inapplicable in many cases. However, this limitation is applicable when:

a. expenses are treated as compensation to employees.

b. costs are excludable from the income of nonemployees.

c. customers can purchase the entertainment.

d. refreshments are treated as de minimis fringe benefits.

Substantiation - §274(d)

Taxpayers must prove their deductions for travel, meals, and business gift expenses by either:

(1) adequate records, *or*

(2) sufficient evidence that will corroborate the taxpayer's own statement (§274(d)).

Without such records to substantiate travel expenditures, the taxpayer will suffer a total disallowance of deductions by reason thereof. The taxpayer must, therefore, make every effort to substantiate travel expenses.

> **Comment:** Some practitioners add language similar to the following to their tax return enclosure letter - "Additionally, I did not evaluate, review, or make any judgment regarding the adequacy of your travel, entertainment, or auto documentation. The IRS has established extensive and complicated rules and regulations regarding the documentation of travel, entertainment, and automobile expenses. I expressly disclaim any opinion as to the adequacy of your travel, entertainment, and auto record keeping."

Travel Expense Substantiation

Items needed for travel expense substantiation include:

(1) *Amount* - The amount of each separate expenditure for traveling away from home, such as the cost of transportation or lodging.

> **Comment:** The daily cost of breakfast, lunch, and dinner, and other incidental travel elements may be aggregated if they are set forth in reasonable categories, such as for meals, oil and gas, taxi fares, etc.

(2) *Time and Date* - The dates of the departure and return home for each trip and the number of days spent on business away from home.

(3) *Place* - The destinations or locality of the travel.

(4) *Purpose* - The business reason for the travel or the nature of the business benefit derived or expected to be derived as a result of the travel.

Meal Expense Substantiation

To deduct meal expenses taxpayer must substantiate each of the following elements:

(1) *Amount* - The total cost of the meal, including tax and tip.

> **Standard Meal Allowance:** Taxpayers can use the standard meal allowance method as an alternative to the actual amount. The set amount varies depending on where and when you travel.

(2) *Time and Date* - The date and time when the meal was consumed.

(3) *Place* – the place where the meal was consumed.

(4) *Purpose* - The reason for the meal.

(5) *Business Relationship* - How meal relates to the business.

(6) *Physical presence* - Taxpayer or his or her employee was present.

Business Gifts Expense Substantiation

Deductions for business gifts are subject to a special $25 limitation. However, even for these allowable expenses, a taxpayer must substantiate each of the following elements:

(a) *Amount* - cost of gift to taxpayer,

(b) *Time* - date of gift,

(c) *Description* - description of gift,

(d) *Purpose* - business reason for, or business benefit expected from the gift, *and*

(e) *Relationship* - name, title, occupation, or other information concerning the recipient of the gift sufficient to establish a business relationship with the taxpayer.

Substantiation Methods

There are two basic substantiation methods - adequate records and sufficiently corroborated statements.

Adequate Records

The adequate records rule requires taxpayers to maintain:

(a) An account book, diary, log, statement of expenses, trip sheets, or similar record listing the required elements of each expense and use, *and*

(b) Documentary evidence (where necessary) sufficient to establish each element of every expenditure or use.

> **Comment:** Documentary evidence is required under the "adequate records" rule for the following types of travel and pre-2018 entertainment and listed property expenditures:
>
> (1) Expenditures for lodging (regardless of amount) while traveling away from home, and
>
> (2) Any other "separate expenditure" of $75.00 or more *(*Reg. §1.274-5(c)(2)(iii)(*B).*

Documentary evidence consists of receipts, canceled checks, paid bills, or similar evidence that establish the amount, date, place, and essential character of an expenditure or use, or of one or more elements of an expenditure or use

Adequate records must be prepared *at or near the time of the expenditure or use* - i.e., at a time when the taxpayer has full knowledge of the elements of the expenditure or use.

> **Warning:** When there is no documentary evidence for lodging costs, or for separate expenditures of $75.00 or more, no deduction will be allowed, even if records are otherwise "adequate."

Sufficiently Corroborated Statements

When a taxpayer fails to comply with the "adequate records" rule, then they can still substantiate the required elements by written or oral statements, but only if such statements are supported by sufficient corroborating evidence.

Written evidence is better than oral evidence, and its probative value increases closer in time to the expenditure or use. However, direct evidence is required when the element to be substantiated is the description of a gift, amount, time, place, or date of an expenditure or use. Direct evidence constitutes:

(a) Statements in writing or the oral testimony of witnesses giving detailed information about the element, *and/or*

(b) Documentary evidence (i.e., receipts).

Exceptional Circumstances

Other evidence may be allowed if because of the inherent nature of the situation in which an expense is made, the taxpayer cannot get a receipt. If a taxpayer can establish that, by reason of the inherent nature of the situation taxpayer:

(a) was unable to obtain evidence for an element of the expense or use that conforms fully to the adequate records requirements,

(b) is unable to obtain evidence for an element that conforms fully to the other sufficient evidence requirements, *and*

(c) has presented other evidence for the element that possesses the highest degree of probative value possible under the circumstances.

This other evidence is considered to satisfy the substantiation requirements.

> **Note:** Taxpayers may prove an expense by reconstructing their expenses if they cannot produce a receipt for reasons beyond their control, such as fire, flood, or other casualty (Reg. §1.274-5T(c)(5)).

Retention of Records

Records should be retained as long as the income tax return is open to audit. Thus taxpayers should keep expense records for three years from the date of filing the income tax return.

Employees who give their records and documentation to their employers and are reimbursed for their expenses generally do not have to keep duplicate copies of this information. However, an employee who turns over their records to their employer and is reimbursed for their expenditures should still keep duplicate copies of that information if they:

(a) claim deductions for expenses in excess of reimbursements,

(b) are certain related stockholder-employees, *or*

(c) have employers who do not maintain adequate accounting procedures for verification of expense accounts.

Exceptions to Substantiation Requirements

A limited number of expenses are exempt from the strict substantiation requirements of §274(d) and may be deducted and substantiated as any other ordinary business expense, including:

(a) expenses for recreational, social, or similar activities primarily for the benefit of employees (including the expenses of facilities used for such purposes),

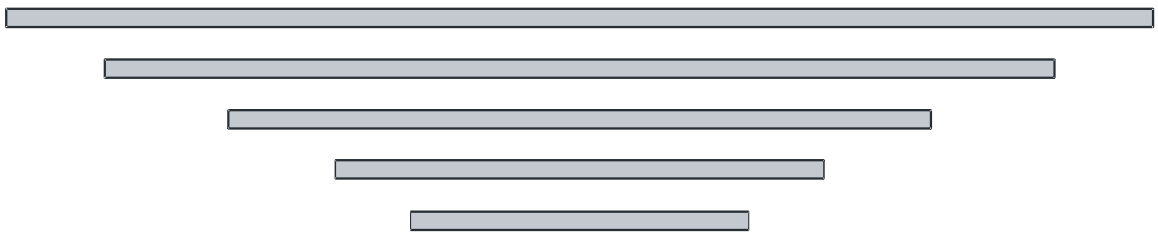
(b) expenses for food and beverages furnished on the business premises primarily for the benefit of employees (including the expenses of facilities used),

(c) expenses for goods, services, and facilities furnished to employees and treated as compensation subject to withholding,

(d) expenses for goods, services, and facilities made available to the general public,

(e) entertainment sold to customers, *and*

(f) telephone and laundry expenses.



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56. Section 274(d) detailed substantiation of expenses requires a number of elements to be proven. However, which of the following items is irrelevant?

a. amount.

b. time.

c. place.

d. attire.

57. The adequate records substantiation rule requires documentary evidence for certain kinds of expenses. For example, documentary evidence is required for:

a. lodging.

b. separate expenditures of $25.

c. de minimis expenses.

d. tips.

58. Taxpayers using adequate records substantiation must maintain a diary, trip book or log sheet, and documentary evidence proving the required expense elements. However, which of the following items fails to qualify as such documentary evidence?

a. receipts.

b. a canceled check.

c. paid bills.

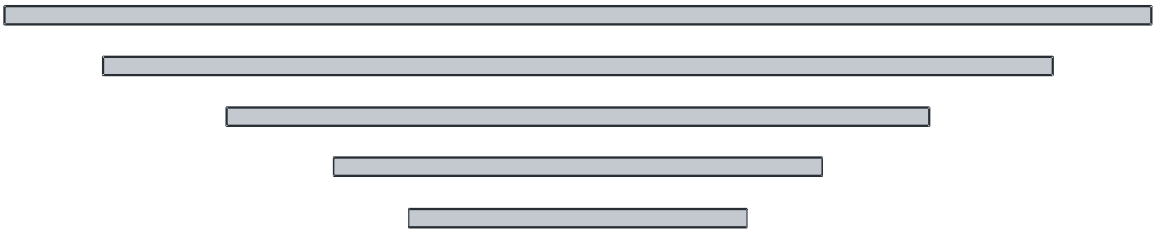
d. the taxpayer's signed statement.

59. The detailed substantiation requirements of §274(d) apply to many sets of expenses. However, which type of expense is excluded from these substantiation requirements?

a. entertainment sold to customers.

b. travel.

c. business gifts.
d. entertainment facilities.



Employee Expense Reimbursement & Reporting

Unreimbursed Employee Expenses

The TCJA eliminated *unreimbursed* employee expense deductions for all but a few specific employment categories. As a result, most taxpayers can no longer claim any miscellaneous itemized deductions that were subject to the 2% AGI limitation such as unreimbursed employee expenses.

> **Comment:** Unreimbursed expenses attributable to the trade or business of being an employee are now suspended through 2025 and taxpayers cannot currently claim *unreimbursed* employee business expenses as itemized deductions during this suspension period. An individual also remains unable to claim such deductions in calculating his or her AMT liability.
>
> **Note:** If a taxpayer was an eligible educator for the tax year, they may be able to deduct qualified expenses they paid as an adjustment to gross income rather than as a miscellaneous itemized deduction.

However, the following taxpayers can still claim a deduction for unreimbursed employee expenses:

(1) armed forces reservists,
(2) qualified performing artists,
(3) fee-basis state or local government officials, *and*
(4) employees with impairment-related work expenses.

Such taxpayers must complete Form 2106, *Employee Business Expenses*, to take the deduction.

Reimbursed Employee Expenses

Reimbursed employee expenses are treated in one of two ways, depending on whether the employer uses an accountable or nonaccountable plan. Under an accountable plan, allowances or reimbursements paid to employees for business-related expenses are not counted as income and are not subject to withholding. Under a nonaccountable plan, reimbursed employee expenses are considered taxable income and reported on the employee's W-2. Reimbursements treated as paid under an *accountable plan* are *not* reported as compensation. Reimbursements treated as paid under *nonaccountable plans* are reported as compensation.

> **Note:** The employer makes the decision whether to reimburse employees under an accountable plan or a nonaccountable plan. An employee who receives payments under a nonaccountable plan cannot convert these amounts to payments under an accountable plan by voluntarily accounting to the employer for the expenses and voluntarily returning excess reimbursements to the employer (Reg. §1.62-2(c)(3)).
>
> **Comment:** If a single payment includes both wages and expense reimbursement, the amount of the reimbursement must be specifically identified. If an employee is paid a salary or commission with the understanding that they will pay their own expenses, there is no reimbursement or allowance arrangement.

Accountable Plans

To be an accountable plan, the employer's reimbursement or allowance arrangement (e.g., per diem *and* mileage plans) *must* meet *all three* of the following rules:

(1) Expenses must have a *business connection* (i.e., the employee must have paid or incurred deductible expenses *while* performing services for the employer *and* the advance must reasonably *relate* to anticipated business expenses),

Example

Dux Inc. provides President Dan with an "advance" of $2,000 when it is not anticipated that Dan will incur travel or other expenses deductible in the trade or business of being an employee. This "advance" does not meet the business connection requirement and is not paid under an accountable plan.

---

(2) Employees must *adequately account* to the employer (under §162 & §274) for these expenses within a *reasonable period of time*, and

> **Note:** If expenses are reimbursed under an otherwise accountable plan but the employee does not return, within a reasonable period of time, any reimbursement of expenses for which they did not adequately ac-

count, then only the amount for which they did adequately account is considered as paid under an accountable plan. The remaining expenses are treated as having been reimbursed under a nonaccountable plan (Reg. §1.62-2(c)(2)(ii)).

(3) Employees must *return any excess* reimbursement or allowance within a *reasonable period of time* (§62(a)(2); Reg. §1.62-2(c)).

> **Note:** Excess reimbursement means any amount for which the employee did not adequately account within a reasonable period of time. For example, if an employee received a travel advance and did not spend all the money on business-related expenses, or did not have proof of all expenses, there is excess reimbursement (§62(c); Reg. §1.62-2(f); Reg. §1.62-2(g)).

If all these rules are met, the employer does *not* include any reimbursements in the employee's income. If expenses *equal* reimbursement, there is *no* deduction for or compensation to the employee (Reg. §1.62-2(c)(4); Reg. §1.3231(e)-3(a)).

Business Connection

A business connection under an accountable plan is a requirement that the expenses incurred by the employee must be related to their job performance and not to their personal or private affairs.

Reasonable Period of Time

The definition of a "reasonable period of time" depends on the facts. However, the regulations create *two* safe harbors:

(i) fixed date, *and*

(ii) periodic statement.

Fixed Date Safe Harbor - #1

The Service considers it *reasonable* to:

(i) *Receive an advance* within 30 days of when the employee has an expense,

(ii) *Adequately account for expenses* within 60 days after they were paid or incurred, *and*

(iii) *Return any excess* reimbursement within 120 days after the expense was paid or incurred (Reg. §1.62-2(g)(1); Reg. §1.62-2(g)(2)(i)).

Periodic Statement Safe Harbor - #2

If an employer provides employees with periodic statements (no less frequently than quarterly) stating the amount, if any, paid under the arrangement in excess of the expenses the employee has substantiated and requesting the employee to substantiate any additional business

expenses that have not yet been substantiated (whether or not such expenses relate to the expenses with respect to which the original advance was paid) and/or to return any amounts remaining unsubstantiated within 120 days of the statement, an expense substantiated or an amount returned within that period will be treated as being substantiated or returned within a reasonable period of time (Reg. 1.62-2(g)(2)(ii)).

Adequate Accounting

Employees adequately account by giving the employer documentary evidence of travel and other employee business expenses, along with a statement of expense, an account book, a diary, or a similar record in which the employee entered each expense at or near the time they made it. Documentary evidence includes receipts, canceled checks, and bills (Reg. §1.274-5T(f)(4)).

Per Diem Allowance Arrangements

A per diem allowance satisfies the adequate accounting requirements as to *amount* if:

(a) the employer reasonably limits payments of the travel expenses to those that are *ordinary and necessary* in the conduct of the trade or business,

> Note: If the IRS finds that an employer's travel allowance practices are not based on reasonably accurate estimates of travel costs, including recognition of cost differences in different areas, the employee is not considered to have accounted to the employer.

(b) the allowance is similar in form to and *not more* than the *federal rate,*

> Note: The federal per diem rate can be figured by using any one of three methods (i) the regular (or standard) federal per diem rate (for combined lodging, meals, and incidental expenses), (ii) the meals only (or standard meal) allowance (for meals and incidental expenses only), or (iii) the high-low method (for combined lodging, meals, and incidental expenses or lodging only).
>
> **Comment:** The regular (or standard) federal per diem rate is different for different locations. IRS Publication 1542 gives the rates in the continental United States. In addition, a proration is *required* on the federal per diem rate (and the federal M&IE rate) if the employee travels *less than 24 hours* of any day.

(c) the employee is *not* related (as defined under the rules applicable to the standard per diem meal allowance) to the employer, *and*

> **Comment:** A taxpayer is related to their employer if the employer is their brother or sister, half-brother or half-sister,

spouse, ancestor, or lineal descendant (§267(c)(4)),or the employer is a corporation in which the taxpayer owns, directly or indirectly, more than 10% in stock (Reg. §1.2745T(f)(5)(ii)).

Note: Business owners must provide actual receipts in all circumstances..

(d) the time, place, and business purpose of the travel are proved (Reg. §1.62-2(c)(1); Reg. §1.62-2(e); Reg. §1.274-5T(g); R.P. 2011-47 & R.P. 2019-48).

Note: If an employee does not prove that they actually traveled on *each* day for which they received a per diem, they must return this unproven amount of the *travel advance* within a reasonable period of time. If the employee does not return the unproven amount, then it will be considered paid under a *nonaccountable* plan.

Note: A receipt for lodging expenses is not required in order to apply the Federal per diem rate for the locality of travel (R.P. 2011-47 & R.P. 2019-48).

Nonaccountable Plans

A nonaccountable plan is a reimbursement or expense allowance arrangement that does *not* meet the three rules listed earlier under the discussion of accountable plans.

In addition, the following payments made under an *accountable* plan will be treated as being paid under a *nonaccountable* plan:

(1) excess reimbursements the employee *fails* to return to the employer (Reg. §1.62-2(c)(2)(ii)), *and*

(2) reimbursement of *nondeductible* expenses related to the employer's business (Reg. §1.62-2(d)(2)).

Note: For example, when an employee is reimbursed under an accountable plan, some of which *are* deductible as employee business expenses and some of which are *not* deductible. The reimbursements received for the *nondeductible* expenses are treated as paid under a *nonaccountable* plan.

Example from Pub. 463 (Rev '23)

Your employer's plan reimburses you for travel expenses while away from home on business and also for meals when you work late at the office, even though you are not away from home. The part of the arrangement that reimburses you for the nondeductible meals when you work late at the office is treated as paid under a nonaccountable plan (Reg. §1.62-2(c)(2)).

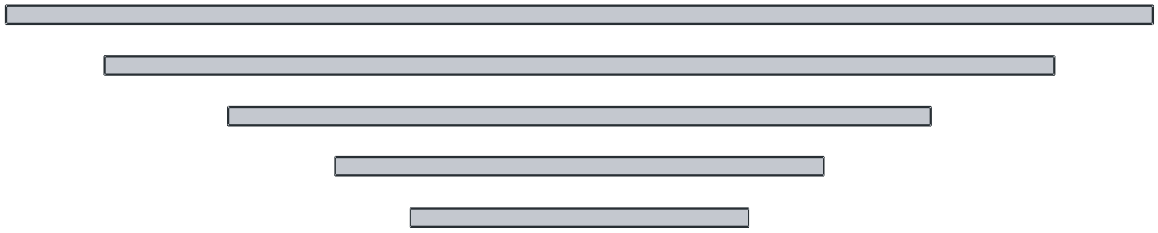
An arrangement that repays the employee for business expenses by *reducing* their wages, salary, or other compensation will be treated as a *nonaccounta-*

ble plan because the employee is entitled to receive the full amount of their compensation regardless of whether they incurred any business expenses (Reg. §1.62-2(d)(3)(i)).

Example from Pub. 463 (Rev '23)

You are paid $2,000 a month by your employer. On days that you travel away from home on business, your employer designates $50 a day of your salary as paid to reimburse your travel expenses. Because your employer would pay your monthly salary whether or not you were traveling away from home, the arrangement is a nonaccountable plan. No part of the $50 a day designated by your employer is treated as paid under an accountable plan.

Reimbursements from nonaccountable plans produce *taxable* income for the *employee*. All advances and reimbursements from nonaccountable plans must be included on the employee's W-2 in Box 1. Employers must *withhold* income taxes on reimbursements *without* regard to any expenses that the employee may have. FICA and FUTA taxes are also imposed on *unaccounted* expense reimbursements.



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60. In addition to other §62 requirements, to qualify as an accountable plan for employee expense reimbursement and reporting purposes, the employer's reimbursement or allowance arrangement must meet three rules. What is one of these rules?

a. Employers must receive sufficient accounting of expenses within 180 days.

b. An estimate of expenses must be provided within a reasonable period of time.

c. Excess reimbursement or allowance must be treated as compensation.

d. Expenses must have a business connection.

61. Under the accountable plan rules, two conditions require action within a specifically defined "reasonable period of time." However, which of the following circumstances would demonstrate an unreasonable amount of time?

a. The employee receives an advance within 30 days.

b. The employee accounts for expenses within 60 days.

c. The employee returns any excess within 120 days.

d. The employee substantiates expenses within 180 days of a periodic statement.

62. What the employer has to report on Form W-2 depends on the type of reimbursement or other expense allowance arrangement that is in existence. Which type of reimbursement does an employer report on Form W-2?

a. actual expenses reimbursed under an accountable plan.

b. excess amounts returned to the employer.

c. adequately accounted for amounts under a nonaccountable plan.

d. per diem or mileage allowance under an accountable plan.

63. A nonaccountable plan is a reimbursement or expense allowance arrangement outside the requirements of §62. Reimbursements from such a plan are:

a. taxable income to the employer.

b. taxable income to the employee.

c. are income to the employee and cannot be deducted by the employee.

d. are not deductible by an employer.

Local Transportation

Transportation expenses directly attributable to the conduct of the taxpayer's business are deductible even though they are not away from home overnight. Such expenses include air, train, bus, and cab fares and costs of operating autos.

Commuting Expenses

Transportation expenses between a taxpayer's residence and a regular place of business are *nondeductible* commuting expenses (§262). These costs are personal commuting expenses. Taxpayers cannot deduct commuting expenses no matter how far their home is from their regular place of work. Neither can taxpayers deduct commuting expenses if they work during the commuting trip.

Example from Pub. 463 (Rev '23)

You sometimes use your cell phone to make business calls while commuting to and from work. Sometimes business associates ride with you to and from work, and you have a business discussion in the car. These activities don't change the trip from personal to business.

Miscellaneous Personal Usages & Items

Parking fees: Fees paid to park a car at the taxpayer's regular place of work are nondeductible commuting expenses. However, taxpayers can deduct business-related parking fees when visiting a customer or client.

Tools: Hauling tools or instruments while commuting to and from work does not make car expenses deductible. However, any additional costs (such as for renting a trailer that is towed) for hauling tools or instruments can be deducted.

Display advertising: Putting display material that advertises the taxpayer's business on a car does not change the use of the car from personal use to business use.

Car pools: Taxpayers cannot deduct the cost of using their car in a nonprofit car pool. The payments received from passengers are not income but, are considered reimbursement of expenses.

Transportation to Temporary Work Locations

When a taxpayer has one or more regular work locations away from their residence and they commute to a temporary work location in the same trade or business, they can deduct the expenses of the daily round-trip transportation between their home and the temporary location, regardless of distance (i.e., inside or outside the metropolitan area).

> **Note:** According to the IRS, a metropolitan area is a region that includes a city and the densely populated surrounding areas (i.e., suburbs) that are socially and economically integrated with it. In practice, a metropolitan area extends no more than 50 miles.

Example from Pub. 463 (Rev '23)

You regularly work in an office in the city where you live. Your employer sends you to a 1-week training session at a different office in the same city. You travel directly from your home to the training location and return each day. You can deduct the cost of your daily round-trip transportation between your home and the training location.

Temporary Work Location

If employment at a work location is realistically expected to last (and does in fact last) for 1 year or less, the employment is temporary unless there are facts and circumstances that would indicate otherwise. However, if employment at a work location is realistically expected to last for more than 1 year or if there is no realistic expectation that the employment will last for 1 year or less, the employment is not temporary.

Finally, if employment at a work location initially is realistically expected to last for 1 year or less, but at some later date the employment is realistically expected to last more than 1 year, that employment will be treated as temporary until the taxpayer's expectation changes. It won't be treated as temporary after the date the taxpayer determines it will last more than 1 year.

Transportation When Residence is Principle Place of Business

Workers whose residence is their principal place of business may deduct their daily travel expenses if they are traveling between their residence and another work location (regular or temporary; in the same trade or business regardless of whether the work is temporary or permanent and regardless of the distance (i.e., inside or outside the metropolitan area).

Example from Pub. 463 (Rev '23)

Your principal place of business is in your home. You can deduct the cost of round-trip transportation between your qualifying home office and your client's or customer's place of business.

No Regular Place of Work

Workers who have no regular place of work but ordinarily work in the metropolitan area where they live can deduct daily transportation costs between their and a temporary work site outside that metropolitan area.

However, such worker cannot deduct daily transportation costs between their residence and temporary work sites within their metropolitan area. These are nondeductible commuting expenses.

Note: A metropolitan area includes the area within the city limits and the suburbs that are considered part of that metropolitan area.

Example from Pub. 463 (Rev '23)

You have no regular office, and you don't have an office in your home. In this case, the location of your first business contact inside the metropolitan area is considered your office. Transportation expenses between your home and this first contact are nondeductible commuting expenses. Transportation expenses between your last business contact and your home are also nondeductible commuting expenses. While you can't deduct the costs of these trips, you can deduct the costs of going from one client or customer to another.

Two Places of Work

When a taxpayer works at two places in a day, whether or not for the same employer, they can deduct the expense of getting from one workplace to the other (R.R. 55-109). However, if for some personal reason they do not go directly from one location to the other, they cannot deduct more than the amount it would have cost them to go directly from the first location to the second.

Note: Transportation expenses in going between home and a part-time job on a day off from a main job are commuting expenses and cannot be deducted.

Automobile Deductions & Credits

Operating costs for an automobile, truck, or other vehicle used in a trade or business are deductible to the extent that they represent transportation expenses to carry on the taxpayer's business. Thus, when a taxpayer uses their car in their business or employment, they can deduct that portion of the cost of operating the car. When a taxpayer uses a vehicle for both business and personal purposes, they may deduct only the cost of its business use.

For depreciation purposes, a car is any four-wheeled vehicle (including a truck or van) made primarily for use on public streets, roads, and highways. Its unloaded gross vehicle weight (for trucks and vans, gross vehicle weight) must not be more than 6,000 pounds.

Taxpayers can choose between two methods of calculating their vehicle expenses:

(1) the standard mileage rate method, *or*

> **Note:** The standard mileage rate method allows the taxpayer to deduct a fixed amount per mile driven for business purposes.

(2) the actual expense method.

> **Note:** The actual expense method allows the taxpayer to deduct the actual costs of operating and maintaining their car for business purposes.

Some auto expenses can be deducted regardless of which method is used. For example, if a taxpayer is self-employed and uses an auto in their business, they can deduct that part of the interest expense that represents their business use of the car. In addition, if a taxpayer itemizes their deductions, they can deduct state and local personal property taxes on motor vehicles even if they don't use the car for business. Finally, taxpayers can deduct any business related parking fees and tolls.

Record Keeping

Regardless of the method chosen, a taxpayer must keep adequate records or evidence to support their auto expense deductions. This may include receipts for gas, oil, repairs, tires, insurance premiums, registration fees, and license fees as well as mileage logs or odometer readings.

Apportionment of Personal & Business Use

When a taxpayer makes both personal and business use of their auto, they must apportion their expenses between business travel and personal travel, unless the personal use is negligible. Thus, total car expenses (except business parking fees and tolls) are deducted in proportion of business to total use.

> **Note:** Parking fees and tolls attributable to business use are fully deductible, whether the standard mileage rate or actual expenses is used.

There is no definitive rule for making an apportionment between business and personal expenses. However, generally accepted methods include:

(1) A proration of *actual expenses and depreciation* based on the percentage of business use to total use; *and*

(2) The *standard mileage rate* deduction for business miles driven.

The taxpayer is free to use whichever method produces the largest deduction, provided the right to the deduction is properly substantiated.

Example

You are a contractor and use your car in your business. During the year you drove 20,000 miles of which 16,000 miles were for business purposes. You are entitled to deduct 80% (16,000/20,000) of the total cost of operating your car.

Actual Cost Method

The actual cost method allows taxpayers to claim a deduction for the actual costs of operating their business use vehicle. Eligible expenses incurred (including depreciation) are totaled together and then multiplied by the business-use percentage (see the above example) to determine the amount of the deduction. Only the business-use percentage (based on the ratio of business miles to total miles) allowable to business transportation is allowed as a deduction.

> **Comment:** The actual cost method may give a larger deduction than the standard mileage rate method, which only allows a deduction of a fixed amount per mile driven for business purposes. However, the actual cost method may also be more complicated and time-consuming to calculate and report.

Eligible Expenses

If a taxpayer does not use the standard mileage rate, any expense of operating and maintaining a car used for business purposes such as gasoline, oil, repairs, insurance, depreciation, interest to purchase the car, taxes, licenses, garage, rent, parking, fees, tolls, etc. are deductible.

Depreciation & Expensing

Depreciation is an annual income tax deduction that allows taxpayers to recover the cost or other basis of certain property over the time they use the property (see Form 4562 to calculate). For autos used in business, it is the amount that can be deducted each year representing a reduction in an auto's value due to wear and tear. There are two primary methods for calculating vehicle depreciation:

(1) MACRS (200% or 150% declining balance method), *and*

Comment: MACRS is generally considered more beneficial compared to other methods. for autos since it allows for faster depreciation in the first years and slower depreciation later on. To use MACRS a vehicle must be used for business reasons at least 50% of the time,

(2) straight-line depreciation.

Note: Straight-line depreciation calculates depreciation of an auto uniformly over a 5-year recovery period. If the business use of a vehicle is less than 50%, then straight-line depreciation must be used

Depreciation begins when the vehicle is placed in service for use in trade or business. It stops when the auto cost has been fully recovered or when the auto is retired from business service.

Placed in Service

A car is placed in service when it is ready and available for use in the taxpayer's work or business, in the production of income, or in a personal activity. However, depreciation can only begin when used in the taxpayer's work, business, or production of income.

If a taxpayer places property in service in a personal activity, they cannot claim depreciation. However, if they change the property's use to use in a business activity, then they can begin to depreciate it at the time of the change.

Half-year Convention

The half-year convention is a tax rule used to calculate depreciation and applies to all forms of depreciation methods. It assumes that an asset is acquired and disposed of in the middle of the year, and therefore only half of the annual depreciation expense is allowed in the first year. The remaining half of the depreciation expense is deducted from the income in the last year of the asset's useful life

Under the half-year convention, an automobile is assumed to have been placed in service during the middle of the tax year for MACRS. As such, depreciation for the first year will be based on one-half a year.

Quarterly Convention

If at least 40% of the cost basis of all tangible personal property (including autos) acquired in a year occurs in the last three months of the tax year, then a mid-quarter convention must be used instead of the half-year convention. This means that all property (including autos) placed in service (or disposed of) during any quarter of a year is placed in service (or disposed of) at the midpoint of that quarter.

MACRS

The modified cost recovery system (MACRS) is the depreciation system that applies to tangible property. It allows the capitalized cost of an asset to be recovered over a specified period via annual deductions.

Under MACRS, autos are classified as five-year property. However, as a result of the half-year convention, a car is actually depreciated over a six-year period.

200% Declining Balance Method

To figure MACRS depreciation, divide one by the recovery period (5 years for cars). This basic rate (20% for five-year property) is multiplied by two to get the double declining (200%) balance rate of 40%. Multiply the adjusted basis of the car (determined by reducing the cost by the percentage of personal use and any §179 deduction) by this 40% and apply the appropriate convention to figure your depreciation for the first year. This process is continued for each year of recovery. However, at the point (year four for cars) where straight-line is more beneficial, a switch is made to straight-line.

150% Declining Balance Method

The basic rate (20% for five-year property) is multiplied by 1.5 to get the double declining (150%) balance rate of 30%. Multiply the adjusted basis of the car (determined by reducing the cost by the percentage of personal use and any §179 deduction) by this 30% and apply the appropriate convention to figure your depreciation for the first year. This process is continued for each year of recovery.

Vehicle Depreciation "Caps" - §280F(a)

Automobiles and other vehicles are subject to strict depreciation and expensing rules and limitations. Unlike many other assets, there are limits on the amount of annual depreciation (regular or bonus) that can be claimed.

> **Note:** The term "passenger automobiles" includes trucks and vans. In addition, the expense deduction under §179 is depreciation for purposes of applying this limitation (§280F(d)(1)).

For 2024, the depreciation (including the §179 expensing deduction) limitations under §280F for a business use vehicle could not be more than $12,400 ($20,400 if first-year bonus depreciation was used) for the first tax year of the recovery period, $19,800 for the second year, $11,900 for the third year, and $7,160 for each later tax year. These amounts are adjusted annually for inflation. The above 2024 caps applied to all types of vehicles (§280F(a)(2)(A) & R.P. 2024-13).

For 2025, auto depreciation limits have not been published as of this writing.

These depreciation limits are reduced *only* by the percentage of personal use. They are *not* reduced if the taxpayer uses a vehicle for *less* than a full year. There is *no* reduction if the taxpayer is using a half-year or mid-quarter convention. This applies even in the year the vehicle is either placed in service or disposed of (Reg. §1.280F-2T(i)).

The depreciation caps (and lease inclusion amounts) do not apply to:

(a) cars with an unloaded gross vehicle weight of more than 6,000 pounds; *and*

(b) SUVs, trucks, and vans with a gross vehicle weight rating of more than 6,000 pounds.

Vehicle Bonus (or Additional First-year) Depreciation - §168(k)

Because of bonus depreciation, the limitation under §280F on the amount of depreciation deductions allowed with respect to certain passenger automobiles is increased in the first year by $8,000 for automobiles that qualify (and for which the taxpayer did not elect out of the additional first-year deduction). The $8,000 increase is not indexed for inflation.

> **Note:** Additional first year depreciation deduction does not apply if the taxpayer (1) did not use the passenger automobile more than 50 percent for business purposes; (2) elected out of the additional first year depreciation deduction; or (3) acquired the passenger automobile before September 28, 2017, and placed it in service after 2019 (R.P. 2023-14).

Thus, while the vehicle depreciation limitation for the first year in 2024 was $20,400 when bonus depreciation was taken, the bonus depreciation component was limited to 60% (down from 80% in 2023) of the cost of the vehicle not to exceed $8,000. In 2025, the bonus depreciation component is limited to 40% (down from 60% in 2024) of the cost of the vehicle not to exceed $8,000.

> **Note:** The additional first-year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes for the taxable year in which the property is placed in service.
>
> **Comment:** See R.P. 2019-13 for the effect of taking additional first-year (bonus) depreciation on subsequent tax years and the relief provided by the safe harbor method.

$25,000 SUV Limit - §179(b)(5)(A)

The $25,000 maximum §179 deduction limit on specified vehicles that are exempt from the passenger vehicle depreciation caps is adjusted for inflation. This maximum §179 deduction limit is $31,300

for 2025 (up from $30,500 in 2024). Such vehicles include sport utility vehicles, trucks with an interior cargo bed length of less than six feet, and certain weighted vans (§179(b)(5)(A)).

Expensing Limit

Section 179 allows a deduction based on an election to treat a portion or all of the cost of a car as an immediate expense. The amount of the §179 deduction *reduces* the basis of the car.

> **Note:** If the taxpayer elects the §179 deduction, they must reduce the basis of their car *before* figuring the depreciation deduction (§280F(d)(1); §1016(a)(2)). A §179 tax deduction vehicle can be purchased new or used but the vehicle must be utilized more than 50% of the time for business purposes.

The §179 deduction is treated as depreciation for the tax year a car is placed in service. Thus, if a taxpayer placed a car in service in 2024 and elected §179 treatment, it would be deemed depreciation and still limited by the depreciation "caps" to $12,400 ($20,400 if bonus depreciation is used) in the first tax year.

Standard Mileage Method

The standard mileage deduction allows a "flat" or standard amount of deduction for every business mile traveled regardless of actual cost, and therefore only requires substantiation of the distance traveled in the pursuit of trade or business.

In 2024, the standard mileage rate was 67 cents a mile for all business miles. For 2025, the rate is 70 cents per mile. These rates are adjusted periodically for inflation (R.P. 2010-51; Notice 2025-05).

If a taxpayer chooses to take the standard mileage rate, they cannot deduct actual operating expenses, such as depreciation, maintenance, repairs, gasoline (including gasoline taxes), oil, insurance, and vehicle registration fees.

> **Note:** However, parking fees and tolls may still be deducted in addition to the standard mileage rate.

Choosing the Standard Mileage Method

A taxpayer must choose to use the standard mileage method in the first year the auto is available for use in their business. However, in later years, they can choose to use either the standard mileage rate or actual expenses. If the standard mileage method is used for a leased auto, it must be used for the entire lease period.

Taxpayers must make the choice to use the standard mileage method by the due date (including extensions) of their return. While this choice cannot be revoked, in later years, a taxpayer can switch from the standard mileage method to the actual expense method.

Limitations

To use the standard mileage rate, a taxpayer must own or lease the auto and not:

(1) operate five or more autos at the same time, as in a fleet operation (R.P. 2010-51 & Notice 2010-88),

> **Note:** However, a taxpayer may be able to deduct their actual expenses for operating each of the autos in their business. In addition, a taxpayer is not using five or more autos for business at the same time if they alternate using (use at different times) the autos.

(2) have claimed a depreciation deduction for the auto using any method other than straight-line (R.P. 2010-51),

(3) have claimed a §179 deduction on the vehicle,

(4) have claimed the special depreciation allowance on the vehicle, *and*

(5) have claimed actual expenses if the auto is leased (T.D. 8784; REG-122488-97).

Alternating Use

A taxpayer, who owns two cars, using one as an alternative or replacement for the other, may still utilize the standard mileage rate. When an individual uses more than one car on an alternating basis, they may use the standard mileage rate and combine their mileage when both cars otherwise qualify. The rate is applied to the total business miles that both cars are driven. However, if one of the autos has been fully depreciated, the business mileage of the two vehicles is not combined.

Switching Methods

An election to use the standard mileage rate must be made in the first year the vehicle is placed in service for business purposes and constitutes an election to exclude the vehicle from depreciation under the modified accelerated cost recovery system (MACRS). In later years, a taxpayer can continue to use the standard mileage rate or switch to the actual expense method. However, if the taxpayer did not choose the standard mileage rate in the first year, they may not use it for that car in any subsequent year. (R.P. 2010-51, Sec. 5.06(3)).

If a taxpayer changes to the actual cost method in a later year, but before the car is considered fully depreciated, the car must be depreciated on a straight-line basis.

Mileage Rates

The standard mileage deduction allows a "flat" or standard amount of deduction for every business mile traveled regardless of actual cost, and therefore

only requires substantiation of the distance traveled in the pursuit of trade or business.

What follows are the 2024 and 2025 rates. The 2025 mileage rates will be applicable from January 1st, 2025 to December 31st, 2025

Business mileage: For 2024, the standard mileage rate for the cost of operating your car van, pick-up, or panel truck for business use was 67 cents per mile.

For 2025, the standard mileage rate for the cost of operating your car van, pick-up, or panel truck for business use is 70 cents per mile.

> **Note:** The business standard mileage rate listed cannot be used to claim an itemized deduction for unreimbursed *employee* travel expenses from 2018 through 2025.

Medical and move-related mileage: For 2024, the standard mileage rate for the cost of operating your car for medical reasons or as part of a deductible move was 21 cents per mile.

For 2025, the standard mileage rate for the cost of operating your car for medical reasons or as part of a deductible move is also be 21 cents per mile.

> **Note:** Other than members of the Armed Forces of the United States on active duty who move pursuant to a military order and incident to a permanent change of station, the standard mileage rate is not applicable for the use of an automobile as part of a move occurring from 2018 thru 2025 (R.P. 2019-46).

Medical expenses must exceed 7.5% of AGI to be deductible.

Charitable-related mileage: For 2024, the standard mileage rate for the cost of operating your car for charitable purposes remained at 14 cents per mile (Notice 2023-8). For 2025, the charitable organization rate is also 14 cents per mile (Notice 2025-05).

> **Note:** A taxpayer may not use the business standard mileage rate for a vehicle after using any depreciation method under the Modified Accelerated Cost Recovery System (MACRS) or after claiming a §179 deduction for that vehicle. In addition, the business standard mileage rate cannot be used for more than four vehicles used simultaneously (R.P. 2019-46).
>
> **Comment:** Taxpayers always have the option of calculating the actual costs of using their vehicle rather than using the standard mileage rates.

No deduction is allowed for charitable travel expenses unless there is no significant element of personal pleasure, recreation, or vacation in the travel (§170(k)).

Leased Auto Deduction & Inclusion Amount

When a taxpayer leases a vehicle for business they are eligible to use the standard mileage or actual cost method. However, regulations under §280F require

that they reduce the amount of their deduction by an "inclusion amount" if their vehicle is a passenger automobile such as a car, truck, or van with a fair market value in excess of stated dollar amounts when the lease began. This amount is determined as a percentage of the car's fair market value (on the first day of the lease term).

Clean Vehicle Credit - §30D

Under §30D, when a taxpayer places in service a new plug-in electric vehicle (EV) or fuel cell vehicle (FCV) from 2023 through 2032, they may qualify for a nonrefundable clean vehicle tax credit up to $7,500. This credit is available to individuals and their businesses. To qualify, a taxpayer must (i) buy the vehicle for their own use, not for resale, and (ii) use it primarily in the U.S.

> **Note:** Taxpayers can use their modified AGI from the year they take delivery of the vehicle or the year before, whichever is less. If their modified AGI is below the threshold in 1 of the two years, they can claim the credit.

Qualified clean vehicles must:

(i) have a battery capacity of at least 7 kilowatt hours,

(ii) have a gross vehicle weight rating of less than 14,000 pounds

(iii) be made by a qualified manufacturer

> **Note:** FCVs do not need to be made by a qualified manufacturer to be eligible (See R.P. 2022-42).

(iv) undergo final assembly in North America, *and*

(v) meet critical mineral *and* battery component requirements (as of April 18, 2023) (§30D(c).

Form 8936 is used to calculate the qualified plug-in electric drive motor vehicle credit.

Credit Amount

The credit for clean vehicles has two component requirements – the battery component and the critical mineral component. The credit is $3,750 for any vehicle meeting the battery component requirement and $3,750 for any vehicle meeting the critical minerals requirement. Thus, the maximum credit per qualifying clean vehicle is $7,500 ($3,750 x2) for vehicles meeting both battery and critical mineral requirements with caps on the price, based on the buyer's income.

> **Note:** *Buyer's Income:* The credit is disallowed for certain higher-income taxpayers. Specifically, no credit is allowed if the current year or preceding year's modified AGI exceeds $300,000 for married taxpayers, $225,000 in the case of head of household filers, and $150,000 in the case of other filers (§30D(f)(10)).

> **Note:** *Price Caps:* The credit is only allowed for vehicles that have a manufacturer's suggested retail price of no more than $80,000 for vans, SUVs, or

pickup trucks, and $55,000 for other vehicles. Taxpayers are allowed to claim the credits for one vehicle per year (§30D(f)(11)(B)).

In short, the credit will be up to:

$3,750 if the vehicle meets the critical minerals requirement only,

$3,750 if the vehicle meets the battery components requirement only, and

$7,500 if the vehicle meets both.

Battery Components Requirement - §30D(b)(3) & §30D(e)(2)(A)

To receive the $3,750 battery components portion of the credit, the percentage of the battery's components manufactured or assembled in North America has to meet threshold amounts. For vehicles placed in service through 2023, the percentage was 50%. The percentage increased to 60% for 2024 and 2025, 70% for 2026, 80% for 2027, 90% for 2028, and 100% after 2028.

Critical Minerals Requirement - §30D(b)(2) & §30D(e)(1)(A)

To receive the $3,750 critical minerals portion of the credit, the vehicle's battery must contain a threshold percentage (in value) of critical minerals that were extracted or processed in a country with which the United States has a free trade agreement, or recycled in North America. The threshold percentage was 40% for 2023 and 50% in 2024, increasing to 60% in 2025, 70% in 2026, and 80% after 2026. For vehicles placed in service after 2024, qualifying vehicles do not include any vehicle in which applicable critical minerals in the vehicle's battery were from a foreign entity of concern.

Note: The IRS has published proposed regulations (88 FR 23370) related to requirements that must be met for critical mineral and battery components for the clean vehicle credit.

Credit for Used Clean Vehicles - §25E

IRA created a new tax credit for buyers of previously owned qualified clean (plug-in electric and fuel cell) vehicles, subject to income limitations, through 2032 (§25E). The credit is up to $4,000 limited to 30% of the vehicle purchase price.

Note: Previously owned qualified clean vehicles do not have to comply with the final assembly in North America requirement.

Buyer's Income: The credit is disallowed for taxpayers above certain modified AGI thresholds. Married taxpayers filing a joint return cannot claim the credit if their modified AGI is above$150,000, $112,500 in the case of head of household filers, and $75,000 in the case of other filers (§25E(b)). The taxpayer's modified AGI would be the lesser of the modified AGI in the taxable year or prior year.

Price Caps: The credit is only allowed for vehicles with a sale price of $25,000 or less with a model year that is at least two years earlier than the calendar year in which the vehicle is sold.

This credit can only be claimed for vehicles sold by a dealer and on the first transfer of a qualifying vehicle. Taxpayers can only claim this credit once every three years and are required to include the VIN on their tax return to claim a tax credit. The credit does not apply to vehicles acquired after December 31, 2032.

Transfer to Dealership – R.P. 2023-33

Effective 2024 and later, taxpayers who buy a qualifying new or used clean vehicle can transfer that credit to the dealership. This means that the taxpayer who is buying the vehicle can exchange their credit for a financial benefit such as reduced final cost. The financial benefit is equal to the amount of the credit, whether in cash, a partial payment, or a down payment (R.P. 2023-33).

Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regard to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references,

you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

64. Which of the following is <u>not</u> a deductible transportation expense?

a. You regularly work at an office on Main Street. The Main Street office is temporarily shut down and you work across town on Elm Street for two months.

b. You regularly work at an office on Main Street. You are required to attend an afternoon meeting across town on Elm Street.

c. You are a construction contractor with no regular place of work and you commute between your home and temporary work sites within your normal metropolitan area.

d. You work at Discount Mart and are also in the Army Reserves. After a shift at Discount Mart, you drive to the local Army base for a Reserve meeting.

65. Automobile expenses must be apportioned between business travel and personal travel. What is an accepted method of apportionment?

a. the actual cost method.

b. the specific identification method.

c. the high-low method.

d. the annual lease value method.

66. Tangible business property is depreciated using the modified cost recovery system (MACRS). How does this system classify cars?

a. as five-year property.

b. as seven-year property.

c. as ten-year property.

d. as fifteen-year property.

67. A taxpayer may elect the §179 expensing deduction for a portion or all of the cost of an automobile. When the election is made, what must be done?

a. reduce the automobile's basis and then figure the depreciation deduction.

b. use the mid-quarter convention.

c. increase the basis of their car.

d. use the half-year convention.

68. Under the standard mileage method for taking auto expenses, what may be deducted separately?

a. oil.

b. parking fees.

c. maintenance and repairs.

d. license fees.

Gas Guzzler Tax - §4064 [Form 6197]

The gas-guzzler tax is an excise tax imposed on the sale by the manufacturer or importer of any automobile that does not meet statutory standards for fuel economy. The tax begins at $1,000 for automobile models that do not meet a 22.5-miles-per-gallon standard and increases to $7,700 for models with a fuel economy rating of less than 12.5 miles per gallon (§4064(a)):

Miles Per Gallon	Tax
22.5 & above	$0
21.5 - 22.5	$1,000
20.5 - 21.5	$1,300
19.5 - 20.5	$1,700
18.5 - 19.5	$2,100
17.5 - 18.5	$2,600
16.5 - 17.5	$3,000
15.5 - 16.5	$3,700
14.5 - 15.5	$4,500
13.5 - 14.5	$5,400
12.5 - 13.5	$6,400
12.5 - 0	$7,700

Automobiles

An automobile is any four-wheeled vehicle that is:

(a) Rated at an unloaded gross vehicle weight of 6,000 pounds or less,

(b) Propelled by an engine powered by gasoline or diesel fuel, *and*

(c) Intended for use mainly on public streets, roads, and highways.

Limousines

The tax generally applies to limousines (including stretch limousines) regardless of their weight. However, since September 30, 2005, Transportation

Equity Act (P.L. 109-59) has repealed the gas guzzler tax for limousines rated at *greater* than 6,000 pounds unloaded gross vehicle weight (§4064(b)(1)(A)).

Vehicles Not Subject To Tax

For the gas guzzler tax, the following vehicles are not considered automobiles:

1. Vehicles operated exclusively on a rail or rails.

2. Vehicles sold for use and used primarily:

(a) as ambulances or combination ambulance-hearses,

(b) for police or other law enforcement purposes by federal, state, or local governments, *or*

(c) for firefighting purposes.

3. Vehicles treated under 49 USC 32901 (1978) as non-passenger automobiles. This includes limousines manufactured primarily to transport more than 10 persons.

The manufacturer can sell a vehicle described in item (2) tax-free only when the sale is made directly to a purchaser for the described emergency use and the manufacturer and purchaser (other than a state or local government) are registered.

Fringe Benefits

In addition to compensation, many employers provide fringe benefits to employees. Unless specifically exempted from taxation by law, the employer must include these fringe benefits in the employee's gross income and withhold income taxes thereon (§132 and §61).

Excluded Fringe Benefits

Excluded fringe benefits are one of the finest tax concepts under the Code. Valuable to the employee these benefits are typically deductible by the employer and not includible income to the employee.

Prizes & Awards - §74

Employee achievement awards (as defined in §274(j)) are excluded from gross income. However, tax law limits deductible employee achievement awards to those awards made for length of service or safety. The annual dollar limit awarded to an individual employee from a qualified written plan is $1,600 per year. If the award is not part of such a plan, the limit is $400

The award must:

(1) be given for length-of-service or safety,

(2) be awarded as part of a meaningful presentation,

(3) not be disguised wages or made under conditions and circumstances that create a significant likelihood that it is disguised wages, and

(4) be an item of tangible personal property.

> **Note:** Cash, cash equivalents, gift certificates, vacations, meals, lodging, tickets to theater or sporting events, stocks, bonds, other securities, and other similar items are not considered tangible personal property.

Excludable awards may not be presented more than every five years

Group Life Insurance Premiums - §79

Premiums paid by an employer for group life insurance providing only for term coverage are not taxable income to a covered employee if the employee's coverage does not exceed $50,000. For each $1,000 in coverage in excess of $50,000, the employee must include the following amounts in gross income:

Employee's Age	**Monthly Inclusion**
At Year End	**Per $1,000**
Under 25	5 cents
25 - 29	6 cents
30 - 34	8 cents
35 - 39	9 cents
40- -44	10 cents
45 - 49	15 cents
50 - 54	23 cents
55 - 59	43 cents
60 - 64	66 cents
65 - 69	$1.27
70 & over	$2.06

Personal Injury Payments - §104

Gross income does not include insurance payments for permanent loss or use of a member or function of the body or the permanent disfigurement, of the taxpayer, their spouse, or a dependent since the funds received are compensation for losses endured. However, pain and suffering and emotional distress payments are not taxable only if there is a physical injury.

Employer Contributions to Accident and Health Plans - §106 & §105

Contributions paid by an employer to accident and health plans for compensation to the employee for personal injuries or sickness are excluded from the employee's gross income. In addition, employer payments that reimburse employees for medical expenses of the employee, a spouse, or dependents are also excluded from income.

Expenses an employer incurs related to health insurance (for employees or for dependents) are tax-deductible as ordinary business expenses.

Meals & Lodging - §119

An employee can exclude from their gross income the value of any meals or lodging furnished to the taxpayer, their spouse, or any of the taxpayer's dependents by their employer for the convenience of the employer, if:

(1) in the case of meals, the meals are furnished on the employer's business premises, *or*

(2) in the case of lodging, the employee is required to accept the lodging on the employer's business premises as a condition of employment.

Meals are considered furnished for the convenience of the employer where the employee's continued presence on the employer's premises is necessary to enable the employee to perform duties properly.

Cafeteria Plans - §125

A cafeteria plan is a written plan under which participants may choose among two or more benefits consisting of cash and qualified benefits without resulting in the benefit being included in the employee's gross income. A plan offering a choice only among nontaxable benefits is *not* a cafeteria plan.

A qualified benefit is any benefit that is excluded from income by a specific provision of the Code except for:

(1) Scholarships and fellowships (§117),

(2) Employer-provided meals and lodging (§119)

(3) Taxable fringe benefits (other than cash and group-term life insurance) (§125(f),

(4) Educational assistance programs (§127),

(5) Employer-provided fringe benefits such as a no-additional-cost service, working condition fringe, qualified employee discounts, and de minimis fringe (§132),

(6) Qualified transportation provided by the employer (§132),

(7) Contributions to Archer MSAs (§220), *and*

(8) Elective deferrals for 403(b) plans.

The following benefits can be offered under a cafeteria plan:

(1) Coverage under a group-term life insurance plan up to $50,000 (§79),

(2) Coverage under an accident or health plan, including disability coverage (§105 & §106)

(3) Coverage under a dependent care assistance program (§129),

(4) Adoption assistance (§137),

(5) Participation in a cash or deferred arrangement that is part of a profit-sharing plan (§401(k)),

(6) Business provided health savings accounts (§223), *and*

(7) Paid vacation days if the plan precludes any participant from receiving, cash for, in a subsequent plan year, any of such paid vacation days remaining unused as of the end of the plan year.

> **Note:** Elective vacation days provided under the plan are not considered to be used until all nonelective paid vacation days have been used.

Educational Assistance Programs - §127

Employer-paid educational expenses are excludable from the gross income and wages of an employee if provided under a §127 educational assistance plan or if the expenses qualify as a working condition fringe benefit under §132.

Section 127 provides an exclusion of $5,250 annually for employer-provided educational assistance. Assistance exceeding $5,250 can be excluded only if it qualifies as a working condition fringe benefit (§132(j)(8)). The exclusion for employer-provided educational assistance applies to *both* undergraduate and graduate education.

> Note: Educational payments excluded from an employee's gross income, include "eligible student loan repayments" made through 2025.

In order for the exclusion to apply, certain requirements must be satisfied. The educational assistance must be provided pursuant to a separate written plan of the employer. The educational assistance program must not discriminate in favor of highly compensated employees. In addition, not more than 5% of the amounts paid or incurred by the employer during the year for educational assistance under a qualified educational assistance plan can be provided for the class of individuals consisting of more than 5% owners of the employer (and their spouses and dependents).

Dependent Care Assistance - §129

The gross income of an employee does not include expenses paid or incurred by an employer for dependent care assistance provided under a qualified program (§129). The aggregate amount excluded cannot exceed $5,000 ($2,500 in the case of a separate return by a married individual) or the earned income of the lower-earning spouse.

> **Comment:** A taxpayer is not allowed both an exclusion from income under §129 and a child and dependent care credit under §21 on the same amount. Childcare expenses are reduced dollar for dollar by the amount of reimbursement.

Employees are required to include in income excess amounts (above an exclusion level) that an employer provides for dependent care assistance. Such excess dependent care assistance must be included in the employee's income in the year in which services are provided, even if the actual payment is made later.

No-Additional-Cost Services - §132(b)

If an employer provides its employees with a service that is offered for sale to customers in the ordinary course of its line of business, and the employer incurs no substantial additional cost in providing this service, the employee will not have to include in income the value of the service.

In order to qualify as a no-additional-cost benefit, the service available for use must have otherwise gone unused and the employer must not have foregone any revenue in providing the service to its employees.

Examples of services that qualify as no-additional-cost services include hotel accommodations, transportation by aircraft, bus, subway, or cruise line, telephone services, and tickets to sporting events.

> **Comment:** If these services are generally available only to officers, owners, or highly compensated employees, then the value of the services cannot be excluded from the income of the officers, owners, or highly compensated employees.

Qualified Employee Discounts - §132(c)

If a taxpayer's employer allows employees to buy qualified property or services (defined below) at a discount (a price that is less than the price it is sold for to customers), they will not have to include in income the value of the discount to the extent that:

(1) the discount the employee gets on property does not exceed the gross profit percentage of the price at which the property is being offered for sale to customers, *or*

(2) the discount the employee gets on services does not exceed 20% of the price at which the services are offered for sale to customers.

Qualified property or services generally means any property (other than real property and personal property held for investment) or services offered for sale to customers in the ordinary course of the employer's line of business in which you work.

> **Comment:** If these discounts are generally available only to officers, owners, or highly compensated employees, the value of the discount cannot be excluded from the income of the officers, owners, or highly compensated employees.

Working Condition Fringe Benefits - §132(d)

A working condition fringe benefit is any property or service provided to an employee by an employer to the extent that the cost of such property or service would have been deductible by the employee as a business expense under §162 or §167 (Reg. § 1.132-5).

Examples of working-condition fringe benefits include:

(1) use of a company car or plane for business purposes,

(2) employer-paid subscriptions to business periodicals to employees,

(3) employer expenditures for employees' business travel,

(4) demonstration cars provided to a full-time car salesperson if there are substantial restrictions on the salesperson's personal use of the car and the car is available for test drives by customers,

(5) on-premises gyms and other athletic facilities, *and*

(6) benefits provided by an employer for the safety of its employees (Reg. §1.132-5).

Transportation in Unsafe Areas - Reg.§1.132-5(m)

While working condition fringes are excludable from income. the value of employer-provided transportation for commuting purposes is not excludable. Nevertheless, a special valuation rule applies to transportation provided by an employer due to unsafe conditions (Reg.§1.132-5(m)).

Under Reg. §1.61-21(k), only $1.50 (per one-way commute) is includable in certain rank-and-file employees' income for transportation furnished due to unsafe conditions to employees who walk or use public transportation.

> **Note:** Unsafe conditions exist when a reasonable person would consider it unsafe to walk to or from home or use public transportation during commute time. An important factor is the crime history in the subject area.

Applied on a trip-by-trip basis, if any particular trip fails to comply with the regulations, its value is included in the employee's income. The regulations require an employer to have a written policy stating that transportation is provided only for avoiding unsafe conditions.

The following employees are ineligible:

(a) highly compensated employees (§414(q)(1)(C)),

(b) salaried employees, *and*

(c) employees exempt from the minimum wage and maximum hour provisions.

De Minimis Fringe Benefits - §132(a)(4)

De minimis fringe benefits are excluded from an employee's income(§132(a)(4)). A de minimis fringe benefit is any property or service whose value is so small that accounting for it is unreasonable or administratively impractical.

> **Note:** The IRS has ruled previously in a particular case that items with a value exceeding $100 could not be considered de minimis, even under unusual circumstances.

Cash cannot be a de minimis fringe benefit. An exception is provided for occasional meal or transportation money to enable an employee to work over-

time. Gift certificates that are redeemable for general merchandise or have a cash equivalent value are not de minimis benefits and are taxable.

Examples of de minimis fringe benefits include:

(a) Typing of personal letters by a company secretary,

(b) Occasional cocktail parties or picnics for employees,

(c) Traditional holiday gifts with low fair market value, *and*

(d) Coffee and donuts.

Employer-Provided Automobile

If an employer-provided vehicle is used solely for business purposes, it is considered a working condition fringe benefit. The value of the use of the vehicle is not included in the employee's income. However, the employee's personal use of the vehicle is a taxable noncash fringe benefit. The employer must determine the actual value of this fringe benefit to include in the employee's income. The value of an employer-provided vehicle can be determined under either the:

(1) general valuation rule,

(2) cents-per-mile method,

(3) commuting value method, or

(4) annual lease value method.

> **Comment:** If the employer includes 100% of the value in the employee's income, formerly the employee might have deducted the value of their business use of the car using Form 2106. However, from 2018 thru 2025, employee business expenses subject to §67 are suspended.

General Valuation Rule

Under the general evaluation rule, fair market value (FMV) is the amount the employee would have to pay a third party to lease the same or similar vehicle on the same or comparable terms in the geographic area where the employee uses the vehicle.

Neither the amount the employee considers to be the value of the fringe benefit nor the cost incurred to provide the benefit determines its FMV. In addition, the FMV cannot be determined by multiplying a cents-per-mile rate times the number of miles driven unless the employee can prove the vehicle could have been leased on a cents-per-mile basis.

> **Note:** Under Reg.§1.61-2T(b)(4), if none of the methods below are used, the valuation must be determined by reference to this rule.

Cents-Per -Mile Method

An employer may determine the value of a vehicle provided to an employee by multiplying the standard mileage rate by the total number of *personal* miles driven by the employee, for autos that:

(1) Are *regularly used* in a trade or business, *or*

Note: A vehicle is considered regularly used in a trade or business if (i) at least 50% of the vehicle's total annual mileage is for the taxpayer's trade or business, or (ii) the taxpayer sponsors a commuting pool that generally uses the vehicle each workday to drive at least three employees to and from work.

(2) Satisfy the *mileage rule* - i.e., driven annually at least 10,000 miles primarily by employees (Reg. §1.61-2T(e)).

Note: If a taxpayer owns or leases the vehicle only for part of the year, the 10,000-mile requirement is reduced proportionately.

However, in order to use this method the value of the automobile must be less than a maximum fair market value (Reg. §1.61-21(e)(1) (iii)(A)). In Notice 2025-05, the IRS provided that the maximum value of an employer-provided vehicle (including cars, vans, and trucks) for use under the fleet-average valuation rule (Regs. §1.61-21(d)(5)(v)) and the vehicle cents-per-mile method was $61,200 for 2025 (down from $62,000 in 2024) [Regs. §1.61-21(e)].

Commuting Value Method

Under this rule, employers determine the value of a vehicle they provide to an employee for commuting use by multiplying each one-way commute (i.e., from home to work or from work to home) by $1.50. If more than one employee commutes in the vehicle, this value applies to each employee. This amount must be included in the employee's wages or reimbursed by the employee.

In order to use this method, the vehicle must be used in the employer's trade or business and the employer must have a written policy prohibiting employee use of the automobile for personal purposes other than commuting.

This rule isn't available if an employee is allowed to, or actually does, make more than de minimis use of the vehicle for personal reasons other than commuting. The rule also is unavailable if the employee is a "control" employee - an employee such as a highly compensated employee who controls the use or availability of employer-provided cars.

Annual Lease Value Method

Under the annual lease value method, an employee reports the annual lease value of the automobile from tables in Reg. §1.61-2T (d) (2) (iii) based on the automobile's fair market value when it is first made available to the employee. The employee reports only their personal use percentage of the annual lease value in income. Any use of an employer-provided vehicle that is not substantiated as business use is included in income.

Annual Lease Value Table for Automobiles

(1) Automobile Fair Market Value	(2) Annual Lease Value
0 - 999	600
1,000 - 1,999	850
2,000 - 2,999	1,100
3,000 - 3,999	1,350
4,000 - 4,999	1,600
5,000 - 5,999	1,850
6,000 - 6,999	2,100
7,000 - 7,999	2,350
8,000 - 8,999	2,600
9,000 - 9,999	2,850
10,000 - 10,999	3,100
11,000 - 11,999	3,350
12,000 - 12,999	3,600
13,000 - 13,999	3,850
14,000 - 14,999	4,100
15,000 - 15,999	4,350
16,000 - 16,999	4,600
17,000 - 17,999	4,850
18,000 - 18,999	5,100
19,000 - 19,999	5,350
20,000 - 20,999	5,600
21,000 - 21,999	5,850
22,000 - 22,999	6,100
23,000 - 23,999	6,350
24,000 - 24,999	6,600
25,000 - 25,999	6,850
26,000 - 27,999	7,250
28,000 - 29,999	7,750
30,000 - 31,999	8,250
32,000 - 33,999	8,750
34,000 - 35,999	9,250
36,000 - 37,999	9,750
38,000 - 39,999	10,250
40,000 - 41,999	10,750
42,000 - 43,999	11,250
44,000 - 45,999	11,750
46,000 - 47,999	12,250
48,000 - 49,999	12,750
50,000 - 51,999	13,250
52,000 - 53,999	13,750
54,000 - 55,999	14,250

56,000 - 57,999	14,750
58,000 - 59,999	15,250

For automobiles with a fair market value greater than $59,999, Annual Lease Value = (.25 x fair market value) + $500.

Example

Alpha Corp. provides free to its employee, Tom Smith, a car worth $15,000 on April 30th. During the year Tom drove the car 75% for business purposes.

Annual lease value of $15,000 automobile

Per Tables	*4,350*
Personal use Percentage	*25%*
Proration for 8 Months Use	*67%*
Amount to be included in Compensation	*729*

Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regard to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

69. When a manufacturer or importer sells an automobile failing to meet U.S. statutory fuel economy standards, the purchaser of the automobile is subject to an excise tax. What is this special tax called?

a. personal property tax.

b. a gas guzzler tax.

c. a luxury excise tax.

d. transportation tax.

70. Under the gas guzzler tax, a special definition of the term "automobile" is used. As a result, which vehicle is considered such an automobile?

a. a limousine.

b. a police car.

c. a vehicle operated exclusively on a rail or rails.

d. an ambulance.

71. Employees can choose from at least seven qualified benefits under a cafeteria plan. What is one of these qualified benefits?

a. educational assistance programs.

b. a profit-sharing plan that includes a qualified cash or deferred arrangement.

c. qualified employee discounts.

d. scholarships and fellowships.

72. Under §127, an employee may exclude from gross income for income tax purposes and from wages for employment tax purposes:

a. all or part of the amounts they receive as a scholarship or fellowship grant.

b. amounts in a qualified tuition program (QTP).

c. the cost of higher education for themselves if they itemize deductions.

d. no more than $5,250 annually for employer educational assistance.

73. An employer may provide §129 dependent care assistance for employees tax-free. Up to what amount may an employer exclude for each employee annually?

a. $5,000.

b. the amount of the higher-earning spouse's earned income.

c. 50% of the total costs.

d. There is no statutory limit on the amount.

74. Section 132 identifies several fringe benefits such as no-additional-cost services that are excludable from gross income. What is an example of a service that qualifies as a no-additional-cost service?

a. employer-paid subscriptions to business periodicals to employees.

b. on premises gyms and other athletic facilities.

c. tickets to sporting events.

d. typing of personal letters by a company secretary.

75. Which transportation-related fringe must be included in income under §132?

a. business use of employer-provided automobiles.

b. demonstration cars provided to a full-time car salesperson if there are substantial restrictions on personal use and the car is available for test

drives by customers.

c. expenditures for employees' business travel.

d. the value of employer-provided commuting transportation.

76. The author lists four methods for valuing an employer-provided automobile. Under Reg.§1.61-2T(e), for autos with fair market values (FMV) less than the maximum recovery deductions allowable for the first five years the auto is in service, what valuation method should an employer use?

a. the annual valuation method.

b. the cents per mile method.

c. the commuting value method.

d. the general method.

Methods of Accounting - §446

The accounting method implemented determines the period in which a taxpayer recognizes income and expenses for tax purposes. The cash and accrual methods are the two most often used methods of accounting.

Cash Method

Under the cash method of accounting all items of income are reported in the year they are actually or constructively received and expenses are deducted in the year that they are paid.

