CONTINUING EDUCATION

INCOME TAX FOR INDIVIDUALS

24 CPE Hours

Course 3105

sequoia CPE

SELF-STUDY ONLINE

INCOME TAX FOR INDIVIDUALS
(COURSE #3105M)

COURSE DESCRIPTION

This course provides a general overview of federal income tax laws for individuals. It explains who must file, which tax forms to use, when the return is due, and other general information. It will provide guidance on which filing status can be used and whether the income received is taxable. The course also explains the standard deduction, the kinds of expenses that can be deducted, and the various credits that are available to reduce the total tax due.

LEARNING ASSIGNMENTS AND OBJECTIVES

As a result of studying each assignment, you should be able to meet the objectives listed below each individual assignment.

ASSIGNMENT 1: SUBJECT

Introduction

Study the course materials from pages 1 to 10

Complete the review questions at the end of the Introduction

Answer the exam questions 1 to 6

Objectives:

- To recall important tax changes to be used for 2024 tax returns

ASSIGNMENT 2: SUBJECT

PART ONE: THE INCOME TAX RETURN

Filing Information

Filing Status

Dependents

Estimated Tax

Study the course materials from pages 11 to 34

Complete the review questions at the end of each chapter

Answer the exam questions 7 to 13

Objectives:

- To recognize the length of the automatic extension provided by filing Form 4868
- To recognize the various filing statuses and who is eligible to use them
- To recall the various requirements for a qualifying relative
- To identify the purpose of estimated taxes

ASSIGNMENT 3: **SUBJECT**

PART TWO: INCOME

Wages, Salaries, and Other Earnings

Tip Income

Interest Income

Dividends and Other Corporate Distributions

Rental Income and Expenses

Retirement Plans, Pensions, and Annuities

Social Security and Equivalent Railroad Retirement Benefits

Other Income

Study the course materials for pages 35 to 140

Complete the review questions at the end of each chapter

Answer the exam questions 14 to 35

Objectives:

- To recall what types of compensation are included as income for tax purposes
- To recognize what tips should be included in income for tax purposes
- To recall the proper tax treatment for various types of interest
- To identify the proper treatment of various types of dividends
- To recognize the proper treatment of rental property income and expenses for tax purposes
- To identify various requirements regarding retirement plan taxation
- To recognize key taxation thresholds related to social security income
- To identify the taxability of various types of other income

ASSIGNMENT 4: **SUBJECT**

PART THREE: GAINS AND LOSSES

Basis of Property

Sale of Property

Selling Your Home

Reporting Gains and Losses

Study the course materials from pages 141 to 192

Complete the review questions at the end of each chapter

Answer the exam questions 36 to 50

Objectives:

- To identify the factors to consider in calculating the basis of property
- To recognize the taxability of the sale of personal use property
- To identify the special tax rules related to selling your home
- To recall the capital gain rates for the current year

ASSIGNMENT 5: SUBJECT

PART FOUR: ADJUSTMENTS TO INCOME

Individual Retirement Arrangements (IRAs)

Alimony

Education-Related Adjustments

Other Adjustments to Income

Study the course materials for pages 193 to 296

Complete the review questions at the end of each chapter

Answer the exam questions 51 to 73

Objectives:

- To recall the thresholds, requirements, and additional taxes related to individual retirement arrangements
- To recognize what is and is not alimony
- To identify education-related adjustments that can be made to income
- To identify what business-related expenses associated with travel, transportation, and gifts are deductible

ASSIGNMENT 6: SUBJECT

PART FIVE: STANDARD DEDUCTION AND ITEMIZED DEDUCTIONS

Standard Deduction

Medical and Dental Expenses

Taxes

Interest Expense

Contributions

Nonbusiness Casualty and Theft Losses

Other Itemized Deductions

Section 199A Pass-Through Income Deduction

Study the course materials for pages 297 to 462

Complete the review questions at the end of this chapter

Answer the exam questions 74 to 102

Objectives:

- To recall the standard deduction amounts for the current year

- To recognize the deductibility characteristics of medical and dental expenses
- To recognize what taxes you can deduct if you itemize deductions
- To recall what types of interest you can and cannot deduct
- To recall the types of charitable contributions you can deduct and the records you should keep
- To recall the tax treatment of personal casualty and theft losses
- To identify types of other itemized deductions allowable to reduce adjusted gross income
- To identify the rules in the TCJA related to claiming a deduction for "qualified business income"

ASSIGNMENT 7: **SUBJECT**

PART SIX: FIGURING YOUR TAXES AND CREDITS

How to Figure Your Tax

Tax on Unearned Income of Certain Children

Child and Dependent Care Credit

Credit for the Elderly or the Disabled

Child Tax Credit/Credit for Other Dependents

Education Credits

Earned Income Credit

Premium Tax Credit

Other Credits

Study the course materials from pages 463 to 544

Complete the review questions at the end of each chapter

Answer the exam questions 103 to 120

Objectives:

- To recognize various alternative minimum tax adjustments and preference items
- To recall the rules related to the tax on unearned income of certain children
- To recall how to figure the child and dependent care credit
- To identify who qualifies to take the credit for the elderly or disabled
- To recall the limits of the child tax credit
- To identify the requirements for and benefits of the American opportunity credit and the lifetime learning credit
- To recall the limit of investment income to qualify for the earned income credit
- To recognize who is eligible to claim the premium tax credit
- To identify various nonrefundable and refundable credits available for income tax purposes

ASSIGNMENT 8:

Complete the Online Exam

NOTICE

This course is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional advice and assumes no liability whatsoever in connection with its use. Since laws are constantly changing, and are subject to differing interpretations, we urge you to do additional research and consult appropriate experts before relying on the information contained in this course to render professional advice.

Program publication date **11/13/2024**

EXAM OUTLINE

- **TEST FORMAT:** The final exam for this course consists of 120 multiple-choice questions and is based specifically on the information covered in the course materials.

- **ACCESS FINAL EXAM:** Log in to your account and click Take Exam. A copy of the final exam is provided at the end of these course materials for your convenience, however you must submit your answers online to receive credit for the course.

- **LICENSE RENEWAL INFORMATION:** This course (#3105M) qualifies for **24** CPE hours.

- **PROCESSING:** You will receive the score for your final exam immediately after it is submitted. A score of 70% or better is required to pass.

- **CERTIFICATE OF COMPLETION:** Will be available in your account to view online or print. If you do not pass an exam, it can be retaken free of charge.

ENJOY YOUR COURSE

TABLE OF CONTENTS

Note: All references to IRS forms and line numbers throughout this course are based on prior year or draft forms available from the IRS in late 2024. There is a possibility some of these references will change.

INTRODUCTION

Chapter Objective

After completing this chapter, you should be able to:

- Recall important tax changes to be used for 2024 tax returns.

Note

Many of the changes/provisions affecting 2024 are from the Tax Cuts and Jobs Act of 2017 (TCJA) and the usual inflation adjustments. Subsequent to the TCJA, the SECURE Act of 2019, the American Rescue Plan Act, the Further Consolidated Appropriations Act of 2021, the Inflation Reduction Act, and the SECURE Act 2.0 were passed and include key provisions that continue to affect taxes in 2024. These changes are summarized here and also noted throughout the course.

This course is a general overview of federal income tax laws for individuals filing 2024 tax returns. The course begins with the rules for filing a tax return. The course explains who must file a return, which tax forms to use, when the return is due, and other general information. It will help identify which filing status your clients qualify for and whether the income they are receiving is taxable. The course goes on to explain the standard deduction, the kinds of expenses they may be able to deduct, and the various kinds of credits they may be able to take to reduce their tax.

Throughout the course are examples showing how the tax law applies in typical situations. Sample forms and schedules show how to report certain items on tax returns. Also, throughout the course are flowcharts and tables that present tax information in an easy-to-understand manner.

We start with a section on important tax changes.

I. IMPORTANT TAX CHANGES/PROVISIONS FOR 2024

- **Individual tax rates are set at 0%, 10%, 12%, 22%, 24%, 32%, 35%, and 37%.**

- **Increase of the standard deduction** to $14,600 and $29,200 for individuals and married couples filing jointly, respectively (2024).

  Elderly and/or blind taxpayers receive an additional standard deduction amount added to the basic standard deduction. The additional standard deduction for a blind taxpayer—a taxpayer whose vision is less than 20/200—and for a taxpayer who is age 65 or older at the end of the year is:

    - $1,550 for married individuals; and
    - $1,950 for singles and heads of household.

  The additional standard deduction for taxpayers who are both age 65 or older at year-end and blind is double the additional amount for a taxpayer who is blind (but not age 65 or older) or age 65 (but not blind). For example, a 65 year-old single blind taxpayer would add $3,900 to his or her usual standard deduction: $1,950 for being age 65 plus $1,950 for being blind ($1,950 x 2 = $3,900). Thus, his or her standard deduction would be $18,500 ($14,600 + $3,900 = $18,500).

- **Personal exemptions are eliminated for 2018-2025.**
- **Write off of state and local taxes are restricted to $10,000.**
- **Many itemized deductions are eliminated.** The tax law eliminates itemized deductions for:
    - Unreimbursed employee expenses, such as mileage (previously deductible to the extent they exceeded 2% of adjusted gross income)
    - Tax preparation expenses
    - Alimony payments (see details)
    - Investment expenses
    - Miscellaneous itemized deductions
    - Moving expenses to move to a new job, and
    - Personal casualty losses (except for losses associated with special disaster relief legislation).
- **Charitable contributions.** People who itemize are allowed to deduct cash contributions up to 60% of their adjusted gross income, instead of 50% under prior law.
- **The mortgage interest deduction.**
    - For all homeowners with existing mortgages at 12/17/2017 that were taken out to buy a home, there is no change to the prior mortgage interest deduction.
    - For homeowners with new mortgages after 12/17/2017 on a first or second home, the home mortgage interest deduction is available for up to $750,000 of mortgage debt.
- **Medical bills.** Medical expenses can be deducted in 2024 for medical expenses exceeding 7.5 percent of adjusted gross income.
- **Alimony - Post 2018 Divorce Agreements.** Under the tax code before TCJA passage, alimony (but **not** child support) was deductible by the payer and included in the income of the recipient for tax purposes. Under the TCJA, that tax treatment continues only for

alimony payments made pursuant to a divorce or separation agreement entered into on or before December 31, 2018.

However, under TCJA, §11051 as of January 1, 2019, alimony payments are no longer tax deductible to the payer or includible in the income of the recipient if made under:

a) A divorce or separation agreement entered into after December 31, 2018; or

b) A divorce or separation agreement entered into on or before December 31, 2018 but modified after that date if the modified agreement specifically provides that the provisions of the Tax Cuts and Jobs Act of 2017 will apply.

Alimony payments made under a divorce or separation agreement entered into on or before December 31, 2018 but paid after that date—with the exception of such payments made under a modified agreement described in b) above—will continue to be tax deductible to the payer and includible in the income of the recipient.

- **Adjusted estate taxes.** Estates worth up to $13.61 million per person are exempt from the federal estate tax in 2024. This means that married couples with estates worth up to $27.22 million will not be affected by the federal estate tax. These numbers are increased for inflation each year.
- **The corporate tax rate was lowered to 21% (beginning January 1, 2018)**.
- **Section 199A. 20% tax deduction that applies to the first $383,900 (2024) of joint income** earned by all businesses organized as S corporations, partnerships, LLCs, and sole proprietorships. See detailed rules for income above this amount in chapter 28.
- **Rental Real Estate Safe Harbor for § 199A.** As discussed in Notice 2019-07, a safe harbor is available to individuals and owners of pass through entities. Under the safe harbor, a rental real estate enterprise will be treated as a trade or business for purposes of the QBI deduction. Taxpayers may still treat rental real estate that does not meet the requirements of the safe harbor as a trade or business for purposes of the QBI deduction if it is a section 162 trade or business.

  Solely for the purposes of section 199A, a rental real estate enterprise will be treated as a trade or business if the following requirements are satisfied during the taxable year with respect to the rental real estate enterprise:

  (A) Separate books and records are maintained to reflect income and expenses for each rental real estate enterprise;

  (B) For taxable years beginning prior to January 1, 2023, 250 or more hours of rental services are performed per year with respect to the rental enterprise. For taxable years beginning after December 31, 2022, in any three of the five consecutive taxable years that end with the taxable year (or in each year for an enterprise held for less than five years), 250 or more hours of rental services are performed per year with respect to the rental real estate enterprise; and

(C) The taxpayer maintains contemporaneous records, including time reports, logs, or similar documents, regarding –

(i) hours of all services performed;

(ii) description of all services performed;

(iii) dates on which such services were performed; and

(iv) who performed the services.

The records must be made available for inspection at the request of the IRS. The contemporaneous records requirement did not apply to taxable years beginning prior to January 1, 2019.

- **Increase to Section 179 expensing.** The Section 179 maximum annual deduction limit is increased to $1,220,000, and increases the phase-out threshold to $3,050,000 in tax year 2024.
- **Decrease of bonus depreciation percentage.** Decreases to 60% the first-year bonus depreciation percentage (from the prior 80% rate) for long-term assets placed in service in 2024. Bonus depreciation is allowed to be used for purchases of used property, as well as new property.
- **Computers are no longer listed property.** Computers are not classified as listed property in tax year 2024.
- **Elimination of entertainment and meals deduction.** Deductions for entertainment expenses are eliminated for tax year 2024. Businesses may still deduct 50% of the cost of food consumed by employees during work or travel.

Note

IRS Notice 2018-76, issued in October 2018, indicates that meals provided during an entertainment event fall under the meals deduction limit, and are not considered to be entertainment expenses.

- **Increase of business vehicle depreciation limits for 2024.** The allowable depreciation limits for certain passenger automobiles are increased to: $12,400 for the first year in which the vehicle was placed in service, $19,800 for the second year, $11,900 for the third year, and $7,160 for the fourth and later years in the recovery period.

  If a taxpayer claims 60% bonus depreciation, the greatest allowable passenger automobile depreciation is:

  - $20,400 for the first year;

- $19,800 for the second year;
- $11,900 for the third year; and
- $7,160 for each later taxable year in the recovery period.

- **Business use of a taxpayer's personal vehicle.** Taxpayers may no longer deduct unreimbursed employee expenses—including unreimbursed expenses related to business use of a personal vehicle—as "miscellaneous itemized deductions" to the extent the total of such expenses exceeds 2% of his or her AGI.

  However, the 2024 alternative standard mileage rate applicable to ***eligible*** business use of a vehicle is 67.0 cents per mile.

- **Use of a personal vehicle for charitable purposes remains at 14 cents per mile.**

- **Use of a taxpayer's personal vehicle to move.** Many taxpayers change their residence each year, and many of those taxpayer relocations involve new jobs. Prior law permitted a taxpayer to deduct moving expenses by car, provided the new location was at least 50 miles farther from the taxpayer's former home than the former main job location. The moving expense deduction has been suspended and has made the moving expense reimbursement taxable income.

- **Alternative minimum tax exemption amount increased.** The tax code provides for an AMTI exemption for purposes of determining the alternative minimum tax amount. The amount of the AMTI exemption varies according to the taxpayer's filing status and the tax year. The applicable AMTI exemption amounts for 2024 are as follows:

Filing Status	Phaseout of Exemption Amount	Alternative Minimum Taxable Income Exemption*
Single or Head of Household	$609,350	$85,700
Married Filing Jointly & Qualifying Surviving Spouse	$1,218,700	$133,300
Married Filing Separately	$609,350	$66,650

**The AMTI exemption amounts are indexed for inflation.*

The AMTI exemption amount is reduced (but not below zero) by 25 percent of the amount by which the taxpayer's alternative minimum taxable income exceeds:

- $1,218,700 for taxpayers whose filing status is "married filing jointly" or "qualifying surviving spouse"; and

- $609,350 for taxpayers whose filing status is "single," "head of household," and "married filing separately."

- **Limitation on itemized deductions.** The TCJA suspended the phase-out of itemized deductions for 2018 through 2025. Accordingly, itemized deductions are unlimited regardless of the taxpayer's income.

- **Maximum capital gain/dividend tax rate.** High-income taxpayers are subject to higher capital gain and qualified dividend tax rates. For tax years beginning in 2024, the long-term capital gain and qualified dividend tax rate is 20% for married taxpayers filing jointly whose taxable income exceeds $583,750 and for singles whose taxable income exceeds $518,900. For taxpayers in lower income tax brackets:

- The 0% rate applies to –
    - Single filers with income up to $47,025,
    - Joint filers with income up to $94,050; and
- The 15% rate applies to –
    - Single filers with income between $47,025 and $518,900, and
    - Joint filers with income between $94,050 and $583,750.

II. SUMMARY OF THE TAX CUTS AND JOBS ACT OF 2017

The Tax Cuts and Jobs Act of 2017 (the Act)—legislation generally effective for years beginning after 12/31/17 and before 1/1/26—made changes to both individual and corporate taxation. The more significant tax changes impacting individual tax preparation and planning made by the Act include:

- Revising individual tax rates downward;
- Eliminating personal exemptions;
- Increasing the AMT exemption and the income at which AMT exemption phaseout occurs;
- Increasing the standard deduction;
- Limiting the deduction for state and local taxes;
- Reducing the mortgage debt on which mortgage interest is deductible;
- Eliminating the equity debt interest deduction except for interest on loans used to buy, build or substantially improve the home that secures the loan;
- Increasing the limit on the deductibility of charitable cash contributions;
- Eliminating miscellaneous itemized deductions subject to 2% of AGI limit;
- Eliminating the moving expense deduction/exclusion for other than military;
- Eliminating the deduction for alimony payments made and the inclusion in income of alimony payments received for agreements after 12/31/2018;

- Eliminating the phaseout of itemized deductions for higher income taxpayers;
- Increasing the Child Tax Credit and making part of the credit refundable;
- Broadening the definition of eligible education expenses under §529 College Savings Plans to include limited annual tax-free distributions for elementary and secondary school tuition;
- Eliminating the recharacterization of traditional-to-Roth IRA conversions;
- Eliminating the individual mandate penalty for failing to maintain health coverage beginning in 2019; and
- Increasing the estate and gift tax exemption.

III. SECURE ACT OF 2019

The SECURE Act of 2019 was signed into law on December 20, 2019. Key provisions of the Act include the following:

- Removes the maximum age limits on retired contributions, formerly capped at age 70½.
- Raises the required minimum distribution age from 70½ to 72. However, the age limit for RMDs was raised again to 73 by the SECURE Act 2.0, discussed later.
- Allows penalty-free withdrawals of up to $5,000 from retirement plans for the birth or adoption of a child.

IV. SUMMARY OF THE FURTHER CONSOLIDATED APPROPRIATIONS ACT OF 2021

The Further Consolidated Appropriations Act of 2021 was signed into law on December 27, 2020.

Included below are some of the most important tax changes, extenders, and other provisions signed into law and extended through the end of 2023 and in some situations, even later:

- Makes the 7.5% of AGI limitation for the medical expense deduction permanent for all tax years beginning after December 31, 2020.
- Eliminated the tuition and fees deduction.
- Increased the modified AGI limitation for the lifetime learning credit to equal that of the American opportunity credit for tax years beginning after December 31, 2020. Phase-out ranges for both credits are $160,000 to $180,000 for married filing joint, and $80,000 to $90,000 for all other taxpayers.
- Extended the cancellation of qualified principal residence indebtedness exclusion from gross income through the end of 2025.
- Extended the residential energy efficient property credit through the end of 2023.

V. SUMMARY OF THE AMERICAN RESCUE PLAN ACT OF 2021

The American Rescue Plan Act of 2021 was signed into law on March 11, 2021.

Included below are some of the most important tax changes, extenders, and other provisions signed into law and extended through the end of 2022:

- Temporarily increased the maximum exclusion for the dependent care assistance program to $10,500 (from $5,000) for 2021, but reverts to $5,000 for 2022 and beyond.
- For 2021 through 2025, any discharge of student loan debt for any reason may be excluded from taxable income, as long as there is no provision for the student to provide services to the discharging lender.
- The premium tax credit (PTC) is a refundable credit designed to subsidize the purchase of health insurance through an exchange. The PTC is based on a sliding scale. The PTC amount is determined based on the percentage of income the cost of premiums represents. For tax years 2021 and 2022, an individual with household income at 300% of the federal poverty line (FPL) pays 6% of his or her household income for the cost of health insurance after receiving the credit. These percentages are indexed to the excess of premium growth over income growth for the preceding calendar year.

The reduction of the percentage amounts under the ARP applied for tax years beginning in 2021 and 2022. For 2023 and beyond, the percentages reverted to the 2020 amounts as adjusted for inflation.

VI. INFLATION REDUCTION ACT

The Inflation Reduction Act was signed into law on August 16, 2022 and provides tax credits for energy efficient home improvements and the purchase of electric vehicles, which took effect in 2023.

VII. SECURE ACT 2.0

The SECURE Act 2.0 was signed into law on December 29, 2022. The Act builds on the SECURE Act of 2019. The three goals of the Act are to increase individual retirement savings, simplify and clarify the retirement plan rules, and lower the employer cost of setting up a retirement plan.

Key provisions of the Act that impact 2023 and beyond include the following:

- Increases the age for required minimum distributions for retirement plans from 72 to 73. Individuals who had not reached the age of 72 prior to January 1, 2023 are not required to take RMDs until April 1, 2025.
- Reduces the penalty for failure to take required minimum distributions from 50% to 25%. Further, if a failure to take a required minimum distribution from an IRA is corrected in a timely manner (within 2 years) the penalty is further reduced from 25% to 10%.

INTRODUCTION: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1.	**What is the highest individual tax rate in 2024:** **A.** 21% **B.** 25% **C.** 37% **D.** 39.5%
2.	**Which of the following deductions have been eliminated:** **A.** miscellaneous itemized deductions **B.** personal casualty losses **C.** moving expenses to move to a new job **D.** all of the above
3.	**For 2024, what medical expenses can be deducted:** **A.** none **B.** those greater than 7.5% of the taxpayer's adjusted gross income **C.** those greater than 10% of the taxpayer's adjusted gross income **D.** 100%

INTRODUCTION: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. Twenty-one percent is the maximum tax rate for corporations. **B.** Incorrect. The highest rate is greater than 25%. **C.** **CORRECT**. The TCJA reduced the top rate down to 37%. **D.** Incorrect. The top rate in 2017 was 39.5%, but this was lowered by the TCJA. *(See page 1 of the course material.)*
2.	**A.** Incorrect. The TCJA eliminated several itemized deductions, including miscellaneous itemized deductions. However, this is not the best answer. **B.** Incorrect. Personal casualty loss deductions, other than those associated with special disaster relief legislation, have been eliminated by the TCJA, but this is not the best answer. **C.** Incorrect. The deduction for moving expenses to a new job for most employees has been eliminated by the TCJA, but this is not the best answer. **D.** **CORRECT**. All of the responses are included in the list of deductions that were eliminated by the TCJA. *(See page 2 of the course material.)*
3.	**A.** Incorrect. Medical expenses are still at least partly deductible. **B.** **CORRECT**. For 2024, medical expenses that exceed 7.5% of a taxpayer's adjusted gross income can be deducted. **C.** Incorrect. Beginning with the year 2021, the limit on deductible medical expenses was permanently adjusted by the Further Consolidated Appropriations Act of 2021 to those expenses greater than 7.5% of the taxpayer's adjusted gross income. **D.** Incorrect. Not all of medical expenses incurred are deductible. *(See page 2 of the course material.)*

PART ONE: THE INCOME TAX RETURN

The four chapters in this part provide basic information on the tax system.

CHAPTER 1: FILING INFORMATION

Chapter Objective

After completing this chapter, you should be able to:

- Recognize the length of the automatic extension provided by filing Form 4868.

I. IMPORTANT REMINDERS

Who must file. Generally, the amount of income you can receive before you must file a return has been increased. See Table 1-1 for the specific amounts.

Installment agreement. If you cannot pay the full amount due with your return, you may ask to make monthly installment payments.

Automatic 6-month extension. Form 4868, *Application for Automatic Extension of Time to File U.S. Individual Income Tax Return*, provides for an automatic 6-month extension. When you file Form 4868, you will get an automatic extension to file for 6 months.

Service in combat zone. You are allowed extra time to take care of your tax matters if you are a member of the Armed Forces who served in a combat zone, or if you served in the combat zone in support of the Armed Forces.

Adoption taxpayer identification number. If a child has been placed in your home for purposes of legal adoption and you will not be able to get a social security number for the child in time to file your return, you may be able to get an adoption taxpayer identification number (ATIN).

Taxpayer identification number for aliens. If you or your dependent is a nonresident or resident alien who does not have and is not eligible to get a social security number, file Form W-7 with the IRS to apply for an Individual Taxpayer Identification Number (ITIN).

II. INTRODUCTION

Table 1-1 summarizes the key filing requirements.

TABLE 1-1. 2024 FILING REQUIREMENTS FOR MOST TAXPAYERS

IF your filing status is…	AND at the end of 2024 you were…*	THEN file a return if your gross income was at least…**
single	under 65	$14,600
	65 or older	$16,550
married filing jointly***	under 65 (both spouses)	$29,200
	65 or older (one spouse)	$30,750
	65 or older (both spouses)	$32,300
married filing separately	any age	$5
head of household	under 65	$21,900
	65 or older	$23,850
qualifying surviving spouse	under 65	$29,200
	65 or older	$30,750

** If you were born on January 1, 1960, you are considered to be age 65 at the end of 2024.*

*** Gross income means all income you received in the form of money, goods, property, and services that is not exempt from tax, including any income from sources outside the United States (even if you may exclude part or all of it). Do not include social security benefits unless (a) you are married filing a separate return and you lived with your spouse at any time during 2024, or (b) one-half of your social security benefits plus your other gross income is more than $25,000 ($32,000 if married filing jointly). If (a) or (b) applies, see the Instructions for Form 1040 to figure the taxable part of social security benefits you must include in gross income. Gross income includes gains, but not losses, reported on Form 8949 or Schedule D. Gross income from a business means, for example, the amount on Schedule C, line 7, or Schedule F, line 9. But, in figuring gross income, do not reduce your income by any losses, including any loss on Schedule C, line 7, or Schedule F, line 9.*

**** If you did not live with your spouse at the end of 2024 (or on the date your spouse died) and your gross income was at least $5, you must file a return regardless of your age.*

CERTAIN CHILDREN UNDER AGE 19 OR FULL-TIME STUDENTS

If a child's only income is interest and dividends (including capital gain distributions and Alaska Permanent Fund dividends), the child was under age 19 at the end of 2024 or was a full-time student under age 24 at the end of 2024, and certain other conditions are met, a parent can elect to include the child's income on the parent's return. If this election is made, the child does not have to file a return. See *Parent's Election To Report Child's Interest and Dividends* in chapter 30.

CHAPTER 1: TEST YOUR KNOWLEDGE

The following question is designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). It is included as an additional tool to enhance your learning experience and does not need to be submitted in order to receive CPE credit.

We recommend that you answer the question and then compare your response to the suggested solution on the following page before answering the final exam question(s) related to this chapter (assignment).

1.	**If your filing status is married filing jointly, and at the end of 2024 both you and your spouse were under age 65, then you need to file a return if your gross income was at least how much:** **A.** $14,600 **B.** $29,200 **C.** $30,750 **D.** $32,300

CHAPTER 1: SOLUTION AND SUGGESTED RESPONSES

Below is the solution and suggested responses for the question on the previous page. If you choose an incorrect answer, you should review the page(s) as indicated for the question to ensure comprehension of the material.

1.	**A.** Incorrect. If your filing status is single, and at the end of 2024 you were under 65, then you need to file a return if your gross income was at least $14,600. **B.** **CORRECT**. If your filing status is married filing jointly, and at the end of 2024 both spouses were under 65, then you need to file a return if your gross income was at least $29,200. **C.** Incorrect. If your filing status is married filing jointly, and at the end of 2024 one spouse was 65 or older, then you need to file a return if your gross income was at least $30,750. **D.** Incorrect. If your filing status is married filing jointly, and at the end of 2024 both spouses were 65 or older, then you need to file a return if your gross income was at least $32,300. *(See page 14 of the course material.)*

CHAPTER 2: FILING STATUS

Chapter Objective

After completing this chapter, you should be able to:

- Recognize the various filing statuses and who is eligible to use them.

I. INTRODUCTION

This chapter helps you determine which filing status to use. There are five filing statuses:

- Single,
- Married Filing Jointly,
- Married Filing Separately,
- Head of Household, and
- Qualifying Surviving Spouse.

Tip

If more than one filing status applies to you, choose the one that will give you the lowest tax.

You must determine your filing status before you can determine your filing requirements (chapter 1), your standard deduction (chapter 21), and your tax (chapter 29). You also use your filing status in determining whether you are eligible to claim certain deductions and credits.

II. MARITAL STATUS

In general, your filing status depends on whether you are considered unmarried or married.

Unmarried persons. You are considered unmarried for the whole year if, on the last day of your tax year, you are either unmarried or legally separated from your spouse under a divorce or a separate maintenance decree. State law governs whether you are married or legally separated under a divorce or separate maintenance decree.

Divorced persons. If you are divorced under a final decree by the last day of the year, you are considered unmarried for the whole year.

Divorce and remarriage. If you obtain a divorce in one year for the sole purpose of filing tax returns as unmarried individuals, and at the time of divorce you intended to and do, in fact, remarry each other in the next tax year, you and your spouse must file as married individuals in both years.

Annulled marriages. If you obtain a court decree of annulment, which holds that no valid marriage ever existed, you are considered unmarried even if you filed joint returns for earlier years. You must file amended returns (Form 1040-X, *Amended U.S. Individual Income Tax Return*) 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. Generally, for a credit or refund, you must file Form 1040-X within 3 years (including extensions) after the date you filed your original return or within 2 years after the date you paid the tax, whichever is later. If you filed your original return early (for example, March 1), your return is considered filed on the due date (generally April 15). However, if you had an extension to file (for example, until October 15) but you filed earlier and we received it on July 1, your return is considered filed on July 1.

Head of household or qualifying surviving spouse. If you are considered unmarried, you may be able to file as a head of household or as a qualifying surviving spouse. See *Head of Household and Qualifying Surviving Spouse* to see if you qualify.

Married persons. If you are considered married for the whole year, you and your spouse can file a joint return, or you can file separate returns.

Considered married. You are considered married for the whole year, if on the last day of your tax year, you and your spouse meet any one of the following tests.

1. You are married and living together.
2. You are living together in a common law marriage that is recognized in the state where you now live or in the state where the common law marriage began.
3. You are married and living apart, but not legally separated under a decree of divorce or separate maintenance.
4. You are separated under an interlocutory (not final) decree of divorce.

Spouse died during the year. If your spouse died during the year, you are considered married for the whole year for filing status purposes. If you did not remarry before the end of the tax year, you can file a joint return for yourself and your deceased spouse. For the next 2 years, you may be entitled to the special benefits described later under *Qualifying Surviving Spouse*. If you remarried before the end of the tax year, you can file a joint return with your new spouse. Your deceased spouse's filing status is married filing separately for that year.

Married persons living apart. If you live apart from your spouse and meet certain tests, you may be able to file as head of household even though you are not divorced or legally separated. If you qualify to file as head of household instead of as married filing separately, your standard deduction will be higher. Also, your tax may be lower, and you may be able to claim the earned income credit. See *Head of Household*, later.

III. SINGLE

Your filing status is single if you are considered unmarried and you do not qualify for another filing status. To determine your marital status on the last day of the year, see *Marital Status*, earlier.

Your filing status may be single if your spouse died before January 1, 2024, and did not remarry in 2024. However, you might be able to use another filing status that will give you a lower tax. See *Head of Household* and *Qualifying Surviving Spouse* to see if you qualify.

How to file. On Form 1040 or 1040-SR, check the “Single” box at the top of the form.

IV. MARRIED FILING JOINTLY

You can choose married filing jointly as your filing status if you are considered married and both you and your spouse agree to file a joint return. On a joint return, you and your spouse report your combined income and deduct your combined allowable expenses. You can file a joint return even if one of you had no income or deductions.

If you and your spouse decide to file a joint return, your tax may be lower than your combined tax for the other filing statuses. Also, your standard deduction (if you do not itemize deductions) may be higher, and you may qualify for tax benefits that do not apply to other filing statuses.

How to file. On Form 1040 or 1040-SR, check the “Married filing jointly” box at the top of the form.

Spouse died during the year. If your spouse died during the year, you are considered married for the whole year and can choose married filing jointly as your filing status. See *Spouse died during the year*, earlier, for more information.

If your spouse died in 2025 before filing a 2024 return, you can choose married filing jointly as your filing status on your 2024 return.

Divorced persons. If you are divorced under a final decree by the last day of the year, you are considered unmarried for the whole year and you cannot choose married filing jointly as your filing status.

FILING A JOINT RETURN

Both you and your spouse must include all of your income, exemptions, and deductions on your joint return.

Joint responsibility. Both of you may be held responsible, jointly and individually, for the tax and any interest or penalty due on your joint return. This means that if one spouse does not pay the tax due, the other may have to. Or, if one spouse does not report the correct tax, both spouses may be responsible for any additional taxes assessed by the IRS. One spouse may be held responsible for all the tax due even if all the income was earned by the other spouse.

You may want to file separately if:

- You believe your spouse is not reporting all of his or her income, or
- You do not want to be responsible for any taxes due if your spouse does not have enough tax withheld or does not pay enough estimated tax.

Divorced taxpayer. You may be held jointly and individually responsible for any tax, interest, and penalties due on a joint return filed before your divorce. This responsibility may apply even if your divorce decree states that your former spouse will be responsible for any amounts due on previously filed joint returns.

Relief from joint liability. In some cases, one spouse may be relieved of joint liability for tax, interest, and penalties on a joint return for items of the other spouse that were incorrectly reported on the joint return. You can ask for relief no matter how small the liability. There are three types of relief available.

1. Innocent spouse relief.
2. Separation of liability, which is available only to joint filers who are divorced, widowed, legally separated, or have not lived together for the 12 months ending the date election of this relief is filed.
3. Equitable relief.

You must file Form 8857, *Request for Innocent Spouse Relief*, to request any of these kinds of relief.

Signing a joint return. For a return to be considered a joint return, both spouses must generally sign the return. If your spouse died before signing the return, the executor or administrator must sign the return for your spouse. If neither you nor anyone else has yet been appointed as executor or administrator, you can sign the return for your spouse and enter “filing as surviving spouse” in the area where you sign the return.

Spouse away from home. If your spouse is away from home, you should prepare the return, sign it, and send it to your spouse to sign so that it can be filed on time.

Signing as guardian of spouse. If you are the guardian of your spouse who is mentally incompetent, you can sign the return for your spouse as guardian.

Spouse in combat zone. If your spouse is unable to sign the return because he or she is serving in a combat zone (such as the Persian Gulf Area, Serbia, Montenegro, Albania, or Afghanistan), and you do not have a power of attorney or other statement, you can sign for your spouse. Attach a signed statement to your return that explains that your spouse is serving in a combat zone.

Nonresident alien or dual-status alien. A joint return generally cannot be filed if either spouse is a nonresident alien at any time during the tax year. However, if one spouse was a nonresident alien or dual-status alien who was married to a U.S. citizen or resident at the end of the year, the spouses can choose to file a joint return. If you do file a joint return, you and your spouse are both treated as U.S. residents for the entire tax year.

V. MARRIED FILING SEPARATELY

You can choose married filing separately as your filing status if you are married. This filing status may benefit you if you want to be responsible only for your own tax or if it results in less tax than filing a joint return. If you and your spouse do not agree to file a joint return, you must use this filing status, unless you qualify for head of household status.

If you live apart from your spouse and meet certain tests, you may be considered unmarried and may be able to file as head of household. This can apply to you even if you are not divorced or legally separated. If you qualify to file as head of household, instead of as married filing separately, your tax may be lower, you may be able to claim the earned income credit and certain other credits, and your standard deduction will be higher. The head of household filing status allows you to choose the standard deduction even if your spouse chooses to itemize deductions. See *Head of Household*, later, for more information.

Tip

You will generally pay more combined tax on separate returns than you would on a joint return primarily because the tax rate is higher for married persons filing separately. However, unless you are required to file separately, you should figure your tax both ways (on a joint return and on separate returns). This way you can make sure you are using the filing status that results in the lowest combined tax.

VI. HEAD OF HOUSEHOLD

You may be able to file as head of household if you meet all of the following requirements.

1. You are unmarried or "considered unmarried" on the last day of the year. You are "considered unmarried" on the last day of the year if you meet the following requirements:
    - You file a separate return.
    - You paid more than half the cost of keeping up your home for the tax year.
    - Your spouse did not live in your home during the last 6 months of the tax year. Your spouse is considered to live in your home even if he or she is temporarily absent due to special circumstances.
    - Your home was the main home of your child, stepchild, or foster child for more than half the year.
    - You must be able to claim the child as a dependent. However, you meet this test if you cannot claim the child as a dependent only because the noncustodial parent can claim the child. The general rules for claiming the child as a dependent are explained in chapter 3.
2. You paid more than half the cost of keeping up a home for the year.

3. A qualifying person lived with you in the home for more than half the year (except for temporary absences, such as school). However, if the qualifying person is your dependent parent, he or she does not have to live with you.

Tip

If you qualify to file as head of household, your tax rate usually will be lower than the rates for single or married filing separately. You will also receive a higher standard deduction than if you file as single or married filing separately.

QUALIFYING PERSON

A qualifying person can be either a qualifying child or qualifying relative.

Example - Child

Your unmarried son lived with you all year and was 18 years old at the end of the year. He did not provide more than half of his own support and does not meet the tests to be a qualifying child of anyone else. As a result, he is your qualifying child (see Table 3-1, Overview of the Rules for a Dependent in chapter 3) and, because he is single, your qualifying person for you to claim head of household filing status.

Home of qualifying person. Generally, the qualifying person must live with you for more than half of the year.

Special rule for parent. If your qualifying person is your father or mother, you may be eligible to file as head of household even if your father or mother does not live with you. However, you must be able to claim your father or mother as a dependent. Also, you must pay more than half the cost of keeping up a home that was the main home for the entire year for your father or mother.

If you pay more than half the cost of keeping your parent in a rest home or home for the elderly, that counts as paying more than half the cost of keeping up your parent's main home.

Temporary absences. You and your qualifying person are considered to live together even if one or both of you are temporarily absent from your home due to special circumstances such as illness, education, business, vacation, military service, or detention in a juvenile facility. It must be reasonable to assume that the absent person will return to the household after the temporary absence. You must continue to keep up the home during the absence.

Death or birth. You may be eligible to file as head of household if the individual who qualifies you for this filing status is born or dies during the year. If the individual is your qualifying child, the child must have lived with you for more than half the part of the year he or she was alive.

VII. QUALIFYING SURVIVING SPOUSE

If your spouse died in 2024, you can use married filing jointly as your filing status for 2024 if you otherwise qualify to use that status. The year of death is the last year for which you can file jointly with your deceased spouse. See *Married Filing Jointly*, earlier.

You may be eligible to use qualifying surviving spouse as your filing status for 2 years following the year of death of your spouse. For example, if your spouse died in 2023, and you have not remarried, you may be able to use this filing status for 2024 and 2025.

This filing status entitles you to use joint return tax rates and the highest standard deduction amount (if you do not itemize deductions). This status does not entitle you to file a joint return.

How to file. On Form 1040 or 1040-SR, check the "Qualifying surviving spouse" box on the top of the form.

Eligibility rules. You are eligible to file your 2024 return as a qualifying surviving spouse if you meet all of the following tests.

1. You were entitled to file a joint return with your spouse for the year your spouse died. It does not matter whether you actually filed a joint return.

2. Your spouse died in 2022 or 2023 and you did not remarry before the end of 2024.

3. You have a child or stepchild (not a foster child) whom you can claim as a dependent or could claim as a dependent except that, for 2024:

   a) The child had gross income of $5,050 or more,

   b) The child filed a joint return, or

   c) You could be claimed as a dependent on someone else's return.

   If the child is not claimed as your dependent in the *Dependents* section on Form 1040 or 1040-SR, enter the child's name in the entry space at the far right of the filing status checkboxes (next to *Qualifying surviving spouse*).

4. This child lived in your home all year, except for temporary absences.

5. You paid more than half the cost of keeping up a home for the year.

Example

John's wife died in 2022. John has not remarried. During 2023 and 2024, he continued to keep up a home for himself and his child who lives with him and for whom he can claim as a dependent. For 2022, he was entitled to file a joint return for himself and his deceased wife. For 2023 and 2024, he can file as qualifying surviving spouse. After 2024, he can file as head of household if he qualifies.

Death or birth. You may be eligible to file as a qualifying surviving spouse if the child who qualifies you for this filing status is born or dies during the year. You must have provided more than half of the cost of keeping up a home that was the child's main home during the entire part of the year he or she was alive.

Caution!

As mentioned earlier, this filing status is only available for 2 years following the year of death of your spouse.

CHAPTER 2: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1.	**For a tax return to be considered a joint return, both spouses generally must sign the return. Each of the following is a recognized exception allowing a one-party signature <u>except</u>:** **A.** signing as a guardian of spouse **B.** spouse in combat zone **C.** spouse is a nonresident alien **D.** if your spouse died before filing the return and an executor or administrator had not been appointed
2.	**You will generally pay more combined tax on separate tax returns than you would on a joint return.** **A.** true **B.** false
3.	**Generally, a qualifying person must have lived with you for how long in order for you to be able to file as head of household:** **A.** more than half of the year **B.** at least one year **C.** 18 months **D.** two consecutive years

CHAPTER 2: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.

A. Incorrect. Being the guardian of your spouse is a valid situation where one spouse can sign a joint tax return for the other spouse.

B. Incorrect. If your spouse is serving in a combat zone and you do not have a power of attorney or other statement, you can sign the joint tax return.

C. **CORRECT**. This is not a recognized exception, as a nonresident alien generally cannot sign a joint tax return.

D. Incorrect. If your spouse died before signing the return, the executor or administrator must sign the return for your spouse. If neither you nor anyone else has yet been appointed as executor or administrator, you can sign the return for your spouse and enter "filing as surviving spouse" in the area where you sign the return.

(See page 20 of the course material.)

2.

A. **CORRECT**. This is because the tax rate is higher for married persons filing separately.

B. Incorrect. However, unless you are required to file separately, you should figure your tax both ways, and make sure you are using the filing status that results in the lowest combined tax.

(See page 21 of the course material.)

3.

A. **CORRECT**. Along with other qualifications, you may be able to file as head of household if a qualifying person has lived with you for more than half of the year. If the person is your dependent, however, he or she does not have to live with you.

B. Incorrect. Generally, the qualifying person only has to live with you for more than half of the year, but not necessarily for the entire year. Be aware there are other requirements that must also be met in order to file as head of household.

C. Incorrect. In order to file as head of household, a person must live with you for more than half of the year. Be aware there are other requirements that must also be met in order to file as head of household.

D. Incorrect. Generally, the qualifying person only has to live with you for more than half of the year, not for two consecutive years. Be aware there are other requirements that must also be met in order to file as head of household.

(See pages 21 to 22 of the course material.)

CHAPTER 3: DEPENDENTS

Chapter Objective
After completing this chapter, you should be able to:
• Recall the various requirements for a qualifying relative.

I. INTRODUCTION

Exemption amount. The exemptions have been suspended for the years 2018 through 2025 as part of the passage of the TCJA.

II. DEPENDENTS

The term "dependent" means:

- A qualifying child, or
- A qualifying relative.

You can claim a qualifying child or qualifying relative as a dependent only if these three tests are met.

1. Dependent taxpayer test.
2. Joint return test.
3. Citizen or resident test.

All the requirements for dependents are summarized in Table 3-1.

TABLE 3-1. OVERVIEW OF THE RULES FOR A DEPENDENT

- You cannot claim any dependents if you (or your spouse if filing jointly) could be claimed as a dependent by another taxpayer.
- You cannot claim a married person who files a joint return as a dependent unless that joint return is filed only to claim a refund of withheld income tax or estimated tax paid.
- You cannot claim a person as a dependent unless that person is a U.S. citizen, U.S. resident alien, U.S. national, or a resident of Canada or Mexico.[1]
- You cannot claim a person as a dependent unless that person is your qualifying child or qualifying relative.

Tests to Be a Qualifying Child	Tests to Be a Qualifying Relative
1) The child must be your son, daughter, stepchild, foster child, brother, sister, half brother, half sister, stepbrother, stepsister, or a descendant of any of them.	1) The person cannot be your qualifying child or the qualifying child of any other taxpayer.
2) The child must be (a) under age 19 at the end of the year and younger than you (or your spouse, if filing jointly), (b) under age 24 at the end of the year, a student, and younger than you (or your spouse, if filing jointly), or (c) any age if permanently and totally disabled.	2) The person either: (a) must be related to you in one of the ways listed under the IRS's Relationship test, or (b) must live with you all year as a member of your household (and your relationship must not violate local law).[2]
3) The child must have lived with you for more than half of the year.[2]	3) The person's gross income for the year must be less than $5,050.[3]
4) The child must not have provided more than half of his or her own support for the year.	4) You must provide more than half of the person's total support for the year.[4]
5) The child must not be filing a joint return for the year (unless that return is filed only to get a refund of income tax withheld or estimated tax paid). If the child meets the rules to be a qualifying child of more than one person, only one person can actually treat the child as a qualifying child.	

1. There is an exception for certain adopted children.
2. There are exceptions for temporary absences, children who were born or died during the year, children of divorced or separated parents (or parents who live apart), and kidnapped children.
3. There is an exception if the person is disabled and has income from a sheltered workshop.
4. There are exceptions for multiple support agreements, children of divorced or separated parents (or parents who live apart), and kidnapped children.

CHAPTER 3: TEST YOUR KNOWLEDGE

The following question is designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). It is included as an additional tool to enhance your learning experience and does not need to be submitted in order to receive CPE credit.

We recommend that you answer the question and then compare your response to the suggested solution on the following page before answering the final exam question(s) related to this chapter (assignment).

1.	**Each of the following is one of the tests that must be met in order to claim an exemption for a qualifying child or qualifying relative as a dependent except:** **A.** dependent taxpayer test **B.** joint return test **C.** citizen or resident test **D.** age test

CHAPTER 3: SOLUTIONS AND SUGGESTED RESPONSES

Below is the solution and suggested responses for the question on the previous page. If you choose an incorrect answer, you should review the page(s) as indicated for the question to ensure comprehension of the material.

1.	**A.** Incorrect. Under the dependent taxpayer test, the taxpayer cannot claim anyone else as a dependent if he or she can be claimed as a dependent by another person. Even if you have a qualifying child or qualifying relative, you cannot claim that person as a dependent. **B.** Incorrect. Under the joint return test, you generally cannot claim a married person as a dependent if he or she files a joint return. Therefore, even if you have a qualifying child, if that child files a joint return (other than to claim a refund), you cannot claim him or her as a dependent. **C.** Incorrect. Under the citizen or resident test, you cannot claim a person as a dependent unless that person is a U.S. citizen, U.S. resident alien, U.S. national, or a resident of Canada or Mexico. However, there is an exception for adopted children. **D.** **CORRECT**. The age test is specific to a qualifying child, but not a qualifying relative. In order to be a qualifying child, the child must be under age 19 at the end of the year and younger than you (or your spouse if filing jointly), a full-time student under age 24 at the end of the year and younger than you (or your spouse if filing jointly), or permanently and totally disabled at any time during the year, regardless of age. *(See pages 27 to 28 of the course material.)*

CHAPTER 4: ESTIMATED TAX

Chapter Objective

After completing this chapter, you should be able to:

- Identify the purpose of estimated taxes.

I. IMPORTANT

Estimated tax safe harbor for higher income taxpayers. If your 2024 adjusted gross income was more than $150,000 ($75,000 if you are married filing a separate return), you will have to deposit the smaller of 90% of your expected tax for 2025 or 110% of the tax shown on your 2024 return to avoid an estimated tax penalty.

II. ESTIMATED TAX

Estimated tax is the method used to pay tax on income that is not subject to withholding. This includes income from self-employment, interest, dividends, certain alimony, rent, gains from the sale of assets, prizes, and awards. You also may have to pay estimated tax if the amount of income tax being withheld from your salary, pension, or other income is not enough.

Estimated tax is used to pay both income tax and self-employment tax, as well as other taxes and amounts reported on your tax return. If you do not pay enough tax, either through withholding or estimated tax, or a combination of both, you may have to pay a penalty. If you do not pay enough by the due date of each payment period (see *When To Pay Estimated Tax*, later), you may have to pay a penalty even if you are due a refund when you file your tax return.

WHO MUST PAY ESTIMATED TAX PAYMENTS?