> **Comment:** Section 448 places limitations on the use of the cash method of accounting for certain entities such as farming businesses, qualified personal service corporations, and entities that meet a gross receipts test.

Constructive Receipt - §451

A taxpayer constructively receives income in the taxable year during which it is credited to their account, set apart for them, or otherwise made available so that taxpayer may draw upon it.

> **For example:** A check received before the end of the tax year is constructively received in that year even though the check is not cashed or deposited into the taxpayer's account until the next year.

However, income is not constructively received if the taxpayer's control of the receipt is subject to substantial limitations, restrictions, or is contingent on the happening of some future event. Funds held in escrow pending release of a third party's claim fall within this category.

Accrual Method

Under the accrual method, income is reported when it is earned rather than when it is collected and expenses are deducted when they are incurred even though they are paid at a later date.

Advance Payments

Advance payments received without restriction as to disposition for future use of property or for future services are generally reported in income in the year of receipt whether the cash or accrual method of accounting is used. Thus prepaid rent, prepaid interest, and advances for services to be performed later are generally included in income when received rather than when earned.

Accrual Method Required

The accrual method must be used where the production, purchase, or sale of merchandise is a material income-producing factor. In addition, C corporations, partnerships that have a C corporation as a partner and tax shelters are barred from using the cash method of accounting.

Exceptions are allowed for small businesses engaged in farming, qualified personal service corporations, and other entities that meet the $31 million (up from $30 million in 2024) gross receipts test in 2025 (§448). The average gross receipts test is indexed to inflation.

> **Comment:** A qualified personal service corporation is any corporation, substantially all of the activities of which involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts or consulting, and substantially all of the stock owned by employees performing such services to the corporation.

Other Methods of Accounting

A variety of special and special accounting methods exist under the Code.

Hybrid Methods

Combinations of accounting methods are permitted if income is clearly reflected and such combinations are consistently used. For example, a small retail store could use an accrual method for sales, purchases, receivables, and payables and a cash basis for the deduction of rent, interest, salaries, and similar items. However, a cash method of accounting for income cannot be combined with an accrual method of accounting for expenses.

Long-Term Contracts - §460

A long-term contract is any contract for the manufacture, building, installation, or construction of property if not completed in the taxable year in which it is entered into. A *manufacturing contract* is long-term only if the contract is

to manufacture (1) a unique item not normally carried in inventory or (2) items that normally require more than 12 months to complete.

There are two basic methods of accounting for long-term contracts:

(1) The percentage of completion method, *or*

(2) The percentage of completion-capitalized cost method.

Percentage of Completion

Under the percentage of completion method, gross income from a long-term contract is allocated among the accounting periods by comparing costs allocated to the contract and incurred before the close of the tax year, with the total expected contract costs and subtracting any gross income previously recognized.

Percentage of Completion - Capitalized Cost Method

Under this method, the taxpayer must account for 90% of the long-term contract items under the percentage of completion method. Only the remaining 10% of the contract may be accounted for under the completed contract method.

Look-back Rule

In the tax year that a long-term contract is completed, the taxpayer must compare the amount of taxes paid in previous years under the percentage method (including the 90%-method used in the percentage of completion-capitalized cost method) with the tax that would have been owed if actual, rather than anticipated, costs and contract price had been used to compute gross income. Interest at the overpayment rate compounded daily is owed by or payable to the taxpayer if there is, respectively, an underpayment or overpayment for any tax year under the look-back method.

Uniform Capitalization Rules - §263A

The uniform capitalization rules generally require certain direct and indirect costs associated with real or tangible personal property manufactured by a business to be included in either inventory or capitalized into the basis of such property produced or acquired for resale (§263A).

> **Comment:** These rules are also for most assets constructed by a taxpayer and used in their trade, business, or enterprise.

Annual Sales Limit

The capitalization rules do not apply to costs dealing with property purchased for resale unless average gross receipts are over $31 million (in 2025, up from $30 million in 2024) in the last three tax years. This ex-

emption applies to real and personal property acquired or manufactured by such business.

Note: Home construction contractors are required to capitalize costs unless construction can be completed within 2 years and the taxpayer's average annual gross for the three prior years is less than $31 million in 2025.

Artist Exception

Artists, writers, photographers, and similar "creative types" are exempted from the rules. However, care must be taken because all production costs (i.e., printing, photo plates, films, videotapes) are still under the §263A provisions. This exception does not apply to expenses paid or incurred by an employee.

Classification of Property

Two classes of property are covered under the uniform capitalization rules:

(1) Tangible personal property and real property constructed by the taxpayer, *and*

(2) Tangible personal property and real property purchased for resale to customers.

Costs

Manufacturing costs that must be capitalized include the previously required direct material and labor and indirect costs but also a much wider range of indirect costs:

	Old Law	**New Law**
Direct material & cost	Capitalize	Capitalize
Repairs, maintenance, utilities, rent, indirect labor, materials, supplies, small tools, equipment	Capitalize	Capitalize
Marketing, advertising selling & distribution	Expense	Expense
Interest	Expense	*Capitalize*
Research & experiment	Expense	Expense
Engineering & design	Expense	*Capitalize*
Excess tax depreciation	Expense	*Capitalize*
Past service costs and pension plans	Expense	*Capitalize*
Taxes other than state, local and foreign	Optional	*Capitalize*
Rework labor, scrap and spoilage	Optional	*Capitalize*

Factory administration and employee benefits	Optional	*Capitalize*

Self Constructed Assets

Costs to be capitalized on self-constructed assets include direct material and labor, repair, maintenance, utilities, rent, indirect labor and supervisory wages, indirect material and supplies, small tools, interest, tax depreciation, employee benefits, administration, and other support costs.

Allocation Method

Standard cost accounting methods may be used for the allocation of §263A and §471 costs. Remember that there is a conformity requirement for most allocable costs between statement presentation and tax allocation methods.

Manufactured Products

The simplified accounting method for production costs may be used for manufactured products. The election is made for each separate business in the first tax year that §263A is effective.

Costs are to be allocated to inventory or property based on the absorption ratio. The amount of additional §263A costs to be capitalized is computed by multiplying the absorption ratio times the amount of §471 costs remaining in the taxpayer's ending §471 inventory balance.

Interest

Section 263A(f) contains special rules for capitalizing interest with respect to certain property produced by the taxpayer and for determining the amount of interest required to be capitalized.

Change in Accounting Method – Form 3115

A change in the method of accounting includes a change in the taxpayer's overall method of accounting or a change in the treatment of an item affecting the timing for including the item in income or taking the item as a deduction. It covers such changes as from the cash basis to the accrual basis or from one basis of inventory valuation to another. For example, taxpayers are changing their method of accounting if they have been capitalizing certain amounts that they characterized as improvements and would like to currently deduct the amounts as repairs and maintenance costs pursuant to the final regulations.

Taxpayers must get the IRS Commissioner's consent to change a current accounting method to a new accounting method. The Treasury Department and the IRS provides automatic consent procedures for those who want to change to a method of accounting permitted under the final regulations.

Generally, taxpayers receive automatic consent to change a method of accounting by completing and filing Form 3115, *Application for Change in Accounting Method*, and including it with their timely filed original federal tax return for the year of change. Form 3115 will identify the taxpayer, describe the methods that are being changed, identify the type of property involved in the change, and include a §481(a) adjustment, if applicable. An application for change must be filed with the IRS within 180 days after the beginning of the taxable year.

Accounting Periods

Taxable income must be computed on the basis of the taxpayer's taxable year. The taxable year is the 12-month period for which the tax is calculated and is typically either :

(1) the calendar year

(2) a fiscal year, *or*

(3) a 52-53 week year.

Definitions

A *calendar year* is a period of twelve months ending on December 31.

A *fiscal year* is a period of twelve months ending on the last day of any month other than December.

A *52-53 week year* is an annual period that varies from 52 to 53 weeks and ends always on the same day of the week and ends:

(1) On the date such same day of the week last occurs in a calendar month, *or*

(2) On the date such same day of the week falls which is nearest the last day of a calendar month.

A *short period return* is a return for a period of less than twelve months and may be filed when the taxpayer with the approval of the Secretary, changes their annual accounting period. A short period return may also be filed in the taxpayer's initial and final year when it is in existence during only part of what would otherwise be their taxable year.

The opportunities for income tax deferral by selecting different tax year-ends for an owner and their business have been limited, especially for partnerships, S corporations, and personal service corporations. However, the latter types of entities may still make a special election to have a September, October, or November fiscal year. Nevertheless, this §444 election, in effect, requires the entity to agree to give up any tax deferral benefits that might result from using the fiscal year.

No Books Kept

When a taxpayer does not keep any books or records, does not have an annual accounting period, or their present tax year does not qualify as a fiscal year, they must adopt the calendar year for their tax year.

> **Comment:** Records that are sufficient to reflect income adequately and clearly on the basis of an accounting period will be regarded as the keeping of books.

New Taxpayer

A new taxpayer must adopt a taxable year on or before the time prescribed by law (not including extensions) for filing the taxpayer's first return.

Partnership

Under §706, partnerships may have only a "permitted" year. Permitted years of a partnership include:

(1) An *ownership* taxable year that is:

(a) The taxable year of one or more partners having a greater than 50% aggregate interest in partnership profits and capital;

(b) If no group of partners holding more than 50% of the interests has the same taxable year, as all principal partners (that is, those with interests of 5% or more); *or*

(c) If no year results under either of these tests, the calendar year or other year resulting in the least deferral of income to the partners (Reg. §1.706-1).

(2) A *fiscal* year with a business purpose-that is:

(a) A natural business year that meets the 25%-of-gross-receipts test (R.P. 2002-38);

(b) Another year that IRS determines meets a bona fide business purpose (R.R. 87-57); *or*

(c) A grandfathered year-that is, a year approved after June 3, 1974, that does not result in a deferral of income pass-throughs to partners of three months or less, for which the partnership is able to comply with the special notification procedures of R.P. 2002-38.

(3) A *deferral* year permitted under §444 in exchange for the entity-level payments on pass-throughs deferred for partners - i.e., for newly created partnerships, a year resulting in a partner's deferral of three months or less (generally a September 30, October 31, or November 30 year-end).

S Corporations

Under §1378, an S corporation may have only a "permitted" year. Permitted years for an S corporation are:

(1) A calendar year;

(2) An ownership tax-year-that is, a year used by shareholders owning 50% or more of the issued and outstanding stock or a year to which such owners are changing (R.P. 2002-38);

(3) A fiscal year with a business purpose-that is:

(a) A natural business year that meets the 25%-of-gross-receipts test (R.P. 2002-38);

(b) Another year that the IRS determines meets a bona fide business purpose (R.R. 87-57; R.P. 89-15); *or*

(c) A grandfathered year - that is, a year approved after June 30, 1974, that does not result in a deferral of income pass-throughs to shareholders of three months or less, for which the corporation is able to comply with the special notification procedures of R.P. 2002-38.

(4) A deferral year permitted under §444 in exchange for entity-level payments on pass-throughs deferred for shareholders- that is:

(a) For newly created corporations electing S corporation status, a year resulting in a shareholder deferral of three months or less (generally a September 30, October 31, or November 30 year-end); *or*

(b) For other corporations that have not previously made a §444 election, a year resulting in a deferral period not greater than the lesser of:

(i) The previous deferral period, *or*

(ii) Three months.

Note: This rule provides no relief to calendar-year corporations.

Personal Service Corporations

A personal service corporation must file on a calendar year basis. However, the required tax year does not have to be used if the personal service corporation establishes a business purpose for a different period, or makes a §444 election.

Note: A personal service corporation is a corporation whose principal activity is the performance of personal services (e.g., medical, dental, legal, engineering, architecture, accounting, actuarial, consulting, or performing arts) where such services are substantially performed by owner-employees (§441 & §448).

C Corporations

It is still possible for a C corporation that is not a personal service corporation to elect a fiscal year (such as a year that ends January 31) and obtain significant tax deferral benefits by paying a relatively low base salary through December of each year to its employee-owners. Then, in January of the following year, for example, it can pay a large bonus to reduce the corporation's taxable income for the year from February 1 to January 31. Since the employee-owner would be on a calendar year for tax purposes, the bonuses

would not be taxable income to the employee-owner for the year, since the salary was received in January of the following year.

Business Purpose Exception

Partnerships, S-Corporations, and personal service corporations can generally establish a business purpose for using a fiscal year if they can show that gross receipts from sales and services for the last two months of the requested year exceed 25% of the gross receipts for the entire fiscal year requested and in each of the three preceding fiscal years.

Section 444 Election

Partnerships, S-Corporations, and personal service corporations can elect to use a tax year other than a required year if they follow certain procedures established under §444.

Partnerships & S Corporations

Partnerships and S corporations may elect an otherwise impermissible year if the year results in a deferral of not more than three months' income and the entity agrees to make required tax payments. Such payments are intended to represent the value of the tax deferral obtained by the partners and shareholders through the use of a tax year other than the required year.

Personal Service Corporations

A fiscal year may be elected by a personal service corporation if the year results in a deferral of not more than three month's income, the corporation pays the shareholder-employee's salary during the portion of the calendar year after the close of the fiscal year, and the salary for that period is at least proportionate to the shareholder-employee's salary received for such fiscal year.

Tiered Structures

A member of a tiered structure cannot make the §444 election unless all members have the same tax year.

Expensing - §179

All or part of the cost of certain qualifying property may be treated as an expense rather than a capital expenditure. Under §179, taxpayers[2] can elect to deduct all

[2] Estates and trusts are not eligible to elect the §179 deduction.

or part of the cost in one year (i.e., expense the item) rather than taking depreciation deductions spread over several years.

Taxpayers must decide for each item of qualifying property whether to deduct, subject to the yearly limit or capitalize and depreciate its cost. If an election is made for the deduction, taxpayers can deduct a limited amount of the cost of qualifying property in the first year the property is placed in service.

Placed In Service

For §179 expensing, property is considered placed in service in the tax year it is first ready and available for its specified use, whether in a trade or business, the production of income, a tax-exempt activity, or a personal activity.

The determination of whether property is qualifying property, defined later, is made in the first year the property is placed in service. If property is placed in service in a tax year and it does not qualify for the §179 deduction, no §179 deduction is ever allowed for it, even though it becomes qualifying property in a later tax year.

Qualifying Property

A §179 deduction may be elected for any tangible §168 property which is generally defined as *§1245 property* and which is acquired by *purchase* for use in the active conduct of a trade or business (§179(d)(1)). Depreciation cannot be taken to the extent that §179 is elected to expense the cost of property.

Eligible §1245 Property

Section 1245 property eligible for the §179 election includes:

(1) Tangible personal property,

> **Note:** The definition of qualified tangible personal property eligible for §179 expensing includes machinery and equipment, refrigerators, grocery store counters, office equipment, printing presses, testing equipment, signs, gasoline storage tanks and pumps at retail service stations, livestock, portable air conditioners or heaters, and certain property used predominantly to furnish lodging.
>
> **Comment:** Formerly, property used primarily for lodging was not §1245 property and was excluded from expensing treatment (§50(b)). Expensing treatment now applies to such property.

(2) Other tangible property that is:

(a) Used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electricity, gas, water, or sewage disposal services,

(b) A research facility used in connection with any of the activities in (a) above, *or*

(c) A facility used in connection with any of the activities in (a) above for the bulk storage of fungible commodities.

(3) Single purpose livestock or horticultural structures,

Note: For purposes of determining whether a structure is a single purpose agricultural structure, poultry is considered livestock.

(4) Qualified real §179 property under §168(e)(6),

Note: This includes not only qualified improvement property under §168(e)(6) but any of the following improvements to nonresidential real property placed in service after the date the property was first placed in service - roofs. heating, ventilation, air-conditioning, fire protection and alarm systems, and security systems.

(5) Storage facilities that are used in connection with distribution of petroleum or any primary product of petroleum, *and*

(6) Off-the-shelf computer software.

Note: This is computer software that is readily available for purchase by the general public, is subject to a nonexclusive license, and has not been substantially modified.

The §179 deduction cannot be claimed on the cost of any of the following:

(1) Property held only for the production of income,

Note: Property acquired only for the production of income, such as investment property, rental property (if renting property is not taxpayer's trade or business), and property that produces royalties, does not qualify.

(2) Real property, including buildings and their structural components,

(3) Property acquired from certain related groups or persons,

(4) Certain property used predominately outside the United States,

(5) Property used by foreign persons or entities, *and*

(6) Certain property leased to others (if taxpayer is a noncorporate lessor).

To qualify for the §179 deduction, the property must have been acquired by purchase. Property acquired by gift or inheritance does not qualify.

Qualified §179 Real Property

The definition of qualified real property eligible for §179 expensing is defined to include:

(a) any qualified improvement property described in §168(e)(6), *and*

(b) any of the following improvements to nonresidential real property after the nonresidential real property was first placed in service:

(1) roofs,

(2) heating, ventilation, and air-conditioning property,

(3) fire protection and alarm systems, *and*

(4) security systems (§179(f)).

Qualified improvement property is an improvement (after the building was first placed in service) to an interior portion of a building that is nonresidential real property (§168(e)(6)(A)). Improvements related to building enlargement, an elevator or escalator, or internal structural framework are not qualified improvement property (§168(e)(6)(B)).

> **Note:** Previously, qualified §179 real property eligible for expensing consisted of qualified leasehold improvement property, qualified retail improvement property, and qualified restaurant improvements and buildings that were eligible for 15-year MACRS. These were later all combined into the definition of qualified improvement property.

Purchase Restrictions

The following property does *not* qualify for the §179 deduction:

(1) Property acquired by one member of a controlled group from another component member of the same group,

(2) Property acquired from another person if the basis in that property is determined in whole or in part by reference to the adjusted basis of the property in the hands of the person from whom it was acquired, or under the stepped-up basis rules for property acquired from a decedent, *or*

(3) Property acquired from a related person if the relationship to the related person would result in the disallowance of losses.

The rules for disallowance of loss in a transaction between related parties apply to the §179 deduction with the following modifications:

(1) The family of an individual includes only his or her spouse, ancestors, and lineal descendants, *and*

(2) The percentages of ownership in a corporation or partnership are changed to 50%.

Deduction Limit

The §179 deduction cannot be more than the business cost of the qualifying property. In addition, in figuring the §179 deduction, taxpayers must apply the following limits.

Maximum Dollar & Investment Limits

For 2025, the aggregate cost of any §179 property treatable as an expense cannot exceed $1,250,000 (up from $1,220,000 in 2024). The maximum applies to each taxpayer and not to each business operated by a taxpayer. This maximum dollar limit is reduced if you go over the investment limit (see below) in any year.

This limitation is reduced (but not below zero) by the cost of §179 property placed in service during 2025 exceeding $3,130,000 (up from $3,050,000 in 2024). These amounts (as well as the sports utility vehicle limitation) are indexed for inflation (§179(b)(2)).

Note: For sport utility vehicles subject to the §280F limitation, the amount that can be expensed for 2025 is $31,300 (up from $30,500 in 2024).

Example

In 2025, Danny purchased a machine for $3,900,000 to be used in his business. Since the cost exceeds $3,130,000, the $1,250,000 limitation must be reduced dollar for dollar by the amount that the cost exceeds $3,130,000. Thus, Danny would be entitled to deduct $480,000 ($1,250,000 - $770,000) of the cost of the machine in 2025.

If the cost of property placed in service is $4,380,000 ($1,250,000 + $3,130,000) or more in 2025 ($4,270,000 in 2024), then no §179 deduction is allowed.

Taxable Income Limit

The total cost that can be deducted in each tax year is limited to the taxable income from the active conduct of any trade or business during the tax year. Taxable income is figured as usual but without a deduction for the cost of any §179 property and the deduction for half the self-employment tax. Taxpayers cannot use a §179 deduction to increase or create a net operating loss.

Example

Danny purchases a printer for $8,750. His taxable income from his business activities (determined without regard to the cost of the printer) is $3,700 for the taxable year. Thus, Danny's §179 deduction is limited to $3,700, his taxable income for the year.

Any cost that is not deductible in one tax year under §179 because of this limit *can* be carried to the next tax year and added to the cost of qualifying property placed in service in that tax year.

Carryover of Unallowable Deduction

If the cost of §179 property placed in service in 2025 is $4,380,000 ($4,270,000 in 2024) or more, the §179 deduction cannot be taken and there is no carryover.

If the cost of §179 property placed in service in 2025 is less than $4,380,000 ($4,270,000 in 2024), the maximum dollar limit is reduced by the amount, if any, by which the cost of §179 property placed in service during the tax year exceeds $3,130,000 ($3,050,000 in 2024).

If the cost of §179 property placed in service in 2025 is $1,250,000 ($1,220,000 in 2024) or less, the maximum dollar limit is the cost of §179 property placed in service during the tax year.

After determining the maximum dollar amount that applies, figure the taxable income limit. Determine the taxable income limit by figuring the taxable income from the active conduct of the business without deductions for the cost of §179 property and half the self-employment tax.

If this taxable income amount is more than the maximum dollar amount, the §179 deduction is the maximum dollar amount and there is no carryover to the next tax year.

If this taxable income amount is less than the maximum dollar amount, the §179 deduction is the taxable income amount. The carryover is the excess of the maximum dollar amount over the §179 deduction. The amount carried over will be taken into account in determining the taxpayer's §179 deduction next year.

If the taxable income limit is less than the maximum dollar limit, attach a statement to the return showing the computation of the taxable income.

> **Note:** A husband and wife filing separate returns for a tax year are treated as one taxpayer for the maximum and investment limits. Unless they elect otherwise, 50% of the cost of §179 property, before the taxable income limit is applied, will be allocated to each.

Partnerships

The §179 limits apply to both the partnership and each partner. The partnership determines its §179 deduction subject to the limits. It allocates the deduction so determined among its partners. Each partner adds the amount allocated from the partnership to the partner's own deduction and applies the limit to this total to determine the partner's §179 deduction. The total amount of each partner's partnership and nonpartnership §179 deduction cannot exceed the maximum dollar limit.

The basis of a partnership's §179 property must be reduced by the amount of the §179 deduction elected by the partnership. This reduction of basis must be made even if a partner cannot deduct all or a part of the §179 deduction allocated to that partner by the partnership because of the limitations.

S Corporations

The rules that apply to a partnership and its partners also apply to an S corporation and its shareholders. The limits apply to an S corporation and to each shareholder. The corporation allocates the deduction among the shareholders, who then take their §179 deduction subject to the limits.

Cost

The cost of property for the §179 deduction does not include that part of the basis of the property determined by reference to the basis of other property held at any time by the person acquiring the property.

Example

When a taxpayer buys a new truck to use in business, the cost for the §179 deduction does not include the adjusted basis of the truck the taxpayer trades in on the new vehicle.

When property is used for both business and nonbusiness, the §179 deduction may only be elected if more than 50% of the property's use in the tax year the property is placed in service is for trade or business purposes. The cost of the property must be allocated to reflect only the business use of the property. Multiplying the cost of the property by the percentage of business use does this. Use this adjusted cost to figure the §179 deduction.

Election

An election must be made to take the §179 deduction. The election is made in the tax year the property is placed in service. Form 4562 is used to make the election and report the §179 deduction. Taking the deduction on Form 4562 filed with the original tax return makes the election.

> **Note:** The election cannot be made on an amended tax return filed after the due date (including extensions).

Records

Records must be maintained that permit specific identification of each piece of §179 property and reflect how and from whom the property was acquired and when it was placed in service. Taxpayers must adhere to their selection of §179 property for which a deduction is claimed in computing their taxable income for the tax year the election is made and all later tax years.

Revocation of Election

Once made, the election can be revoked only with IRS consent. Consent to revoke a §179 election will be granted only in extraordinary circumstances. Requests for consent must be filed with the Commissioner of Internal Revenue, Washington, DC 20224.

The request must include the taxpayer's:

(i) Name,

(ii) Address, *and*

(iii) Taxpayer identification number.

The taxpayer or their duly authorized representative must sign it. It must be accompanied by a statement showing the year and property involved and must set forth in detail the reasons for the request.

Recapture of §179 Deductions

If a taxpayer deducts the cost of property placed in service and the property is not used more than 50% in a trade or business for any tax year before the end of the property's recovery period, they must include in income the benefit received from the deduction.

> **Note:** Any recapture of the §179 deduction is reported on Form 4797, Sales of Business Property.

Figure the amount to be included in income by subtracting from the §179 deduction the depreciation that would have been allowable on the §179 amount for prior tax years and the tax year of recapture.

Dispositions

If a taxpayer elects the §179 deduction, the amount deducted is treated as depreciation for the recapture rules. Thus, any gain recognized on disposition of the property is treated as ordinary income to the extent of the §179 deduction and depreciation taken.

Installment Sales

If a taxpayer makes an installment sale of qualifying property, they must generally include as ordinary income in the year of sale any depreciation recapture income to the extent of gain even if no payments are received in the year of sale.

Depreciation & Cost Recovery - §167 & §168

Taxpayers are permitted a deduction for the exhaustion, wear, tear, and obsolescence of an asset used in a trade or business or for the production of income. The cost of property is recovered by taking deductions for the cost over a set period of years. Property is classified as either real or personal and can be used in business or for personal purposes. The Modified Accelerated Cost Recovery System (MACRS) is the current tax depreciation system and is required for most property.

> **Note:** The Accelerated Cost Recovery System (ACRS) was mandatory for property placed in service after 1980 and before 1987.

Under MACRS, the basis of property is recovered over a specified life (defined in the Code) by annual deductions for depreciation. Although there are technically two types of MACRS systems -the general depreciation system (GDS) and the al-

ternative depreciation system (ADS), the GDS is predominantly used and ADS only applies in special cases.

Personal Property

MACRS

The general effect of MACRS is to maximize deductions using accelerated depreciation and encourage capital investments. As a result, MACRS places personal tangible property into 6 recovery classes based on ADR midpoint life (R. P. 83-35).

(1) *3-Year Class (200% DB)* - includes tractor units for use over the road, special tools used in the manufacturing of motor vehicles, racehorses if 2 years old when placed in service, breeding hogs, and other personal property with an ADR midpoint of 4 years or less (except autos and light trucks).

(2) *5-Year Class (200% DB)* - includes automobiles, buses, light and heavy general purpose trucks, breeding, and dairy cattle, trailers and trailer mounted containers, computers and peripheral equipment, typewriters, calculators, copiers, R&D property, and other personal property with an ADR midpoint of more than 4 years and less than 10 years.

(3) *7-Year Class (200% DB)* - includes office furniture, fixtures, equipment, breeding and workhorses, agricultural machinery and equipment, railroad trucks, single purpose agricultural or horticultural structures, and other property with an ADR midpoint of 10 years and less than 16 and property not specifically assigned to any other class.

(4) *10-Year Class (200% DB)* - includes vessels, barges, tugs, assets used for petroleum refining, manufacture of grain, sugar, and vegetable oils, and other property with an ADR midpoint of 16 years or more but less than 20 years.

(5) *15-Year Class (150%)* - includes land improvements, assets used for electrical generation, pipeline transportation, and cement manufacture, railroad track, nuclear production plants, sewage treatment plants, and other property with an ADR midpoint of 20 years or more but less than 25 years.

> **Comment:** An allocation to land improvements in the acquisition of residential rental and commercial property results in both a shorter depreciable life (i.e., not the 27.5, 31.5, or 39 years under MACRS) and accelerated depreciation.

(6) *20-Year Class (150% DB)* - includes water utilities, municipal sewer, farm buildings, gas distribution facilities, and other property with an ADR midpoint of 25 years or more.

Elections

MACRS permits a taxpayer to elect straight-line depreciation but only over the MACRS class to which the asset belongs. This election, if made, must be made for all property within a recovery class, but can be made for one class but not another.

In addition, an election may also be made to use the 150% declining balance method for property other than 15-year, 20-year, nonresidential real property, and residential real property.

> **Warning:** When this election is made, the alternative minimum tax calculates the adjustment for accelerated depreciation using the alternative depreciation system.

MACRS Conventions

Generally, only a half-year of MACRS depreciation is allowed for personal property for the acquisition and disposition year. This is referred to as the "half-year convention" however there is an exception.

Mid-quarter Convention Exception

MACRS substitutes the mid-quarter convention for all personal property placed in service during a tax year if more than 40% of the total basis of all personal property placed in service during the year is placed in service during the last three months. Property placed in service and disposed of during the same year is not included in the 40% test.

The mid-quarter convention treats personal property placed in service or disposed of during any quarter as placed in service or disposed of at the midpoint of that quarter.

Quarter	Months of Depreciation
1st	10.5
2nd	7.5
3rd	4.5
4th	1.5

Recapture - §1245

Generally, gains from the sale of depreciable tangible personal property are treated as capital gains under §1231 while losses are treated as ordinary losses. Section 1245 reclassifies gain from the sale of depreciable tangible personal property from capital gain to ordinary income to the extent depreciation or cost recovery deductions were claimed on the asset.

The §179 expense election is treated as a MACRS deduction for recapture purposes. Recapture would occur if the expensed property is converted to personal use prior to the expiration of its life under MACRS. A property is

converted to personal use if it is not used predominantly in a trade or business.

Bonus (or Additional First-year) Depreciation - §168

Business taxpayers are allowed to recover the cost of capital expenditures over time according to a depreciation schedule (§168). However, at various times, Congress has allowed such taxpayers to take an additional (or bonus) depreciation deduction allowance equal to either 50% or 100% of the cost of the depreciable property.

For qualified property acquired and placed in service after September 27, 2017, and before 2023, the bonus depreciation rate was increased to 100%. However, the 100% allowance is being phased down by 20% per calendar year for property placed in service and specified plants planted or grafted, in taxable years beginning after 2022 (after 2023 for longer production period property and certain aircraft). As a result, the bonus depreciation percentage rates are as follows.

Placed in Service Year	**Bonus Depreciation Percentage**	
	Qualified Property in General	**Longer Production Period Property and Certain Aircraft**
Portion of Basis of Qualified Property Acquired before Sept. 28.2017		
Sept. 28. 2017-Dec. 31,2017	50 percent	50 percent
2018	40 percent	50 percent
2019	30 percent	40 percent
2020	None	30 percent
2021 and thereafter	None	None
Portion of Basis of Qualified Property Acquired after Sept. 27, 2017		
Sept. 28.2017-Dec. 31,2022	100 percent	100 percent
2023	80 percent	100 percent
2024	60 percent	80 percent
2025	40 percent	60 percent
2026	20 percent	40 percent
2027	None	20 percent
2028 and thereafter	None	None

Property acquired *before* September 28, 2017, was subject to a 50% rate if placed in service in 2017, a 40% rate if placed in service in 2018, and a 30% rate

if placed in service in 2019. A taxpayer could elect to apply the 50% rate instead of the 100% rate for qualified property placed in service during the taxpayer's first tax year ending after September 27, 2017.

A taxpayer may elect out of the additional first year (bonus) depreciation for the taxable year the property is placed in service. The election must be made by filing a statement with Form 4562.

Qualified Property - §168(k)(2)

Property that qualified for this special depreciation allowance includes:

(1) tangible property depreciated under the modified accelerated cost recovery system (MACRS) with a recovery period of 20 years or less (Reg. §1.168(k)-1(a)(2)(ii)),

(2) water utility property (§168(e)(5)),

(3) computer software depreciable over three years under §167(f) [Reg. §1.168(k)-1(b)(2)(B)], *or*

(4) qualified improvement property (§168(k)(3).

> **Note:** Qualified improvement property is an improvement to the interior of nonresidential real property, but does not include improvements for building enlargement, any elevator or escalator, or internal structural framework (§168(e)(6)). It is 15-year recovery property and bonus depreciation can apply.
>
> **Comment:** The previous categories of 15-year qualified leasehold improvement property, 15-year qualified retail improvement property, and 15-year restaurant property, a 15-year recovery period (and bonus depreciation) can still apply if they meet the qualified improvement property definition.

Qualified property also has to meet the following tests:

1. Qualified property needs to be placed in service before January 1, 2027 (before January 1, 2028, in the case of long production property and noncommercial aircraft) [§168(k)(2)(A)(iii)].

2. The original use of the property must begin with the taxpayer (§168(k)(2)(A)(ii)).

Depreciation Limits on Business Vehicles - §168(k)(2)(F)(iii)

Because of bonus depreciation, the limitation under §280F on the amount of depreciation deductions allowed with respect to certain passenger automobiles is increased in the first year by $8,000 for automobiles that qualify (and for which the taxpayer did not elect out of the additional first-year deduction). The $8,000 increase is not indexed for inflation.

Nonqualified Property

Property that did not qualify for special depreciation allowance included:

(1) property placed in service and disposed of in the same tax year;

(2) property converted from business use to personal use in the same tax year it is acquired (Reg. §1.168(k)-1(f)(6)(ii)),

(3) property required to be depreciated under the alternative depreciation system (ADS) [§168(k)(2)(D)(i)]; *and*

(4) property included in a class of property for which you elected not to claim the special depreciation allowance (R.P. 2017-33).

Tables

Table MACRS-1

General Depreciation System
Applicable Depreciation Method: 200 or 150 Percent
Declining Balance Switching to Straight-line
Applicable Recovery Periods: 3, 5, 7, 10, 15, and 20 years
Applicable Convention: Half-year

If the Recovery Year is:	And the Recovery Period is:					
	3-year	5-year	7-year	10-year	15-year	20-year
	The Depreciation Rate is:					
1	33.33	20.00	14.29	10.00	5.00	3.750
2	44.45	32.00	24.49	18.00	9.50	7.219
3	14.81	19.20	17.49	14.40	8.55	6.677
4	7.41	11.52	12.49	11.52	7.70	6.177
5		11.52	8.93	9.22	6.93	5.713
6		5.76	8.92	7.37	6.23	5.285
7			8.93	6.55	5.90	4.888
8			4.46	6.55	5.90	4.522
9				6.56	5.91	4.462
10				6.55	5.90	4.461
11				3.28	5.91	4.462
12					5.90	4.461
13					5.91	4.462
14					5.90	4.461
15					5.91	4.462
16					2.95	4.461
17						4.462
18						4.461
19						4.462
20						4.461
21						2.231

Table MACRS-2

General Depreciation System
Applicable Depreciation Method: 200 or 150 Percent
Declining Balance Switching to Straight-line
Applicable Recovery Periods: 3, 5, 7, 10, 15, and 20 years
Applicable Convention: Mid-quarter (property placed in service in first quarter)

If the Recovery Year is:	And the Recovery Period is:					
	3-year	5-year	7-year	10-year	15-year	20-year
	The Depreciation Rate is:					
1	58.33	35.00	25.00	17.50	8.75	6.563
2	27.78	26.00	21.43	16.50	9.13	7.000
3	12.35	15.60	15.31	13.20	8.21	6.482
4	1.54	11.01	10.93	10.56	7.39	5.996
5		11.01	8.75	8.45	6.65	5.546
6		1.38	8.74	6.76	5.99	5.130
7			8.75	6.55	5.90	4.746
8			1.09	6.55	5.91	4.459
9				6.56	5.90	4.459
10				6.55	5.91	4.459
11				0.82	5.90	4.459
12					5.91	4.460
13					5.90	4.459
14					5.91	4.460
15					5.90	4.459
16					0.74	4.460
17						4.459
18						4.460
19						4.459
20						4.460
21						0.557

Table MACRS-3

General Depreciation System
Applicable Depreciation Method: 200 or 150 percent
Declining Balance Switching to Straight-line
Applicable Recovery Periods: 3, 5, 7, 10, 15, and 20 years
Applicable Convention: Mid-quarter (property placed in service in second quarter)

If the Recovery Year is:	And the Recovery Period is:					
	3-year	5-year	7-year	10-year	15-year	20-year
	The Depreciation Rate is:					
1	41.67	25.00	17.85	12.50	6.25	4.688
2	38.89	30.00	23.47	17.50	9.38	7.148
3	14.14	18.00	16.76	14.00	8.44	6.612
4	5.30	11.37	11.97	11.20	7.59	6.116
5		11.37	8.87	8.96	6.83	5.658
6		4.26	8.87	7.17	6.15	5.233
7			8.87	6.55	5.91	4.841
8			3.33	6.55	5.90	4.478
9				6.56	5.91	4.463
10				6.55	5.90	4.463
11				2.46	5.91	4.463
12					5.90	4.463
13					5.91	4.463
14					5.90	4.463
15					5.91	4.462
16					2.21	4.463
17						4.462
18						4.463
19						4.462
20						4.463
21						1.673

Table MACRS-4

General Depreciation System
Applicable Depreciation Method: 200 or 150 percent
Declining Balance Switching to Straight-line
Applicable Recovery Periods: 3, 5, 7, 10, 15, and 20 years
Applicable Convention: Mid-quarter (property placed in service in third quarter)

If the Recovery Year is:	And the Recovery Period is:					
	3-year	5-year	7-year	10-year	15-year	20-year
	The Depreciation Rate is:					
1	25.00	15.00	10.71	7.50	3.75	2.813
2	50.00	34.00	25.51	18.50	9.63	7.289
3	16.67	20.40	18.22	14.80	8.66	6.742
4	8.33	12.24	13.02	11.84	7.80	6.237
5		11.30	9.30	9.47	7.02	5.769
6		7.06	8.85	7.58	6.31	5.336
7			8.86	6.55	5.90	4.936
8			5.53	6.55	5.90	4.566
9				6.56	5.91	4.460
10				6.55	5.90	4.460
11				4.10	5.91	4.460
12					5.90	4.460
13					5.91	4.461
14					5.90	4.460
15					5.91	4.461
16					3.69	4.460
17						4.461
18						4.460
19						4.461
20						4.460
21						2.788

Table MACRS-5

General Depreciation System
Applicable Depreciation Method: 200 or 150 Percent
Declining Balance Switching to Straight-line
Applicable Recovery Periods: 3, 5, 7, 10, 15, and 20 years
Applicable Convention: Mid-quarter (property placed in service in fourth quarter)

If the Recovery Year is:	And the Recovery Period is:					
	3-year	5-year	7-year	10-year	15-year	20-year
	The Depreciation Rate is:					
1	8.33	5.00	3.57	2.50	1.25	0.938
2	61.11	38.00	27.55	19.50	9.88	7.430
3	20.37	22.80	19.68	15.60	8.89	6.872
4	10.19	13.68	14.06	12.48	8.00	6.357
5		10.94	10.04	9.98	7.20	5.880
6		9.58	8.73	7.99	6.48	5.439
7			8.73	6.55	5.90	5.031
8			7.64	6.55	5.90	4.654
9				6.56	5.90	4.458
10				6.55	5.91	4.458
11				5.74	5.90	4.458
12					5.91	4.458
13					5.90	4.458
14					5.91	4.458
15					5.90	4.458
16					5.17	4.458
17						4.458
18						4.459
19						4.458
20						4.459
21						3.901

Real Property

MACRS

Under MACRS real property is 27.5-year class if it is residential rental property. All other depreciable real property (e.g., commercial) was assigned to the 31.5-year class. *On or after May 13, 1993*, all other depreciable real property is assigned to the 39-year class.

The straight-line method must be used for all real property in the 27.5-year class, 31.5-year class, and 39-year class.

MACRS uses the half-month convention rules for all real property. Thus, all real property placed in service during any month is treated as being placed in service on the midpoint of each month for purposes of computing the MACRS depreciation deduction.

The following tables show the depreciation rate for 27.5-year and 31.5-year class real property.

Qualified Improvement Property - §168(e)(6)(A)

Qualified improvement property (QIP) is any improvement made by the taxpayer to an interior portion of a building that is *nonresidential* real property if the improvement is placed in service after the date the building was first placed in service.

> **Note:** The TCJA *eliminated* the former qualified leasehold, retail, and restaurant improvement property classes (§168(e)(3)(E)). All improvements that previously qualified for a 15-year recovery period as qualified leasehold, retail, and restaurant improvement property are now combined in the definition of qualified improvement property (§168(e)(6)(A)).

Recovery Period & Depreciation Method - §168(b)(3)(G)

Qualified improvement property has a 15-year recovery period (20 years for ADS) for property placed in service after 2017. It is depreciated using the straight-line method and half-year convention (§168(b)(3)(G)). In addition, all qualified improvement property remains eligible for bonus depreciation (§168(k)). Finally, for 2018 and later, the definition of qualified real property eligible for expensing under §179 includes qualified improvement property (§179(f)).

Qualified Improvement Property - §168(e)(6)(A)

The definition of qualified improvement property for purposes of the 15-year recovery period is any improvement to the interior of a building that is nonresidential real property if the improvement is placed in service after the date the building was first placed in service by any taxpayer (§168(e)(6)(A)).

Note: This definition is the same as used for bonus depreciation purposes (however, §168(k)(3) has been moved to §168(e)(6)(A)). In addition, qualified improvement property remains eligible for bonus depreciation.

However, qualified improvement property does not include expenditures attributable to:

(1) the enlargement of a building;

(2) any elevator or escalator; *or*

(3) the internal structural framework of a building (§168(e)(6)(B).

Table MACRS-6

Applicable Depreciation Method: Straight-line
Applicable Recovery Period: 27.5 years
Applicable Convention: Mid-month

If the Recovery Year is:	And the Month in the First Recovery Year the Property is Placed in Service is:					
	1	2	3	4	5	6
	The Applicable Percentage is:					
1	3.485	3.182	2.879	2.576	2.273	1.970
2	3.636	3.636	3.636	3.636	3.636	3.636
3	3.636	3.636	3.636	3.636	3.636	3.636
4	3.636	3.636	3.636	3.636	3.636	3.636
5	3.636	3.636	3.636	3.636	3.636	3.636
6	3.636	3.636	3.636	3.636	3.636	3.636
7	3.636	3.636	3.636	3.636	3.636	3.636
8	3.636	3.636	3.636	3.636	3.636	3.636
9	3.636	3.636	3.636	3.636	3.636	3.636
10	3.637	3.637	3.637	3.637	3.637	3.637
11	3.636	3.636	3.636	3.636	3.636	3.636
12	3.637	3.637	3.637	3.637	3.637	3.637
13	3.636	3.636	3.636	3.636	3.636	3.636
14	3.637	3.637	3.637	3.637	3.637	3.637
15	3.636	3.636	3.636	3.636	3.636	3.636
16	3.637	3.637	3.637	3.637	3.637	3.637
17	3.636	3.636	3.636	3.636	3.636	3.636
18	3.637	3.637	3.637	3.637	3.637	3.637
19	3.636	3.636	3.636	3.636	3.636	3.636
20	3.637	3.637	3.637	3.637	3.637	3.637
21	3.636	3.636	3.636	3.636	3.636	3.636
22	3.637	3.637	3.637	3.637	3.637	3.637
23	3.636	3.636	3.636	3.636	3.636	3.636
24	3.637	3.637	3.637	3.637	3.637	3.637
25	3.636	3.636	3.636	3.636	3.636	3.636
26	3.637	3.637	3.637	3.637	3.637	3.637
27	3.636	3.636	3.636	3.636	3.636	3.636
28	1.970	2.273	2.576	2.879	3.182	3.485
29	0.000	0.000	0.000	0.000	0.000	0.000

Table MACRS-6
(Continued)

Applicable Depreciation Method: Straight-line
Applicable Recovery Period: 27.5 years
Applicable Convention: Mid-Month

If the Recovery Year is:	And the Month in the First Recovery Year the Property is Placed in Service is:					
	7	8	9	10	11	12
	The Applicable Percentage is:					
1	1.667	1.364	1.061	0.758	0.455	0.152
2	3.636	3.636	3.636	3.636	3.636	3.636
3	3.636	3.636	3.636	3.636	3.636	3.636
4	3.636	3.636	3.636	3.636	3.636	3.636
5	3.636	3.636	3.636	3.636	3.636	3.636
6	3.636	3.636	3.636	3.636	3.636	3.636
7	3.636	3.636	3.636	3.636	3.636	3.636
8	3.636	3.636	3.636	3.636	3.636	3.636
9	3.636	3.636	3.636	3.636	3.636	3.636
10	3.636	3.636	3.636	3.636	3.636	3.636
11	3.637	3.637	3.637	3.637	3.637	3.637
12	3.636	3.636	3.636	3.636	3.636	3.636
13	3.637	3.637	3.637	3.637	3.637	3.637
14	3.636	3.636	3.636	3.636	3.636	3.636
15	3.637	3.637	3.637	3.637	3.637	3.637
16	3.636	3.636	3.636	3.636	3.636	3.636
17	3.637	3.637	3.637	3.637	3.637	3.637
18	3.636	3.636	3.636	3.636	3.636	3.636
19	3.637	3.637	3.637	3.637	3.637	3.637
20	3.636	3.636	3.636	3.636	3.636	3.636
21	3.637	3.637	3.637	3.637	3.637	3.637
22	3.636	3.636	3.636	3.636	3.636	3.636
23	3.637	3.637	3.637	3.637	3.637	6.637
24	3.636	3.636	3.636	3.636	3.636	3.636
25	3.637	3.637	3.637	3.637	3.637	3.637
26	3.636	3.636	3.636	3.636	3.636	3.636
27	3.637	3.637	3.637	3.637	3.637	3.637
28	3.636	3.636	3.636	3.636	3.636	3.636
29	0.152	0.455	0.758	1.061	1.364	1.667

Table MACRS-7

31.5 Year - Straight-line - Mid-Month Convention

If the Recovery Year is:	And the Month in the First Recovery Year the Property is Placed in Service is:					
	1	2	3	4	5	6
	The Applicable Percentage is:					
1	3.042	2.778	2.513	2.249	1.984	1.720
2	3.175	3.175	3.175	3.175	3.175	3.175
3	3.175	3.175	3.175	3.175	3.175	3.175
4	3.175	3.175	3.175	3.175	3.175	3.175
5	3.175	3.175	3.175	3.175	3.175	3.175
6	3.175	3.175	3.175	3.175	3.175	3.175
7	3.175	3.175	3.175	3.175	3.175	3.175
8	3.175	3.174	3.175	3.174	3.175	3.174
9	3.174	3.175	3.174	3.175	3.174	3.175
10	3.175	3.174	3.175	3.174	3.175	3.174
11	3.174	3.175	3.174	3.175	3.174	3.175
12	3.175	3.174	3.175	3.174	3.175	3.174
13	3.174	3.175	3.174	3.175	3.174	3.175
14	3.175	3.174	3.175	3.174	3.175	3.174
15	3.174	3.175	3.174	3.175	3.174	3.175
16	3.175	3.174	3.175	3.174	3.175	3.174
17	3.174	3.175	3.174	3.175	3.174	3.175
18	3.175	3.174	3.175	3.174	3.175	3.174
19	3.174	3.175	3.174	3.175	3.174	3.175
20	3.175	3.174	3.175	3.174	3.175	3.174
21	3.174	3.175	3.174	3.175	3.174	3.175
22	3.175	3.174	3.175	3.174	3.175	3.174
23	3.174	3.175	3.174	3.175	3.174	3.175
24	3.175	3.174	3.175	3.174	3.175	3.174
25	3.174	3.175	3.174	3.175	3.174	3.175
26	3.175	3.174	3.175	3.174	3.175	3.174
27	3.174	3.175	3.174	3.175	3.174	3.175
28	3.175	3.174	3.175	3.174	3.175	3.174
29	3.174	3.175	3.174	3.175	3.174	3.175
30	3.175	3.174	3.175	3.174	3.175	3.174
31	3.174	3.175	3.174	3.175	3.174	3.175
32	1.720	1.984	2.249	2.513	2.778	3.042
33	0.000	0.000	0.000	0.000	0.000	0.000

Table MACRS-7
(Continued)

31.5 Year - Straight-line - Mid-Month Convention

If the Recovery Year is:	And the Month in the First Recovery Year the Property is Placed in Service is:					
	7	8	9	10	11	12
	The Applicable Percentage is:					
1	1.455	1.190	0.926	0.661	0.397	0.132
2	3.175	3.175	3.175	3.175	3.175	3.175
3	3.175	3.175	3.175	3.175	3.175	3.175
4	3.175	3.175	3.175	3.175	3.175	3.175
5	3.175	3.175	3.175	3.175	3.175	3.175
6	3.175	3.175	3.175	3.175	3.175	3.175
7	3.175	3.175	3.175	3.175	3.175	3.175
8	3.175	3.175	3.175	3.175	3.175	3.175
9	3.174	3.175	3.174	3.175	3.174	3.175
10	3.175	3.174	3.175	3.174	3.175	3.174
11	3.174	3.175	3.174	3.175	3.174	3.175
12	3.175	3.174	3.175	3.174	3.175	3.174
13	3.174	3.175	3.174	3.175	3.174	3.175
14	3.175	3.174	3.175	3.174	3.175	3.174
15	3.174	3.175	3.174	3.175	3.174	3.175
16	3.175	3.174	3.175	3.174	3.175	3.174
17	3.174	3.175	3.174	3.175	3.174	3.175
18	3.175	3.174	3.175	3.174	3.175	3.174
19	3.174	3.175	3.174	3.175	3.174	3.175
20	3.175	3.174	3.175	3.174	3.175	3.174
21	3.174	3.175	3.174	3.175	3.174	3.175
22	3.175	3.174	3.175	3.174	3.175	3.174
23	3.174	3.175	3.174	3.175	3.174	3.175
24	3.175	3.174	3.175	3.174	3.175	3.174
25	3.174	3.175	3.174	3.175	3.174	3.175
26	3.175	3.174	3.175	3.174	3.175	3.174
27	3.174	3.175	3.174	3.175	3.174	3.175
28	3.175	3.174	3.175	3.174	3.175	3.174
29	3.174	3.175	3.174	3.175	3.174	3.175
30	3.175	3.174	3.175	3.174	3.175	3.174
31	3.174	3.175	3.174	3.175	3.174	3.175
32	3.175	3.174	3.175	3.174	3.175	3.174
33	0.132	0.397	0.661	0.926	1.190	1.455

Recapture - §1250 & §1245

There are basically three depreciation recapture provisions: §1245, §1250, and §291. Recapture converts gains that would have been taxed at capital gains rates into ordinary income.

Section 1245

Section 1245 applies to tangible personal property (like machinery or equipment) and intangible personal property (like a patent or copyright) that is or has been subject to an allowance for depreciation or amortization. It does not apply to real estate

Section 1245 provides that the portion of gain from the disposition of §1245 property (including §167 depreciation, §168 cost recovery, and §179 expensing) is recaptured as ordinary income.

Full Recapture

All depreciation taken is subject to §1245 recapture. The method of depreciation (straight-line, ACRS, or MACRS) does not matter.

Section 1250

Recapture under §1250 is less damaging than under §1245. Section 1250 only recaptures the excess of accelerated depreciation actually deducted over straight-line depreciation. Generally, §1250 property is depreciable real property (i.e., buildings and improvements) that is not subject to §1245.

Partial Recapture

Straight-line depreciation (except for property held one year or less) is not recaptured. Thus, §1250 is a partial recapture provision.

MACRS Recapture Exception for Real Property

Since residential real property in the 27.5-year class and nonresidential real property in the 31.5 or 39-year class is depreciable only under straight-line, MACRS real property is not subject to recapture.

Alternative Depreciation System - §168(g)

Mandatory Application

Depreciation must be calculated under the alternative depreciation system in the case of:

(a) Any tangible property that is used predominantly outside the United States,

(b) Any tax-exempt use (of more than 35% of the property) and tax-exempt bond financed property,

(c) An election to apply the alternative depreciation system to all property in a class placed in service during the taxable year, *and*

> **Comment:** A property-by-property election can be made in the case of nonresidential real property or residential rental property. The election once made is irrevocable.

(d) The alternative minimum tax to determine the portion of depreciation treated as a tax preference item.

Method

The Alternative Depreciation System (ADS) provides different recovery periods for different types of property and they are generally longer than the GDS. Examples of recovery periods under the alternative depreciation system are:

(a) Five years for qualified technological equipment, computers, automobiles, and light-duty trucks,

(b) Ten years for business office furniture and fixtures,

(c) Twelve years for personal property with no class life,

(d) Thirty years for all residential rental property and all nonresidential real property.

> **Note:** Starting in 2018, the ADS recovery period was changed from 40 years to 30 years. However, for property placed in service before, the recovery period remains 40 years.

Amortization

Amortization is the method of writing off costs that benefit more than one accounting period over the benefit period or some period set by the IRS. These costs are usually thought of as intangible but certain tangible property such as leasehold improvements is amortizable.

Costs Eligible for Amortization

Generally, the cost or investment must have an ascertainable value and have a limited useful life that can be determined with reasonable assurance or have an amortization life set by the IRS as a time period or a percentage of revenue such as depletion.

> **Note:** No amortization or depreciation deduction is allowed for any trademark or trade name expenses (§167(r)).

Methods & Periods for Amortization

Methods and periods for amortization vary, but generally, useful life must be demonstrated and used unless otherwise specified.

Partnership & Corporate Organization Costs - §709 & §248

Organization costs usually include expenditures made in preparation for starting a business such as legal fees, financial planning for the prospective business, and other costs incurred before business commences. These costs are essentially amortizable over 180 months. Taxpayers have to elect to amortize them and failure to elect will prevent the write-off.

Business Start-Up Costs - §195

In general, start-up costs must be capitalized subject to an election to amortize such costs over a period of 15 years. A start-up cost is any amount paid or incurred in connection with:

(a) Investigating the creation of or acquisition or establishment of an active trade or business,

(b) Creating an active trade or business, *or*

(c) Any activity engaged in for profit and for the production of income before the day the active trade or business begins, in anticipation of that activity becoming an active trade or business.

Depletion - §613

Depletion can be taken on exhaustible natural deposits and timber based on its cost or basis times the amount used or exhausted divided by the amount available. This is termed cost depletion.

Percentage depletion is calculated on a specified percentage of gross income from the property, but can never exceed 50% of taxable income before depletion.

Virtually all mineral deposits qualify for percentage depletion. The tables for specified percentages for the various minerals are included in §613(b) & Reg. §1.613-2(b).

Other Assets

Other assets may be amortizable such as:

(a) Franchise fees,

(b) Customer lists if life can be determined,

(c) Bond premiums and discounts,

(d) Circulation costs,

(e) Commitment fees for loans and closing costs,

(f) Covenants not to compete, *and*

(g) Construction period interest.

Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regard to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

77. Constructive receipt of income under §451 is a concern for cash basis taxpayers. Under which circumstance would income be reported on the cash method in a year other than the current taxable year?

a. During the current tax year, the income is only credited to the taxpayer's account.

b. During the current tax year, the income is only made available so that the taxpayer may draw upon it.

c. During the current tax year, the income is set apart for the taxpayer.

d. During the current tax year, considerable limitations are placed on receipt of the income.

78. The accrual method often must be used. In which of the following circumstances is the use of this method required under §448?

a. An entity meets a $29,000,000 gross receipts test.

b. A farming business with gross receipts under $29,000,000.

c. Advances are made for services to be performed later.

d. The production of merchandise is a material income-producing factor.

79. Which of the following is an example of a long-term contract under §460?

a. A company has been contracted to build a bridge. The contract commences this year and will be completed next year.

b. A company has been contracted to manufacture 500 tractors. The company normally takes 3 weeks to complete a tractor. The contract commences this year and will be complete next year.

c. A firm has been contracted to provide accounting services for Company

X. The duration of the contract is two years.

d. A company has been contracted to build a home. The contract commences this year and will be completed next year.

80. Taxpayers are required to compute their taxable income on the basis of their taxable year. What is the taxable year when the taxpayer fails to keep any books?

a. the 52-53 week year.

b. the calendar year.

c. the fiscal year.

d. the short period year.

81. Personal service corporations may make a §444 election. This election allows them to use a tax year other than:

a. an established business year.

b. the traditional calendar year by more than four months.

c. a fiscal year.

d. the mandatory tax year.

82. The mid-quarter depreciation convention must be used if a taxpayer places property in service during the last three months of the year and:

a. these assets' total basis is in excess of 40% of the basis of all assets.

b. the cost of residential property is included.

c. the taxpayer elected out of the half-year convention.

d. the cost of property acquired and sold in the same year is included.

83. The cost of certain assets must be deducted over the multiple accounting periods that are deemed to benefit from the asset. What term is used to define this method of writing off asset costs?

a. amortization.

b. cost recovery.

c. depreciation.

d. expensing.

Learning Objectives

After reading Chapter 3, participants will be able to:

1. Specify the tax consequences on the sale of easements and the holding period and basis of inherited property.

2. Identify the application elements of the §121 home sale exclusion specifying the ownership and use requirements.

3. Recognize the §453 installment method requirements, the residential lot exception, and the pledging rule limitation.

4. Identify the elements necessary for a §1038 repossession, the different rules for real property and personal property repossessions, and calculating basis and gain on repossession

5. Specify the tax treatment of a §1033 involuntary conversion on condemnation or threat of condemnation; differentiate between condemnation awards and severance damages; and identify replacement periods needed to postpone gain.

6. Recognize the scope of the §465 at-risk rules and their effect on property depreciation, and identify the requirements, taxation, and types of §1031 like-kind exchanges.

7. Identify planning considerations for benefit planning and funding a qualified retirement plan; determine the compensation base used for funding calculations and the impact of PBGC insurance in assuring benefits.

8. Identify the requirements of the basic forms of qualified pension plans permitting clients to compare and contrast such plans.

9. Differentiate defined contribution and defined benefit plans; specify the types of defined contribution plans particularly Keogh plans and IRAs identifying their effect on retirement benefits.

10. Identify how self-employed plans differ from qualified plans for other business types and owners; and specify the requirements of IRAs and the Roth IRAs recognizing their contribution, rollover, and RMD requirements and restrictions.

CHAPTER 3

Property Transfers & Retirement Plans

Sales & Exchanges of Property

A transaction must be a sale or exchange for any gain on it to be taxable or any loss to be deductible. While there are some exceptions[1], the IRS requires the reporting of a transaction that consists in whole or in part of the sale or exchange for money, indebtedness, property, or services of any present or future ownership interest.

> **For example:** Taxpayers must file Form 1099-S, *Proceeds From Real Estate Transactions*, to report the sale or exchange of most real estate.
>
> **Note:** The Infrastructure Investment and Jobs Act (HR 3684) requires sales of digital assets to be reported and businesses to report receipts of digital assets valued over $10,000 for transactions occurring in 2024 or after. The IIJA defines a digital asset as "any digital representation of value which is recorded on cryptographically secured distributed ledger or any similar technology" specified by the Treasury.

A *sale* is a transfer of property for money or for a mortgage, note, or some other promise to pay money. An *exchange* is a transfer of property for other property or services[2].

[1] For example, the sale or exchange of a principle residence for $250,000 or less.

[2] A transfer of property to satisfy a debt is a taxable exchange.

Conditional Sales Contract or Lease

Some agreements that seem to be leases may really be conditional sales contracts. If the agreement is a lease, the taxpayer is a lessee and payments are rent. When the agreement is a conditional sales contract, The taxpayer is a buyer and the payments are purchase payments. The intention of parties to the agreement can help distinguish between a sale and a lease.

Each agreement should be considered based on its own facts and circumstances. However, in general, taxpayers should consider an agreement as a conditional sales contract rather than a lease if one or more of the following conditions apply:

(1) the agreement designates part of each payment towards an equity interest that taxpayer will receive in the property;

(2) taxpayer gets title to the property upon the payment of a stated amount of "rental" payments required under the agreement;

(3) the amount taxpayer must pay to use the property for a short time is an inordinately large part of the amount taxpayer would pay to get title to the property;

(4) taxpayer pays much more than the current fair rental value of the property;

(5) taxpayer has an option to buy the property at a nominal price compared to the value of the property;

(6) taxpayer has the option to buy the property for a small amount compared to the total amount required under the agreement; *and*

(7) the agreement designates some part of the payments as interest, or parts of the payments are easy to recognize as interest (R.R. 55-540).

Easements

Granting or selling an easement is usually not a taxable sale of property. Instead, the amount received for the easement is subtracted from the basis of the property. If only a part of the entire tract of property is permanently affected by the easement, only the basis of that part is reduced by the amount received. When it is impossible or impractical to separate the basis of the part of the property on which the easement is granted, the basis of the whole property is reduced by the amount received. However, any amount received that is more than the basis to be reduced is a taxable gain.

Capital Gains & Losses

When a taxpayer sells a capital asset for more than its adjusted basis, a capital gain is generated. Capital gains are classified as either short-term or long-term. Short-term capital gains are generated from the sale of assets the taxpayer has owned for one year or less. They are typically taxed as ordinary income. Long-

term capital gains are generated from the sale of assets the taxpayer has owned for more than one year. They are typically taxed at either 0%, 15%, or 20% depending on the taxpayer's income. When a taxpayer sells a capital asset for less than its adjusted basis, a capital loss is generated. Capital losses generally are deductible in full against capital gains. In addition, individual taxpayers may deduct capital losses against up to $3,000 of ordinary income each year. Any remaining unused capital losses may be carried forward indefinitely to another taxable year.

> **Note:** Gain from selling or trading stocks, bonds, investment property, or other capital assets may be taxed or it may be tax-free, at least in part. A loss may or may not be deductible.

Section 1221 defines a capital asset as property held by the taxpayer (whether or not connected with his trade or business), but does not include certain types of property.

Capital Assets - §1221

Everything is a capital asset *except*:

(1) property held mainly for sale to customers or property that will physically become a part of the merchandise that is for sale to customers,

(2) accounts or notes receivable acquired in the ordinary course of a trade or business, or for services rendered as an employee, or from the sale of any of the properties described in (1),

(3) depreciable property used in a taxpayer's trade or business (even though fully depreciated),

(4) real property used in a taxpayer's trade or business,

(5) a copyright, literary, musical, or artistic composition, letter or memorandum, or similar property:

(a) created by a taxpayer's personal efforts,

(b) a letter, memorandum, or similar property prepared or produced for the taxpayer, *or*

(c) acquired from a person who created the property, or for whom the property was prepared, under circumstances entitling a taxpayer to the basis of the person who created the property, or for whom it was prepared or produced (for example, by gift), *and*

(6) U.S. Government publications that a taxpayer got from the government for free or for less than the normal sales price or that a taxpayer acquired under circumstances entitling them to the basis of someone who got the publications for free or for less than the normal sales price if the taxpayer sells, exchanges, or contributes the publication.

Capital Gains & Qualified Dividends Rate – §1(h)

The long-term capital gains tax rates are 0%, 15%, or 20%, depending on a taxpayer's income. Interestingly, these three capital gains income breakpoints do not match up perfectly with tax brackets. Instead, they are applied to maximum taxable income levels.

For 2024, the 15% capital gain tax rate breakpoint was $94,050 ($47,025, for single filers) for joint returns and surviving spouses. The 20% capital gain tax rate breakpoint was $583,750 ($518,900, for single filers) for joint returns and surviving spouses. Below is a chart of capital gain rates (MFJ) based on income for 2024:

Income	Capital Gains Rate
$0 - $94,050	0%
$94,050 - $583,750	15%
Over $583,750	20%

For 2025, the 15% capital gain tax rate breakpoint is $96,700 ($48,350, for single filers) for joint returns and surviving spouses. The 20% capital gain tax rate breakpoint is $600,050 ($533,400, for single filers) for joint returns and surviving spouses. Below is a chart of capital gain rates (MFJ) based on income for 2025:

Income	Capital Gains Rate
$0 - $96,700	0%
$96,700 - $600,050	15%
Over $600,050	20%

Note: Short-term capital gains are still taxed as ordinary income and unrecaptured §1250 gain generally is taxed at a maximum rate of 25%, and 28% rate gain is taxed at a maximum rate of 28%.

The 3.8% net investment income tax was also retained for 2025 and 2024. As a result, the 20% rate may actually end up 23.5% for certain high-income earners.

A higher maximum rate of 28% is provided for:

(1) Net long-term capital gain attributable to the sale or exchange of collectibles, *and*

(2) Certain small business stocks to the extent the gain is included in income.

Likewise, a maximum rate of 25% exists for the long-term capital gain attributable to depreciation from real estate held for more than 12 months.

Holding Periods - (§1222 & §1223)

Assets the taxpayer has owned for more than one year are eligible for the lower long-term capital gain rates.

> **Note:** With long-term capital gains rates available for investments held more than 12 months, tax-planning strategies that produce capital gains instead of ordinary income are certainly favored. Ordinary income can be subject to a 37% rate (in 2025 & 2024) while capital gains may only pay 0% to 20%.

Holding periods are measured by months not days. In addition, the holding period starts one day after the asset is acquired and ends the day the asset is disposed of.

Generally, the holding period of property acquired from a decedent starts at the date of death. However, for capital gain purposes, it is automatically deemed to be more than one year (see below and §1223(9)).

The holding period for a surviving spouse's share of community property that was acquired during the marriage vests to the survivor at the time of the decedent's acquisition. Thus, the holding period for the deceased spouse's share of the community property which is inherited by the surviving spouse also starts at the date of the deceased spouse's death.

If the property acquired from a decedent is sold within the short-term capital gain period after the decedent's death the sale is considered *long-term* if:

(a) The person who sells the property has a basis determined under §1014 (fair market value on the date of death or alternate valuation date), *or*

(b) The property is sold or disposed of within one year after the decedent's death (§1223(9)).

Example

Tom and Sarah acquired a four-bedroom house in Sunnyvale, California in 1986, which they held as a rental. Their total cost was $25,000. Tom passed away in November 2024. Sarah sold the rental in April 2025 for $600,000. The holding period for the gain for Sarah's community property share would be 1986; for the part she inherited from Tom, the holding period would start at Tom's death in November 2024. Her gain would be considered long-term for the entire property as noted above.

The holding period for property acquired by gift is determined by its ultimate disposition. Property held or sold at a gain retains the same basis and holding period as that of the donor. Property sold at a loss that is based on the mar-

ket value at the time of the gift is considered to acquire the gift's date for the beginning of its holding period.

Example

Alex received a gift of 10,000 shares of IBM that his grandfather gave him in November 2025. If the market value of IBM is $100 per share on that date and Alex sells those shares six months later for $110 he will have a gain based on his grandfather's holding period and basis. If, on the other hand, he sells the stock at $95 per share, he will have a short-term loss, since the value at the date of the gift was $100 per share.

Capital Losses - §1211

Capital losses may be deducted in full against capital gains. In addition, individual taxpayers may deduct capital losses against ordinary income each year.

However, the capital loss deduction is limited to the *lower* of:

(a) the amount of the loss, *or*

(b) $3,000 ($1,500 for married individuals filing separately).

Any unused capital loss can be carried forward indefinitely to other taxable years.

Business Property - §1231

Section 1231 "property" is real or depreciable business property held for more than one year. When the net of all §1231 transactions is a loss, it is treated as an ordinary loss. Unlike capital losses, there is no limitation on the amount of ordinary loss that can be deductible. On the other hand, §1231 gain is taxed as follows:

(1) gain in excess of accumulated depreciation is taxed as a capital gain (calculated on Form 4797 and carried over to Schedule D),

(2) gain up to the amount of accumulated depreciation is taxed as ordinary income under provisions of §1245 and §1250 (reported on Form 4797), *then*

(3) gain equal to "nonrecaptured net 1231 losses" is taxed as ordinary income.

Note: Nonrecaptured net 1231 losses are defined as the net §1231 loss for the 5 most recent preceding tax years which have not had a net section 1231 gain in an intervening tax year (§1231(c)(2)).

Basis of Property

The basis of property is generally determined by its cost. Cost is generally the amount paid plus the fair market value of any assets transferred plus:

(1) Sales taxes,

(2) Freight,

(3) Installation, *and*

(4) Testing charges (§1012).

Real estate cost basis includes abstract fees, surveys, title and escrow charges, title insurance, utility installation charges, and seller expenses that a buyer pays. These non-recurring acquisition costs are added to the property basis and depreciated where applicable.

Adjusted Basis

The original cost basis in property is adjusted (increased or decreased) by certain events and becomes an "adjusted basis." This basis is used to determine gain or loss on the disposition of an asset.

Increases to basis can include:

(1) improvements (not repairs),

(2) legal fees-title challenges, *and*

(3) assessments for improvements (streets, sidewalks, sewers).

Decreases to basis can include:

(1) depreciation (MACRS)

(2) §179 expense deductions (for personal property only)

(3) casualty or theft losses (where permitted), *and*

(4) easements (note: if the amount received for an easement is greater than the basis, a capital gain must be recognized.)

Property Received as a Gift

The donee's basis is equal to the donor's basis except when the donee sells the property in a taxable transaction at a later date. If such a sale results in a loss, the donee's basis is then the lower of the donor's basis or the fair market value of the property on the date of the gift.

Note: Before 1977, the basis of a gift was increased by any gift tax paid. However, for gifts received after 1976, the basis increase is limited to the portion of gift tax paid that is attributable to the net appreciation in value of the gift.

Example

Mom gives her daughter a gift of 200 shares of AT&T stock worth $30 a share. The stock cost Mom $50/share. The

daughter sells the AT&T stock for $25 per share six months later. The daughter's loss is $30 (FMV) - $25 (sales price) x 200 shares = $1000. If the daughter had sold the 200 shares for $60 per share, her gain would have been $60 (sales price) - $50 (Mom's basis) x 200 shares = $2000.

Property Received by Inheritance

The basis of inherited property is usually the fair market value (FMV) at the date of the decedent's death. This is often referred to as a "stepped-up basis," because the basis is adjusted to the property's value at the time of the decedent's death, which is often higher than the decedent's original cost basis.

Note: The basis of inherited property can be its FMV on the alternate valuation date (six months after death), but only if the executor of the estate files an estate tax return (Form 706) and elects to use the alternate valuation.

Changes in Property Usage

After a change in property usage, the basis for depreciation is the *lower* of:

(1) fair market value of property on the date of change, *or*

(2) cost of property plus additional adjustments, improvements, assessments, etc.

Basis for gain on sale is the original cost plus or minus basis adjustments. For loss on sale, basis is the depreciable basis.

Stocks & Bonds

The basis of stocks and bonds is determined by the method of acquisition; i.e. purchase, gift, or inheritance. Four situations require adjustments to this general rule:

1. Stock Dividends & Splits

In the case of a stock dividend or split, the basis of the old stock must be adjusted over the total shares.

Example

XYZ Corporation declares a 25% stock dividend. Shareholder A has 100 shares of XYZ Corp. stock with a basis of $10 per share. After the stock dividend of 25 shares, A must now allocate his basis of $1,000 over 125 shares or $8 per share.

2. Non Taxable Distributions

A receipt of a non-taxable distribution results in a reduction of the basis of the stock or bond.

3. Mutual Funds

Sales of mutual fund shares are among the most time-consuming and confusing areas that tax practitioners encounter. Frequently, the data needed regarding dividends automatically reinvested and shares redeemed is unavailable or misplaced. Those distributions that are automatically reinvested must be added to the basis of the fund. Shares of the fund redeemed reduce the basis. Unless specifically designated, shares sold are considered to have been sold from the first lot acquired (FIFO). A taxable event occurs when shares are sold, redeemed, or exchanged.

> **Note:** To avoid the FIFO basis of shares sold taxpayers must designate specific mutual fund shares being sold to the agent broker for confirmation notice requirements. Taxpayers can elect to determine the basis by using one of two averaging methods but only on a timely basis. (*Joseph E. Hall*, 92 TC No. 64)

4. Wash Sales - §1091

Losses on the sale of stock or securities are not deductible if the taxpayer acquires stock or securities that are substantially identical within 30 days before the date of sale and 30 days after the date of sale (a total 61-day time period). The same rule prevails regarding options.

Example

John purchased 100 shares of XYZ stock for $10 per share on June 1, 2024. John sold 100 shares of XYZ stock for $5 each on December 30, 2024. John purchases 100 shares of XYZ stock on January 10, 2025, at $6 each. John's $500 loss for 2024 is disallowed because he purchased substantially identical stock within 30 days of the sale. Had John purchased the stock on January 31, 2025, this loss would have been allowed.

Tax law requires recognition of gain (but not loss) upon a constructive sale of any appreciated position in stock, a partnership interest, or certain debt instruments. A constructive sale occurs when a taxpayer enters into a short sale, an offsetting notional principal contract, or certain other transactions.

> **Note:** In effect, this provision eliminates "short-against-the-box" sales, notional principal contracts, and future and forward contracts to defer the recognition of gain.

Review Questions

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84. For any property gain to be taxable or loss to be deductible, the property must:

a. be mortgaged.

b. appreciate or depreciate.

c. be transferred.

d. be sold or exchanged.

85. Basis must be figured prior to calculating gain or loss on a sale of property. What is an addition to basis?

a. depreciation.

b. easements.

c. legal fees-title challenges.

d. §179 expense deductions.

86. According to the author, which of the following property disposition issues is one of the most time-consuming areas for tax practitioners?

a. stocks received as a gift.

b. sales of mutual funds.

c. stock dividends and splits.

d. wash sales.

87. Under §1091, a taxpayer cannot deduct a loss on a sale of stock or security when, within 30 days of the sale, similar stock or securities are purchased. Which of the following is also subject to the wash sale rule?

a. exchanges of stock for stock.

b. stock or securities acquired by gift.

c. stock or securities acquired by option.

d. stock acquired incident to divorce.

Sale of Personal Residence - §121

Section 121 provides homeowners with a $500,000 exclusion for joint filers ($250,000 for single filers) from their income of gain realized from the sale of their main home, provided they meet specific criteria. This exclusion can be used once every two years.

> **Comment:** The former rules for gains on the sale of a personal residence under old §121 and §1034 were replaced by the TRA '97 with this exclusion.
>
> **Note:** This exclusion does not apply to any gain attributable to depreciation deductions taken in connection with the rental or business use of the property for periods after May 6, 1997.

Two-Year Ownership & Use Requirements

The exclusion requires a taxpayer to have owned *and* used the property as his or her principal residence for at least *two years* during the *five-year period* ending on the date of the sale or exchange. The exclusion is allowed each time a taxpayer who sells or exchanges a principal residence meets the eligibility requirements, but no more often than once every two years.

Married couples filing a joint return are entitled to a $500,000 exclusion where:

(1) *either* spouse meets the ownership requirement,

(2) *both* spouses meet the use requirement, *and*

(3) *neither* spouse has had a sale in the preceding two years subject to the exclusion.

Married couples not sharing a principal residence, but filing a joint return, are each entitled to a $250,000 exclusion. In addition, single taxpayers who marry a taxpayer who has used the exclusion within two years are allowed a $250,000 exclusion.

> **Note:** Once both spouses satisfy the eligibility requirements and two years have passed since the last exclusion was allowed to either spouse, a full $500,000 exclusion is available for the next sale or exchange.

Prorata Exception

A taxpayer may be entitled to a prorated *exclusion* if they fail to meet either two-year requirement because of a change in:

(a) place of employment,

(b) health, *or*

(c) other unforeseen circumstances.

Under this prorata exception, the exclusion is a ratio of:

(a) the aggregate amount of time the taxpayer owned and used the property as his or her principal residence during the five-year period, or, if shorter, the amount of time since the most recent prior sale to which the exclusion applied, *to*

(b) 24 months (i.e., two years).

Example

Dan and his spouse purchased and occupied a home in Los Angeles. One year later, his employer transfers Dan to Orlando and the family moves. Dan sells the family home for a $300,000 gain. Since the time Dan and his spouse spent in the home is only one-half the required two years, the gain eligible for exclusion is one-half the exclusion otherwise allowed, or $250,000.

Limitations & Criteria on Exclusion

Certain limitations and criteria apply to the exclusion, including:

(1) taxpayers can elect not to have the exclusion apply;

(2) certain periods an individual resides in a nursing home count under the two-year use requirement;

(3) periods a deceased spouse owned and used the property before death count under the two-year requirements;

(4) an individual is held to use property as his or her principal residence during any period of ownership while the individual's spouse or former spouse is granted use of the property under a divorce or separation instrument; *and*

(5) for stock co-ops, the ownership requirement applies to the holding of such stock and the use requirement is applied to the house or apartment the taxpayer is entitled to occupy as a stockholder.

Reduced Home Sale Exclusion for Periods of Nonqualified Use

Gain from the sale or exchange of a principal residence allocated to periods of nonqualified use is *not* excluded from gross income. The provision is designed to prevent §121 usage on appreciation attributable to periods where a residence was a rental property or a vacation home before being a principal residence.

Computation

The amount of gain allocated to periods of nonqualified use is the amount of gain multiplied by a fraction the numerator of which is the aggregate periods of nonqualified use during the period the property was owned by the taxpayer and the denominator of which is the period the taxpayer owned the property. Nonqualified use does not include any use prior to 2009.

Note: The provision does not require a market appraisal of the property on January 1, 2009, nor when use is converted to a principal resi-

dence but, rather determines the excluded appreciation on a pro-rata basis over time.

Nonqualified Use

A period of nonqualified use means any period (not including any period before 2009) during which the property is not used by the taxpayer or the taxpayer's spouse or former spouse as a principal residence. For purposes of determining periods of nonqualified use, the following are not taken into account:

(1) any period after the last date the property is used as the principal residence of the taxpayer or spouse (regardless of use during that period), *and*

(2) any period (not to exceed two years) that the taxpayer is temporarily absent by reason of a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances.

Post-May 6, 1997 Depreciation

If any gain is attributable to post-May 6, 1997, depreciation, the exclusion does not apply to that amount of gain, as under present law, and that gain is not taken into account in determining the amount of gain allocated to nonqualified use.

Surviving Spouse Home Sale Exclusion

The maximum exclusion on the sale of a main home by an unmarried surviving spouse is $500,000 if the sale occurs no later than 2 years after the date of the other spouse's death. However, this rule applies only if the requirements for joint filers relating to ownership and use were met immediately before the date of such death, and during the 2-year period ending on the date of such death, there was no sale or exchange of a main home by either spouse which qualified for the exclusion.

Installment Sales - §453

An installment sale is a sale of property where a taxpayer receives at least one payment after the tax year of the sale. In an installment sale, the taxpayer reports part of their gain when they receive each payment. However, taxpayers cannot use the installment method to report a loss. In addition, the installment sale rules do not apply to the regular sale of inventory.

General Rules

The installment method is available for reporting income from the following:

(1) dispositions of personal property by a person who does not regularly sell or otherwise dispose of personal property on the installment plan, *and*

(2) disposition of real property that is not held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business.

The installment method for reporting dispositions of property applies automatically to all deferred payment sales unless the taxpayer elects not to have the provisions apply with respect to a particular sale. The election is made by reporting an amount realized equal to the selling price on the face of the return in the year of sale. In addition, the election once made, is irrevocable except with IRS consent.

The amount of any payment that represents income to the taxpayer is that portion of the installment payment actually received in the year times the gross profit ratio. The gross profit ratio is the total gain divided by the contract price.

Dealer Sales

The installment method is not available for dealers in personal property with these exceptions:

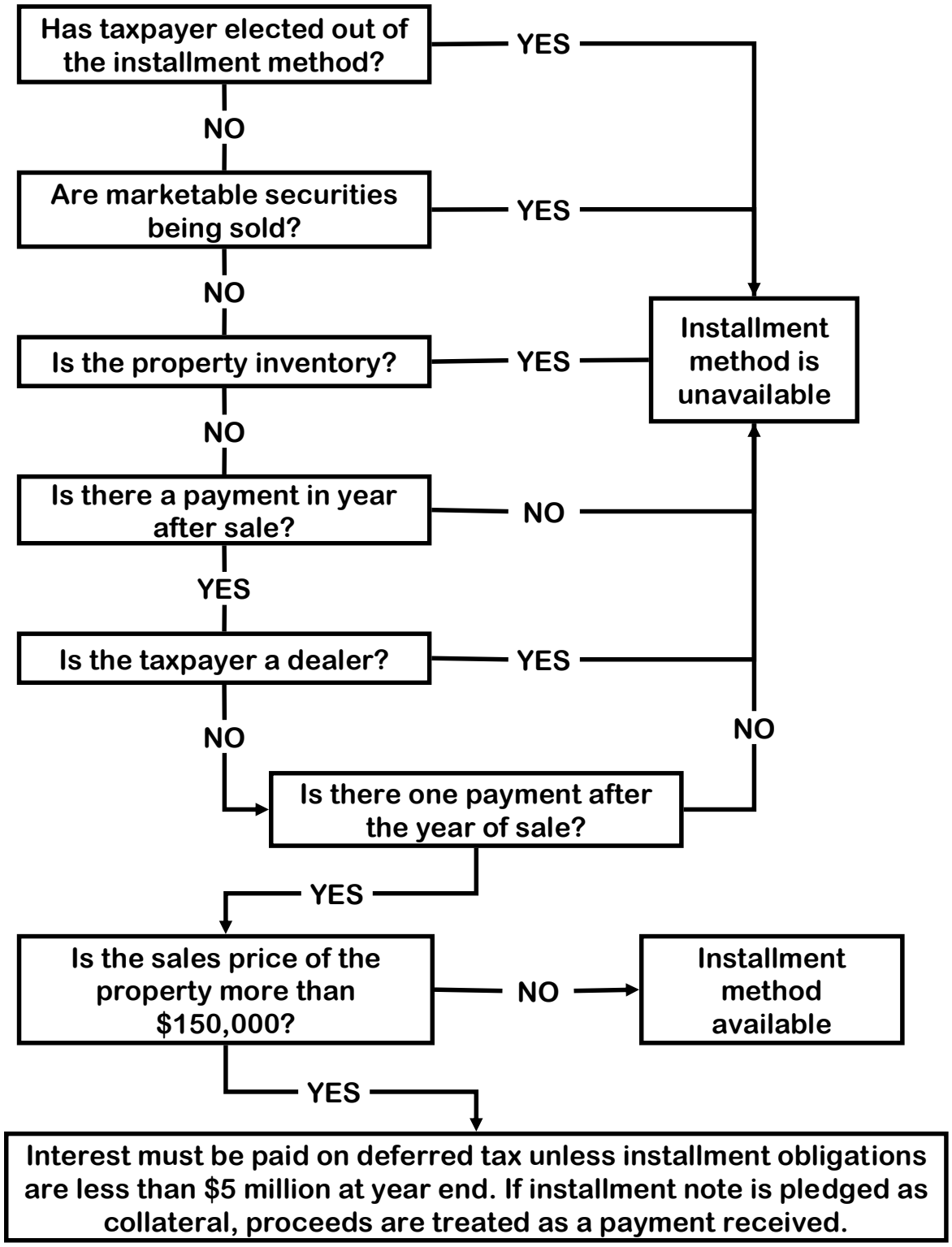
(1) dispositions of any property used or produced in the trade or business of farming, *and*

(2) dispositions of certain timeshare rights and residential lots; however the dealer must elect to pay interest on the amount of taxes deferred by installment reporting.

Unstated Interest

If a sale calls for payments in a later year and the sales contract provides for little or no interest, unstated interest may have to be figured, even if there is a loss.

Installment Sales



Related Party Two-Year Rule - §453(e)

If an installment sale is made to a related party who then makes a second disposition within two years of the first disposition and before all payments are made on the final disposition, part or all of the amount realized by the seller in the second disposition is treated as being received by the original seller at the time of the second disposition.

Example

Mrs. Smith sells her home to her daughter for $150,000. The home cost Mrs. Smith $50,000. Her daughter paid Mrs. Smith $20,000 and gave her a note for $130,000. The daughter immediately sells the home to a third party for a single payment of $150,000. There is no gain on the daughter's sale, but the family unit has received the full selling price. Because of the resale rule, Mrs. Smith must recognize the entire gain on sale of the residence regardless of whether or not her daughter makes payment on the original note.

Related persons for this purpose include spouses, brothers and sisters, children, grandchildren, parents, a 50%-owned corporation, and partnerships, trusts, and estates that are related parties to a person under the general corporate stock ownership attribution rules.

All payments to be received are considered received in the tax year in which the related party sale (second disposition) occurs in the case of an installment sale of depreciable property between related persons.

Related person sales for this purpose include:

(1) sales between a person and a controlled entity,

(2) sales between a taxpayer and a trust that has the taxpayer or his or her spouse as a beneficiary, unless the beneficiary's interest is a remote contingent interest, *and*

(3) sales between an employer and a welfare benefit fund controlled directly or indirectly by the employer.

Disposition of Installment Notes - §453B

If an installment obligation is distributed, transmitted, or disposed of other than by sale, exchange, or satisfaction, gain or loss is recognized, making the entire profit still to be recognized taxable at once.

> **Note:** An installment obligation can be in the form of a deed of trust, note, land contract, mortgage, or other evidence of debt.

The gain or loss is the difference between the basis of the obligation and its fair market value at the time of its disposition.

Taxable dispositions include:

(1) gift,

(2) assignment to a trust by a dissolving partnership, *and*

(3) transfer by an individual to an irrevocable trust.

The following are *not* taxable dispositions:

(1) the transmission of an installment obligation at death, *and*

(2) distribution in certain tax-free corporate reorganizations, liquidations, and contributions to the capital of a corporation or a partnership.

Determining Installment Income

Each payment on an installment sale usually consists of the following three parts:

(1) interest income,

(2) return of adjusted basis in the property, *and*

(3) gain on the property

In each year a payment is received, the taxpayer must include the interest part in income, as well as the part that is their gain on the sale. Taxpayers do not include in income the part that is the return of their basis in the property. Basis is the amount of the taxpayer's investment in the property for tax purposes.

> **Note:** If the taxpayer took depreciation deductions on the asset, they may need to recapture part of the gain on the sale as ordinary income.

If the buyer assumes a mortgage that is more than the taxpayer's installment sale basis in the property, the selling taxpayer recovers their entire basis. The selling taxpayer is also relieved of the obligation to repay the amount borrowed. The part of the mortgage greater than the taxpayer's basis is treated as a payment received in the year of sale.

Use Form 6252 to report an installment sale in the year it takes place and to report payments received in later years. Attach it to the tax return for each year.

Installment Sale Worksheet

Part I - Gross Profit

1. Sales Price	$_____
Less:	
2. Adjusted basis of property sold	$_____
Less:	
3. Selling expenses	$_____
Equals:	
4. Gross profit	$_____

Part II - Contract Price

5. Cash downpayment $_____

Plus:

6. Fair market value of other property received $_____

Plus

7. Face value of purchaser's note $_____

Plus

8. Excess of assumed mortgage over adjusted basis $_____

Equals:

9. Contract price $_____

Part III - Gross Profit Percentage

10. Divide item 4 by item 9 _____%

Part IV - Payments Received in Year of Sale

11. Cash downpayment $_____

Plus:

12. Fair market value of other property received $_____

Plus:

13. Principal payments on purchaser's note $_____

Plus:

14. Excess of assumed mortgage over adjusted basis $_____

Equals:

15. Payments in year of sale $_____

Part V - Recognized Gain

16. Payments received in year of sale (item 15) $_____

Times:

17. Gross profit percentage (item 10) X_____

Equals:

18. Recognized gain $_____

Pledging Rule

If a taxpayer uses an installment obligation to secure any debt, the net proceeds from the debt may be treated as a payment on the installment obligation (§453A(d)(1)). This is known as the pledging rule and it applies if the selling price of the property is over $150,000. It does not apply to the following dispositions:

(1) sales of property used or produced in farming,

(2) sales of personal-use property, *and*

(3) qualifying sales of time-shares and residential lots.

Escrow Account

In some cases, the sales agreement or a later agreement may call for the buyer to establish an irrevocable escrow account from which the remaining installment payments (including interest) are to be made. These sales cannot be reported on the installment method. The buyer's obligation is paid in full when the balance of the purchase price is deposited into the escrow account.

> **Note:** If an escrow arrangement imposes a substantial restriction on the taxpayer's right to receive the sale proceeds, the sale can be reported on the installment method, provided it otherwise qualifies.

Depreciation Recapture

If a taxpayer sells property for which they claimed a depreciation deduction, they must report any depreciation recapture income in the year of sale, whether or not an installment payment was received that year.

Like-Kind Exchange

If, in addition to like-kind property, a taxpayer receives an installment obligation in a §1031 exchange as boot, the following rules apply:

(1) the contract price is reduced by the FMV of the like-kind property received in the trade,

(2) the gross profit is reduced by any gain on the trade that can be postponed, *and*

(3) like-kind property received in the trade is not considered payment on the installment obligation.

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88. Section 121 provides homeowners with an exclusion for gains on the sale of a personal residence. Under §121, who can be entitled to a $500,000 exclusion on the sale of their principal residence?

a. a single taxpayer who marries a taxpayer who has used the exclusion within two years.

b. married couples filing a joint return and using the property as their principal residence for at least one year during a five-year period.

c. married couples sharing a principal residence and filing a joint return.

d. married couples who have sold a primary residence in the preceding two years.

89. If a taxpayer fails to meet the home sales exclusion requirement, he or she may still be entitled to a prorated exclusion. This exclusion may be available if the failure to satisfy the requirements was due to:

a. an uncooperative spouse.

b. being on vacation.

c. having an irresponsible tenant.

d. an illness.

90. Under §453, a portion of any gain must be reported when each installment sale payment is received. If all other requirements are met under §453, when is the installment method available?

a. The property sold is not inventory.

b. The entire purchase price will be received in the year of sale.

c. The taxpayer is a dealer.

d. There are marketable securities being sold.

91. Under §453B, if there is a disposition of an installment sale note, the fair market value of the obligation is subtracted from its basis to determine the gain or loss. However, which of the following dispositions is tax-free?

a. a gift.

b. an individual's transfer to an irrevocable trust.

c. a transfer of an installment obligation at death.

d. a transfer to a trust by a dissolving partnership.

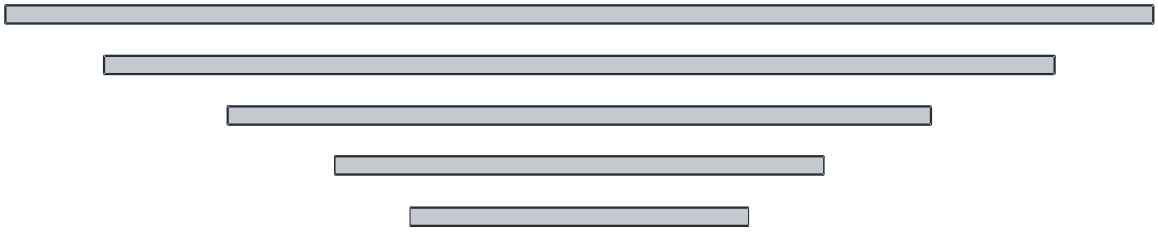
92. Three rules apply when a taxpayer receives an installment obligation along with like-kind property in a §1031 exchange. What is one of these three rules?

a. The taxpayer does not have to report any part of their gain.

b. The contract price includes the fair market value of the exchanged like-kind property.

c. Any gain on the exchange that may be deferred reduces gross profit.

d. The exchanged like-kind property is deemed a payment on the installment obligation.



Repossessions - §1038

When, after making an installment sale, a seller repossesses their property from the buyer, the seller must figure:

(1) gain (or loss) on the repossession, *and*

(2) basis in the repossessed property (§1038; Reg. §1.1038-1).

The rules for doing this depend on the kind of property repossessed. The rules for repossession of *personal* property differ from those for *real* property. Special rules may also apply if the repossessed property was the seller's principal residence before the sale (Reg. §1.1038-1; Reg. §1.1038-2).

The repossession rules apply *whether or not* title to the property was ever transferred to the buyer. Nor does it matter how the property was repossessed, whether foreclosed on or the buyer voluntarily surrendered the property to the seller. However, it is *not* a repossession if the buyer puts the property up for sale and the seller repurchases it (Reg. §1.1038-1(a)(3)).

For the repossession rules to apply, the repossession must at least partially discharge (satisfy) the buyer's installment obligation to the seller (Reg. §1.1038-1). The discharged obligation must be secured by the property the seller repossesses. This requirement is met if the property is auctioned off after the seller forecloses and the seller applies the installment obligation to their bid price at the auction (Reg. §1.1038-1(a)(3)).

The seller reports gain or loss from repossession on the same form used to report the original sale. If the seller reported the sale on Form 4797, Form 4797 is used to report the gain or loss on the repossession.

Personal Property

When sellers repossess personal property, they may have a gain or a loss on the repossession. In some cases, they may also end up with a bad debt.

To figure gain or loss, subtract the seller's basis in the installment obligation and any expenses the seller has for the repossession from the fair market value of the property. If the seller receives anything from the buyer in addition to the repossessed property, it is added to the property's fair market value before making this subtraction (§453B(f)(1)).

The way the seller figures their basis in the installment obligation depends on whether or not they reported the original sale using the installment method. The method the seller used to report the original sale also affects the character of the gain or loss on the repossession.

Non- Installment Method Sales

Basis of Installment Obligation

For non-installment method sales, the seller's basis in the installment obligation is figured on its full face value or its *fair market value* at the time of the original sale, whichever the seller used to figure their gain or loss in the year of sale. From this amount, all *principal* payments the seller has received on the obligation are subtracted. Any repossession expenses are added to the seller's basis in the obligation. The result is the seller's basis in the installment obligation.

> **Note:** If only a part of the obligation is discharged by the repossession, basis is figured only on that part.

Gain or Loss on Repossession

If the *fair market value* of the property repossessed is more than this total, the seller has a gain. Because the gain is gain on the installment obligation, it is all ordinary income. If the fair market value of the repossessed property is less than the total of basis plus repossession expenses, the seller has a loss. Because the loss is a loss on the installment obligation, it is a *bad debt* loss. How the loss is deducted depends on whether the seller sold *business* or *nonbusiness* property in the original sale (§166(d)(1); §453B(f)(1)).

Installment Method Sales - §453

Basis of Installment Obligation

For installment method sales (§453), the seller's basis in the installment obligation is its face value at the time of repossession minus the unreported profit - i.e., gain the seller would report as income in the future if they held the obligation to maturity (§453B(b); Reg. §1.453-1(d)).

Note: If only a part of the installment obligation is discharged by the repossession, basis is figured only on that part.

Gain or Loss on Repossession

The gain or loss on repossession is the same character as the gain on the original sale. If the seller had a long-term capital gain on the original sale, they will have a long-term capital gain or loss on the repossession. If the seller's original gain was ordinary, their gain or loss on the repossession is also ordinary (§453B(a)).

The following worksheet can be used to determine the taxable gain or loss on a repossession of *personal* property reported on the *installment method*.

Worksheet

1. Fair market value of property repossessed	$_____
2. Selling price	$_____
3. Minus: Payments made before repossession	$_____
4. Face value of obligation at the time of repossession	$_____
5. Minus: Unrealized profit (amount on line 4 times gross profit percentage)	$_____
6. Basis of obligation (amount on line 4 minus amount on line 5)	$_____
7. Gain or loss on repossession (amount on line 1 minus amount on line 6)	$_____
8. Minus: Repossession costs	$_____
9. Taxable gain or loss on repossession	$_____

Example

You sold your piano for $1,500 in December 2024 for $300 down and $100 a month (plus interest). The payments began in January 2025. Your gross profit percentage is 40%. You reported the sale on the installment method on your 2024 income tax return. After the fourth monthly payment, the buyer defaults on the contract and you are forced to foreclose on the piano. The fair market value of the piano on the date of repossession is $1,400. The legal costs of foreclosure and the expense of moving the piano back to your home total $75. You figure your gain on the repossession as follows:

1) Fair market value of property repossessed		*$1,400*
2) Selling price	*$1,500*	
3) Minus: Payments made before repossession	*$700*	
4) Face value of obligation at time of repossession	*$800*	
5) Minus: Unrealized profit (amount on line 4 times gross profit percentage)	*$320*	
6) Basis of obligation (amount on line 4 minus the amount on line 5)		*$480*
7) Gain or loss on repossession (amount on line 1 minus amount on line 6)		*$920*
8) Minus: Repossession costs		*75*
9) Taxable gain or loss on repossession		*$845*

Basis of Repossessed Personal Property

The basis of the repossessed personal property is its *fair market value* at the time of the repossession (Reg. §1.166-6(c)).

The fair market value of repossessed property is a question of fact to be established in each case. If the seller bids for the property at a lawful public auction or judicial sale, its fair market value is presumed to be the price it sells for, unless there is clear and convincing evidence to the contrary (Reg. §1.166-6).

Bad Debt

If the installment obligation is not fully satisfied by the repossession, the same circumstances that led the seller to repossess the property may mean that the seller cannot collect on the rest of the buyer's debt to the seller. If the seller cannot collect, they may be able to take a bad debt de-

duction for that part of the installment obligation. This rule also applies to sales *not* reported under the installment method (§166).

Real Property

The rules for repossessions of real property allow the seller to keep essentially the same adjusted basis in the repossessed property as they had before the original sale. The seller can recover this entire adjusted basis when they resell the property. This, in effect, cancels out the tax treatment the seller had on the original sale and puts them in the same tax position they were in before that sale (Reg. §1.1038-1).

Thus, the full amount of any payments the seller already received from the buyer on the original sale must be regarded as *income* to the seller. The seller reports, as gain on the repossession, any part of those payments that they did not yet include in their income, that is, the part that was regarded as a return of adjusted basis rather than as gross profit (Reg. §1.1038-1(b)(1); Reg. §1.1038-1(c)(1)).

Conditions

The following rules are mandatory and must be used to figure basis in the repossessed real property and gain on the repossession. They apply whether or not the sale was reported on the installment method.

However, they apply only if *all* of the below conditions are met:

(1) the repossession must be to protect the seller's security rights in the property;

(2) the installment obligation satisfied by the repossession must have been received in the original sale; *and*

(3) the seller cannot pay any *additional consideration* to the buyer to get the property back, *unless* either:

(a) the reacquisition and payment of the additional consideration were provided for in the original contract of sale, *or*

(b) the buyer has defaulted, or default is imminent (Reg. §1.1038-1(a)(1); Reg. §1.1038-1(a)(3)(i)).

Note: *Additional consideration* includes money and other property the seller pays or transfers to the buyer. For example, additional consideration is present if the seller reacquired the property subject to an indebtedness that arose after the original sale (Reg. §1.1038-1(a)(3)(i)).

If any of the three conditions is not met, the rules discussed earlier under personal property must be used, as if the property repossessed was *personal* rather than real property (Reg. §1.1038-1(a)(1); Reg. §1.1038-1(a)(3)).

Figuring Gain on Repossession

The seller's gain on repossession is the difference between:

(1) the total payments received, or considered received, on the sale, *and*

(2) the total gain already reported as income (Reg. §1.1038-1(b)(1)(i)).

Limit on Taxable Gain

There is a limit on the amount of gain that is taxable. Taxable gain is limited to the gross profit on the original sale, minus the sum of:

(a) the gain on the sale seller reported as income before the repossession, *and*

(b) the seller's *repossession costs*.

This method of figuring taxable gain, in essence, treats all payments the seller received on the sale as income but limits total taxable gains to the gross profit the seller originally expected on the sale (Reg. §1.1038-1(c)(1)).

Repossession Costs

Repossession costs include money or property paid for the reacquisition of the real property. This includes amounts paid to the buyer of the property as well as amounts paid to others for such items as court costs and legal fees. Repossession costs do not include the fair market value of the buyer's obligations to the seller that are secured by the real property (Reg. §1.1038-1(c)(1)(iii); Reg. §1.1038-1(c)(4)).

The following worksheet can be used to determine the taxable gain on repossession of *real property* reported on the *installment method*.

Worksheet

1. Payments received before repossession	$_____
2. Minus: Gain reported (amount on line 1 times gross profit percentage)	$_____
3. Gain on repossession	$_____
4. Gross profit on sale	$_____
5. Gain reported (amount on line 2)	$_____
6. Plus: Repossession costs	$_____
7. Subtract amount on line 6 from amount on line 4	$_____
8. Taxable gain (lesser of amount on line 3 or 7)	$_____

Example

You sold a tract of land in January 2024 for $25,000. You accepted from the buyer a $5,000 downpayment, plus a $20,000 (9.5%) mortgage secured by the property and payable at the rate of $4,000 annually plus interest. The payments began on January 1, 2025. Your adjusted basis in the property was $19,000 and you reported the transaction as an installment sale. Your selling expenses were $1,000. You figured your gross profit as follows:

Selling price		*$25,000*
Minus:		
Adjusted basis	*$19,000*	
Selling expenses	*$ 1,000*	*$20,000*
Gross profit		*$ 5,000*

For this sale, the contract price equals the selling price. Therefore, the gross profit percentage is 20%. This is figured by dividing the gross profit of $5,000 by the contract price of $25,000.

In 2024, you included $1,000 in your income (20% of the $5,000 down payment). In 2025, you reported profit of $800 (20% of the $4,000 annual installment). In 2025, the buyer defaulted and you repossessed the property. You spent $500 in legal fees to get your property back. Your gain on the repossession is figured as follows:

Payments received ($5,000 + $4,000)		*$9,000*
Minus: Gain previously reported as income ($1,000 + $800)	*$1,800*	
Gain		*$7,200*

Not all of this gain is taxable. The limit on taxable gain is figured as follows:

Gross profit on original sale		*$5,000*
Minus:		
Gain previously reported as income	*$1,800*	
Repossession costs	*$500*	*$2,300*
Taxable gain on repossession		*$2,700*

Indefinite Selling Price

The limit on taxable gain does *not* apply if the selling price is indefinite and cannot be determined at the time of repossession. For example, a selling price that is stated as a percentage of the profits to be realized from the buyer's development of the property is an indefinite selling price (Reg. §1.1038-1(c)(2)).

Character of Gain

The taxable gain on repossession is ordinary income or capital gain, the same as the gain on the original sale. However, if the seller did not report the sale on the installment method, the gain is *ordinary income* (Reg. §1.1038-1(d)).

Basis of Repossessed Real Property

The basis of the repossessed property is determined as of the date of repossession and is the sum of the seller's:

(1) Adjusted basis in the installment obligation,

(2) Repossession costs, *and*

(3) Taxable gain on the repossession (Reg. §1.1038-1(g)(1)).

To figure the adjusted basis on the installment obligation at the time of repossession, subtract any unreported profit (the gain the seller would report as income in the future if they held the obligation to maturity) from its face value at the time of repossession. The face value of the obligation at the time of repossession is the selling price minus the payment received.

The following worksheet can be used to determine the basis of real property repossessed.

Worksheet

1. Face value of obligation at the time of repossession	$_____
2. Minus: Unreported profit (amount on line 1 times gross profit percentage)	$_____
3. Adjusted basis on date of repossession	$_____
4. Plus:	
Taxable gain on repossession	$_____
Repossession costs	$_____
5. Basis of repossessed real property	$_____

Example

Assume the same facts as in the preceding example. The face value of the installment obligation (the $20,000 note) is $16,000 at the time of repossession because the buyer

made a $4,000 payment. The gross profit percentage on the original sale was 20%. Therefore, $3,200 (20% of the $16,000 still due on the note) is unreported profit. You figure your basis in the repossessed property as follows:

Face value of obligation at time of repossession		*$16,000*
Minus: Unreported profit		*$3,200*
Adjusted basis on date of repossession		*$12,800*
Plus: Taxable gain on repossession		*$2,700*
Repossession costs	*$500*	*$3,200*
Basis of repossessed real property		*$16,000*

Holding Period for Resales

If the seller resells the property they repossessed, the resale may result in a capital gain or a capital loss. To figure whether it is a long-term or a short-term gain or loss, the holding period includes the period the seller owned the property before the original sale plus the period after the repossession. It does not include the period the buyer owned the property (Reg. §1.1038-1(g)(3)). If the buyer made improvements to the reacquired property, the holding period for these improvements begins on the day after the date of repossession (Reg. §1.1038-1(f)).

Bad Debt

If the seller repossesses real property under these rules, they *cannot* take a bad debt deduction for any part of the buyer's installment obligation. This is so even if the obligation is not fully satisfied by the repossession.

If the seller already took a bad debt deduction before the tax year of repossession, they are considered to have recovered the bad debt when they repossessed the property. The amount of the bad debt deduction the seller took in the earlier year must be reported as income in the year of repossession. However, if any part of the earlier deduction did not serve to lower the seller's tax, they do not have to report that part as income. The adjusted basis in the installment obligation is increased by the amount reported as income as a recovery of the bad debt (Reg. §1.1038-1(f)(2),(3); §111).

Seller's Former Home Exception

If a taxpayer sold their principal residence and excluded all or part of the gain under §121, then the rule for reporting repossessions of real property is inapplicable provided property is *resold* within one year from the date of reacquisition (§1038(e)). Under §1038(e), the seller does *not* have any gain or loss at the time of repossession. The resale of the property is treated as part

of the original sale of such property. See Reg. §1.1038-2 for further information.

Repossession on Installment Sale Method - §1038

Part I
Computation of Gain on Original Sale

Consideration Received

1. Cash Down	$_____
2. Existing Encumbrance	$_____
3. Purchase Money Trust Deed	$_____
4. FMV of Other Property	$_____
5. Total Sale Price	$_____
Less:	
6. Expense of Sale	$(_____)
7. Adjusted Sales Price	$_____
Less:	
8. Adjusted Basis of Property	$(_____)
9. Realized Gain	$_____

Contract Price

10. Down Payment (Line 1)	$_____
11. Purchase Money Trust Deed (Line 3)	$_____
12. FMV of Other Property (Line 4)	$_____
13. Excess of Mortgage over Basis (Line 2 less 7 plus 8)	$_____
14. Total contract Price	$_____

Gross Profit Ratio

15. Realized Gain (Line 9)	$_____	
16. Divided by Contract Price (Line 14)	$_____	= _____%

Summary of Reported Gain

		Gross Profit Percentage	Reported Gain
17. 20___ Initial Payments in Year of Sale[3]	$_____	_____%	$_____
18. 20___ Payments on Principal	$_____	_____%	$_____
19. 20___ Payments on Principal	$_____	_____%	$_____
20. 20___ Payments on Principal	$_____	_____%	$_____
21. 20___ Payments on Principal	$_____	_____%	$_____
22. 20___ Payments on Principal	$_____	_____%	$_____
23. Total Payments Received	$_____		
24. Total Gain Reported			$_____

Part II
Computation of Repossession Gain under General Rule

Amounts Received with Respect to the Sale

1. Total Amount Received Directly by Seller	$_____

[3] Line 17 includes (1) cash down payment, (2) payments on principal during the year, (3) fair market value of other property, and (4) excess of mortgage over basis.

2. Amount Received on Sale of Purchaser's Indebtedness $_____
3. Payments Made on Mortgage by Purchaser for Seller's Benefit $_____
4. Other Amounts _____ $_____
5. Total Amount Received $_____

Gain Returned As Income

6. Gain Reported as Income (Part I, Line 24) $_____
7. Gain Reported on Sale of Notes $_____
8. Total Gain Reported $_____
9. Gain Before Limitation (Line 5 less 8) $_____

Limitation on Gain

10. Sales Price (Part I, Line 5) $_____
Less:
11. Expenses of Sale (Part I, Line 6) $(_____)
12. Adjusted Basis of Property (Part I, Line 8) $(_____)
13. Net Gain Realized $_____
Less:
14. Reported Gain (Part II, Line 8) $_____
15. Additional amounts Paid or Transferred Upon Reacquisitions
A. Payments to Purchaser or Other Persons $_____
B. Payments to Reacquire Purchaser's Notes $_____
C. Assumption by Seller of Purchaser's Indebtedness Which Arose After Original Sale $_____
D. Advances by Seller on Indebtedness $_____
E. Payments by Seller on Taxes, Insurance, Etc. $_____
F. Foreclosure Costs, Legal Fees, Etc. $_____
16. Total (Lines 14 through 15F) $_____
17. Limitation of Gain[4] (Line 12 less 16 - but not less than zero) $_____
18. Gain on Repossession - Lesser of (A) or (B) $_____

Part III

Determination of Basis For Reacquired Property

1. Original Selling Price (Part I, Line 5) $_____
Less:
2. Existing Encumbrances (Part I, Line 2) $_____
3. Contract Price $_____
4. Payments Received (Part I, Line 23) $_____
5. Unsatisfied Debt (Line 3 minus Line 4) $_____
6. Reduction of Debt of Unreported Gain:
A. Profit Ratio (Part I, Line 15) _____%
7. Unreported Gain (Line 6A times Line 5) $_____
8. Basis of Unsatisfied Debt (Line 5 less 7) $_____

Increased By:

9. Repossession Gain (Part III, Line 18) $_____
10. Payments to Purchaser or Others $_____
11. Payments to Reacquire Purchaser's Notes $_____
12. Assumption by Seller of Purchaser's Indebtedness $_____
13. Advances by Seller on Indebtedness $_____

[4] If Line 17 is a negative amount enter zero. As a result, Line 18 will also be zero.

14. Payments by Seller on Taxes, Insurance, Etc.	$_____	
15. Foreclosure Costs, Legal Fees, Etc.	$_____	
16. Total (Line 9 through 15)	$_____	
17. Basis of Repossessed Property (Line 8 plus 16)	$_____	

Proof of Basis

Adjusted Basis of Property (Part I, Line 8)		$_____
Add:		
Selling Expenses (Part I, Line 7)	$_____	
Gain Previously Reported (Part II, Line 8)	$_____	
Gain on Repossession (Part II, Line 18)	$_____	
Additional Amounts Paid or Transferred (Part II, Line 15a - 15F)	$_____	
Total		$_____
Less:		
Money and Property Received (Part II, Line 5)	$(_____)	
New Basis	$_____	

Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regard to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

93. Reg. §1.1038-1 and Reg. §1.1038-2 lay out the rules for repossessions. However, these rules vary depending on:

a. whether the buyer willingly relinquished the property to the seller.

b. whether the property title was transferred to the buyer.

c. the type of property repossessed.

d. whether the property was foreclosed on.

94. For non-installment method sales, the seller's basis in their note must be determined on repossession. What is added to the seller's basis in the note to figure this basis?

a. all principal payments the buyer has paid on the obligation.

b. any gain the seller would report if they held the obligation to maturity.

c. any repossession expenses.

d. unreported profit.

95. A seller's basis in the installment obligation also must be determined in the repossession of a property sold under the installment sales method. Based on §453, how is the seller's basis figured in such an event?

a. subtract principal payments made by the buyer from its full face value at the time of the original sale.

b. subtract the unreported profit from its face value at the time the property is repossessed.

c. subtract repossession expenses from its original fair market value.

d. add repossession expenses to the gain seller would report as income.

96. Under §166, if repossessing personal property fails to fully satisfy the obligation and the seller is unable to collect on the remainder amount, what may the seller be able to do?

a. keep the same original adjusted basis in the repossessed property.

b. report as a gain any part that was a return of adjusted basis.

c. take a bad debt deduction for that portion of the installment obligation.

d. take a bad debt deduction for the entire installment obligation.

97. When a seller repossesses real property from a buyer, they may recover their adjusted basis upon a resale. In such an event, under Reg. §1.1038-1(b)(1), how is the full amount of any payments received from the buyer on the original sale treated?

a. as condemnation proceeds.

b. as a gain on the repossession.

c. as a loss on the repossession.

d. as income to the seller.

98. Three conditions must be met to figure basis for the repossessed real property and gain on the repossession. What is one of these conditions?

a. Any installment obligation is satisfied and is received in the latest sale.

b. Repossessing the property must protect everyone's security rights.

c. The seller pays any additional consideration that the buyer requires.

d. The buyer may not receive any additional consideration from the seller to get the property back unless default is about to happen.

99. Upon the resale of repossessed real property, a seller may have to report capital gain or loss. For these purposes, the combination of the time the seller owned the property prior to the original sale and the time following the repossession becomes?

a. the exchange period.

b. the identification period.

c. the holding period.

d. the replacement period.

100. A taxpayer may sell her principal residence and exclude all or part of the gain under §121. Thus, the rule for reporting real property repossessions may be inapplicable provided:

a. she has gain at the time of repossession.

b. she has loss at the time of repossession.

c. the resale is not treated as part of the original sale of the property.

d. she resells the property within a year from the date of reacquisition.

Involuntary Conversions - §1033

An involuntary conversion (exchange) occurs when property is destroyed, stolen, condemned, or disposed of under the threat of condemnation, and other property or money is received in payment, such as insurance or a condemnation award.

Gain is not reported if property is involuntarily converted and property that is similar or related in service or use to it is received. The basis for the new property is the same as the basis for the converted property. Thus, the gain on the current transaction is deferred until a taxable sale or exchange occurs.

Condemnations

Condemnation is the process by which private property is legally taken, without the owner's consent, for public use. The federal government, a state government, a political subdivision, or a private organization that has the power to legally take the property may take the property. The owner receives money or property in exchange for the taken property. A condemnation is like a forced sale, with the owner being the seller and the condemning authority being the buyer.

Example

A local government authorized to acquire land for public parks told Dan that it wished to acquire his property. After the local government took action to condemn Dan's property, he went to court to keep the property. However, the court decided in favor of the local government. The government took Dan's property and paid him an amount fixed by the court. This is a condemnation of private property for public use.

Threat of Condemnation

A taxpayer is under threat of condemnation if a representative of a government body or a public official authorized to acquire property for pub-

lic use tells the taxpayer that the government body or official has decided to acquire their property. From this, there are reasonable grounds to believe that if the taxpayer does not sell voluntarily, their property will be condemned.

A taxpayer is under threat of condemnation if they sell their property to someone other than the condemning authority, provided there are reasonable grounds to believe that their property will be condemned. If the buyer of this property knows it is under threat of condemnation at the time of purchase and sells the property to the condemning authority, such a forced sale will also qualify as a condemnation.

Reports of Condemnation

A taxpayer is under threat of condemnation if they learn of a decision to acquire their property for public use through a report in a newspaper or other news media, and this report is confirmed by a representative of the government body or public official involved.

There must be reasonable grounds to believe that necessary steps will be taken to condemn the property if the taxpayer does not sell voluntarily. If oral statements made by a government representative or public official were relied upon, the IRS may ask the taxpayer to provide written confirmation of the statements.

Example

Dan's property lies along public utility lines. The utility company has the authority to condemn property. They notify Dan that they intend to acquire his property by negotiation or condemnation. Dan's property was under threat of condemnation when he received the notice.

Property Voluntarily Sold

A voluntary sale of property may be treated as a forced sale that qualifies as a condemnation if the property had a substantial economic relationship to property that was condemned.

A substantial economic relationship exists if together the properties are one economic unit. It must be shown that a suitable nearby property of a like-kind (the same or similar) to the condemned property is not available, and the taxpayer cannot continue to do business as before.

This treatment will not apply to the taxpayer if they do not own both properties.

Easements

If a taxpayer grants an easement on their property (e.g., a right-of-way over it) under condemnation or threat of condemnation, they are considered to have made a forced sale, even though legal title is retained. Although gain or loss on the easement is determined in the same way as a sale of property, the gain or loss is treated as a gain or loss from a condemnation.

Example

The Department of Agriculture is authorized to acquire any lands or interest in them for the protection of the historic, cultural, and scenic values of an area. The Department informed Dan in writing that condemnation proceedings would be started unless he agrees to sell voluntarily a scenic easement over his property. Dan will have made a forced sale when he gives up any use of his property by the sale.

Condemnation Award

A condemnation award is the money paid or the value of other property received for the condemned property. The award is also the amount paid for the sale of property under threat of condemnation.

Amounts Withheld From Award

Amounts withheld from the award to pay the taxpayer's debts are considered paid to the taxpayer. Amounts paid directly to the holder of a mortgage or other lien (i.e., claim) against the property are part of the award, even though the debt attaches to the property and is not a personal liability.

Example

The state condemned Dan's property for public use. The award was set at $200,000. The state paid Dan only $148,000 because it paid $50,000 to his mortgage holder and $2,000 accrued real estate taxes. Dan is considered to have received the entire $200,000 as a condemnation award.

Net Condemnation Award

A net condemnation award is a total award actually or constructively received for the condemned property minus the expenses of obtaining the award. If only part of a property was condemned, the award must

be reduced by any severance damages and any special assessment levied against the part of the property retained.

Interest on Award

If the condemning authority pays interest for its delay in payment of the award, it is not part of the condemnation award. The interest should be reported separately as ordinary income.

Payments to Relocate

Payments received to relocate and replace housing because the taxpayer has been displaced from their home, business, or farm as a result of federal or federally assisted programs are not part of the condemnation award. They are not included in income. The replacement housing payments are added to the cost of the taxpayer's newly acquired property.

Severance Damages

Severance damages are compensation paid if part of a property is condemned and the value of the part retained is decreased because of the condemnation.

If part of a property is condemned, the part retained may be damaged as a result of the condemnation. For example, severance damages may be received if the retained property is subject to flooding. Severance damages may also be given if the taxpayer must replace fences, dig new wells or ditches, or plant trees to restore the remaining property to the same usefulness it had before the condemnation.

The contracting parties should agree on the amount of the severance damages and put that in writing. If this is not done, all the proceeds from the condemning authority are considered awarded for the condemned property.

Example

Dan transferred part of his property to the state under threat of condemnation. To figure the total award for the condemned part, Dan and the condemning authority agree to severance damages for the part Dan kept. The contract Dan and the authority signed showed only the total award. It did not specify a fixed sum for severance damages. However, when the condemning authority paid Dan the award, it gave him closing papers that clearly showed that part of the award was for severance damages. Dan may treat this part as severance damages.

A completely new allocation of the total award may not be made after the transaction is completed. However, taxpayers may show how much of the award both parties intended for severance damages. The severance damages part of the award is determined from all the facts and circumstances.

Treatment of Severance Damages

Expenses in obtaining the damages must first reduce severance damages. They are then reduced by any special assessment levied against the remaining part of the property if the assessment was withheld from the award by the condemning authority. The balance is the net severance damages. The basis of the remaining property is then reduced by the net severance damages.

If the amount of severance damages is based on damage to a specific part of a property the taxpayer kept, they may reduce only the basis for that part by the net severance damages.

When the net severance damages are more than the basis of the retained property, the taxpayer has a gain. The taxpayer may choose to postpone the gain by purchasing replacement property.

If the remaining property is restored to its former use, the cost of restoring it can be treated as the cost of replacement property. Taxpayers can also make this choice if they spend the severance damages, together with other money received for the condemned property, to acquire nearby property that will allow them to continue their business.

Expenses of Obtaining an Award

Subtract the expenses of obtaining a condemnation award, such as legal, engineering, and appraisal fees, from the amount of the total award. The expenses of obtaining severance damages must also be subtracted from the severance damages paid. If part of the condemnation award is for severance damages, determine which part of the expenses is for each part of the award. If this cannot be done, a proportionate allocation must be made.

Example

Dan received a condemnation award. One-fourth of it was stated in the award as severance damages. Dan had legal expenses in connection with the entire condemnation proceeding. He cannot determine how much of his legal expenses are for each part of the award. Dan must allocate one-fourth of his legal expenses to the severance damages and the other three-fourths to the award for the condemned property.

Special Assessment Withheld from Award

When part of a property is condemned, the condemnation award must be reduced by the expenses of obtaining the award *and* by any amount withheld because of a special assessment levied against the remaining property.

An assessment may be levied if the remaining part of the property is benefited by the improvement resulting from the condemnation. Examples of improvements that may cause a special assessment are the widening of a street or the installation of a sewer.

The assessment must be withheld from the award. The award cannot be reduced by any assessment levied after the award is made, even if the assessment is levied in the same year the award is made.

Example

To widen the street in front of Dan's home, the city acquired 25 feet of his land. Dan was awarded $5,000 for this and spent $300 to get the award. Before paying the award, the city levied a special assessment of $700 for the street improvement against Dan's remaining property. The city then paid Dan only $4,300. His net award is $4,000 ($5,000 total award minus $300 expenses in obtaining the award and $700 for the special assessment withheld).

If the $700 special assessment was not withheld from the award, and Dan was paid $5,000, his net award would be $4,700 ($5,000 minus $300). The net award is not changed, even if Dan later paid the assessment from the amount received.

Severance Damages Included in Award

If severance damages are included in the award, the severance damages must first be reduced by the special assessment withheld. Any balance is used to reduce the condemnation award.

Example

Assume that in the previous example, Dan was awarded $4,000 for the condemned property and $1,000 for severance damages. Dan spent $300 to obtain the severance damages. A special assessment of $800 was withheld from the award. The $1,000 severance damages are reduced to zero by first subtracting the $300 expenses and then $700 of the special assessment. Dan's award for the condemned property, $4,000, is reduced by the $100 balance of the special assessment, leaving a net condemnation award of $3,900.

Gain or Loss from Condemnations

If the net condemnation award is more than the adjusted basis of the condemned property, there is a gain. This gain may be postponed.

If the award is less than the taxpayer's adjusted basis, there is a loss. If the loss is from property held for personal use, it is a nondeductible loss.

How to Figure Gain or Loss

If property is condemned, gain or loss is determined by comparing the adjusted basis of the condemned property with the award received minus the expenses of obtaining it.

Part Business or Part Rental

If part of the condemned property was used as the taxpayer's home and part as business or rental property, each part must be treated as a separate property and gain or loss is figured separately for each part because gain or loss may be treated differently.

Some examples of this type of property are a farm or ranch the taxpayer operates and lives on, a building in which the taxpayer lives and operates a grocery or a building in which the taxpayer lives on the first floor and rents out the second floor.

Postponement of Gain

Gain on condemned, damaged, destroyed, or stolen property is not reported if the taxpayer receives property that is similar or related in service or use to it. The basis for the new property is the same as the basis for the old property.

Choosing to Postpone Gain

Gain must be reported if money or unlike property is received as reimbursement. However, taxpayers can choose to postpone reporting the gain if they purchase:

(i) property that is similar or related in service or use to the condemned, damaged, destroyed, or stolen property, *or*

(ii) a controlling interest (at least 80%) in a corporation owning property that is similar or related in service or use to the property

within a specified replacement period.

If the taxpayer is a member of a partnership or a shareholder in a corporation that owns the condemned, damaged, destroyed, or stolen property, only the partnership or corporation, and not the taxpayer, can choose to postpone reporting the gain.

Cost Test

To postpone all the gain, the cost of the replacement property must be equal to or more than the amount realized (reimbursement) for the condemned, damaged, destroyed, or stolen property.

Replacement Period

To postpone reporting gain from a condemnation the taxpayer must buy replacement property within a specified period of time. This is the "replacement period."

Condemnation

The replacement period for a *condemnation* begins on the earlier of:

(i) the date on which the condemned property was disposed of, *or*

(ii) the date on which the threat of condemnation began.

The replacement period ends *2 years* after the close of the first tax year in which any part of the gain on the condemnation is realized.

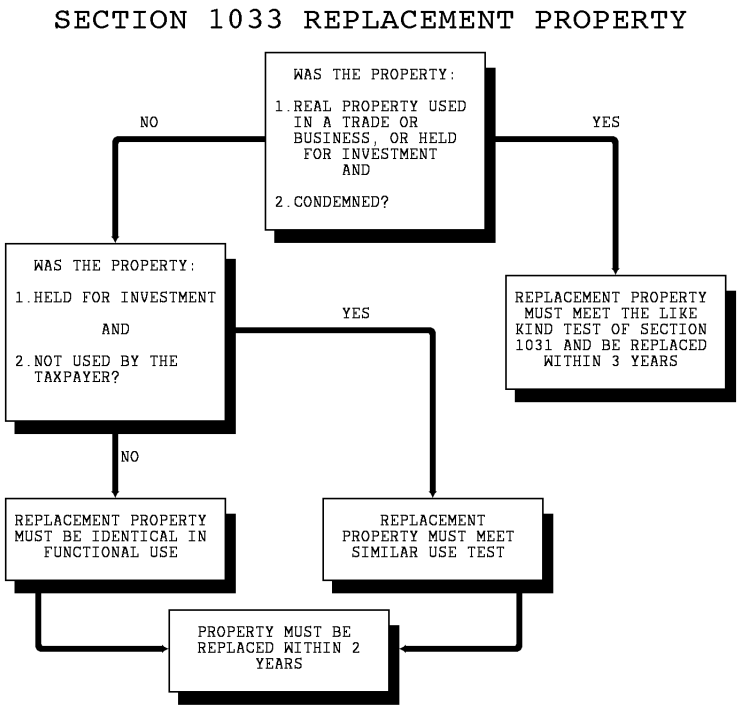
If *real property held for use in a trade or business or for investment* (not including property held primarily for sale) is condemned, the replacement period ends *3 years* after the close of the first tax year in which any part of the gain on the condemnation is realized.

Replacement Property Acquired Before the Condemnation

If the replacement property is acquired after there is a threat of condemnation but before the actual condemnation, and the taxpayer still holds the replacement property at the time of the condemnation, the replacement property is deemed acquired within the replacement period. Property acquired before there is a threat of condemnation does not qualify as replacement property acquired within the replacement period.

Example

On April 3, 2024, city authorities notified Dan that his property would be condemned. On June 5, 2024, Dan acquired property to replace the property to be condemned. Dan still had the new property when the city took possession of his old property on September 5, 2025. Dan made a replacement within the required replacement period.



Extension

An extension of the replacement period may be granted if application is made to the District Director. The application should be made before the end of the replacement period and contain all the details about the need for the extension.

An application may be filed within a reasonable time after the replacement period ends if reasonable cause can be shown for the delay. An extension of time will be granted if reasonable cause for not making the replacement within the regular period is established.

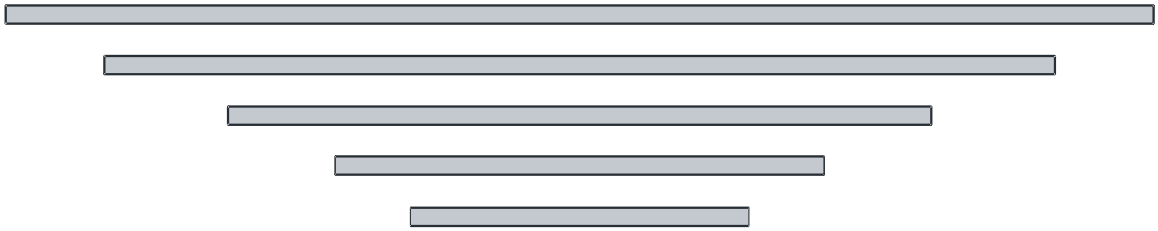
Ordinarily, requests for extensions are granted near the end of the replacement period or the extended replacement period. Extensions are usually limited to a period of one year or less.

The high market value or scarcity of replacement property is not a sufficient reason for granting an extension. If the replacement property is

being constructed and the replacement or restoration cannot be made within the replacement period, an extension of the period is normally granted.

Time for assessing a deficiency

If the taxpayer chooses not to recognize gain from a condemnation, any deficiency for any tax year in which part of the gain is realized may be assessed at any time before the expiration of 3 years from the date the District Director is notified that the taxpayer is replacing the condemned property, or intends not to replace, within the required replacement period.



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101. A federal or federally assisted program may require and pay for a taxpayer to move to another location. Under §1033, how are such relocation payments treated?

a. They are added to the cost of the taxpayer's new property.

b. They are §217 deductible moving expenses.

c. They are included in income.

d. They are part of the condemnation award.

102. When part of a property is condemned and another part of the property has its value decreased due to the condemnation, the taxpayer may receive severance damages. In such an event, how are such severance damages initially reduced?

a. by any special assessment levied against the remaining part of the property.

b. by costs in getting the damages.

c. by the basis of the remaining property.

d. by a prorata share of the condemnation award.

103. Under which circumstance would the reporting of gain on condemned, damaged, destroyed, or stolen property be unnecessary under §1033?

a. A corporation of which the taxpayer is a shareholder owns the property.

b. Compensation or property is received from a governmental agency.

c. Part of the condemned property was used as the taxpayer's home and part as business or rental property.

d. Property that is similar or related in service or use to it is received.

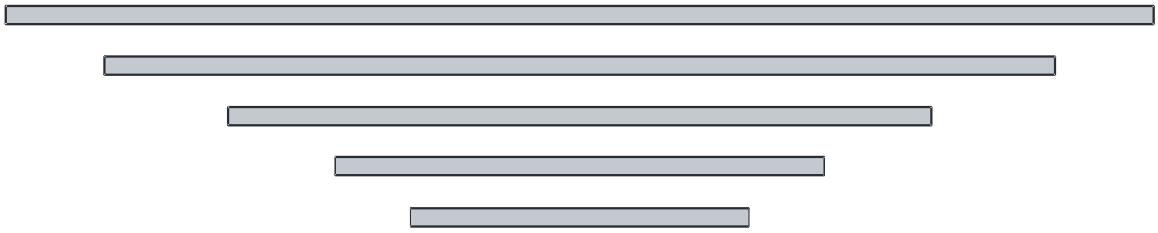
104. The author lists several transactions whereby taxpayers may postpone reporting gain on condemned property. However, which of the following transactions would deny taxpayer this postponement option?

a. They buy a controlling interest in a corporation owning property that is similar to the condemned property.

b. They buy less than an 80% interest in a corporation owning property that is similar to the condemned property.

c. They buy property that is related in use to the condemned property.

d. They buy property that is similar in service to the condemned property.



At-Risk Limits for Real Estate - §465 [Form 6198]

The at-risk rules limit losses from most activities to the amount at risk in the activity. The at-risk limits apply to individuals and to certain closely held corporations (other than S corporations). Moreover, the at-risk rules affect real estate and must be applied before the §469 passive activity rules. Any loss that is disallowed because of the at-risk limits is treated as a deduction from the same activity in the next tax year.

Amount At Risk

A taxpayer is at risk in any activity for:

(1) the money and adjusted basis of property contributed to the activity, *and*

(2) amounts borrowed for use in the activity if the taxpayer:

(a) is personally liable for repayment, *or*

(b) pledges property (other than property used in the activity) as security for the loan.

If the amount at risk is reduced below zero (e.g., by distributions to the taxpayer or by changes in the status of debt from recourse to nonrecourse or from a qualified person to a nonqualified person), the taxpayer recognizes current income to the extent of the reduction below zero. However, the amount recaptured is limited to the excess of the losses previously allowed. The amount added to income is treated as a deduction allocable to the activity in the first succeeding year and allowed if, and to the extent, the taxpayer's at-risk basis is increased.

Qualified Nonrecourse Financing

A taxpayer who holds real property is considered at risk with respect to any "qualified nonrecourse financing" which means financing:

(a) that is borrowed by the taxpayer with respect to the activity of holding real property,

(b) from a "qualified person" or from any federal, state, or local government or instrumentality, or is guaranteed by any federal, state, or local government,

(c) where no person is personally liable for repayment, *and*

(d) that is not convertible debt.

Qualified Person

A "qualified person" is defined as any person who is actively and regularly engaged in the business of lending money and who is not:

(a) Related to the taxpayer (but see the special rule for certain commercially reasonable financing from related persons);

(b) The person (or not related to the person) from whom the taxpayer acquired the property; *or*

(c) The person (or not related to the person) who receives a fee with respect to the taxpayer's investment in the property.

"Qualified persons" would include banks, savings and loans, credit unions, insurance companies, or pension trusts. Seller financing and promoter financing are not "qualified persons."

A special rule provides that if financing from a related person is commercially reasonable and on substantially the same terms as loans involving an unrelated person, the related person may be considered to be a qualified person. Related persons include family members, fiduciaries, and corporations/partnerships in which the taxpayer or relative has at least a 10% interest.

Taxpayers Affected

The at-risk limits apply to individuals (including in their capacities as partner or S corporation shareholder) and to certain closely held corporations (other than S corporations).

Closely Held Corporation

For the at-risk rules, a corporation is a closely held corporation if, at any time during the last half of the tax year, more than 50% in value of its outstanding stock is owned, directly or indirectly, by or for five or fewer individuals.

Qualified Corporation Exception

A qualified corporation is not subject to the at-risk limits for any *qualifying business* carried on by the corporation. Each qualifying business is treated as a separate activity. A qualified corporation is a closely held corporation, defined earlier that is *not*:

(a) a personal holding company,

(b) a foreign personal holding company, *or*

(c) a personal service corporation (defined in §269A(b), but determined by substituting 5% for 10%).

Partner & S Corporation Shareholders

Three separate limits apply to a partner's or shareholder's distributive share of a loss from a partnership or S corporation. The limits determine the amount of the loss each partner or shareholder can deduct on its own return. These limits and the order in which they apply are:

(1) the adjusted basis of:

(a) the partner's partnership interest, *or*

(b) the shareholder's stock plus any loans the shareholder makes to the corporation,

(2) the at-risk rules, *and*

(3) the passive loss rules.

Partner

A partner is considered at risk for:

(a) The amount of *money* and the *adjusted basis of any property* he or she contributed to the activity,

(b) The *income retained* by the partnership, *and*

(c) Certain amounts borrowed by the partnership for use in the activity.

> **Note**: However, a partner is generally *not* considered at risk for amounts borrowed *unless* that partner is *personally* liable for repayment, or the amounts borrowed are secured by the *partner's* property *other* than property used in the activity.