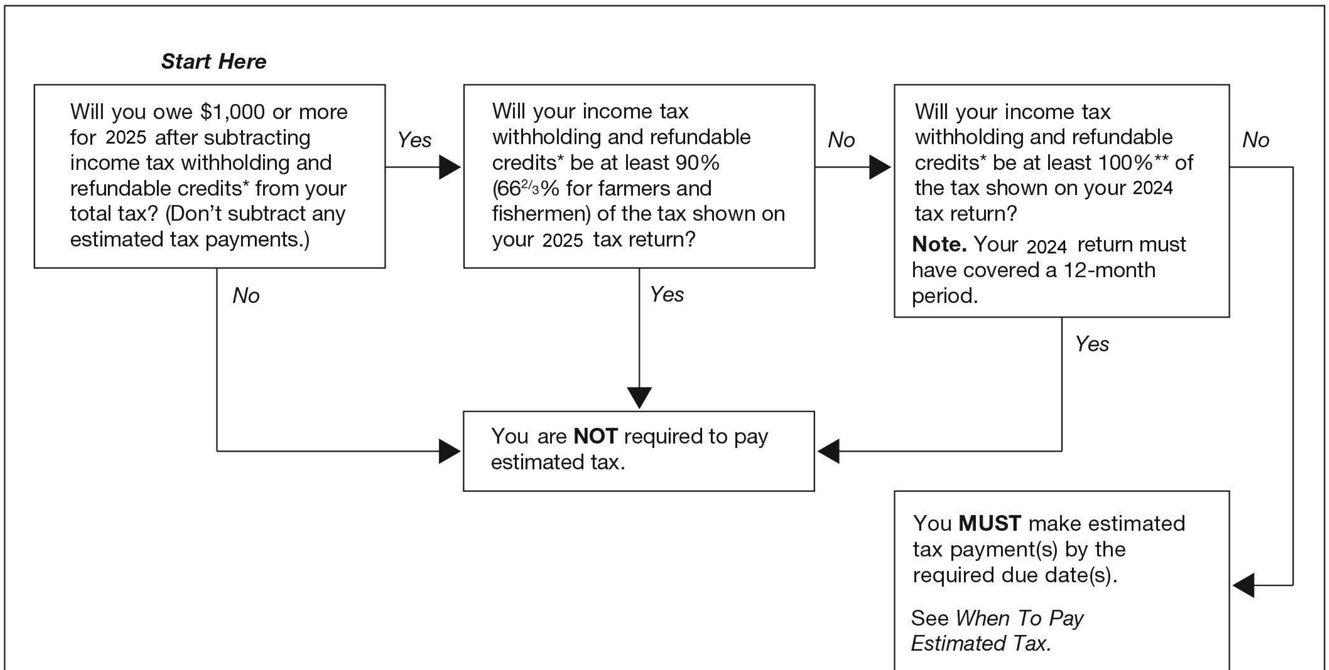
If you owe additional tax for 2024, you may have to pay estimated tax for 2025.

General rule. In most cases, you must pay estimated tax for 2025 if both of the following apply.

1. You expect to owe at least $1,000 in tax for 2025 after subtracting your withholding and refundable credits.
2. You expect your withholding plus your refundable credits to be less than the smaller of:
    - 90% of the tax to be shown on your 2025 tax return, or
    - 100% of the tax shown on your 2024 tax return. Your 2024 tax return must cover all 12 months.

Special rules for farmers, fishermen, and higher income taxpayers. There are exceptions to the general rule for farmers, fishermen, and certain higher income taxpayers. See *Figure 4-A.*

FIGURE 4-A. DO YOU HAVE TO PAY ESTIMATED TAX?



*Use the refundable credits shown on the 2025 Estimated Tax Worksheet.
**110% if less than two-thirds of your gross income for 2024 and 2025 is from farming or fishing and your 2024 adjusted gross income was more than $150,000 ($75,000 if your filing status for 2025 is married filing a separate return).

WHEN TO PAY ESTIMATED TAX

For estimated tax purposes, the year is divided into four payment periods. Each period has a specific payment due date. If you do not pay enough tax by the due date of each of the payment periods, you may be charged a penalty even if you are due a refund when you file your income tax return. The following chart gives the payment periods and due dates for estimated tax payments.

For the period:	Due Date:
Jan. 1 through Mar. 31	Apr. 15
Apr. 1 through May 31	Jun. 15
Jun. 1 through Aug. 31	Sept. 15

Saturday, Sunday, holiday rule. If the due date for an estimated tax payment falls on a Saturday, Sunday, or legal holiday, the payment will be on time if you make it on the next day that is not a Saturday, Sunday, or legal holiday.

CHAPTER 4: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1. **There is an estimated tax safe harbor for high income taxpayers.**

A. true

B. false

2. **Estimated tax payments can be used to pay all of the following taxes <u>except</u>:**

A. income taxes

B. self-employment taxes

C. alternative minimum taxes

D. property taxes

3. **When is your estimated tax payment for the period January 1st through March 31st due:**

A. April 15th

B. June 15th

C. September 15th

D. January 15th of the next year

CHAPTER 4: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** **CORRECT**. For 2024, if your adjusted gross income was more than $150,000 ($75,000 if you are married filing a separate return), you will have to deposit the smaller of 90% of your expected tax for 2025 or 110% of the tax shown on your 2024 return to avoid penalties. **B.** Incorrect. You may have to pay estimated tax if the amount withheld from your salary, pension, or other income is not enough. There is a safe harbor for higher income taxpayers whose adjusted gross income was more than given amounts. *(See page 31 of the course material.)*
2.	**A.** Incorrect. Income taxes are usually payable for self-employed individuals through quarterly estimated tax payments. **B.** Incorrect. Self-employment taxes can be paid through quarterly estimated tax payments. **C.** Incorrect. Alternative minimum taxes can be paid through quarterly estimated tax payments. **D.** **CORRECT**. Property taxes are typically paid to state and local governments and not to the federal government. *(See page 31 of the course material.)*
3.	**A.** **CORRECT**. Your estimated tax payment for the period January 1st through March 31st is due April 15th. **B.** Incorrect. Your estimated tax payment for the period April 1st through May 31st is due June 15th. **C.** Incorrect. Your estimated tax payment for the period June 1st through August 31st is due September 15th. **D.** Incorrect. Your estimated tax payment for the period September 1st through December 31st is due January 15th of the next year. *(See page 32 of the course material.)*

PART TWO: INCOME

The eight chapters in this part discuss many kinds of income. They explain which income is and is not taxed. See Part Three for information on gains and losses you report the sale or disposition of property.

CHAPTER 5: WAGES, SALARIES, AND OTHER EARNINGS

Chapter Objective

After completing this chapter, you should be able to:

- Recall what types of compensation are included as income for tax purposes.

I. WHAT'S NEW

For 2024, the tax rate on the employee portion of social security is 6.2% on wages up to $168,600. Social security tax withholdings should not exceed $10,453.20. Medicare tax of 1.45% is withheld from all wages regardless of amount.

Self-employment tax of 15.3% applies to earnings of up to $168,600 after the earnings are reduced by 7.65%. The 15.3% rate equals 12.4% for social security (6.2% employee share and 6.2% employer share) plus 2.9% for Medicare. If net earnings exceed $168,600, the 2.9% Medicare rate applies to the entire amount. For 2025, the wage base will rise to $174,900.

Net self-employment earnings will be subject to the 0.9% Additional Medicare Tax if earnings exceed $200,000 if single, head of household, or qualifying widow(er), $250,000 if married filing jointly, and $125,000 if married filing separately.

II. INTRODUCTION

This chapter discusses compensation received for services as an employee, such as wages, salaries, and fringe benefits. The following topics are included:

- Bonuses and awards,
- Special rules for certain employees, and
- Sickness and injury benefits.

The chapter explains what income is included in the employee's gross income and what is not included.

III. EMPLOYEE COMPENSATION

This section discusses various types of employee compensation followed by a detailed explanation of fringe benefits.

MISCELLANEOUS COMPENSATION

Bonuses and awards. If you receive a bonus or award (cash, goods, services) from your employer, you must include its value in your income. However, if your employer merely promises to pay you a bonus or award at some future time, it is not taxable until you receive it or it is made available to you.

Sick pay. Pay you receive from your employer while you are sick or injured is part of your salary or wages. In addition, you must include in your income sick pay benefits received from any of the following payers.

1. A welfare fund.
2. A state sickness or disability fund.
3. An association of employers or employees.
4. An insurance company, if your employer paid for the plan.

However, if you paid the premiums on an accident or health insurance policy yourself, the benefits you receive under the policy are not taxable.

FRINGE BENEFITS

Fringe benefits received in connection with the performance of your services are included in your income as compensation unless you pay fair market value for them or they are specifically excluded by law. Refraining from the performance of services (for example, under a covenant not to compete) is treated as the performance of services for purposes of these rules.

Accident or Health Plan

In most cases, the value of accident or health plan coverage provided to you by your employer is not included in your income. Benefits you receive from the plan may be taxable, as explained later under *Sickness and Injury Benefits*.

Long-term care coverage. Contributions by your employer to provide coverage for long-term care services are generally not included in income. However, contributions made through a flexible spending or similar arrangement offered by your employer must be included in your income. This amount will be reported as wages in box 1 of your Form W-2.

Archer MSA contributions. Contributions by your employer to your Archer MSA are not included in your income. Their total will be reported in box 12 of Form W-2 with code R. You must report this amount on Form 8853, *Archer MSAs and Long-Term Care Insurance Contracts*. File the form with your return.

De Minimis (Minimal) Benefits

If your employer provides you with a product or service and the cost of it is so small that it would be unreasonable for the employer to account for it, you generally do not include the value in your income. In most cases, the value of discounts at company cafeterias, cab fares home when working overtime, and company picnics are not included in your income.

Holiday gifts. If your employer gives you a turkey, ham, or other item of nominal value at Christmas or other holidays, do not include the value of the gift in your income. However, if your employer gives you cash or cash equivalent, you must include it in your income.

Educational Assistance

You can exclude from your income up to $5,250 of qualified employer-provided educational assistance.

Group-Term Life Insurance

In most cases, the cost of up to $50,000 of group-term life insurance coverage provided to you by your employer (or former employer) is not included in your income. However, you must include in income the cost of employer-provided insurance that is more than the cost of $50,000 of coverage reduced by any amount you pay toward the purchase of the insurance.

Transportation

If your employer provides you with a qualified transportation fringe benefit, it can be excluded from your income, up to certain limits. A qualified transportation fringe benefit is:

- Transportation in a commuter highway vehicle (such as a van) between your home and work place,
- A transit pass, or
- Qualified parking.

Cash reimbursement by your employer for these expenses under a bona fide reimbursement arrangement is also excludable. However, cash reimbursement for a transit pass is excludable only if a voucher or similar item that can be exchanged only for a transit pass is not readily available for direct distribution to you.

Exclusion limit. The exclusion for commuter highway vehicle transportation and transit pass fringe benefits cannot be more than $315 a month.

The exclusion for the qualified parking fringe benefit cannot be more than $315 per month.

If the benefits have a value that is more than these limits, the excess must be included in your income.

Commuter highway vehicle. This is a highway vehicle that seats at least six adults (not including the driver). At least 80% of the vehicle's mileage must reasonably be expected to be:

- For transporting employees between their homes and work place, and
- On trips during which employees occupy at least half of the vehicle's adult seating capacity (not including the driver).

Transit pass. This is any pass, token, farecard, voucher, or similar item entitling a person to ride mass transit (whether public or private) free or at a reduced rate or to ride in a commuter highway vehicle operated by a person in the business of transporting persons for compensation.

Qualifying parking. This is parking provided to an employee at or near the employer's place of business. It also includes parking provided on or near a location from which the employee commutes to work by mass transit, in a commuter highway vehicle, or by carpool. It does not include parking at or near the employee's home.

IV. SPECIAL RULES FOR CERTAIN EMPLOYEES

FOREIGN EMPLOYER

Special rules apply if you work for a foreign employer.

U.S. citizen. If you are a U.S. citizen who works in the United States for a foreign government, an international organization, a foreign embassy, or any foreign employer, you must include your salary in your income.

Social security and Medicare taxes. You are exempt from social security and Medicare taxes if you are employed in the United States by an international organization or a foreign government. However, you must pay self-employment tax on your earnings from services performed in the United States, even though you are not self-employed. This rule also applies if you are an employee of a qualifying wholly-owned instrumentality of a foreign government.

Employees of international organizations or foreign governments. Your compensation for official services to an international organization is exempt from federal income tax if you are not a citizen of the United States or you are a citizen of the Philippines (whether or not you are a citizen of the United States).

Your compensation for official services to a foreign government is exempt from federal income tax if all of the following are true:

- You are not a citizen of the United States or you are a citizen of the Philippines (whether or not you are a citizen of the United States).
- Your work is like the work done by employees of the United States in foreign countries.
- The foreign government gives an equal exemption to employees of the United States in its country.

Waiver of alien status. If you are an alien who works for a foreign government or international organization and you file a waiver under section 247(b) of the Immigration and Nationality Act to keep your immigrant status, different rules may apply.

MILITARY

Payments you receive as a member of a military service generally are taxed as wages except for retirement pay, which is taxed as a pension. Allowances generally are not taxed.

Military retirement pay. If your retirement pay is based on age or length of service, it is taxable and must be included in your income as a pension on lines 5a and 5b of Form 1040 or 1040-SR. Do not include in your income the amount of any reduction in retirement or retainer pay to provide a survivor annuity for your spouse or children under the Retired Serviceman's Family Protection Plan or the Survivor Benefit Plan.

Veterans' benefits. Do not include in your income any veterans' benefits paid under any law, regulation, or administrative practice administered by the Department of Veterans Affairs (VA). The following amounts paid to veterans or their families are not taxable.

- Education, training, and subsistence allowances.
- Disability compensation and pension payments for disabilities paid either to veterans or their families.
- Grants for homes designed for wheelchair living.
- Grants for motor vehicles for veterans who lost their sight or the use of their limbs.
- Veterans' insurance proceeds and dividends paid either to veterans or their beneficiaries, including the proceeds of a veteran's endowment policy paid before death.
- Interest on insurance dividends you leave on deposit with the VA.
- Benefits under a dependent-care assistance program.
- The death gratuity paid to a survivor of a member of the Armed Forces who dies after September 10, 2001.
- Payments made under the compensated work therapy program.
- Any bonus payment by a state or political subdivision because of service in a combat zone.

VOLUNTEERS

Peace Corps. Living allowances you receive as a Peace Corps volunteer or volunteer leader for housing, utilities, household supplies, food, and clothing are exempt from tax.

Taxable allowances. The following allowances must be included in your income and reported as wages.

- Allowances paid to your spouse and minor children while you are a volunteer leader training in the United States.

- Living allowances designated by the Director of the Peace Corps as basic compensation. These are allowances for personal items such as domestic help, laundry and clothing maintenance, entertainment and recreation, transportation, and other miscellaneous expenses.
- Leave allowances.
- Readjustment allowances or termination payments. These are considered received by you when credited to your account.

Example

Gary Carpenter, a Peace Corps volunteer, gets $175 a month as a readjustment allowance during his period of service, to be paid to him in a lump sum at the end of his tour of duty. Although the allowance is not available to him until the end of his service, Gary must include it in his income on a monthly basis as it is credited to his account.

Volunteers in Service to America (VISTA). If you are a VISTA volunteer, you must include meal and lodging allowances paid to you in your income as wages.

National Senior Services Corps programs. Do not include in your income amounts you receive for supportive services or reimbursements for out-of-pocket expenses from the following programs.

- Retired Senior Volunteer Program (RSVP).
- Foster Grandparent Program.
- Senior Companion Program.

Service Corps of Retired Executives (SCORE). If you receive amounts for supportive services or reimbursements for out-of-pocket expenses from SCORE, do not include these amounts in gross income.

V. SICKNESS AND INJURY BENEFITS

In most cases, you must report as income any amount you receive for personal injury or sickness through an accident or health plan that is paid for by your employer. If both you and your employer pay for the plan, only the amount you receive that is due to your employer’s payments is reported as income. However, certain payments may not be taxable to you.

Tip

Do not report as income any amounts paid to reimburse you for medical expenses you incurred after the plan was established.

Cafeteria plans. In most cases, if you are covered by an accident or health insurance plan through a cafeteria plan, and the amount of the insurance premiums was not included in your income, you are not considered to have paid the premiums and you must include any benefits you receive in your income. If the amount of the premiums was included in your income, you are considered to have paid the premiums, and any benefits you receive are not taxable.

DISABILITY PENSIONS

If you retired on disability, you must include in income any disability pension you receive under a plan that is paid for by your employer. You must report your taxable disability payments as wages on line 1h of Form 1040 or 1040-SR until you reach minimum retirement age. Minimum retirement age generally is the age at which you can first receive a pension or annuity if you are not disabled. There is a tax credit for people who are permanently and totally disabled when they retired. For information on this credit and the definition of permanent and total disability, see chapter 32.

Beginning on the day after you reach minimum retirement age, payments you receive are taxable as a pension or annuity. Report the payments on lines 5a and 5b of Form 1040 or 1040-SR.

Retirement and profit-sharing plans. If you receive payments from a retirement or profit-sharing plan that does not provide for disability retirement, do not treat the payments as a disability pension. The payments must be reported as a pension or annuity. For more information on pensions, see chapter 10.

Accrued leave payment. If you retire on disability, any lump-sum payment you receive for accrued annual leave is a salary payment. The payment is not a disability payment. Include it in your income in the tax year you receive it.

Military and Government Disability Pensions

Certain military and government disability pensions are not taxable.

Service-connected disability. You may be able to exclude from income amounts you receive as a pension, annuity, or similar allowance for personal injury or sickness resulting from active service in one of the following government services.

- The armed forces of any country.
- The National Oceanic and Atmospheric Administration.

- The Public Health Service.
- The Foreign Service.

Pension based on years of service. If you receive a disability pension based on years of service, you generally must include it in your income. However, if the pension qualifies for the exclusion for a service-connected disability, do not include in income the part of your pension that you would have received if the pension had been based on a percentage of disability. You must include the rest of your pension in your income.

Terrorist attack or military action. Do not include in your income disability payments you receive for injuries resulting directly from a terrorist attack directed against the United States (or its allies), whether outside or within the United States or from military action.

WORKERS' COMPENSATION

Amounts you receive as workers' compensation for an occupational sickness or injury are fully exempt from tax if they are paid under a workers' compensation act or a statute in the nature of a workers' compensation act. The exemption also applies to your survivors. The exemption, however, does not apply to retirement plan benefits you receive based on your age, length of service, or prior contributions to the plan, even if you retired because of an occupational sickness or injury.

OTHER SICKNESS AND INJURY BENEFITS

Railroad sick pay. Payments you receive as sick pay under the Railroad Unemployment Insurance Act are taxable and you must include them in your income. However, do not include them in your income if they are for an on-the-job injury.

Federal Employees' Compensation Act (FECA). Payments received under this Act for personal injury or sickness, including payments to beneficiaries in case of death, are not taxable. However, you are taxed on amounts you receive under this Act as continuation of pay for up to 45 days while a claim is being decided. Report this income as wages. Also, pay for sick leave while a claim is being processed is taxable and must be included in your income as wages.

Caution!

If part of the payments you receive under FECA reduces your social security or equivalent railroad retirement benefits received, that part is considered social security (or equivalent railroad retirement) benefits and may be taxable.

Other compensation. Many other amounts you receive as compensation for sickness or injury are not taxable. These include the following amounts.

- Compensatory damages you receive for physical injury or physical sickness, whether paid in a lump sum or in periodic payments.

- Benefits you receive under an accident or health insurance policy on which either you paid the premiums or your employer paid the premiums but you had to include them in your income.
- Disability benefits you receive for loss of income or earning capacity as a result of injuries under a no-fault car insurance policy.
- Compensation you receive for permanent loss or loss of use of a part or function of your body, or for your permanent disfigurement. This compensation must be based only on the injury and not on the period of your absence from work. These benefits are not taxable even if your employer pays for the accident and health plan that provides these benefits.

Reimbursement for medical care. A reimbursement for medical care is generally not taxable. However, it may reduce your medical expense deduction.

CHAPTER 5: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1.	**In 2024, how much can you exclude from your income for qualified employer-provided educational assistance:** **A.** $1,000 **B.** $2,000 **C.** $4,000 **D.** $5,250
2.	**What is the exclusion limit for a qualified parking fringe benefit for 2024:** **A.** $150 per month **B.** $315 per month **C.** $415 per month **D.** $630 per month

CHAPTER 5: SOLUTION AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. The amount is higher than $1,000. **B.** Incorrect. The amount is higher than $2,000. **C.** Incorrect. The amount is higher than $4,000. **D.** **CORRECT**. Employer-provided educational assistance is among the list of employer fringe benefits that can be excluded from income. *(See page 39 of the course material.)*
2.	**A.** Incorrect. One hundred fifty dollars per month is significantly lower than the allowed fringe benefit exclusion. **B.** **CORRECT**. The exclusion limit for a qualified parking fringe benefit is $315 per month. If the benefit has a value greater than this limit, the excess must be included in the taxpayers' income. **C.** Incorrect. Four hundred fifteen dollars per month is not related to any fringe benefit exclusion limit. **D.** Incorrect. Six hundred thirty dollars per month is not related to any fringe benefit exclusion limit discussed. *(See page 39 of the course material.)*

CHAPTER 6: TIP INCOME

Chapter Objective

After completing this chapter, you should be able to:

- Recognize what tips should be included in income for tax purposes.

I. REPORTING TIP INCOME

This chapter is for employees who receive tips.

All tips you receive are income and are subject to federal income tax. You must include in gross income all tips you receive directly, charged tips paid to you by your employer, and your share of any tips you receive under a tip-splitting or tip-pooling arrangement.

The value of noncash tips, such as tickets, passes, or other items of value, is also income and subject to tax.

Reporting your tip income correctly is not difficult. You must do three things.

1. Keep a daily tip record.
2. Report tips to your employer.
3. Report all your tips on your income tax return.

CHAPTER 6: TEST YOUR KNOWLEDGE

The following question is designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). It is included as an additional tool to enhance your learning experience and does not need to be submitted in order to receive CPE credit.

We recommend that you answer the question and then compare your response to the suggested solution on the following page before answering the final exam question(s) related to this chapter (assignment).

1.	**Tip income must be correctly reported. Which of the following tasks is <u>not</u> required of employees receiving tips:** **A.** keep a daily tip record **B.** separate and report only currency tips to your employer **C.** report all tips to your employer **D.** report all your tips on your income tax return

CHAPTER 6: SOLUTION AND SUGGESTED RESPONSES

Below is the solution and suggested responses for the question on the previous page. If you choose an incorrect answer, you should review the page(s) as indicated for the question to ensure comprehension of the material.

1.	**A.** Incorrect. Keeping a daily tip record in some form is required of all employees who regularly receive tip income. **B.** **CORRECT**. This task statement is incomplete for any employee receiving tip income. All cash (currency + coins), checks, and credit card tips received must be reported to your employer. These will be subject to social security taxes. **C.** Incorrect. Reporting all tips (except non-cash items such as tickets, passes etc.) to your employer is required. **D.** Incorrect. Reporting all of your tip income (including non-cash items of value such as tickets and passes) must be reported on your income tax return. *(See page 49 of the course material.)*

CHAPTER 7: INTEREST INCOME

Chapter Objective

After completing this chapter, you should be able to:

- Recall the proper tax treatment for various types of interest.

I. IMPORTANT REMINDER

Foreign-source income. If you are a U.S. citizen with interest income from sources outside the United States (foreign income), you must report that income on your tax return unless it is exempt by U.S. law. This is true whether you reside inside or outside the United States and whether or not you receive a Form 1099 from the foreign payer.

II. INTRODUCTION

This chapter discusses:

- Different types of interest income, and
- What interest is taxable and what interest is nontaxable.

III. TAXABLE INTEREST

Taxable interest includes interest you receive from bank accounts, loans you make to others, and other sources. The following are some other sources of taxable interest.

Dividends that are actually interest. Certain distributions commonly called dividends are actually interest. You must report as interest so-called "dividends" on deposits or on share accounts in:

- Cooperative banks,
- Credit unions,
- Domestic building and loan associations,
- Domestic savings and loan associations,
- Federal savings and loan associations, and
- Mutual savings banks.

The "dividends" will be shown as interest on Form 1099-INT.