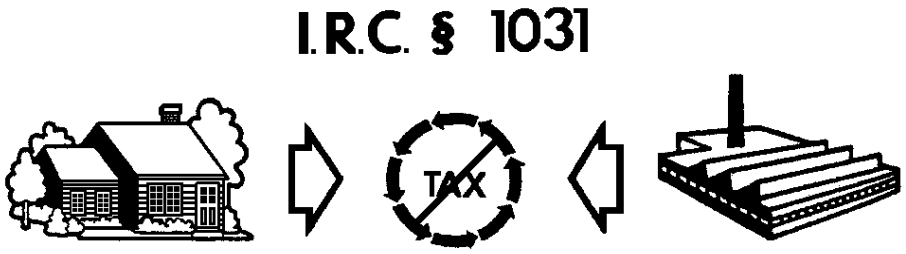
S Corporation Shareholder

At-risk rules can limit an S corporation shareholder's deductible loss from an activity conducted through an S corporation. These limitations apply at the *shareholder* level. An S corporation shareholder's amount at risk equals:

(a) The shareholder's cash contributions and the adjusted basis of other property that the shareholder contributed to the S corporation, *plus*

(b) Amounts borrowed for use in the activity that the shareholder is personally liable for the repayment of, or has pledged property not used in the activity as security for the borrowed amount.

Like-Kind Exchanges - §1031 [Form 8824]



Section 1031, by permitting deferral of the recognition of all or part of the gain or loss realized on the exchange of property, provides an exception from the general rule of §1001 requiring recognition of gain or loss upon the sale or exchange of real property. Taxpayers report like-kind exchanges by filing Form 8824.

Statutory Requirements & Definitions

Assuming that a property is not within one of the excluded classes set forth in §1031, there are essentially only three basic elements for an exchange under §1031:

(1) The properties must actually be exchanged and not sold;

(2) Both the property exchanged and the property received must be held by the same taxpayer for productive business use in the taxpayer's trade or business or for investment; *and*

(3) The properties must be of a "like-kind" with one another.

Qualified Transaction - Exchanges v. Sales

In order to come within the scope of §1031, there must be a reciprocal transfer of property, as distinguished from a transfer of property solely for money. (Reg. §1.1001-1(d)) In short, there must be an exchange as distinguished from a sale.

Held for Productive Use or investment

To qualify under §1031, both the property transferred and the property received in an exchange must be held by the taxpayer either for productive use in his or her trade or business or for investment. A personal residence is not property held for investment or use in a trade or business and §1031 does not apply to it. (R.R. 59-229).

Note: Regulations do state that "unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale" (Reg. §1.1031(a)-1(b)).

Statutory Exclusions from §1031

Not all property, even when held for productive use in a trade or business or for investment, qualifies under the nonrecognition provisions of §1031. Certain types of property are specifically excepted:

(1) stock in trade or other property held primarily for sale,

(2) stocks, bonds, or notes,

(3) other securities or evidences of indebtedness or interest,

(4) interests in a partnership,

> **Note:** Section 1031(a)(2)(D) provides that §1031 does not apply to any exchange of interests in a partnership. This rule applies whether the partnership interests exchanged are general or limited or are in the same partnership (Reg. §1.1031(a)-1(a)(1))

(5) personal property

> **Note:** For 2018 and later, personal property is no longer property of a *like-kind* or *like class* and cannot be exchanged under §1031.

(6) certificates of trust or beneficiary interests, *and*

(7) choses in action.

Like-Kind Property

In addition to the requirement relating to the purpose for which the property is held, there is a further requirement that the property given up in the exchange must be of a like-kind to the property received. The term "like-kind" has reference to the nature or character of the property and not to its grade or quality, so that one kind or class of property may not, under §1031, be exchanged for property of a different class or kind.

The Concept of "Boot"

An exchange under §1031 is only fully tax deferred if the taxpayer exchanges property solely for qualifying like-kind property. However, the receipt of nonlike-kind property commonly referred to as "boot" will not prevent the partial application of §1031 in an exchange that otherwise consists of like-kind property. If the taxpayer receives money or other non-like kind property in an exchange, the taxpayer's gain is recognized to the extent of the sum of the money and the fair market value of the other property received.

Determining this taxability is a two-step process. First, one must ascertain the taxpayer's realized gain. Second, the amount of money and the value of any other property received by the taxpayer must be calculated to determine recognized gain.

Realized Gain

Section 1001 provides that realized gain is the excess of the amount realized from a transaction over the adjusted basis of the property disposed

of in the same transaction. The "amount realized" from a transaction is the sum of any money received plus the fair market value of property (other than money) received.

Recognized Gain

Recognized gain, on the other hand, is the gain that must be reported for income tax purposes. Without the benefits of §1031, all gains realized would have to be recognized.

Limitation on Recognition of Gain under §1031

Section 1031(b) provides a ceiling as to the amount that can be taxed. This taxable amount cannot exceed the lesser of the net boot received or the realized gain (Reg. §1.1031(b)-1(b). As a result, the taxpayer should not be taxed at anytime greater than if he or she sold the property outright.

The Definition of "Boot"

Boot consists of money (including liability assumed or attached to the property received in exchange), non-qualifying property, and property which although qualifying by definition is not like-kind to the property given in the exchange. Except for money and debt, which are taken at face dollar value, the other categories of boot are taken at fair market value.

The Rules of "Boot"

To simplify the understanding of "boot," many practitioners have divided it into two categories - "property" and "mortgage" boot.

Property Boot

A taxpayer who receives money or nonqualifying property is considered to have received property boot. A taxpayer who pays money or gives nonqualifying property in the exchange is considered to have given property boot.

Mortgage Boot

Mortgage boot consists of liabilities assumed or taken subject to in the exchange. If a taxpayer's liabilities are assumed or taken subject to, the taxpayer is considered to have received mortgage boot. A taxpayer who assumes another party's liabilities or takes subject to those liabilities in the exchange is considered to have given mortgage boot.

Note: The terms "property boot" (or "cash boot") and "mortgage boot" are not specifically used in the Regulations or Code, although they have been adopted by the Tax Court in at least two cases (*Earlen T. Barker*, 74 TC 555 (1980) and *Estate of Meyer*, 58 TC 311 (1972)).

Netting "Boot" - The Rules of Offset

Where boot is not only given but is also received (whether it be in the form of property boot or mortgage boot), then a series of "offset" rules apply. These rules permit, in certain instances, the netting of boot.

Property Boot Given Offsets Any Boot Received

Consideration given in the form of cash or other property (property boot) is offset against consideration received in the form of such property boot or an assumption of liability or a transfer of properties subject to liability (mortgage boot).

> **Note:** As a result of R.R. 72-456, brokerage commissions paid in a §1031 exchange are treated as property boot paid.

Mortgage Boot Given Offsets Mortgage Boot Received

In the case of the reciprocal assumption or acquisition of property subject-to liabilities, the regulations clearly provide for netting of liabilities in determining the amount of boot received by the taxpayer (Reg. §1.1031(b)-1(c). Thus, it is only to the extent the taxpayer realizes a net reduction in the indebtedness owed that the taxpayer has in fact received mortgage boot.

Mortgage Boot Given Does Not Offset Property Boot Received

Consideration received in a §1031 transaction in the form of cash or other non-qualified property (property boot) is *not* offset by the consideration given in the form of an assumption of liabilities or a receipt of property subject to liability (mortgage boot). (Reg. §1.1031(d)-2)

Gain or Loss on Boot

Gain or loss will be recognized on nonlike-kind property given even if no gain is recognized on the like-kind property involved in the exchange. The transfer of non-cash boot is treated as a sale (not an exchange) of such property. (Reg. §1.1031(d)-1(e).)

Basis on Tax-Deferred Exchange

The basis of property received in an exchange qualifying under §1031 is the basis of the property transferred, decreased by the amount of money received (note: mortgage boot received is treated as cash received), and increased by any gain or decreased by any loss (on nonlike-kind property) recognized in the exchange (§1031(d)).

Allocation of Basis

If the property received in an exchange consists in part of like-kind property and in part of nonlike-kind property (boot), the total basis of such

properties must be allocated between the properties (other than money) received. When such nonlike-kind property is received, basis must be first allocated to the nonlike-kind property to the extent of its fair market value. The remainder of the basis is allocated to the like-kind properties received. (Reg. §1.1031(d)-1(c).)

Installment Reporting of Boot - §453(f)(6)

When §1031 and §453 occur together, the rules are as follows:

(1) The like-kind property received under 1031 is not treated as a payment in the year of disposition (§453(f)(6)(C));

(2) The gross profit from the exchange is reduced by the gain not recognized (453(f)(6)(B));

(3) The contract price does not include the value of the like-kind property (§453(f)(6)(A)); *and*

(4) The taxpayer's basis in the property put into the exchange is allocated first to the like-kind property received to the extent of its fair market value.

Exchanges Between Related Parties

Section 1031(f) requires gain or loss on an exchange between related persons to be recognized if either the property transferred or the property received is disposed of within two years after the exchange. Any gain or loss recognized by a taxpayer because of this rule is deemed to have occurred on the date of the disposition.

Reporting an Exchange

The instructions to Schedule D (Form 1040) state that all exchanges must be reported. The instructions apply to even fully tax-deferred exchanges. If taxpayer exchanges property in a like-kind exchange, they must file Form 8824, *Like-Kind Exchanges,* in addition to Schedule D (Form 1040) or Form 4797.

Types of Exchanges

Although somewhat of a simplification, in actuality there are only three basic types of true exchanges:

(1) two-party exchanges,

(2) multiple-party exchanges, *and*

(3) a delayed exchange.

Two-Party Exchanges

The two-party exchange is the simplest but rarest form of exchange. This exchange merely involves a transfer of properties between the parties in

the form of a true "barter" transaction. While each party has a similar interest in the deferral of the gain on the exchange, the respective tax status of each is independent of the other. Thus, one party to the exchange may qualify under §1031 and the other may not. This could happen, for instance, when one party is acquiring the property in an exchange for purposes of immediate resale.

Despite the simplicity of two-party exchanges, they occur very rarely. Not only must both parties be willing to exchange the properties, but also the properties must be of approximately the same value and the parties must be willing to accept each other's property. In the real world, this rarely occurs.

Multiple-Party Exchanges

Multiple-party exchanges typically involve three or more parties and two or more properties and are consummated in two basic steps, each of which should be accomplished by a separate escrow. For example, in the first step and escrow, a buyer purchases property B from a seller for cash. In the second step and escrow, The buyer transfers property B to a client (who wants §1031 treatment) in exchange for property A. Functionally, the buyer serves as a middleman (i.e., accommodator) and property B is transferred twice. The buyer ultimately obtains property A and the seller is "cashed out." When structured properly, the client will have a tax-deferred exchange under §1031, the buyer will have no tax consequences, and the seller will be the only party having a taxable event in the form of a recognized sale (R.R. 77-297).

Delayed (or Deferred) Exchanges

While multiple-party exchanges were formerly very popular, the delayed exchange, because of its flexibility and express Code authorization, is currently the most common type of §1031 exchange. The regulations (TD 8346) define a deferred exchange as an exchange in which a taxpayer transfers qualified property and *later* receives like-kind property (Reg. §1.1031(a)-3).

In a delayed exchange, pursuant to an agreement, the client (who wants §1031 treatment) transfers property A (the relinquished property) to a qualified intermediary who sells property A to a buyer. The qualified intermediary then uses those sale proceeds to purchase property B (the replacement property). Property B is then transferred by the qualified intermediary to the client.

Time Requirements

The client has 45 days from the transfer of the relinquished property to identify potential replacement properties. In addition, the client

must close on the replacement property on the earlier of the day which is 180 days following the transfer of the relinquished property or the due date for the exchangor's tax return for the year of the transfer including extensions.

Qualified Intermediary

A "qualified intermediary" is a person who is not the exchangor or a disqualified person and who, for a *fee*, acts to facilitate a delayed exchange by agreeing with the exchangor to an exchange of properties in which the intermediary:

(i) acquires the relinquished property from the exchangor (either on its own behalf or as the *agent* of any party to the transaction),

(ii) transfers the relinquished property,

(iii) acquires the replacement property (either on its own behalf or as the *agent* of any party to the transaction), *and*

(iv) transfers the replacement property to the exchangor (Reg. §1.1031(a)-3(g)(4)).

Disqualified Person

A person is a "disqualified person" if:

(i) The person is an agent of the taxpayer at the time of the transaction, *or*

(ii) The person and the taxpayer (or the taxpayer's agent) bear a relationship defined under §267(b) *or*§707(b) substituting 10% ownership for 50% ownership (Reg. §1.1031(a)-3(k)).

Section 1031 Exchange of Property Worksheet

Part I - Basis of Property Conveyed

1. Cost or other basis of property conveyed	$_____
2. Less depreciation allowed or allowable	$_____
3. Adjusted basis of property conveyed (line 1 less line 2)	$_____

Part II - Realized Gain

4. Fair market value of property received	$_____
5. Cash received	$_____
6. Fair market value of boot (other than cash) received	$_____
7. Mortgage balance on property conveyed	$_____
8. Total consideration received (add lines 4 through 7)	$_____
Less:	
9. Adjusted basis of property conveyed (line 3)	$_____
10. Cash given	$_____
11. Adjusted basis of boot (other than cash) conveyed	$_____
12. Mortgage on property received	$_____

13. Exchange expenses $_____
14. Total consideration given (add lines 9 through 13) $_____
15. Gain realized on exchange (line 8 less line 14) $_____

Part III - Recognized Gain

Property Boot

16. Cash and boot (other than cash) received (add lines 5 and 6) $_____
17. Cash and boot (other than cash) conveyed (add lines 10 and 11) $_____
18. Exchange expenses (line 13) $_____
19. Net cash and boot (other than cash) received (line 16 less lines 17 & 18) $_____

Mortgage (Relief) Boot

20. Mortgage on property conveyed (line 7) $_____
21. Mortgage on property received (line 12) $_____
22. Net mortgage relief (line 20 less line 21; if less than zero, enter zero) $_____
23. Gain recognized (line 19 plus line 22; line 23 cannot exceed line 15; if less than zero, enter zero) $_____

Part IV - Basis of New Property

24. Adjusted basis of property conveyed (line 3) $_____
25. Cash and boot (other than cash) conveyed (line 17) $_____
26. Mortgage on property received (line 12) $_____
27. Total (add lines 24 through 26) $_____
28. Cash and boot (other than cash) received (line 16) $_____
29. Mortgage on property conveyed (line 7) $_____
30. Total (add lines 28 and 29) $_____
31. Line 27 less line 30 $_____
32. Gain recognized on exchange (line 23) $_____
33. Exchange expenses (line 13) $_____
34. Basis of new property (add lines 31 through 33) $_____

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you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

105. Section 465 defines "qualified persons" for purposes of determining at-risk limits. For these purposes, which of the following is a qualified person?

a. a person from whom the taxpayer acquired the property.

b. a person related to the taxpayer.

c. a person who receives a fee due to the taxpayer's investment in the real property.

d. a person who actively and regularly engages in the business of lending money.

106. Under §465, a partner is considered at risk for three items. What is one of these items?

a. amounts borrowed if the lender has an interest in the activity.

b. amounts borrowed if the lender is related to a person having an interest in the activity.

c. amounts borrowed that are secured by the partner's property other than property used in the activity.

d. amounts protected against loss through guarantees.

107. According to the author, it is helpful to break down the like-kind exchange provisions into three requirements. What is one of these three basic requirements of §1031?

a. One of the properties must be held for investment.

b. Personal use must be limited to the property given up.

c. The properties exchanged must be like-kind.

d. The properties must be similar in use.

108. When disposing of property, taxpayers may receive money and/or property. What tax term is used for the total money received plus the fair market value of property, other than money, received?

a. the adjusted basis.

b. the amount realized.

c. the realized gain.

d. the contract price.

109. The existence of boot can create valuation problems in a §1031 exchange. However, two items of boot are taken at face value. What is one of these types of boot?

a. debt.

b. furniture.

c. stock.

d. vehicles.

110. In a §1031 exchange, an exchangor may receive both like-kind and non like-kind property. If this occurs, what happens to the total basis?

a. It is allocated using the gross-profit ratio.

b. Basis is first allocated to like-kind properties received.

c. Basis is first allocated to non-like kind properties received.

d. It is allocated in the ratio of the respective fair market values.

111. The author identifies four rules for like-kind exchanges for installment sale purposes. What is one of these rules under §453(f)(6)?

a. The value of the like-kind property is included in the contract price.

b. The gain not recognized increases the gross profit from the exchange.

c. The like-kind property received under §1031 is treated as a payment in the year that it is disposed of.

d. In such an exchange, the basis of the property put in must be allocated first to property received to the extent of its fair market value.

112. Under §1031, properties must be traded in a reciprocal transaction. Which of the following types of exchange is the most fundamental example of that principle?

a. a multiple-party exchange.

b. a Baird format exchange.

c. a delayed exchange.

d. a two-party exchange.

Retirement Plans

Qualified Deferred Compensation

Qualified deferred compensation plans are an important form of compensation used to provide retirement and separation from service benefits. For a small closely held company that can operate in the corporate form, a qualified corporate pension, or profit-sharing plan generally is the best vehicle for deferring income until retirement. The principal advantages fall into two categories - *current and deferred*.

Current advantages include:

(1) the employer obtaining a current deduction for amounts paid or accruable to the qualified plan (§404(a));

(2) the employee not recognizing income currently on contributions made by his or her employer even though the benefits may be nonforfeitable and fully vested (§§402(a) & 403(a)); *and*

(3) employee benefits accumulate tax-free (§501(a).

Among the deferred tax advantages are:

(1) lump-sum distributions from a qualified employee benefit plan are eligible for favorable five (or in some cases still ten) year income averaging treatment (§402(e)); *and*

(2) certain distributions may be rolled over tax-free into an IRA.

> **Comment:** Since the objective of many qualified retirement plans of closely held companies is to provide the greatest benefit to the controlling shareholders/owners, the cost of covering rank-and-file employees is often considered a disadvantage.

Qualified v. Nonqualified Plans

A retirement plan that meets the requirements of Internal Revenue Code Section 401(a) is referred to as a "qualified plan." IRC Section 401(a) sets standards for retirement plans including:

(i) minimum participation standards under §410,

(ii) nondiscrimination standards (i.e., the plan cannot discriminate in favor of highly compensated employees) under §401(a)(4),

(iii) minimum vesting standards under §411,

(iv) minimum funding standards (particularly, for defined benefit plans) under §412, *and*

(v) specified limits on benefits and contributions under §415.

Major Benefit

For many employees, the retirement plan will be the primary vehicle in their employer-provided benefit program. These plans are expressly approved by the Government and are significant wealth building devices.

> **Comment:** Historically, the employer considered pension plan benefits a "gift" to the employee. Unfortunately, the current thinking of many employees is that such benefits are a "right."

Despite the popularity of qualified retirement plans, benefits are rarely planned with any logic. To have sufficient income to meet one's retirement needs requires some long-term planning.

Current Deduction

Qualified deferred compensation allows the employer to have a tax deduction every time the employer puts money aside for the employee's retirement. "Funding" the retirement plan through the use of a trust or similar arrangement does this.

Timing of Deductions

A contribution to a qualified plan is generally deductible in the employer's taxable year when paid. However, §404(a)(6) provides that an employer is deemed to have made a contribution to the plan as of its year-end if the contribution is made on account of such year and is made by the due date of its tax return including extensions.

Part of Total Compensation

Corporate contributions to a qualified plan are currently deductible as an ordinary and necessary business expense. However, keep in mind that benefits will be combined with salary to arrive at total compensation that must be "reasonable."

Compensation Base

As a general rule, qualified plan benefits or contributions may not be based on imputed salary or non-qualified deferred compensation arrangements. Thus, an employee who draws no current salary may not be included as a participant in a qualified plan.

> **Comment:** Similarly, shareholder-employees who elect to reduce their current salaries under non-qualified deferred compensation contracts may suffer the disadvantages of reduced contribution limits for qualified plan purposes.

For purposes of determining nondiscrimination under §401(a)(4), an employee's compensation is defined as total compensation included in gross income. An employer also has the option to include in the definition of compensation salary reductions under a §401(k) plan or §125 plan.

A qualified plan may not consider any employee's salary in excess of $350,000 in 2025 ($345,000 in 2024) for purposes of determining contributions, benefits, and deductibility of contributions or nondiscrimination requirements.

ERISA Regulatory Requirements & PBGC Insurance

The Employee Retirement Income Security Act (ERISA) imposes a large paperwork burden in connection with any qualified retirement plan. This burden includes preparing reports that must be sent to the IRS, plan participants, plan beneficiaries, the Department of Labor, and the Pension Benefit Guaranty Corporation.

Basic ERISA Provisions

ERISA consists of *four* main sections (Titles):

Title I is primarily concerned with all types of retirement and welfare benefit programs. Reporting and disclosure requirements are provided under Title I which requires that detailed plan summaries be provided

to all plan participants and beneficiaries. Similarly, any plan amendments must also be reported to the participants and beneficiaries.

Title II covers only qualified retirement plans and tax-deferred annuities, primarily from a federal tax standpoint.

Title III involves jurisdiction, administration, enforcement, and the enrollment of actuaries.

Title IV outlines the requirements for plan termination insurance.

Fiduciary Responsibilities

The fiduciary responsibilities of plan administration are also detailed by Title I. Any person who exercises any discretionary control or authority over the management of a plan or any authority over the management of the plan's assets is a fiduciary.

Note: A federal prudent man investment rule is imposed on fiduciaries and adequate portfolio diversification is normally required.

Bonding Requirement

All fiduciaries, except certain banks, must be bonded. The amount of the bond must not be less than 10% of the amount of funds handled or $1,000, whichever is greater, or generally, not more than $500,000. Plans covering only partners and their spouses, or a sole shareholder, or a sole proprietor and spouse, are *not* subject to the bonding requirements.

Prohibited Transactions

There are also several prohibited transactions that fiduciaries are forbidden to engage in with party-in-interest. These prohibited transactions include:

(1) a sale, exchange, or lease of property between the plan and a party-in-interest;

(2) a loan or other extension of credit between the plan and a party-in-interest;

(3) the furnishing of goods, services, or facilities between the plan and a party-in-interest;

(4) a transfer of plan assets to a party-in-interest or a transfer that is for the use and benefit of a party-in-interest; *and*

(5) an acquisition by the plan of employer securities or real estate that is in violation of ERISA §407(a).

Additional Restrictions

The following actions by plan fiduciaries are also prohibited:

(a) dealing with the assets of the plan for their own account;

(b) receiving any consideration for his or her own account from any party dealing with the plan in connection with a transaction involving plan assets; *or*

(c) acting in any capacity in any transaction involving a plan on behalf of a party, or in representation of a party, whose interests are adverse to the interests of the plan, its participants, or beneficiaries.

Loans

A loan from a qualified plan to a plan participant or beneficiary is treated as a taxable distribution unless:

(i) the loan must be repaid within 5 years (except for certain home loans), *and*

(ii) the loan does not exceed the lesser of (a) $50,000, or (b) the greater of $10,000 or ½ of the participant's accrued benefit under the plan.

Employer Securities

With the exception of profit-sharing plans, pension plans may not acquire or hold qualifying employer securities or real property in the plan in excess of 10% of the fair market value of all of the plan's assets.

Excise Penalty Tax

Where a disqualified person participates in a prohibited transaction, an initial non-deductible excise tax equal to 5% of the amount of the transaction is imposed on such a person. An additional tax equal to 100% of the transaction amount is imposed if the transaction is not corrected within the correction period which is 90 days from the notice of deficiency, plus any extensions.

PBGC Insurance

Defined benefit pension plans may be subject to the plan termination insurance requirements of the Pension Benefit Guarantee Corporation (PBGC). The basic purpose is to guarantee payment of vested plan benefits at the time of termination of a plan where the plan's assets are insufficient to pay such benefits.

Sixty-Month Requirement

The PBGC guarantees the plan benefits to the extent that a plan has been in existence for 60 months at the time of plan termination. This 60-month requirement allows for a phase-in of 20% per year for plans that have not

been in existence for 5 years. Even fully insured plans are required to obtain PBGC coverage.

Note: Where the PBGC is required to pay benefits to participants, it may recover such amounts from the employer up to 30% of the employer's net worth plus additional sums.

Comment: The PBGC can also be thoroughly involved in the operations of defined benefit pension plans. For example, the PBGC may institute proceedings to terminate a plan under certain conditions.

Plans Exempt from PBGC Coverage

Some plans are specifically excluded from the requirement of PBGC insurance coverage. These plans include:

(a) individual account plans, such as money purchase pension plans, target benefit plans, profit-sharing plans, thrift and savings plans, and stock bonus plans;

(b) governmental plans;

(c) a church plan that is not volunteered for coverage does not cover the employees of a non-related trade or business and is not a multi-employer plan in which one or more of the employers are not churches or a convention or association of churches;

(d) nonqualified deferred compensation plans established for a select group of management or highly compensated employees; *and*

(e) a qualified plan established exclusively for substantial owners;

Basic Requirements for a Qualified Retirement Plan

A qualified retirement plan must satisfy the Internal Revenue Code (and DOL rules) in both form and operation. What follows is a list of some of the more important retirement plan requirements.

Written Plan

The employer must establish and communicate to its employees a written plan (and, usually, a trust), which is valid under state law (Reg. §1.401(a)(2)). A plan must actually be reduced to a formal written document and communicated to employees by the end of the employer's taxable year, in order to be qualified for such a year.

Note: Under ERISA, a summary plan description must be furnished to participants within 120 days after the plan is established or, if later, 90 days after an employee becomes a participant (DOL Reg. §2520.104b-2(a)).

Comment: The IRS administers a determination letter program that enables plan sponsors to get advance assurance as to the form of their retirement plan document.

The plan must not reduce the accrued benefit of any participant by amendment and prohibit the assignment or alienation of plan benefits.

Trust

The assets of a qualified plan must be held in a valid trust created or organized in the United States. As an alternative, a custodial account or an annuity contract issued by an insurance company or a custodial account held by a bank (for a plan that uses IRAs) may be used (ERISA §403(b)).

Permanency

The plan must be a permanent and continuing program. It must not be a temporary arrangement set up in high tax years as a tax savings scheme to benefit the employer. Thus, if a plan is discontinued after only a short period of years, the IRS may retroactively disqualify the plan. For this reason, if a plan termination is contemplated, a favorable determination should be applied for and received from the IRS *prior* to any such termination.

Exclusive Benefit for Employees

The plan and trust must be for the exclusive benefit of employees and their beneficiaries. A qualified plan cannot be a subterfuge for the distribution of profits to shareholders. Thus, the plan cannot discriminate in favor of highly compensated employees as defined in §414(q)(1).

Reversion of Trust Assets to Employer

There must ordinarily be no reversion of trust assets and contributions to the employer except for actuarial errors or an excess of plan assets upon termination of a defined benefit pension plan (Reg. §1.401-2).

Participation & Coverage

Section 401(a)(3) requires that a plan meet the minimum participation standards of §410. Section 410 divides these participation standards into two general categories:

(i) age and service requirements, *and*

(ii) coverage requirements.

Age & Service

A qualified plan cannot exclude any employee from participation on account of his or her age or years of service, except for the exclusion of employees who are:

(i) under age 21, *or*

(ii) have less than one "year of service."

Coverage

To ensure that lower paid employees have the benefit of a retirement plan, tax law requires qualified plans to provide coverage for them. This is accomplished by *two* sets of requirements.

The first set is composed of three separate tests:

(i) percentage,

> **Note:** Under this test, the plan must "benefit" at least 70% of all the employees who are not highly compensated employees.

(ii) ratio, *and*

> **Note:** To satisfy this test, a plan must benefit a percentage of nonhighly compensated employees which is at least 70% of the percentage of highly compensated employees under the plan.

(iii) average benefits.

> **Note:** The average benefit percentage of nonhighly compensated employees, considered as a group, is at least 70% of the average benefit percentage of the highly compensated employees, considered as a group.

The second set requires a specific minimum number of covered participants. Section 401(a)(26) provides that a trust will not be qualified unless it benefits the lesser of:

(i) 50 employees; *or*

(ii) 40% of "all employees."

Vesting

Vesting refers to the percentage of accrued benefit to which an employee would be entitled if they left employment prior to attaining the normal retirement age under the plan. Vesting represents that portion of the employee's benefit that is nonforfeitable. Section 401(a)(7) requires a plan to meet the rules under §411, regarding vesting standards.

Under §411(a), a participant's normal retirement benefit derived from employer contributions must be nonforfeitable upon the attainment of normal retirement age. In addition, §411(a)(1) requires that a participant must be fully vested at all times in the accrued benefit derived from the employee's own contributions to the plan. Finally, §411(d)(3) requires that a qualified plan provide that accrued benefits become nonforfeitable on a complete or partial termination of, or a discontinuance of contributions to, a plan.

Minimum Vesting

For *employer* contributions, plans have to meet the requirements of two minimum vesting schedules:

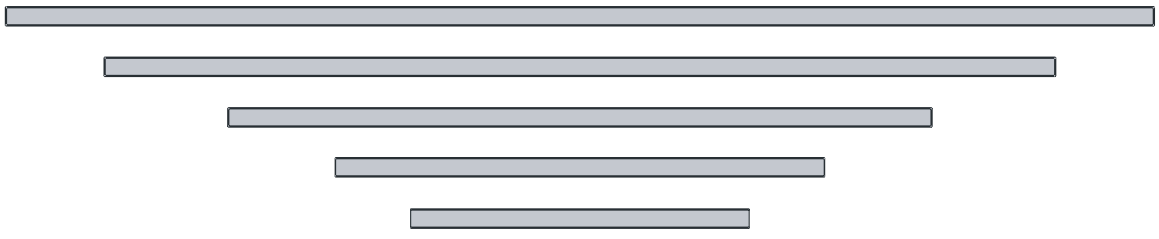
1. Three-Year Cliff Vesting. Under this schedule, participants who have completed three years of service with the employer must receive a 100% nonforfeitable claim to employer-derived benefits. Thus, the schedule is as follows:

Completed Years of Service	Nonforfeitable Percentage
1-2	0%
3	100%

2. Two-to-Six Year Graded Vesting. This schedule is graded in a similar fashion to the old five-to-15-year graded schedule, except, of course, that it provides a more rapid rate of vesting. The schedule is:

Completed Years of service	Nonforfeitable Percentage
2	20%
3	40%
4	60%
5	80%
6	100%

Note: Even if a plan adopts one of the statutory vesting schedules, it may still be held to discriminate in favor of highly compensated employees in practice.



Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regard to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

113. The author identifies two deferred tax advantages of retirement plans. What is one of these advantages?

a. There is a tax-free accumulation of the employee benefit trust.

b. Some distributions may roll over tax-free.

c. Qualified corporate plans permit substantially larger contributions than a Keogh plan.

d. Employer contributions aren't recognized currently as income.

114. There are four main sections of the Employment Retirement Income Security Act (ERISA). Which basic ERISA provision is concerned with only qualified retirement plans and tax-deferred annuities, mainly from a federal tax perspective?

a. Title I.

b. Title II.

c. Title III.

d. Title IV.

115. Qualified plans have similar qualification requirements. What is a basic requirement of a qualified retirement plan?

a. The assets must not be held in a trust.

b. The employer must establish a written plan that is valid under federal law.

c. The plan must at least be a temporary arrangement.

d. The plan must meet specific age, service, and coverage nondiscriminatory requirements.

116. Section 401 provides several sets of requirements designed to prevent retirement plan coverage discrimination. What is one set of those requirements?

a. The plan benefits a percentage of nonhighly compensated employees that is at least 50% of the percentage of highly compensated employees.

b. The plan benefits at least 70% of all employees.

c. The plan meets the discrimination classification test.

d. The trust will qualify only when it benefits the lesser of 50 employees or 40% of all employees.

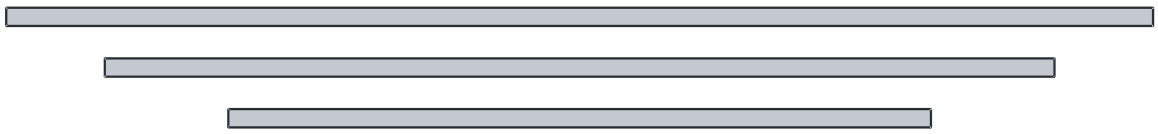
117. For employer contributions, retirement plans must meet minimum vesting schedules. Under the two-to-six-year graded vesting schedule, what is a participant's nonforfeitable claim to employer-derived benefits after three years of completed service?

a. 40%.

b. 60%.

c. 80%.

d. 100%.



Contribution & Benefit Limits

Section 401(a)(16) requires a plan to comply with §415 limitations for contributions and benefits. These limitations set the maximum amounts that the employer may provide under the plan. A plan must include provisions to ensure that these limitations are never exceeded for any participant; otherwise, the entire plan will become disqualified for the year.

The limitations imposed on both defined contribution and defined benefit plans are based on the participant's compensation. However, there is a maximum dollar amount of compensation that may be considered. In 2025, it is set to $350,000 (up from $345,000 in 2024).

Defined Benefit Plans (Annual Benefits Limitation) - §415

A defined benefit plan may not provide "annual benefits" in excess of the lesser of:

(i) A dollar limit of $160,000 (subject to COLAS) ((§415(b)(1)(A)); *or*

(ii) 100% of the participant's average annual compensation for the three consecutive years in which their compensation was the highest (§415(b)(1)(B)).

The $160,000 limit is subject to cost of living adjustments. For 2025 plan years, this amount is $280,000 (up from $275,000 in 2024).

The *annual benefit* means a benefit payable annually at the participant's social security retirement age in the form of a straight-life annuity, with no ancillary benefits, under a plan to which employees do not contribute and under which the employee makes no rollover contributions.

Note: Employee contributions, whether mandatory or voluntary, are considered to be a separate defined contribution plan to which the limitations thereon apply.

Defined Contribution Plans (Annual Addition Limitation) - §415

For 2025, a defined contribution plan's maximum annual contributions and other additions (excluding earnings) to the account of a participant is the lesser of:

(1) $70,000 (up from $69,000 in 2024), *or*

(2) 100% of the compensation actually paid to the participant (§415(c)(1)(A) & (B)).

Annual additions include employer contributions, including contributions made at the election of the employee (i.e., employee elective deferrals), after-tax employee contributions, and any forfeitures allocated to the employee (§415(c)(2)).

Limits on Deductible Contributions - §404

To be deductible, a contribution to a qualified plan must be an ordinary and necessary expense of carrying on a trade, business, or other activity engaged in for the production of income. In addition, a contribution may not be deducted unless it is actually paid into the plan.

1. Defined contribution plans: For profit-sharing, stock bonus, simplified employee pension, and money purchase pension plans, *deductible* contributions are limited to 25% of the compensation otherwise paid or accrued during the taxable year to plan beneficiaries (§404(a)(3)(A)).

2. Defined benefit plans: An employer is permitted to use either one of two methods for determining the *minimum* deductible annual contribution to a defined benefit pension plan:

a. The level funding method (§404(a)(1)(A)(ii)), *or*

b. The normal cost method (§404(a)(1)(A)(iii)).

Note: However, if the annual contribution necessary to satisfy the minimum funding standard provided by §412(a) is greater than the

amount determined under either of the above two, the limit may be increased to that amount.

As to the *maximum* deductible annual contribution (subject to a special rule for plans with more than 100 participants), the employer may not deduct an amount that exceeds the *full* funding limitation determined under the minimum funding rules (§412).

3. Combination plans: Where any employee is the beneficiary under *both* a defined benefit and a defined contribution plan of the employer, *deductible* contributions are limited to 25% of the compensation otherwise paid or accrued during the taxable year to plan beneficiaries (§404(a)(9)).

Assignment & Alienation

Section 401(a)(13) requires qualified plans to provide that the participants' benefits under the plan may not be assigned, alienated, or subject to attachment, garnishment, levy, execution, or other equitable process.

Miscellaneous Requirements

Forfeitures arising from the non-vested accounts of terminated employees under defined benefit plans must be used to reduce employer contributions. Under money purchase or target benefit plans, forfeitures may be reallocated to the accounts of remaining participants or used to reduce employer contributions.

Types of Qualified Retirement Plans

There are a variety of qualifying retirement plans. Basic types are often divided into:

(1) defined benefit plans,

Note: Here the plan stipulates an amount due to the participant at the time of their retirement. Such plans are increasingly rare.

Comment: Although defined benefit plans offer several advantages, defined contribution plans are frequently better to start with and are generally more practical for a small corporation.

(2) defined contribution plans,

Note: Under such a plan the employer and/or employee contribute a set amount to the employee's individual account. Examples can include money purchase pension, profit-sharing, and employer established §401(k) plans.

(3) plans commonly available to individuals such as a:

(a) traditional individual retirement accounts (IRAs),

Note: Traditional IRAs give the taxpayer a tax deduction for their contributions, but withdrawals in retirement are taxed.

(b) ROTH IRA,

Note: A Roth IRA gives no tax deduction upfront, but withdrawals in retirement are tax-free.

(c) self-employed §401(k)

Defined Benefit Plans

Generally, a defined benefit plan attempts to specify benefit levels for employees. Once benefit levels are established, contributions are determined based on actuarial calculations.

The employer bears the risk of the investment program used by the employee benefit trust that administers the plan's assets. If that program causes the plan assets to fall below the amount actuarially necessary to pay the defined benefits then the employer must make additional contributions.

Thus, defined benefit plans are subject to the minimum funding requirements under ERISA, whereas those rules have little meaning for defined contribution plans. The primary form of the defined benefit plan is the defined benefit pension plan.

Comment: Although contributions may vary based on the investment program, such plans are a fixed obligation of the corporation and contributions must be made annually to the plan regardless of the company's profits.

Defined Contribution Plans

In defined contribution plans, an individual account is established for each employee. The total vested amount of each employee's account at termination or retirement will be the amount available to provide each covered employee with a benefit. The employer defines or fixes the annual cost rather than defining the benefit it wants to have its employees receive. Contributions to the employee's account are based on a formula that is usually expressed as a percentage of the employee's salary. Considerable discretion by the board of directors is permitted without jeopardizing the qualification of the plan. (Reg. §1.401-1(b)(1)(ii)).

Types of Defined Contribution Plans

There are a variety of defined contribution plans:

Profit-sharing

A profit-sharing plan is a defined contribution plan under which the plan may provide, or the employer may determine, annually, how much will be contributed to the plan out of profits or otherwise. As a result, profit-sharing plans cannot provide determinable benefits. The maximum annu-

al deduction is 25% of the aggregate gross compensation of all plan participants.

Money Purchase Pension

A money purchase plan is a pension plan but, nevertheless, it is categorized as a defined contribution plan. The employer contributes a fixed amount each year based on a percentage of each employee's compensation. The employee's benefits are the amount of total contributions to the plan plus (or minus) investment gains (or losses).

Money Purchase Pension Plans & Profit-sharing	
Planholder	Corporations S corporations Non-profit organizations Partnerships Sole proprietorships (i.e., self-employed)
Eligibility Requirements	**The employer must include employees who have:**
	Reached age 21 Completed 2 years of service if 100% vesting is elected or completed 1 year of service if a vesting schedule is elected
	The plan must also meet certain coverage and participant requirements.
Contribution Limits	**Profit-sharing**: Maximum *deductible* amount is 25% of total eligible participant compensation. Employer contributions are discretionary and can be based on, but are not limited to profits. **Money Purchase:** Maximum *deductible* amount is 25% of total eligible participant compensation. Employers must contribute a predetermined percentage each year. Contributions are mandatory regardless of profits. **Combination Plans:** Combined Money Purchase Pension and Profit Sharing Plans are subject to a single maximum *deductible* limit of 25% of compensation. **Annual Additions Maximum:** Annual additions to any participant's account may not exceed 100% of compensation, or $70,000 in 2025 ($69,000 in 2024) if less. Minimum Employer Contribution may be required if a plan primarily benefits key employees.
Deadlines For Establishment & Contributions	**Establishment:** On or before the last day of the employer's fiscal year, for the year in which the deduction is taken. **Funding:** On or before the date the employer's federal income tax return is due, plus extensions. **Pension Plans:** Must be funded no later than 8½ months after the plan year-end, even if the deadline for deduction purposes is later. **Filings:** Each year there are assets in the plan, a 5500 series tax form should be filed with the IRS no later than the last day of the 7th month following the plan year end (except for cer-

	tain "one participant" plans with $250,000 or less in assets).
Distributions	**Earliest (without 10% tax penalty):**
	Death Permanent disability Attainment of age 59½ Distribution to pay for deductible medical expenses Separation from service and age 55 Plan termination and age 59½ Separation from service and periodic payments based on a life expectancy formula that cannot be modified for at least 5 years or until attainment of age 59½, if later Payments made to an alternate payee because of a divorce settlement as required by a Qualified Domestic Relations Order Profit-sharing Plans Only (if the plan permits): In-service withdrawal and age 59½. Hardship withdrawal and age 59½
	Latest (without 50% excise tax penalty):
	April 1 of the calendar year following the year in which the participant reaches age 73 for individuals who attain age 72 after December 31, 2022.
Tax Treatment on Distribution	Taxed as ordinary income. Distributions from an account containing non-deductible voluntary contributions must consist of a non-taxable portion and a taxable portion. **Lump-Sum Distributions:** Individuals who were age 50 on 1/1/86 can elect 10-year or 5-year averaging with limited capital gain treatment. Thus, averaging is not realistically available unless the individual was born before 1935.

Section 401(k) Plans

This is an arrangement whereby an employee will not be taxed currently for amounts contributed by an employer to an employee trust, even though the employee could have elected under the plan to receive the contribution in cash. Section 401(k) has several requirements:

(1) it must be a qualified profit-sharing or stock bonus plan;

(2) each employee can elect to receive cash or to have an employer contribution made to the employee trust;

(3) benefits are not distributable to an employee earlier than age 59½, termination of service, death, disability, or hardship;

(4) each employee's accrued benefit under the plan is fully vested; *and*

(5) there is no discrimination in favor of highly paid employees.

Section 401(k) Plans	
Planholder	Corporations S corporation Partnerships Sole proprietorships (i.e., self-employed)
Eligibility Requirements	**Employees who meet age & service requirements.** **The employer must include employees who have:**

	Reached 21 and have 1 year of service (defined as 1,000 hours worked in a 12-month period) or 500 hours per year for 3 consecutive years for long-term part-time employees (starting in 2025)
	The plan must also meet certain coverage and participant requirements. Employees who have completed 1 year of service must be eligible to make salary deferral contributions.
Contribution Limits	**Maximum Deductible Amount:** The maximum *deductible* amount is 25% of total eligible participant compensation. This amount includes employer basic, employer match, and salary deferral. Employer contributions are discretionary and can be based on, but not limited to, profits. **Maximum Salary Deferral Amount:** Not to exceed $23,500 in 2025 ($23,000 in 2024) and is included in the maximum contribution limit. Subject to a special anti-discrimination test. **Catch-up Contribution:** Workers age 50 and up are allowed an additional catch-up contribution of up to $7,500 in 2025 & 2024. **Non-Deductible Voluntary Contributions** are included in the maximum contribution limit. Subject to a special anti-discrimination test. **Combination Plans:** Combined Money Purchase Pension and 401(k) Plans are subject to a single maximum deductible limit of 25% of compensation. **Annual Additions Maximum:** Annual additions to any participant's account may not exceed 100% of compensation, or $70,000 in 2025 ($69,000 in 2024) if less. Minimum Employer Contribution may be required if a plan primarily benefits key employees.
Deadlines For Establishment & Contributions	**Establishment:** On or before the last day of the employer's fiscal year, for the year in which the deduction is taken. **Funding:** On or before the date the employer's federal income tax return is due, plus extensions. **Filings:** Each year there are assets in the plan, a 5500 series tax form should be filed with the IRS no later than the last day of the 7th month following the plan year end (except for certain "one participant" plans with $250,000 or less in assets).
Distributions	**Earliest (without 10% tax penalty):**
	Death Permanent disability Distribution to pay for deductible medical expenses Separation from service and age 55 Plan termination and age 59½ Separation from service and periodic payments based on a life expectancy formula that cannot be modified for at least 5 years or until attainment of age 59½, if later Payments made to an alternate payee because of a divorce settlement as required by a Qualified Domestic Relations Order In-service withdrawal and age 59½ Hardship withdrawal and age 59½
	Latest (without 50% excise tax penalty):
	April 1 of the calendar year following the year in which the participant reaches age 73 for individuals who attain age 72 after December 31, 2022.

Tax Treatment on Distribution	Taxed as ordinary income. Distributions from an account containing non-deductible voluntary contributions must consist of a non-taxable portion and a taxable portion. **Lump-Sum Distributions:** Individuals who were age 50 on 1/1/86 can elect 10-year or 5-year averaging with limited capital gain treatment. Thus, averaging is not realistically available unless the individual was born before 1935.

Self-Employed Keogh or HR10 Plan

A Keogh plan (named for its creator), also known as an HR 10 plan, is a tax-deferred retirement plan designed for self-employed individuals and unincorporated small businesses. It can be set up as either a defined-contribution plan or a defined-benefit plan.

Plan contributions may be made any time prior to the due date of the taxpayer's tax return, rather than by the close of the taxable year. However, the Keogh plan itself, as well as any related trust instruments, must be established prior to the close of the taxable year for which the first contributions are to be made.

When figuring the deduction for contributions made to a self-employed retirement plan, compensation is net earnings from self-employment after subtracting:

(i) the deduction allowed for one-half of the self-employment tax, *and*

(ii) the deduction for contributions on behalf of the self-employed taxpayer to the plan.

This adjustment to net earnings in (ii) above is made indirectly by using a self-employed person's rate.

Self-Employed Rate

If the plan's contribution rate is a *whole* number (e.g., 12% rather than 12.5%), taxpayers can use the following table to find the rate that applies to them.

Self-Employed Rate Table

Plan's Rate	Self-Employed's Rate
1	.009901
2	.019608
3	.029126
4	.038462
5	.047619
6	.056604
7	.065421
8	.074074
9	.082569

10	.090909
11	.099099
12	.107143
13	.115044
14	.122807
15	.130435
16	.137931
17	.145299
18	.152542
19	.159664
20	.166667
21	.173554
22	.180328
23	.186992
24	.193548
25	.200000

If the plan's contribution rate is *not* a whole number (e.g., 10.5%), the taxpayer must calculate their self-employed rate using the following worksheet.

Self-Employed Rate Worksheet

1. Plan contributions rate as a decimal (for example, 10% would be 0.10) $_____

2. Rate in Line 1 plus 1, as a decimal (for example, 0.10 plus 1 would be 1.10) $_____

3. Divide Line 1 by Line 2, this is the taxpayer's self-employed rate as a decimal $_____

Determining the Deduction

Once the self-employed rate is determined, taxpayers figure their deduction for contributions on their behalf by completing the following steps:

Step 1

Enter the self-employed rate from the Table or Worksheet above _____

Step 2

Enter the amount of net earnings from Line 29, Schedule C, or Line 36, Schedule F $_____

Step 3

Enter the deduction for self-employment tax from Line 25, Form 1040 $_____

Step 4

Subtract Step 3 from Step 2 and enter the amount $_____

Step 5

Multiply Step 4 by Step 1 and enter the amount $_____

Step 6

Multiply $350,000 (in 2025) by the plan Contribution rate. Enter the result but not more than $70,000 (in 2025) $_____

Step 7

Enter the smaller of Step 5 or Step 6. This is the deductible contribution. Enter this amount on Line 27, Form 1040 $_____

Individual Retirement Accounts - IRAs

Any individual with earned income, whether or not presently participating in a qualified retirement, plan can set up an individual retirement plan (IRA), and take a deduction from gross income. Individuals age 50 and older may make additional catch-up IRA contributions.

An individual may establish one or more of the types of IRA funding vehicles as long as the annual contributions limit is not exceeded in the aggregate.

Individual Retirement Accounts	
Planholder	Individual taxpayer Individual taxpayers and a non-working spouse
Eligibility Requirements	Individuals who have earned income
Contribution Limits	**Maximum Contribution Limit:**
	$7,000 ($6,500 in 2023) per working individual and $14,000 ($13,000 in 2023) per married couple with a working & a non-working spouse in 2025. If at least 50 years old, an extra $1,000 can be contributed for a total of $8,000 ($7,500 in 2023) in 2025.
	Tax-Deductible Contributions - Who Qualifies:
	If neither individual nor spouse is covered by an employer-sponsored retirement plan, 100% is deductible at any income level. If an individual or spouse is covered by an employer-sponsored plan in 2024:

<table>
<tr><td></td><td>
<table>
<tr><td>Adjusted Gross Income</td><td colspan="2">Contribution</td></tr>
<tr><td>Married</td><td>Tax-Deferred</td><td>Deductibility</td></tr>
<tr><td>Below $123,000</td><td>Yes</td><td>Full</td></tr>
<tr><td>$123,000-$143,000</td><td>Yes</td><td>Partial</td></tr>
<tr><td>Over $143,000</td><td>Yes</td><td>No</td></tr>
<tr><td>Single</td><td>Tax-Deferred</td><td>Deductibility</td></tr>
<tr><td>Below $77,000</td><td>Yes</td><td>Full</td></tr>
<tr><td>$77,000-$87,000</td><td>Yes</td><td>Partial</td></tr>
<tr><td>Over $87,000</td><td>Yes</td><td>No</td></tr>
<tr><td colspan="3">If an individual or spouse is covered by an employer-sponsored plan in 2025:</td></tr>
<tr><td>Adjusted Gross Income</td><td colspan="2">Contribution</td></tr>
<tr><td>Married</td><td>Tax-Deferred</td><td>Deductibility</td></tr>
<tr><td>Below $126,000</td><td>Yes</td><td>Full</td></tr>
<tr><td>$126,000-$146,000</td><td>Yes</td><td>Partial</td></tr>
<tr><td>Over $146,000</td><td>Yes</td><td>No</td></tr>
<tr><td>Married</td><td>Tax-Deferred</td><td>Deductibility</td></tr>
<tr><td>Below $79,000</td><td>Yes</td><td>Full</td></tr>
<tr><td>$79,000-$89,000</td><td>Yes</td><td>Partial</td></tr>
<tr><td>Over $89,000</td><td>Yes</td><td>No</td></tr>
</table>
</td></tr>
<tr><td>Deadlines For Establishment & Contributions</td><td>On or before tax filing deadline, not including extensions (usually April 15 or the next business day if April 15 falls on a holiday or weekend).
Penalties:
$50 penalty for failure to file Form 8606 to report nondeductible contributions
$100 penalty for overstating the designated amount of nondeductible contributions</td></tr>
<tr><td>Distributions</td><td>Earliest (without 10% tax penalty):
Death, Permanent Disability, Attainment of age 59½: Periodic payments based on a life expectancy formula that cannot be modified for at least 5 years or until attainment of age 59½, if later. Transfer of assets from a participant's IRA to a spouse's or former spouse's IRA in accordance with a divorce or separation document.
Latest (without 50% excise tax penalty):
April 1 of the calendar year following the year in which the participant reaches age 73 for individuals who attain age 72 after December 31, 2022</td></tr>
<tr><td>Tax Treatment on Distribution</td><td>All distributions from any type of IRA are taxed as ordinary income. Remember, however, that if the individual made nondeductible contributions, each distribution consists of a nontaxable portion and a taxable portion.</td></tr>
</table>

Employer IRA

Any employer, including a corporation, may establish an IRA plan for the benefit of some or all of its employees. Contributions may be made by the employer on an additional compensation basis or on a salary reduction plan. There is no nondiscrimination requirement with respect to the establishment, availability, or funding of an IRA plan. Employer Contributions

10% Distribution Penalty

In order to encourage participants to set aside funds for their retirement, tax law imposes a 10% penalty tax on "premature distributions." That is distributions that are received by the participant prior to the attainment of age 59½. This penalty tax is imposed in addition to the participant's ordinary income tax liability. However, this penalty does not occur where the distribution is the result of the death, disability, or the timely repayment of excess contributions.

Simplified Employee Pension Plans (SEPs)

A simplified employee pension (SEP) is a written arrangement (a plan) that allows an employer to make deductible contributions for the benefit of participating employees. The contributions are made to individual retirement arrangements (IRAs) set up for participants in the plan. Traditional IRAs set up under a SEP plan are referred to as SEP-IRAs (§408(k)).

Like an individual IRA, an employee may participate in a SEP even though he or she is also a participant in a qualified plan. A simplified employee pension plan is an IRA that meets all of the following requirements:

(a) for the calendar year, the employer contributes for each employee who has attained age 21 and who has performed any service for the employer during three of the preceding five years;

(b) contributions must not discriminate in favor of highly compensated employees;

(c) employer contributions may be integrated with Social Security based upon the rules for qualified defined contribution plans; *and*

(d) each plan participant must own the IRA account or annuity and employer contributions must not be conditioned upon the retention in such plan of any amount so contributed.

(e) the employer has complete contribution flexibility since the employer is not required to contribute to the SEP each year regardless of whether or not there are profits. The amount to be contributed each year may also vary at the election of the employer so long as the contributions remain non-discriminatory in nature.

(f) employer contributions must be made pursuant to a written instrument and be based on a definite written allocation formula that specifies:

(i) the requirements for an employee to share in an allocation, *and*

(ii) the manner in which the amount allocated is to be computed.

Salary Reduction (SAR-SEP) & Simplified Employee Pension Plans (SEP-IRA)	
Planholder	Corporations S corporations Non-profit organizations (SEP only) Partnerships Sole proprietorships (i.e., self-employed)
Eligibility Requirements	**The employer must include employees who have:**
	Reached age 21 Worked at least 3 or more of the last 5 preceding years Annual compensation of at least $750 (in 2025 & 2024)
	SEP: All eligible employees must participate in the plan. **SAR/SEP:** Employer must have 25 or fewer eligible employees at all times during the preceding year. 50% of all eligible employees must participate in the salary reduction provision of the plan.
Contribution Limits	**SEP Maximum Contribution Limit:** Employer contributions are limited to 25% of each participant's compensation not to exceed $70,000 ($69,000 in 2024) in 2025 (overall limit includes employer basic and salary reduction contributions). **SAR/SEP Maximum Contribution Limit:** Salary reduction contributions are limited to 25% of each participant's compensation not to exceed $23,500 ($23,000 in 2024) in 2025. These contributions, reported in Box 16 on the employee's W-2 Form, are subject to an anti-discrimination test. **Minimum SEP & SAR/SEP Contribution:** A minimum employer contribution of 3% may be required if certain highly compensated or key employees participate.
Deadlines For Establishment & Contributions	On or before the employer's tax filing deadline plus extensions. A SEP may be maintained on a calendar or fiscal year basis.

Distributions	**Earliest without 10% tax penalty:** * Death * Permanent disability * Attainment of age 59½ *Periodic payments based on a life expectancy formula that cannot be modified for at least 5 years or until attainment of age 59½, if later *Transfer of assets from a participant's IRA to a spouse's or former spouse's IRA in accordance with a divorce or separation document.
	Latest (without 50% excise tax penalty): April 1 of the calendar year following the year in which the participant reaches age 73.
Tax Treatment on Distribution	All distributions from any type of IRA are taxed as ordinary income. Remember, however, that if the individual made nondeductible contributions, each distribution consists of a nontaxable portion and a taxable portion.

SIMPLE Plans

A savings incentive match plan for employees (SIMPLE plan) is a tax-favored retirement plan that certain small employers (including self-employed individuals) can set up for the benefit of their employees. Under a SIMPLE plan, employees can choose to make salary reduction contributions to the plan rather than receive these amounts as part of their regular pay. In addition, you will contribute matching or nonelective contributions.

A SIMPLE plan can be set up in either of the following ways:

(1) Using SIMPLE IRAs (SIMPLE IRA plan), *or*

(2) As part of a §401(k) plan (SIMPLE 401(k) plan).

SIMPLE IRA Plan

A SIMPLE IRA plan is a retirement plan that uses SIMPLE IRAs for each eligible employee. Under a SIMPLE IRA plan, a SIMPLE IRA must be set up for each eligible employee.

> **Note:** Any employee who received at least $5,000 in compensation during any 2 years preceding the current calendar year and is reasonably expected to receive at least $5,000 during the current calendar year is eligible to participate. The term "employee" includes a self-employed individual who receives earned income.

Employers can set up a SIMPLE IRA plan if they meet both the following requirements:

(a) they have 100 or fewer employees who received $5,000 or more in compensation for the preceding year, *and*

(b) they do not maintain another qualified plan unless the other plan is for collective bargaining employees.

The SIMPLE IRA plan generally must be the only retirement plan to which the employer makes contributions. Employers can use *Form 5304-SIMPLE* or *Form 5305-SIMPLE* to set up a SIMPLE IRA plan.

Contributions are made up of salary reduction contributions and employer contributions. The employer must make either matching contributions or nonelective contributions.

SIMPLE §401(k) Plan

Employers can adopt a SIMPLE plan as part of a §401(k) plan if they meet the 100-employee limit. A SIMPLE §401(k) plan is a qualified retirement plan and generally must satisfy the rules discussed applicable to such type plans. However, a SIMPLE §401(k) plan is not subject to the nondiscrimination and top-heavy rules if the plan meets certain conditions.

Roth IRA - §408A

A Roth IRA is a special tax-free nondeductible individual retirement account for individuals to contribute after-tax dollars. It can be either an account or an annuity.

> **Note:** To be a Roth IRA, the account or annuity must be designated as a Roth IRA when it is set up. Neither a SEP-IRA nor a SIMPLE IRA can be designated as a Roth IRA.

Unlike a traditional IRA, contributions to a Roth IRA are not deductible. However, distributions from a Roth IRA are tax-free if made more than 5 years after a Roth IRA has been established or if the distribution is:

(i) made after age 59½, death, or disability, *or*

(ii) for first-time homebuyer expenses (up to $10,000).

Individuals can contribute to a Roth IRA if they have taxable *compensation* and their *modified AGI* is less than certain thresholds. Contributions can be made to a Roth IRA regardless of an individual's age. Contributions can be made to a Roth IRA for a year at any time during the year or by the due date of the individual's return for that year (*not* including extensions).

It is possible to convert amounts from either a traditional, SEP, or SIMPLE IRA into a Roth IRA. In addition, taxpayers can roll amounts over from one Roth IRA to another Roth IRA. An IRA contribution can also be recharacterized into a Roth IRA.

Taxpayers are not required to take distributions from their Roth IRA at any age. The minimum distribution rules that apply to traditional IRAs do not apply to Roth IRAs while the owner is alive. When a Roth IRA owner dies, the minimum distribution rules that apply to traditional IRAs apply to Roth IRAs as though the Roth IRA owner died before his or her re-

quired beginning date. The basis of property distributed from a Roth IRA is its fair market value (FMV) on the date of distribution, whether or not the distribution is a qualified distribution.

Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regard to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

118. The mechanics of defined benefit and defined contribution retirement plans have many similarities. However, what is a unique aspect of defined benefit plans?

a. An individual account is established for each employee.

b. Contributions are based on a formula that is usually expressed as a percentage of the employee's salary.

c. The employer defines or fixes the annual cost.

d. The employer must make adequate funding.

119. A profit-sharing plan is a type of defined contribution plan. What is a characteristic of a profit-sharing plan?

a. Total contributions are limited to a specific dollar amount.

b. Employer contributions are flexible and can be based on profits.

c. Employer contributions are mandatory regardless of profits.

d. Employer must contribute a predetermined percentage each year.

120. Section 401(k) plans must meet five requirements. What is one such requirement?

a. Employees may receive benefits at any time.

b. Plan benefits that have accrued are fully vested.

c. The plan must be a qualified money purchase pension plan.

d. Employees must receive benefits in cash.

121. A Keogh plan is a popular type of retirement plan. Which individuals can be participants in such a plan?

a. sole proprietors.

b. employees of an S corporation.

c. employees of a C corporation.

d. partners owning 10% or less of an interest in partnerships.

122. Individual taxpayers and their non-working spouses may establish individual retirement arrangements (IRAs). What is the eligibility requirement for IRAs?

a. 1 year of service if vesting schedule is elected.

b. 2 years of service if 100% vesting is elected.

c. earned income.

d. sole proprietor or more than 50% partner.

123. Under a simplified employee pension (SEP) IRA, the employer must contribute for each employee. However, an employee:

a. must have attained age 18 to qualify.

b. can still participate if over age 73.

c. must have earned at least $450 in the tax year to qualify.

d. must have performed services for the employer during two of the preceding four years.

Required Minimum Distributions (RMDs)

Funds cannot be kept indefinitely in a retirement plan. Eventually, distributions must be made. Required minimum distributions (RMDs) are those minimum amounts that must be withdrawn from a taxpayer's retirement accounts each year.

> **Note:** The IRS has issued final regulations (TD 10001) updating required minimum distribution requirements for retirement plan participants and IRA owners and beneficiaries, reflecting changes under the SECURE Acts. The final rules incorporate statutory changes to §401(a)(9) regarding required minimum distributions (RMDs) from qualified plans.

The minimum distribution rules apply to original account holders *and* their beneficiaries in these types of plans:

(1) traditional IRAs,
(2) SEP IRAs,
(3) SIMPLE IRAs,
(4) 401(k) plans,
(5) 403(b) plans,
(6) 457(b) plans,
(7) profit sharing plans,
(8) other defined contribution plans[5] (e.g., money purchase pension), *and*
(9) Roth IRA beneficiaries.

> **Note:** Roth IRAs do not require withdrawals until after the death of the owner; however, beneficiaries of a Roth IRA are subject to the RMD rules. Designated Roth accounts in a 401(k) or 403(b) plan were subject to the RMD rules for 2022 and 2023. However, for 2024 and later years, RMDs are no longer required from designated Roth accounts.

Owners of traditional IRAs, SIMPLE IRAs, and SEP IRAs, plan accounts must start receiving distributions by April first of the year following the year in which they attained age 73 (prior law was at first age 70½ and then 72). Owners of 401(k), profit-sharing, 403(b), or other defined contribution plan accounts must start receiving distributions by the later of April first of the year following the year in which they attained age 73 or, their retirement (assuming the plan permits)[6]. These dates are referred to as the required beginning date (RBD). For each year after the required beginning date, a taxpayer must withdraw their RMD by December 31.

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[5] A defined benefit plan generally must make RMDs by distributing the participant's entire interest in periodic annuity payments (i.e., the defined benefit) as calculated by the plan.

[6] Account owners in a workplace retirement plan (for example, 401(k) or profit-sharing plan) can delay taking their RMDs until the year they retire, unless they're a 5% owner of the business sponsoring the plan.

Note: The minimum distribution amount for the year the taxpayer attained age 73 must be received no later than April 1st of the next year. Thereafter, the required minimum distribution for any year must be made by December 31st of that later year.

Comment: The age on which the required beginning date is determined for starting required minimum distributions increases further to age 75 for individuals who attain age 74 after December 31, 2032.

Example

Jodie has decided to retire from their employer on her 73rd birthday, December 31, 2024. The employer's 401(k) plan allows participants to delay taking RMDs until after they retire. Jodie's first RMD is due by April 1, 2025, for the 2024 year (based on December 31, 2023, balance). Their second RMD is due on December 31, 2025, for 2025 (based on December 31, 2024, balance). Subsequent RMDs are due on December 31st annually thereafter. If Jodie was a 5% owner of the employer, her first RMD would have been due for 2023. If Jodie also had an IRA, her first RMD from her IRA was due by April 1, 2024, for the 2023 year. Jodie's RMD from her IRA doesn't affect the RMD due from the retirement plan.

As a result, for the first year following the year taxpayer reaches age 73, they will have two required distribution dates:

(1) an April 1 withdrawal for the year you turn 73, *and*

(2) an additional withdrawal by December 31.

Comment: Taxpayers can make their first withdrawal by December 31 of the year they turn 73 instead of waiting until April 1 of the following year. This would allow the distributions to be included in their income in separate tax years.

Updated IRS Chart: Required Minimum Distributions for Account Owners

Question	IRAs including SEP, SIMPLE and SARSEPIRAs	Defined Contribution Plans

When do 1 take my first RMD (the required beginning date)?	You must take your first RMD by April 1 of the year following the year in which you turn 73 regardless of whether you are still employed.	April 1 of the year following the later of the year you turn 73 or the year you retire (if allowed by your plan). If you are a 5% owner, you must start RMDs by April 1 of the year following the year you turn 73.
What is the deadline for taking subsequent RMDs after the first RMD?	After the first RMD, you must take subsequent RMDs by December 31 of each year beginning with the calendar year containing your required beginning date.	Same as the IRA rule
How do 1 calculate my RMD?	Your RMD is generally determined by dividing the adjusted market value of your IRAs as of December 31 of the preceding year by the distribution period that corresponds with your age in the Uniform Lifetime Table If your spouse is your sole beneficiary and is more than 10 years younger than you, you will use the Joint Life and Last Survivor Expectancy Table.	Same as the IRA rule. Your plan sponsor/administrator should calculate the RMD for you.
How should 1 take my RMDs if 1 have multiple accounts?	If you have more than one IRA, you must calculate the RMD for each IRA separately each year. However, you may aggregate your RMD amounts for all your IRAs and withdraw the total from one IRA or a portion from each of your IRAs. You do not have to take a separate RMD from each IRA.	If you have more than one defined contribution plan, you must calculate and satisfy your RMDs separately for each plan and withdraw that amount from that plan.

If the required minimum distribution is not made, then an excise tax equal to 50% of the excess of the minimum required distribution over the amount actually distributed will be imposed on the payee (see Form 5329).

Calculating RMDs

The RMD amount changes from year to year and is based on life expectancy. It is calculated by dividing an account's year-end value by the estimated remaining years of a participant's life, in tables provided by the IRS. The tables contained IRS Pub. 590-B, used to calculate RMD are:

(a) *Table I (Single Life Expectancy)* is used for beneficiaries of an account (an inherited IRA) who are *not* the spouse of the IRA owner or the beneficiary is not an individual and the owner died on or after the RBD;

(b) *Table II (Joint Life and Last Survivor Expectancy)* is used for owners whose spouses are more than 10 years younger *and* are the IRA's sole beneficiaries; *or*

(c) *Table III* (*Uniform Lifetime)* – for all unmarried IRA owners calculating their own withdrawals, married owners whose spouses aren't more than 10 years younger, and married owners whose spouses aren't the sole beneficiaries of their IRAs.

An IRA owner must calculate the RMD separately for each IRA they own but can withdraw the total amount from one or more of the IRAs. Similarly, a 403(b) contract owner must calculate the RMD separately for each 403(b) contract they own but can take the total amount from one or more of the 403(b) contracts. However, RMDs required from other types of retirement plans, such as 401(k) and 457(b) plans, must be taken separately from each of those plan accounts. Although the IRA custodian or retirement plan administrator may calculate the RMD, the account owner is ultimately responsible for taking the correct RMD amount.

Designated Beneficiary

The term "designated beneficiary" is a term of art, and basically means that the beneficiary must be a human being. Thus, an estate is *not* a "designated beneficiary" nor is a charity or other legal entity. If there is more than one beneficiary, then all of them must be human beings, or there is no designated beneficiary.