Money market funds. Generally, amounts you receive from money market funds should be reported as dividends, not as interest.

Certificates of deposit and other deferred interest accounts. If you open any of these accounts, interest may be paid at fixed intervals of 1 year or less during the term of the account. You generally must include this interest in your income when you actually receive it or are entitled to receive it without paying a substantial penalty. The same is true for accounts that mature in 1 year or less and pay interest in a single payment at maturity. If interest is deferred for more than 1 year, see *Original Issue Discount* (OID), later.

Interest subject to penalty for early withdrawal. If you withdraw funds from a deferred interest account before maturity, you may have to pay a penalty. You must report the total amount of interest paid or credited to your account during the year, without subtracting the penalty.

Interest on insurance dividends. Interest on insurance dividends left on deposit with an insurance company that can be withdrawn annually is taxable to you in the year it is credited to your account. However, if you can withdraw it only on the anniversary date of the policy (or other specified date), the interest is taxable in the year that date occurs.

Prepaid insurance premiums. Any increase in the value of prepaid insurance premiums, advance premiums, or premium deposit funds is interest if it is applied to the payment of premiums due on insurance policies or made available for you to withdraw.

U.S. obligations. Interest on U.S. obligations, such as U.S. Treasury bills, notes, and bonds, issued by any agency or instrumentality of the United States is taxable for federal income tax purposes.

Interest on tax refunds. Interest you receive on tax refunds is taxable income.

Interest on condemnation award. If the condemning authority pays you interest to compensate you for a delay in paying an award, the interest is taxable.

Installment sale payments. If a contract for the sale or exchange of property provides for deferred payments, it also usually provides for interest payable with the deferred payments. Generally, that interest is taxable when you receive it. If little or no interest is provided for in a deferred payment contract, part of each payment may be treated as interest.

Interest on annuity contract. Accumulated interest on an annuity contract you sell before its maturity date is taxable.

Usurious interest. Usurious interest is interest charged at an illegal rate. This is taxable as interest unless state law automatically changes it to a payment on the principal.

Interest income on frozen deposits. Exclude from your gross income interest on frozen deposits. A deposit is frozen if, at the end of the year, you cannot withdraw any part of the deposit because:

1. The financial institution is bankrupt or insolvent, or

2. The state where the institution is located has placed limits on withdrawals because other financial institutions in the state are bankrupt or insolvent.

The amount of interest you must exclude is the interest that was credited on the frozen deposits minus the sum of:

1. The net amount you withdrew from these deposits during the year, and
2. The amount you could have withdrawn as of the end of the year (not reduced by any penalty for premature withdrawals of a time deposit).

The interest you exclude is treated as credited to your account in the following year. You must include it in income in the year you can withdraw it.

Example

$100 of interest was credited on your frozen deposit during the year. You withdrew $80 but could not withdraw any more as of the end of the year. You must include $80 in your income for the year and exclude $20 from your income for the year. You must include the $20 in your income for the year you can withdraw it.

Bonds traded flat. If you buy a bond when interest has been defaulted or when the interest has accrued but has not been paid, the transaction is described as trading a bond flat. The defaulted or unpaid interest is not income and is not taxable as interest if paid later. When you receive a payment of that interest, it is a return of capital that reduces the remaining cost basis of your bond. Interest that accrues after the date of purchase, however, is taxable interest income for the year it is received or accrued. See *Bonds Sold Between Interest Dates*, later, for more information.

Below-market loans. A below-market loan is a loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate.

U.S. SAVINGS BONDS

Accrual method taxpayers. If you use an accrual method of accounting, you must report interest on U.S. savings bonds each year as it accrues. You cannot postpone reporting interest until you receive it or the bonds mature.

Cash method taxpayers. If you use the cash method of accounting, as most individual taxpayers do, you generally report the interest on U.S. savings bonds when you receive it.

U.S. TREASURY BILLS, NOTES, AND BONDS

Treasury bills, notes, and bonds are direct debts (obligations) of the U.S. Government.

Taxation of interest. Interest income from Treasury bills, notes, and bonds is subject to federal income tax, but is exempt from all state and local income taxes. You should receive a Form 1099-INT showing the amount of interest (in box 3) that was paid to you for the year.

Treasury bills. These bills generally have a 4-week, 13-week, 26-week, or 52-week maturity period. They are issued at a discount in the amount of $100 and multiples of $100. The difference between the discounted price you pay for the bills and the face value you receive at maturity is interest income. Generally, you report this interest income when the bill is paid at maturity. If you paid a premium for a bill (more than face value), you generally report the premium as a section 171 deduction when the bill is paid at maturity.

Treasury notes and bonds. Treasury notes have maturity periods of more than one year, ranging up to ten years. Maturity periods for Treasury bonds are longer than ten years. Both of these Treasury issues generally are issued in denominations of $100 to $1 million. Both notes and bonds generally pay interest every six months. Generally, you report this interest for the year paid.

BONDS SOLD BETWEEN INTEREST DATES

If you sell a bond between interest payment dates, part of the sales price represents interest accrued to the date of sale. You must report that part of the sales price as interest income for the year of sale.

If you buy a bond between interest payment dates, part of the purchase price represents interest accrued before the date of purchase. When that interest is paid to you, treat it as a nontaxable return of your capital investment, rather than interest income.

INSURANCE

Life insurance proceeds paid to you as beneficiary of the insured person are usually not taxable. But if you receive the proceeds in installments, you must usually report a part of each installment payment as interest income.

Annuity. If you buy an annuity with life insurance proceeds, the annuity payments you receive are taxed as pension and annuity income from a nonqualified plan, not as interest income. See chapter 10 for information on pension and annuity income from nonqualified plans.

ORIGINAL ISSUE DISCOUNT (OID)

Original issue discount (OID) is a form of interest. You generally include OID in your income as it accrues over the term of the debt instrument, whether or not you receive any payments from the issuer.

A debt instrument generally has OID when the instrument is issued for a price that is less than its stated redemption price at maturity. OID is the difference between the stated redemption price at maturity and the issue price.

All debt instruments that pay no interest before maturity are presumed to be issued at a discount. Zero coupon bonds are one example of these instruments.

The OID accrual rules generally do not apply to short-term obligations (those with a fixed maturity date of 1 year or less from date of issue).

Example 1

You bought a 10-year bond with a stated redemption price at maturity of $1,000, issued at $980 with OID of $20. One-fourth of 1% of $1,000 (stated redemption price) times 10 (the number of full years from the date of original issue to maturity) equals $25. Because the $20 discount is less than $25, the OID is treated as zero. (If you hold the bond at maturity, you will recognize $20 ($1,000 - $980) of capital gain.)

Example 2

The facts are the same as in Example 1, except that the bond was issued at $950. The OID is $50. Because the $50 discount is more than the $25 figured in Example 1, you must include the OID in income as it accrues over the term of the bond.

Debt instrument bought after original issue. If you buy a debt instrument with de minimis OID at a premium, the discount is not includible in income. If you buy a debt instrument with de minimis OID at a discount, the discount is reported under the market discount rules.

Certificates of deposit (CDs). If you buy a CD with a maturity of more than 1 year, you must include in income each year a part of the total interest due and report it in the same manner as other OID.

This also applies to similar deposit arrangements with banks, building and loan associations, etc., including:

- Time deposits
- Bonus plans,
- Savings certificates,
- Deferred income certificates,
- Bonus savings certificates, and
- Growth savings certificates.

Bearer CDs. CDs issued after 1982 generally must be in registered form. Bearer CDs are CDs that are not in registered form. They are not issued in the depositor's name and are transferable from one individual to another.

Banks must provide the IRS and the person redeeming a bearer CD with a Form 1099-INT.

STATE OR LOCAL GOVERNMENT OBLIGATIONS

Interest on a bond used to finance government operations generally is not taxable if the bond is issued by a state, the District of Columbia, a possession of the United States, or any of their political subdivisions.

Bonds issued after 1982 (including tribal economic development bonds issued after February 17, 2009) by an Indian tribal government are treated as issued by a state. Interest on these bonds is generally tax exempt if the bonds are part of an issue of which substantially all proceeds are to be used in the exercise of any essential government function.

CHAPTER 7: TEST YOUR KNOWLEDGE

The following question is designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). It is included as an additional tool to enhance your learning experience and does not need to be submitted in order to receive CPE credit.

We recommend that you answer the question and then compare your response to the suggested solution on the following page before answering the final exam question(s) related to this chapter (assignment).

1.	**A U.S. citizen with interest income from sources outside of the United States must report the income on his or her tax return in all cases listed below <u>except</u>:** **A.** when he or she resides outside of the U.S. year round **B.** when he or she resides inside the U.S. for a portion of the tax year **C.** when the foreign payer does not provide Form 1099 **D.** when the specific interest income is exempt by U.S. law

CHAPTER 7: SOLUTION AND SUGGESTED RESPONSES

Below is the solution and suggested responses for the question on the previous page. If you choose an incorrect answer, you should review the page(s) as indicated for the question to ensure comprehension of the material.

1.	**A.** Incorrect. Unless specifically excluded by law, U.S. citizens must report interest income regardless of the duration and location of residency. **B.** Incorrect. Unless specifically excluded by law, U.S. citizens must report interest income regardless of the duration and location of residency. **C.** Incorrect. The non-delivery of a Form 1099 to a U.S. taxpayer by a foreign payer has no effect on a U.S. taxpayer's legal reporting obligations. **D.** **CORRECT**. Only foreign payer interest income exempted by U.S. law can be excluded from a U.S. taxpayer's tax return. *(See page 53 of the course material.)*

CHAPTER 8: DIVIDENDS AND OTHER DISTRIBUTIONS

Chapter Objective

After completing this chapter, you should be able to:

- Identify the proper treatment of various types of dividends.

I. WHAT'S NEW

CAPITAL GAINS AND DIVIDENDS

Qualified dividends and long-term capital gains may escape tax entirely under the 0% rate, or be subject to capital gain rates of 15% or 20% depending on filing status, taxable income, and how much of the taxable income consists of qualified dividends and eligible long-term gains. The 20% capital gain rate taxable income thresholds for 2024 are either $583,750, $551,350, $518,900, or $291,850, depending on the filing status. The 0%, 15%, and 20% rates do not apply to long-term gains from collectibles, which are subject to a 28% rate, or the 25% rate for unrecaptured real estate depreciation.

II. INTRODUCTION

This chapter discusses the tax treatment of:

- Ordinary dividends,
- Capital gain distributions,
- Nontaxable distributions, and
- Other distributions you may receive from a corporation or a mutual fund.

III. ORDINARY DIVIDENDS

Ordinary (taxable) dividends are the most common type of distribution from a corporation or a mutual fund. They are paid out of the earnings and profits of a corporation and are ordinary income to you. This means they are not capital gains. You can assume that any dividend you receive on common or preferred stock is an ordinary dividend unless the paying corporation tells you otherwise. Ordinary dividends will be shown in box 1a of the Form 1099-DIV you receive.

QUALIFIED DIVIDENDS

Qualified dividends are the ordinary dividends subject to the same 0%, 15%, or 20% maximum tax rate that applies to net capital gain. They should be shown in box 1b of Form 1099-DIV you receive.

The maximum rate of tax on qualified dividends is the following.

- The 0% rate applies to -
    - Single filers with income up to $47,025,
    - Married filers filing separately with income up to $47,025,
    - Head of household filers with income up to $63,000,
    - Joint filers with income up to $94,050,
    - Trusts and estates with income up to $3,150;
- The 15% rate applies to -
    - Single filers with income between $47,025 and $518,900,
    - Married filers filing separately with income between $47,025 and $291,850,
    - Head of household filers with income between $63,000 and $551,350,
    - Joint filers with income between $94,050 and $583,750,
    - Trusts and estates with income between $3,150 and $15,450; and
- The 20% rate applies to -
    - Single filers with income exceeding $518,900,
    - Married filers filing separately with income exceeding $291,850,
    - Head of household filers with income exceeding $551,350,
    - Joint filers with income exceeding $583,750,
    - Trusts and estates with income exceeding $15,450.

To qualify for the maximum rate, all of the following requirements must be met.

- The dividends must have been paid by a U.S. corporation or a qualified foreign corporation.
- The dividends are not of the type listed later under *Dividends that are not qualified dividends*, later.
- You meet the holding period (discussed next).

Holding period. You must have held the stock for more than 60 days during the 121-day period that begins 60 days before the ex-dividend date. The ex-dividend date is the first date following the declaration of a dividend on which the buyer of a stock will not receive the next dividend payment. Instead, the seller will get the dividend.

When counting the number of days you held the stock, include the day you disposed of the stock, but not the day you acquired it.

Exception for preferred stock. In the case of preferred stock, you must have held the stock more than 90 days during the 181-day period that begins 90 days before the ex-dividend date if the dividends are attributable to periods totaling more than 366 days. If the preferred dividends are attributable to periods totaling less than 367 days, the holding period in the previous paragraph applies.

Dividends that are not qualified dividends. The following dividends are not qualified dividends. They are not qualified dividends even if they are shown in box 1b of Form 1099-DIV.

- Capital gain distributions.
- Dividends paid on deposits with mutual savings banks, cooperative banks, credit unions, U.S. building and loan associations, U.S. savings and loan associations, federal savings and loan associations, and similar financial institutions. (Report these amounts as interest income.)
- Dividends from a corporation that is a tax-exempt organization or farmer's cooperative during the corporation's tax year in which the dividends were paid or during the corporation's previous tax year.
- Dividends paid by a corporation on employer securities which are held on the date of record by an employee stock ownership plan (ESOP) maintained by that corporation.
- Dividends on any share of stock to the extent that you are obligated (whether under a short sale or otherwise) to make related payments for positions in substantially similar or related property.
- Payments in lieu of dividends, but only if you know or have reason to know that the payments are not qualified dividends.
- Payments shown in Form 1099-DIV, box 1b, from a foreign corporation to the extent you know or have reason to know the payments are not qualified dividends.

IV. CAPITAL GAIN DISTRIBUTIONS

Capital gain distributions (also called capital gain dividends) are paid to you or credited to your account by mutual funds (or other regulated investment companies) and real estate investment trusts (REITs). They will be shown in box 2a of the Form 1099-DIV you receive from the mutual fund or REIT.

Report capital gain distributions as long-term capital gains, regardless of how long you owned your shares in the mutual fund or REIT.

Qualified Opportunity Fund. Effective December 22, 2017, IRC 1400Z-2 provides a temporary deferral of inclusion in gross income for capital gains invested in Qualified Opportunity Funds, and permanent exclusion of capital gains from the sale or exchange of an investment in the Qualified Opportunity Fund if the investment is held for at least 10 years. See Form 8949 instructions on how to report your election to defer eligible gains invested in a Qualified Opportunity Fund.

Qualified opportunity investment. If you held a qualified investment in a qualified opportunity fund (QOF) at any time during the year, you must file your return with Form 8997, Initial and Annual Statement of Qualified Opportunity Fund Investments, attached. See Form 8997 instructions.

Undistributed capital gains of mutual funds and REITs. Some mutual funds and REITs keep their long-term capital gains and pay tax on them. You must treat your share of these gains as distributions, even though you did not actually receive them. However, they are not included on Form 1099-DIV. Instead, they are reported to you in box 1a of Form 2439, *Notice to Shareholder of Undistributed Long-Term Capital Gains.*

Form 2439 also will show how much, if any, of the undistributed capital gains is unrecaptured Section 1250 gain (box 1b), gain from qualified small business stock (Section 1202 gain, box 1c), or collectibles (28%) gain (box 1d). The tax paid on these gains by the mutual fund or REIT is shown in box 2 of Form 2439.

Basis adjustment. Increase your basis in your mutual fund, or your interest in a REIT, by the difference between the gain you report and the credit you claim for the tax paid.

V. NONDIVIDEND DISTRIBUTIONS

Basis adjustment. A nondividend distribution reduces the basis of your stock. It is not taxed until your basis in the stock is fully recovered. This nontaxable portion is also called a return of capital; it is a return of your investment in the stock of the company. If you buy stock in a corporation in different lots at different times, and you cannot definitely identify the shares subject to the nondividend distribution, reduce the basis of your earliest purchases first.

When the basis of your stock has been reduced to zero, report any additional nondividend distribution that you receive as a capital gain. Whether you report it as a long-term or short-term capital gain depends on how long you have held the stock. See *Holding Period* in chapter 14.

Example

You bought stock in 2010 for $100. In 2014, you received a nondividend distribution of $80. You did not include this amount in your income, but you reduced the basis of your stock to $20. You received a return of capital of $30 in 2024. The first $20 of this amount reduced your basis to zero. You report the other $10 as a long-term capital gain for 2024. You must report as a long-term capital gain any nondividend distribution you receive on this stock in later years.

LIQUIDATING DISTRIBUTIONS

Liquidating distributions, sometimes called liquidating dividends, are distributions you receive 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. You will receive a Form 1099-DIV from the corporation showing you the amount of the liquidating distribution in box 9 or 10.

VI. OTHER DISTRIBUTIONS

You may receive any of the following distributions during the year.

Exempt-interest dividends. Exempt-interest dividends you receive from a mutual fund or other regulated investment company are not included in your taxable income. Exempt-interest dividends should be shown in box 12 of Form 1099-DIV.

Information reporting requirement. Although exempt-interest dividends are not taxable, you must show them on your tax return if you have to file a return. This is an information reporting requirement and does not change the exempt-interest dividends to taxable income.

Alternative minimum tax treatment. Exempt-interest dividends paid from specified private activity bonds may be subject to the alternative minimum tax. See *Alternative Minimum Tax* in chapter 29 for more information.

Dividends on insurance policies. Insurance policy dividends that the insurer keeps and uses to pay your premiums are not taxable. However, you must report as taxable interest income the interest that is paid or credited on dividends left with the insurance company.

If dividends on an insurance contract (other than a modified endowment contract) are distributed to you, they are a partial return of the premiums you paid. Do not include them in your gross income until they are more than the total of all net premiums you paid for the contract.

Dividends on veterans' insurance. Dividends you receive on veterans' insurance policies are not taxable. In addition, interest on dividends left with the Department of Veterans Affairs is not taxable.

Patronage dividends. Generally, patronage dividends you receive in money from a cooperative organization are included in your income.

Do not include in your income patronage dividends you receive on:

1. Property bought for your personal use, or
2. Capital assets or depreciable property bought for use in your business. But you must reduce the basis (cost) of the items bought. If the dividend is more than the adjusted basis of the assets, you must report the excess as income.

These rules are the same whether the cooperative paying the dividend is a taxable or tax-exempt cooperative.

Alaska Permanent Fund dividends. Do not report these amounts as dividends. Instead, include these amounts on Schedule 1 (Form 1040), line 8g.

CHAPTER 8: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1.	**Ordinary dividends are the most common type of distribution from a corporation, and are considered capital gain income.** **A.** true **B.** false
2.	**Qualified dividends are taxable as ordinary income, but are subject to a lower tax rate. Which of the following is <u>not</u> one of the tests that must be met to be treated as a qualified dividend:** **A.** the dividend is paid by a U.S. corporation or qualified foreign corporation **B.** the dividend is paid on deposits held by a U.S. savings bank or credit union **C.** the dividend is not a capital gain distribution **D.** the taxpayer meets the appropriate stock holding period
3.	**All dividends distributed to an individual on insurance contracts should be included in gross income.** **A.** true **B.** false

CHAPTER 8: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. Ordinary (taxable) dividends are paid out of the earnings and profits of a corporation and are ordinary income to the taxpayer. **B.** **CORRECT**. They are ordinary income rather than capital gain to the taxpayer. *(See page 61 of the course material.)*
2.	**A.** Incorrect. Payment of a dividend by a U.S. corporation, or a qualified foreign corporation, is one of three necessary tests to determine whether a dividend payment qualifies for the favorable tax rates of a qualified dividend. **B.** **CORRECT**. Dividends paid on deposits with mutual savings banks, cooperative banks, credit unions, U.S. building and loan associations, and similar financial institutions do not qualify as qualified dividends. They therefore are not included in any three-factor test. **C.** Incorrect. To meet one of the three tests to qualify as a qualified dividend, the dividend cannot be a capital gain distribution. **D.** Incorrect. Meeting the holding period of the dividend's underlying stock is one of three necessary tests needed to establish a qualifying dividend from other payments. *(See pages 62 to 63 of the course material.)*
3.	**A.** Incorrect. If dividends on an insurance contract (other than a modified endowment contract) are distributed to the individual, they are a partial return of the premiums the individual paid. As such, they are not included in gross income until they are more than the total of all net premiums paid for the contract. **B.** **CORRECT**. Only distributions greater than the total of all net premiums paid for the contract are taxable. *(See page 65 of the course material.)*

CHAPTER 9: RENTAL INCOME AND EXPENSES

Chapter Objective

After completing this chapter, you should be able to:

- Recognize the proper treatment of rental property income and expenses for tax purposes.

I. INTRODUCTION

This chapter discusses rental income and expenses. It covers the following topics.

- Personal use of dwelling unit (including vacation home).
- Depreciation.
- Limits on rental losses.

II. RENTAL INCOME

In most cases, you must include in your gross income all amounts you receive as rent. Rental income is any payment you receive for the use or occupation of property. It is not limited to amounts you receive as normal rent payments.

When to report. If you are a cash basis taxpayer, report rental income on your return for the year you actually or constructively receive it, regardless of when it was earned. You constructively receive income when it is made available to you, for example, by being credited to your bank account. If you are an accrual basis taxpayer, you generally report income when you earn it, rather than when you receive it.

Advance rent. Advance rent is any amount you receive before the period that it covers. Include advance rent in your rental income in the year you receive it regardless of the period covered or the method of accounting you use.

Example

You sign a 10-year lease to rent your property. In the first year, you receive $9,600 for the first year's rent and $9,600 as rent for the last year of the lease. You must include $19,200 in your income in the first year.

Security deposits. Do not include a security deposit in your income when you receive it if you plan to return it to your tenant at the end of the lease. But if you keep part or all of the security deposit during any year because your tenant does not live up to the terms of the lease, include the amount you keep in your income in that year.

If an amount called a security deposit is to be used as a final payment of rent, it is advance rent. Include it in your income when you receive it.

Payment for canceling a lease. If your tenant pays you to cancel a lease, the amount you receive is rent. Include the payment in your income in the year you receive it regardless of your method of accounting.

Expenses paid by tenant. If your tenant pays any of your expenses, those payments are rental income. You must include them in your income. You can deduct the expenses if they are deductible rental expenses. See *Rental Expenses*, later, for more information.

Property or services. If you receive property or services, instead of money, as rent, include the fair market value of the property or services in your rental income.

If the services are provided at an agreed upon or specified price, that price is the fair market value unless there is evidence to the contrary.

Rental of property also used as a home. If you rent property that you also use as your home and you rent it fewer than 15 days during the tax year, do not include the rent you receive in your income and do not deduct rental expenses. However, you can deduct on Schedule A (Form 1040) the interest, taxes, and casualty and theft losses that are allowed for nonrental property. See *Personal Use of Dwelling Unit (Including Vacation Home)*, later.

Part interest. If you own a part interest in rental property, you must report your part of the rental income from the property.

III. RENTAL EXPENSES

This part discusses repairs and certain other expenses of renting property that you ordinarily can deduct from your rental income. It includes information on the expenses you can deduct if you rent part of your property, or if you change your property to rental use. Depreciation, which you can also deduct from your rental income, is discussed later.

When to deduct. If you are a cash basis taxpayer, you generally deduct your rental expenses in the year you pay them. If you are an accrual basis taxpayer, you generally deduct your expenses when you incur them, rather than when you pay them.

Vacant rental property. If you hold property for rental purposes, you may be able to deduct your ordinary and necessary expenses (including depreciation) for managing, conserving, or maintaining the property while the property is vacant. However, you cannot deduct any loss of rental income for the period the property is vacant.

Vacant while listed for sale. If you sell property you held for rental purposes, you can deduct the ordinary and necessary expenses for managing, conserving, or maintaining the property until it is sold. If the property is not held out and available for rent while listed for sale, the expenses are not deductible rental expenses.

Pre-rental expenses. You can deduct your ordinary and necessary expenses for managing, conserving, or maintaining rental property from the time you make it available for rent.

Personal use of rental property. If you sometimes use your rental property for personal purposes, you must divide your expenses between rental and personal use. Also, your rental expense deductions may be limited. See *Personal Use of Dwelling Unit (Including Vacation Home)*, later.

Part interest. If you own a part interest in rental property, you can deduct expenses that you paid according to your percentage of ownership.

Uncollected rent. If you are a cash basis taxpayer, you do not deduct uncollected rent. Because you do not include it in your income, it is not deductible.

Depreciation. You can begin to depreciate rental property when it is ready and available for rent. See *Placed-in-Service Date* under *Depreciation*, later.

REPAIRS AND IMPROVEMENTS

Generally, an expense for repairing or maintaining your rental property may be deducted if you are not required to capitalize the expense.

Improvements. You must capitalize any expense you pay to improve your rental property. An expense is for an improvement if it results in a betterment to your property, restores your property, or adapts your property to a new or different use.

Betterments. Expenses that may result in a betterment to your property include expenses for fixing a pre-existing defect or condition, enlarging or expanding your property, or increasing the capacity, strength, or quality of your property.

Restoration. Expenses that may be for restoration include expenses for replacing a substantial structural part of your property, repairing damage to your property after you properly adjusted the basis of your property as a result of a casualty loss, or rebuilding your property to a like-new condition.

Adaptation. Expenses that may be for adaptation include expenses for altering your property to a use that is not consistent with the intended ordinary use of your property when you began renting the property.

Safe harbor for routine maintenance. If you determine that your cost was for an improvement to a building or equipment, you still may be able to deduct your cost under the routine maintenance safe harbor.

Note

Separate the costs of repairs and improvements, and keep accurate records. You will need to know the cost of improvements when you sell or depreciate your property. The expenses you capitalize for improving your property generally can be depreciated as if the improvement were separate property.

Safe Harbors under the IRS Regulations

The final regulations provide for three safe harbors related to improvements. They are a *de minimis* safe harbor, a safe harbor for small taxpayers, and a safe harbor for routine maintenance. If a safe harbor applies, a current deduction is allowed. The *de minimis* and small taxpayer safe harbors are annual elections made on a statement to be attached to the return, and not a change in accounting method.

***De minimis* safe harbor.** This safe harbor allows you to 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 (as substantiated by invoice). If you do not have an AFS, you may use the safe harbor to deduct amounts up to $2,500 per invoice or item (as substantiated by invoice). The *de minimis* safe harbor does not include amounts paid for inventory and land.

Small taxpayer safe harbor. This safe harbor allows small taxpayers to not capitalize an improvement, and therefore to deduct such costs of work performed on owned or leased buildings. In order to qualify, the requirements for small taxpayers are:

- Average annual gross receipts of $10 million or less; and
- Owns or leases building property with an unadjusted basis of $1 million or less; and
- The total amount paid during the taxable year for repairs, maintenance, improvements, or similar activities performed on such building property does not exceed the lesser of (1) two percent of the unadjusted basis of the eligible building property, or (2) $10,000.

Routine maintenance safe harbor. This safe harbor allows you to deduct expenses if the amounts meet all of the following criteria:

- Amounts paid for recurring activities that you expect to perform;
- As a result of your use of the property in your trade or business;
- To keep the property in its ordinarily efficient operating condition; and
- You reasonably expect, at the time the property is placed in service, to perform the activities (1) for building structures and building systems, more than once during the 10-year period beginning when placed in service, or (2) for property other than buildings, more than once during the class life of the unit of property.

The routine maintenance safe harbor does not apply to amounts paid for betterments, but does apply to certain restorations that would otherwise be improvements, including when you pay amounts to replace a major component or substantial structural part of a unit of property.

OTHER EXPENSES

Other expenses you can deduct from your rental income include advertising, cleaning and maintenance, utilities, fire and liability insurance, taxes, interest, commissions for the collection of rent, ordinary and necessary travel and transportation, and other expenses, discussed next.

Rental of property. You can deduct the rent you pay for property that you use for rental purposes. If you buy a leasehold for rental purposes, you can deduct an equal part of the cost each year over the term of the lease.

Rental of equipment. You can deduct the rent you pay for equipment that you use for rental purposes. However, in some cases, lease contracts are actually purchase contracts. If so, you cannot deduct these payments. You can recover the cost of purchased equipment through depreciation.

Insurance premiums paid in advance. If you pay an insurance premium for more than one year in advance, you cannot deduct the total premium in the year you pay it. For each year of coverage, you deduct only the part of the premium payment that applies to that year.

Local benefits taxes. In most cases, you cannot deduct charges for local benefits that increase the value of your property, such as charges for putting in streets, sidewalks, or water and sewer systems. These charges are nondepreciable capital expenditures, and must be added to the basis of your property. However, you can deduct local benefit taxes if they are for maintaining, repairing, or paying interest charges for the benefits.

Travel expenses. You can deduct the ordinary and necessary expenses of traveling away from home if the primary purpose of the trip was to collect rental income or to manage, conserve, or maintain your rental property. You must properly allocate your expenses between rental and nonrental activities. You cannot deduct the cost of traveling away from home if the primary purpose of the trip was to improve your property. For information on travel expenses, see chapter 20.

Local transportation expenses. You may be able to deduct your ordinary and necessary local transportation expenses if you incur them to collect rental income or to manage, conserve, or maintain your rental property. However, transportation expenses incurred to travel between your home and a rental property generally constitute nondeductible commuting costs unless you use your home as your principal place of business.

Generally, if you use your personal car, pickup truck, or light van for rental activities, you can deduct the expenses using one of two methods: actual expenses or the standard mileage rate. For 2024, the standard mileage rate for all business travel is 67.0 cents per mile.

Records. To deduct car expenses under either method, you must keep records that follow the rules in chapter 20.

IV. PERSONAL USE OF DWELLING UNIT (INCLUDING VACATION HOME)

If you have any personal use of a dwelling unit (including a vacation home) that you rent, you must divide your expenses between rental use and personal use. In general, your rental expenses will be no more than your total expenses multiplied by a fraction; the denominator of which is the total number of days the dwelling unit is used and the numerator of which is the total number of days actually rented at a fair rental price. Only your rental expenses may be deducted on Schedule E (Form 1040). Some of your personal expenses may be deductible if you itemize your deductions on Schedule A (Form 1040).

You must also determine if the dwelling unit is considered a home. The amount of rental expenses that you can deduct may be limited if the dwelling unit is considered a home. Whether a dwelling unit is considered a home depends on how many days during the year are considered to be days of personal use. There is a special rule if you used the dwelling unit as a home and you rented it for less than 15 days during the year.

Dwelling unit. A dwelling unit includes a house, apartment, condominium, mobile home, boat, vacation home, or similar property. A dwelling unit has basic living accommodations, such as sleeping space, a toilet, and cooking facilities.

A dwelling unit does not include property used solely as a hotel, motel, inn, or similar establishment. Property is used solely as a hotel, motel, inn, or similar establishment if it is regularly available for occupancy by paying customers and is not used by an owner as a home during the year.

Example

You rent a room in your home that is always available for short-term occupancy by paying customers. You do not use the room yourself, and you allow only paying customers to use the room. The room is used solely as a hotel, motel, inn, or similar establishment and is not a dwelling unit.

DWELLING UNIT USED AS HOME

The tax treatment of rental income and expenses for a dwelling unit that you use for both rental and personal purposes depends on whether you are considered to be using the dwelling unit as a home.

You use a dwelling unit as a home during the tax year if you use it for personal purposes more than the greater of:

1. 14 days, or
2. 10% of the total days it is rented to others at a fair rental price.

See *What is a day of personal use*, later.

If a dwelling unit is used for personal purposes on a day it is rented at a fair rental price, do not count that day as a day of rental use in applying (2) above. Instead, count it as a day of personal use in applying both (1) and (2) above. This rule does not apply when dividing expenses between rental and personal use.

Fair rental price. A fair rental price for your property generally is the amount of rent that a person who is not related to you would be willing to pay. The rent you charge is not a fair rental price if it is substantially less than the rents charged for other properties that are similar to your property in your area.

WHAT IS A DAY OF PERSONAL USE?

A day of personal use of a dwelling unit is any day that it is used by any of the following persons.

1. You or any other person who has an interest in it, unless you rent it to another owner as his or her main home under a shared equity financing agreement (defined later).
2. A member of your family or a member of the family of any other person who has a financial interest in it, unless the family member uses the dwelling unit as his or her main home and pays a fair rental price. Family includes only brothers and sisters, half-brothers and half-sisters, spouses, ancestors (parents, grandparents, etc.) and lineal descendants (children, grandchildren, etc.).
3. Anyone under an arrangement that lets you use some other dwelling unit.
4. Anyone at less than a fair rental price.

Main home. If the other person or member of the family in (1) or (2) above has more than one home, his or her main home is ordinarily the one lived in most of the time.

Shared equity financing agreement. This is an agreement under which two or more persons acquire undivided interests for more than 50 years in an entire dwelling unit, including the land, and one or more of the co-owners is entitled to occupy the unit as his or her main home upon payment of rent to the other co-owner or owners.

Donation of use of property. You use a dwelling unit for personal purposes if:

- You donate the use of the unit to a charitable organization,
- The organization sells the use of the unit at a fund-raising event, and
- The “purchaser” uses the unit.

Examples

The following examples show how to determine days of personal use.

Example 1

You and your neighbor are co-owners of a condominium at the beach. Last year, you rented the unit to vacationers whenever possible. The unit was not used as a main home by anyone. Your neighbor used the unit for two weeks last year; you did not use it at all.

Because your neighbor has an interest in the unit, both of you are considered to have used the unit for personal purposes during those 2 weeks.

Example 2

You and your neighbors are co-owners of a house under a shared equity financing agreement. Your neighbors live in the house and pay you a fair rental price.

Even though your neighbors have an interest in the house, the days your neighbors live there are not counted as days of personal use by you. This is because your neighbors rent the house as their main home under a shared equity financing agreement.

Example 3

You own a rental property that you rent to your son. Your son does not own any interest in this property. He uses it as his main home. He pays you a fair rental price for the property.

Your son's use of the property is not personal use by you because your son is using it as his main home, he owns no interest in the property, and he is paying you a fair rental price.

Example 4

You rent your beach house to Joshua. Joshua rents his house in the mountains to you. You each pay a fair rental price.

You are using your house for personal purposes on the days that Joshua uses it because your house is used by Joshua under an arrangement that allows you to use his house.

Days Used for Repairs and Maintenance

Any day that you spend working substantially full time repairing and maintaining your property is not counted as a day of personal use. Do not count such a day as a day of personal use even if family members use the property for recreational purposes on the same day.

Days Used as Main Home Before or After Renting

For purposes of determining whether a dwelling unit was used as a home, you may not have to count days you used the property as your main home before or after renting it or offering it for rent as days of personal use. Do not count them as days of personal use if:

1. You rented or tried to rent the property for 12 or more consecutive months.
2. You rented or tried to rent the property for a period of less than 12 consecutive months and the period ended because you sold or exchanged the property.

This special rule does not apply when dividing expenses between rental and personal use.

Examples

The following examples show how to determine whether you used your rental property as a home.

Example 1

You converted the basement of your home into an apartment with a bedroom, a bathroom, and a small kitchen. You rented the basement apartment at a fair rental price to college students during the regular school year. You rented to them on a 9-month lease (273 days). You figured 10% of the total days rented to others at a fair rental price is 27 days.

During June (30 days), your brothers stayed with you and lived in the basement apartment rent free.

Your basement apartment was used as a home because you used it for personal purposes for 30 days. Rent-free use by your brother is considered personal use. Your personal use (30 days) is more than the greater of 14 days or 10% of the total days it was rented (27 days).

Example 2

You rented the guest room in your home at a fair rental price during the local college's homecoming, commencement, and football weekends (a total of 27 days). Your sister-in-law stayed in the room, rent free, for the last 3 weeks (21 days) in July. You figured 10% of the total days rented to others at a fair rental price is 3 days.

The room was used as a home because you used it for personal purposes for 21 days. That is more than the greater of 14 days or 10% of the 27 days it was rented (3 days).

Example 3

You own a condominium apartment in a resort area. You rented it at a fair rental price for a total of 170 days during the year. For 12 of those days, the tenant was not able to use the apartment and allowed you to use it even though you did not refund any of the rent. Your family actually used the apartment for 10 of those days. Therefore, the apartment is treated as having been rented for 160 (170 - 10) days. You figured 10% of the total days rented to others at a fair rental price is 16 days. Your family also used the apartment for 7 other days during the year.

You used the apartment as a home because you used it for personal purposes for 17 days. That is more than the greater of 14 days or 10% of the 160 days it was rented (16 days).

HOW TO DIVIDE EXPENSES

If you use a dwelling unit for both rental and personal purposes, divide your expenses between the rental use and the personal use based on the number of days used for each purpose.

When dividing your expenses follow these rules.

1. Any day that the unit is rented at a fair rental price is a day of rental use even if you used the unit for personal purposes that day. This rule does not apply when determining whether you used the unit as a home.
2. Any day that the unit is available for rent but not actually rented is not a day of rental use.

Example

Your beach cottage was available for rent from June 1 through August 31 (92 days). During that time, except for the first week in August (7 days) when you were unable to find a renter, you rented the cottage at a fair rental price. The person who rented the cottage for July allowed you to use it over a weekend (2 days) without any reduction in or refund of rent. Your family also used the cottage during the last 2 weeks of May (14 days). The cottage was not used at all before May 17 or after August 31.

You figure the part of the cottage expenses to treat as rental expenses as follows.

1. The cottage was used for rental a total of 85 days (92 - 7). The days it was available for rent but not rented (7 days) are not days of rental use. The July weekend (2 days) you used it is rental use because you received a fair rental price for the weekend.

Example (continued)

2. You used the cottage for personal purposes for 14 days (the last 2 weeks in May).
3. The total use of the cottage was 99 days (14 days personal use + 85 days rental use).
4. Your rental expenses are 85/99 (86%) of the cottage expenses.

When determining whether you used the cottage as a home, the July weekend (2 days) you used it is personal use even though you received a fair rental price for the weekend. Therefore, you had 16 days of personal use and 83 days of rental use for this purpose. Because you used the cottage for personal purposes more than 14 days and more than 10% of the days of rental use (8 days), you used it as a home. If you have a net loss, you may not be able to deduct all of the rental expenses.

V. DEPRECIATION

You recover your cost in income producing property through yearly tax deductions. You do this by depreciating the property; that is, by deducting some of your cost on your tax return each year.

Three basic factors determine how much depreciation you can deduct. They are: (1) your basis in the property, (2) the recovery period for the property, and (3) the depreciation method used. You cannot simply deduct your mortgage or principal payments, or the cost of furniture, fixtures and equipment, as an expense.

You can deduct depreciation only on the part of your property used for rental purposes. Depreciation reduces your basis for figuring gain or loss on a later sale or exchange.

You may have to use Form 4562 to figure and report your depreciation.

Section 179 deduction. The section 179 deduction is a means of recovering part or all of the cost of certain qualifying property in the year you place the property in service. It is separate from your depreciation deduction.

Alternative minimum tax (AMT). If you use accelerated depreciation, you may be subject to the AMT. Accelerated depreciation allows you to deduct more depreciation earlier in the recovery period than you could deduct using a straight line method (same deduction each year).

Claiming the correct amount of depreciation. You should claim the correct amount of depreciation each tax year. If you did not claim all the depreciation that you were entitled to deduct, you must still reduce your basis in the property by the full amount of depreciation that you could have deducted.

If you deducted an incorrect amount of depreciation for property in any year, you may be able to make a correction for that year by filing Form 1040-X. If you are not allowed to make the correction on an amended return, you can change your accounting method to claim the correct amount of depreciation.

Changing your accounting method to deduct unclaimed depreciation. To change your accounting method, you must file Form 3115, *Application for Change in Accounting Method*, to get the consent of the IRS. In some instances, that consent is automatic.

Land. You can never depreciate the cost of land because land does not wear out, become obsolete, or get used up. The costs of clearing, grading, planting, and landscaping are usually all part of the cost of land and are not depreciable.

DEPRECIATION METHODS

There are three ways to figure depreciation. The depreciation method you use depends on the type of property and when the property was placed in service. For property used in rental activities you use one of the following.

- MACRS (Modified Accelerated Cost Recovery System) for property placed in service after 1986.
- ACRS (Accelerated Cost Recovery System) for property placed in service after 1980 but before 1987.
- Useful lives and either straight line or an accelerated method of depreciation, such as the declining balance method, if placed in service before 1981.

If you placed rental property in service before 2024, continue to use the same method of figuring depreciation that you used in the past.

Cooperative apartments. If you are a tenant-stockholder in a cooperative housing corporation and rent your cooperative apartment to others, you can deduct depreciation for the apartment even though it is owned by the corporation. Your depreciation deduction is your share of the corporation's depreciation.

MACRS

Most business and investment property placed in service after 1986 is depreciated using MACRS.

MACRS consists of two systems that determine how you depreciate your property. The main system is called the ***General Depreciation System (GDS)***. The second system is called the ***Alternative Depreciation System (ADS)***. GDS is used to figure your depreciation deduction for property used in most rental activities, unless you elect to use ADS.

To figure your MACRS deduction, you need to know the following information about your property:

1. Its recovery class,
2. Its applicable recovery period,
3. Its convention,
4. Its placed-in-service date,

5. Its depreciable basis, and

6. Its depreciation method.

Section 179 election. You cannot claim the section 179 deduction for property held to produce rental income (unless renting property is your trade or business).

Qualified real property. Although most real property is not eligible for the section 179 deduction, qualified real property is eligible. Under prior law, qualified real property generally consisted of qualified leasehold improvements, qualified restaurant property, and qualified retail improvements.

The Tax Cuts and Jobs Act significantly expands the definition of qualified real property that taxpayers may elect to treat as section 179 property. Effective for tax years beginning after 2017, qualified real property is defined as:

1. Qualified improvement property; and

2. Any of the following improvements to nonresidential real property that are placed in service after the nonresidential real property was first placed in service:

    - Roofs;
    - Heating, ventilation, and air-conditioning property;
    - Fire protection and alarm systems; and
    - Security systems.

Exclusion for property used in connection with lodging. Effective for property placed in service in tax years beginning after December 31, 2017, property that is used predominantly to furnish lodging or in connection with the furnishing of lodging qualifies for section 179 expensing.

The primary impact of this provision is to allow expensing of section 1245 property purchased for use in connection with a residential rental building. Examples of property used in connection with the furnishing of lodging include lobby furniture, office equipment, and laundry and swimming pool equipment. Property used in furnishing electrical energy, water, sewage disposal services, gas, telephone service, or similar services are not used in connection with the furnishing of lodging.

No deduction greater than basis. The total of all your yearly depreciation deductions cannot be more than the cost or other basis of the property. For this purpose, your yearly depreciation deductions include any depreciation that you were allowed to claim, even if you did not claim it.

Personal home changed to rental use. You must use MACRS to figure the depreciation on property you used as your home and changed to rental property in 2024.

Excluded property. You cannot use MACRS for certain personal property placed in service in your rental property in 2024 if it had been previously placed in service before MACRS became effective in 1987 (before August 1, 1986, if election made).

Recovery Periods Under GDS

Each item of property that can be depreciated is assigned to a property class. The recovery period of the property depends on the class the property is in. Under GDS, the recovery period of an asset is generally the same as its property class. The property classes under GDS are:

- 3-year property,
- 5-year property,
- 7-year property,
- 10-year property,
- 15-year property,
- 20-year property,
- Nonresidential real property, and
- Residential rental property.

Recovery periods for property used in rental activities are shown in *Table 9-1*, next.

TABLE 9-1. MACRS RECOVERY PERIODS FOR PROPERTY USED IN RENTAL ACTIVITIES

MACRS Recovery Period		
Type of Property	**General Depreciation System**	**Alternative Depreciation System**
Computers and their peripheral equipment	5 years	5 years
Office machinery, such as:		
Typewriters		
Calculators		
Copiers	5 years	5 years
Automobiles	5 years	5 years
Light trucks	5 years	5 years
Appliances, such as:		
Stoves		
Refrigerators	5 years	9 years
Carpets	5 years	9 years
Furniture used in rental property	5 years	9 years

MACRS Recovery Period		
Type of Property	**General Depreciation System**	**Alternative Depreciation System**
Office furniture and equipment, such as: Desks Files Any property that does not have a class life and that has not been designated by law as being in any other class	 7 years 7 years	 10 years 12 years
Roads Shrubbery Fences	15 years 15 years 15 years	20 years 20 years 20 years
Residential rental property (buildings or structures) and structural components such as furnaces, water pipes, venting, etc.	27.5 years	30 years
Additions and improvements, such as a new roof	The same recovery period as that of the property to which the addition or improvement is made, determined as if the property were placed in service at the same time as the addition or improvement.	

Additions or improvements to property. Treat depreciable additions or improvements you make to any property as separate property items for depreciation purposes. The recovery period for an addition or improvement to property begins on the later of:

1. The date the addition or improvement is placed in service, or
2. The date the property to which the addition or improvement was made is placed in service.

The class and recovery period of the addition or improvement is the one that would apply to the original property if it were placed in service at the same time as the addition or improvement.

Example

You own a residential rental house that you have been renting since 1987 and depreciating under ACRS. You built an addition onto the house and placed it in service in 2024. You must use MACRS for the addition. Under GDS, the addition is depreciated as residential rental property over 27.5 years.

Placed-in-Service Date

You can begin to depreciate property when you place it in service in your trade or business or for the production of income. Property is considered placed in service in a rental activity when it is ready and available for a specific use in that activity.

Depreciable Basis

To deduct the proper amount of depreciation each year, you must first determine your basis in the property you intend to depreciate. The basis used for figuring depreciation is your original basis in the property increased by any additions or improvements made to the property. Your original basis is usually your cost. However, if you acquire the property in some other way, such as by inheriting it, getting it as a gift, or building it yourself, you may have to figure your original basis in another way. Other adjustments could also affect your basis. See chapter 13.

Conventions

Under MACRS, conventions establish when the recovery period begins and ends. The convention you use determines the number of months for which you can claim depreciation in the year you place property in service and in the year you dispose of the property.

Mid-month convention. A mid-month convention is used for all residential rental property and nonresidential real property. Under this convention, you treat all property placed in service, or disposed of, during any month as placed in service, or disposed of, at the midpoint of that month.

Mid-quarter convention. A mid-quarter convention must be used if the mid-month convention does not apply and the total depreciable basis of MACRS property you placed in service in the last 3 months of a tax year (excluding nonresidential real property, residential rental property, and property placed in service and disposed of in the same year) is more than 40% of the total basis of all such property you place in service during the tax year.

Under this convention, you treat all property placed in service, or disposed of, during any quarter of a tax year as placed in service, or disposed of, at the midpoint of the quarter.

Half-year convention. The half-year convention is used if neither the mid-quarter convention nor the mid-month convention applies. Under this convention, you treat all property placed in service, or disposed of, during a tax year as placed in service, or disposed of, at the midpoint of that tax year.

If this convention applies, you deduct a half-year of depreciation for the first year and the last year that you depreciate the property. You deduct a full year of depreciation for any other year during the recovery period.

Example

During the tax year, Jordan purchased the following items to use in his rental property.

- A dishwasher for $400 that he placed in service in January.
- Used furniture for $100 that he placed in service in September.
- A refrigerator for $800 that he placed in service in October.

Jordan uses the calendar year as his tax year. The total basis of all property placed in service in that year is $1,300. The $800 basis of the refrigerator placed in service during the last 3 months of his tax year exceeds $520 (40% × $1,300). Jordan must use the mid-quarter convention instead of the half-year convention for all three items.

MACRS DEPRECIATION UNDER GDS

You can figure your MACRS depreciation deduction under GDS in one of two ways. The deduction is substantially the same both ways. (The difference, if any, is slight.) You can either:

1. Use the percentage from the optional MACRS tables, see *Table 9-2*, or
2. Actually figure the deduction using the depreciation method and convention that apply over the recovery period of the property.