> **Note:** There is an exception to this rule if each beneficiary has their own certain separate account.

If the beneficiary is a trust, and all of the beneficiaries of the trust are human beings, they will be treated as designated beneficiaries, if certain conditions are met.

Date the Designated Beneficiary Is Determined

Generally, the designated beneficiary is determined on the last day of the calendar year following the calendar year of the IRA owner's death. Any person who was a beneficiary on the date of the owner's death, but is not a beneficiary on the last day of the calendar year following

the calendar year of the owner's death (because, for example, he or she disclaimed entitlement or received his or her entire benefit), will not be taken into account in determining the designated beneficiary.

Required Minimum Distributions during Owner's Lifetime

Required minimum distributions during the owner's lifetime (*and* in the year of death if the owner dies *after* the required beginning date) are based on a distribution period that generally is determined using *Table III (Uniform Lifetime)* from IRS Publication 590-B and set forth below.

The distribution period is not affected by the beneficiary's age *unless* the sole beneficiary is a spouse who is *more* than 10 years younger than the owner.

Table III

Uniform Lifetime (Revised 2022)

For Use by Unmarried Owners, Married Owners Whose Spouses Are Not More Than 10 Years Younger, and Married Owners Whose Spouses Are Not the Sole Beneficiaries

Age	Distribution Period	Age	Distribution Period
72	27.4	97	7.8
73	26.5	98	7.3
74	25.5	99	6.8
75	24.6	100	6.4
76	23.7	101	6.0
77	22.9	102	5.6
78	22.0	103	5.2
79	21.1	104	4.9
80	20.2	105	4.6
81	19.4	106	4.3
82	18.5	107	4.1
83	17.7	108	3.9
84	16.8	109	3.7
85	16.0	110	3.5
86	15.2	111	3.4
87	14.4	112	3.3
88	13.7	113	3.1
89	12.9	114	3.0

90	12.2	115	2.9
91	11.5	116	2.8
92	10.8	117	2.7
93	10.1	118	2.5
94	9.5	119	2.3
95	8.9	120+	2.0
96	8.4		

Example from Pub. 590-B (Rev' 23)

You own a traditional IRA. Your account balance at the end of 2023 was $100,000. You are married and your spouse, who is the sole beneficiary of your IRA, is 6 years younger than you. You turn 75 years old in 2024. You use Table III. Your distribution period is 24.6 Your required minimum distribution for 2024 would be $4,065 ($100,000 ÷ 24.6).

Sole Beneficiary Spouse Who Is More Than 10 Years Younger

If the sole beneficiary is the owner's spouse and their spouse is more than 10 years younger than the owner, use the life expectancy from *Table II (Joint Life and Last Survivor Expectancy)* in IRS Publication 590-B.

Example from Pub. 590-B (Rev' 23)

You own a traditional IRA. Your account balance at the end of 2023 was $100,000. You are married and your spouse, who is the sole beneficiary of your IRA, is 11 years younger than you. You turn 75 in 2024 and your spouse turns 64. You use Table II. Your joint life and last survivor expectancy is 25.3. Your required minimum distribution for 2024 would be $3,953 ($100,000 ÷ 25.3).

Required Minimum Distributions in the Year of the Owner's Death

The required minimum distribution for the year of the owner's death depends on whether the owner died before or after the RMD.

If the owner dies *on or after* the required beginning date, the year-of-death RMD must be taken. The beneficiaries are responsible for figuring and distributing the owner's RMD in the year of death. The RMD is reported as income by the beneficiary.

Note: When there are multiple beneficiaries, each beneficiary is responsible for removing their proportional share of the total RMD amount in the year of death; one beneficiary cannot satisfy the entire RMD amount.

Example

Dan, age 74, died in 2025 before taking his 2025 RMD. Therefore, his year-of-death RMD to be taken from his account will be calculated using the Uniform Lifetime Table and the life expectancy factor (25.5) that corresponds to his age (74).

If the owner died *before* the required beginning date, there is no required minimum distribution in the year of the owner's death.

Example

Dan turned 73 in August 2024. He died on December 15, 2024. A year of death RMD is not necessary because Dan died before his RBD - April 1, 2025 (i.e. April 1st of the following year he turned age 73).

Distributions after Owner's Death to Beneficiaries – "10-year Rule"

Under the SECURE Act, distributions to individual beneficiaries *other* than:

(i) the surviving spouse (a domestic partner does not count, but same-sex married does) of the participant (or IRA owner),

(ii) disabled or chronically ill individuals,

(iii) individuals who are *not* more than 10 years younger than the participant (or IRA owner), *or*

(iv) a minor child of the participant (or IRA owner) but, only until they reach age majority

are generally required to be distributed by the end of the tenth calendar year following the year of the participant or IRA owner's death ("10-year rule"). The 10-year rule applies regardless of whether the participant or IRA owner dies before, on, or after, the required beginning date (RBD) the age at which they had to begin RMDs (age 73).

Any beneficiary listed above is referred to as an "eligible designated beneficiary" (EDB). An EDB is a beneficiary who is exempt from the 10-year rule.

Choice: Even though an eligible designated beneficiary (EDB) is exempt from the 10-year rule they may still choose to use it.

Stretching Required Distributions

As a result, instead of being able to stretch required distributions over decades (depending on the age of the beneficiary), beneficiaries (other than EDBs) have to fully distribute the account within 10 years following the owner's death. The beneficiary can distribute the retirement plan or IRA account on any schedule, but the account must be fully distributed by the end of 10 years.

The SECURE Act's 10-year rule does not apply to EDBs and with proper planning, they may spread the inherited account distribution over the beneficiary's life expectancy at the time of the decedent's death, using tables published by the IRS. Thus, EDBs can continue to stretch distributions, but on their death, any remaining amount must be distributed under the 10-year distribution rule.

> **Note:** The 10-year rule only applies to a non-EDB when the original IRA owner died after 2019. Beneficiaries who inherited IRAs before 2020 are grandfathered and follow the old rules.

Beneficiary Is an Individual - Designated Beneficiary Exists

If the designated beneficiary *is* an EDB *individual* exempt from the SECURE Act, such as the owner's spouse or child, required minimum distributions for years after the year of the owner's death generally are based on the beneficiary's single life expectancy.

> **Note:** This rule applies whether or not the death occurred before the owner's required beginning date.
>
> **Comment:** While a minor child is an EDB, a grandchild is not. Also, a minor child is only an EDB while under the age of majority (18 in most states). Once the beneficiary reaches the age majority, the 10-year rule starts.

To figure the required minimum distribution for the current year, divide the account balance at the end of the preceding year by the appropriate life expectancy from *Table I (Single Life Expectancy) (For Use by Beneficiaries)* in IRS Publication 590-B.

Multiple Individual Beneficiaries

If as of the end of the year following the year in which the owner dies there is more than one beneficiary, the beneficiary with the *shortest* life expectancy (i.e., the oldest beneficiary) will be the designated beneficiary if both of the following apply:

(i) all of the beneficiaries are individuals, *and*

> **Note:** Unless all of the beneficiaries are individuals as of the determination date, none of the individuals are designated beneficiaries.

(ii) the account or benefit has not been divided into separate accounts or shares for each beneficiary.

Surviving Spouse Sole Designated Beneficiary

The spouse of the account owner has more options than non-spouse beneficiaries if they're the sole beneficiary. Surviving spouses who are beneficiaries are excluded from the 10-year rule. They are EDBs and have the same options they had before the SECURE Act.

> **Note:** Determination of whether the spouse is the sole beneficiary is made by September 30 of the year following the year of the account holder's death.

A spouse beneficiary may treat:

(i) the retirement plan or IRA account as their own by designating themselves as the account owner,

(ii) the retirement plan or IRA account as their own IRA by rolling it over (or transferring it) into their IRA, a qualified employer, §403(a), §403(b), or §457 plan, *or*

> **Note:** Spouses have 60 days from receiving the inherited distribution to roll it over into their own IRA. In addition, before a rollover can be made, any RMD due as of the year of rollover must be made first since RMDs can never be rolled over.
>
> **Comment:** Where the surviving spouse elects such a spousal rollover, he or she can name a new beneficiary and delay distributions until his or her own required beginning date.

(iii) themselves as the beneficiary rather than treating the retirement plan or IRA account as their own (i.e., the account remains in the decedent's name).

> **Note:** If the IRA owner dies before they reach age 73, RMDs to the spousal beneficiary (based on their life expectancy) do not need to begin until the year the original owner would have reached age 73. If the IRA owner had already started getting RMDs or reached their required beginning date (RBD) at the time of death, the surviving spouse can continue the distributions as were originally calculated based on the owner's life expectancy.

If the surviving spouse elects to be treated as the owner, they determine the RMD (if any) as if they were the owner beginning with the year they elect or are deemed to be the owner. The surviving spouse takes RMDs based on his or her age and names beneficiaries for their account, all without reference to the deceased spouse's account.

> **Note:** The spouse will be considered to have chosen to treat the IRA as their own if (i) contributions (including rollover contributions) are made to the inherited IRA, or (2) the spouse does not take the required minimum distribution for a year as a beneficiary of the IRA.

Non-Spouse Beneficiary

If anyone other than the account owner's spouse inherits a retirement plan or IRA account they cannot treat the account as their own. Unlike a spouse, a non-spouse beneficiary cannot roll over IRA or retirement plan funds. However, they can make a direct trustee-to-trustee transfer (a 60-day rollover is not permitted) as long as the account into which amounts are being moved is set up and maintained in the name of the deceased account owner for their benefit as beneficiary.

> **Note:** Before a non-spousal rollover can be made, any RMD due must be made first.

The following requirements apply to a non-spouse beneficiary doing a direct transfer to an inherited IRA:

(i) any distribution of the funds directly to the beneficiary instead of the inherited account will preclude the transfer;

(ii) the inherited account must be new, not one already owned by the non-spouse beneficiary, and titled in the name of the decedent for the benefit of the beneficiary;

(iii) beneficiaries are not permitted to make additional contributions to the inherited account; *and*

(iv) the transfer must be completed by December 31st of the year following the account holder's death.

After the transfer is made, if the beneficiary is an EDB and starts distributions by December 31st of the year after the decedent's death, they may take distributions over the longer of their own life expectancy and the employee's remaining life expectancy, or follow the 10-year rule (if the account owner died before that owner's required beginning date).

Beneficiary Is Not an Individual - No Designated Beneficiary

An IRA or retirement plan account must have what the regulations call a designated beneficiary, and *only* individuals can be a designated beneficiary. There is no designated beneficiary when no beneficiary is named or the named beneficiary is not an individual such as an estate, a non-qualifying trust, charity, corporation, or other entity.

The SECURE Act did not alter the rules that apply when an IRA or retirement account does not have a designated beneficiary. For these accounts, the required minimum distributions for years after the owner's death depend on whether the death occurred before the owner's required beginning date (age 73).

a. Death on or after the required beginning date. If the death is on or after the required beginning date for RMDs, then the beneficiary can take payouts over what would have been the deceased account owner's remaining single-life expectancy, had he lived. To determine the

required minimum distribution for the current year the account balance at the end of the preceding year is divided by the appropriate life expectancy from *Table I (Single Life Expectancy) (For Use by Beneficiaries)* in IRS Publication 590-B.

> **Comment:** In short, the IRA can be distributed as though the IRA owner still lived, using the owner's remaining life expectancy.

b. Death before the required beginning date. The entire account must be distributed by the end of the fifth year following the year of the owner's death (5-year rule). No distribution is required for any year before that fifth year.

Trust as Beneficiary

A beneficiary of an IRA or retirement plan can be any person or entity the participant chooses. However, a trust *cannot* be a *designated* beneficiary even if it is a named beneficiary. Only an individual can be a designated beneficiary. In the case of a trust, the trust beneficiaries, rather than the trust itself, are used to determine the classification of the IRA beneficiary.

> **Note:** It is assumed that the IRS will continue, under the SECURE Act, to treat beneficiaries of qualified trusts as individuals (and potential EDBs) as under prior law.

A trust can be either a "*conduit trust*" (all distributions must be passed out to the beneficiary as soon as the trustee receives them) or an "*accumulation trust*" (the trustee can hold distributions in the trust for later distribution to the beneficiary, though not past age 31).

Conduit Trusts

If the trust identifies a specific beneficiary or beneficiaries to receive all withdrawals from the account, that individual or entity is treated as the direct beneficiary. This is only the case when the trust is unable to accumulate any funds prior to disbursing funds directly to its beneficiaries. Essentially, such a trust is considered a conduit trust and its existence is ignored in the beneficiary classification.

> **Comment:** For example, if the identified trust beneficiary is an estate or charity (a non-individual), the IRA or retirement plan has no designated beneficiary. However, when the identified trust beneficiary is an individual, the IRA or retirement plan account has either an eligible designated beneficiary (EDB) or a designated beneficiary, and the respective rules apply.

Accumulation Trusts

On the other hand, if a trust can accumulate withdrawals (rather than disbursing them in their entirety to the beneficiaries) and disburse funds to its trust beneficiaries over time, it is considered an accumula-

tion trust. Such accumulation trusts typically name estates or charities in some capacity as a beneficiary. Because these beneficiaries are not individuals, the trust is subject to either the five-year rule or the pay-out rules for non-designated beneficiaries.

Estate Tax Deduction

A beneficiary may be able to claim a deduction for estate tax resulting from certain distributions from an IRA or retirement plan account. A beneficiary can deduct the estate tax paid on any part of a distribution that is income in respect of a decedent. He or she can take the deduction for the tax year the income is reported.

Post-Retirement Tax Treatment of Distributions

Divorce

The transfer of a participant's interest in an IRA or retirement plan to their former spouse under a decree of divorce or a written instrument incident to such divorce is not a taxable distribution. Thereafter, the IRA will be treated for tax purposes as being owned by the former spouse.

Losses on IRA Investments

As a result of the TCJA, the option to claim a loss on IRA investments has been suspended for tax years 2018 through 2025.

Estate Tax Consequences

The estate tax consequences are generally nil since the surviving spouse is usually the beneficiary and is entitled to the unlimited marital deduction.

Income In Respect of a Decedent

Distributions to a beneficiary or estate of a deceased individual will generally be taxed in the same manner as if the participant received them. Life insurance death benefits, however, will not lose their tax-exempt character. Any amounts that are taxable to the beneficiary should be regarded as income in respect of a decedent. Therefore, the beneficiary will be entitled to a deduction from gross income for any federal estate taxes attributable to the inclusion of the IRA or retirement plan account in the decedent's gross estate.

Tax-Free Rollovers

Most pre-retirement payments received from a retirement plan or IRA can be "rolled over" by depositing the payment in another retirement plan or IRA within 60 days. A rollover is a tax-free distribution of cash or other assets from one

retirement plan that is contributed to another retirement plan. The tax-free rollover provisions relate to all types of qualified plans.

> **Note:** A transfer of funds in a traditional IRA from one trustee directly to another, either at the taxpayer's request or at the trustee's request, is *not a rollover.* Since there is no distribution to the taxpayer, the transfer is tax-free. Because it is not a rollover, it is not affected by the 1-year waiting period required between rollovers.

Amounts paid or distributed to an individual out of an IRA or retirement plan are *not* currently taxable if:

(1) a distribution from an IRA or a retirement plan is paid directly to a participant and they deposit it in an IRA or a retirement plan within 60 days; *or*

(2) the amount is directly paid trustee to trustee from the participant's IRA or retirement plan to another IRA or retirement plan.

Taxpayers cannot deduct the amount that they roll over in an IRA or retirement plan.

Amounts not rolled over within the 60-day period do not qualify for tax-free rollover treatment. Taxpayers must treat them as a taxable distribution from either their IRA or employer's plan. These amounts are taxable in the year distributed, even if the 60-day period expires in the next year.

Taxpayers may also have to pay a 10% tax on early distributions.

Penalty Tax on Premature Distributions

Amounts an individual withdraws from an IRA or retirement plan before reaching age 59½ are called "early" or "premature" distributions. A 10% additional tax generally applies to early distributions from qualified plans, 403(a) or (b) annuity plans, and traditional IRAs, including IRAs that are connected to a SIMPLE IRA or SEP plan maintained by an employer. However, numerous exceptions are provided to this penalty tax (see §72(t), IRS Topic #558, and Notice 2024-55).

Prohibited Rollovers - §402(c)

Certain types of distributions cannot be rolled over, including:

(a) required minimum distributions,

(b) loans treated as a distribution,

(c) hardship distributions,

(d) distributions of excess contributions and related earnings,

(e) a distribution that is one of a series of substantially equal payments,

(f) withdrawals electing out of automatic contribution arrangements,

(g) distributions to pay for accident, health or life insurance, *and*

(h) dividends on employer securities.

Waiting Period Between Rollovers

Taxpayers can make only one rollover from an IRA to another (or the same) IRA in any 12-month period, regardless of the number of IRAs they own. However, the one-per-year limit does not apply to:

(a) rollovers from traditional IRAs to Roth IRAs (i.e., conversions),

(b) trustee-to-trustee transfers to another IRA,

(c) IRA-to-plan rollovers,

(d) plan-to-IRA rollovers, *and*

(e) plan-to-plan rollovers.

Partial Rollovers

If a taxpayer withdraws assets from an IRA or retirement plan, they can roll over part of the withdrawal tax-free and keep the rest of it. The amount kept will generally be taxable (except for the part that is a return of nondeductible contributions) and may be subject to the 10% tax on premature distributions.

Withholding Requirement

If an eligible rollover distribution is paid directly to a *participant*, the payer must withhold a percentage of it. This applies even if the participant plans to roll over the distribution. This withholding can be avoided by a direct trustee-to-trustee rollover.

An IRA distribution paid to a participant is subject to 10% withholding unless they elect out of withholding or choose to have a different amount withheld. A retirement plan distribution paid to a participant is subject to mandatory withholding of 20%, even if they intend to roll it over later.

Conduit IRAs

Taxpayers can use a traditional IRA as a holding account (conduit) for assets they receive in an eligible rollover distribution from one employer's plan that they later roll over into a new employer's plan. The conduit IRA must be made up of only those assets and gains and earnings on those assets.

Miscellaneous Rollovers

Distributions from tax-qualified retirement plans, tax-sheltered annuities, and governmental §457 plans can be rolled over directly from such plans into a Roth IRA, subject to the rules that apply to rollovers from a traditional IRA into a Roth IRA.

If a taxpayer participates in an eligible deferred compensation plan of a state or local government (as defined in §457), they may be able to roll over part of their account tax-free into an eligible retirement plan such as a traditional

IRA and vice versa. The most that a taxpayer can roll over is the amount that would be taxed if the rollover were not an eligible rollover distribution.

A taxpayer is able to roll over distributions tax-free from a traditional IRA into a tax-sheltered annuity (as defined in §403(B). They cannot roll over any amount that would not have been taxable.

Taxpayers can roll over tax-free a distribution from their SIMPLE IRA to a qualified plan, a tax-sheltered annuity (§403(b) plan), or a deferred compensation plan of a state or local government (§457 plan).

Non-spouse beneficiaries are not allowed to complete indirect or 60-day rollovers of amounts received. If a non-spouse beneficiary wants to complete a rollover of inherited plan assets, they must do so through a direct trustee-to-trustee transfer. That retirement account must be named as a beneficiary account including both the deceased and beneficiary's names.

Rollover Individual Retirement Accounts	
Planholder	Recipients of partial or lump-sum distributions from an employer-sponsored retirement plan within one taxable year. Distributions cannot be a series of periodic payments.
Eligibility Requirements	**Recipients of total distributions due to:**
	Separation from service* Attainment of age 59½ Termination of the plan by the employer Permanent disability** Death of employee (if the spouse is beneficiary) Qualified Domestic Relations Order
	*Does not apply to self-employed individuals ** Does apply to self-employed individuals
	Recipients of partial distribution due to:
	Separation from service Death of employee (if the spouse is beneficiary) Permanent disability
Contribution Limits	**Maximum Contribution Limit:** Up to 100% of the distribution. Employee voluntary non-deductible contributions cannot be rolled; earnings on these contributions can. The participant can keep a portion of the payout and roll over the rest.
Deadlines For Establishment & Contributions	Rollovers must be completed by the 60th day after receipt of the distribution. Rollovers from an employer-sponsored retirement plan are an irrevocable election.
Distributions	**Earliest without 10% tax penalty:**

	Death Permanent disability Attainment of age 59½ Periodic payments based on a life expectancy formula that cannot be modified for at least 5 years or until attainment of age 59½, if late Transfer of assets from a participant's IRA to a spouse's or former spouse's IRA in accordance with a divorce or separation document.
	Latest (without 50% excise tax penalty):
	April 1 of the calendar year following the year in which the participant reaches age 73.
Tax Treatment on Distribution	All distributions from any type of IRA are taxed as ordinary income. Remember, however, that if the individual made nondeductible contributions, each distribution consists of a nontaxable portion and a taxable portion.

Contribution Limits

Defined Benefit Plans - §415(b)(1)(A)

For 2025, the maximum annual benefit for a participant under a defined benefit plan is the lesser of:

(1) $280,000 (up from $275,000 in 2024), *or*

(2) 100% of the participant's average compensation for his or her highest 3 consecutive calendar years (§415(b)(1)(A)).

Defined Contribution Plans - § 415(c)(1)(A)

For 2025, a defined contribution plan's maximum annual contributions and other additions (excluding earnings) to the account of a participant is the lesser of:

(1) $70,000 (up from $69,000 in 2024), *or*

(2) 100% of the compensation actually paid to the participant (§415(c)(1)(A) & (B)).

Compensation Limit - §401, §404 & §408

For 2025, the maximum compensation used for figuring contributions and benefits is $350,000 (up from $345,000 in 2024).

IRA Contribution Limit - §219

For 2025, an individual who is not an active participant in certain employer-sponsored retirement plans, and whose spouse is not an active participant, may make an annual deductible cash contribution to an IRA up to the *lesser* of:

(1) $7,000 (up from $6,500 in 2023), *or*

(2) 100% of your compensation for the year.

Catch-up Contribution - §219(b)(5)(B)

Individuals at least age 50 by year-end may make additional "catch-up" contributions. For IRAs, the maximum catch-up contribution is $1,000 (§219(b)(5)(B)). This additional catch-up contribution limit for individuals aged 50 and over is not subject to an annual cost-of-living adjustment and remains $1,000.

Thus, if you were age 50 or older before the end of 2025, the most that can be contributed to your traditional IRA for 2025 is the smaller of the following amounts:

(1) $8,000 (up from $7,500 2023) – i.e., $7,000 plus $1,000 catch up, *or*

(2) 100% of your compensation for the year.

> **Note:** The 2025 catch-up contribution limit for employees aged 50 and over who participate in *§401(k), §403(b), most §457 plans*, and the federal government's Thrift Savings Plan is $7,500 (same as 2024).

IRA AGI Phaseout Limits - §219

Individual Taxpayer is an Active Plan Participant

For 2025, if an individual *is* covered by a retirement plan at work, the deduction for contributions to a traditional IRA is reduced (phased out) when modified AGI is:

(1) more than $126,000 but less than $146,000 (up from $123,000 & $143,000 in 2024) for a married couple filing a joint return or a qualifying widow(er),

(2) more than $79,000 but less than $89,000 (up from $77,000 & $87,000 in 2024) for a single individual or head of household, *or*

(3) less than $10,000 for a married individual filing a separate return ((§219(g)(3)(B)(iii)).

Spouse is an Active Plan Participant

If you either live with your spouse or file a joint return, and your spouse is covered by a retirement plan at work, but you are *not*, your deduction is phased out if your modified AGI is more than $236,000 but less than $246,000 in 2025 (up from $230,000 and $240,000 for 2024) (§219(g)(7)(A)).

If your modified AGI is $246,000 or more, you cannot take a deduction for contributions to a traditional IRA in 2025. The phase-out range remains $0 to $10,000 for a married individual filing a separate return who is covered by a retirement plan at work.

Roth Contribution Limit - §408A(c)(2) & §219

Individuals may make nondeductible contributions to a Roth IRA, subject to the overall limit on IRA contributions. For 2025, if contributions on your behalf are made only to Roth IRAs, your contribution limit is the lesser of:

(1) $7,000 (up from $6,500 in 2023), *or*

(2) 100% of your compensation for the year.

If you are age 50 or older and contributions on your behalf are made only to Roth IRAs, your contribution limit is the lesser of:

(1) $8,000 (up from $7,500 in 2023) – i.e., $7,000 plus $1,000 catch-up, *or*

(2) 100% of your compensation for the year (§219(b)(5)(B)(ii).

However, if your modified adjusted gross income (AGI) is above a certain amount, your contribution limit may be reduced.

Roth AGI Phaseout Limits - §408A(c)(3)

The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with MAGI over certain levels for the tax year. For 2025, your Roth IRA contribution limit is reduced (phased out) in the following situations:

1. Your filing status is married filing jointly or qualifying widow(er) and your modified AGI is at least $236,000 (up from $230,000 in 2024). You cannot make a Roth IRA contribution if your modified AGI is $246,000 (up from $240,000 in 2024) or more (§408A(c)(3)(C)(ii)(I)).

2. Your filing status is single, head of household, or married filing separately and you did not live with your spouse at any time in 2025 and your modified AGI is at least $150,000 (up from $146,000 in 2024). You cannot make a Roth IRA contribution if your modified AGI is $165,000 (up from $161,000 in 2024) or more (§408A(c)(3)(C)(ii)(II)).

3. Your filing status is married filing separately, you lived with your spouse at any time during the year, and your modified AGI is more than -0-. You cannot make a Roth IRA contribution if your modified AGI is $10,000 (same since 2017) or more (§408A(c)(3)(C)(ii)(III)).

§401(k), §403(b) & §457 Elective Deferral & Catch-up Limits

For 2025, the elective deferral (contribution) limit for employees who participate in §401(k), §403(b), or §457(b) plans, and the federal government's Thrift Savings Plan is $23,500 – up from $23,000 in 2024 (§402(g)(3) & Notice 2024-80).

The dollar limitation for catch-up contributions to an applicable employer plan, *other* than a cash or deferred arrangement under §401(k)(11) or a sim-

ple retirement account under §408(p), for individuals aged 50 or over is $7,500 in 2025 (same as 2024) – see §414(v)(2)(B)(i).

> **Note:** The dollar limitation for catch-up contributions to an applicable employer plan described in §401(k)(11) or 408(p) for individuals aged 50 or over is $3,500 in 2025 (same as 2024) – see §414(v)(2)(B)(ii).

The $23,500 limit, plus the $7,500 catch-up contribution, means individuals 50 or older can put as much as $31,000 of their pre-tax income into their workplace retirement plans in 2025.

Roth Treatment of Catch-up Contributions – Secure Act §603

Participants in §401(k), §403(b), and §457 plans have the option of making retirement contributions from their salary, on a pre-tax basis. They may also have the option to make post-tax Roth contributions. However, participants are subject to a combined (pre-tax and post-tax) maximum annual contribution limit on employee salary deferrals of $23,500 in 2025 ($23,000 in 2024). When permitted, participants can exceed this limit, if age 50 or older, by making "catch-up contributions" up to an additional, annually adjusted limit ($7,500 in 2025).

"Rothification" Rules

Effective 2024, the Secure 2.0 Act requires that any catch-up contributions (if permitted by the §401(k), §403(b), or §457 plan) made by employees earning $145,000 or more per year, must be treated only as post-tax, ROTH contributions.

> **Comment:** This forces such plans to either amend the plan to allow for post-tax ROTH contributions, or prohibit employees earning more than $145,000 per year from making any catch-up contributions after 2024.

In Notice 2023-62, the IRS announced it would delay for two years (until 2026) the requirement that workers making $145,000 or more per year who make catch-up contributions to employer-sponsored retirement plans will have to instead put that money into Roth accounts.

> **Note:** SECURE 2.0 technically eliminated all catch-up contributions by accidentally deleting §402(g)(1)(C). Legislators have indicated Congress intends to resolve this error with a future technical correction.

SIMPLE Plans

For 2025, the limit on salary reduction contributions (excluding catch-up contributions) to a SIMPLE plan is $16,500 (up from $16,000 in 2024) (§408(p)(2)(E)). A salary reduction contribution that your employer could make on your behalf under a SIMPLE plan is also $16,500 (Notice 2024-80).

> **Note:** Tax law now permits rollovers of distributions from employer-sponsored retirement plans and traditional IRAs (that are not SIMPLE IRAs)

into a SIMPLE IRA after the expiration of the two-year period following the date the employee first participated in the SIMPLE IRA (the two-year period during which the additional income tax on distributions from a SIMPLE IRA is 25% instead of 10%).

Simplified Employee Pensions (SEPs)

Contribution Limit

For 2025, the annual limit on the amount of employer contributions to a SEP is the *lesser* of:

(1) $70,000 (up from $69,000 in 2024), *or*

(2) 25% of an eligible employee's compensation (Notice 2024-80).

Compensation Limit

For 2025, the maximum amount of an employee's compensation you can consider when figuring SEP contributions (including elective deferrals) and the deduction for contributions was $350,000 (up from $345,000 in 2024).

For 2025, the minimum compensation amount for simplified employee pensions (SEPs) is $750 (same as 2024) (§408(k)(2)(C)).

Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regard to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

124. An IRA beneficiary can be any person or entity the IRA owner chooses. However, a trust:

a. can be designated beneficiary.

b. cannot be a beneficiary.

c. must be a revocable trust to be a designated beneficiary.

d. determines the IRA beneficiary classification.

125. A rollover is a tax-free reinvestment from one retirement plan to another. What fails to qualify as a rollover?

a. funds in a traditional IRA transferred from one trustee directly to another, at the investor's request.

b. all of the assets from a qualified plan are withdrawn and reinvested in a traditional IRA.

c. part of the assets from a traditional IRA that are withdrawn and reinvested in a qualified plan.

d. part of the assets from a traditional IRA that is withdrawn and reinvested within 60 days in the same traditional IRA.

Learning Objectives

After reading Chapter 4, participants will be able to:

1. Identify how the passive loss rules limit the ability to take deductions, what transactions free disallowed losses, how suspended losses are carried forward, and when real estate professionals can escape the passive lost rules.

2. Specify differences between the regular and alternative minimum tax recognizing the impact of tax preferences and adjustments.

3. Identify the reporting requirements for employers, real estate transactions, independent contractors, and cash reporting.

4. Recognize types of accuracy-related and valuation overstatement penalties including the substantial authority defense for reporting positions, and specify the IRS's examination of returns policy and assessment process including applicable statute of limitations.

CHAPTER 4

Losses, AMT & Compliance

Passive Losses

A taxpayer's income and losses for each tax year must be categorized into passive and nonpassive[1]. Losses from passive trade or business activities in excess of income from passive trade or business activities may not be deducted against other income (§469(a)(1)(A)).

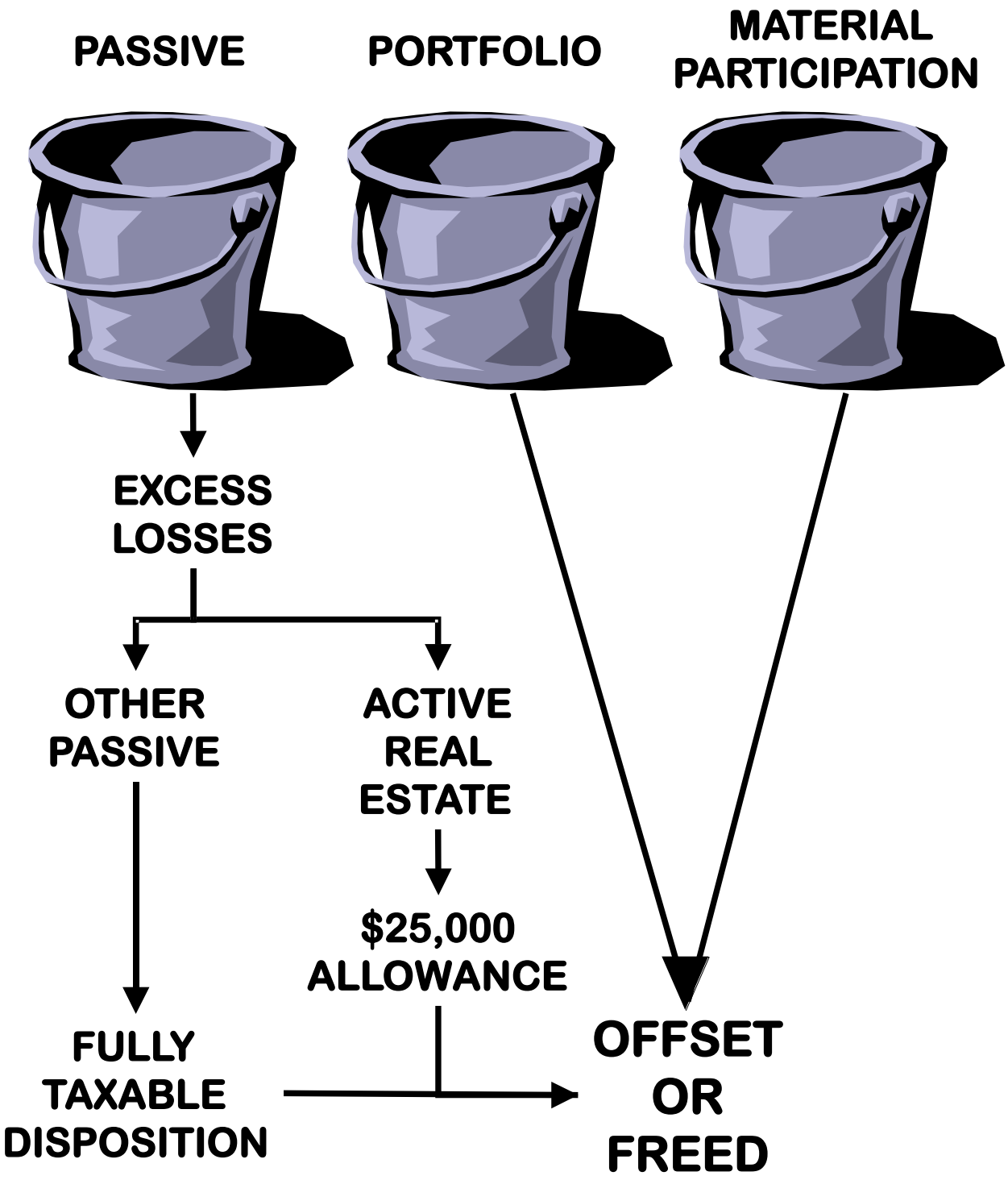
Prior Law

Before the passage of the passive loss rules, few limitations were placed on the ability of a taxpayer to use deductions from a particular activity to offset income from other activities. Similarly, most tax credits could be used to offset tax attributable to income from any of the taxpayer's activities[2].

[1] Nonpassive is further subdivided into portfolio and material participation.

[2] There were some exceptions to this general rule. For example, deductions for capital losses were limited to the extent that there were not offsetting capital gains.

Passive Loss Big Picture



Passive Loss Rules - §469

The passive loss rules provide that deductions from passive trade or business activities, to the extent they exceed income from all such passive activities (exclusive of portfolio income), generally may not be deducted against other income (§469(a)(1)(A)). Similarly, credits from passive activities generally are limited to the tax attributable to the passive activities[3] (§469(a)(1)(A)). Suspended losses and credits are carried forward and treated as deductions and credits from passive activities in the next tax year[4] (§469(b)). Suspended losses from an activity are allowed in full when the taxpayer disposes of their entire interest in the activity. However, the ordering of recognized losses is determined under §469(g)(1).

Aggregate Definition of Passive Activity Loss

Section 469(d)(1)(A) defines the term "passive activity loss" as the amount (if any) by which the aggregate losses from all passive activities for the tax year exceed the aggregate income[5] from all passive activities for such year[6].

Application

The passive loss rule applies to all deductions that are from passive activities, including deductions allowed under §162, §163, §164, and §165.

Observation

As a result, the relationship of a taxpayer to an activity in which they do not materially participate is similar to that of a shareholder to a corporation. Losses and expenses borne by the corporation, and any decline in the value of the corporate stock, do not generate recognition of any loss for shareholders prior to the sale of their stock.

[3] Thus, if there is no net passive activity income for the year, passive credits will generally not be allowed. However, if the $25,000 allowance for rental real estate is not fully used, passive credits can sometimes be converted to deductions and used under the allowance.

[4] The carryforward has no time limit.

[5] Reg. §§1.469-2T(c) and (d) identify the items treated as passive activity gross income and passive activity deductions.

[6] Passive activity credits have a similar aggregate definition (§469(d)(2)).

Active Losses

Section 469 is a passive loss limitation and does not affect active losses. In general, active losses may offset any type of income.

Credits - §469(a)(1)(B)

There are limits on credits as well as losses from passive activities. Credits from a passive activity are generally limited to the income tax allocable to the net passive activity income (§469(a)(1)(B)).

Calculating Passive Loss

The annual computation of passive losses can be summarized as a series of several basic steps:

(1) determine all the separate activities of the taxpayer;

(2) categorize all activities as either:

(a) passive,

(b) portfolio, *or*

(c) material participation;

(3) take the passive activities and net income against loss:

(a) first, netting the income of each activity solely against the losses of that activity[7], *then*

(b) next, offsetting all net income activities against all net loss activities; *and*

(4) if a loss still exists, it constitutes a passive activity loss and §469 applies.

Categories of Income & Loss

Section 469 annually divides a taxpayer's income and losses into two basic categories - passive and non-passive. Non-passive is further subdivided into portfolio and material participation. The result is three categories or "buckets" of income and loss.

Passive - §469(c)

Sections 469(c)(1), (c)(2) and (h)(2) define passive items to be any of the following:

(1) any activity that involves the conduct of a trade or business in which the taxpayer does not materially participate;

(2) any rental activity; *and*

[7] This first netting will be important for purposes of allocating suspended losses among net passive loss activities.

Mini Definition

A rental activity is defined as any activity where payments received are principally for the use of tangible property (§469(j)(8)). This is true even if the property is rented under a net lease (Conference Report, II-138). However, if substantial services are rendered or the taxpayer is a dealer with respect to the property (Senate Report, p.720), the activity will not be considered a rental activity.

(3) any limited partnership.

Portfolio - §§469(e)(1)(A) & (B)

While the term "portfolio income" is not used in the Code, the following items (which make up "portfolio income") are deemed to be non-passive under §469(e)(1)(A) and (B):

(1) interest (other than qualified residence interest which is nonpassive (§469(j)(7)),

> **Note:** This includes dividends and guaranteed payments from a partnership for interest on capital.

(2) dividends (net of dividend-received deduction) from:

(a) "C" corporations,

(b) REITs, REMICs & RICs (Conference Report, II-146, note 3), *or*

(c) regulated investment companies,

(3) annuities,

(4) royalties (not derived in the ordinary course of a trade or business - e.g., royalties from the licensing of property),

(5) expenses (other than interest) which are clearly and directly allocable to items 1 through 4 (Conference Report H7636),

(6) interest expense properly allocable to items 1 through 4 (Conference Report H7636),

> **Note:** The Conference Agreement stated that regulations related to appropriate interest expense allocation be issued prior to 12/31/86. The Service responded on July 1, 1987, with an intricate set of "tracing" regulations.

(7) gain or loss from the sale of property generating such income or held for investment[8],

(8) income, gain, or loss which is attributable to an investment of working capital[9], *and*

[8] For purposes of this clause, any interest in a passive activity shall not be treated as property held for investment (§469(e)(1)(A)(ii)).

(9) income[10] from a publicly traded partnership (§469(k)).

Material Participation - §469(h)(1)

Section 469(h)(1) defines material participation as an activity in which the taxpayer is involved:

(1) regularly,

(2) continuously, *and*

(3) substantially.

Self-Charged Interest Regulations?***

Passive loss rules under §469 prevent passive losses from offsetting active or portfolio income. Thus, passive losses cannot offset interest income that is portfolio income. However, passive losses can offset passive income.

Passive Deduction - Portfolio Income

When a partner makes a loan to their partnership and the loan proceeds are used in a passive activity, the partnership's interest deduction is passive. However, the interest received by the partner is portfolio income. Since a portion of the partnership interest deduction is allocated to the lending partner, we now have apples and oranges; the interest deduction is *passive*, and the partner's interest income is *portfolio*.

Regulations

The IRS has issued regulations to deal with this situation. Under the regulations, partners are allowed to treat such interest income as *passive* so that it can be offset by the partner's share of the corresponding deduction.

For taxpayer loans to a pass-through entity (i.e., partnership or S corporation), the self-charged interest rules apply if:

(a) the borrowing entity has a deduction for its tax year for interest charged by persons that own directly or qualifying indirect interests in the entity at any time during the taxable year;

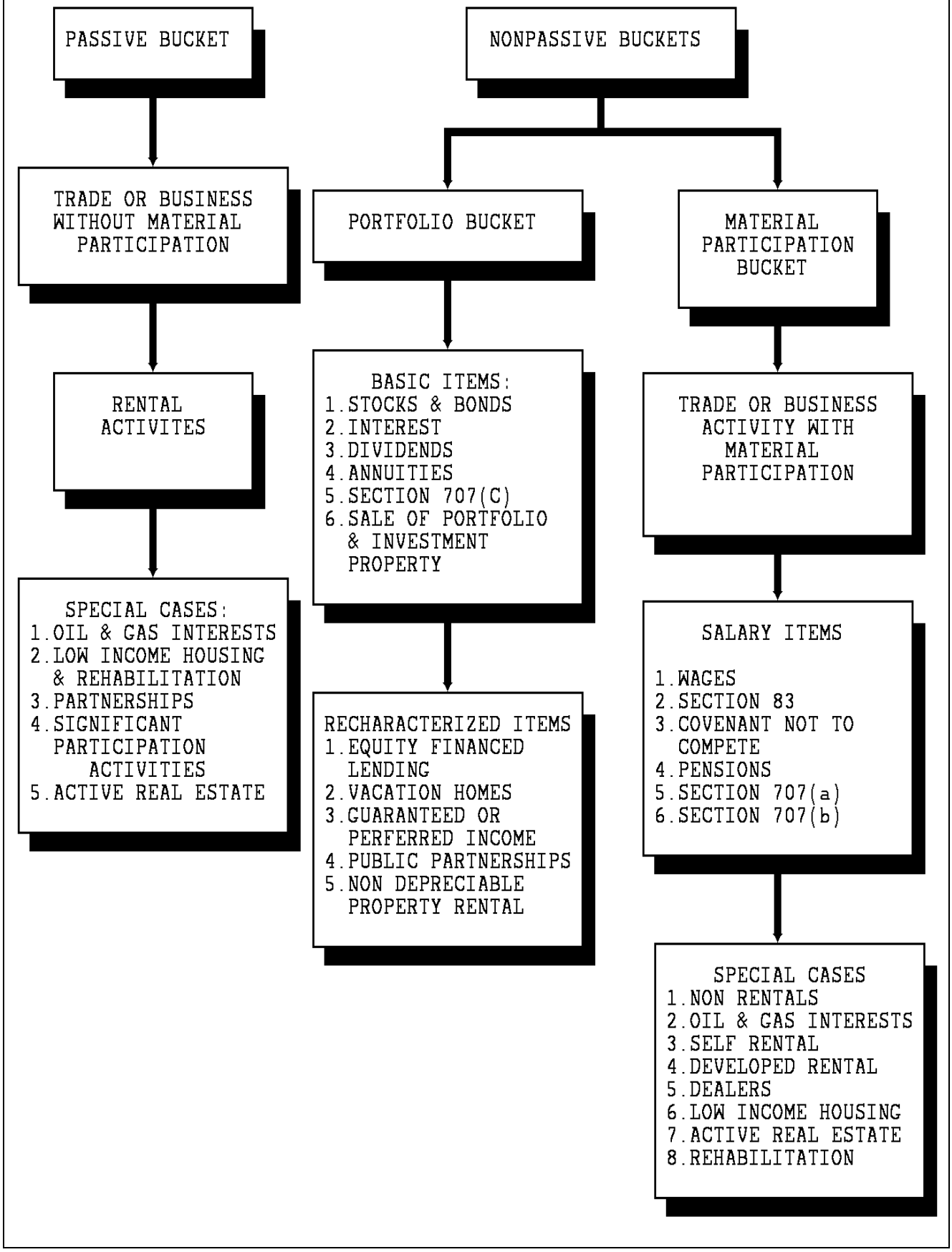
(b) the taxpayer owns a direct or qualifying indirect interest in the borrowing entity at any time during the entity's taxable year and has gross income for the taxable year from interest charged to the borrowing entity; *and*

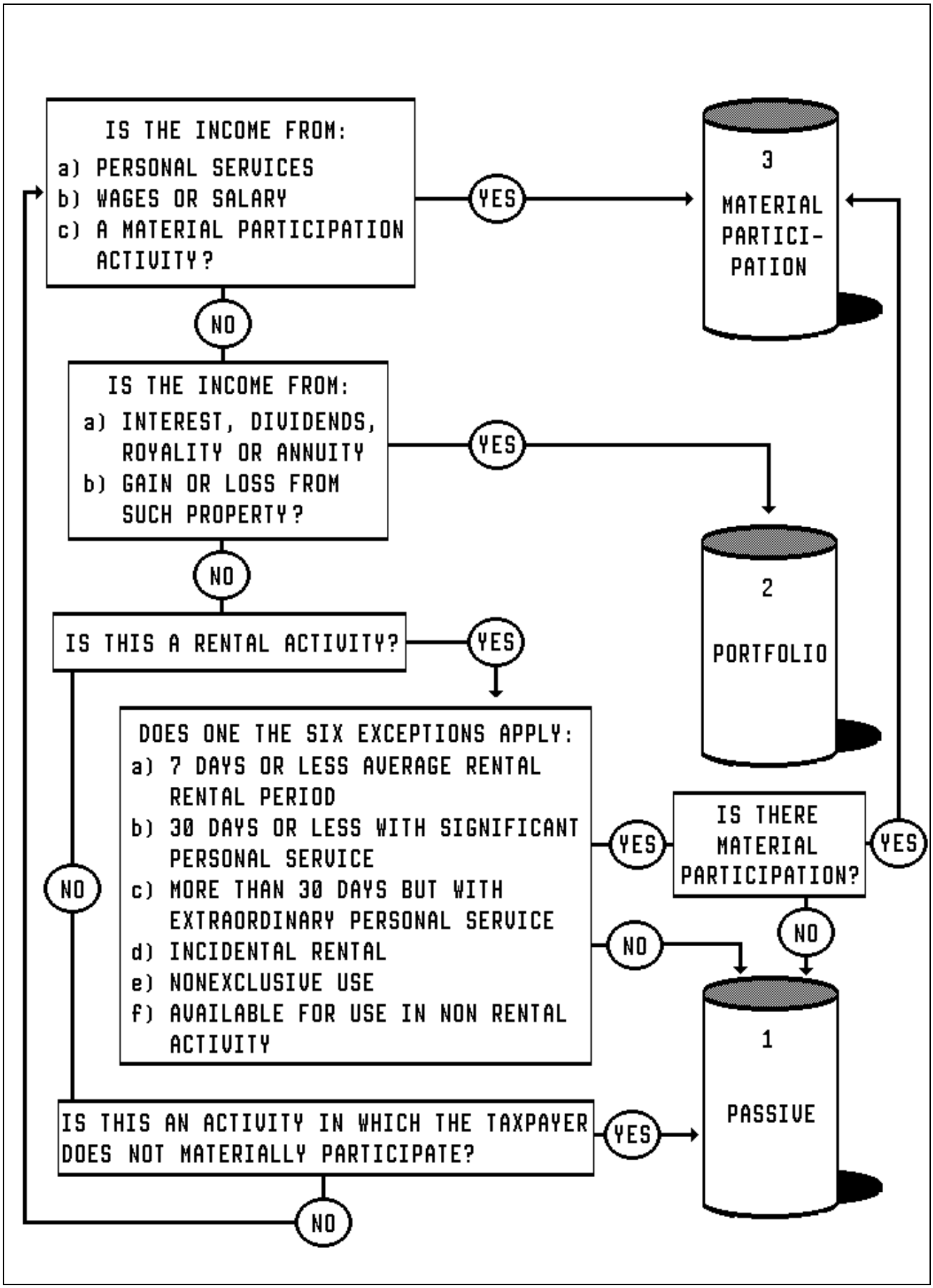
---

[9] Although setting aside such amounts may be necessary to the trade or business, earnings on such amounts are investment related and not a part of the business itself.

[10] Net losses and credits from a publicly traded partnership can only be suspended and carried forward for use against income from that same partnership (Senate Report to RA §87 p. 161).

THREE BUCKETS UNDER SECTION 469




IS THE INCOME FROM:
a) PERSONAL SERVICES
b) WAGES OR SALARY
c) A MATERIAL PARTICIPATION ACTIVITY?
YES
3
MATERIAL PARTICI-PATION
NO
IS THE INCOME FROM:
a) INTEREST, DIVIDENDS, ROYALITY OR ANNUITY
b) GAIN OR LOSS FROM SUCH PROPERTY?
YES
2
PORTFOLIO
NO
IS THIS A RENTAL ACTIVITY?
YES
DOES ONE THE SIX EXCEPTIONS APPLY:
a) 7 DAYS OR LESS AVERAGE RENTAL RENTAL PERIOD
b) 30 DAYS OR LESS WITH SIGNIFICANT PERSONAL SERVICE
c) MORE THAN 30 DAYS BUT WITH EXTRAORDINARY PERSONAL SERVICE
d) INCIDENTAL RENTAL
e) NONEXCLUSIVE USE
f) AVAILABLE FOR USE IN NON RENTAL ACTIVITY
YES
IS THERE MATERIAL PARTICIPATION?
YES
NO
NO
NO
1
PASSIVE
IS THIS AN ACTIVITY IN WHICH THE TAXPAYER DOES NOT MATERIALLY PARTICIPATE?
YES
NO

(c) the taxpayer's distributive share of self-charged interest deductions includes passive activity deductions

The regulations also give favorable treatment where the partner borrows from their partnership and uses the loan in a passive activity. Here, the partner's interest payments are passive deductions, while the interest received by the partnership is portfolio income. The regulations reclassify part of the interest income as *passive* permitting the partner to use their passive interest deduction against their share of the partnership's interest income.

Note: If an entity has more than one activity, the self-charged interest rules must be applied on an activity-by-activity basis.

The regulations contain mechanical rules to calculate what interest income is passive. However, a partnership or S corporation can elect out of these reallocation rules.

Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regard to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

126. One of the three §469 "buckets" of income is portfolio income. Under §469, what is deemed to generate portfolio income?

a. royalties received in the ordinary course of a business.

b. any activity involving the conduct of a trade or business in which the taxpayer does not materially participate.

c. any limited partnership.

d. guaranteed payments from a partnership for interest on capital.

127. Another of the three §469 "buckets" of income is material participation income. Under §469, who is deemed to have materially participated in a trade or business activity?

a. a partner who is actively involved in operations.

b. a taxpayer who is involved in oil or gas working interests.

c. a taxpayer who is involved in rental activities.

d. a taxpayer who is involved in the activity's operations on a regular, continuous, and substantial basis throughout the year.

128. Section 469 restricts taxpayers from sheltering tax in certain activities. However, under §469, passive losses can still offset:

a. active income.

b. any portfolio income.

c. interest income that is portfolio income.

d. passive income.

129. There are three categories of income under §469. When income is from personal services, wages, or a salary, how is the income classified?

a. non-passive material participation.

b. non-passive portfolio.

c. passive.

d. passive portfolio.

Suspension of Disallowed Losses - §§469(g) & (b)

Suspended losses and credits are deemed to be unrealized (i.e., suspended) and only converted to realized losses and credits when:

(1) passive activity income occurs in future tax years (§469(b)); *or*

(2) taxpayer disposes of his or her entire interest in a passive activity in a fully taxable transaction (§469(g)(1)).

Fully Taxable Disposition

When a taxpayer disposes of their entire interest in a passive activity, the actual economic gain or loss on their investment can be finally determined. Thus, under the passive loss rule, upon a fully taxable disposition, any overall loss from the activity realized by the taxpayer is recognized. This result is accomplished by triggering suspended losses upon disposition.

Suspended losses are triggered on a fully taxable disposition, and any overall loss determined is then allowed against income whether passive or active. A fully taxable disposition includes a bona fide and arm's length sale of the property to a third party for a price equal to its value (Senate Report p. 725).

Abandonment & Worthlessness

The scope of a disposition triggering suspended losses under the passive loss rules includes abandonment, constituting a fully taxable event under §165(a), of the taxpayer's entire interest in a passive activity (Conference Report H7635). Thus, for example, if the taxpayer owns rental property that they abandon in a taxable event that would give rise to a deduction under §165(a), the abandonment constitutes a taxable disposition that triggers the recognition of suspended losses under the passive loss rule.

Similarly, to the extent that the event of the worthlessness of a security is treated under §165(g) as a sale or exchange of the security, and the event

otherwise represents the disposition of an entire interest in a passive activity, it is treated as a disposition.

Related Party Transactions - §469(g)(1)(B)

Under §469(g)(1)(B), a taxpayer is not treated as having disposed of an interest in a passive activity, for purposes of triggering suspended losses if they dispose of it in an otherwise fully taxable transaction to a related party (within the meaning of §267(b) or §707(b)(1), including applicable attribution rules). In the event of such a related party transaction, because it is not treated as a disposition for purposes of the passive loss rule, suspended losses are not triggered, but rather remain with the taxpayer. Such suspended losses may be offset by income from the passive activities of the taxpayer.

When the entire interest owned by the taxpayer and the interest transferred to the related transferee in the passive activity are transferred to a party who is not related to the taxpayer in a fully taxable disposition, then to the extent the transfer would otherwise qualify as a disposition triggering suspended losses, the taxpayer may deduct the suspended losses attributable to their interest in the passive activity.

Credits

A purpose of the passive loss rules is to allow losses only when a real economic loss has occurred. Congress believed that credits do not represent such true economic loss. Credits are creatures of statute. They are not directly related to real gain or loss.

Disallowance

As a result, disallowed credits are not allowable on a fully taxable disposition. In general, credits are only[11] allowed when sufficient passive income is realized.

Increase Basis Election - §469(j)(9)

However, §469(j)(9) provides an election to increase the basis of property immediately before the transfer by an amount equal to the portion of any unused credit that reduced the basis of such property for the tax year in which the credit arose. The increase in basis cannot exceed the amount of the original basis reduction of the property.

Entire Interest

The taxpayer must dispose of his or her entire interest in the activity in order to trigger the recognition of loss (Senate Report p.725). This involves a dis-

[11] In some instances they can be added to basis prior to a fully taxable disposition.

position of the taxpayer's interest in all entities (in which he or she holds an interest) engaged in the activity.

Partnership

If a general partnership or S corporation conducts two separate activities, a fully taxable disposition by the entity of all the assets used or created in one activity constitutes a disposition of the partner's or shareholder's entire interest in the activity (Senate Report p.725).

Grantor Trust

If a grantor trust conducts two separate activities and sells all the assets used or created in one activity, the grantor is considered as disposing of his or her entire interest in that activity (Senate Report p.726).

Other Transfers

The following are not deemed to be fully taxable dispositions and are subject to special rules:

Transfer By Reason Of Death - §469(g)(2)

Under §469(g)(2), a transfer of a taxpayer's interest in an activity on death allows suspended losses to the decedent[12] to the extent they exceed the amount by which the basis of the interest in the activity is increased at death under §1014[13].

Thus, the amount of loss deductible on the decedent's final income tax return equals the excess of the sum of the current tax year's loss and prior passive activity losses (not previously deducted) over the following difference:

(a) transferee's adjusted basis as determined under §1014(a), *or*

(b) the decedent's basis immediately prior to death.

Transfer by Gift - §469(j)(6)

Section 469(j)(6) provides that a gift of all or a part of the taxpayer's interest in a passive activity does not trigger suspended losses. However, the statute does allow suspended losses to be added to the basis of the property immediately before the gift. If the gift is a partial interest, an allocable portion of any suspended losses is added to the donee's basis. Suspended losses of the donor are eliminated when added to the donee's basis, and the remainder of the losses continue to be suspended in the donor's hands. The treatment of subsequent deductions from the activity

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[12] Suspended losses are not available to decedent's transferee. The losses allowed would be reported on the final return of the decedent.

[13] Suspended losses are eliminated to the extent of the basis increase.

to the extent of the donee's interest in it depends on whether the activity is passive as to the donee.

Example

Ralph gifts a duplex that constitutes passive property to his son. The duplex has an adjusted basis of $65,000, suspended losses of $15,000, and a fair market value of $110,000. Ralph can't deduct the suspended losses but his son's basis in the duplex is $80,000.

Installment Sale - §469(g)(3)

Under §469(g)(3), when an activity is disposed of in a transaction in which the gain is reported under the installment sale method, the entire suspended loss attributable to the activity is not triggered all at once. The losses are allowed in each year of the installment obligation, in the ratio that the gain recognized in each year bears to the total gain on sale. The installment gains are reported using the gross profit percentage and then offset by the proportionate amount of carryforward losses.

Activity No Longer Treated As Passive Activity - §469(f)(1)

Circumstances may arise that do not constitute a disposition but terminate the application of the passive loss rules to the taxpayer generally or to the taxpayer with respect to a particular activity.

For example, an individual who previously was passive in relation to a trade or business activity that generates net losses may begin materially participating in the activity. When a taxpayer's participation in an activity is material in any year after a year (or years) during which they were not a material participant, previously suspended losses remain suspended and continue to be treated as passive activity losses.

Such previously suspended losses, however, unlike passive activity losses generally, are allowed against income from the activity realized after it ceases to be a passive activity with respect to the taxpayer. However, as with tax-free exchanges of the taxpayer's entire interest in an activity, the taxpayer must be able to show that such income is from the same activity in which the taxpayer previously did not materially participate.

Closely Held To Nonclosely Held Corporation - §469(f)(2)

A similar situation arises when a corporation (such as a closely held corporation or personal service corporation) subject to the passive loss rules ceases to be subject to the passive loss rules because it no longer meets the definition of an entity subject to the rules.

For example, if a closely held corporation makes a public offering of its stock and no longer meets the stock ownership criteria for being closely held, it ceases to be subject to the passive loss rules. The corporation's ownership has been so broadened that the reason for limiting the corporation's ability to shelter its portfolio income becomes less compelling. A corporation that is not closely held is less susceptible to treatment as the alter ego of its shareholders, but competing considerations also apply.

So as not to encourage tax-motivated transactions involving free transferability of losses, the suspended passive losses are not made more broadly applicable (i.e., against portfolio income) by the change in ownership, but continue to be applicable against all income other than portfolio income of the corporation. Deductions arising in years after the year in which the corporation's status changes are not subject to limitation under the passive loss rules.

Nontaxable Transfer

An exchange of the taxpayer's interest in an activity is a nonrecognition transaction, such as an exchange governed by §351, §721, or §1031 in which no gain or loss is recognized, does not trigger suspended losses (Senate Report p.726). Following such an exchange, the taxpayer retains an interest in the activity and hence has not realized the ultimate economic gain or loss on his or her investment in it. To the extent the taxpayer does recognize gain on the transaction (e.g., boot in an otherwise tax-free exchange), the gain is treated as passive activity income, against which passive losses may be deducted[14].

The suspended losses not allowed upon such a nonrecognition transaction continue to be treated as passive activity losses of the taxpayer, except that in some circumstances they may be applied against income from the property received in the tax-free exchange that is attributable to the original activity[15].

Such suspended losses may not be applied against income from the property that is attributable to a different activity from the one that the tax-

[14] As a result, taxpayers could periodically trade down under §1031 to the extent of their suspended losses on their real estate and get the current benefit of their suspended losses on the traded property.

[15] This rule does not apply, however, to permit the offset of suspended passive losses against dividends or other income or gain otherwise treated as portfolio income. In addition, following some transactions such as a §1031 like-kind exchange, for example, the taxpayer may no longer have an interest in the original activity. Therefore, there is no special rule permitting suspended losses from the prior interest to be offset by income from the new activity, unless it, too, is a passive activity.

payer exchanged[16]. Therefore, unless the taxpayer can show that the income against which suspended losses are offset is clearly from the passive activity that the taxpayer exchanged for a different form of ownership, no such offset is permitted.

Ordering of Losses on Disposition of an Entire Interest - §469(g)

In the tax year a taxpayer disposes of their entire interest in any passive activity (or former passive activity) and all gain or loss realized on such disposition is recognized, the excess of any losses from such activity for that taxable year (determined after the application of §469(b)), over any net income or gain for that taxable year from all other passive activities (determined after the application of §469(b)), are treated as losses not from a passive activity.

In short, the unused losses and any current year losses for the activity are allowed to offset income in the following order:

(1) income or gain (including any gain recognized upon disposition) for the tax year from the passive activity disposed of,

(2) net income or gain for the tax year from all other passive activities, *then*

(3) any other income or gain (§469(g)(1)).

Example from Pub. 925 (Rev. 87)

Ray, whose only other income during the year was his $60,000 salary, had a 5% interest in the B Limited Partnership, which had an adjusted basis of $42,000 at the date of sale. He had carried over $2,000 of passive activity losses from prior years and then sold his entire interest in the current tax year to an unrelated person, for $50,000. Ray realized an $8,000 gain from the sale but may offset $2,000 of that gain with his $2,000 carryover loss. Ray's $6,000 net gain is computed as follows:

Sales Price	*$50,000*
Minus: adjusted basis	*$42,000*
Gain	*$8,000*
Minus: carryover losses allowable	*2,000*
Net gain	*$6,000*

Ray will treat the $6,000 net gain as income from a passive activity.

If Ray sold his interest for $30,000, instead of $50,000, his deductible loss would be $5,000, computed as follows:

Sales Price	*$30,000*

[16] For example, suspended passive activity losses cannot be applied against portfolio income of a passthrough entity.

Minus: adjusted basis	*42,000*
Capital loss	*$12,000*
Minus: capital loss limit	*3,000*
Capital loss carryover	*$9,000*
Allowable capital loss on sale	*$3,000*
Carryover losses allowable	*2,000*
Total current deductible loss	*$5,000*

The $5,000 total current deductible loss computed above is currently deductible. The $9,000 capital loss carryover is not subject to the passive activity loss limit. Ray will treat it in the same manner as any other capital loss carryover.

Capital Loss Limitation - §1211

Upon a fully taxable disposition of a taxpayer's entire interest in a passive activity, the passive loss rules provide that any deductions previously suspended with respect to that activity are allowed in full.

However, under §469(g)(1)(C), to the extent that any loss recognized upon such a disposition is a loss from the sale or exchange of a capital asset, it is limited to the amount of gains from the sale or exchange of capital assets plus $3,000 in the case of individuals (§1211).

Carryforwards - §469(b)

Disallowed losses and credits are carried forward in full and treated as passive losses and credits in the latter tax years. There is no time limit on the carryforward (§469(b)). The application of a passive loss or credit carryforward to a later tax year isn't limited to passive income generated by the particular activity that gave rise to the loss or credit. They apply to the taxpayer's net passive income (if they have any) based on the aggregate income and losses from all the interests in passive activities owned by the taxpayer.

Allocation of Suspended Losses - §469(j)(4)

If any passive losses are not deductible in any given year, the amount of the suspended losses and credits from each activity is determined on a prorata basis. With respect to each activity, the portion of the loss or credit that is suspended, and carried forward, is determined by the ratio of net losses from that activity to the total net losses from all passive activities for the year (§469(j)(4)).

Taxpayers Affected - §469(a)(2)

Under §469(a)(2), the passive loss limit applies to:

Noncorporate Taxpayers

All noncorporate taxpayers, including individuals, estates, and trusts, are subject to the passive loss rules (§469(a)(2)(A)). The limitations are imposed at the taxpayer level. Thus, allocations and distributions from pass-through entities such as partnerships and S corporations are limited at the taxpayer level.

Regular Closely Held Corporations

Any "C" corporation in which more than 50% in value of its outstanding stock was owned (directly or indirectly) by five or fewer individuals at any time during the last half of its taxable year (§469(a)(2)(B)).

Personal Service Corporations

Any personal service corporation is subject to the passive loss rules (§469(a)(2)(C)).

Definition

A corporation is a personal service corporation if three conditions are met:

(a) its principal activity is the performance of personal services;

(b) those personal services are "substantially" performed by "employee-owners"; *and*

(c) employee-owners, in the aggregate, own more than 10% of the stock of the corporation.

Real Estate Professionals - §469(c)(7)

If a taxpayer qualifies as a real estate professional, rental real estate activities in which they materially participated are not passive activities. For this purpose, each interest a taxpayer has in a rental real estate activity is a separate activity, unless they choose to treat all interests in rental real estate activities as one activity.

A taxpayer qualifies as a real estate professional for the year if they meet both of the following requirements:

(1) more than half of the personal services they performed in all trades or businesses during the tax year were performed in real property trades or businesses in which they materially participated; *and*

(2) they performed more than 750 hours of services during the tax year in real property trades or businesses in which they materially participated (§469(c)(7)).

Do not count personal services performed as an employee in real property trades or businesses unless taxpayer was a 5% owner of their employer. A taxpayer was a 5% owner if they owned (or are considered to have owned)

more than 5% of their employer's outstanding stock, outstanding voting stock, or capital or profits interest.

> **Note:** If a taxpayer files a joint return, do not count their spouse's personal services to determine whether they met the preceding requirements. However, a spouse's participation in an activity can be counted in determining if the taxpayer materially participated.

A real property trade or business is a trade or business that does any of the following with real property:

(1) develops or redevelops it,
(2) constructs or reconstructs it,
(3) acquires it,
(4) converts it,
(5) rents or leases it,
(6) operates or manages it, *and*
(7) brokers it.

Activities – Reg. §1.469-4

Regulation §1.469-4 sets forth the rules for grouping a taxpayer's trade or business activities and rental activities for purposes of applying the passive activity loss and credit limitation rules of §469. A taxpayer's activities include those conducted through C corporations that are subject to §469, S corporations, and partnerships.

Facts & Circumstances Test – Reg. §1.469-4(c)(2)

Whether activities are treated as a single activity depends upon all the relevant facts and circumstances. A taxpayer can use any reasonable method of applying such factors when grouping activities.

Relevant Factors

The following factors are given the greatest weight in determining whether activities constitute an appropriate economic unit for the application of the passive loss rules:

(a) similarities and differences in types of business,
(b) extent of common control,
(c) extent of common ownership,
(d) geographical location, *and*
(e) interdependencies between the activities[17] (Reg. §1.469-4(c)(2)).

[17] For example, the extent to which the activities purchase or sell goods between themselves, involve products or services that are normally provided together, have the same customers, have the same employees, or are accounted for with a single set of books and records.