TABLE 9-2. OPTIONAL MACRS TABLES

TABLE 9-2A. MACRS 5-YEAR PROPERTY

	Half-year convention	Mid-quarter convention			
Year		First quarter	Second quarter	Third quarter	Fourth quarter
1	20.00%	35.00%	25.00%	15.00%	5.00%
2	32.00	26.00	30.00	34.00	38.00
3	19.20	15.60	18.00	20.40	22.80
4	11.52	11.01	11.37	12.24	13.68
5	11.52	11.01	11.37	11.30	10.94
6	5.76	1.38	4.26	7.06	9.58

TABLE 9-2B. MACRS 7-YEAR PROPERTY

Year	Half-year convention	Mid-quarter convention			
		First quarter	Second quarter	Third quarter	Fourth quarter
1	14.29%	25.00%	17.85%	10.71%	3.57%
2	24.49	21.43	23.47	25.51	27.55
3	17.49	15.31	16.76	18.22	19.68
4	12.49	10.93	11.97	13.02	14.06
5	8.93	8.75	8.87	9.30	10.04
6	8.92	8.74	8.87	8.85	8.73

TABLE 9-2C. MACRS 15-YEAR PROPERTY

Year	Half-year convention	Mid-quarter convention			
		First quarter	Second quarter	Third quarter	Fourth quarter
1	5.00%	8.75%	6.25%	3.75%	1.25%
2	9.50	9.13	9.38	9.63	9.88
3	8.55	8.21	8.44	8.66	8.89
4	7.70	7.39	7.59	7.80	8.00
5	6.93	6.65	6.83	7.02	7.20
6	6.23	5.99	6.15	6.31	6.48

TABLE 9-2D. RESIDENTIAL RENTAL PROPERTY (27.5-YEAR)

	Use the row for the month of the taxable year placed in service					
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
January	3.485%	3.636%	3.636%	3.636%	3.636%	3.636%
February	3.182	3.636	3.636	3.636	3.636	3.636
March	2.879	3.636	3.636	3.636	3.636	3.636
April	2.576	3.636	3.636	3.636	3.636	3.636
May	2.273	3.636	3.636	3.636	3.636	3.636
June	1.970	3.636	3.636	3.636	3.636	3.636
July	1.667	3.636	3.636	3.636	3.636	3.636

	Use the row for the month of the taxable year placed in service					
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
August	1.364	3.636	3.636	3.636	3.636	3.636
September	1.061	3.636	3.636	3.636	3.636	3.636
October	0.758	3.636	3.636	3.636	3.636	3.636
November	0.455	3.636	3.636	3.636	3.636	3.636
December	0.152	3.636	3.636	3.636	3.636	3.636

USING THE OPTIONAL TABLES

You can use the tables in *Table 9-2* to compute annual depreciation under MACRS. The tables show the percentages for the first 6 years. The percentages in *Tables 9-2-A*, *9-2-B*, and *9-2-C* make the change from declining balance to straight line in the year that straight line will yield an equal or larger deduction.

How to use the tables. The following section explains how to use the optional tables.

Figure the depreciation deduction by multiplying your ***unadjusted basis*** in the property by the percentage shown in the appropriate table. Your unadjusted basis is your depreciable basis without reduction for depreciation previously claimed.

Once you begin using an optional table to figure depreciation, you must continue to use it for the entire recovery period unless there is an adjustment to the basis of your property for a reason other than:

1. Depreciation allowed or allowable, or
2. An addition or improvement that is depreciated as a separate item of property.

Tables 9-2-A, 9-2-B, and 9-2-C. The percentages in these tables take into account the half-year and mid-quarter conventions. Use *Table 9-2-A* for 5-year property, *Table 9-2-B* for 7-year property, and *Table 9-2-C* for 15-year property. Use the percentage in the second column (half-year convention) unless you must use the mid-quarter convention (explained earlier). If you must use the mid-quarter convention, use the column that corresponds to the calendar year quarter in which you placed the property in service.

Example 1

You purchased a stove and refrigerator and placed them in service in June. Your basis in the stove is $600 and your basis in the refrigerator is $1,000. Both are 5-year property. Using the half-year convention column in *Table 9-2-A,* you find the depreciation percentage for year 1 is 20%. For that year, your depreciation deduction is $120 ($600 × .20) for the stove and $200 ($1,000 × .20) for the refrigerator.

For year 2, you find your depreciation percentage is 32%. That year's depreciation deduction will be $192 ($600 × .32) for the stove and $320 ($1,000 × .32) for the refrigerator.

Example 2

Assume the same facts as in *Example 1*, except you buy the refrigerator in October instead of June. You must use the mid-quarter convention to figure depreciation on the stove and refrigerator. The refrigerator was placed in service in the last 3 months of the tax year and its basis ($1,000) is more than 40% of the total basis of all property placed in service during the year ($1,600 × .40 = $640).

Because you placed the refrigerator in service in October, you use the fourth quarter column of *Table 9-2-A* and find that the depreciation percentage for year 1 is 5%. Your depreciation deduction for the refrigerator is $50 ($1,000 × .05).

Because you placed the stove in service in June, you use the second quarter column of *Table 9-2-A* and find that the depreciation percentage for year 1 is 25%. For that year, your depreciation deduction for the stove is $150 ($600 × .25).

Table 9-2-D. Use this table for residential rental property. Find the row for the month that you placed the property in service. Use the percentages listed for that month to figure your depreciation deduction. The mid-month convention is taken into account in the percentages shown in the table.

Example

You purchased a single family rental house for $185,000 and placed it in service on February 8. Your basis in the house is $160,000. Using *Table 9-2-D*, you find that the percentage for property placed in service in February of year 1 is 3.182%. That year's depreciation deduction is $5,091 ($160,000 × .03182).

MACRS DEPRECIATION UNDER ADS

If you choose, you can use the ADS method for most property. Under ADS, you use the straight line method of depreciation.

Table 9-1 shows the recovery periods for property used in rental activities that you depreciate under ADS. If your property is not listed, it is considered to have no class life. Under ADS, personal property with no class life is depreciated using a recovery period of 12 years.

Use the mid-month convention for residential rental property and nonresidential real property. For all other property, use the half-year or mid-quarter convention.

Election. For property placed in service during 2024, you choose to use ADS by entering the depreciation on line 20c, Part III of Form 4562.

The election of ADS for one item in a class of property generally applies to all property in that class that is placed in service during the tax year of the election. However, the election applies on a property-by-property basis for residential rental property and nonresidential real property.

Once you choose to use ADS, you cannot change your election.

OTHER RULES ABOUT DEPRECIABLE PROPERTY

In addition to the rules about what methods you can use, there are other rules you should be aware of with respect to depreciable property.

Gain from disposition. If you dispose of depreciable property at a gain, you may have to report, as ordinary income, all or part of the gain.

Alternative minimum tax. If you use accelerated depreciation, you may have to file Form 6251. Accelerated depreciation includes MACRS, ACRS, and any other method that allows you to deduct more depreciation than you could deduct using a straight line method.

VI. LIMITS ON RENTAL LOSSES

If you have a loss from your rental real estate activity, two sets of rules may limit the amount of loss you can report on Schedule E. You must consider these rules in the order shown below.

1. At-risk rules. These rules are applied first if there is investment in your rental real estate activity for which you are not at risk. This applies only if the real property was placed in service after 1986.
2. Passive activity limits. Generally, rental real estate activities are considered passive activities and losses are not deductible unless you have income from other passive activities to offset them. However, there are exceptions.

Excess business loss limitation. The excess business loss limitation under section 461(1) is extended and applies to tax years beginning after December 31, 2020 and before January 1, 2029. For 2024, the amount is $305,000 ($610,000 for joint returns).

AT-RISK RULES

You may be subject to the at-risk rules if you have:

- A loss from an activity carried on as a trade or business or for the production of income, and
- Amounts invested in the activity for which you are not fully at risk.

Losses from holding real property (other than mineral property) placed in service before 1987 are not subject to the at-risk rules.

In most cases, any loss from an activity subject to the at-risk rules is allowed only to the extent of the total amount you have at risk in the activity at the end of the tax year. You are considered at risk in an activity to the extent of cash and the adjusted basis of other property you contributed to the activity and certain amounts borrowed for use in the activity.

PASSIVE ACTIVITY LIMITS

In most cases, all rental real estate activities (except those meeting the exception for real estate professionals, below) are passive activities. For this purpose, a rental activity is an activity from which you receive income mainly for the use of tangible property, rather than for services.

Limits on passive activity deductions and credits. Deductions for losses from passive activities are limited. You generally cannot offset income, other than passive income, with losses from passive activities. Nor can you offset taxes on income, other than passive income, with credits resulting from passive activities. Any excess loss or credit is carried forward to the next tax year.

You may have to complete Form 8582 to figure the amount of any passive activity loss for the current tax year for all activities and the amount of the passive activity loss allowed on your tax return.

Real estate professionals. Rental activities in which you materially participated during the year are not passive activities if, for that year, you were a real estate professional.

Exception for Personal Use of Dwelling Unit

If you used the rental property as a home during the year, any income, deductions, gain, or loss allocable to such use is not taken into account for purposes of the passive activity loss limitation. Instead, follow the rules explained in *Personal Use of Dwelling Unit (Including Vacation Home)*, earlier.

Exception for Rental Real Estate Activities with Active Participation

If you or your spouse actively participated in a passive rental real estate activity, you may be able to deduct up to $25,000 of loss from the activity from your nonpassive income. This special allowance is an exception to the general rule disallowing losses in excess of income from passive activities. Similarly, you can offset credits from the activity against the tax on up to $25,000 of nonpassive income after taking into account any losses allowed under this exception.

Active participation. You actively participated in a rental real estate activity if you (and your spouse) owned at least 10% of the rental property and you made management decisions or arranged for others to provide services (such as repairs) in a significant and bona fide sense. Management decisions that count as active participation include approving new tenants, deciding on rental terms, approving expenditures, and other similar decisions.

Maximum special allowance. The maximum special allowance is:

- $25,000 for single individuals and married individuals filing a joint return for the tax year,
- $12,500 for married individuals who file separate returns for the tax year and lived apart from their spouses at all times during the tax year, and
- $25,000 for a qualifying estate reduced by the special allowance for which the surviving spouse qualified.

If your modified adjusted gross income is $100,000 or less ($50,000 or less if married filing separately), you can deduct your loss up to the amount specified above. If your modified adjusted gross income is more than $100,000 (more than $50,000 if married filing separately), your special allowance is limited to 50% of the difference between $150,000 ($75,000 if married filing separately) and your modified adjusted gross income.

Generally, if your modified adjusted gross income is $150,000 or more ($75,000 or more if you are married filing separately), there is no special allowance.

CHAPTER 9: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1.	**Each of the following payment types is booked as rental income by the property owner <u>except</u>:** **A.** advance rent received **B.** security deposits planned to be returned to tenant **C.** lease cancellation fees **D.** expenses paid by tenant
2.	**Rental property expenses that are typically deductible include which of the following:** **A.** local benefit taxes **B.** cost of improvements **C.** uncollected rent if you are a cash basis taxpayer **D.** cost of repairs
3.	**If during a tax year a dwelling unit is used for both rental and personal home use, what is the <u>maximum</u> number of days that it can be used as a home and still be claimed as a rental property if rented for a total of 100 days during the tax year:** **A.** 10 days **B.** 14 days **C.** 21 days **D.** 30 days

4.	**Each of the following is one of the three factors that determine how much depreciation you can deduct for income producing property except:** **A.** your cost basis in the property **B.** the recovery period for the property **C.** the depreciation method used **D.** the age of the property

CHAPTER 9: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. Include advanced rent in your rental income in the year you receive it regardless of the period covered or the method of accounting used. **B.** **CORRECT**. If you plan to return a security deposit to your tenant at the end of the lease, do not include it in your income when you receive it. If you keep part or all of the security deposit, include the amount you keep in your income for that year. **C.** Incorrect. If your tenant pays you to cancel a lease, the amount you receive is considered rent. Include the payment in your income in the year you receive it regardless of the method of accounting used. **D.** Incorrect. If your tenant pays any of your expenses, the payments are rental income and you must include them in your income. You can deduct the expenses if they are deductible rental expenses. *(See pages 69 to 70 of the course material.)*
2.	**A.** Incorrect. Generally, you cannot deduct charges for local benefits that increase the value of your property. You must add them to the basis of your property. **B.** Incorrect. You cannot deduct the cost of improvements. You can recover the cost of improvements, however, by taking depreciation. **C.** Incorrect. If you are a cash basis taxpayer, you do not report uncollected rent because you do not include it in your income. **D.** **CORRECT**. You can deduct the cost of repairs to your rental property. A repair keeps your property in good operating condition, but it does not materially add to the value of your property or substantially prolong its life. *(See pages 71 to 73 of the course material.)*
3.	**A.** Incorrect. A rental property can be used as a home by the owner for more than 10 days during a tax year, even if rented for 100 days. **B.** **CORRECT**. The maximum number of days a rental property can be used as a home and still retain its classification is the greater of 14 days or 10% of the total days it is rented to others at a fair market price. In this scenario, 14 days is the maximum. **C.** Incorrect. A period of 21 days will result in the loss of rental property status. **D.** Incorrect. A period of 30 days is too long and will result in the loss of rental property status. *(See page 74 of the course material.)*

4.	**A.** Incorrect. Your cost basis in the property is one of the three factors that determine how much depreciation you can deduct. **B.** Incorrect. The recovery period for the property is one of the three factors that determine how much depreciation you can deduct. **C.** Incorrect. The depreciation method used is one of the three factors that determine how much depreciation you can deduct. **D.** **CORRECT**. The age of the property is not a factor in the determination of how much depreciation you can deduct. *(See page 79 of the course material.)*

CHAPTER 10: RETIREMENT PLANS, PENSIONS, AND ANNUITIES

Chapter Objective

After completing this chapter, you should be able to:

- Identify various requirements regarding retirement plan taxation.

I. WHAT'S NEW

SECURE ACT AND SECURE ACT 2.0

The SECURE Act, signed into law on December 20, 2019, made the following changes for tax years after 2019: moved the start date for required minimum distributions (RMDs) to the year in which the owner turns 72; ended the 70½ age limit for contributions to a traditional IRA; and shortened the distribution period for non-spouse inherited IRAs to a 10-year maximum.

Subsequently, the SECURE Act 2.0, signed into law on December 29, 2022, further changed the RMD start date to the year in which the owner turns 73, if not 72 prior to January 1, 2023. The SECURE Act 2.0 also decreased the penalty for not taking an RMD from 50% to 25% of the RMD amount, and 10% if corrected timely.

TRADITIONAL IRA AND ROTH IRA CONTRIBUTION PHASEOUT

For 2024, the contribution limit for traditional IRAs and Roth IRAs is $7,000, or $8,000 for those age 50 or older.

The deduction limit for 2024 contributions to a traditional IRA is phased out for active plan participants with modified AGI (MAGI) of over $77,000 and under $87,000 for a single person or head of household, or over $123,000 and under $143,000 for married persons filing jointly. The phaseout range is MAGI over $230,000 and under $240,000 for a spouse who is not an active plan participant and files jointly with a spouse who is an active plan participant.

The 2024 Roth IRA contribution limit is phased out for a single person or head of household with MAGI over $146,000 and under $161,000, and for married persons filing jointly with MAGI over $230,000 and under $240,000.

401K

The elective deferral limit for employees who participate in 401(k), 403(b), or 457(b) plans is $23,000 in 2024. The catch-up contribution is $7,500 for those age 50 and over for 2024.

II. INTRODUCTION

This chapter discusses the tax treatment of distributions you receive from:

1. An employee pension or annuity from a qualified plan,
2. A disability retirement, and
3. A purchased commercial annuity.

What is not covered in this chapter. The following topics are not discussed in this chapter:

1. **The General Rule.** This is the method generally used to determine the tax treatment of pension and annuity income from nonqualified plans (including commercial annuities). If your annuity starting date is after November 18, 1996, you generally cannot use the General Rule for a qualified plan.
2. **Individual retirement arrangements (IRAs).** Information on the tax treatment of amounts you receive from an IRA is in chapter 17.

III. GENERAL INFORMATION

Designated Roth accounts. A designated Roth account is a separate account created under a qualified Roth contribution program to which participants may elect to have part or all of their elective deferrals to a 401(k), 403(b), or 457(b) plan designated as Roth contributions. Elective deferrals that are designated as Roth contributions are included in your income. However, qualified distributions are not included in your income.

More than one program. If you receive benefits from more than one program under a single trust or plan of your employer, such as a pension plan and a profit-sharing plan, you may have to figure the taxable part of each separately. Your former employer or the plan administrator should be able to tell you if you have more than one pension or annuity contract.

Section 457 deferred compensation plans. If you work for a state or local government or for a tax-exempt organization, you may be able to participate in a section 457 deferred compensation plan. If your plan is an eligible plan, you are not taxed currently on pay that is deferred under the plan or on any earnings from the plan's investment of the deferred pay. You are taxed on amounts deferred in an eligible state or local government plan only when they are distributed from the plan. You are taxed on amounts deferred in an eligible tax-exempt organization plan when they are distributed or otherwise made available to you.

Your 457(b) plan may have a designated Roth account option. If so, you may be able to roll over amounts to the designated Roth account or make contributions. Elective deferrals to a designated Roth account are included in your income. Qualified distributions from a designated Roth account are not subject to tax.

Disability pensions. If you retired on disability, you generally must include in income any disability pension you receive under a plan that is paid for by your employer. You must report your taxable disability payments as wages on line 1a of Form 1040 or 1040-SR until you reach minimum retirement age. Minimum retirement age generally is the age at which you can first receive a pension or annuity if you are not disabled.

Tip

You may be entitled to a tax credit if you were permanently and totally disabled when you retired. For information on this credit, see chapter 32.

Beginning on the day after you reach minimum retirement age, payments you receive are taxable as a pension or annuity. Report the payments on Form 1040 or 1040-SR, lines 5a and 5b.

Tip

Disability payments for injuries incurred as a direct result of a terrorist attack directed against the United States (or its allies) are not included in income.

For more information on how to report disability pensions, including military and certain government disability pensions, see chapter 5.

Railroad retirement benefits. Part of the railroad retirement benefits you receive is treated for tax purposes like social security benefits, and part is treated like an employee pension.

Withholding and estimated tax. The payer of your pension, profit-sharing, stock bonus, annuity, or deferred compensation plan will withhold income tax on the taxable parts of amounts paid to you. You can tell the payer how much to withhold, or not to withhold, by filing Form W-4P. If you choose not to have tax withheld, or you do not have enough tax withheld, you may have to pay estimated tax.

If you receive an eligible rollover distribution, you cannot choose not to have tax withheld. Generally, 20% will be withheld, but no tax will be withheld on a direct rollover of an eligible rollover distribution. See *Direct rollover option* under *Rollovers*, later.

Loans. If you borrow money from your retirement plan, you must treat the loan as a nonperiodic distribution from the plan unless certain exceptions apply. This treatment also applies to any loan under a contract purchased under your retirement plan, and to the value of any part of your interest in the plan or contract that you pledge or assign. This means that you must include in income all or part of the amount borrowed. Even if you do not have to treat the loan as a nonperiodic distribution, you may not be able to deduct the interest on the loan in some situations.

Qualified plans for self-employed individuals. Qualified plans set up by self-employed individuals are sometimes called Keogh or H.R. 10 plans. Qualified plans can be set up by sole proprietors, partnerships (but not a partner), and corporations. They can cover self-employed persons, such as the sole proprietor or partners, as well as regular (common-law) employees.

Distributions from a qualified plan are usually fully taxable because most recipients have no cost basis. If you have an investment (cost) in the plan, however, your pension or annuity payments from a qualified plan are taxed under the Simplified Method.

Purchased annuities. If you receive pension or annuity payments from a privately purchased annuity contract from a commercial organization, such as an insurance company, you generally must use the General Rule to figure the tax-free part of each annuity payment.

Tax-free exchange. No gain or loss is recognized on an exchange of an annuity contract for another annuity contract if the insured or annuitant remains the same. However, if an annuity contract is exchanged for a life insurance or endowment contract, any gain due to interest accumulated on the contract is ordinary income.

IV. COST (INVESTMENT IN THE CONTRACT)

Before you can figure how much, if any, of your pension or annuity benefits is taxable, you must determine your cost (your investment in the contract) in the pension or annuity. Your total cost in the plan includes the total premiums, contributions, or other amounts that you paid. It also includes amounts that were taxable to you when paid. Cost does not include any amounts you deducted or excluded from income.

From this total cost paid or considered paid by you, subtract any refunds of premiums, rebates, dividends, unrepaid loans, or other tax-free amounts you received by the later of the annuity starting date or the date on which you received your first payment.

Your annuity starting date is the later of the first day of the first period for which you received a payment, or the date the plan's obligations became fixed.

Designated Roth accounts. Your cost in these accounts is your designated Roth contributions that were included in your income as wages subject to applicable withholding requirements. Your cost will also include any in-plan Roth rollovers you included in income.

Foreign employment contributions. If you worked in a foreign country and your employer contributed to your retirement plan, special rules apply in determining your cost.

V. TAXATION OF PERIODIC PAYMENTS

Fully taxable payments. Generally, if you did not pay any part of the cost of your employee pension or annuity and your employer did not withhold part of the cost from your pay while you worked, the amounts you receive each year are fully taxable. You must report them on your income tax return.

Partly taxable payments. If you paid part of the cost of your annuity, you are not taxed on the part of the annuity you receive that represents a return of your cost. The rest of the amount you receive is generally taxable. You figure the tax-free part of the payment using either the Simplified Method or the General Rule. Your annuity starting date and whether or not your plan is qualified determine which method you must or may use.

If the annuity starting date is after November 18, 1996, and your payments are from a qualified plan, you must use the Simplified Method. Generally, you must use the General Rule if your annuity is paid under a nonqualified plan, and you cannot use this method if your annuity is paid under a qualified plan.

If you had more than one partly taxable pension or annuity, figure the tax-free part and the taxable part of each separately.

If your annuity is paid under a qualified plan and your annuity starting date is after July 1, 1986, and before November 19, 1996, you could have chosen to use either the General Rule or the Simplified Method.

Exclusion limit. Your annuity starting date determines the total amount that you can exclude from your taxable income over the years. Once your annuity starting date is determined, it does not change. If you calculate the taxable portion of your annuity payments using the Simplified Method Worksheet, the annuity starting date determines the recovery period for your cost. That recovery period begins on your annuity starting date and is not affected by the date you first complete the worksheet.

Exclusion limited to cost. If your annuity starting date is after 1986, the total amount of annuity income that you can exclude over the years as a recovery of the cost cannot exceed your total cost.

Exclusion not limited to cost. If your annuity starting date is before 1987, you can continue to take your monthly exclusion for as long as you receive your annuity. If you chose a joint and survivor annuity, your survivor can continue to take the survivor's exclusion figured as of the annuity starting date. The total exclusion may be more than your cost.

SIMPLIFIED METHOD

Under the Simplified Method, you figure the tax-free part of each monthly annuity payment by dividing your cost by the total number of expected monthly payments. For an annuity that is payable for the lives of the annuitants, this number is based on the annuitants' ages on the annuity starting date and is determined from a table. For any other annuity, this number is the number of monthly annuity payments under the contract.

Who must use the Simplified Method. You must use the Simplified Method if your annuity starting date is after November 18, 1996, and you receive pension or annuity payments from a qualified employee plan, qualified employee annuity, or a tax-sheltered annuity (403(b)) plan, and on your annuity starting date, you were either under age 75, or entitled to less than 5 years of guaranteed payments.

Guaranteed payments. Your annuity contract provides guaranteed payments if a minimum number of payments or a minimum amount (for example, the amount of your investment) is payable even if you and any survivor annuitant do not live to receive the minimum. If the minimum amount is less than the total amount of the payments you are to receive, barring death, during the first 5 years after payments begin (figured by ignoring any payment increases), you are entitled to less than 5 years of guaranteed payments.

Example

Bill Smith, age 65, began receiving retirement benefits in 2024, under a joint and survivor annuity. Bill's annuity starting date is January 1, 2024. The benefits are to be paid for the joint lives of Bill and his wife Kathy, age 65. Bill had contributed $31,000 to a qualified plan and had received no distributions before the annuity starting date. Bill is to receive a retirement benefit of $1,200 a month, and Kathy is to receive a monthly survivor benefit of $600 upon Bill's death.

Bill must use the Simplified Method to figure his taxable annuity because his payments are from a qualified plan and he is under age 75. Because his annuity is payable over the lives of more than one annuitant, he uses his and Kathy's combined ages (and Table 2 at the bottom of the worksheet) in completing line 3 of the Simplified Method Worksheet.

Bill's tax-free monthly amount is $100 ($31,000 / 310) as shown on line 4 of the worksheet. Upon Bill's death, if Bill has not recovered the full $31,000 investment, Kathy will also exclude $100 from her $600 monthly payment. The full amount of any annuity payments received after 310 payments are paid must be included in gross income.