Note: All of the above factors do not have to be present for a taxpayer to treat more than one activity as a single activity

Example

Dan has a significant ownership interest in a bakery and a movie theater at a shopping mall in Baltimore and in a bakery and a movie theater in Philadelphia. Here reasonable methods of applying the facts and circumstances test may, depending on other relevant facts and circumstances, result in grouping the movie theaters and bakeries into a single activity, into a movie theater activity and a bakery activity, into a Baltimore activity and a Philadelphia activity, or into four separate activities. (Reg. 1.469-4(c)(3), Example 1)

The example in the regulations doesn't say whether or not the Baltimore bakery and the Philadelphia movie theater could be claimed as a single activity (or the Philadelphia bakery and the Baltimore movie theater).

Example

Dan is a partner in a business that sells non-food items to grocery stores (Partnership L). Dan also is a partner in a partnership that owns and operates a warehouse (Partnership Q). The two partnership businesses are located in the same industrial park and both are under common control. The predominant part of Partnership Q's business is warehousing goods for Partnership L, which is also the only warehousing business in which Dan is involved. Here Dan treats Partnership L's wholesale business and Partnership Q's warehouse as a single activity under the regs. (Reg. §1.469-4(c)(3), Example 2)

The example in the regulations doesn't say whether Dan may or must treat the two businesses as a single activity—just that he does.

Rental Activities - Reg. §1.469-4(d)(1)

Under Reg. §1.469-4(d)(1), a rental activity cannot be grouped with a nonrental trade or business activity *unless* either:

(i) the rental activity is insubstantial in relation to the trade or business activity, *or*

(ii) the trade or business activity is insubstantial in relation to the rental activity.

Under Reg. §1.469-4(e), an activity involving the rental of *real* property and an activity involving the rental of *personal* property (other than per-

sonal property provided in connection with the real property) cannot be treated as a single activity.

Limited Partnership Activities - Reg. §1.469-4(d)(3)

A taxpayer who is a limited partner or "limited entrepreneur[18]" in certain activities is not allowed to group that activity with any other activity. Activities subject to this rule include:

(1) films,
(2) videotapes,
(3) farming,
(4) oil & gas,
(5) geothermal deposits, *and*
(6) renting depreciable personal property.

However, such an activity can be grouped with another activity in the same type of business if the taxpayer is a limited partner or limited entrepreneur in both.

Two activities in the same type of business can also be grouped if the taxpayer is a limited partner or limited entrepreneur in only one of the two activities if the facts-and-circumstances test is satisfied (Reg. §1.469-4(f)).

Partnership & S Corporation Activities - Reg. §1.469-4(d)(5)

A partnership or S corporation is required to group its activities under the regulations. Once a partnership or S corporation determines its activities, a partner or shareholder groups those activities with activities conducted directly by the partner or shareholder or with activities conducted through other partnerships or S corporations under the regulations (Reg. §1.469-4(d)(5)).

Consistency - Reg. §1.469-4(e)

Under Reg. §1.469-4(e), once a taxpayer has grouped activities in accordance with the proposed rules, they are not permitted to regroup them in later tax years unless:

(1) the original grouping was clearly inappropriate, *or*

(2) there has been a material change in the facts and circumstances that makes the original grouping clearly inappropriate.

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[18] A "limited entrepreneur" is defined as a person other than a limited partner who doesn't actively participate in the management of an activity.

Regrouping - Reg. §1.469-4(e)(2)

When the taxpayer's grouping fails to "reflect one or more appropriate economic units" and one of the primary purposes of the taxpayer's grouping is to circumvent the passive loss rules, the IRS can regroup a taxpayer's activities (Reg. §1.469-4(e)(2)).

Example

Dan, Tom, Harry, Pat, and Mike are doctors who operate separate medical practices. Dan invested in a tax shelter several years ago that generates passive losses and the other doctors intend to invest in real estate that will generate passive losses. The taxpayers form a partnership to acquire and operate X-ray equipment. In exchange for equipment contributed to the partnership, the taxpayers receive limited partnership interests. A general partner selected by the taxpayers manages the partnership. The taxpayers do not participate in the partnership's operations. Substantially all of the partnership's services are provided to the taxpayers or their patients, roughly in proportion to the doctors' interests in the partnership. Fees for the partnership's services are set at a level that assures the partnership a profit. The taxpayers treat the partnership's services as a separate activity from their medical practices and offset the income generated by the partnership against their passive losses. As to each of the taxpayers, the taxpayer's own medical practice and the services provided by the partnership constitute an appropriate economic unit. Moreover, one of the primary purposes of treating the medical practices and the partnership's services as separate activities is to circumvent §469. Accordingly, the IRS may require the taxpayers to treat their medical practices and their interests in the partnership as a single activity (Reg. §1.469-4(h)).

Partial Dispositions - Reg. §1.469-4(g)

Under the regulations, a taxpayer is allowed to treat the disposition of a *substantial* part of an activity as a *complete* disposition in which suspended losses are allowed.

Under Reg. §1.469-4(g), taxpayers are permitted, for a tax year in which they dispose of a substantial part of an activity, to treat that part of the activity as a separate activity, but only if they can establish:

(1) the amount of deductions and credits allocable to that part of the activity for the tax year under the rules governing the carryover of disallowed deductions and credits from earlier years, *and*

(2) the amount of gross income and any other deductions and credits allocable to that part of the activity for the tax year.

Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regard to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

130. Suspended losses are converted to realized losses when an entire interest in a passive activity is sold in a fully taxable transaction. However, if a passive activity is sold on the installment sale method what results under §469(g)(3)?

a. Suspended losses are not triggered.

b. The disposition is deemed to be a fully taxable disposition subject to the general rule.

c. The activity is no longer treated as a passive activity.

d. Suspended losses from the activity are allowed in years during which installments are made.

131. Under which circumstance will an activity that was formerly passive be treated differently under §469(f)(1)?

a. Said activity is disposed of in a transaction in which the gain is reported under the installment sale method.

b. The individual begins to materially participate in said activity.

c. The activity becomes a partnership activity.

d. When an individual transfers their interest in an activity on death.

132. Suspended losses are those losses that cannot be deducted in the present tax year but may be carried forward to the next tax year. Which of the following corresponds to the treatment of suspended losses from a particular activity?

a. They are deductible first against net income or gain from all passive activities.

b. They become nonpassive in subsequent years.

c. They are carried forward according to the ratio of net loss from that activity to the aggregate net loss from all passive activities for that year.

d. They are unusable until the passive interest is sold.

133. Under §469, a corporation is a personal service corporation if it meets three conditions. What is one of the conditions that must be met?

a. Employee-owners possess over 10% of the corporation's stock.

b. No more than six individuals possess over half the value of its outstanding stock.

c. The main activity of the corporation is the selling of goods.

d. The employee-owners assist in making the goods sold.

134. Section 469 is not only concerned with the scope and nature of an activity but also whether it is to be considered separate from or grouped with other activities. For example, under Reg. §1.469-4(e), which activities are treated as separate activities?

a. activities in different states.

b. an activity entailing the rental of real property and an activity entailing the rental of personal property.

c. an activity entailing the rental of real property and an activity entailing the rental of personal property provided in relation to the real property.

d. two activities in the same type of business, if the taxpayer is a limited partner in only one of the two activities and the facts-and-circumstances test, is satisfied.

Alternative Minimum Tax - §55

The tax laws give special treatment to some kinds of income and allow special deductions and credits for some kinds of expenses. Taxpayers who benefit from these laws have to pay at least a minimum amount of tax through an additional tax - the "alternative minimum tax" (AMT) for individuals, trusts, and estates.

> **Note:** The AMT no longer applies to most corporations. However, the Inflation Reduction Act created a new corporate alternative minimum tax, which imposes a 15% minimum tax on the adjusted financial statement income of large corporations with average annual financial statement income exceeding $1 billion.
>
> **Comment:** The AMT is supposedly designed to prevent high-income individuals from paying too little in taxes due to preferential treatment of certain income and expenses, or tax breaks

All taxpayers are subject to the alternative minimum tax (AMT), except partnerships (§701(a)), most regular corporations, and S corporations (§1363(a)). Foreign corporations are subject only on taxable income which is effectively connected with the conduct of a U.S. trade or business (§882(a)(1)). Exempt organizations taxed on unrelated business income as trusts are subject to the AMT on tax preference items that enter into the computation of unrelated business taxable income (§511(d)(2)).

> **Note:** When taxpayers calculate their estimated tax, they must include any alternative minimum tax they expect to pay.

Computation

Alternative minimum taxable income is computed as follows:

Regular Taxable Income (before NOL deduction)
Plus or Minus
AMT Adjustments Under §56
Plus
Tax Preferences Under §57
Equals
Alternative Minimum Taxable Income (AMTI) before AMT NOL deduction
Less
AMT NOL deduction (limited to 90%)
Equals
Alternative Minimum Taxable Income (AMTI)
Less
Exemption Amount
Equals
Alternative Minimum Tax Base
Multiplied by 26% or 28% (see below) Equals
AMT Before AMT Foreign Tax Credit

Less
AMT Foreign Tax Credit (possibly limited to 90%)
Equals
Tentative minimum tax
Less
Regular Tax Liability before Credits minus Regular Foreign Tax Credit
Equals
Alternative Minimum Tax (§55(a); §55(b))

Tentative Minimum Tax

For 2025, the tentative minimum tax is the sum of:

(1) 26% of so much of the taxable excess that does not exceed $119,550 (up from $116,300 in 2024) in the case of a married individual filing a separate return and $239,100 (up from $232,600 in 2024) for all other returns, *and*

(2) 28% of the remaining taxable excess (R.P. 2024-40).

> **Note:** Formerly, a single rate of 20% applied to corporations. However, for 2018 and later, the AMT was repealed for most corporations.

The taxable excess is so much of the alternative minimum taxable income ("AMTI") that exceeds the exemption amount.

AMT Exemption Amounts - §55(d)

For 2025, exemption amounts (as inflation adjusted & increased by the TCJA) are:

(1) $137,000 (up from $133,300 in 2024) in the case of married individuals filing a joint return and surviving spouses;

(2) $88,100 (up from $85,700 in 2024) in the case of single or head of households;

(3) $68,500 (up from $66,650 in 2024) in the case of married filing separately (i.e., 50% of married filing jointly), *and*

(4) $30,700 (up from $29,900 in 2024), in the case of an estate or trust. (R.P. 2024-40).

AMT Exemption Phaseout - §55(d) & §59(j)

The 2025 exemption amounts are phased out by an amount equal to 25% of the amount by which AMTI exceeds:

(1) $1,252,700 (up from $1,218,700 in 2024) in the case of married individuals filing a joint return and surviving spouses,

(2) $626,350 (up from $609,350 in 2024) in the case of single or head of households,

(3) $626,350 (up from $609,350 in 2024) in the case of married filing separately, *and*

(4) $102,500 (up from $99,700 in 2024)**,** if an estate or trust (R.P. 2024-40).

> **Note:** The TCJA did not affect the AMT exemption amount and phaseout threshold for an estate or trust.

Thus, in 2025, the exemption amount is *completely* phased out if AMT taxable income exceeds:

(1) $1,800,700 (up from $1,751,900 in 2024), if married filing a joint return or a qualifying widow or widower,

(2) $978,750 (up from $952,150 in 2024), if single or head of household,

(3) $900,350 (up from $875,950 in 2024), if married filing a separate return, *and*

(4) $225,300 (up from **$**219,300 in 2024), if an estate or trust.

Regular Tax Deduction - §55(c)

In the calculation of alternative minimum tax, "regular tax" is deducted from "tentative minimum tax." The regular tax is the regular tax liability that is used for determining the limitation on various nonrefundable credits reduced by the regular (as opposed to the alternative minimum tax) foreign tax credit and without including:

(1) The 10-year averaging taxes on lump sum distributions from a qualified retirement plan; *or*

(2) Any recapture of the low-income housing credit.

Tax Preferences & Adjustments - §§56 & 57

Any item that is treated differently for alternative tax purposes than it is for regular tax purposes is termed a tax *preference* (§57) or an *adjustment* (§56; §55(b)(2)(A)). Adjustments involve a *substitution* of a special AMT treatment of an item from the regular tax treatment, while a preference involves the *addition* of the difference between the special AMT treatment and the regular tax treatment.

Some adjustments can be negative (i.e., they result in alternative minimum taxable income that is less than taxable income). Tax preferences cannot be negative amounts. Some tax preferences and adjustments only apply to certain types of taxpayers.

Preferences & Adjustments for All Taxpayers

Depreciation
Depletion
Mining Costs
Pollution Control Facilities
Incentive Stock Options

Intangible Drilling Costs
Long-term Contracts
Tax Exempt Interest
Appreciated Charitable Contribution Property
Financial Institutions' Bad Debts
Alternative Tax Net Operating Loss Deduction
Adjusted Basis of Certain Property

Preferences & Adjustments for Noncorporate Taxpayers Only

Itemized Deductions
State Tax Refunds
Research & Experimental Expenditures
Preferences & Adjustments for Noncorporate Taxpayers & Some Corporations
Circulation Expenditures
Farm Losses
Passive Losses

Preferences & Adjustments for Corporations Only Prior to 2018

Untaxed Book Income (pre-1990)
ACE
Earnings & Profits
Blue Cross/Blue Shield Deduction
Merchant Marine Capital Construction Fund

Adjustments - §56

As the AMT formula shows, taxable income is increased by positive adjustments and decreased by negative adjustments. Most positive adjustments arise because of timing differences between the AMT and the regular tax related to the deferral of income or acceleration of deductions. When these timing differences reverse, negative adjustments are made.

There are other adjustments that are based on *permanent* differences between the AMT and the regular tax. These adjustments are similar to preferences and are always positive.

Itemized Deductions

Only certain itemized deductions are allowed in the calculation of AMT. Because the AMT calculation begins with taxable income, those itemized deductions that are *disallowed* for AMT purposes must be *added back* as adjustments.

Medical Expenses

For regular tax purposes, medical expenses are deductible to the extent they exceed 7.5% of AGI. However, medical expenses are deductible for AMT purposes to the extent that they exceed 10% of the regular tax AGI. The adjustment for medical expenses in AMT will be the lesser of medical expenses claimed in regular tax or 2.5% of AGI.

Taxes

All taxes claimed on Schedule A will be an adjustment for AMT. Taxes used to compute AGI such as those on Schedules C, E, or F remain deductible for AMT.

Because no deduction is allowed in AMT for the payment of state or local taxes, §56(b)(1)(E) specifically provides that refunds of those taxes should not be included in AMTI.

Interest

Investment Interest - investment interest is deductible in AMT only to the extent of investment income. This is the same limit imposed in regular tax *without* the phase-out of a certain base amount. However, because special AMT rules apply to many items of income and deduction, investment income for AMT can be very different from investment income in regular tax.

Investment interest disallowed in AMT is *not* carried over to future years as it is in regular tax.

Mortgage Interest - AMT limits the amount of deductible mortgage interest to qualified housing interest. AMT adopts the restriction limiting qualified residences to one principal and one second home.

While regular tax allows a deduction for interest expense in equity loans of less than $100,000, AMT has no similar provision. In AMT, the deduction for refinanced debt is now specifically allowed by §56(e), but only to the extent that the new indebtedness does not exceed the old.

Perhaps the biggest difference in the deductibility of mortgage interest in AMT and regular tax is the "grandfather date." For AMT purposes, debt incurred before July 1, 1982, is considered qualified residence interest. In regular tax, debt incurred prior to October 13, 1987, is grandfathered.

Miscellaneous itemized deductions - only those miscellaneous itemized deductions that are not subject to the 2% of AGI "floor" for regular tax are allowed for AMT. Miscellaneous itemized deductions allowed for AMT include gambling losses, moving expenses, and impairment-related work expenses. Casualty losses and moving expenses are de-

ductible for AMT purposes under the same rules that apply to regular tax.

Depreciation Adjustment

For MACRS property, the AMT *adjustment* for depreciation is the difference between regular tax depreciation and depreciation computed under the Alternative Depreciation System (ADS). ADS uses 150% declining balance for personal property and straight-line for real property.

The AMT depreciation adjustment will be the net of both positive and negative differences for all properties.

Alternative Depreciation System (ADS)

ADS is an optional method in regular tax for most property. Under ADS, depreciation is calculated on a straight-line method over a specified *recovery period*.

The ADS system is modified in AMT for personal property to the extent that 150% declining balance is used, switching to straight-line when straight-line results in a larger deduction.

ADS Recovery Periods

Generally, the recovery period for ADS is the midpoint of the class life in the asset depreciation range as prescribed in §167(m). For some assets or groups of assets, Congress has specifically modified the life.

The following inclusions, exclusions, and default provisions will result in adjustments for the calculation of AMT.

5 Years:

Automobiles, light-duty trucks, over-the-road tractor units, semiconductor manufacturing equipment, and "qualified technological equipment."

Note that for ADS, qualified technological equipment is limited to computer or related peripheral equipment, high-technology telephone station equipment installed on the customer's premises, and high-technology medical equipment. Specifically excluded from the five-year category is equipment that is an integral part of other non-computer properties and typewriters, calculators, adding and accounting machines, copiers, duplicating equipment, and other similar equipment. These assets are 7-year property.

7 Years:

No assets have a 7-year ADS life. Assets in the 7-year MACRS class that have not been specifically assigned an ADS recovery period will revert to their ADR class life.

12 Years:

Assets that are not classified in the ADR system.

40 Years:

Most real property.

A comparison of the MACRS life and the life for AMT of those assets most frequently encountered is as follows:

	MACRS	AMT
Automobiles	5	5
Computers	5	5
Other Office Equipment	5	6
Office Furniture	7	10
Rental Buildings:		
Commercial	39	40
Residential	27.5	40
Personal Property in Rentals:		
(Carpets, drapes & appliances)	7	12
Unclassified Personal Property	7	12

AMT Recovery Periods Conformed to Regular Recovery Periods

Taxpayers can elect to conform the recovery periods (but not the methods) used for AMT depreciation adjustment to the recovery periods used for the regular tax. This means that the same number of years over which an asset is depreciated can be used for both AMT and regular tax calculations. However, while the recovery periods can be conformed, the methods of depreciation may not be. For example, making the election to use AMT depreciation for both regular tax and AMT purposes means using the AMT 150% declining balance method for both tax calculations.

When a taxpayer want**s** the time period for calculating depreciation for the AMT to match the time period used for regular taxes, they can choose to do so on their tax return. This means using the same time periods for calculating depreciation for both regular taxes and the AMT.

Mining Exploration and Development Costs - §56(a)(2)

Mining exploration and development costs that are expensed (or amortized under §291) for regular tax purposes are required to be recovered through ten-year straight-line amortization for purposes of the alternative minimum tax. As with depreciation, the minimum tax treatment of mining exploration and development costs involves a separate calculation for all items of income and expense relating to such costs.

Note: A taxpayer may elect under §59(e) to amortize mining exploration and development costs over 10 years for regular tax purposes, thereby avoiding the AMT adjustments related to such costs.

Basis

The basis of property on which such costs were incurred, and the amount of gain or loss at disposition, likewise may differ for regular and minimum tax purposes, respectively.

When a loss is sustained on a mining property (e.g., the mine is abandoned as worthless, giving rise to a loss under §165), the taxpayer is permitted to deduct, for minimum tax purposes, all mining exploration and development costs relating to that property that have been capitalized and not yet written off under the minimum tax.

Long-Term Contracts - §56(a)(3)

In the case of any long-term contract, use of the completed contract method of accounting (or any other method of accounting that permits deferral of income during the contract period) is not permitted for purposes of the minimum tax (§56(a)(3)). Instead, the taxpayer is required to apply the percentage of completion method (determined using the same percentage of completion as used for purposes of the regular tax) in determining the minimum taxable income relating to that contract. The taxable income (from the contract) for AMT purposes less the corresponding amount for regular tax purposes is the adjustment.

Home Construction Contracts

For regular tax purposes, home construction contracts, defined as contracts where at least 80% of the estimated total costs to be incurred under the contract are attributable to dwelling units in a building with four or fewer dwelling units, are exempted from the percentage of completion-capitalized cost method of accounting.

For AMT purposes, home construction contracts are exempted only for contracts of small contractors. Contracts of small contractors are those that are estimated to be completed within two years and are entered into by a taxpayer who has average annual gross receipts for the three tax years preceding the tax year in which the contract is executed that do not exceed $31 million in 2025(§460(b)(4)).

Pollution Control Facilities - §56(a)(5)

In the case of any certified pollution control facility, a taxpayer is required to use ADS for minimum tax purposes. The same procedure used to calculate excess depreciation above is the procedure to calculate the AMT adjustment.

Installment Sales

For non-dealer dispositions, the installment method of reporting gain is allowable in regular tax and AMT. Since tax law now bars the use of the installment method by dealers in regular tax for their dispositions, the AMT adjustment is eliminated.

Dealers of lots and timeshares who are allowed to report gain on the installment method for regular tax if they pay the interest on the deferred tax are not required to adjust AMTI.

Circulation Expenditures - §56(b)(2)

An individual who incurs circulation expenditures is not permitted to expense their expenditures for minimum tax purposes. Instead, in computing alternative minimum taxable income, the taxpayer is required to amortize such expenditures ratably over a three-year period. However, if the taxpayer realizes a loss with respect to property to which any such expenditures relate, all such expenditures relating to that property but not yet deducted for minimum tax purposes are allowed as a minimum tax deduction.

The AMT adjustment may be avoided by electing to amortize circulation expenditures over a three-year period for regular tax purposes.

Research & Experimental Expenditures - §56(b)(2)

An individual who incurs research and experimental expenditures described in §174 is not permitted to expense the expenditures for minimum tax purposes. Instead, in computing alternative minimum taxable income, the taxpayer is required to amortize such post-1986 expenditures over a ten-year period. As with certain other items (such as depreciation and mining exploration and development costs), this treatment applies for all minimum tax purposes, rather than as an annual adjustment to regular taxable income. If the taxpayer abandons a specific project to which any such expenditures relate, all such expenditures relating to that property but not yet deducted for minimum tax purposes are allowed as a minimum tax deduction.

Again, if the taxpayer elects to amortize research and experimentation expenditures over a ten-year period for regular tax purposes the AMT adjustment is avoided.

Incentive Stock Options - §56(b)(3)

In the case of a transfer of a share of stock pursuant to the exercise of an incentive stock option (as defined in §422A), the amount by which the fair market value of the share at the time of the exercise exceeds the option price (bargain element) is treated as an adjustment. For purposes of

this rule, the fair market value of a share is determined without regard to any restrictions other than one that by its terms, will never lapse.

For minimum tax purposes, the basis of stock acquired through the exercise of an incentive stock option includes the amount of the adjustment.

The time for reporting income from an option is determined under §83. Pursuant to the code section, the excess of fair market value over option price is includable when rights in the stock are not subject to substantial risk of forfeiture and such rights are freely transferable (§56(b)).

Passive Farm Losses - §58(a)(2)

Any passive farm loss of an individual or personal service corporation, to the extent not already denied for minimum tax purposes under the rules described above, is not allowed in computing alternative minimum taxable income.

Definition

A passive farm loss is defined as the excess of the taxpayer's loss for the taxable year from any tax shelter farming activity. The amount of the loss that is otherwise disallowed is reduced, however, by the amount, if any, of the taxpayer's insolvency, as measured using a standard similar to that set forth in §108(d)(3).

Tax shelter farm activity - for purposes of this provision, the term "tax shelter farm activity" means (1) a farming syndicate (as defined in §464(c)), and (2) any other activity consisting of farming that is a passive activity (within the meaning of §469(c)).

Loss Disallowance

Under the passive farm loss rule, deductions allocable to a tax shelter farming activity in excess of gross income allocable to the activity not truly profitable are disallowed for minimum tax purposes. A separate activity is defined consistently with §469, with the result that generally each farm is treated as a separate activity.

The rules for applying the loss disallowance generally are similar to those for applying the passive loss rule for minimum tax purposes, except that there is no netting between different farming activities. An excess farming loss with respect to any farming activity is disallowed even if there is no netting between different farming activities.

The passive farm loss rule is applied, in computing alternative minimum taxable income, prior to the passive loss rule. Thus, the only passive farming activities that enter into the passive loss computation (for minimum tax purposes) are those that generate net gain. The gain can then be offset, for minimum tax purposes under the general passive loss rule, against passive losses that are not from farming activities.

Allocation

The amount of the deductions allocable to a farming activity is determined after taking account of all preferences and making all adjustments required for the determination of alternative minimum taxable income, other than the preference for excess passive activity losses. In other words, no deduction which is treated as minimum tax preference, or which is redetermined (as with depreciation) for minimum tax purposes, is "double-counted" by also being considered in the determination of excess farm losses.

Same Activity Suspension

To the extent that a loss from a farming activity is disallowed under this rule, the amount is treated, for minimum tax purposes, as a farm loss incurred in the same activity in the succeeding taxable year. Thus, it is incurred in the same activity in the succeeding year, to the extent that the taxpayer otherwise has net income from the farm in such year, or upon an appropriate disposition (i.e., a disposition that would qualify under the passive loss rules as triggering the allowance of suspended losses from the activity). Congress generally intended that other aspects of the disposition rules applying with respect to passive losses apply as well for minimum tax purposes with respect to passive farming losses.

Passive Activity Losses

In computing alternative minimum taxable income, limitations apply to the use of losses from passive activities of the taxpayer to offset other income of the taxpayer. The rules are identical to those applying for regular tax purposes, under §469, except for these differences:

(a) for minimum tax purposes, the amount of losses that otherwise would be disallowed for the current taxable year under the limitation is reduced by the amount, if any, of the taxpayer's insolvency, as measured using a standard similar to that set forth in §108(d)(3); *and*

(b) in applying the limitations, minimum tax rules (including the passive farm loss rule) apply to the measurement and allowability of all relevant items of income, deduction, and credit.

In light of differences between the regular tax and minimum tax treatment of such items, the amount of suspended losses relating to an activity may differ for regular and minimum tax purposes, respectively.

Note: The $25,000 loss allowed for active participation in rental real estate is also allowed in AMT.

The passive rules that apply for minimum tax purposes function, in effect, like an adjustment to the regular tax rule. Thus, when a taxpayer has de-

ductions that are limited under the regular tax passive loss rule, such regular tax limitations should be disregarded for minimum tax purposes, with the minimum tax limitation being applied instead. Taxable income is first reduced, by treating as allowable deductions those that were suspended under the regular tax passive loss rule, then adjusted, to reflect minimum tax adjustments and other preferences, and then potentially increased by applying the minimum tax passive loss rule.

It is possible for a taxpayer to have a passive loss under one system but not under the other.

Example

Assume that a taxpayer's deductions with respect to passive activities equaled $80,000 for regular tax purposes and $40,000 for minimum tax purposes. The taxpayer would have regular taxable income of $200,000, a suspended passive loss of $30,000 for regular tax purposes, an alternative minimum taxable income of $210,000, and no suspended passive loss for minimum tax purposes.

	Regular Tax	*Minimum Tax*
Taxable Income	*200,000*	*210,000*
Gross Income - passive activity	*50,000*	*50,000*
Deductions	*(80,000)*	*(40,000)*
Suspended Losses	*(30,000)*	*0*

Former Corporate Untaxed Reported Profits & ACE Adjustments

Originally, an additional positive adjustment was included in determining AMTI for those corporations whose taxable income differed from income used for financial accounting purposes. As a result, one-half of the excess of pretax-adjusted net book income over AMTI was a positive adjustment. This was referred to as the corporate business untaxed reported profits adjustment.

Then, from 1990 until 2018, the business's untaxed reported profits adjustment was replaced with an adjusted current earnings (ACE) adjustment. The ACE was tax-based and could be a negative amount. Corporate AMTI was increased by 75% of the excess of ACE over unadjusted AMTI. Or AMTI was reduced by 75% of the excess of unadjusted AMTI over ACE.

Finally, the TCJA repealed the AMT for most corporations for tax years beginning in 2018 making both adjustments moot. (§55(a)).

Tax Preferences - §57

Most tax preference items reflect permanent differences between the regular tax and minimum tax calculations. They generally are positive.

Depletion - §57(a)(1)

The excess of the regular tax deduction allowable for percentage depletion over the adjusted basis of the property at the end of the taxable year (determined without regard to the depletion deduction for the taxable year) is treated as a preference.

Example

A taxpayer who claimed a deduction for percentage depletion in the amount of $50, with respect to property having a basis (disregarding this deduction) of $10, would have a minimum tax preference in the amount of $40.

Intangible Drilling Costs- §57(a)(2)

Excess intangible drilling costs are treated as a preference to the extent that they exceed 65% (formerly 100%) of the taxpayer's net income from oil, gas, and geothermal properties.

Excess Drilling Costs

The amount of excess intangible drilling costs is defined as the amount of the excess, if any, of the taxpayer's regular tax deduction for such costs (deductible under either §263(c) or §291(b)) over the normative deduction, i.e., the amount that would have been allowable if the taxpayer had amortized the costs over 120 months on a straight-line basis or (if the taxpayer so elects) through cost depletion. Net oil and gas income is determined without regard to deductions for excess intangible drilling costs.

Intangible drilling costs are all costs including wages, repairs, supplies, etc., incurred in the drilling of wells and preparation of wells for production. The preference does not apply to costs incurred with respect to a nonproductive well (dry hole).

Example

$1,000 of expenses are incurred on a well that produces $500 in net income. The preference is:

Intangible drilling costs	*1,000*
Amortization of IDC ($1,000 / 10 yrs)	*(100)*

Excess IDC	*900*
65% of net income	*320*
Preference	*580*

Private Activity Bond Interest- §57(a)(5)(C)

Interest on private activity bonds, reduced by any deduction attributable to it, is a tax preference item. Private activity bonds are bonds issued by state and local governments to provide financing for purposes other than government operations or facilities. Such bonds might provide financing for stadiums or housing projects.

The taxpayer is allowed a reduction in the AMT preference for costs related to the generation of private activity bond interest income.

Alternative Tax NOL Deduction - §56(a)(4)

For AMT purposes, figure an NOL for a tax year in generally the same manner as figured for regular tax, with the following exceptions:

(i) make the AMT adjustments to the NOL that were used for regular tax purposes, *and*

(ii) reduce the NOL by the tax preference items.

> **Note:** The reduction cannot be more than the amount that these items increased the NOL.

Carrybacks & Carryovers - §172

After making the above calculations, the amount of the alternative tax NOL that a taxpayer can deduct in a carryback or a carryover year cannot exceed 90% of their AMT taxable income for that year, as figured before the NOL deduction.

Formerly, taxpayers could carry back their alternative tax NOL for 2 years or carry it forward 20 years. This was the same as under the regular NOL rules. However, under the TCJA, most taxpayers are no longer allowed to carry back NOLs. Instead, these losses can be carried forward indefinitely.

If there is no AMT liability in a carryforward year, taxpayers still must reduce their net operating loss deduction by 90% of the AMT taxable income for that year. For this purpose, AMT taxable income is the amount arrived at on Form 6251. Use Form 6251 to figure the amount even though there is no AMT liability.

Alternative Minimum Foreign Tax Credit - §59

The foreign tax credit is the only credit allowed in figuring AMT. The AMT foreign tax credit is figured in the same manner as the regular tax foreign tax credit except when computing the limit on the credit:

(i) AMT taxable income is used instead of taxable income, *and*

(ii) The tax against which the credit is taken is the tentative minimum tax (before the foreign tax credit).

The AMT foreign tax credit cannot offset more than 90% of the tentative minimum tax figured before claiming the foreign tax credit and the net operating loss deduction.

Use a separate Form 1116, *Foreign Tax Credit*, to figure the amount of foreign tax credit to apply against AMT. Use a separate form for each type of income listed at the top of Form 1116. Print "ALT MIN TAX" across the top of each Form 1116 used to figure the credit against AMT. Attach all the forms to the tax return.

Foreign Tax Credit Carryback or Carryover - §904(c)

A separate carryover or carryback must be figured for the AMT foreign tax credit. It generally is figured the same way as the regular foreign tax credit carryover or carryback. A foreign tax credit carryover can be applied to the previous year or up to 10 years after it was originally claimed. The limit that determines the amount of the unused foreign tax credit available for carryover or carryback to another year is figured using the rules for the AMT foreign tax credit.

Tentative Minimum Tax

The tentative minimum tax is figured separately from the regular tax. In general, compute the tentative minimum tax by:

(1) computing taxable income eliminating or reducing certain exclusions and deductions, and taking into account differences with respect to when certain items are used to compute regular taxable income and alternative minimum taxable income (AMTI),

(2) subtracting the AMT exemption amount,

(3) multiplying the amount computed in (2) by the appropriate AMT tax rates, *and*

(4) subtracting the AMT foreign tax credit.

Minimum Tax Credit - §53

The same income item may be subject to AMT in one year and regular tax in another. The minimum tax credit prevents this double tax. When a taxpayer pays alternative minimum tax, the net minimum tax generally is allowed as a credit against the regular tax liability of the taxpayer in subsequent years.

If a taxpayer paid AMT in an earlier year, the part of it based on adjustments or preference items that deferred their tax liability rather than caused a permanent avoidance of the tax can be claimed as a credit against the regular income tax.

Form 8801, *Credit for Prior Year Minimum Tax*, is used to determine the amount of the credit.

Regular Income Tax Reduced

The credit is limited to the regular income tax for the year to which it is carried minus the following:

(i) credit for child and dependent care,

(ii) credit for the elderly or the disabled,

(iii) mortgage interest credit,

(iv) foreign tax credit,

(v) general business credit, *and*

(vi) the tentative minimum tax for the year in which the credit is being used.

Carryforward of Credit

The AMT credit can be carried forward (indefinitely) to reduce the regular tax liability in later years. If a taxpayer does not use all of the credit, the balance may be carried forward to later tax years. If the net AMT in a later tax year results in an additional credit, the taxpayer can add that credit to any carryforward balance from earlier years (see Part II of Form 8801).

Other Credits

If in a prior year, any part of the orphan drug credit or non-conventional fuels credit was disallowed because it was more than the tentative minimum tax for the year, a taxpayer can increase their minimum tax credit for this year by the amount disallowed.

AMT for Large Corporations - §55

The corporate AMT repealed under TCJA in 2017 is reinstated for large corporations by the Inflation Reduction Act (IRA) but is based on *book income* (the amount of income corporations publicly report on their financial statements to shareholders) instead of taxable income.

The IRA imposed a new alternative minimum tax of 15% on an applicable corporation based on its book earnings (§55(b)(2)). The tentative minimum tax is calculated as 15% of an applicable corporation's adjusted financial statement income (AFSI) for the taxable year, reduced by the corporate AMT foreign tax credit.

> **Note:** The new 15% corporate alternative minimum tax uses a corporation's average annual adjusted financial statement income as the starting point of the calculation. This is a departure from the previous (before the TCJA) calculation of the corporate alternative minimum tax where the starting point was taxable income.

The AMT liability becomes the excess of the tentative minimum tax over the sum of regular tax liability (before general business credits) and its base erosion and antiabuse tax (BEAT). AMT liability can be reduced by general business credits up to $25,000 plus 75% of net income tax liability (regular tax + AMT) that exceeds $25,000 (§38(c)(6)(E)). If AMT liability exceeds regular tax liability (plus BEAT), the excess may be carried forward for an unlimited period as a credit against regular tax liability (plus BEAT) in subsequent years. If the regular tax is higher than the minimum tax, a corporation may carry forward a credit for the net minimum tax for all prior tax years after 2022 to reduce the regular tax.

The provision allows special deductions for cooperatives and Alaska Native Corporations. It makes adjustments to conform financial accounting to tax accounting for certain defined benefit pension plans. It applies with respect to items under the unrelated business income tax for tax-exempt entities. Financial income is adjusted to allow depreciation deductions based on tax rules. It is also adjusted to allow recovery of wireless spectrum rights as allowed under tax rules (recovered over 15 years).

> **Note:** A domestic corporation may take a corporate AMT foreign tax credit for foreign or U.S. possessions taxes taken into account on the corporation's applicable financial statement and paid or accrued (§59(l)(1)(B).

Adjusted Financial Statement Income

Adjusted financial statement income (AFSI) is generally the net income or loss of the corporation set forth on its applicable financial statements for the taxable year, with adjustments to match categories of income reflected on its tax return measured under financial accounting principles (§56A(a)&(b)). Adjustments made to determine adjusted financial statement income (AFSI) are too numerous and complex to be set forth in this summary but, most can be found in §56A(c)(1) thru (15).

Application of Tax

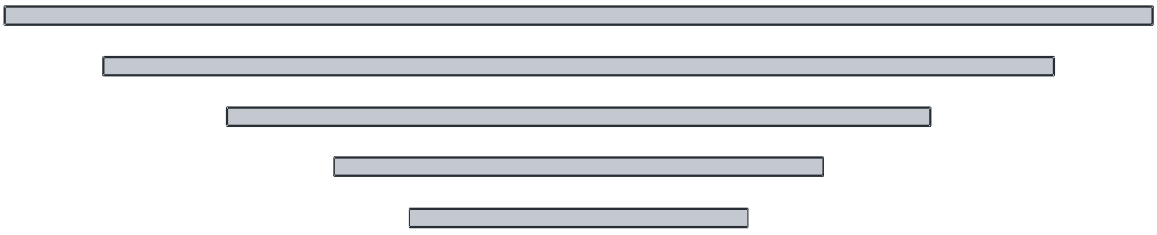
The new alternative minimum tax applies to U.S. applicable corporations (other than regulated investment companies, real estate investment trusts, and S corporations) with $1 billion or more in average annual AFSI in the previous three years (59(k)(1)(B)(i)). It applies to a new corporation in existence for less than three years based on the earnings in the years of existence.

Applicable Corporation: An applicable corporation is any corporation (other than an S corporation, regulated investment company, or a real estate investment trust) meeting the average annual adjusted financial statement income (AFSI) applicable test for one or more earlier tax years that end after December 31, 2021 (§59(k)(1)(A)).

$1 Billion AFSI: The $1 billion AFSI test is applied (i) by including the income of all corporations treated as a single employer under §52(a) (i.e.,

commonly controlled corporations) or §52(b) (i.e., commonly controlled entities) and including the income from all partnerships in which the corporation owns an interest but disregarding the covered benefit plan adjustment.

The provision excludes Subchapter S corporations, regulated investment companies (RICs), and real estate investment trusts (REITs). The tax applies to large private equity firms organized as partnerships but excludes portfolio companies owned by these firms. Firms that file consolidated returns would include income allocable to the firm from related firms including controlled foreign corporations (and any disregarded entities); for other related firms, dividends would be included.



Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regard to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

135. Several components are used in the calculation of the alternative minimum tax (AMT). When figuring AMT, which of the following substitutes an item used to compute the regular tax?

a. a personal exemption.

b. a tax preference.

c. a tentative minimum tax.

d. an adjustment.

136. Numerous tax preferences and adjustments apply to taxpayers under the alternative minimum tax (AMT). Which of the following applies to all taxpayers subject to the AMT?

a. circulation expenditures and passive losses.

b. itemized deductions and state tax refunds.

c. long-term contracts and bad debts of financial institutions.

d. Merchant Marine Capital Construction Fund and untaxed book income (pre-1990).

137. Certain AMT tax preferences and adjustments apply to specific taxpayers. For example, which of the following applies just to noncorporate taxpayers?

a. adjusted basis of certain property and alternative tax net operating loss deduction.

b. earnings & profits and Blue Cross/Blue Shield Deduction.

c. farm losses and expenses for research and experiments.

d. mining costs and intangible drilling costs.

138. Under the AMT, taxpayers may use the Alternative Depreciation System (ADS) to calculate depreciation for most properties. Which of the following assets have a 40-year ADS life?

a. most real property.

b. no assets have a 40-year ADS life.

c. qualified technological equipment.

d. semiconductor manufacturing equipment.

139. The author presents a comparison of the lives of certain assets under the modified accelerated cost recovery system (MACRS) and the lives of those same assets for alternative minimum tax (AMT). For example, what is the life for AMT of office furniture?

a. 5 years.

b. 6 years.

c. 7 years.

d. 10 years.

140. A taxpayer, who enters into a long-term contract, must figure alternative minimum taxable income. In making this calculation, what is required of the taxpayer?

a. They must amortize expenditures ratably over a three-year period.

b. They must utilize the percentage of completion method.

c. They must recover costs through ten-year straight-line amortization.

d. They must use the alternative depreciation system (ADS).

141. For purposes of computing alternative minimum taxable income, some items must be amortized. Which post-1986 items must be amortized over a ten-year period?

a. incentive stock options.

b. installment sales.

c. pollution control facilities.

d. research and experimental expenditures.

142. Passive farm losses are generally disallowed for purposes of calculating alternative minimum taxable income. However, which of the following passive farming activities may be allowed in figuring passive losses for minimum tax purposes?

a. netted farming activities.

b. passive farming activities that produce a net gain.

c. passive losses that are not from farming activities.

d. tax shelter farm activities.

Compliance

Reporting Requirements

Please note that business taxpayers can file electronically any Form 1099 series information returns for free with the IRS Information Returns Intake System (IRIS). IRIS accepts 1099 series forms. IRIS is available to any business of any size. It's secure and accurate and it requires no special software. It also reduces the need for paper forms.

> **Comment:** Businesses with a combination of 10 (down from 250 in 2023) or more information returns must file them electronically. Formerly, only those who filed more than 250 information returns were required to file electronically and the 250-return threshold was applied separately to each type of information return. Currently, filers need to combine all information return types they file to determine if they meet the 10-return threshold.

Reporting Digital Assets Transactions – [Form 8949]

Taxpayers filing tax returns must check a box indicating whether they received digital assets as a reward, award, or payment for property or services or disposed of any digital asset that was held as a capital asset through a sale, exchange, or transfer.

> **Note:** A digital asset is a digital representation of value that is recorded on a cryptographically secured, distributed ledger or any similar technology. Common digital assets include virtual currency and cryptocurrency, stablecoins, and non-fungible tokens.

Taxpayers must report all income related to their digital asset transactions as follows:

1. Use Form 8949, *Sales and other Dispositions of Capital Assets*, to calculate a capital gain or loss and report it on Schedule D (Form 1040), *Capital Gains and Losses*.

2. If individuals received any digital assets as compensation for services or disposed of any digital assets they held for sale to customers in a trade or business, they must report the income as they would report other in-

come of the same type. For example, they would report W-2 wages on Form 1040 or 1040-SR, line 1a, or inventory or services on Schedule C.

3. If an employee was paid with digital assets, they must report the value of assets received as wages. Similarly, if they worked as an independent contractor and were paid with digital assets, they must report that income on Schedule C (Form 1040), Profit or Loss from Business (Sole Proprietorship). Schedule C is also used by anyone who sold, exchanged, or transferred digital assets to customers in connection with a trade or business.

4. If the transaction was a gift, file Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return*.

Real Estate Transactions [Form - 1099S]

Real estate settlement agents are required to file Form 1099-S *Proceeds from Real Estate Sales* with the IRS for certain real estate transactions in which they are involved. In addition, they must also furnish a written statement to their customers.

Generally, the person responsible for closing the transaction must report on Form 1099-S sales or exchanges of the following types of property:

(1) land (improved or unimproved), including airspace,

(2) an inherently permanent structure, including any residential, commercial, or industrial building,

(3) a condominium unit and its related fixtures and common elements (including land), *and*

(4) stock in a cooperative housing corporation.

Real estate settlement agents responsible for filing information returns are defined as:

(1) a person responsible for closing the transaction, such as a title company or an attorney,

(2) a mortgage lender,

(3) a seller's broker,

(4) a buyer's broker, *and*

(5) any other person designated in the regulations.

Settlement agents designated under the Real Estate Settlement Proceedings Act (RESPA) are responsible for closing transactions if uniform settlement statements are used for closing; if they are not used or no settlement agent is listed, then the person who prepares the closing statement or written disposition of the gross proceeds is responsible for filing. If there is no closing statement or written description utilized then the transferee's attorney, if utilized, must file the required information return. If no attorney is utilized then the title or escrow company disbursing the proceeds must file the in-

formation return. Finally, the participants in a real estate transaction may designate someone as the responsible person with respect to the transaction.

The following information is required to be filed between December 31, and February 1 of the year following the transaction:

(1) Tax identification numbers of transferor and responsible person,

(2) General description of real estate involved,

(3) Closing date, *and*

(4) Gross proceeds.

Non-reportable transactions:

(1) Gifts,

(2) Mobile home transactions, *and*

(3) Transferors who are corporate or governmental entities.

Sales of a Principal Residence

The otherwise applicable reporting and information return requirements may not apply to sales of a principal residence when the total consideration for the sale or exchange is $250,000 or less, or $500,000 or less if the sellers are married. For this exemption to apply, the sellers, who include the persons relinquishing property when the transaction is an exchange, must give the real estate reporting person written assurances in a form acceptable to the IRS.

Wage and Tax Statement [Form W-2]

Every employer engaged in a trade or business who pays remuneration, including noncash payments of $600 or more for the year (all amounts if any income, social security, or Medicare tax was withheld) for services performed by an employee must file a Form W-2 for each employee (even if the employee is related to the employer) from whom:

(1) income, Social Security, or Medicare tax was withheld; or

(2) income tax would have been withheld if the employee had claimed no more than one withholding allowance or had not claimed exemption from withholding on Form W-4, *Employee's Withholding Allowance Certificate*.

> **Form W-4:** The Form W-4 is used by employees to specify their federal income tax withholding. It allows employees to indicate their filing status, number of allowances, and any additional withholding they wish to have deducted from their paychecks. This form is used by employers to calculate the amount of income tax to withhold from each employee's wages. It is important for employees to accurately complete Form W-4 to ensure proper tax withholding throughout the year.

Employers are required to send matching copies of this document to each of their employees and to the Social Security Administration (SSA) at the end of every tax year. Employees use this form to prepare their tax returns. If an

employee has worked multiple jobs during the year, they will enter each W-2 form separately.

> **Note:** Changes under the SECURE 2.0 Act have affected amounts to report on Form W-2 for (1) de minimis financial incentives, (2) Roth Savings Incentive Match Plan for Employees (SIMPLE), and Roth Simplified Employee Pension (SEP) Individual Retirement Arrangements (IRAs), and (3) Optional treatment of employer nonelective or matching contributions as Roth contributions (see Notice 2024-2).

Nonemployee Compensation [1099-NEC]

Any trade or business that pays an independent contractor, subcontractor, or an individual not treated as an employee $600 or more during the year must report this amount. To do so, taxpayers file Form 1099-NEC, *Nonemployee Compensation*, for each person in the course of their business to whom they have paid at least $600 during the year for:

(1) services performed by someone who is not an employee (including parts and materials); or

(2) payments to an attorney.

> **Note:** The term "attorney" includes a law firm or other provider of legal services. However, to report payments to an attorney on Form 1099-NEC, you must obtain the attorney's TIN.

Taxpayers report on Form 1099-NEC only when payments are made in the course of a trade or business. Personal payments are not reportable. However, nonprofit organizations are considered to be engaged in a trade or business and are subject to these reporting requirements.

Under §6071(c), a taxpayer is required to file Form 1099-NEC on or before January 31, using either paper or electronic filing procedures.

Employee Status

An employee is anyone who performs services that can be controlled by an employer. The existence of the right to control, not necessarily the exercise of control is critical. Control includes what shall be done and how it shall be done.

The following factors are considered in determining whether there is an employment relationship:

(1) the extent of control exercised over the details of the work;

(2) whether or not the person in question is engaged in a distinct occupation or business;

(3) whether the work is usually done under the direction of the employer or by a specialist without supervision;

(4) the skill required;

(5) whether the employer or the workman supplies instrumentalities, tools, and place of work;

(6) the length of time for which the person is employed;

(7) the method of payment;

(8) whether or not the work is part of the regular business of the employer;

(9) whether the parties believe they are creating a relationship of master and servant; *and*

(10) whether the principal is or is not in business.

Certain individuals are considered statutory employees for FICA, FUTA, and SUI purposes:

(1) driver who delivers food, beverages (other than milk), laundry, or dry-cleaning for someone else,

(2) a full-time life insurance salesperson,

(3) a homeworker who works by the guidelines of the person for whom the work is being done, with materials furnished by and returned to that person or to someone that person designates, *and*

(4) a salesperson who works full-time (except for sideline sales activities) for one firm getting orders from customers.

> **Note:** The orders must be for items for resale or use as supplies in the customer's business. The customers must be retailers, wholesalers, contractors, or operators of hotels, restaurants, or other businesses dealing with food or lodging.

To be considered an employee for FICA, FUTA, and SUI tax purposes, a person in (1) - (4) (above) must meet all three conditions below:

(1) it is understood from a service contract that the person will perform the services;

(2) the person does not have an investment in facilities (other than transportation) used to perform the services; *and*

(3) the services are the kinds that involve a continuing relationship with the person for whom they are performed.

A written contract stating that the individual is an independent contractor will not be considered valid if the relationship is actually one of an employee/employer. A California Court decision held that "...the mere fact that both parties may have mistakenly believed that they were entering into the relationship of principal and independent contractor is not binding." (*Max Grant v. Director of Benefit Payments* (1977), 71 C.A. 3d 647).

An employer's treatment of an individual as an independent contractor may be upheld for employment tax purposes if:

(1) the taxpayer does not treat the individual as an employee;

(2) all federal tax returns are filed on a consistent basis; *and*

(3) the taxpayer has a reasonable basis for treating the individual as a non-employee (Sec. 530(a) of the '78 Revenue Act).

Real estate agents are treated as non-employees if substantially all compensation for services is directly related to sales rather than number of hours worked. Such services must be performed under a written contract providing that they will not be treated as employees for tax purposes (§3508).

If the IRS reclassifies an independent contractor as an employee, the employer is subject to the following penalties detailed in §3509:

(1) 1.5% of wages paid for income tax withholding (3% if willful),

(2) 20% of the amount that should have been withheld as an employee's share of FICA (40% if willful), *and*

(3) Employer's full share of FICA and FUTA.

Miscellaneous Information [Form 1099-MISC]

Taxpayers file Form 1099-MISC, *Miscellaneous Information*, for each person in the course of their business to whom they have paid the following during the year:

(1) at least $10 in royalties or broker payments in lieu of dividends or tax-exempt interest,

(2) at least $600 in:

(a) rents,

(b) prizes and awards,

(c) other income payments,

(d) generally, the cash paid from a notional principal contract to an individual, partnership, or estate,

(e) any fishing boat proceeds,

(f) medical and health care payments (box 6);

(g) crop insurance proceeds,

(h) gross proceeds paid to an attorney,

> **Note:** Attorneys' fees of $600 or more paid in the course of your trade or business are reportable on Form 1099-NEC (§6041A(a)(1)).

(i) §409a deferrals, *or*

(j) nonqualified deferred compensation.

Taxpayers report on Form 1099-NEC only when payments are made in the course of a trade or business. Personal payments are not reportable.

Taxpayers must also file Form 1099-MISC for each person from whom they have withheld any federal income tax under the backup withholding rules regardless of the amount of the payment.

> **Note:** Taxpayers can file Form 1099-NEC or Form 1099-MISC to report sales totaling $5,000 or more of consumer products to a person on a buy-sell, a deposit-commission, or other commission basis for resale.

Taxpayers file Form 1099-MISC by February 28, if they file on paper, or March 31, if they file electronically.

> **Comment:** Business taxpayers can file electronically any Form 1099 series information returns for free with the IRS *Information Returns Intake System* (IRIS). IRIS accepts 1099 series forms for tax year 2022 and after. IRIS is available to any business of any size. It's secure and accurate and it requires no special software. It also reduces the need for paper forms. Businesses with a combination of 10 or more information returns must file them electronically.

Payment Card & Third Party Network Transactions [Form 1099-K]

Section 6050W requires third-party settlement organizations (TPSOs), such as some online marketplaces that connect users to goods and services to file an information return (Form 1099-K) for each calendar year with respect to payments made in the settlement of certain reportable payment transactions. However, TPSOs were not required to report payments unless they exceeded $20,000 and an aggregate of 200 transactions.

The American Rescue Plan Act of 2021 changed these reporting requirements for TPSOs. As amended, TPSOs must report payments that exceed $600 annually. However, the IRS decided in Notice 2023-74 to delay full implementation for 2 years – i.e., 2023. Thus, TPSOs were not required to report tax year 2023 transactions on Form 1099-K to the IRS or the payee for the lower, $600 threshold amount, and reporting was not required unless the taxpayer received over $20,000 and had more than 200 transactions in 2023.

For 2024, part of a phase-in process by the IRS to eventually implement the $600 threshold, these thresholds dropped significantly. With the change, payment platforms must report payments totaling $5,000 or more in a calendar year, with no transaction minimum. As of this writing, the threshold is expected to drop again to $600 for 2025, unless the IRS makes more changes.

Interest Income [Form 1099-INT]

Form 1099-INT, "Interest Income", is used by taxpayers to report interest income paid. This form is issued by all entities that pay interest income at the end of the year. It is typically issued by banks, financial institutions, and other entities that pay interest, and it is used by taxpayers to report and calculate their taxable interest income. It includes a breakdown of all types of interest income and related expenses.

Payers must issue Form 1099-INT for any party to whom they paid at least $10 of interest during the year. The form must be filed by January 31, unless that date falls on a weekend or holiday. Then, it's the next business day.

Dividends and Distributions [Form 1099-DIV]

Form 1099-DIV is required for individuals who have received dividends or other distributions valued at $10 or more, those who have had foreign taxes

withheld on dividends and distributions, those subject to federal income tax withholding under backup withholding rules on dividends, and individuals who have received $600 or more in money or property as part of a liquidation.

Form 1099-DIV does not require reporting for the following:

(1) taxable dividend distributions from life insurance contracts and employee stock ownership plans (these are reported on Form 1099-R),

(2) substitute payments in lieu of dividends received by a broker on behalf of a customer as a result of a loan of securities, *and*

(3) payments made to certain payees, including corporations, tax-exempt organizations, IRAs, Archer MSAs, HSAs, U.S. agencies, and states.

Payments from Qualified Education Programs [Form 1099-Q]

Form 1099-Q should be filed when an officer or employee, or a designated representative of an officer or employee, in charge of a program established by a state or eligible educational institution has made a distribution from a §529 plan or a Coverdell Education Savings Account.

The manager of a qualified education program reports annual distributions on Form 1099-Q to the IRS *and* the beneficiary of the savings account. If the money from a §529 plan is not sent directly to the beneficiary or their educational institution, the account owner (like a parent) will receive the Form 1099-Q.

Distributions From Retirement Plans [Form 1099-R]

Form 1099-R must be filed for each individual who received a designated distribution of $10 or more from various sources such as profit-sharing or retirement plans, IRAs, annuities, pensions, insurance contracts, survivor income benefit plans, permanent and total disability payments under life insurance contracts, and charitable gift annuities.

Mortgage Interest Statement [Form 1098]

Form 1098 is used to report mortgage interest of $600 or more received during the year from an individual in the course of your trade or business. Lenders need to file a separate form for each mortgage, and the $600 threshold applies separately to each mortgage.

If a lender received less than $600 in interest on a mortgage, they are not required to file Form 1098 for that specific mortgage. However, they can still choose to file. If there is a refund, credit, or an overpayment of interest from a previous year, a Form 1098 may also need to report it.

If a taxpayer pays $600 or more in mortgage interest, they must receive a 1098 tax form from their lender. If a taxpayer's mortgage interest is less than $600, they should not receive this form.

Cash Reporting – §6050I [Form 8300]

A person who receives in his or her trade or business, more than $10,000 in cash (including foreign currency) in one transaction (or 2 or more related transactions), must file an information return with IRS and furnish the payor with a statement. Reporting is done on Form 8300, *Report of Cash Payments Over $10,000 Received in a Trade or Business*.

> **Note:** Starting in 2024, businesses that file 10 or more information returns must e-file Form 8300, *Report of Cash Payments Over $10,000*, instead of filing a paper return. For those with fewer information returns, e-filing Form 8300 is still optional. To file electronically Form 8300, a business must set up an account with the Financial Crimes Enforcement Network's BSA E-Filing System.

Generally, a business must file Form 8300 within 15 days after they receive the cash. If the 15th day falls on a Saturday, Sunday, or holiday the business must file the report on the next business day.

Notification Statement

The business filing Form 8300 must provide its identified customers and all parties on the form that are part of the transaction with a written notification statement on or before Jan. 31 of the year immediately following the year the customer made the reported cash payment. The statement must include the following information: (i) the name and address of the cash recipient's business, (ii) the name and telephone number of a contact person for the business, (iii) the total amount of reportable cash received in a 12-month period, and (iv) a statement the cash recipient is reporting the information to the IRS.

Definitions

The definition of cash under this reporting rule includes certain monetary instruments to the extent provided in regulations (TD 8373). Under the regulations, specified monetary instruments are cash when they are received in "designated reporting transactions." The specified monetary instruments are:

(1) cashier's checks,

(2) bank drafts,

(3) traveler's checks, *and*

(4) money orders,

having a face amount of not more than $10,000 (Reg. §1.6050I-1(c)(1)(ii)).

Such instruments are under the cash reporting rules whether the instruments are payable to:

(1) bearer,

(2) a named payee, *or*

(3) left blank.

Checks other than cashier's checks are not included in the definition of cash. Thus, the term does not include checks drawn on the personal account of an individual or business checks even if such checks are certified.

A designated reporting transaction is a retail sale of a:

(1) consumer durable,

(2) collectible, *or*

(3) travel or entertainment activity (Reg. §1.6050I-1(c)(1)(iii)).

A *consumer durable* is tangible personal property sold for personal consumption or use that is expected to be useful for at least one year under ordinary usage and has a sales price of more than $10,000. Thus, for example, a $20,000 automobile is a consumer durable, but a $20,000 factory machine is not (Reg. §1.6050I-1(c)(2)).

A *travel or entertainment activity* is one or more items of travel or entertainment relating to a single trip or event, but only if the total sales price of all items relating to the trip or event exceeds $10,000 (Reg. §1.6050I-1(c)(4)).

Items of travel or entertainment relating to a single trip or event include, for example, the chartering of an airliner to transport persons to and from a sporting event, hotel accommodations related to the event, and admission to the event itself.

In deciding whether the total sales price is more than $10,000, related sales by a single merchant/recipient of items of travel and entertainment relating to the same trip or event are totaled. However, retail sales of items relating to a trip or event are not totaled with retail sales of items relating to another trip or event.

Exceptions

A specified monetary instrument is not cash if the instrument represents the proceeds of a bank loan. The recipient may rely on a copy of the loan document or a statement from the bank (Reg. §1.6050I-1 (c)(1)(iv)).

Another exception applies to instruments received in payment on a promissory note or an installment sales contract if:

(1) the recipient uses promissory notes or installment sales contracts with the same or substantially similar terms in the ordinary course of its trade or business related to sales to ultimate consumers, *and*

(2) the total amount of payments received with respect to the sale on or before the 60th day after the date of the sale does not exceed 50% of the purchase price (Reg. §1.6050I-1(c)(1)(v)).

A third exception applies to an instrument received pursuant to a payment plan requiring one or more down payments and the payment of the balance of the purchase price by the time of the sale if:

(1) the recipient uses plans with the same or substantially similar terms in the ordinary course of its trade or business related to sales to ultimate consumers, *and*

(2) the instrument is received more than 60 days before the date of the sale (Reg. §1.6050I-i(c)(1)(vi)).

Recipient's Knowledge

Whether or not a specified monetary instrument is received in a designated reporting transaction, the instrument is cash if the recipient knows that the instrument is being used in an attempt to avoid the cash reporting U.S. rules (Reg. §1.6050I-1(c)(1)(ii)).

Cash Reporting Rules - Attorneys

In *U.S. v. Goldberger & Dubin*, 67 AFTR 2d 91-1166, the Second Circuit has held that attorneys are not exempt from the cash reporting rules.

Attorneys have argued that such disclosure violates the attorney-client privilege and the Fifth and Sixth Amendments (self-incrimination and right to counsel).

The Second Circuit found that when Congress passed §6050I, it did not exempt attorneys despite lobbying for an exemption. The Court held that Congress deliberately didn't wish to supply an exclusion and rejected the Sixth Amendment argument, reasoning that §60501 didn't prevent clients from paying their counsel in a medium other than cash.

> **Note:** This argument may have limited application since the RRA '89 and proposed regulations treat monetary instruments such as cashier's checks and money orders as cash.

Since a violation of federal law was involved, the attorney-client privilege law of New York was held not to apply.

Example

An attorney receives more than $10,000 cash from a person as advance payment for legal services. Even though no service has been performed at the time the cash is received, the attorney is required to file Form 8300 within fifteen days after the cash is received. Once a person receives (in a transaction or related transactions) cash exceeding $10,000 in a person's trade or business, a Form 8300 must be filed.

Sale of Certain Partnership Interests - §751(a) [Form 8308]

Partnerships file Form 8308 to report the sale or exchange by a partner of all or part of a partnership interest where any money or other property received in exchange for the interest is attributable to unrealized receivables or inventory items (i.e., where there has been a §751(a) exchange).

Partnerships must include Form 8308 with their partnership return (Form 1065) if a sale or exchange of any partnership interests under §751(a) takes place during the year. Section 751(a) sales and exchanges are defined as transactions where partnership interests are attributable to unrealized receivables or substantially appreciated inventory.

Tax Shelter Registration Number - §6111 [Form 8271]

Form 8271 is used to report the tax shelter registration number that the IRS assigns to certain tax shelters required to be registered under §6111 known as "registration-required tax shelters."

Anyone claiming or reporting a loss, deduction, credit, or other tax benefit or reporting any income or any tax return from an interest purchased or acquired in a registration-required tax shelter must file a Form 8271. The form is attached to the tax return on which the loss, deduction, credit, or other tax benefit is claimed. The registration number is located on Schedule K-1 for partners or shareholders in S Corporations.

A $250 penalty is charged for each failure to include a tax shelter registration number on a return on which it is required to be included unless the failure is due to reasonable cause.

Asset Acquisition Statement - §1060 [Form 8594]

Both the buyer and seller of a group of assets constituting a trade or business must prepare and attach Form 8594 to their tax return (Forms 1040, 1041, 1065, 1120, 1120-S, etc.). This form is used to report such a sale if goodwill or going concern value attaches, or could attach, to such assets and if the purchaser's basis in the assets is determined only by the amount paid for the assets.

Accuracy-Related Penalties - §6662

The accuracy-related penalties under §6662(b) include penalties for:

(1) negligence or disregard,
(2) substantial understatement of an income tax liability,
(3) substantial valuation misstatement,
(4) any substantial overstatement of pension liabilities, *and*
(5) substantial estate & gift tax valuation understatements.

Generally, the accuracy-related penalties are set at a common rate of 20% and the taxpayer defense to their imposition is largely uniform(§6664(c)). However, the penalty rate can rise to 40% for certain gross valuation misstatements (§6662(h)).

Negligence or Disregard - §6662(b)(1)

Negligence in tax preparation refers TO any failure to make a reasonable attempt to comply with the provisions of tax law or any (careless or intentional) disregard of rules and regulations (§6662(c)). A position with respect to an item is considered to be attributable to negligence if it is frivolous or if it is not frivolous but lacks a reasonable basis.

Negligence is strongly indicated where a taxpayer:

(1) Fails to include income shown on an information return, such as a Form 1099, *or*

(2) Fails to make a reasonable attempt to ascertain the correctness of a deduction, credit, or exclusion that would seem to a reasonable and prudent person to be "too good to be true" under the circumstances.

Negligence also is strongly indicated where the returns of a partner and partnership or of an S corporation shareholder and S corporation are not consistent with the treatment on the return of the partnership or S corporation (Reg. §1.6662-3(b)(1)).

Disregard, on the other hand, means any careless, reckless, or intentional disregard of the Code, temporary or final Treasury regulations, revenue rulings, or notices published in the Internal Revenue Bulletin (Reg. §1.6662-3(b)(2)). However, a taxpayer will not be considered to have disregarded a revenue ruling, if the position contrary to the ruling has a realistic possibility of being sustained on its merits.

Adequate Disclosure

For disregard of rules or regulations, the regulations provide that disclosure is adequate if:

(1) made on a Form 8275, *or*

(2) in the case of a position contrary to regulation, the penalty can be avoided if the position represents a good faith challenge to the validity of the regulation (Reg. §1.6662-3(c)).

Penalty

In cases of negligence or disregard of the rules or regulations, the is 20% of the portion of the underpayment of tax that happened because of negligence or disregard. The negligence penalty applies to all taxes but does not apply when fraud is involved. The penalty can be avoided by showing reasonable cause and good faith action.

Substantial Understatement of Income Tax - §6662(d)

A substantial understatement of a tax income liability is when the understatement exceeds the larger of:

(1) 10% of the tax due, *or*

(2) $5,000 ($10,000 for corporations)

The understatement to which the penalty applies is 10% of the difference between the amount of tax required to be shown on the return and the amount of tax actually reported.

The penalty can be avoided in the following circumstances:

(1) the taxpayer has substantial authority for such treatment,

(2) the relevant facts affecting the treatment were adequately disclosed in the return, *or*

(3) the taxpayer has reasonable cause and acts in good faith.

This penalty is not imposed if there is substantial authority for the position claimed on the return. "Authority" under the regulations includes private letter rulings and technical advice memoranda issued after October 31, 1976, and general counsel memoranda and actions on decisions issued after March 12, 1981 (Reg. §1.6662-4(d)(3)(iii)).

The regulations further provide that an authority ceases to be an authority if overruled or modified, implicitly or explicitly, by an authority of the same or higher source. For example, a private letter ruling will not be considered authority if revoked or if inconsistent with a subsequently proposed regulation, revenue ruling, or other administrative pronouncement published in the Internal Revenue Bulletin.

A district court opinion isn't an authority if overruled by the court of appeals for that district. However, a Tax Court opinion is not considered overruled or modified by a court of appeals to which a taxpayer doesn't have a right of appeal unless the Tax Court adopts the holding of the court of appeals.

In determining whether authority is substantial, an older private letter ruling, technical advice memorandum, general counsel memorandum, or action on decision generally will be accorded less weight than a more recent one and any such document that is more than ten years old generally will be accorded very little weight. However, the relevance and persuasiveness of documents should be taken into account as well as their age (Reg. §1.6662-4(d)(3)).

Adequate Disclosure

The regulations provide for only two methods of disclosure in order for items to be treated as though they were properly shown on the return for purposes of the substantial understatement penalty:

(1) disclosure on a Form 8275 attached to the return (or a qualified amended return), *and*

(2) disclosure in accordance with the annual revenue procedure that permits disclosure on the return itself (or a qualified amended return) for this purpose (Reg. §1.6662-4(f)).

Penalty

The amount of the penalty is 20% of the amount of the underpayment attributable to the understatement,

Substantial Valuation Misstatement - §6662(e)

There is a substantial valuation misstatement if:

(1) the value of any property (or the adjusted basis of any property) claimed on any return is 150% or more of the amount determined to be the correct amount of such valuation or adjusted basis,

(2) the price for any property or services (or for the use of property) claimed on any such return in connection with any transaction between persons defined in §482 is 200% or more (or 50% or less) of the amount determined to be the correct amount of such price.

> **Note:** A substantial valuation misstatement also occurs when the net §482 transfer price adjustment for the taxable year exceeds the lesser of $5,000,000 or 10 percent of the taxpayer's gross receipts.

The valuation overstatement penalty can be avoided if the taxpayer can show reasonable cause and good faith. However, if the overvaluation involves charitable deduction property, two additional facts must be shown:

(1) The claimed value of the property is based on a qualified appraisal made by a qualified appraiser; *and*

(2) The taxpayer made a good faith investigation of the value of the contributed property.

Penalty

The penalty is 20% of the tax that should have been paid had the correct valuation or basis been used. However, the penalty applies only to the extent that the resulting income tax underpayment exceeds $5,000 ($10,000 for a corporation other than an S corporation or a personal holding company).

Substantial Overstatement of Pension Liabilities - §6662(f)

There is a substantial overstatement of pension liabilities if the actuarial determination of the liabilities taken into account for purposes of computing the deduction under §404(a) is 200% or more of the amount determined to be the correct amount of such liabilities. The penalty will not be imposed if it is shown that there was a reasonable cause for an underpayment and the taxpayer acted in good faith.

Penalty

A 20% penalty is imposed on any portion of any underpayment of tax resulting from a substantial overstatement of pension liabilities. However, the penalty applies only to the extent that the portion of the underpayment for the taxable year attributable to substantial overstatements of pension liabilities exceeds $1,000.

Substantial Estate & Gift Tax Valuation Understatement - §6662(g)

There is a substantial estate or gift tax valuation understatement if the value of any property claimed is 65% or less of the amount determined to be the correct amount of such valuation.

Penalty

The penalty is 20% of the transfer tax that would have been due had the correct valuation been used on Form 706 (estate) or Form 709 (gifts). However, the penalty applies only to the extent that the portion of the underpayment attributable to substantial estate or gift tax valuation understatements for the taxable period exceeds $5,000. Reasonable cause and good faith is a defense.

Understatement Due to Unreasonable Position - §6694(a)

Under §6694(a), a person who is an income tax return preparer with respect to a given return or refund claim is liable for a penalty equal to the greater of $1,000 or 50% of the income derived for that return or refund claim if:

(1) any part of an understatement of liability is due to an unreasonable position (§6694(a)(2)),

(2) the return preparer knew (or reasonably should have known) of such position (§6694(a)(1)(B)), *and*

(3) such position was not disclosed as provided in §6662(d)(2)(B)(ii).

If the understatement of liability is due to willful or reckless conduct, the penalty is more severe. In this case, the preparer can pay a penalty equal to the greater of $5,000 or 75% of the income derived with respect to the return or claim (§6694(b)).

> **Note:** Willful conduct includes intentionally attempting to understate the tax liability or recklessly disregarding rules and regulations.

However, the penalty is not imposed where the preparer shows both that there is a reasonable cause for the understatement and that the preparer acted in good faith.

Section 6694 provides that a reportable tax position must satisfy the subjective "more likely than not" standard as well as the objective "substantial authority" standard.

Reasonable Position – "More Likely Than Not Standard" - §6694(a)(2)(C)

When the position is with respect to a tax shelter or a reportable transaction, the position is unreasonable unless it is reasonable to believe that the position would *more likely than not* be sustained on its merits (§6694(a)(2)(C)). This standard is the reasonable belief that the position would more likely than not be sustained (a 50% plus chance of success) on its merits.

> **Note:** Formerly, a position was considered to have a realistic possibility of being sustained if a person knowledgeable in tax law would conclude that the position had approximately a one in three or greater likelihood of being sustained on its merits

Reasonable Position - Substantial Authority Standard - §6694(a)(2)(A)

A position will be considered reasonable if it has substantial authority. The substantial authority standard provides that the tax treatment of an item has "substantial authority" only if the weight of published cases, rules, and other legal and administrative authorities is substantial in relation to the weight of opposing authorities.

The authorities considered in determining whether a position satisfies this standard are:

(1) Applicable provisions of the Internal Revenue Code and other statutory provisions;

(2) Proposed, temporary, and final regulations construing such statutes;

(3) Revenue rulings and revenue procedures;

(4) Tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties;

(5) Court cases;

(6) Congressional intent as reflected in committee reports, joint explanatory statements of managers included in conference committee reports, and floor statements made prior to enactment by one of a bill's managers;

(7) General Explanations of tax legislation prepared by the Joint Committee on Taxation (the Blue Book);

(8) Private letter rulings and technical advice memoranda issued after October 31, 1976;

(9) Actions on decisions and general counsel memoranda issued after March 12, 1981 (as well as general counsel memoranda published in pre-1955 volumes of the Cumulative Bulletin); *and*

(10) Internal Revenue Service information or press releases; notices, announcements, and other administrative pronouncements published by the Service in the Internal Revenue Bulletin.

Conclusions reached in treatises, legal periodicals, legal opinions, or opinions rendered by tax professionals are not authority.

Example

The instructions for an item on a tax form published by the Internal Revenue Service are incorrect and are clearly contrary to the regulations. Before the return is prepared, the Internal Revenue Service publishes an announcement acknowledging the error and providing the correct instruction. Under these facts, a position taken on a return that is consistent with the regulations satisfies the standard. On the other hand, a position taken on a return that is consistent with incorrect instructions does not satisfy the standard. However, if the preparer relied on the incorrect instructions and was not aware of the announcement or the regulations, the reasonable cause and good faith exception may apply depending on all facts and circumstances (see Reg. §1.6694-2(d)).

Adequate Disclosure - §6694(a)(2)(B)

The penalty will not be imposed on a preparer if the position taken is adequately disclosed. The regulations provide two different sets of rules for signing and non-signing preparers.

In the case of a signing preparer, disclosure of a position is made on a properly completed and filed Form 8275 or 8275-R, as appropriate, or on the return in accordance with an annual revenue procedure.

Since the nonsigning preparers ordinarily have no control over a return or refund claim, the regulations allow nonsigning preparers to make adequate disclosure by advising the taxpayer or another preparer that disclosure is necessary (Reg. §1.6694-2(c)).

> **Note:** A "nonsigning preparer" is any preparer who is not a signing preparer. Examples of nonsigning preparers are preparers who provide advice (written or oral) to a taxpayer or to a preparer who is not associated with the same firm as the preparer who provides the advice. Where there are two or more individuals in the same firm who could be regarded as nonsigning preparers, it is the individual with overall supervisory responsibility for the advice given by the firm who is the nonsigning preparer (Reg. §1.6694-1(b))

Form 8275-R

Form 8275-R, *Regulation Disclosure Statement*, must be used to disclose items or positions on a tax return that are contrary to regulations (Ann.

92-120). This form is used instead of Form 8275 when the position being disclosed is contrary to a regulation.

Information Reporting & Penalties - §6721 et al

Employers must report wages paid to employees on Forms W-2. A business must also file a Form 1099-NEC with the IRS to report payment of non-employee compensation aggregating $600 or more to a single payee in a tax year. Payment recipients must receive copies of these forms (called payee statements). These forms are generally referred to as information returns.

> **Note:** Forms 1099-NEC and W-2 are to be filed by January 31 of the following year (March 31 for electronic filing is no longer available) (§6721). The deadline to supply payee statements remains January 31 (§6722).

Penalties are imposed on persons who fail to file or supply these required information returns and payee statements. The *general* penalty is $340 ($330 in 2024) for each return but, the total amount imposed cannot exceed $4,098,500 ($3,987,000 in 2024) in 2025. However, if a failure is corrected within 30 days of the required filing date the penalty is $60 and $130 ($120 in 2024) if corrected after the 30th but on or before August 1) in lieu of $340 and the total amount imposed cannot exceed $683,000 ($664,500 in 2024) in 2025. These penalties are adjusted annually for inflation. As a result, the penalty in 2025 is $340 (up from $330 in 2024) per return, with a maximum penalty of $4,098,500 (up from $3,987,000 in 2024).

> **Note:** Other information reporting requirements have different penalty provisions for failure to provide information.

These penalties can be reduced when errors are corrected within certain deadlines. The maximum penalty can also be reduced if the filer is a small business. However, the penalty is increased for intentional disregard of the rules. The penalties do not apply to inconsequential or de minimis failures, or when there is reasonable cause.

Corrections Resulting in Reduced Penalties

When the failure is corrected within 30 days after the return is due, penalties are reduced to $60 per return, up to a maximum of $683,000 for 2025 (up from $664,500 in 2024). However, if the failure is corrected more than 30 days after the return is due, but before August 1 of the same year, penalties are only reduced to $130 per return, up to a maximum of $2,049,000 for 2025 (up from $1,993,500 in 2024).

Small Businesses

For businesses with no more than $5 million in annual gross receipts, the total of $60 penalties caps at $239,000 for 2025 (up from $232,500 in 2024); the total of $130 penalties caps at $683,000 for 2025 (up from $664,500 in 2024); and a total of $340 penalties caps at $1,366,000 for 2025 (up from $1,329,000 in 2024).

Reasonable Cause

If a failure to file is due to reasonable cause and not willful neglect, the penalties do not apply. To show reasonable cause, a taxpayer must show either that the failure was caused by:

(1) mitigating factors, *or*

(2) events beyond the filer's control.

Taxpayers must also show responsible action in trying to comply with requirements.

Failures

Failure to Furnish Copy of Return to Taxpayer - §6695(a)

The penalty is $50 for each failure to comply with §6107 regarding furnishing a copy of a return or claim to a taxpayer. However, the maximum penalty imposed on any tax return preparer can not exceed $25,500 in a calendar year.

Failure to Sign Return - §6695(b)

The penalty is $50 for each failure to sign a return or claim for a refund as required by regulations. The maximum penalty imposed on any tax return preparer shall not exceed $25,500 in a calendar year.

Failure to Furnish Identifying Number - §6695(c)

The penalty is $50 for each failure to comply with IRC Sec. 6109(a)(4) regarding furnishing an identifying number on a return or claim. The maximum penalty imposed on any tax return preparer shall not exceed $25,500 in a calendar year.

Failure to Retain Copy or List - §6695(d)

The penalty is $50 for each failure to comply with IRC Sec. 6107(b) regarding retaining a copy or list of a return or claim. The maximum penalty imposed on any tax return preparer shall not exceed $25,500 in a return period.

Failure to File Partnership Return - §6698

For tax years beginning in 2025, the dollar amount used to determine the amount of the penalty under §6698(b)(1) is $245 (up from $245 in 2024) per partner.

Failure to File S Corporation Return - §6699

For tax years beginning in 2025, the dollar amount used to determine the amount of the penalty under §6699(b)(1) is $250 (up from $235 in 2023) per shareholder.

Disclosure or Use of Information - §6713

The penalty is $250 for each unauthorized disclosure or use of information furnished for, or in connection with, the preparation of a return. The maximum penalty on any person shall not exceed $10,000 in a calendar year.

Statute of Limitations for Assessments

Three-Year Assessment Periods

All taxes must be assessed within three years after the return was filed or its due date, if later. For returns that are filed late, the assessment period starts the day after the return is actually filed. If an amended return is filed, within 60 days of the end of the statutory assessment period the IRS has 60 days from the date of receipt to assess additional taxes.

Six-Year Assessment Period

If there is an omission from gross income which is over 25% of the income reported on the tax return then the assessment period is extended to six years. This does not include amounts where adequate information is provided on the return or attached statements.

No Statute Of Limitations

There is no statute of limitations on assessments when taxpayers:

(a) does not file a return,

(b) files a fraudulent return with the intent to evade taxes, *or*

(c) does not furnish information or a property transfer in a tax-free exchange.

Extension of Statute Of Limitations

Both parties can agree to extend the statute of limitations prior to the expiration of the assessment period by signing a completed Form 872.

Examination of Returns

The IRS may examine a taxpayer's return for any of various reasons and the examination may take place in any one of several ways. After the examination, if the IRS proposes any changes to tax, the taxpayer may either agree with those changes and pay any additional tax or may disagree with the changes and appeal the decision.

How Returns Are Selected

The IRS selects returns for examination by several methods. A computer program called the Discriminant Function System (DIF) selects most returns. This method scores each return for potential error based on past experience. IRS personnel then screen the returns and select those most likely to have mistakes.

The IRS also selects returns by examining claims for credit or refund and by matching information documents, such as Forms W-2 and 1099, with returns.

Arranging the Examination

Many examinations are handled by mail. However, if the IRS notifies the taxpayer that the examination is to be conducted through a personal interview, or if the taxpayer requests an interview, the taxpayer has the right to ask that the examination take place at a reasonable time and place. However, the IRS has the final determination on how, when, and where an examination takes place.

Transfers

Generally, an individual return is examined in the IRS office nearest the taxpayer's home. However, not all offices have examination facilities. Business returns are examined where the books and records are maintained. If the place of examination is not convenient, the taxpayer may ask to have the examination done in another office or transferred.

Representation

Throughout the examination, the taxpayers may represent themselves, have someone else accompany them, or, with proper written authorization, have someone represent them in their absence. If a taxpayer wants to consult an attorney, an enrolled agent, a CPA, or any other person permitted to represent a taxpayer during an examination, the IRS will stop and reschedule the

interview. However, the IRS will not suspend the interview if the taxpayer is there because of an administrative summons.

Recordings

An audio recording can generally be made of an interview with an IRS Examination officer. The request to record the interview should be made in writing. The taxpayer must notify the IRS at least 10 days before the meeting and bring recording equipment. The IRS also can record an interview. If the IRS initiates the recording, they will notify the taxpayer 10 days before the meeting, and the taxpayer can get a copy of the recording at their expense.

Repeat Examinations

IRS policy is not to examine an individual's tax return if the taxpayer has been examined for the same issue(s) in either of the two preceding years and the audit resulted in no or a small change in tax.

> **Note:** This policy does not apply to business returns or individual returns that include a Schedule C (Profit or Loss from Business) or Schedule F (Farm Income and Expenses).

If a taxpayer receives a notice of an audit in which the IRS is questioning the same item(s) as on a previously audited return, they should call the agent whose name appears on the notice and inform him or her that the IRS audited the same issue(s) in one of the two prior years with little or no change in tax.

Changes to Return

If the IRS proposes any changes to the taxpayer's return, they will explain the reasons for the changes. If the taxpayer agrees with the proposed changes, they may sign an agreement form and pay any additional tax owed. A taxpayer must pay interest on any additional tax. If the taxpayer pays when they sign the agreement, the interest is generally figured from the due date of the return to the date the taxes were paid.

If the taxpayer does not pay the additional tax when they sign the agreement, they will receive a bill. The interest on the additional tax is generally figured from the due date of the return to the billing date. However, the taxpayer will not be billed for more than 30 days additional interest, even if the bill is delayed.

> **Note:** If the taxpayer is due a refund, they will be paid interest on the refund.

Appealing Examination Findings

If the taxpayer does not agree with the examiner's report, they may meet with the examiner's supervisor to discuss the case further. If the taxpayer still does not agree after receiving the examiner's findings, they have the right to appeal them. The examiner will explain appeal rights and give the taxpayer a copy of

Publication 5, *Appeal Rights and Preparation of Protests for Unagreed Cases,* explaining appeal rights in detail.

Appeals Office

A taxpayer can appeal the findings of an examination within the IRS through the Appeals Office. The Appeals Office is independent of the examiner and IRS District Director or Service Center Director. Often differences can be settled through this appeals system without expensive and time-consuming court trials. If the matter cannot be settled in Appeals, the taxpayer can take their case to court.

Appeals to the Courts

Depending on whether the taxpayer first pays the disputed tax, the taxpayer can take their case to:

(1) The U.S. Tax Court,

> **Note:** If the taxpayer has not yet paid the additional tax and disagrees about whether they owe it, a taxpayer must take their case to the Tax Court. The IRS will mail a formal notice (called a "notice of deficiency") telling the taxpayer that they owe additional tax. Thereafter, the taxpayer ordinarily has 90 days to file a petition with the Tax Court.

(2) The U.S. Court of Federal Claims, *or*

(3) The U.S. District Court.

> **Note:** If the taxpayer has already paid the disputed tax in full and filed a claim for refund for it that the IRS disallowed (or on which the Service did not take action within 6 months), they may take their case to the U.S. District Court or U.S. Court of Federal Claims.

These courts are entirely independent of the IRS. However, the Appeals Office generally reviews a U.S. Tax Court case before the Tax Court hears it.

> **Note:** Taxpayers can represent themselves or have someone admitted to practice before the court represent them.

Court Decisions

The IRS must follow Supreme Court decisions. However, the IRS can lose cases in other courts involving taxpayers with the same issue and still apply their interpretation of the law.

Recovering Litigation Expenses

If the court agrees with the taxpayer on most issues and finds the IRS's position to be largely unjustified, the taxpayer may be able to recover some of their litigation expenses from the IRS. However, to do this, the taxpayer must have used up all administrative procedures within the IRS, including going through the Appeals system.

Other Remedies

If the taxpayer believes that tax, penalty, or interest was unjustly charged, they have rights that may remedy the situation.

Claims for Refund

Once a taxpayer has paid their tax, they have the right to file a claim for a credit or refund if they believe the tax is too much.

Cancellation of Penalties

A taxpayer may ask that certain penalties (but not interest) be canceled (abated) if they can show reasonable cause for the failure that led to the penalty (or can show that they exercised due diligence if that is the standard for the penalty).

If the taxpayer relied on wrong advice given by IRS employees on the toll-free telephone system, the IRS will cancel certain penalties that may result, but the taxpayer must show that their reliance on the advice was reasonable.

Reduction of Interest

If an IRS error caused a delay in a taxpayer's case, and this is grossly unfair, they may be entitled to a reduction of the interest that would otherwise be due. Only delays caused by procedural or mechanical acts that do not involve exercising judgment or discretion qualify.

Review Questions

Under NASBA-AICPA self study standards, self study sponsors are required to present review questions intermittently throughout each self-study course. The following questions are designed to meet those requirements and increase the benefit of the materials. However, they do not have to be completed to receive any credit you may be seeking with regard to the text. Nevertheless, they may help you to prepare for any final exam.

Short explanations for both correct and incorrect answers are given after the list of questions. We recommend that you answer each of the following questions and then compare your answers. For more detailed explanations and references, you may do an electronic search using Ctrl+F (if you are viewing this course on computer), consult the text Index, or review the general Glossary.

143. Form 1099-S is used to report sales or exchanges of certain transactions. Which transactions must be reported on this form by the individual accountable for closing the transaction?

a. sales or exchanges of a commercial building if the transferors are corporations.

b. gift transactions or transfers.

c. sales or exchanges of mobile home transactions.

d. sales or exchanges of stock in a cooperative housing corporation.

144. Independent contractors should not be confused with employees. Which individual would most likely be deemed in an employment relationship?

a. an individual who does not believe they created a relationship of master and servant.

b. an individual who provides services that another controls.

c. an individual who provides his or her own tools and/or supplies.

d. an individual whose work is not part of the regular business of another.

145. The author lists four categories of individuals who are considered statutory employees for purposes of the Federal Insurance Contribution Act (FICA) tax, the Federal Unemployment Tax Act (FUTA), and State Unemployment Insurance (SUI). Which of the following is included in this list?

a. food delivery drivers.

b. individuals who have an investment in facilities used to perform the services.

c. part-time life insurance salespersons.

d. full-time factory machinists.

146. Section 530(a) of the 1978 Revenue Act provides three conditions whereby the employment tax treatment of an individual as an independent contractor by an employer may be upheld. What is one of these conditions?

a. The employer often files Form 1099s or W-2s.

b. The employer made an honest mistake.

c. The employer can show there is a reasonable cause for this tax treatment.

d. The employer treats all workers as employees.

147. Section 3508 provides that employers may treat certain individuals as non-employees where they pay the individual compensation based on sales rather than number of hours worked. Which of the following workers is covered under this provision?

a. full-time salespeople who work for one firm getting orders from customers.

b. real estate agents.

c. statutory employees.

d. individuals who work from home under another person's guidance.

148. The regulations (TD 8373) for reporting cash on Form 8300 specify four monetary instruments as being subject to cash reporting rules. Which of the following is a specified monetary instrument under these regulations?

a. an instrument that represents the proceeds of a bank loan.

b. certified business checks.

c. money orders.

d. personal checks.

149. Reg. §1.16050I-1(c)(1)(iii) defines a designated reporting transaction for purposes of cash reporting on Form 8300. Which of the following is excluded from the definition of a designated reporting transaction?

a. a sale of a collectible.

b. a sale of a factory machine.

c. a sale of an automobile.

d. total sales of all items relating to a trip.

150. If a taxpayer disagrees with the findings of an IRS examination, he or she may appeal the findings. Where must the taxpayer go to appeal the findings if the additional tax is unpaid?

a. the Appeals Office.

b. the Tax Court.

c. the U.S. Court of Federal Claims.

d. the U.S. District Court.

Answers & Explanations

1. The federal tax revenue is comprised of a variety of taxes. However, which of the following is the greatest source of federal revenues?

a. Incorrect. Corporate income tax is the third greatest source of federal revenue.

b. Incorrect. The most minor sources of federal revenue are the estate and gift taxes and the excise tax.

c. Correct. The greatest source of revenue for the federal government is individual income taxes.

d. Incorrect. The second greatest revenue source for the United States government is Social Security and other payroll taxes. [Chp. 1]

2. In 2025 Mary earned $40,000. What is Mary's marginal income tax rate if she files as head of household?

a. Correct. The 2025 taxable income rate for a taxpayer who earns between $17,000 and $64,850 and is filing as head of household is 12%. Head of

household is disproportionately favored under the Code and should not be overlooked.

b. Incorrect. The 2025 taxable income rate for a taxpayer who earns *between $64,850 and $103,350* and is filing as head of household is 22%. Still, 22% is a very favorable rate for this amount of income.

c. Incorrect. The 2025 taxable income rate for a taxpayer who earns *between $103,350 and $197,350* and is filing as head of household is 24%. Not too long ago 28% was the capital gain rate.

d. Incorrect. The 2025 taxable income rate for a taxpayer who earns between $197,350 and $250,500 and is filing as head of household is 32%. Even at 32%, this is the marginal rate, not the effective rate. [Chp. 1]

3. A taxpayer may lose their earned income tax credit if they have disqualified income. In 2025, what was the permissible limit of investment income?

a. Incorrect. The limit of investment income was $10,000 in 2021.

b. Incorrect. The limit of investment income was $11,600 in 2024.

c. Correct. The limit of investment income is $11,950 for 2025. What this means is that a taxpayer's earned income tax credit is lost if the amount of disqualified income surpasses this limit.

d. Incorrect. The figure $11,000 was the 2013 earned income amount. [Chp. 1]

4. The standard mileage rate is used to compute the deductible costs for operating the vehicle. For 2024, what mileage rate was used to compute such costs if the automobile was used for charitable purposes?

a. Correct. For 2024, the optional standard mileage rate used in computing the deductible costs paid or incurred for operating a passenger automobile for charitable purposes is 14. Charitable purpose automobile mileage has not been particularly favored by Congress. This amount has rarely been adjusted to any large degree.

b. Incorrect. The optional standard mileage rate used in computing the deductible costs paid or incurred for operating a passenger automobile for medical or moving purposes was 19 in 2016.

c. Incorrect. For 2024, the optional standard mileage rate used in computing the deductible costs paid or incurred for operating a passenger automobile for mail carrier purposes is 47½. This is a specialty rate and rarely applies to most taxpayers.

d. Incorrect. The optional standard mileage rate used in computing the deductible costs paid or incurred for operating a passenger automobile for business purposes in 2010 was 50. While this was a nice increase over previous years, it is still better to use the actual cost method if you keep proper records. [Chp. 1]

5. Withholding applies to a variety of types of income including pensions, bonuses, and commissions. What other type of income is subject to withholding?

a. Correct. Income tax withholding is required for large gambling winnings. The amount withheld on the winning is subject to a minimum threshold.

b. Incorrect. Interest is not subject to income tax withholding but it can be subject to estimated tax.

c. Incorrect. While alimony was considered earned income for a variety of purposes including IRA contributions, it is not subject to income tax withholding.

d. Incorrect. Prizes and awards are not subject to income tax withholding but can be subject to estimated tax. [Chp. 1]

6. Certain taxpayers are required to pay estimated tax on income that is excluded from withholding. How may a taxpayer calculate estimated tax when income is received at irregular intervals throughout the year?

a. Correct. The annualized income installment method may be used to figure their estimated tax if a taxpayer does not receive their income evenly throughout the year. Under this method, the required installment for one or more payment periods may be less than one-fourth of the normally required annual payment.

b. Incorrect. Except for certain farmers and fishermen, the income averaging method no longer exists and even when it did, it did not apply to the calculation of estimated tax.

c. Incorrect. The accrual method is a method for calculating income during a tax year and is not used in determining estimated tax.

d. Incorrect. Seasonal business year method is used to determine a fiscal year for certain businesses. It is not used to determine estimated tax liability. [Chp. 1]

7. Based on marital and family factors, filing status determines which deductions and credits an individual may claim. What else is determined by an individual's filing status?

a. Incorrect. Filing status is not a determining factor in the refundable child credit. The credit is based on a taxpayer having qualified children.

b. Incorrect. Medicare is a separate government entitlement program not dependent upon federal income tax filing status.

c. Incorrect. The earned income credit is based upon certain earnings thresholds and the number of children not filing status.

d. Correct. Filing status does determine a taxpayer's amount of standard deduction. Each filing status is entitled to a different standard deduction. [Chp. 1]

8. A person's filing requirement and correct tax are also determined by his or her filing status. What are the available federal filing statuses for an unmarried taxpayer?

a. Incorrect. Under the Code, there are no tax filing statuses for separate or individual.

b. Correct. When a taxpayer is unmarried, their filing status is single or head of household. Practitioners should exercise care in using the single tax filing status. In many cases, the taxpayer could also qualify for head of household which is disproportionately favored under the Code.

c. Incorrect. While some states have recognized a tax status as domestic partner, the federal government has not.

d. Incorrect. Living together is not a tax filing status under the Code. [Chp. 1]

9. When a marriage is annulled, the marriage is held to never have existed. As a result, what must the parties file?

a. Correct. Upon annulment, they must file amended returns claiming single or head of household status for all tax years affected by the annulment that are not closed by the statute of limitations for filing a tax return.

b. Incorrect. Form 8379 is used to prevent a spouse's share of a tax refund on a joint return from being applied to a debt owed by their spouse. It is not used upon an annulment.

c. Incorrect. Requests for innocent spouse relief are filed by legitimately married parties seeking relief from joint and several liability.

d. Incorrect. Abandoned spouse status is only available to a married person living apart from their spouse. [Chp. 1]

10. Taxpayers may find it desirable to file as head of household. What is an advantage of this filing status?

a. Incorrect. An advantage of filing a separate return is that if one spouse owes such debts as back taxes from before the marriage or back child support payments, it may keep the nondebtor's tax refunds from being taken by the IRS for the other's old debts.

b. Correct. An advantage of filing as head of household is that the standard deduction can be claimed *even if* the other spouse itemizes deductions on a separate return.

c. Incorrect. An advantage of filing as head of household is that the standard deduction is *higher* than that allowed on a single or married filing separate return.

d. Incorrect. This filing does not increase the allowable amount of childcare tax credit under §21. This credit is based on earnings and number of children. [Chp. 1]

11. When a tenant pays a landlord to use or occupy a property, the landlord receives rental income. For income tax purposes, what is the tax treatment of an amount paid by a tenant to a landlord to terminate a lease?

a. Incorrect. A security deposit is not included in income if the taxpayer plans to return it to the tenant at the end of the lease.

b. Incorrect. Advance rent is any amount received before the period that it covers. Advance rent is included in income in the year received regardless of the period covered or the method of accounting used.

c. Incorrect. The payment for canceling a lease is included in income for the year received regardless of the taxpayer's method of accounting.

d. Correct. If a tenant pays a taxpayer to cancel a lease, the amount received is rent. [Chp. 1]

12. Divorce or separation instruments may define child support payments as being for the support of a child. However, when does federal tax law deem payments to constitute child support?

a. Incorrect. The insufficiency of payments to support a child is not determinative in deeming certain payments to be child support for federal income tax purposes. The sufficiency of child support payments is a matter of state law.

b. Correct. Under §71, any amount that is reduced upon the happening of a contingency related to the child is deemed to be child support.

c. Incorrect. Spousal support is a separate legal issue, and any waiver of spousal support has no bearing on other payments being deemed child support.

d. Incorrect. Form 8332 relates to the transfer of a child's dependency exemption between former spouses. It does not result in any payments being reclassified as child support. [Chp. 1]

13. When must canceled debt be included in a taxpayer's gross income?

a. Correct. Income from debt discharged prior to the filing of a bankruptcy does not qualify for the exclusion (and may not be entitled to either the insolvency or farm debt exclusion). Taxpayers do not include a canceled debt in gross income if the cancellation takes place in a bankruptcy case under Title 11 of the United States Code.

b. Incorrect. Taxpayers do not include a canceled debt in gross income if the cancellation is a qualified farm debt discharged by an unrelated lender.

c. Incorrect. Taxpayers do not include a canceled debt in gross income if the cancellation is real property business debt.

d. Incorrect. Taxpayers do not include a canceled debt in gross income if the debt arises from certain student loans. Many states make loans to students on the condition that the loan will be forgiven if, upon completion of study, the student will practice a profession in the state. The amount of the loan that is forgiven is excluded from gross income. [Chp. 1]

14. There are many exceptions to the discharge of indebtedness inclusion rule. However, the use of most of these exceptions requires that the taxpayer:

a. Correct. Use of many of the exceptions to the discharge of indebtedness inclusion rule requires that the taxpayer reduce tax attributes by the amount of such canceled debt.

b. Incorrect. Cancellation of a debt while in bankruptcy is specifically authorized as an exception to the discharge of indebtedness inclusion rule.

c. Incorrect. Insolvency is specifically authorized as an exception to the discharge of indebtedness inclusion rule. However, the amount excluded is not more than the amount by which the taxpayer is insolvent at the moment immediately prior to discharge.

d. Incorrect. Cash management and debt counseling are requirements of the new Bankruptcy Act. They are not required for an exception to the discharge of indebtedness inclusion rule. [Chp. 1]

15. The reduction of tax attributes must follow a specific order. What should be reduced first when there is nonrecognition of debt discharge income?

a. Incorrect. Generally, alternative minimum tax credits must be reduced when debt discharge income is not recognized.

b. Incorrect. Generally, passive activity losses must be reduced sixth when debt discharge income is not recognized.

c. Incorrect. Carryovers in the order in which they arose must be reduced second when debt discharge income is not recognized.

d. Correct. The net operating loss and capital losses for the current year are reduced first when debt discharge income is not recognized. [Chp. 1]

16. The foreclosure rules vary for nonrecourse debt and recourse debt. Upon the foreclosure of property subject to a recourse loan, how does the borrower treat the canceled debt?

a. Incorrect. This is the rule for nonrecourse debt. For such debts, the entire amount canceled is treated as an amount realized.

b. Incorrect. When recourse debt is canceled through foreclosure, there is typically a split between the amount realized and ordinary income based on the fair market value of the property.

c. Correct. For recourse debt, if the fair market value of the property transferred is less than the canceled debt, the amount realized by the owner includes the canceled debt up to the fair market value of the property. The owner is only treated as receiving ordinary income from the canceled debt for that part of the canceled debt not included in the amount realized.

d. Incorrect. While the amount realized on the foreclosure of a recourse debt on a primary personal residence might be excluded from taxation by §121, the ordinary income portion would not receive such protection. [Chp. 1]

17. Deductions for items taken in earlier years but later recovered typically must be included in income in the year of the recovery. However, the required recomputation of income is complex and must be ordered based upon:

a. Incorrect. While the filing status of the taxpayer may determine the amount or the effect of the recovery, it does not dictate the ordering of the recovery computation.

b. Incorrect. Recoveries may impact the recomputed regular and alternative minimum tax. However, these taxes do not affect the ordering of the re-computation.

c. Incorrect. The reduction in tax attributes rules are applicable to debt cancellation and do not apply to the recomputation of income under the recovery provisions.

d. Correct. Recovered itemized and non-itemized deductions have different methods for income recomputation. If amounts recovered were attributable to itemized deductions and to non-itemized deductions, taxable income must be first recalculated on the non-itemized deduction recoveries before determining the amount to include in income on the itemized deduction recoveries. [Chp. 1]

18. As a result of the "kiddie" tax, parents will likely shift fewer income-producing assets to their children. The reasoning for this is that their children's net unearned income can be taxed at the greater of:

a. Incorrect. This "high-low" formula is not used in calculating a child's unearned income taxation.

b. Incorrect. The competing alternative minimum tax and regular tax systems are not compared in determining a child's unearned income taxation.

c. Correct. For a child under age 19, their net unearned income (commonly called investment income) is taxed at the *greater* of the child's normal tax rate or the parents' tax rate. Investment income includes all taxable income other than salaries, wages, professional fees, and amounts received as pay for work actually done.

d. Incorrect. This tax "straddle" formula and comparison of tax years is not used to calculate a child's unearned income taxation. [Chp. 1]

19. Section 117 scholarships granted to qualified students are tax-free to the extent they are used to cover qualified expenses. For example, scholarship income could be used to pay for:

a. Correct. Scholarships granted to qualified students are tax-free to the extent they are used to cover tuition, fees, and required books, supplies, and equipment.

b. Incorrect. Grants for research or clerical help are *taxable*. This is considered payment for services and wages are salary.

c. Incorrect. Grants for room and board are *taxable*. Such expenses are not included in the scholarship exemption.

d. Incorrect. Grants for travel are *taxable*. Travel costs are not included in the scholarship exemption. [Chp. 1]

20. A §529 qualified tuition program is an investment vehicle allowing individuals to make contributions to accounts for a beneficiary's qualified educational expenses. What rule applies when qualified higher education expenses are paid using a distribution from a qualified tuition program?

a. Incorrect. Contributions to a §529 qualified tuition account are not deductible.

b. Correct. Under §529, when qualified higher education expenses are paid from a distribution from a qualified tuition program, no portion of the distribution is subject to income tax.

c. Incorrect. When a distribution from a qualified tuition program is not used to pay for qualified higher education expenses, the earnings portion is subject to a 10% additional tax. However, certain exceptions to this rule apply.

d. Incorrect. If a distribution from a qualified tuition program is not used to pay for qualified higher education expenses, the earnings portion is subject to federal income tax. Contributions are not includible in the income of the designated beneficiary because they are made on an after-tax basis. [Chp. 1]

21. A number of items are identified in the course material as exclusions from income. Which of the following is one such item?

a. Incorrect. Wages and salaries are a form of taxable income.

b. Correct. Amounts received in the form of gifts or inheritances are not included in taxable income.

c. Incorrect. A common example of a tax-deferred investment is the IRA, which allows many workers to invest money each year for their retirement. The amount they invest in the plan each year is a tax deduction. Further, the earnings on such funds are not taxed until withdrawn.

d. Incorrect. Royalties are a type of taxable income. [Chp. 1]

22. Section 104 covers the tax treatment of personal injury awards. Regardless of the recovery method, how are damages for personal injuries treated?

a. Incorrect. Personal injury awards are excludable from income under §104. However, awards for lost wages, profits, and interest are includable in income.

b. Incorrect. Installment method reporting, under §453, is not available to personal injury awards under §104.

c. Correct. Damages for personal injuries, no matter how recovered, are specifically *excluded* from gross income (§104(a)(2)).

d. Incorrect. Damages for personal injuries, under §104, are subject to neither regular tax nor alternative minimum tax. [Chp. 1]

23. Under §163, there are several types of interest expense. Which type of interest is defined as interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for purposes of making a profit?

a. Correct. Investment interest is interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment.

b. Incorrect. The course material does not define "trade interest." Business interest, however, is interest that can be attributed to a trade or business.

c. Incorrect. Qualified residence interest is a type of home mortgage interest. A mortgage is typically held for personal purposes, rather than for purposes of making a profit.

d. Incorrect. Prepaid interest is deductible only in the period to which it relates and must be capitalized and deducted over the period of the loan to the extent it represents the cost of using borrowed funds during such period. [Chp. 1]

24. Points are considered a type of interest expense. Under §461(g)(1), what is a characteristic of points that have features of an additional interest charge?

a. Incorrect. Points paid to refinance an existing home mortgage are incurred for the purpose of repaying an existing indebtedness, not to purchase or improve a home. Such points do not qualify for a full deduction.

b. Incorrect. Points that are in the nature of an additional interest charge constitute prepaid interest.

c. Correct. Points that are in the nature of an additional interest charge must be deducted ratably over the term of the loan if incurred in a business transaction, the same as if the taxpayer were on the accrual basis.

d. Incorrect. Points that are in the nature of an additional interest charge must be capitalized by a cash-basis taxpayer. [Chp. 1]

25. The author lists ten deductible items under §213 to the extent the taxpayer is <u>not</u> reimbursed for such expenses. What is one of these items that taxpayers may deduct?

a. Incorrect. Funeral, burial, or cremation costs are not medical care items and are therefore not deductible under §213. However, medical care for the taxpayer paid out of the estate shall be treated as paid by the taxpayer for a period of 1 year and is deductible from the estate.

b. Incorrect. Cosmetic surgery is not a medical care item and is therefore not deductible under §213. However, the cost of surgery to correct a congenital condition can be a deductible medical expense.

c. Correct. Under §213, "medical care" is defined as amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease. To the extent not reimbursed, taxpayers may deduct what they paid for medical treatment at a center for drug addicts or alcoholics under §213.

d. Incorrect. Medications are covered under §213 "only if such drug is prescribed or is insulin." Nonprescription medicines or drugs are not deductible under §213. [Chp. 1]

26. Under §213, physically handicapped individuals may deduct certain expenses incurred to modify their primary residence. However, which expense is nondeductible as such a medical expense?

a. Incorrect. Some expenses incurred by a physically handicapped individual to remove structural barriers in his or her residence in order to accommodate his or her physical condition such as constructing access ramps, widening doorways, and installing special support bars are presumed not to increase the value of the residence and are deductible in full.

b. Incorrect. Individuals with physical handicaps should include as part of the medical deduction amounts spent for such operating and maintenance expenses as electricity, repairs, or a service contract.

c. Correct. A written opinion from a competent real estate appraiser detailing how little or how much the installation raised the value of the property is needed. The appraisal fee does not count under the 7.5% AGI limit for medical expenses. Taxpayers may count them with other miscellaneous deductions, such as return preparation fees, which were allowable to the extent they exceed 2% of AGI.

d. Incorrect. Whether the taxpayer is an owner or a renter, deductible items include the entire cost of detachable equipment (e.g., a window air conditioner that relieves a medical problem). [Chp. 1]

27. According to the author, four requirements must be met for most §170 charitable contributions. What is one of these four basic requirements?

a. Incorrect. Contributions are reported on Schedule A, therefore a requirement for deductibility of charitable contributions is that contributions must be itemized.

b. Correct. A requirement for the deductibility of charitable contributions is that contributions cannot exceed certain statutory limits. For example, contributions to churches are limited to 50% of AGI before any net operating loss carryback.

c. Incorrect. A requirement for deductibility of charitable contributions is that contributions generally must be paid within the year, even if the taxpayer is on an accrual basis. This requirement is not limited to cash basis taxpayers.

d. Incorrect. A requirement for deductibility of charitable contributions is that contributions must be to or for the use of qualifying organizations, rather than for individuals. [Chp. 1]

28. Charities often conduct games, events, and activities at which participants transfer funds. However, which of the following payments to charity is most likely deductible outside of the §170 charitable provisions?

a. Correct. Amounts paid for bingo and raffle tickets are not charitable contributions. They are gambling losses, deductible only to the extent of winnings under §165.

b. Incorrect. Prior to 2018, a taxpayer who made a charitable contribution to or for a college or university and was thereby entitled to purchase tickets to athletic events was allowed to deduct 80% of the payment as a charitable contribution. However, effective in 2018 and later, this special rule was repealed.

c. Incorrect. If the taxpayer pays more than the fair market value to qualified organizations for charity balls, banquets, shows, etc., the amount that is more than the value of the privileges or other benefits received is deductible as a contribution.

d. Incorrect. Dues, fees, or assessments may be deductible to the extent the amount paid exceeds benefits received if paid to qualified organizations. However, amounts paid to country clubs, lodges, other social organizations, and homeowners associations are not deductible. [Chp. 1]

29. The type of property contributed to a charity determines the tax treatment of the contribution. With regard to charitable contributions of clothing and household items, what is required?

a. Incorrect. Paintings and antiques are excluded from the provision, as they do not fall under the category of household items. A qualified appraisal would most likely be required to deduct the value of these items.

b. Correct. The Pension Protection Act of 2006 provides that donated clothing and household items must be in good used condition or better.

c. Incorrect. The 2006 Pension Act provides that taxpayers may claim a deduction for an item that is not in good used condition or better as long as the amount claimed for the item is more than $500 and the taxpayer includes a qualified appraisal of the item.

d. Incorrect. Used socks and used undergarments have minimal monetary value and, by regulation, the Secretary is authorized to deny a contribution of this sort. [Chp. 1]

30. Taxpayers may be able to deduct certain automobile expenses as a charitable contribution. Which of these expenses may taxpayers deduct whether they use the standard mileage rate or the actual expense method?

a. Incorrect. Depreciation, insurance, and repairs are not deductible under the standard mileage method.

b. Correct. Regardless of whether the standard mileage rate or the actual expense method is used, the taxpayer may also deduct parking fees and tolls.

c. Incorrect. Unreimbursed out-of-pocket expenses in performing services free for a qualified charity are contributions. The value of services is not deductible.

d. Incorrect. Travel expenses are not deductible as a contribution unless there is no significant element of personal pleasure, recreation, or vacation in the travel. [Chp. 1]

31. The author lists several miscellaneous itemized deductions subject to the 2% of adjusted gross income (AGI) limitation of §67 that are now suspended. Which of the following is such an item?

a. Incorrect. Miscellaneous itemized deductions do *not* include any deduction for taxes under §164. However, what is included are costs of preparing tax returns and related expenses.

b. Incorrect. Miscellaneous itemized deductions do *not* include casualty losses deductible under §165. However, what is included are fees that a taxpayer pays to appraise the amount of a casualty loss or a charitable contribution of property.

c. Incorrect. Miscellaneous itemized deductions do *not* include the deduction for amortizable bond premiums under §171. However, what are included are certain fees and other expenses in connection with investment income or property.

d. Correct. Miscellaneous itemized deductions include unreimbursed employee business expenses, including union and professional dues and office-at-home expenses to the extent deductible. [Chp. 1]

32. The deduction for moving expenses is currently suspended. Nevertheless, during this suspension period, the deduction is retained for:

a. Incorrect. Disaster area residents receive no §217 deduction for moving expenses.

b. Correct. The deduction for moving expenses is retained for members of the Armed Forces (or their spouse or dependents) on active duty who move pursuant to a military order.

c. Incorrect. A moving expense deduction has never been available to first-time job seekers.

d. Incorrect. Armed forces members must active duty to receive the exception. [Chp. 1]

33. Which of the following credits was created by §32 to provide relief for lower-income taxpayers?

a. Incorrect. For 2009 and 2010, the American Recovery and Reinvestment Act of 2009 made the Making Work Pay credit available for individuals with earned income. Eligible individuals had to be United States citizens, could not be claimed as a dependent on another's return, and could not be an estate or trust.

b. Incorrect. The §21 child care tax credit is intended to offset child or dependent care expenses necessary for a taxpayer to maintain employment.

c. Incorrect. This credit under §36 was allowed for those who purchase a qualifying home as a first-time homebuyer.

d. Correct. The earned income tax credit is a special credit allowable for persons who work and meet certain criteria established by §32. The credit reduces the amount of tax owed and may qualify taxpayers for a refund even if

they do not owe any tax, or earned enough money to file a return. The credit is intended to offset some of the increases in living expenses and social security taxes for taxpayers with limited incomes. [Chp. 1]

34. Section 23 provides an individual credit for qualified adoption expenses. Such expenses must meet four general requirements. For example, such adoption fees and related expenses:

a. Correct. Qualified adoption expenses are reasonable and necessary adoption fees, court costs, attorney's fees, and other expenses that are not incurred in violation of state or federal law, or in carrying out any surrogate parenting arrangement.

b. Incorrect. Qualified adoption expenses must be directly related to, and the principal purpose of which is for, the legal adoption of an eligible child by the taxpayer. Indirect expenses are not eligible for this credit.

c. Incorrect. Qualified adoption expenses do not include expenses for the adoption of a child of the taxpayer's spouse by statute.

d. Incorrect. A taxpayer cannot qualify for the adoption credit if an employer reimburses the adoption expenses. In other words, "double dipping" is not allowed. [Chp. 1]

35. Parents can take advantage of several child-related credits. Which credit is available to certain taxpayers based on having a qualifying child under age 17?

a. Incorrect. The lifetime learning credit is a credit for higher education expenses and was not based on having a qualified child under age 17.

b. Correct. The child tax credit, under §24, is a credit provided based on having a qualified child under age 17. A qualified child is determined under the uniform qualified child definition.

c. Incorrect. The Hope credit is for higher education expenses and is not based on having a qualified child under age 17.

d. Incorrect. The adoption credit is a credit for qualified adoption expenses paid or incurred by a taxpayer and is not based on having a qualified child under age 17. [Chp. 1]

36. Under §24, an individual may claim a tax credit for each qualifying child. This credit:

a. Incorrect. The credit is usable against both the regular income tax and AMT.

b. Incorrect. For taxpayers with modified adjusted gross income AGI in excess of certain thresholds, the otherwise allowable child credit is phased out.

c. Correct. The child credit is refundable equal to 15% of a taxpayer's earned income in excess of $3,000.

d. Incorrect. The refundable child tax credit is not reduced by the amount of the alternative minimum tax. [Chp. 1]

37. The American Opportunity Education Tax Credit is available to qualified individuals for qualified tuition and related expenses. What does this tax credit include in the definition of qualified tuition and related expenses?

a. Correct. Students can claim the American Opportunity Education Tax Credit for qualified tuition and related expenses. Under the new Act, costs for course materials are included in the definition, which means that lab fees, books, etc. would be considered in determining qualified tuition and related expenses.

b. Incorrect. Under the regulations for the new credit, costs for lodging are excluded from the definition of qualified tuition and related expenses. Thus, these amounts would not be used to figure the allowable credit amount.

c. Incorrect. When figuring their qualified tuition and related expenses for the American Opportunity education, qualified students may still not take meals into consideration.

d. Incorrect. Qualified students may only count expenses of education involving sports, games, and hobbies if this education is part of the student's degree program. [Chp. 1]

38. Which payments received for military service are taxable as wages?

a. Incorrect. Certain travel allowances, including an annual round trip for dependents, as well as leave between consecutive overseas tours, whether furnished in kind or by reimbursement or allowance, are excludable from income according to IRS Publication 3.

b. Correct. Basic pay for attendance at a designated service school is included in gross wages as outlined in IRS Publication 3. Armed services academy pay falls into this category and is therefore included in wages and salaries.

c. Incorrect. Under §112, gross income does not include compensation for active service in the armed forces for any month when a member served time in a combat zone. For a commissioned officer this exclusion is limited to the highest rate of basic pay for enlisted members plus any combat pay.

d. Incorrect. IRS Publication 3, as well as §134, excludes death gratuity payments to eligible survivors as well as travel of dependents to the burial site from income. [Chp. 1]

39. Which costs are nondeductible when a taxpayer holds property for rental purposes?

a. Correct. The cost of improvements adds value to the property and is not deductible. Instead, improvements are recovered by taking depreciation.

b. Incorrect. If a taxpayer holds property for rental purposes, they may be able to deduct ordinary and necessary expenses for maintaining the property from the time the property is made available for sale, including while the property is vacant.

c. Incorrect. If a taxpayer holds property for rental purposes, they may be able to deduct ordinary and necessary expenses for managing the property,

such as salaries and wages to management personnel, even while the property is vacant.

d. Incorrect. Repairs are necessary to keep the property in good operating condition and are therefore an expense of renting the property. A taxpayer can deduct the cost of repairs they make to their rental property. [Chp. 2]

40. Landlords may deduct employee expenses related to renting property. However, which of the following employee costs are nondeductible by landlords?

a. Incorrect. Landlords can deduct bonuses paid to employees if, when added to their regular salaries or wages, the total is not more than reasonable pay.

b. Incorrect. A taxpayer can deduct reasonable salaries and wages paid to employees.

c. Incorrect. A taxpayer can deduct reasonable wages paid to their dependent child if the child is a bona fide employee.

d. Correct. A taxpayer cannot deduct the cost of meals and lodging for a dependent child. [Chp. 2]

41. Rent paid for business property is deductible under §162. However, under which circumstance will an agreement be deemed a conditional sale contract, instead of a lease, and thus be nondeductible as rent?

a. Incorrect. An agreement may be considered a conditional sales contract rather than a lease if the agreement designates part of the payments as interest, or that part is easy to recognize as interest.

b. Correct. An agreement may be considered a conditional sales contract rather than a lease if the amount the taxpayer must pay to use the property for a short time is a large part of the amount they would pay to get title to the property.

c. Incorrect. An agreement may be considered a conditional sales contract rather than a lease if the taxpayer has an option to buy the property at a *nominal* price compared to either the value of the property when they may exercise the option or the total amount they have to pay under the agreement.

d. Incorrect. An agreement may be considered a conditional sales contract rather than a lease if the taxpayer pays much *more* than the current fair rental value of the property. [Chp. 2]

42. The author lists three requirements for the health insurance cost deduction for self-employed individuals. Which of the following rules apply for purposes of determining eligibility?

a. Incorrect. For purposes of determining eligibility, if the taxpayer has employees, they may not take the deduction unless they provide nondiscriminatory health insurance coverage to all employees.

b. Incorrect. In the event the self-employed taxpayer has a job in addition to self-employment and is eligible to participate in a subsidized health plan maintained by that employer, the taxpayer is disqualified from deducting the

cost of health insurance as a business expense under §162. This test for eligibility is made each calendar month.

c. Incorrect. Deduction for health insurance is limited to the amount of earned income derived from the trade or business with respect to which the plan providing medical coverage is established. Therefore, if the taxpayer has a net loss from self-employment, he or she will not be able to take a deduction for health insurance under §162.

d. Correct. A self-employed taxpayer may be eligible to deduct 100% of the amount paid for health insurance for himself or herself, his or her spouse, and his or her dependents, subject to certain limitations. However, no individual who is eligible to participate in a subsidized plan maintained by any employer of the taxpayer or the taxpayer's spouse is entitled to this deduction under §162. [Chp. 2]

43. Under §183, deductions for expenses associated with a not-for-profit business:

a. Incorrect. State and local property taxes and other items that are deductible as an itemized deduction are deductible without regard to a profit motive and therefore are eligible itemized deductions.

b. Incorrect. Deductions for expenses related to the activity are limited, as described in §183.

c. Correct. Deductions for expenses related to the activity can be taken only if the taxpayer itemizes deductions on Schedule A (Form 1040). Instructions for claiming deductions for activities that are "not engaged for profit" are located in IRS Publication 535.

d. Incorrect. Deductions for expenses related to the activity cannot total more than the income reported. Therefore, expenses for activities "not engaged in for profit" cannot result in a loss. [Chp. 2]

44. If an individual operates a business out of their home, three requirements must be met to allocate a portion of the expenses of the residence to business. What is one of these requirements?

a. Incorrect. A requirement that must be met in order for a taxpayer to allocate a portion of expenses of the residence to business is that there must be a specific room or area that is used on a *regular* basis as a place where the taxpayer meets with patients, clients, or customers in the normal course of the trade or business.

b. Incorrect. A requirement that must be met in order for a taxpayer to allocate a portion of the expenses of the residence to business is that there must be a specific room or area that is set aside for and used *exclusively* as the principal place of any business.

c. Incorrect. An employee can take a home office deduction if he or she meets the *regular and exclusive use test and the use is for the convenience of the employer*.

d. Correct. Under IRS regulations for home office deductions, no deduction is allowed unless there is a trade or business involved. Managing personal investments is not considered a trade or business for this purpose. [Chp. 2]

45. Taxpayers must claim business deductions for the business use of a home in a specific order. Which business deductions must be deducted first?

a. Incorrect. The other business expenses for the business use of the home such as maintenance, utilities, insurance, and depreciation are deducted third.

b. Correct. The business percentage of the expenses that would otherwise be allowable as a deduction, that is, mortgage interest, real estate taxes, and deductible casualty losses, are deducted first.

c. Incorrect. Deductions that adjust the basis in the home are taken last.

d. Incorrect. The direct expenses for the business in the home, such as expenses for supplies and compensation, but not the other expenses of the office in the home, are deducted second. [Chp. 2]

46. The author lists nine examples of deductible travel expenses undertaken for business. What is included as an example?

a. Incorrect. Only reasonable tips are deductible as they relate to travel.

b. Incorrect. Travel expenses do not include business gifts.

c. Correct. Deductible travel expenses undertaken for business include laundry, cleaning, and clothes pressing costs.

d. Incorrect. Travel expenses must be incurred while a taxpayer is "away from home." Transportation within the general geographical work area does not qualify. [Chp. 2]

47. The Service uses a number of factors and requirements to determine a taxpayer's regular place of abode. However, which of the following items does the Service disregard in making this determination?

a. Incorrect. A requirement of the claimed abode test is that the taxpayer performs a portion of his or her business in the vicinity of his or her claimed abode *and* uses such abode (for purposes of his or her lodging) while performing such business there.

b. Incorrect. A requirement of the claimed abode test is that the taxpayer's living expenses incurred at his or her claimed abode are duplicated because his or her business requires him or her to be away.

c. Correct. Any tax home or claimed abode set forth in a taxpayer's business plan is self-serving and immaterial.

d. Incorrect. A factor used in the claimed abode test is whether the taxpayer has a member or members of his or her family (marital or lineal only) currently residing at his or her claimed abode. [Chp. 2]

48. Under Reg. §1.162-2, deductible travel costs must be primarily for business. When are domestic travel costs deemed primarily for business?

a. Correct. As a general rule, a domestic trip is primarily for business if bona fide business is conducted on over 50% of the trip days.

b. Incorrect. The Service will consider the location of the site (e.g., vacation resorts). The increasing number of organizations that schedule their conventions and seminars in resort areas has caused the Service to deny deductions of alleged business trips that are merely disguised vacations.

c. Incorrect. The Service will consider whether the taxpayer had control over planning the trip. The more control the taxpayer has, the less likely he or she would be able to deduct the expenses.

d. Incorrect. In order to be deductible currently, the travel must be related to an existing business. Travel costs to investigate new or different business opportunities must be capitalized or amortized (except for an initial $10,000) over 180 months under §195. [Chp. 2]

49. A taxpayer may travel to a foreign country mainly for business purposes. If this taxpayer also engages in some personal activities, how is the travel cost treated?

a. Incorrect. If the trip outside the United States is primarily for business, but there were some nonbusiness activities, the entire travel cost is not disallowed.

b. Incorrect. Travel costs are not subject to the 50% reduction rule. This rule primarily applies to meal and entertainment costs.

c. Incorrect. If the trip outside the U.S. is primarily for business but there were some nonbusiness activities, the travel cost is subject to a proration restriction. The travel cost is not allowed in full.

d. Correct. When the trip outside the U.S. is primarily for business (e.g., more than 50%) but there were some nonbusiness activities, not all of the travel cost from home to the business destination and return are deductible by an individual. The travel cost will have to be allocated between business and nonbusiness activities on a day-to-day basis (Reg. §1.274-4(d)(2)). [Chp. 2]

50. There are five circumstances that can avoid the mixed-use allocation rule for primarily business foreign travel. What is one of these conditions?

a. Incorrect. For foreign travel to be fully deductible, more than *75%*, not 50%, of the total number of days on the trip must be business days.

b. Incorrect. For foreign travel to be fully deductible, *the taxpayer must be an employee who is not related to his or her employer.* An employee is related to his or her employer if the employee owns, directly or indirectly, more than 10%.

c. Correct. For foreign travel to be fully deductible, the taxpayer must have had little control over arranging the business trip.

d. Incorrect. No special exception to the mixed-use allocation rule for foreign travel is provided for trips to a single foreign destination. [Chp. 2]

51. Convention expenses can be deductible if attendance primarily benefits the taxpayer's business. To determine whether it is beneficial, what is compared with an individual's business duties?

a. Incorrect. Sponsors of business conventions are not required to register with the IRS.

b. Correct. The Service compares an individual's business and employment duties with the purposes of the meeting as stated in the program or agenda. The "primarily for business" test is satisfied when the agenda of the convention or meeting is so related to the conduct of the taxpayer's trade or business that attendance was predominantly for a business purpose (R.R 59-316).

c. Incorrect. Most business conventions do not provide a sponsor's statement. However, certain cruise conventions must do so. Thus, the IRS would not be able to make a comparison.

d. Incorrect. The sponsor of a business convention does not have to provide a legal or tax opinion as to the deductibility of the convention to either the participants or the IRS. [Chp. 2]

52. The "North American area" encompasses some Caribbean countries and Bermuda. When are the costs of attending a convention in such a country deductible?

a. Incorrect. It is not required for the Caribbean country to be a member of the North Atlantic Treaty Organization in order to be included in the term "North American area."

b. Incorrect. Diplomatic relations with the United States are not a prerequisite to being included. However, an agreement for the exchange of tax information is required.

c. Correct. Certain Caribbean countries are included in the definition of the North American area if the country has entered into an agreement for the exchange of tax information. However, such a country must also be a beneficiary country and have no laws discriminating against U.S. conventions.

d. Incorrect. There is no "friendly" nation status maintained by the State Department for convention purposes. [Chp. 2]

53. When a convention is held outside the North American area, a deduction is permitted so long as the meeting directly relates to the business, and holding said meeting outside the area is deemed to be reasonable. Which of the following factors listed below is disregarded when determining this reasonableness?

a. Incorrect. The purpose of the meeting and the activities taking place at the meeting are important factors in determining the reasonableness of holding the meeting outside the North American area.

b. Correct. The times at which the lectures are given are immaterial to the determination of whether it was reasonable to hold the meeting outside the North American area.

c. Incorrect. An important determining factor is the residence of the active members of the sponsoring organization.

d. Incorrect. The places at which other meetings of the sponsoring organizations or groups have been held or will be held are an important factor in determining reasonableness. [Chp. 2]

54. If a cruise ship convention otherwise qualifies for deduction, a taxpayer's statement must be attached to the tax return. This statement requires detailed information about the convention. However, which of the following information items can be omitted from the taxpayer's statement?

a. Incorrect. The total *days* of the trip (excluding the days of transportation to and from the cruise ship port) are required to be in the taxpayer's statement.

b. Incorrect. The taxpayer's statement must set forth the number of hours of each day of the trip that the individual devoted to scheduled business activity.

c. Incorrect. The program of the scheduled business activity of the meeting must be included in the taxpayer's statement.

d. Correct. The names of other participants are not required in the taxpayer's statement. [Chp. 2]

55. The reduction limitation for meals is inapplicable in many cases. However, this limitation is applicable when:

a. Incorrect. When expenses are treated as compensation to employees, the costs are fully deductible.

b. Correct. Under §274, expenses that are excludable from the income of nonemployees are subject to the reduction limitation.

c. Incorrect. When customers can purchase the entertainment that is provided, under §274, the costs are fully deductible since costs of providing entertainment (or meals, goods, and services, or the use of facilities) that are actually sold to the public are deductible.

d. Incorrect. When refreshments are treated as de minimis fringe benefits that are excluded from income, the limitation for entertainment expenses does not apply. [Chp. 2]

56. Section 274(d) detailed substantiation of expenses requires a number of elements to be proven. However, which of the following items is irrelevant?

a. Incorrect. To satisfy the detailed substantiation requirements, taxpayers must substantiate the amount of each separate expense for travel, lodging, and meals.

b. Incorrect. Section 274 requires that the time and date of travel and entertainment expenditures be substantiated.

c. Incorrect. The name and address or designation of the place of travel, meal, or entertainment, or place of use of a facility for entertainment must be substantiated.

d. Correct. Attire, whether business, casual, or otherwise, is not an element that needs to be proven or shown to satisfy the detailed substantiation requirements. [Chp. 2]

57. The adequate records substantiation rule requires documentary evidence for certain kinds of expenses. For example, documentary evidence is required for:

a. Correct. Documentary evidence is required under the "adequate records" rule for expenditures for lodging (regardless of amount) while traveling away from home.

b. Incorrect. The adequate records rule requires documentary evidence for separate expenditures of $75 dollars or more. However, prior to 10/1/95, documentary evidence was required for separate expenditures of $25 or more.

c. Incorrect. De minimis expenses must not be accounted for using documentary evidence. It would be impractical to require such evidence for these small expenses.

d. Incorrect. Taxpayers are not required to keep detailed records of tips. Taxpayers may deduct such expenditures on the basis of reasonable estimates (Reg. §1.162-17(d)(2)). [Chp. 2]

58. Taxpayers using adequate records substantiation must maintain a diary, trip book or log sheet, and documentary evidence proving the required expense elements. However, which of the following items fails to qualify as such documentary evidence?

a. Incorrect. Documentary evidence can consist of receipts that establish the amount, date, place, and essential character of an expenditure or use, or of one or more elements of an expenditure or use (Reg. §1.274-5T(c)(2)(iii)).

b. Incorrect. A canceled check or charge slip, together with a bill from the payee, ordinarily establishes the amount of expenditure. However, a canceled check or charge slip does not by itself support a business expense without other evidence to show that it was for a business purpose (Reg. §1.274-5T(c)(2)(iii)).

c. Incorrect. Documentary evidence can consist of paid bills that establish the amount, date, place, and essential character of an expenditure or use.

d. Correct. The taxpayer's own signed statement does not constitute documentary evidence under the adequate records rule. Such evidence is self-serving and not determinative. [Chp. 2]

59. The detailed substantiation requirements of §274(d) apply to many sets of expenses. However, which type of expense is excluded from these substantiation requirements?

a. Correct. While the deduction of entertainment sold to customers is subject to the general requirements of §162, it is not required to meet the detailed substantiation requirements of §274(d).

b. Incorrect. Expenses for travel away from home are subject to the detailed substantiation requirements of §274(d).

c. Incorrect. Under §274(d), business-related gifts must be substantiated in detail.

d. Incorrect. Entertainment and entertainment facilities are subject to the detailed substantiation requirements of §274(d). [Chp. 2]

60. In addition to other §62 requirements, to qualify as an accountable plan for employee expense reimbursement and reporting purposes, the employer's reimbursement or allowance arrangement must meet three rules. What is one of these rules?

a. Incorrect. To qualify as an accountable plan for employee expense reimbursement and reporting purposes, employees must adequately account to the employer for the expenses within 60 days.

b. Incorrect. To qualify as an accountable plan for employee expense reimbursement and reporting purposes, employees must adequately account to the employer for the expenses within a reasonable period of time.

c. Incorrect. To qualify as an accountable plan for employee expense reimbursement and reporting purposes, employees must return any excess reimbursement or allowance within a reasonable period of time.

d. Correct. To qualify as an accountable plan for employee expense reimbursement and reporting purposes, expenses must have a business connection (i.e., the employee must have paid or incurred deductible expenses while performing services for the employer and the advance must reasonably relate to anticipated business expenses). [Chp. 2]

61. Under the accountable plan rules, two conditions require action within a specifically defined "reasonable period of time." However, which of the following circumstances would demonstrate an unreasonable amount of time?

a. Incorrect. The IRS considers it reasonable for an employee to receive an advance within 30 days of when the employee has an expense.

b. Incorrect. Adequately accounting for expenses within 60 days after they were paid or incurred is considered reasonable under the accountable plan regulations (Reg. §1.62-2(g).

c. Incorrect. The Service considers it reasonable to return any excess reimbursement within 120 days after the expense was paid or incurred (Reg. §1.62-2(g)(2)(i)).

d. Correct. If an employee were to substantiate expenses *within* 120 days of a periodic statement, this would be deemed a reasonable amount of time.