Who must use the General Rule. You must use the General Rule if you receive pension or annuity payments from:

1. A nonqualified plan (such as a private annuity, a purchased commercial annuity, or a nonqualified employee plan), or
2. A qualified plan if you are age 75 or older on your annuity starting date and your annuity payments are guaranteed for at least 5 years.

Who cannot use the General Rule. You cannot use the General Rule if you receive your pension or annuity from a qualified plan and none of the circumstances described in the preceding discussions apply to you. See *Who must use the Simplified Method*, earlier.

VI. TAXATION OF NONPERIODIC PAYMENTS

Nonperiodic distributions are also known as amounts not received as an annuity. They include all payments other than periodic payments and corrective distributions.

Corrective distributions of excess plan contributions. Generally, if the contributions made for you during the year to certain retirement plans exceed certain limits, the excess is taxable to you. To correct any excess, your plan may distribute it to you (along with any income earned on the excess).

Figuring the taxable amount of nonperiodic payments. How you figure the taxable amount of a nonperiodic distribution depends on whether it is made before the annuity starting date or on or after the annuity starting date. If it is made before the annuity starting date, its tax treatment also depends on whether it is made under a qualified or nonqualified plan. If it is made under a nonqualified plan, its tax treatment depends on whether it fully discharges the contract or is allocable to an investment you made before August 14, 1982.

Distribution on or after annuity starting date. If you receive a nonperiodic payment from your annuity contract on or after the annuity starting date, you generally must include all of the payment in gross income.

Distribution before annuity starting date. If you receive a nonperiodic distribution before the annuity starting date from a qualified retirement plan, you generally can allocate only part of it to the cost of the contract. You exclude from your gross income the part that you allocate to the cost. You include the remainder in your gross income.

If you receive a nonperiodic distribution before the annuity starting date from a plan other than a qualified retirement plan, it is generally allocated first to earnings (the taxable part) and then to the cost of the contract (the tax-free part). This allocation rule applies, for example, to a commercial annuity contract you bought directly from the issuer.

Caution!

Distributions from nonqualified plans are subject to the NIIT. See the Instructions for Form 8960.

LUMP-SUM DISTRIBUTIONS

Lump-sum distribution defined. A lump-sum distribution is the distribution or payment in 1 tax year of a plan participant's entire balance from all of the employer's qualified plans of one kind (for example, pension, profit-sharing, or stock bonus plans). A distribution from a nonqualified plan (such as a privately purchased commercial annuity or a section 457 deferred compensation plan of a state or local government or tax-exempt organization) cannot qualify as a lump-sum distribution.

The participant's entire balance from a plan does not include certain forfeited amounts. It also does not include any deductible voluntary employee contributions allowed by the plan after 1981 and before 1987.

If you receive a lump-sum distribution from a qualified employee plan or qualified employee annuity and the plan participant was born before January 2, 1936, you may be able to elect optional methods of figuring the tax on the distribution. The part from active participation in the plan before 1974 may qualify as capital gain subject to a 20% tax rate. The part from participation after 1973 (and any part from participation before 1974 that you do not report as capital gain) is ordinary income. You may be able to use the 10-year tax option, discussed later, to figure tax on the ordinary income part.

Use Form 4972 to figure the separate tax on a lump-sum distribution using the optional methods. The tax figured on Form 4972 is added to the regular tax figured on your other income. This may result in a smaller tax than you would pay by including the taxable amount of the distribution as ordinary income in figuring your regular tax.

How to treat the distribution. If you receive a lump-sum distribution, you may have the following options for how you treat the taxable part.

- Report the part of the distribution from participation before 1974 as a capital gain (if you qualify) and the part from participation after 1973 as ordinary income.
- Report the part of the distribution from participation before 1974 as a capital gain (if you qualify) and use the 10-year tax option to figure the tax on the part from participation after 1973 (if you qualify).
- Use the 10-year tax option to figure the tax on the total taxable amount (if you qualify).
- Roll over all or part of the distribution. See *Rollovers*, later. No tax is currently due on the part rolled over. Report any part not rolled over as ordinary income.
- Report the entire taxable part of the distribution as ordinary income on your tax return.

The first three options are explained in the following discussions.

Electing optional lump-sum treatment. You can choose to use the 10-year tax option or capital gain treatment only once after 1986 for any plan participant. If you make this choice, you cannot use either of these optional treatments for any future distributions for the participant.

Taxable and tax-free parts of the distribution. The taxable part of a lump-sum distribution is the employer's contributions and income earned on your account. You may recover your cost in the lump sum and any *net unrealized appreciation (NUA)* in employer securities tax free.

Cost. In general, your cost is the total of:

1. The plan participant's nondeductible contributions to the plan,
2. The plan participant's taxable costs of any life insurance contract distributed,
3. Any employer contributions that were taxable to the plan participant, and
4. Repayments of any loans that were taxable to the plan participant.

You must reduce this cost by amounts previously distributed tax free.

Capital Gain Treatment

Capital gain treatment applies only to the taxable part of a lump-sum distribution resulting from participation in the plan before 1974. The amount treated as capital gain is taxed at a 20% rate. You can elect this treatment only once for any plan participant, and only if the plan participant was born before January 2, 1936. Complete Part II of Form 4972 to choose the 20% capital gain election.

10-Year Tax Option

The 10-year tax option is a special formula used to figure a separate tax on the ordinary income part of a lump-sum distribution. You pay the tax only once, for the year in which you receive the distribution, not over the next 10 years. You can elect this treatment only once for any plan participant, and only if the plan participant was born before January 2, 1936.

The ordinary income part of the distribution is the amount shown in box 2a of the Form 1099-R given to you by the payer, minus the amount, if any, shown in box 3. You also can treat the capital gain part of the distribution (box 3 of Form 1099-R) as ordinary income for the 10-year tax option if you do not choose capital gain treatment for that part.

Complete Part III of Form 4972 to choose the 10-year tax option. You must use the Special Tax Rates Schedule shown in the instructions for Part III to figure the tax.

VII. ROLLOVERS

If you withdraw cash or other assets from a qualified retirement plan in an eligible rollover distribution, you can defer tax on the distribution by rolling it over to another qualified retirement plan or a traditional IRA, or, after 2 years of participation in a SIMPLE IRA plan sponsored by your employer, a SIMPLE IRA under that plan.

For this purpose, the following plans are qualified retirement plans.

- A qualified employee plan.
- A qualified employee annuity.
- A tax sheltered annuity plan (403(b) plan).
- An eligible state or local government section 457 deferred compensation plan.

Rollovers to SIMPLE retirement accounts. You can roll over amounts from a qualified retirement plan (as described next) or an IRA into a SIMPLE retirement account as follows.

1. During the first 2 years of participation in a SIMPLE retirement account, you may roll over amounts from one SIMPLE retirement account into another SIMPLE retirement account.
2. After 2 years of participation in a SIMPLE retirement account, you may roll over amounts from a SIMPLE retirement, a qualified retirement plan, or an IRA into a SIMPLE retirement account.

Eligible rollover distributions. Generally, an eligible rollover distribution is any distribution of all or any part of the balance to your credit in a qualified retirement plan.

Rollover of nontaxable amounts. You may be able to roll over the nontaxable part of a distribution (such as your after-tax contributions) made to another qualified retirement plan that is a qualified employee plan or a 403(b) plan, or to a traditional or Roth IRA. The transfer must be made either through a direct rollover to a qualified plan or 403(b) that separately accounts for the taxable and nontaxable parts of the rollover or through a rollover to a traditional or Roth IRA.

If you roll over only part of a distribution that includes both taxable and nontaxable amounts, the amount you roll over is treated as coming first from the taxable part of the distribution.

Any after-tax contributions that you roll over into your traditional IRA become part of your basis (cost) in your IRAs. To recover your basis when you take distributions from your IRA, you must complete Form 8606 for the year of the distribution.

Direct rollover option. You can choose to have any part or all of an eligible rollover distribution paid directly to another qualified retirement plan that accepts rollover distributions or to a traditional or Roth IRA. If you choose the direct rollover option, or have an automatic rollover, no tax will be withheld from any part of the distribution that is directly paid to the trustee of the other plan.

Payment to you option. If an eligible rollover distribution is paid to you, 20% generally will be withheld for income tax. However, the full amount is treated as distributed to you even though you actually receive only 80%. You generally must include in income any part (including the part withheld) that you do not rollover within 60 days to another qualified retirement plan or to a traditional or Roth IRA.

If you are under age 59½ when a distribution is paid to you, you may have to pay a 10% tax (in addition to the regular income tax) on the taxable part (including any tax withheld) that you do not roll over.

Caution!

If you decide to roll over an amount equal to the distribution before withholding, your contribution to the new plan or IRA must include other money (for example, from savings or amounts borrowed) to replace the amount withheld.

Time for making rollover. You generally must complete the rollover of an eligible distribution paid to you by the 60th day following the day on which you receive the distribution from your employer's plan. (If an amount distributed to you becomes a frozen deposit in a financial institution during the 60-day period after you receive it, the rollover period is extended for the period during which the distribution is in a frozen deposit in a financial institution.)

The administrator of a qualified plan must give you a written explanation of your distribution options within a reasonable period of time before making an eligible rollover distribution.

Tip

The IRS may waive the 60-day requirement where the failure to do so would be against equity or good conscience, such as in the event of a casualty, disaster, or other event beyond your reasonable control.

Qualified domestic relations order. You may be able to roll over all or any part of a distribution from a qualified retirement plan that you receive under a qualified domestic relations order (QDRO). If you receive the distribution as an employee's spouse or former spouse (not as a nonspousal beneficiary), the rollover rules apply to you as if you were the employee. You can roll over the distribution from the plan into a traditional IRA or to another eligible retirement plan.

Rollover by surviving spouse. You may be able to roll over tax free all or part of a distribution from a qualified retirement plan you receive as the surviving spouse of a deceased employee. The rollover rules apply to you as if you were the employee. You can roll over a distribution into a qualified retirement plan or a traditional IRA or Roth IRA.

A distribution paid to a beneficiary other than the employee's surviving spouse is generally not an eligible rollover distribution. However, see *Rollovers by nonspouse beneficiary*, next.

Rollovers by nonspouse beneficiary. If you are a designated beneficiary (other than a surviving spouse) of a deceased employee, you may be able to roll over tax free all or a portion of a distribution you receive from an eligible retirement plan of a deceased employee. The distribution must be a direct trustee-to-trustee transfer to your traditional or Roth IRA that was set up to receive the distribution. The transfer will be treated as an eligible rollover distribution and the receiving plan will be treated as an inherited IRA.

Designated Roth accounts. You can roll over an eligible distribution from a designated Roth account only into another designated Roth account or a Roth IRA. If you want to roll over the part of the distribution that is not included in income, you must make a direct rollover of the entire distribution or you can roll over the entire amount (or any portion) to a Roth IRA.

In-plan rollovers to designated Roth accounts. If you are a participant in a 401(k), 403(b), or 457(b) plan, your plan may permit you to roll over amounts in those plans to a designated Roth account within the same plan. The rollover of any untaxed money must be included in income in the year you receive the distribution.

Rollovers to Roth IRAs. You can roll over distributions directly from a qualified retirement plan (other than a designated Roth account) to a Roth IRA.

You must include in your gross income distributions from a qualified retirement plan (other than a designated Roth account) that you would have had to include in income if you had not rolled them over into a Roth IRA. You do not include in gross income any part of a distribution from a qualified retirement plan that is a return of contributions to the plan that were taxable to you when paid. In addition, the 10% tax on early distributions does not apply.

VIII. SPECIAL ADDITIONAL TAXES

To discourage the use of pension funds for purposes other than normal retirement, the law imposes additional taxes on early distributions of those funds and on failures to withdraw the funds timely. Ordinarily, you will not be subject to these taxes if you roll over all early distributions you receive, as explained earlier, and begin drawing out the funds at a normal retirement age, in reasonable amounts over your life expectancy. These special additional taxes are the taxes on:

- Early distributions, and
- Excess accumulation (not receiving minimum distributions).

These taxes are discussed in the following sections.

If you must pay either of these taxes, report them on Form 5329. However, you do not have to file Form 5329 if you owe only the tax on early distributions and your Form 1099-R shows a “1” in box 7. Instead, enter 10% of the taxable part of the distribution on Schedule 2 (Form 1040), line 8. Also, check the box on line 8 to indicate that you do not have to file Form 5329.

Even if you do not owe any of these taxes, you may have to complete Form 5329 and attach it to your Form 1040 or 1040-SR. This applies if you meet an exception to the tax on early distributions but box 7 of your Form 1099-R does not indicate an exception.

Tax on Early Distributions

Most distributions (both periodic and nonperiodic) from qualified retirement plans and nonqualified annuity contracts made to you before you reach age 59½ are subject to an additional tax of 10%. This tax applies to the part of the distribution that you must include in gross income.

For this purpose, a qualified retirement plan is:

- A qualified employee plan,
- A qualified employee annuity plan,
- A tax-sheltered annuity plan, or
- An eligible state or local government section 457 deferred compensation plan (to the extent that any distribution is attributable to amounts the plan received in a direct transfer or rollover from one of the other plans listed here or on IRA).

5% rate on certain early distributions from deferred annuity contracts. If an early withdrawal from a deferred annuity is otherwise subject to the 10% additional tax, a 5% rate may apply instead. A 5% rate applies to distributions under a written election providing a specific schedule for the distribution of your interest in the contract if, as of March 1, 1986, you had begun receiving payments under the election. On line 4 of Form 5329, multiply the line 3 amount by 5% instead of 10%. Attach an explanation to your return.

Exceptions to tax. Certain early distributions are excepted from the early distribution tax. If the payer knows that an exception applies to your early distribution, distribution code “2,” “3,” or “4” should be shown in box 7 of your Form 1099-R and you do not have to report the distribution on Form 5329. If an exception applies but distribution code “1” (early distribution, no known exception) is shown in box 7, you must file Form 5329. Enter the taxable amount of the distribution shown in box 2a of your Form 1099-R on line 1 of Form 5329. On line 2, enter the amount that can be excluded and the exception number shown in the Form 5329 instructions.

General exceptions. The tax does not apply to distributions that are:

- Made as part of a series of substantially equal periodic payments (made at least annually) for your life (or life expectancy) or the joint lives (or joint life expectancies) of you and your designated beneficiary (if from a qualified retirement plan, the payments must begin after your separation from service),
- Made because you are totally and permanently disabled,
- Made to you because you have received a certification that you are terminally ill, or
- Made on or after the death of the plan participant or contract holder.

Additional exceptions for qualified retirement plans. The tax does not apply to distributions that are:

- From a qualified retirement plan (other than an IRA) after your separation from service in or after the year you reached age 55 (the earlier of age 50 or 25 years of service under the plan for qualified public safety employees),
- From a qualified retirement plan (other than an IRA) after your separation from service in or after the year you reached the earlier of age 50 or 25 years of service under the plan, if you are a private sector firefighter.
- From a qualified retirement plan (other than an IRA) to an alternate payee under a qualified domestic relations order,
- From a qualified retirement plan to the extent you have deductible medical expenses that exceed 7.5% of your adjusted gross income, whether or not you itemize your deductions for the year,
- From an employer plan under a written election that provides a specific schedule for distribution of your entire interest if, as of March 1, 1986, you had separated from service and had begun receiving payments under the election,
- From an employee stock ownership plan for dividends on employer securities held by the plan,
- From a qualified retirement plan due to an IRS levy of the plan,
- From elective deferral accounts under 401(k) or 403(b) plans or similar arrangements that are qualified reservist distributions,
- Phased retirement annuity payments made to federal employees, or
- From a qualified retirement plan (other than an IRA) for a qualified birth or adoption.

Qualified reservist distributions. A qualified reservist distribution is not subject to the additional tax on early distributions. A qualified reservist distribution is a distribution: (a) from elective deferrals under a section 401(k) or 403(b) plan or similar arrangement, (b) to an individual ordered or called to active duty (because he or she is a member of a reserve component) for a period of more than 179 days or for an indefinite period, and (c) made during the period beginning on the date of the order or call and ending at the close of the active duty period. You must be ordered or called to active duty after September 11, 2001.

Tax on Excess Accumulation

To make sure that most of your retirement benefits are paid to you during your lifetime, rather than to your beneficiaries after your death, the payments that you receive from qualified retirement plans must begin no later than on your required beginning date (defined later). The payments each year cannot be less than the required minimum distribution.

Required distributions not made. If the actual distributions to you in any year are less than the minimum required distribution for that year, you are subject to an additional tax. The tax equals 25% of the part of the required minimum distribution that was not distributed.

Note

A provision in the SECURE Act 2.0 reduced the amount of this additional tax in 2023 and after from 50% to 25%, and possibly to 10% if the RMD is timely corrected within 2 years.

For this purpose, a qualified retirement plan includes a:

1. Qualified employee plan,
2. Qualified employee annuity plan,
3. An eligible section 457 deferred compensation plan, or
4. Tax-sheltered annuity plan (403(b) plan) (for benefits accruing after 1986).

Required beginning date. Unless the rule for 5% owners applies, you generally must begin to receive distributions from your qualified retirement plan by April 1 of the year that follows the later of:

1. The calendar year in which you reach age 72, (73 if you are not 72 before January 1, 2023), or
2. The calendar year in which you retire from employment with the employer maintaining the plan.

However, your plan may require you to begin to receive distributions by April 1 of the year that follows the year in which you reach age 72 (73 if applicable) even if you have not retired.

If you reached age 72 in 2022, you may be required to receive your first distribution by April 1, 2023. Your required distribution then must be made for 2023 by December 31, 2023. If you reach age 73 in

2024, you may be required to receive your first distribution by April 1, 2025. Your required distribution for 2025 then must be made by December 31, 2025.

5% owners. If you are a 5% owner of the company maintaining your qualified retirement plan, you must begin to receive distributions by April 1 of the calendar year that follows the year in which you reach age 72 (73 if applicable).

You are a 5% owner if, for the plan year ending in the calendar year in which you reach age 72 (73 if applicable), you own (or are considered to own under section 318 of the Internal Revenue Code) more than 5% of the outstanding stock (or more than 5% of the total voting power of all stock) of the employer, or more than 5% of the capital or profits interest in the employer.

Required distributions. By the required beginning date, as explained above, you must either:

- Receive your entire interest in the plan (for a tax-sheltered annuity, your entire benefit accruing after 1986), or
- Begin receiving periodic distributions in annual amounts calculated to distribute your entire interest (for a tax-sheltered annuity, your entire benefit accruing after 1986) over your life or life expectancy or over the joint lives or joint life expectancies of you and a designated beneficiary (or over a shorter period).

Form 5329. You must file a Form 5329 if you owe a tax because you did not receive a minimum required distribution from your qualified retirement plan.

CHAPTER 10: TEST YOUR KNOWLEDGE

The following question is designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). It is included as an additional tool to enhance your learning experience and does not need to be submitted in order to receive CPE credit.

We recommend that you answer the question and then compare your response to the suggested solution on the following page before answering the final exam question(s) related to this chapter (assignment).

1.	**If an eligible rollover distribution is paid directly to an individual, 10% will be withheld for income tax.** **A.** true **B.** false
2.	**Generally, at what age would most distributions made to you from a qualified retirement plan no longer be subject to an early distribution tax of 10%:** **A.** 50 years **B.** 55 years **C.** 59½ years **D.** 65 years

CHAPTER 10: SOLUTION AND SUGGESTED RESPONSES

Below is the solution and suggested responses for the question on the previous page. If you choose an incorrect answer, you should review the page(s) as indicated for the question to ensure comprehension of the material.

1.	**A.** Incorrect. A sum is withheld for income tax, but it is greater than 10%. **B. CORRECT**. The sum withheld for income tax is 20%, not 10%. Even though the individual actually receives only 80%, the full amount is treated as distributed, and the individual must include in income any part (including the part withheld) that he or she does not rollover within 60 days to another qualified retirement plan or to a traditional or Roth IRA. *(See page 106 of the course material.)*
2.	**A.** Incorrect. Avoiding an early distribution tax at age 50 is not generally available. However certain qualified public safety employees, after a separation in service, may qualify. **B.** Incorrect. An exception rule for distributions at age 55 after separation from service can apply to payments made from a qualified retirement plan, but this is not the age in general. **C. CORRECT**. Early distribution taxes no longer apply to individuals receiving qualified retirement plan payments upon reaching the age of 59½. **D.** Incorrect. Age 65 has no significance with regard to determining an early distribution tax liability. *(See page 108 of the course material.)*

CHAPTER 11: SOCIAL SECURITY AND EQUIVALENT RAILROAD RETIREMENT BENEFITS

Chapter Objective

After completing this chapter, you should be able to:

- Recognize key taxation thresholds related to social security income.

I. INTRODUCTION

This chapter explains the federal income tax rules for social security benefits and equivalent tier 1 railroad retirement benefits. It explains:

- How to figure whether your benefits are taxable,
- How to report your taxable benefits,
- How to use the social security benefits worksheet (with examples), and
- How to treat repayments that are more than the benefits you received during the year.

Social security benefits include monthly survivor and disability benefits. They do not include supplemental security income (SSI) payments, which are not taxable.

Equivalent tier 1 railroad retirement benefits are the part of tier 1 benefits that a railroad employee or beneficiary would have been entitled to receive under the social security system. They are commonly called the social security equivalent benefit (SSEB) portion of tier 1 benefits.

If you received these benefits during 2024, you should receive a Form SSA-1099 or Form RRB-1099 (Form SSA-1042S or Form RRB-1042S if you are a nonresident alien). These forms show the amounts received and repaid, and taxes withheld for the year. You may receive more than one of these forms for the same year. You should add the amounts shown on all Forms SSA-1099 and Forms RRB-1099 you receive for the year to determine the "total" amounts received and repaid, and taxes withheld for that year.

Note

When the term "benefits" is used in this chapter, it applies to both social security benefits and the SSEB portion of tier 1 railroad retirement benefits.

What is not covered in this chapter. This chapter does not cover the tax rules for the following railroad retirement benefits:

- Non-social security equivalent benefit (NSSEB) portion of tier 1 benefits,
- Tier 2 benefits,
- Vested dual benefits, and
- Supplemental annuity benefits.

II. ARE ANY OF YOUR BENEFITS TAXABLE?

To find out whether any of your benefits are taxable, compare the base amount for your filing status with the total of:

1. One-half of your benefits, plus
2. All your other income, including tax-exempt interest.

When making this comparison, do not reduce your other income by any ***exclusions*** for:

- Interest from qualified U.S. savings bonds,
- Employer-provided adoption benefits,
- Foreign earned income or foreign housing, or
- Income earned by bona fide residents of American Samoa or Puerto Rico.

Figuring total income. To figure the total of one-half of your benefits plus your other income, use Worksheet 7-1 in IRS Publication 17. If the total is more than your base amount, part of your benefits may be taxable.

If you are married and file a joint return for 2024, you and your spouse must combine your incomes and your benefits to figure whether any of your combined benefits are taxable. Even if your spouse did not receive any benefits, you must add your spouse’s income to yours to figure whether any of your benefits are taxable.

Base amount. Your base amount is:

- $25,000 if you are single, head of household, or qualifying surviving spouse,
- $25,000 if you are married filing separately and lived apart from your spouse for all of 2024,
- $32,000 if you are married filing jointly, or
- $-0- if you are married filing separately and lived with your spouse at any time during 2024.

Tax withholding and estimated tax. You can choose to have federal income tax withheld from your social security benefits and/or the SSEB portion of your tier 1 railroad retirement benefits. If you choose to do this, you must complete a Form W-4V.

If you do not choose to have income tax withheld, you may have to request additional withholding from other income or pay estimated tax during the year.

III. HOW TO REPORT YOUR BENEFITS

If part of your benefits are taxable, you must use Form 1040 or 1040-SR.

Reporting on Form 1040 or 1040-SR Report your net benefits (the amount in box 5 of your Forms SSA-1099 or Form RRB-1099) on line 6a and the taxable part on line 6b. If you are married filing separately and you lived apart from your spouse for all of 2024, also enter “D” to the right of the word “benefits” on line 6a.

Benefits not taxable. Report your net benefits (the total amount from box 5 of all your Forms SSA-1099 and Forms RRB-1099) on Form 1040 or 1040-SR, line 6a. Enter -0- on Form 1040 or 1040-SR, line 6b. If you are married filing separately and you lived apart from your spouse for all of 2024, also enter “D” to the right of the word “benefits” on Form 1040 or 1040-SR, line 6a.

HOW MUCH IS TAXABLE?