However, if the substantiation occurred *after* 120 days, this would be considered unreasonable. [Chp. 2]

62. What the employer has to report on Form W-2 depends on the type of reimbursement or other expense allowance arrangement that is in existence. Under what type of reimbursement arrangement does the employer report on Form W-2 the normal reporting of wages?

a. Incorrect. An actual expense reimbursement under an accountable plan is not reported on Form W-2.

b. Incorrect. Excess reimbursement amounts returned to the employer within a reasonable period of time are not reported on Form W-2.

c. Correct. Under a nonaccountable plan, the employer reports the entire reimbursement on Form W-2.

d. Incorrect. A per diem or mileage allowance under an accountable plan is not reported on Form W-2. [Chp. 2]

63. A nonaccountable plan is a reimbursement or expense allowance arrangement outside the requirements of §62. Reimbursements from such a plan are:

a. Incorrect. Reimbursements of expenses to an employee under a nonaccountable plan do not create income for the employer.

b. Correct. Reimbursements from nonaccountable plans produce taxable income for the employee.

c. Incorrect. Reimbursements from nonaccountable plans may be deductible by the employee. However, the employee must complete Form 2106 and itemize their deductions on Schedule A (Form 1040) subject to the 2% of adjusted gross income limit.

d. Incorrect. Reimbursements from a nonaccountable plan would be deductible by the employer as compensation. [Chp. 2]

64. Which of the following is <u>not</u> a deductible transportation expense?

a. Incorrect. Transportation expenses between your home and a temporary work location are deductible. If your employment at the temporary work location, in this case, the Elm Street office, is expected to last less than one year, it is a temporary location and therefore these expenses are deductible.

b. Incorrect. If you work at two places in one day, you can deduct the costs of getting from one workplace to another. In this case, you are initially at work in the Main Street office and must drive to the Elm Street office. This is a deductible transportation expense. If, however, you did not go directly from one location to another, you would only be able to deduct the amount it would have cost you to go directly from one work location to the other.

c. Correct. If you have no regular place of work, you can deduct transportation costs between your home and a temporary workplace *outside* of your metropolitan area (R.R. 99-7). Transportation to and from a temporary

workplace *within* your normal metropolitan area is not deductible transportation expense.

d. Incorrect. If you work in two places in one day, you can deduct the costs of getting from one workplace to another, even if the two work locations are for different employers. If, however, you did not go to Discount Mart on the same day, your transportation from home to the Army Reserve base would not be deductible. [Chp. 2]

65. Automobile expenses must be apportioned between business travel and personal travel. What is an accepted method of apportionment?

a. Correct. Accepted methods include a proration of actual expenses and depreciation based on the percentage of business use to total use and the standard mileage rate deduction for business miles driven.

b. Incorrect. The specific identification method is used for inventory identification, not for the allocation of automobile use.

c. Incorrect. The high-low method is a subcategory of travel expense identification using recognized seasonal per diems.

d. Incorrect. The annual lease value method is not used to apportion the business use of an automobile between business and personal. The method is used to place a value on the use of an employer-provided vehicle. [Chp. 2]

66. Tangible business property is depreciated using the modified cost recovery system (MACRS). How does this system classify cars?

a. Correct. Passenger automobiles weighing 6,000 pounds or less are listed property, which, under MACRS, are classified as five-year property.

b. Incorrect. Seven-year property includes office furniture, fixtures, equipment, breeding and workhorses, agricultural machinery and equipment, railroad trucks, single purpose agricultural or horticultural structures, and other property with an ADR midpoint of 10 years and less than 16 and property not specifically assigned to any other class.

c. Incorrect. Ten-year property includes vessels, barges, tugs, assets used for petroleum refining, manufacture of grain, sugar, and vegetable oils, and other property with an ADR midpoint of 16 years or more but less than 20 years.

d. Incorrect. Fifteen-year property includes land improvements, assets used for electrical generation, pipeline transportation, cement manufacture, railroad track, nuclear production plants, sewage treatment plants, and other property with an ADR midpoint of 20 years or more but less than 25 years [Chp. 2]

67. A taxpayer may elect the §179 expensing deduction for a portion or all of the cost of an automobile. When the election is made, what must be done?

a. Correct. If a taxpayer elects §179 expensing, they must reduce the basis of their car before figuring any depreciation deduction (§280F(d)(1); §1016(a)(2)).

b. Incorrect. There is no requirement that, if a taxpayer elects §179 expensing, they must use the mid-quarter convention.

c. Incorrect. The amount of the §179 deduction reduces the basis of the car.

d. Incorrect. There is no requirement that, if a taxpayer elects §179 expensing, they must use the half-year convention. [Chp. 2]

68. Under the standard mileage method for taking auto expenses, what may be deducted separately?

a. Incorrect. Expenses for oil may not be deducted separately under the standard mileage method. These expenses are included in a standard mileage rate.

b. Correct. Parking fees and tolls are excluded from the standard mileage rate. Thus, these expenses may be deducted separately.

c. Incorrect. Maintenance and repairs are included in the standard mileage rate, and thus, they cannot be deducted separately.

d. Incorrect. License fees are included in the standard mileage rate, and thus they may not be deducted separately. [Chp. 2]

69. When a manufacturer or importer sells an automobile failing to meet U.S. statutory fuel economy standards, the purchaser of the automobile is subject to an excise tax. What is this special tax called?

a. Incorrect. Personal property tax is a tax on "movable" property, such as machinery, that is used in business. Personal property tax is not based on fuel economy.

b. Correct. The gas-guzzler tax is an excise tax imposed under §4064 on the sale by the manufacturer or importer of any automobile that does not meet statutory standards for fuel economy.

c. Incorrect. Section 4001 imposed an excise tax on automobiles. The luxury tax was imposed on the first retail sale or use (other than use as a demonstrator) of a passenger vehicle with a price exceeding a base amount ($40,000 in 2002). The seller of the taxable article paid the luxury tax. This tax did not relate to fuel economy.

d. Incorrect. The transportation tax is a tax levied in certain localities and is generally used to improve public roadways. This is neither a federal tax nor is it a tax based on the fuel consumption of an automobile. [Chp. 2]

70. Under the gas guzzler tax, a special definition of the term "automobile" is used. As a result, which vehicle is considered such an automobile?

a. Correct. Limousines are generally considered passenger vehicles, and therefore the gas guzzler tax generally applies to limousines (including stretch limousines). Effective September 30, 2005, limousines with a gross unloaded vehicle weight of greater than 6,000 pounds are not subject to the gas guzzler tax.

b. Incorrect. By statute, vehicles sold for use and used primarily for police or other law enforcement purposes by federal, state, or local governments are not considered automobiles.

c. Incorrect. Under §4064, vehicles operated exclusively on a rail or rails are not considered automobiles and are not subject to the gas guzzler tax.

d. Incorrect. The law contains an exception for emergency vehicles. Therefore, for the gas guzzler tax, vehicles sold for use and used primarily as ambulances or combination ambulance-hearses are not considered automobiles. [Chp. 2]

71. Employees can choose from at least seven qualified benefits under a cafeteria plan. What is one of these qualified benefits?

a. Incorrect. Under Code §125(f), an educational assistance program under §127 may not be offered under a cafeteria plan.

b. Correct. Under Code §125(f) a list is provided of qualified benefits under a cafeteria plan. Participation in a cash or deferred arrangement that is part of a profit-sharing plan, such as a 401(k) can be offered under a cafeteria plan.

c. Incorrect. Code §125(f) provides a list of items that are labeled nonqualified benefits and may not be offered in a cafeteria plan. No-additional-cost services and qualified employee discounts offered under §162 are among the items that may not be offered as part of a cafeteria plan.

d. Incorrect. Scholarships and fellowships offered under §117 are disqualified from being offered on a qualified plan under §125(f). [Chp. 2]

72. Under §127, an employee may exclude from gross income for income tax purposes and from wages for employment tax purposes:

a. Incorrect. Under §117, taxpayers may be able to treat as tax-free all or part of the amounts they receive as a scholarship or fellowship grant.

b. Incorrect. Section 529 provides tax-exempt status to a QTP under which persons may purchase tuition credits or certificates or make contributions to an account.

c. Incorrect. The higher education expense deduction allows certain taxpayers to deduct the cost of higher education for themselves, their spouse, or a dependent, even if they do not itemize deductions. However, this deduction is not provided under §127.

d. Correct. Under §127, an employee may exclude from gross income for income tax purposes and from wages for employment tax purposes up to $5,250 annually paid by the employer for educational assistance. [Chp. 2]

73. An employer may provide §129 dependent care assistance for employees tax-free. Up to what amount may an employer exclude for each employee annually?

a. Correct. The amount that an employer may exclude for each employee annually is $5,000 or less. If the individual is married filing separately, the

amount that an employer may exclude for each employee annually is $2,500 or less.

b. Incorrect. The amount that an employer may exclude for each employee annually is the amount of the lower-earning spouse's earned income or less.

c. Incorrect. Fifty percent of dependent care costs could total much greater than the §129 deductible limit.

d. Incorrect. Section 129 does place a ceiling on excludable reimbursements. Dependent care assistance is often a huge expense, and any amount that the employer pays beyond the limit is included in the employee's income on Form W-2. [Chp. 2]

74. Section 132 identifies several fringe benefits such as no-additional-cost services that are excludable from gross income. What is an example of a service that qualifies as a no-additional-cost service?

a. Incorrect. Employer-paid subscriptions to business periodicals for employees are an example of a working condition fringe benefit, rather than a no-additional-cost fringe benefit.

b. Incorrect. On-premises gyms and other athletic facilities are defined in §132 as a working-condition fringe benefit.

c. Correct. No-additional-cost services are for sale to customers in the normal course of business. Examples of services that qualify as no-additional-cost services include hotel accommodations, transportation by aircraft, bus, subway, or cruise line, telephone services, and tickets to sporting events, which would have otherwise gone unused.

d. Incorrect. An example of de minimis fringe benefits is the typing of personal letters by a company secretary. This differs from a no-additional-cost fringe as outlined in §132. [Chp. 2]

75. Which transportation-related fringe must be included in income under §132?

a. Incorrect. Working condition fringes such as business use of employer-provided automobiles are excludable from income under §132.

b. Incorrect. Working condition fringes such as demonstration cars provided to a full-time car salesperson if there are substantial restrictions on the salesperson's personal use of the car and the car is available for test drives by customers are excludable from income under §132.

c. Incorrect. Working condition fringes such as expenditures for employees' business travel are excludable from income under §132.

d. Correct. The value of employer-provided transportation for commuting purposes is not excludable from income under §132. [Chp. 2]

76. The author lists four methods for valuing an employer-provided automobile. Under Reg.§1.61-2T(e), for autos with fair market values (FMV) less than the maximum recovery deductions allowable for the first five years the auto is in service, what valuation method should an employer use?

a. Incorrect. Reg. §1.61-2T(d) states that if an employer provides an employee with an auto, the value of the benefit may be determined using a lease valuation method. Under this method, an employee reports the annual lease value of the auto from the tables in Reg. §1.61-2T(d)(2)(iii) based on the auto's FMV when it is first made available to the employee.

b. Correct. For autos with FMVs less than the maximum recovery deductions allowable for the first five years the auto is placed in service, an employer may determine the value of a vehicle provided to an employee by multiplying the standard mileage rate by the total number of personal miles driven by the employee. The value cannot be determined using this method if the auto's FMV is more than the maximum recovery deductions allowable in this time period.

c. Incorrect. If the auto is provided under the written commuting policy statement exception, the value of the employee's use of the vehicle for such commuting purposes is computed as $1.50 per one-way commute.

d. Incorrect. Under Reg.§1.61-2T(b)(4), if none of the special methods are used, the valuation must be determined by reference to the cost to a hypothetical person of leasing from a hypothetical third party the same or comparable vehicle on the same or comparable terms in the geographic area in which the vehicle is available for use. [Chp. 2]

77. Constructive receipt of income under §451 is a concern for cash basis taxpayers. Under which circumstance would income be reported on the cash method in a year other than the current taxable year?

a. Incorrect. A taxpayer would report income in the current taxable year when the income is credited to their account.

b. Incorrect. A taxpayer would report income in the current taxable year when the income is made available so that the taxpayer may draw upon it.

c. Incorrect. A taxpayer would report income in the current taxable year when the income is set apart for them.

d. Correct. Income is reported in a year other than the current taxable year if the taxpayer's control of the receipt is subject to substantial limitations, restrictions, or is contingent on the happening of some future event. [Chp. 2]

78. The accrual method often must be used. In which of the following circumstances is the use of this method required under §448?

a. Incorrect. C corporations, partnerships that have a C corporation as a partner, and tax shelters are barred from using the cash method of accounting. Exceptions are allowed for entities that meet a $31,000,000 (in 2025) gross receipts test (§448).

b. Incorrect. Under §447, corporations engaged in farming must use the accrual method of accounting. However, businesses engaged in farming with gross receipts of less than $31,000,000 (in 2025) are excluded from this regulation and may use the cash method of accounting (§448).

c. Incorrect. For tax purposes, prepaid rent, prepaid interest, and advances for services to be performed later are generally included in income when received rather than when earned, regardless of the method of accounting used.

d. Correct. The accrual method must be used where the production, purchase, or sale of merchandise is a material income-producing factor. [Chp. 2]

79. Which of the following is an example of a long-term contract under §460?

a. Correct. A long-term contract is any contract for the manufacture, building, installation, or construction of specific property that is completed over multiple accounting periods (i.e. not completed in the taxable year). Special revenue recognition rules apply to long-term contracts.

b. Incorrect. A long-term contract does not include inventory items unless the manufacturing period of the item normally requires more than 12 months to complete. Because the tractors can be constructed in 3 weeks and this is a normal inventory item for the company, this is not a long-term contract.

c. Incorrect. Long-term contracts under §460, do not include personal service items such as accounting, health care, and legal services.

d. Incorrect. A specific exclusion is included in §460(e)(1)(a) for "home construction contracts." Because the contract in question is for the construction of a home, it is not considered a long-term contract under §460. [Chp. 2]

80. Taxpayers are required to compute their taxable income on the basis of their taxable year. What is the taxable year when the taxpayer fails to keep any books?

a. Incorrect. A 52-53 week year is an annual period that varies from 52 to 53 weeks and ends always on the same day of the week and ends: on the date such same day of the week last occurs in a calendar month, or on the date such same day of the week falls which is nearest the last day of a calendar month. A 52-53 week year is an election and requires that books be maintained by the taxpayer

b. Correct. Under §441, a taxpayer's taxable year is the calendar year if the taxpayer does not keep any books. A calendar year is a period of twelve months ending on December 31.

c. Incorrect. A fiscal year is a period of twelve months ending on the last day of any month other than December. A fiscal year requires that a taxpayer maintain books.

d. Incorrect. A short-period return is a return for a period of less than twelve months and may be filed when the taxpayer with the approval of the Secretary, changes their annual accounting period. [Chp. 2]

81. Personal service corporations may make a §444 election. This election allows them to use a tax year other than:

a. Incorrect. This election does not apply to any personal service corporation that establishes a business purpose for a different period.

b. Incorrect. Even when made, the §444 election only permits at most a three-month variation from the required taxable year.

c. Incorrect. Other than pursuant to a §444 election or special business purpose year, a personal service corporation may not use a fiscal year.

d. Correct. Personal service corporations may elect to use a tax year that is different from the required tax year under §444. [Chp. 2]

82. The mid-quarter depreciation convention must be used if a taxpayer places property in service during the last three months of the year and:

a. Correct. Taxpayers must use a mid-quarter convention in the first and last year of the recovery period, instead of a half-year convention, if they place property, including cars, in service during the last 3 months of their tax year, and the total basis of these assets is more than 40% of the total basis of all property placed in service during the entire year.

b. Incorrect. In determining the total cost of property placed in service during the year, residential rental and nonresidential real property are disregarded.

c. Incorrect. The half-year convention must be used unless the taxpayer is required to use the mid-quarter convention (§168(d)(4)(A)).

d. Incorrect. The taxpayer can elect to disregard any property acquired and disposed of within the same year (§168(d)(3)). [Chp. 2]

83. The cost of certain assets must be deducted over the multiple accounting periods that are deemed to benefit from the asset. What term is used to define this method of writing off asset costs?

a. Correct. Amortization is the method of writing off costs that benefit more than one accounting period over the benefit period or some period set by the IRS. Amortization is generally thought of as a way of expensing intangible costs; however, certain tangible property may be eligible for amortization

b. Incorrect. The cost of property is recovered by taking deductions for the cost over a set period of years using depreciation.

c. Incorrect. Depreciation is a decrease in the value of property due to the exhaustion, wear and tear, and obsolescence of an asset used in a trade or business or for the production of income.

d. Incorrect. Costs that benefit more than one accounting period are generally not eligible to be expensed in a single year. Generally, a taxpayer is required to deduct costs that benefit more than one year by taking deductions spread over several years. However, under §179, taxpayers can elect to deduct all or part of an asset's cost in one year (i.e., expense the item) rather than taking depreciation deductions spread over several years. [Chp. 2]

84. For any property gain to be taxable or loss to be deductible, the property must:

a. Incorrect. Financing or mortgaging a property is not an event triggering gain or loss.

b. Incorrect. Property appreciation or depreciation does not trigger taxable gain or loss. A taxable disposition is required to make realized gain or loss recognizable.

c. Incorrect. A property transfer does not necessarily trigger taxable gain or loss. For example, when property is transferred by gift no gain or loss is triggered.

d. Correct. Property must be sold or exchanged for any gain to be taxable or loss deductible. In short, there must be a taxable disposition under §1001. [Chp. 3]

85. Basis must be figured prior to calculating gain or loss on a sale of property. What is an addition to basis?

a. Incorrect. Basis reductions include depreciation (MACRS, ACRS).

b. Incorrect. Basis reductions include easement transfers. If the amount received for an easement is greater than the basis, a capital gain must be recognized.

c. Correct. Additions to basis include improvements, legal fees-title challenges, and assessments for improvements.

d. Incorrect. Basis reductions include §179 expense deductions (for personal property only). [Chp. 3]

86. According to the author, which of the following property disposition issues is one of the most time-consuming areas for tax practitioners?

a. Incorrect. The general rule for figuring the basis of stocks and bonds is based on the method of acquisition. In this case, the donee's basis is equal to the donor's basis. No adjustments are required for these stocks. This is relatively clear-cut.

b. Correct. Sales of mutual fund shares are among the most time-consuming and confusing areas that tax practitioners encounter. Frequently, the data needed regarding dividends automatically reinvested and shares redeemed is unavailable or misplaced.

c. Incorrect. Stock dividends and splits require adjustments to the general rule for determining basis, but these are relatively easy to figure, as shown in the example in the course material. The information necessary to count the number of shares and the basis is generally readily available and therefore not overly burdensome to tax practitioners.

d. Incorrect. These sales are fairly straightforward. In effect, this provision eliminates "short-against-the-box" sales, notional principal contracts, and future and forward contracts to defer the recognition of gain. [Chp. 3]

87. Under §1091, a taxpayer cannot deduct a loss on a sale of stock or security when, within 30 days of the sale, similar stock or securities are purchased. Which of the following is also subject to the wash sale rule?

a. Incorrect. The §1091 wash sale rule does not apply to stock or securities acquired in an exchange of stock for stock.

b. Incorrect. The §1091 wash sale rule does not apply to stock or securities acquired by gift.

c. Correct. The wash sale rule applies to stock acquired by option.

d. Incorrect. The §1091 wash sale rule does not apply to stock or securities acquired incident to divorce. [Chp. 3]

88. Section 121 provides homeowners with an exclusion for gains on the sale of a personal residence. Under §121, who can be entitled to a $500,000 exclusion on the sale of their principal residence?

a. Incorrect. A single taxpayer who marries a taxpayer who has used the exclusion within two years is allowed a $250,000 exclusion.

b. Incorrect. Married couples who do not use the property as their principal residence for at least two years during the five-year period ending on the date of the sale or exchange do not meet the use requirement and therefore do not qualify for the full $500,000 exclusion.

c. Correct. Married couples filing a joint return are entitled to a $500,000 exclusion where both spouses meet the use requirement.

d. Incorrect. Married couples filing a joint return are entitled to a $500,000 exclusion where neither spouse has had a sale in the preceding two years subject to the exclusion. [Chp. 3]

89. If a taxpayer fails to meet the home sales exclusion requirement, he or she may still be entitled to a prorated exclusion. This exclusion may be available if the failure to satisfy the requirements was due to:

a. Incorrect. Having an uncooperative spouse does not entitle a taxpayer to the exclusion. If one of three allowable reasons caused a taxpayer to fail to meet the requirements, the exclusion would be allowed. However, this cause does not fall into any of these categories.

b. Incorrect. If a taxpayer goes on vacation for an extended period of time, long enough to fail to meet the use requirement, then the exclusion would still be disallowed.

c. Incorrect. If a taxpayer rents out a home and he or she failed to meet the use requirement for this reason, he or she would still be disallowed the exclusion.

d. Correct. One of the three reasons that may permit a taxpayer to take advantage of the exclusion even though he or she fails to meet the use and ownership requirements is if the failure is due to health reasons. [Chp. 3]

90. Under §453, a portion of any gain must be reported when each installment sale payment is received. If all other requirements are met under §453, when is the installment method available?

a. Correct. The installment sale rules do not apply to the regular sale of inventory.

b. Incorrect. The installment method is not available if the taxpayer receives the entire purchase price in the year of sale.

c. Incorrect. The installment method is not available if the taxpayer is a dealer. There are a few exceptions.

d. Incorrect. The installment method is not available if there are marketable securities being sold. [Chp. 3]

91. Under §453B, if there is a disposition of an installment sale note, the fair market value of the obligation is subtracted from its basis to determine the gain or loss. However, which of the following dispositions is tax-free?

a. Incorrect. Under §453B, taxable dispositions of installment notes include gifts.

b. Incorrect. Under §453B, taxable dispositions of installment notes include transfers by an individual to an irrevocable trust.

c. Correct. Under §453B, the transmission of an installment obligation at death, and the distribution in certain tax-free corporate reorganizations, liquidations, and contributions to the capital of a corporation or a partnership are not taxable dispositions of installment notes.

d. Incorrect. Under §453B, taxable dispositions of installment notes include assignments to a trust by a dissolving partnership. [Chp. 3]

92. Three rules apply when a taxpayer receives an installment obligation along with like-kind property in a §1031 exchange. What is one of these three rules?

a. Incorrect. In a like-kind exchange, a taxpayer does not have to report any part of their gain if they receive only like-kind property.

b. Incorrect. If, in addition to like-kind property, a taxpayer receives an installment obligation in the exchange, the contract price does not include the fair market value of the like-kind property received in the trade.

c. Correct. If, in addition to like-kind property, a taxpayer receives an installment obligation in the exchange, the gross profit is reduced by any gain on the trade that can be postponed.

d. Incorrect. If, in addition to like-kind property, a taxpayer receives an installment obligation in the exchange, like-kind property received in the trade is not considered payment on the installment obligation. [Chp. 3]

93. Reg. §1.1038-1 and Reg. §1.1038-2 lay out the rules for repossessions. However, these rules vary depending on:

a. Incorrect. There is no preferential treatment under tax law if the property was surrendered voluntarily.

b. Incorrect. There is no distinction in the rules for repossession based on whether or not the title to the property was transferred to the buyer.

c. Correct. The rules for repossession depend on the kind of property repossessed. The rules for repossession of personal property differ from those for real property.

d. Incorrect. The rules for repossession are not affected by whether the property is repossessed via foreclosure or by another method. [Chp. 3]

94. For non-installment method sales, the seller's basis in their note must be determined on repossession. What is added to the seller's basis in the note to figure this basis?

a. Incorrect. All principal payments the seller has received on the obligation are subtracted from the seller's basis in the installment obligation.

b. Incorrect. The unreported profit is the gain the seller would report as income in the future if they held the obligation to maturity minus repossession costs.

c. Correct. Any repossession expenses are added to the seller's basis in the obligation. The result is the seller's basis in the installment obligation. This basis is then used to figure any gain or loss on the repossession.

d. Incorrect. The seller's basis in the installment obligation is its face value at the time of repossession minus the unreported profit. [Chp.3]

95. A seller's basis in the installment obligation also must be determined in the repossession of a property sold under the installment sales method. Based on §453, how is the seller's basis figured in such an event?

a. Incorrect. In non-installment method sales, the seller's basis in the installment obligation may be figured on its full face value at the time of the original sale. From this amount, all principal payments the seller has received on the obligation are subtracted.

b. Correct. The basis in an installment obligation based on §453B is the excess of the face value of the obligation over an amount equal to the income returnable were the obligation to be satisfied in full. Therefore, the face value at the time of the repossession minus any unreported profit is the taxpayer's basis in the installment obligation.

c. Incorrect. In non-installment method sales, the seller's basis in the installment obligation may be figured on its fair market value at the time of the original sale. Any repossession expenses are added to the seller's basis in the obligation.

d. Incorrect. The seller's basis in the installment obligation is the gain the seller would report as income in the future if they held the obligation to maturity minus repossession costs. [Chp. 3]

96. A seller may repossess personal property from a buyer to satisfy an installment obligation. Under §166, if repossessing personal property fails to fully satisfy the obligation and the seller is unable to collect on the remainder amount, what may the seller be able to do?

a. Incorrect. The rules for repossessions of real property allow the seller to keep essentially the same adjusted basis in the repossessed property as he or she had before the original sale.

b. Incorrect. The full amount of any payments the seller already received from the buyer on the original sale of real property must be regarded as income to the seller. The seller reports, as gain on the repossession, any part of those payments that he or she did *not* yet include in their income, that is, the part that was regarded as a return of adjusted basis rather than as gross profit.

c. Correct. The same circumstances that let the seller repossess the property may mean that the seller cannot collect on the remainder of the buyer's debt to the seller, and therefore the taxpayer may be able to take a bad debt deduction for that part of the installment obligation.

d. Incorrect. It is implied that the seller has already collected some of the buyer's debt. This portion that has already been collected may not be used to take a bad debt deduction. [Chp. 3]

97. When a seller repossesses real property from a buyer, they may recover their adjusted basis upon a resale. In such an event, under Reg. §1.1038-1(b)(1), how is the full amount of any payments received from the buyer on the original sale treated?

a. Incorrect. Condemnation proceeds would be under §1033 involuntary conversion, not a §1038 repossession.

b. Incorrect. When a seller repossesses personal property, they may have a gain on the repossession. Payments received on the obligation will be a factor in determining the gain, if any; however, the gain will not be equal to the full amount of payments received.

c. Incorrect. When a seller repossesses personal property, they may have a loss on the repossession. There is no loss on the repossession of real property.

d. Correct. The seller can recover the entire adjusted basis when they resell the real property which, in effect, cancels out the tax treatment the seller had on the original sale and puts the seller in the same tax position he or she was in before that sale. Thus, the full amount of any payments the seller already received from the buyer on the original sale is regarded as income to the seller. [Chp. 3]

98. Three conditions must be met to figure basis for the repossessed real property and gain on the repossession. What is one of these conditions?

a. Incorrect. If all other conditions are met, the installment obligation satisfied by the repossession must have been received in the original sale.

b. Incorrect. If all other conditions are met, the repossession must be to protect the seller's security rights in the property.

c. Incorrect. If all other conditions are met, the seller cannot pay any additional consideration to the buyer to get the property back, unless the reacquisition and payment of the additional consideration were provided for in the original contract of sale.

d. Correct. If all other conditions are met, the seller cannot pay any additional consideration to the buyer to get the property back, unless the buyer has defaulted, or default is imminent. (Reg. §1.1038-1(a)(3)(i)) [Chp. 3]

99. Upon the resale of repossessed real property, a seller may have to report capital gain or loss. For these purposes, the combination of the time the seller owned the property prior to the original sale and the time following the repossession becomes?

a. Incorrect. The term "exchange period" is a §1031, not a §1038 concept. The exchange period begins on the transfer of the relinquished property and ends on the earlier of (1) 180 days later or (2) the due date, including extensions, for the exchangor's tax return for the year in which the transfer of the relinquished property occurs.

b. Incorrect. The term "identification period" is a §1031, not a §1038 concept. The identification period starts the day the exchangor transfers the relinquished property and ends 45 days later.

c. Correct. If the seller resells the property they repossessed, the resale may result in a capital gain or a capital loss. To figure whether it is a long-term or a short-term gain or loss, the holding period includes the period the seller owned the property before the original sale plus the period after the repossession. It does not include the period the buyer owned the property.

d. Incorrect. The term "replacement period" is a §1033, not a §1038 concept. To postpone reporting gain from a condemnation the taxpayer must buy replacement property within a specified period of time. This is the "replacement period." [Chp. 3]

100. A taxpayer may sell her principal residence and exclude all or part of the gain under §121. Thus, the rule for reporting real property repossessions may be inapplicable provided:

a. Incorrect. Under §1038(a), a sale of real property that gives rise to indebtedness to the seller which is secured by the real property sold, and the seller reacquires property in satisfaction of the debt, no gain or loss results from the reacquisition subject to certain limitations. Under §1038(e), a principal residence is included in the exclusion of gain or loss outlined in §1038(e). Therefore, the seller does not have any gain at the time of repossession.

b. Incorrect. Under §1038(e), the seller does not have any loss at the time of repossession.

c. Incorrect. Under §1038(e), under regulations prescribed by the Secretary, for the purposes of applying §121, the resale of the property is treated as part of the original sale of such property. Without this provision, the taxpayer would not be able to exclude the gain on the resale of the principal residence.

d. Correct. If a taxpayer sells her principal residence and excludes all or part of the gain under §121, then the rule for reporting repossessions of real

property is inapplicable provided the property is resold within one year from the date of reacquisition (§1038(e)). [Chp. 3]

101. A federal or federally assisted program may require and pay for a taxpayer to move to another location. Under §1033, how are such relocation payments treated?

a. Correct. The replacement housing payments are added to the cost of the taxpayer's newly acquired property, as outlined in IRS Publication 544.

b. Incorrect. Such relocation payments are not paid by the taxpayer and are not §217 deductible moving expenses.

c. Incorrect. Payments received to relocate and replace housing because the taxpayer has been displaced from their home, business, or farm as a result of federal or federally assisted programs are not included in income. This information is outlined under the guidance for "payments to relocate" in IRS Publication 544.

d. Incorrect. Payments received to relocate and replace housing because the taxpayer has been displaced from their home, business, or farm as a result of federal or federally assisted programs are not part of the condemnation award. The condemnation award is money paid or other property received for the condemned property. Payments to relocate are excluded from the condemnation award as outlined in IRS Publication 544. [Chp. 3]

102. When part of a property is condemned and another part of the property has its value decreased due to the condemnation, the taxpayer may receive severance damages. In such an event, how are such severance damages initially reduced?

a. Incorrect. Second, they are reduced by any special assessment levied against the remaining part of the property if the assessment was withheld from the award by the condemning authority.

b. Correct. First, severance damages must be reduced by expenses in obtaining the damages.

c. Incorrect. The basis of the remaining property is reduced by the net severance damages.

d. Incorrect. Severance damages are not reduced by a prorata share of the condemnation award. Severance and condemnation are calculated separately. [Chp. 3]

103. Under which circumstance would the reporting of gain on condemned, damaged, destroyed, or stolen property be unnecessary under §1033?

a. Incorrect. If the taxpayer is a member of a partnership or a shareholder in a corporation that owns the condemned, damaged, destroyed, or stolen property, only the partnership or corporation, and not the taxpayer, can choose to postpone reporting the gain.

b. Incorrect. Gain must be reported if money or unlike property is received as reimbursement.

c. Incorrect. If part of the condemned property was used as the taxpayer's home and part as business or rental property, each part must be treated as a separate property, and gain or loss is figured separately for each part because gain or loss may be treated differently.

d. Correct. Gain on condemned, damaged, destroyed, or stolen property is not reported if the taxpayer receives property that is similar or related in service or use to it under §1033. The basis for the new property is the same as the basis for the old property. [Chp. 3]

104. The author lists several transactions whereby taxpayers may postpone reporting gain on condemned property. However, which of the following transactions would deny taxpayer this postponement option?

a. Incorrect. Taxpayers can choose to postpone reporting the gain if they purchase a controlling interest in a corporation owning property that is similar to the condemned, damaged, destroyed, or stolen property.

b. Correct. If the taxpayer fails to purchase at least 80% interest in the corporation, they will be unable to choose to postpone reporting the gain.

c. Incorrect. Taxpayers can choose to postpone reporting the gain if they purchase property that is related in use to the condemned, damaged, destroyed, or stolen property.

d. Incorrect. Taxpayers can choose to postpone reporting the gain if they purchase property that is similar in service to the condemned, damaged, destroyed, or stolen property. [Chp. 3]

105. Section 465 defines "qualified persons" for purposes of determining at-risk limits. For these purposes, which of the following is a qualified person?

a. Incorrect. A qualified person is not a person from whom the taxpayer acquired the property.

b. Incorrect. A qualified person is not a person related to the taxpayer. However, a person related to the taxpayer may be a qualified person if the nonrecourse financing is commercially reasonable, and on the same terms as loans involving unrelated persons.

c. Incorrect. A qualified person is not a person who receives a fee due to the taxpayer's investment in the real property.

d. Correct. A qualified person actively and regularly engages in the business of lending money. The most common example is a bank. [Chp. 3]

106. Under §465, a partner is considered at risk for three items. What is one of these items?

a. Incorrect. A partner is generally not considered at risk for amounts borrowed if the lender has an interest in the activity.

b. Incorrect. A partner is generally not considered at risk for amounts borrowed if the lender is related to a person having an interest in the activity.

c. Correct. A partner is generally considered at risk for amounts borrowed that are secured by the partner's property other than property used in the activity.

d. Incorrect. A partner is generally not considered at risk for amounts protected against loss through guarantees. [Chp. 3]

107. According to the author, it is helpful to break down the like-kind exchange provisions into three requirements. What is one of these three basic requirements of §103?

a. Incorrect. One of the three basic requirements of exchanging is that the property exchanged and the property received must be held for productive use in trade or business or for investment.

b. Incorrect. A basic requirement of exchanging is that neither the property exchanged nor the property received may be held for personal use.

c. Correct. One of the three basic requirements of exchanging is that the properties must be of a "like-kind" with one another. Generally, this means that real property must be traded for real property and personal property must be traded for personal property.

d. Incorrect. There is no "similar in use" requirement or test under §1031. [Chp. 3]

108. When disposing of property, taxpayers may receive money and/or property. What tax term is used for the total money received plus the fair market value of property, other than money, received?

a. Incorrect. "Adjusted basis" is simply defined as the cost of the property (including any indebtedness taken subject to or assumed) increased by capital improvements, broker's commissions, attorneys' fees, appraisal costs, escrow charges, and other acquisition costs and decreased by allowable depreciation (§1016).

b. Correct. The "amount realized" from a transaction is the sum of any money received plus the fair market value of property (other than money) received.

c. Incorrect. Section 1001 provides that realized gain is the excess of the amount realized from a transaction over the adjusted basis of the property disposed of in the same transaction.

d. Incorrect. The contract price is the total of all principal payments to be received in an installment sale (§162). [Chp. 3]

109. The existence of boot can create valuation problems in a §1031 exchange. However, two items of boot are taken at face value. What is one of these types of boot?

a. Correct. Money and debt are taken at face dollar value.

b. Incorrect. Furniture and furnishings are taken at fair market value.

c. Incorrect. Stocks are taken at fair market value.

d. Incorrect. Vehicles are taken at fair market value. [Chp. 3]

110. In a §1031 exchange, an exchangor may receive both like-kind and non like-kind property. If this occurs, what happens to the total basis?

a. Incorrect. If an exchange is combined with an installment sale, the basis of the like-kind property will be determined as if the installment obligation had been satisfied at face and any remaining basis will be used to determine the gross profit ratio.

b. Incorrect. When non like-kind property is received, basis must be first allocated to the non like-kind property to the extent of its fair market value.

c. Correct. If the property received in an exchange consists of like-kind and non like-kind property, the amount allocated to the non like-kind property must be equal to its fair market value as of the date of the exchange.

d. Incorrect. When non like-kind property is received, basis is first allocated to the non-like-kind property to the extent of its fair market value. The remainder of the basis is allocated to like-kind property received. [Chp. 3]

111. The author identifies four rules for like-kind exchanges for installment sale purposes. What is one of these rules under §453(f)(6)?

a. Incorrect. Under §453(f)(6)(A), the contract price does not include the value of the like-kind property.

b. Incorrect. Under §453(f)(6)(B), the gross profit from the exchange is reduced by the gain not recognized.

c. Incorrect. Under §453(f)(6)(C), the like-kind property received under 1031 is not treated as a payment in the year of disposition.

d. Correct. Under §453(f)(6) the taxpayer's basis in the property put into the exchange is allocated first to the like-kind property received to the extent of its fair market value. [Chp. 3]

112. Under §1031, properties must be traded in a reciprocal transaction. Which of the following types of exchange is the most fundamental example of that principle?

a. Incorrect. There are several steps to a multiple-party exchange, making this type of exchange more complex than others.

b. Incorrect. Under the Baird exchange, there are several steps to complete a like-kind exchange. Thus, this type of exchange is more complex than others.

c. Incorrect. Delayed exchanges are often complex due to having to locate an acceptable exchange property. Thus, there are simpler exchanges.

d. Correct. Two-party exchanges are the simplest (but rarest) of exchanges. You transfer your property to another in return for their transfer of property to you. Children do this a lot with toys. [Chp.3]

113. The author identifies two deferred tax advantages of retirement plans. What is one of these advantages?

a. Incorrect. A *current* benefit of a retirement plan is that employee benefit trust accumulates tax-free.

b. Correct. A deferred tax advantage of a retirement plan is that certain distributions may be rolled over tax-free, deferring tax obligations to a later year.

c. Incorrect. Formerly, corporate plans exceeded Keogh plans. However, effective 1984, such Keogh plans are essentially equal to corporate retirement plans.

d. Incorrect. A *current* benefit of a corporate plan is that the employee does not recognize income currently on contributions made by his or her employer even though the benefits may be nonforfeitable and fully vested. [Chp. 3]

114. There are four main sections of the Employment Retirement Income Security Act (ERISA). Which basic ERISA provision is concerned with only qualified retirement plans and tax-deferred annuities, mainly from a federal tax perspective?

a. Incorrect. Title I is primarily concerned with all types of retirement and welfare benefit programs.

b. Correct. Title II covers only qualified retirement plans and tax-deferred annuities, primarily from a federal tax standpoint.

c. Incorrect. Title III involves jurisdiction, administration, enforcement, and the enrollment of actuaries.

d. Incorrect. Title IV outlines the requirements for plan termination insurance. [Chp. 3]

115. Qualified plans have similar qualification requirements. What is a basic requirement of a qualified retirement plan?

a. Incorrect. A basic requirement of a qualified pension plan is that the assets must be held in a valid trust created or organized in the United States. A valid trust must have a trustee.

b. Incorrect. A basic requirement of a qualified pension plan is that the employer must establish and communicate to its employees a written plan that is valid under state law.

c. Incorrect. A basic requirement of a qualified pension plan is that the plan must be a permanent and continuing program. It must not be a temporary arrangement set up in high tax years as a tax savings scheme to benefit the employer.

d. Correct. A basic requirement of a qualified pension plan is that the plan must cover a required percentage of employees or a nondiscriminatory classification of employees. The plan may not discriminate in favor of highly compensated employees. Participation standards include age and service requirements and coverage requirements. [Chp. 3]

116. Section 401 provides several sets of requirements designed to prevent retirement plan coverage discrimination. What is one set of those requirements?

a. Incorrect. To ensure that lower paid employees have the benefit of a retirement plan, a plan may satisfy the ratio test. However, to satisfy this test, a plan must benefit a percentage of nonhighly compensated employees that is at least 70% of the percentage of highly compensated employees benefiting under the plan.

b. Incorrect. A plan may satisfy the percentage test to avoid discrimination. However, under this test, the plan must "benefit" at least 70% of all employees who are not highly compensated employees.

c. Incorrect. To ensure that lower paid employees have the benefit of a retirement plan, a plan may satisfy the average benefits test. A plan will meet the average benefits test if: the plan meets a nondiscriminatory classification test; *and* the average benefit percentage of nonhighly compensated employees, considered as a group, is at least 70% of the average benefit percentage of the highly compensated employees, considered as a group.

d. Correct. To ensure that lower paid employees have the benefit of a retirement plan, tax law requires that a trust will not be qualified unless it benefits the lesser of 50 employees; *or* 40% of all employees. Thus, each plan must have a minimum number of employees covered, without regard to any designation of another plan. [Chp. 3]

117. For employer contributions, retirement plans must meet minimum vesting schedules. Under the two-to-six-year graded vesting schedule, what is a participant's nonforfeitable claim to employer-derived benefits after three years of completed service?

a. Correct. For matching contributions, under the two-to-six-year graded vesting schedule, the nonforfeitable claim to employer-derived benefits after 3 years of completed service is 40%.

b. Incorrect. For matching contributions, under the two-to-six-year graded vesting schedule, the nonforfeitable claim to employer-derived benefits after 4 years of completed service is 60%.

c. Incorrect. For matching contributions, under the two-to-six-year graded vesting schedule, the nonforfeitable claim to employer-derived benefits after 5 years of completed service is 80%.

d. Incorrect. For matching contributions, under the two-to-six-year graded vesting schedule, the nonforfeitable claim to employer-derived benefits after 6 years of completed service is 100%. [Chp. 3]

118. The mechanics of defined benefit and defined contribution retirement plans have many similarities. However, what is a unique aspect of defined benefit plans?

a. Incorrect. In defined contribution plans, an individual account is established for each employee. No such account is established under a defined benefit plan.

b. Incorrect. Generally, a defined benefit plan attempts to specify benefit levels for employees. Once benefit levels are established, contributions are determined based on actuarial calculations.

c. Incorrect. In defined benefit plans, the employer defines the benefit it wants to have its employees receive rather than defining or fixing the annual cost.

d. Correct. Defined benefit plans are subject to the minimum funding requirements, whereas those rules have little meaning for defined contribution plans. [Chp. 3]

119. A profit-sharing plan is a type of defined contribution plan. What is a characteristic of a profit-sharing plan?

a. Incorrect. The contribution limits of individual retirement accounts (IRAs) are limited to specific dollar amounts adjusted annually for inflation. However, the total contributions that can be made to profit-sharing plans are not limited to a specific dollar amount.

b. Correct. Employer contributions to profit-sharing plans are discretionary and can be based on, but are not limited to profits.

c. Incorrect. Employer contributions to money purchase pension plans are mandatory regardless of profits. Contributions to profit-sharing plans are not mandatory.

d. Incorrect. Employers must contribute a predetermined percentage each year to money purchase pension plans. No such requirement is made under profit-sharing plans. [Chp. 3]

120. Section 401(k) plans must meet five requirements. What is one such requirement?

a. Incorrect. A requirement of a §401(k) plan is that benefits are not distributable to an employee earlier than age 59½, termination of service, death, disability, or hardship.

b. Correct. A requirement of a §401(k) plan is that each employee's accrued benefit under the plan is fully vested.

c. Incorrect. A requirement of a §401(k) plan is that it must be a qualified profit-sharing or stock bonus plan.

d. Incorrect. A requirement of a §401(k) plan is that each employee can elect to receive cash or to have an employer contribution made to the employee trust. [Chp. 3]

121. A Keogh plan is a popular type of retirement plan. Which individuals can be participants in such a plan?

a. Correct. Under a Keogh plan, a self-employed individual is allowed to take a deduction for money he or she sets aside to provide for retirement. Self-employed individuals include sole proprietors.

b. Incorrect. Employees of an S corporation are not considered self-employed or eligible to participate in a Keogh plan, and therefore cannot take a deduction for a Keogh plan.

c. Incorrect. Employees of a C corporation are not considered self-employed or eligible to participate in a Keogh plan, and therefore cannot take a deduction for a Keogh plan.

d. Incorrect. Partners owning 10% or more of an interest in a partnership may be eligible to take the deduction; however, partners owning less than 10% are not eligible to take this deduction. [Chp. 3]

122. Individual taxpayers and their non-working spouses may establish individual retirement arrangements (IRAs). What is the eligibility requirement for IRAs?

a. Incorrect. If a vesting schedule is elected, completion of 1 year of service is an eligibility requirement of profit-sharing pension plans, money purchase pension plans, and 401(k) plans.

b. Incorrect. If 100% vesting is elected, completion of 2 years of service is an eligibility requirement of profit-sharing pension plans, money purchase pension plans, and 401(k) plans.

c. Correct. To contribute to a traditional IRA, you must have taxable compensation such as wages, salaries, commissions, tips, bonuses, or net income from self-employment.

d. Incorrect. The eligibility requirements of IRAs do not have any stipulations that require the plan participant to be a sole proprietor or more than 50% partner. [Chp. 3]

123. Under a simplified employee pension (SEP) IRA, the employer must contribute for each employee. However, an employee:

a. Incorrect. For the calendar year, the employer contributes for each employee who has attained age *21*, not 18.

b. Correct. Contributions and deductions are available even if the employee has attained age 73 (the normal IRA age limit).

c. Incorrect. Employee participants must have earned at least *$750* (2024) in the tax year to qualify.

d. Incorrect. For the calendar year, the employer contributes for each employee who has performed any service for the employer during *three* of the preceding *five* years. [Chp. 3]

124. An IRA beneficiary can be any person or entity the IRA owner chooses. However, a trust:

a. Incorrect. A trust cannot be a designated beneficiary even if it is a named beneficiary.

b. Incorrect. Only an individual can be a designated beneficiary. The beneficiaries of a trust will be treated as having been designated as beneficiaries if a trust is named beneficiary.

c. Incorrect. A trust cannot be a designated beneficiary regardless of whether it is revocable or revocable. Only individuals can serve as designated beneficiaries.

d. Correct. The trust beneficiaries, rather than the trust itself, are used to determine the classification of the IRA beneficiary. [Chp. 3]

125. A rollover is a tax-free reinvestment from one retirement plan to another. What fails to qualify as a rollover?

a. Correct. A transfer of funds in a traditional IRA from one trustee directly to another, either at the taxpayer's request or at the trustee's request, is *not a rollover.* Since there is no distribution to the taxpayer, the transfer is tax-free.

b. Incorrect. For distributions after December 31, 2001, taxpayers can roll over both the taxable and nontaxable part of a distribution from a qualified plan into a traditional IRA.

c. Incorrect. For distributions after December 31, 2001, taxpayers can roll over tax-free a distribution from their IRA into a qualified plan. The part of the distribution that they can roll over is the part that would otherwise be taxable. Qualified plans may, but are not required to, accept such rollovers.

d. Incorrect. Taxpayers can withdraw, tax-free, all or part of the assets from one traditional IRA if they reinvest them within 60 days in the same or another traditional IRA. [Chp. 3]

126. One of the three §469 "buckets" of income is portfolio income. Under §469, what is deemed to generate portfolio income?

a. Incorrect. Nonpassive portfolio income includes royalties <u>not</u> received in the ordinary course of business. Royalties received in the ordinary course of business would be deemed material participation income.

b. Incorrect. Passive items include any activity involving the conduct of a trade or business in which the taxpayer does not materially participate.

c. Incorrect. Passive items include any limited partnership (but *not* publicly traded partnerships that are classified as portfolio).

d. Correct. Guaranteed payments from a partnership for interest on capital are deemed to be non-passive portfolio income, whereas guaranteed payments from a partnership for services are deemed to be non-passive material participation income. [Chp. 4]

127. Another of the three §469 "buckets" of income is material participation income. Under §469, who is deemed to have materially participated in a trade or business activity?

a. Incorrect. Active participation is not the same as material participation. The rules for active participation are much easier to satisfy than the rules for material participation.

b. Incorrect. Except for oil and gas working interests, the taxpayer must materially participate in a trade or business activity to avoid the activity being

subject to the passive loss limits. Oil and gas interests have very special rules applied to them under §469.

c. Incorrect. Any involvement in rental activities is presumed to be passive.

d. Correct. A taxpayer materially participates if he or she is involved in the activity's operations on a regular, continuous, and substantial basis throughout the year. [Chp. 3]

128. Section 469 restricts taxpayers from sheltering tax in certain activities. However, under §469, passive losses can still offset:

a. Incorrect. Passive loss rules under §469 prevent passive losses from offsetting active income.

b. Incorrect. Section 469 passive loss rules disallow passive losses from offsetting portfolio income.

c. Incorrect. Passive losses cannot offset interest income that is portfolio income.

d. Correct. Under §469, passive losses can offset passive income. [Chp. 4]

129. There are three categories of income under §469. When income is from personal services, wages, or a salary, how is the income classified?

a. Correct. When income is from personal services or wages or a salary, the income is classified as a non-passive material participation activity.

b. Incorrect. Income from interest, dividends, and annuities is classified as non-passive portfolio.

c. Incorrect. Passive items include income derived from activities considered passive under §469.

d. Incorrect. There are only three buckets of income and portfolio income is a type of non-passive income. [Chp. 4]

130. Suspended losses are converted to realized losses when an entire interest in a passive activity is sold in a fully taxable transaction. However, if a passive activity is sold on the installment sale method what results under§469(g)(3)?

a. Incorrect. An installment sale does trigger suspended losses. However, such losses must be taken ratably over the term of the note.

b. Incorrect. Installment sales are not deemed to be fully taxable dispositions and are subject to special rules.

c. Incorrect. Circumstances may arise that do not constitute a disposition but terminate the application of the passive loss rules to the taxpayer generally or to the taxpayer with respect to a particular activity. However, this example is not one of these circumstances.

d. Correct. Under §469(g)(3), when an activity is disposed of in a transaction in which the gain is reported under the installment sale method, the entire suspended loss attributable to the activity is not triggered all at once. Such losses must be taken ratably over the term of the note. [Chp. 4]

131. Under which circumstance will an activity that was formerly passive be treated differently under §469(f)(1)?

a. Incorrect. When a passive activity is disposed of in a transaction in which the gain is reported under the installment sale method, the entire suspended loss attributable to the activity does not become active under §469(g)(3).

b. Correct. An individual who previously was passive in relation to a trade or business activity that generates net losses may begin materially participating in the activity. While previously suspended losses continue to be treated as passive activity losses, future losses will be non-passive under §469(f)(1).

c. Incorrect. Partnerships are subject to §469 passive loss rules. Thus, this change of ownership, from an individual to a partnership, would not affect the treatment of a passive activity.

d. Incorrect. Under §469(g)(2), a transfer of a taxpayer's interest in an activity on death allows suspended losses to the decedent to the extent they exceed the amount by which the basis of the interest in the activity is increased at death under §1014. [Chp. 4]

132. Suspended losses are those losses that cannot be deducted in the present tax year but may be carried forward to the next tax year. Which of the following corresponds to the treatment of suspended losses from a particular activity?

a. Incorrect. Suspended losses are deductible first against income or gain from passive income and then against net income or gain from all passive activities.

b. Incorrect. Suspended losses do not become nonpassive in later years, but are carried forward as passive losses until there is additional passive income or a fully taxable disposition.

c. Correct. The amount of suspended losses carried forward from a particular activity is determined by the ratio of the net loss from that activity to the aggregate net loss from all passive activities for that year.

d. Incorrect. Suspended losses are converted to realized losses when passive activity income occurs in future tax years or the taxpayer disposes of the entire interest in a passive activity in a fully taxable transaction. [Chp. 4]

133. Under §469, a corporation is a personal service corporation if it meets three conditions. What is one of the conditions that must be met?

a. Correct. A corporation is a personal service corporation if, among other things, employee-owners, in aggregate, own more than 10% of the stock of the corporation.

b. Incorrect. Under §469(a)(2), the passive loss limit applies to any "C" corporation in which more than 50% in value of its outstanding stock was owned (directly or indirectly) by five or fewer individuals at any time during the last half of its taxable year.

c. Incorrect. A corporation is a personal service corporation if, among other things, its principal activity is the performance of personal services.

d. Incorrect. A corporation is a personal service corporation if, among other things, those personal services are "substantially" performed by "employee-owners." [Chp. 4]

134. Section 469 is **not** only concerned with the scope and nature of an activity but also whether it is to be considered separate from or grouped with other activities. For example, under Reg. §1.469-4(e), which activities are treated as separate activities?

a. Incorrect. In the example provided in the course material, Dan had a significant ownership interest in a bakery and a movie theater in both Baltimore and Philadelphia. Depending on other relevant facts and circumstances, he could group the activities into a movie theater activity and a bakery activity, into a Baltimore activity and a Philadelphia activity, or into four separate activities.

b. Correct. Under Reg. §1.469-4(e), an activity involving the rental of *real* property and an activity involving the rental of *personal* property could *not* be treated as a *single* activity.

c. Incorrect. Under Reg. §1.469-4(e), an activity involving the rental of *real* property and an activity involving the rental of personal property provided in connection with the real property could be treated as a *single* activity.

d. Incorrect. Two activities in the same type of business can be grouped if the taxpayer is a limited partner or limited entrepreneur in only one of the two activities and if the facts-and-circumstances test is satisfied. [Chp. 4]

135. Several components are used in the calculation of the alternative minimum tax (AMT). When figuring AMT, which of the following substitutes an item used to compute the regular tax?

a. Incorrect. The deduction of personal exemptions for AMT purposes is prohibited.

b. Incorrect. A tax preference involves the *addition* of the difference between the special AMT treatment and the regular tax treatment.

c. Incorrect. The tentative minimum tax is determined by multiplying AMT taxable income, minus the appropriate exemption amount, by the AMT tax rate. This amount is the tentative minimum tax unless the taxpayer has an AMT foreign tax credit. If the taxpayer has an AMT foreign tax credit, it is subtracted to arrive at the tentative minimum tax.

d. Correct. Adjustments involve a *substitution* of a special AMT treatment of an item for the regular tax treatment. [Chp. 4]

136. Numerous tax preferences and adjustments apply to taxpayers under the alternative minimum tax (AMT). Which of the following applies to all taxpayers subject to the AMT?

a. Incorrect. Circulation expenditures and passive losses are preferences and adjustments for noncorporate taxpayers only.

b. Incorrect. Itemized deductions and state tax refunds are preferences and adjustments for noncorporate taxpayers only.

c. Correct. Long-term contracts and financial institutions' bad debts are tax preferences and adjustments for all taxpayers.

d. Incorrect. Merchant Marine Capital Construction Fund and untaxed book income (pre-1990) are tax preferences and adjustments for corporations only. [Chp. 4]

137. Certain AMT tax preferences and adjustments apply to specific taxpayers. For example, which of the following applies just to noncorporate taxpayers?

a. Incorrect. Adjusted basis of certain property and alternative tax net operating loss deduction are tax preferences and adjustments for all taxpayers subject to the AMT.

b. Incorrect. Earnings & profits and Blue Cross/Blue Shield Deduction are tax preferences and adjustments for only corporations.

c. Correct. Farm losses and research and experimental expenditures are preferences and adjustments for noncorporate only taxpayers.

d. Incorrect. Mining costs and intangible drilling costs are tax preferences and adjustments for all taxpayers subject to the AMT. [Chp. 4]

138. Under the AMT, taxpayers may use the Alternative Depreciation System (ADS) to calculate depreciation for most property. Which of the following assets have a 40-year ADS life?

a. Correct. Most real property has a 40-year ADS life.

b. Incorrect. A 40-year ADS life does exist for certain assets. However, no assets have a 7-year ADS life. Assets in the 7-year MACRS class that have not been specifically assigned an ADS recovery period will revert to their ADR class life.

c. Incorrect. "Qualified technological equipment" has a 5-year ADS life. Note that for ADS, qualified technological equipment is limited to computer or related peripheral equipment, high-technology telephone station equipment installed on the customer's premises, and high-technology medical equipment.

d. Incorrect. Semiconductor manufacturing equipment has a 5-year ADS life. [Chp. 4]

139. The author presents a comparison of the lives of certain assets under the modified accelerated cost recovery system (MACRS) and the lives of those same assets for alternative minimum tax (AMT). For example, what is the life for AMT of office furniture?

a. Incorrect. The life for AMT of automobiles and computers is 5 years.

b. Incorrect. The life for AMT of office equipment other than computers is 6 years.

c. Incorrect. No property listed has a life for AMT of 7 years. However, the MACRS life of office furniture is 7 years.

d. Correct. The life for AMT of office furniture is 10 years. [Chp. 4]

140. A taxpayer, who enters into a long-term contract, must figure alternative minimum taxable income. In making this calculation, what is required of the taxpayer?

a. Incorrect. In computing alternative minimum taxable income, an individual who incurs circulation expenditures is required to amortize such post-1986 expenditures ratably over a three-year period.

b. Correct. In the case of any long-term contract entered into by the taxpayer after February 28, 1986, the taxpayer is required to apply the percentage of completion method (determined using the same percentage of completion as used for purposes of the regular tax) in determining minimum taxable income relating to that contract.

c. Incorrect. Mining exploration and development costs, incurred after 1986, that are expensed (or amortized under §291) for regular tax purposes are required to be recovered through ten-year straight-line amortization for purposes of the alternative minimum tax.

d. Incorrect. In the case of any certified pollution control facility placed in service after 1986, the taxpayer is required to use ADS for minimum tax purposes. [Chp. 4]

141. For purposes of computing alternative minimum taxable income, some items must be amortized. Which post-1986 items must be amortized over a ten-year period?

a. Incorrect. In the case of a transfer of a share of stock pursuant to the exercise of an incentive stock option (as defined in §422A), the amount by which the fair market value of the share at the time of the exercise exceeds the option price (bargain element) is treated as an adjustment.

b. Incorrect. For non-dealer dispositions after 1986, the installment method of reporting gain is allowable in regular tax and AMT.

c. Incorrect. In the case of any certified pollution control facility placed in service after 1986, the taxpayer is required to use ADS for minimum tax purposes.

d. Correct. In computing alternative minimum taxable income, the taxpayer is required to amortize such post-1986 expenditures over a ten-year period. As with certain other items, this treatment applies for all minimum tax purposes, rather than as an annual adjustment to regular taxable income. [Chp. 4]

142. Passive farm losses are generally disallowed for purposes of calculating alternative minimum taxable income. However, which of the following pas-

sive farming activities may be allowed in figuring passive losses for minimum tax purposes?

a. Incorrect. The rules for applying the loss disallowance generally are similar to those for applying the passive loss rule for minimum tax purposes, except that there is no netting between different farming activities.

b. Correct. The only passive farming activities that enter into the passive loss computation (for minimum tax purposes) are those that generate net gain.

c. Incorrect. The gain can then be offset, for minimum tax purposes under the general passive loss rule, against passive losses that are not from farming activities.

d. Incorrect. A passive farm loss is defined as the excess of the taxpayer's loss for the taxable year from any tax shelter farming activity. The term "tax shelter farm activity" means (1) a farming syndicate (as defined in §464(c)), and (2) any other activity consisting of farming which is a passive activity (within the meaning of §469(c)). [Chp. 4]

143. Form 1099-S is used to report sales or exchanges of certain transactions. Which transactions must be reported on this form by the individual accountable for closing the transaction?

a. Incorrect. Non-reportable transactions include any transactions where the transferors are corporate or governmental entities.

b. Incorrect. Non-reportable transactions include gift transactions.

c. Incorrect. Non-reportable transactions include mobile home transactions.

d. Correct. Generally, the person responsible for closing the transaction must report on Form 1099-S sales or exchanges of the stock in a cooperative housing corporation. [Chp. 4]

144. Independent contractors should **not** be confused with employees. Which individual would most likely be deemed in an employment relationship?

a. Incorrect. If the individual believes that they have created a relationship of master and servant, it is likely that it is an employment relationship, rather than that of an independent contractor.

b. Correct. An employee is anyone who performs services that can be controlled by an employer. The existence of the right to control, not necessarily the exercise of control, is critical. Control includes what shall be done and how it shall be done.

c. Incorrect. If the workman supplies instrumentalities, tools, and place of work, he or she is likely to be an independent contractor. If the employer provides them, the individual is likely an employee.

d. Incorrect. If the work is not part of the regular business of the employer, then it is likely the relationship is between a principal and an independent contractor. [Chp. 4]

145. The author lists four categories of individuals who are considered statutory employees for purposes of the Federal Insurance Contribution Act

(FICA) tax, the Federal Unemployment Tax Act (FUTA), and State Unemployment Insurance (SUI). Which of the following is included in this list?

a. Correct. Drivers who deliver food, beverages (other than milk), laundry, or dry-cleaning for someone else are considered statutory employees for FICA, FUTA, and SUI purposes.

b. Incorrect. To be considered an employee for FICA, FUTA, and SUI tax purposes, the statutory employee must not have an investment in facilities used to perform the services.

c. Incorrect. Under §3121(d)(3)(B), a full-time life insurance salesperson is considered a statutory employee for FICA, FUTA, and SUI purposes.

d. Incorrect. Full-time factory machinists are not statutory employees but would be most likely common law employees. [Chp. 4]

146. Section 530(a) of the 1978 Revenue Act provides three conditions whereby the employment tax treatment of an individual as an independent contractor by an employer may be upheld. What is one of these conditions?

a. Incorrect. An employer's treatment of an individual as an independent contractor may be upheld for employment tax purposes if, among other things, all federal tax returns are filed on a consistent basis. The IRS may consider past records, but don't count on it.

b. Incorrect. The '78 Revenue Act does not provide that the treatment will be upheld if it appears as though the employer made a mistake. The IRS will likely make a point that the employer should have known better since he or she is experienced in distinguishing between independent contractors and employees.

c. Correct. An employer's treatment of an individual as an independent contractor may be upheld for employment tax purposes if, among other things, the taxpayer has a reasonable basis for treating the individual as a non-employee.

d. Incorrect. An employer's treatment of an individual as an independent contractor may be upheld for employment tax purposes if, among other things, the taxpayer does not treat the individual as an employee. [Chp. 4]

147. Section 3508 provides that employers may treat certain individuals as non-employees where they pay the individual compensation based on sales rather than number of hours worked. Which of the following workers is covered under this provision?

a. Incorrect. A salesperson who works full-time (except for sideline sales activities) for one firm getting orders from customers is considered a statutory employee for FICA, FUTA, and SUI purposes.

b. Correct. Real estate agents are treated as non-employees if substantially all compensation for services is directly related to sales rather than the number of hours worked. Such services must be performed under a written contract providing that they will not be treated as employees for tax purposes.

c. Incorrect. A statutory employee is treated as an employee for FICA, FUTA, and SUI purposes, by definition.

d. Incorrect. A homeworker who works by the guidelines of the person for whom the work is being done, with materials furnished by and returned to that person or to someone that person designates, is considered a statutory employee for FICA, FUTA, and SUI purposes. [Chp. 4]

148. The regulations (TD 8373) for reporting cash on Form 8300 specify four monetary instruments as being subject to cash reporting rules. Which of the following is a specified monetary instrument under these regulations?

a. Incorrect. A specified monetary instrument is not cash if the instrument represents the proceeds of a bank loan. The recipient may rely on a copy of the loan document or a statement from the bank.

b. Incorrect. The specified monetary instruments do not include business checks even if such checks are certified.

c. Correct. The specified monetary instruments are cashier's checks, bank drafts, traveler's checks, and money orders.

d. Incorrect. Checks are not included in the definition of cash. Thus, the term does not include checks drawn on the personal account of an individual. [Chp. 4]

149. Reg. §1.16050I-1(c)(1)(iii) defines a designated reporting transaction for purposes of cash reporting on Form 8300. Which of the following is excluded from the definition of a designated reporting transaction?

a. Incorrect. A designated reporting transaction is a retail sale of collectibles.

b. Correct. Under TD 8373, a designated reporting transaction is the sale of a consumer durable. A consumer durable is tangible personal property sold for personal consumption or use that is expected to be useful for at least one year under ordinary usage and has a sales price of more than $10,000. A factory machine is not considered a consumer durable under this description and is therefore not a designated reporting transaction on Form 8300.

c. Incorrect. A designated reporting transaction is a retail sale of consumer durables such as automobiles.

d. Incorrect. A designated reporting transaction is a retail sale of travel or entertainment activity, defined as one or more items of travel or entertainment relating to a single trip or event. [Chp. 4]

150. If a taxpayer disagrees with the findings of an IRS examination, he or she may appeal the findings. Where must the taxpayer go to appeal the findings if the additional tax is unpaid?

a. Incorrect. The courts are entirely independent of the IRS. However, the Appeals Office generally reviews a U.S. Tax Court case before the Tax Court hears it.

b. Correct. If the taxpayer has not yet paid the additional tax and disagrees about whether they owe it, a taxpayer must take their case to the Tax Court.

The IRS will mail a formal notice (called a "notice of deficiency") telling the taxpayer that they owe additional tax. Thereafter, the taxpayer ordinarily has 90 days to file a petition with the Tax Court.

c. Incorrect. If the taxpayer has paid the claim, he or she must file a claim for refund. If the IRS either denies the claim or fails to act, the taxpayer may file a suit for refund in the U.S. Court of Federal Claims within six months of the IRS's denial of claim for refunds.

d. Incorrect. If the taxpayer has already paid the disputed tax in full and filed a claim for refund for it that the IRS disallowed (or on which the Service did not take action within 6 months), they may take their case to the U.S. District Court. [Chp. 4]

Glossary

Adjusted gross income (AGI): Total income reduced by allowable adjustments, such as for an IRA, student loan interest, alimony, and Keogh deductions. The AGI is important in determining whether various tax benefits are phased out.

Alternative minimum tax: A tax triggered when certain tax benefits reduce regular income tax below a certain threshold.

Annuity: An annual payment of money by a company or individual to a person called an annuitant.

Bankruptcy: Typically, a formal petition filed in Bankruptcy Court under Chapters 7, 11, or 13.

Capital asset: Property listed in §1221.

Community property: Property or income of a married couple, living in a community property state, which is considered to belong equally to each spouse.

Deferred compensation: Funds held by an employer or put into an account for distribution to the employee at a later date. Deferred compensation is normally taxed when received or upon the removal of certain conditions.

Earned income: Income from personal services as compared to income generated from property or other sources. It includes wages, salaries, tips, and self-employment earnings.

Expensing: A reference to §179 expense deduction.

FIFO: An acronym for "first-in, first-out."

Filing status: Determines the rate at which income is taxed. The five filing statuses are: single, married filing a joint return, married filing a separate return, head of household, and qualifying widow(er) with a dependent child.

Foreclosure: A legal procedure upon the fault on a mortgage to invest title in the mortgagee.

Gross income: Money, goods, services, and property a person receives that must be reported on a tax return. Includes unemployment compensation and certain scholarships. It does not include welfare benefits and nontaxable Social Security benefits.

Head of household: Head of household is a federal income tax filing status available to unmarried taxpayers that can claim a dependent as a "qualifying child" or qualifying relative."

Improvement: Expenditure for the correction of the defect in property that extends its useful life or improves its value. Unlike some repairs, improvements cannot be deducted by the taxpayer.

Individual Retirement Arrangement (IRA): A type of individual retirement arrangement using a funding arrangement of a trust or a custodial account.

Keogh plans: A form of qualified pension or profit-sharing plan for self-employed individuals.

LIFO: An acronym for "last in, first-out."

Like-kind exchange: a reciprocal transfer of property without the substantial interjection of cash.

MACRS: An acronym for "Modified Accelerator Cost Recovery System."

Net operating loss: A business loss that exceeds current income and may be carried back against income of prior years or carried forward as a deduction against future income.

OCONUS: Acronym for "outside the continental United States."

Passive activity: An activity in which the taxpayer does not materially participate.

Placed in service: When property is available for use.

Qualified child: A qualifying child meets the relationship, age, and residency tests. A person can be claimed as a qualifying child on one tax return only.

QDRO: Acronym for "qualified domestic relations order."

Recapture: The forced recovery of depreciation taken as ordinary income.

Repossession: The taking back of property by a lender from a borrower or buyer.

S corporation: A particular type of corporation established under the Code that is taxed like but not as a partnership.

Standard deduction: Reduces the income subject to tax and varies depending on filing status, age, blindness, and dependency.

Tangible assets: Equipment, buildings, and other physical assets which are not intangible.

Tax year: The calendar, fiscal, or hybrid year adopted by the taxpayer or required by tax law for determining annual income.

Unemployment compensation: Funds received under federal or state law to compensate for unemployment. Unemployment compensation is now taxable.

Unrelated business taxable income: Non-exempt income of an exempt organization.

Vested benefits: Retirement plan benefits owned by the taxpayer.

Working condition fringe benefit: A working-condition fringe benefit is any property or service provided to an employee by an employer to the extent that the cost of such property or service would have been deductible by the employee as a business expense.

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