If part of your benefits are taxable, how much is taxable depends on the total amount of your benefits and other income. Generally, the higher that total amount, the greater the taxable part of your benefits.

Maximum taxable part. Generally, up to 50% of your benefits will be taxable. However, up to 85% of your benefits can be taxable if either of the following situations applies to you.

1. The total of one-half of your benefits and all your other income is more than $34,000 ($44,000 if you are married filing jointly).
2. You are married filing separately and lived with your spouse at any time during 2024.

Lump-sum election. You must include the taxable part of a lump-sum (retroactive) payment of benefits received in 2024 in your 2024 income, even if the payment includes benefits for an earlier year.

Tip

This type of lump-sum benefit payment should not be confused with the lump-sum death benefit that both the SSA and RRB pay to many of their beneficiaries. No part of the lump-sum death benefit is subject to tax.

Generally, you use your 2024 income to figure the taxable part of the total benefits received in 2024. However, you may be able to figure the taxable part of a lump-sum payment for an earlier year separately, using your income for the earlier year. You can elect this method if it lowers your taxable benefits.

Making the election. If you received a lump-sum benefit payment in 2024 that includes benefits for one or more earlier years, follow the instructions in Publication 915 under *Lump-Sum Election* to see whether making the election will lower your taxable benefits. That discussion also explains how to make the election.

Caution!

Because the earlier year's taxable benefits are included in your 2024 income, no adjustment is made to the earlier year's return. **Do not** file an amended return for the earlier year.

CHAPTER 11: TEST YOUR KNOWLEDGE

The following question is designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). It is included as an additional tool to enhance your learning experience and does not need to be submitted in order to receive CPE credit.

We recommend that you answer the question and then compare your response to the suggested solution on the following page before answering the final exam question(s) related to this chapter (assignment).

1. **Which of the following is correct regarding social security benefits:**

   A. they are never taxable

   B. they are taxable in full as ordinary income

   C. they are taxable in full as capital income

   D. they may be taxable based on the base amount of your filing status

CHAPTER 11: SOLUTION AND SUGGESTED RESPONSES

Below is the solution and suggested responses for the question on the previous page. If you choose an incorrect answer, you should review the page(s) as indicated for the question to ensure comprehension of the material.

1.	**A.** Incorrect. Social security benefits may be taxable depending on the base amount for your filing status. **B.** Incorrect. Social security benefits may be taxable, but they would not be 100% taxable. The calculation of determining if any of the benefits are taxable begins with one-half of your benefits. **C.** Incorrect. Social security benefits that may be taxable would not be taxed as capital gain income. **D.** **CORRECT**. To find out if any of your benefits are taxable, you compare the base amount for your filing status with the total of one-half of your benefits plus all of your other income, including tax-exempt interest. *(See page 116 of the course material.)*

CHAPTER 12: OTHER INCOME

Chapter Objective

After completing this chapter, you should be able to:

- Identify the taxability of various types of other income.

I. REMINDER

Repeal of deduction for alimony payments. You cannot deduct alimony or separate maintenance payments made under a divorce or separation agreement (1) executed after 2018, or (2) 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 you receive under such an agreement are not included in your gross income.

II. INTRODUCTION

This chapter discusses many kinds of income and explains whether they are taxable or nontaxable.

- Income that is taxable must be reported on your tax return and is subject to tax.
- Income that is nontaxable may have to be shown on your tax return but is not taxable.

This chapter begins with discussions of the following income items.

- Canceled debts.
- Life insurance proceeds.
- Partnership income.
- S Corporation income.
- Recoveries (including state income tax refunds).
- Rents from personal property.
- Repayments.
- Royalties.
- Unemployment benefits.

These discussions are followed by brief discussions of many income items arranged in alphabetical order.

III. CANCELED DEBTS

In most cases, if a debt you owe is canceled or forgiven, other than as a gift or bequest, you must include the canceled amount in your income. You have no income from the canceled debt if it is intended as a gift to you. A debt includes any indebtedness for which you are liable or which attaches to property you hold.

If the debt is a nonbusiness debt, report the canceled amount on Schedule 1 (Form 1040), line 8c. If it is a business debt, report the amount on Schedule C (Form 1040) (or on Schedule F, *Profit or Loss From Farming* (Form 1040), if the debt is farm debt and you are a farmer).

Form 1099-C. If a federal government agency, financial institution, or credit union cancels or forgives a debt you owe of $600 or more, you will receive a Form 1099-C, *Cancellation of Debt*. The amount of the canceled debt is shown in box 2.

Interest included in canceled debt. If any interest is forgiven and included in the amount of canceled debt in box 2, the amount of interest will also be shown in box 3. Whether or not you must include the interest portion of the canceled debt in your income depends on whether the interest would be deductible when you paid it.

If the interest would not be deductible (such as interest on a personal loan), include in your income the amount from box 2 of Form 1099-C. If the interest would be deductible (such as on a business loan), include in your income the net amount of the canceled debt (the amount shown in box 2 less the interest amount shown in box 3).

Discounted mortgage loan. If your financial institution offers a discount for the early payment of your mortgage loan, the amount of the discount is canceled debt. You must include the canceled amount in your income.

Mortgage relief upon sale or other disposition. If you are personally liable for a mortgage (recourse debt), and you are relieved of the mortgage when you dispose of the property, you may realize gain or loss up to the fair market value of the property. To the extent the mortgage discharge exceeds the fair market value of the property, it is income from discharge of indebtedness unless it qualifies for exclusion under *Exceptions*, later. Report any income from discharge of indebtedness on nonbusiness debt that does not qualify for exclusion as other income on Schedule 1 (Form 1040), line 8c.

If you are not personally liable for a mortgage (nonrecourse debt), and you are relieved of the mortgage when you dispose of the property (such as through foreclosure), that relief is included in the amount you realize. You may have a taxable gain if the amount you realize exceeds your adjusted basis in the property. Report any gain on nonbusiness property as a capital gain.

Stockholder debt. If you are a stockholder in a corporation and the corporation cancels or forgives your debt to it, the canceled debt is a constructive distribution that is generally dividend income to you.

If you are a stockholder in a corporation and you cancel a debt owed to you by the corporation, you generally do not realize income. This is because the canceled debt is considered as a contribution to the capital of the corporation equal to the amount of debt principal that you canceled.

Repayment of canceled debt. If you included a canceled amount in your income and later pay the debt, you may be able to file a claim for refund for the year the amount was included in income. You can file a claim on Form 1040-X if the statute of limitations for filing a claim is still open. The statute of limitations generally does not end until 3 years after the due date of your original return.

Exceptions

There are several exceptions to the inclusion of canceled debt in income, including:

- The debt is canceled in a bankruptcy case under title 11 of the U.S. Code. See Pub. 908, Bankruptcy Tax Guide.
- The debt is canceled when you are insolvent. However, you cannot exclude any amount of canceled debt that is more than the amount by which you are insolvent. See Pub. 908.
- The debt is qualified farm debt and is canceled by a qualified person. See chapter 3 of Pub 225, Farmer's Tax Guide.
- The debt is qualified real property business debt. See chapter 5 of Pub. 334.
- The cancellation is intended as a gift.
- The debt is qualified principal residence indebtedness.
- Student loan cancellation due to meeting certain work requirements.
- Cancellation of certain loans after December 31, 2020, and before January 1, 2026.
- Certain student loan repayment assistance programs.

IV. LIFE INSURANCE PROCEEDS

Life insurance proceeds paid to you because of the death of the insured person are not taxable unless the policy was turned over to you for a price. This is true even if the proceeds were paid under an accident or health insurance policy or an endowment contract. However, interest income received as a result of life insurance proceeds may be taxable.

Proceeds not received in installments. If death benefits are paid to you in a lump sum or other than at regular intervals, include in your income only the benefits that are more than the amount payable to you at the time of the insured person's death. If the benefit payable at death is not specified, you include in your income the benefit payments that are more than the present value of the payments at the time of death.

Proceeds received in installments. If you receive life insurance proceeds in installments, you can exclude part of each installment from your income.

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 your income as interest.

Surviving spouse. If your spouse died before October 23, 1986, and insurance proceeds paid to you because of the death of your spouse are received in installments, you can exclude up to $1,000 a year of the interest included in the installments. If you remarry, you can continue to take the exclusion.

Surrender of policy for cash. If you surrender a life insurance policy for cash, you must include in income any proceeds that are more than the cost of the life insurance policy. In most cases, your cost (or investment in the contract) is the total of premiums that you paid for the life insurance policy, less any refunded premiums, rebates, dividends, or unrepaid loans that were not included in your income.

You should receive a Form 1099-R showing the total proceeds and the taxable part. Report these amounts on lines 5a and 5b of Form 1040 or 1040-SR.

ENDOWMENT CONTRACT PROCEEDS

Endowment proceeds paid in a lump sum to you at maturity are taxable only if the proceeds are more than the cost of the policy. To determine your cost, add the aggregate amount of premiums (or other consideration) paid for the contract and subtract any amount that you previously received under the contract and excluded from your income. Include in your income the part of the lump sum payment that is more than your cost in your income.

ACCELERATED DEATH BENEFITS

Certain amounts paid as accelerated death benefits under a life insurance contract or viatical settlement before the insured's death are excluded from income if the insured is terminally or chronically ill.

Viatical settlement. This is the sale or assignment of any part of the death benefit under a life insurance contract to a viatical settlement provider. A viatical settlement provider is a person who regularly engages in the business of buying or taking assignment of life insurance contracts on the lives of insured individuals who are terminally or chronically ill and who meets the requirements of section 101(g)(2)(B) of the Internal Revenue Code.

Exclusion for terminal illness. Accelerated death benefits are fully excludable if the insured is a terminally ill individual. This is a person who has been certified by a physician as having an illness or physical condition that can reasonably be expected to result in death within 24 months from the date of the certification.

Exclusion for chronic illness. If the insured is a chronically ill individual who is not terminally ill, accelerated death benefits paid on the basis of costs incurred for qualified long-term care services are fully excludable. Accelerated death benefits paid on a per diem or other periodic basis are excludable up to a limit. This limit applies to the total of the accelerated death benefits and any periodic payments received from long-term care insurance contracts.

Exception

The exclusion does not apply to any amount paid to a person (other than the insured) who has an insurable interest in the life of the insured because the insured:

- Is a director, officer, or employee of the other person, or
- Has a financial interest in the person's business.

V. PARTNERSHIP INCOME

A partnership generally is not a taxable entity. The income, gains, losses, deductions, and credits of a partnership are passed through to the partners based on each partner's distributive share of these items.

Schedule K-1 (Form 1065). Although a partnership generally pays no tax, it must file an information return on Form 1065, *U.S. Return of Partnership Income*, and send Schedule K-1 (Form 1065) to each partner. In addition, the partnership will send each partner a copy of the *Partner's Instructions for Schedule K-1 (Form 1065)* to help each partner report his or her share of the partnership's income, deductions, credits, and tax preference items.

Records. Keep Schedule K-1 (Form 1065) for your records. Do not attach it to your Form 1040 or 1040-SR, unless you are specifically required to do so.

VI. S CORPORATION INCOME

In most cases, an S corporation does not pay tax on its income. Instead, the income, losses, deductions, and credits of the corporation are passed through to the shareholders based on each shareholder's pro rata share.

Schedule K-1 (Form 1120S). An S corporation must file a return on Form 1120-S, *U.S. Income Tax Return for an S Corporation*, and send Schedule K-1 (Form 1120-S) to each shareholder. In addition, the S corporation will send each shareholder a copy of the *Shareholder's Instructions for Schedule K-1 (Form 1120-S)* to help each shareholder report his or her share of the S corporation's income, losses, credits, and deductions.

Records. Keep Schedule K-1 (Form 1120-S) for your records. Do not attach it to your Form 1040 or 1040-SR, unless you are required to do so.

For more information on S corporations and their shareholders, see the instructions for Form 1120-S.

VII. RECOVERIES

A recovery is a return of an amount you deducted or took a credit for in an earlier year. The most common recoveries are refunds, reimbursements, and rebates of deductions itemized on Schedule A (Form 1040). You may also have recoveries of non-itemized deductions (such as payments on previously deducted bad debts) and recoveries of items for which you previously claimed a tax credit.

Tax benefit rule. You must include a recovery in your income in the year you receive it up to the amount by which the deduction or credit you took for the recovered amount reduced your tax in the earlier year. For this purpose, any increase to an amount carried over to the current year that resulted from the deduction or credit is considered to have reduced your tax in the earlier year.

Federal income tax refund. Refunds of federal income taxes are not included in your income because they are never allowed as a deduction from income.

State tax refund. If you received a state or local income tax refund (or credit or offset) in 2024, you generally must include it in income if you deducted the tax in an earlier year. The payer should send Form 1099-G, *Certain Government Payments*, to you by January 31, 2025. The IRS will also receive a copy of the Form 1099-G. Use the State and Local Tax Refund Worksheet in the 2024 Form 1040 or 1040-SR Instructions for Schedule 1 to figure the amount (if any) to include in your income.

If you could choose to deduct for a tax year either:

- State and local income taxes, or
- State and local general sales taxes, then

the maximum refund that you may have to include in income is limited to the excess of the tax you chose to deduct for that year over the tax you did not choose to deduct for that year.

Mortgage interest refund. If you received a refund or credit in 2024 of mortgage interest paid in an earlier year, the amount should be shown in box 4 of your Form 1098, *Mortgage Interest Statement*. Do not subtract the refund amount from the interest you paid in 2024. You may have to include it in your income under the rules explained in the following discussions.

Interest on recovery. Interest on any of the amounts you recover must be reported as interest income in the year received. For example, report any interest you received on state or local income tax refunds on Form 1040 or 1040-SR, line 2b.

Recovery and expense in same year. If the refund or other recovery and the expense occur in the same year, the recovery reduces the deduction or credit and is not reported as income.

Recovery for 2 or more years. If you receive a refund or other recovery that is for amounts you paid in 2 or more separate years, you must allocate, on a pro rata basis, the recovered amount between the years in which you paid it. This allocation is necessary to determine the amount of recovery from any earlier years and to determine the amount, if any, of your allowable deduction for this item for the current year.

VIII. RENTS FROM PERSONAL PROPERTY

If you rent out personal property, such as equipment or vehicles, how you report your income and expenses is generally determined by:

1. Whether or not the rental activity is a business, and
2. Whether or not the rental activity is conducted for profit.

In most cases, if your primary purpose is income or profit and you are involved in the rental activity with continuity and regularity, your rental activity is a business.

Reporting business income and expenses. If you are in the business of renting personal property, report your income and expenses on Schedule C (Form 1040). The form instructions have information on how to complete them.

Reporting nonbusiness income. If you are not in the business of renting personal property, report your rental income on Schedule 1 (Form 1040), line 8l.

Reporting nonbusiness expenses. If you rent personal property for profit, include your rental expenses in the total amount you enter on Schedule 1 (Form 1040), line 24b.

If you do not rent personal property for profit, your deductions are limited and you cannot report a loss to offset other income.

IX. REPAYMENTS

If you had to repay an amount that you included in your income in an earlier year, you may be able to deduct the amount repaid from your income for the year in which you repaid it. Or, if the amount you repaid is more than $3,000, you may be able to take a credit against your tax for the year in which you repaid it. Generally, you can claim a deduction or credit only if the repayment qualifies as an expense or loss incurred in your trade or business or in a for-profit transaction.

Type of deduction. The type of deduction you are allowed in the year of repayment depends on the type of income you included in the earlier year. You generally deduct the repayment on the same form or schedule on which you previously reported it as income. For example, if you reported it as self-employment income, deduct it as a business expense on Schedule C (Form 1040) or Schedule F (Form 1040). If you reported it as a capital gain, deduct it as a capital loss on Schedule D (Form 1040). If you reported it as wages, unemployment compensation, or other nonbusiness income, you may be able to deduct it as an other itemized deduction if the amount repaid is over $3,000.

Caution!

In 2024, you cannot claim any miscellaneous itemized deductions, so if the amount repaid was $3,000 or less, you are not able to deduct it from your income in the year you repaid it.

Repayment over $3,000. If the amount you repaid was more than $3,000, you can deduct the repayment as an other itemized deduction on Schedule A (Form 1040), line 16, if you included the income under a claim of right. This means that at the time you included the income, it appeared that you had an unrestricted right to it. However, you can choose to take a credit for the year of repayment. Figure your tax under both methods and compare the results. Use the method (deduction or credit) that results in less tax.

Caution!

When determining whether the amount you repaid was more or less than $3,000, consider the total amount being repaid on the return. Each instance of repayment is not considered separately.

Method 1. Figure your tax for 2024 claiming a deduction for the repaid amount. If you deduct it as an other itemized deduction, enter it on Schedule A (Form 1040), line 16.

Method 2. Figure your tax for 2024 claiming a credit for the repaid amount. Follow these steps.

1. Figure your tax for 2024 without deducting the repaid amount.
2. Refigure your tax from the earlier year without including in income the amount you repaid in 2024.
3. Subtract the tax in (2) from the tax shown on your return for the earlier year. This is the credit.
4. Subtract the answer in (3) from the tax for 2024 figured without the deduction (Step 1).

If method 1 results in less tax, deduct the amount repaid. If method 2 results in less tax, claim the credit figured in (3) above on Schedule 3 (Form 1040), line 13b, by adding the amount of the credit to any other credits on this line, and see the instructions there.

X. ROYALTIES

Royalties from copyrights, patents, and oil, gas, and mineral properties are taxable as ordinary income.

In most cases, you report royalties in Part I of Schedule E (Form 1040). However, if you hold an operating oil, gas, or mineral interest or are in business as a self-employed writer, inventor, artist, etc., report your income and expenses on Schedule C (Form 1040).

Copyrights and patents. Royalties from copyrights on literary, musical, or artistic works, and similar property, or from patents on inventions, are amounts paid to you for the right to use your work over a specified period of time. Royalties are generally based on the number of units sold, such as the number of books, tickets to a performance, or machines sold.

Oil, gas, and minerals. Royalty income from oil, gas, and mineral properties is the amount you receive when natural resources are extracted from your property. The royalties are based on units, such as barrels, tons, etc., and are paid to you by a person or company who leases the property from you.

Depletion. If you are the owner of an economic interest in mineral deposits or oil and gas wells, you can recover your investment through the depletion allowance.

Coal and iron ore. Under certain circumstances, you can treat amounts you receive from the disposal of coal and iron ore as payments from the sale of a capital asset, rather than as royalty income.

Sale of property interest. If you sell your complete interest in oil, gas, or mineral rights, the amount you receive is considered payment for the sale of section 1231 property, not royalty income. Under certain circumstances, the sale is subject to capital gain or loss treatment on Schedule D (Form 1040). For more information on selling section 1231 property, see chapter 3 of Publication 544. If you retain a royalty, an overriding royalty, or a net profit interest in a mineral property for the life of the property, you have made a lease or a sublease, and any cash you receive for the assignment of other interests in the property is ordinary income subject to a depletion allowance.

Part of future production sold. If you own mineral property but sell part of the future production, you generally treat the money you receive from the buyer at the time of the sale as a loan from the buyer. Do not include it in your income or take depletion based on it.

When production begins, you include all the proceeds in your income, deduct all the production expenses, and deduct depletion from that amount to arrive at your taxable income from the property.

XI. UNEMPLOYMENT BENEFITS

The tax treatment of unemployment benefits you receive depends on the type of program paying the benefits.

Unemployment compensation. You must include in your income all unemployment compensation you received. You should receive a Form 1099-G, *Certain Government Payments*, showing in box 1 the total unemployment compensation paid to you. In most cases, you enter unemployment compensation on Schedule 1 (Form 1040), line 7.

Types of unemployment compensation. Unemployment compensation generally includes any amount received under an unemployment compensation law of the United States or of a state. It includes the following benefits.

- Benefits paid by a state or the District of Columbia from the Federal Unemployment Trust Fund.
- State unemployment insurance benefits.
- Railroad unemployment compensation benefits.
- Disability payments from a government program paid as a substitute for unemployment compensation. (Amounts received as workers' compensation for injuries or illness are not unemployment compensation. See chapter 5 for more information.)
- Trade readjustment allowances under the Trade Act of 1974.
- Unemployment assistance under the Disaster Relief and Emergency Assistance Act.
- Unemployment assistance under the Airline Deregulation Act of 1978 program.

Governmental program. If you contribute to a governmental unemployment compensation program and your contributions are not deductible, amounts you receive under the program are not included as unemployment compensation until you recover your contributions. If you deducted all of your contributions to the program, the entire amount you receive under the program is included in your income.

Repayment of unemployment compensation. If you repaid in 2024 unemployment compensation you received in 2024, subtract the amount you repaid from the total amount you received and enter the difference on line 7 of Schedule 1 (Form 1040). On the dotted line next to your entry enter "Repaid" and the amount you repaid. If you repaid unemployment compensation in 2024 that you included in income in an earlier year, you can deduct the amount repaid on Schedule A (Form 1040), line 16 if you itemize deductions and if the amount is more than $3,000.

Tax withholding. You can choose to have federal income tax withheld from your unemployment compensation. To make this choice, complete Form W-4V, *Voluntary Withholding Request*, and give it to the paying office. Tax will be withheld at 10% of your payment.

Supplemental unemployment benefits. Benefits received from an employer-financed fund (to which the employees did not contribute) are not unemployment compensation. They are taxable as wages. Report these payments on Form 1040 or 1040-SR, line 1a.

Repayment of benefits. You may have to repay some of your supplemental unemployment benefits to qualify for trade readjustment allowances under the Trade Act of 1974. If you repay supplemental unemployment benefits in the same year you receive them, reduce the total benefits by the amount you repay. If you repay the benefits in a later year, you must include the full amount of the benefits received in your income for the year you received them.

Deduct the repayment in the later year as an adjustment to gross income on Form 1040 or 1040-SR. Include the repayment on Schedule 1 (Form 1040), line 24e. If the amount you repay in a later year is more than $3,000, you may be able to take a credit against your tax for the later year instead of deducting the amount repaid. For more information on this, see *Repayments*, earlier.

Private unemployment fund. Unemployment benefit payments from a private fund to which you voluntarily contribute are taxable only if the amounts you receive are more than your total payments into the fund. Report the taxable amount on Schedule 1 (Form 1040), line 8z.

Payments by a union. Benefits paid to you as an unemployed member of a union from regular union dues are included in your gross income on Schedule 1 (Form 1040), line 8z. However, if you contribute to a special union fund and your payments to the fund are not deductible, the unemployment benefits you receive from the fund are includible in your income only to the extent they are more than your contributions.

Guaranteed annual wage. Payments you receive from your employer during periods of unemployment, under a union agreement that guarantees you full pay during the year, are taxable as wages. Include them on Form 1040 or 1040-SR, line 1a.

State employees. Payments similar to a state's unemployment compensation may be made by the state to its employees who are not covered by the state's unemployment compensation law. Although the payments are fully taxable, do not report them as unemployment compensation. Report these payments on Schedule 1 (Form 1040), line 8z.

XII. OTHER INCOME

The following brief discussions are arranged in alphabetical order. Income items that are discussed in greater detail in another publication include a reference to that publication.

Activity not for profit. You must include on your return income from an activity from which you do not expect to make a profit. An example of this type of activity is a hobby or a farm you operate mostly for recreation and pleasure. Enter this income on Schedule 1 (Form 1040), line 8j. Deductions for expenses related to the activity are limited. They cannot total more than the income you report and can be taken only if you itemize deductions on Schedule A (Form 1040).

Alimony. Include in your income on Schedule 1 (Form 1040), line 2a any taxable alimony payments you receive. Amounts you receive for child support are not income to you. Alimony and child support payments are discussed in chapter 18.

Caution!

Do not include alimony payments you receive under a divorce or separation agreement (1) executed after 2018, or (2) executed before 2019 but later modified if the modification expressly states the repeal of the deduction for alimony payments applies to the modification.

Campaign contributions. These contributions are not income to a candidate unless they are diverted to his or her personal use. To be nontaxable, the contributions must be spent for campaign purposes or kept in a fund for use in future campaigns. However, interest earned on bank deposits, dividends received on contributed securities, and net gains realized on sales of contributed securities are taxable and must be reported on Form 1120-POL, *U.S. Income Tax Return for Certain Political Organizations.* Excess campaign funds transferred to an office account must be included in the officeholder's income on Schedule 1 (Form 1040), line 8z, in the year transferred.

Cash rebates. A cash rebate you receive from a dealer or manufacturer of an item you buy is not income, but you must reduce your basis by the amount of the rebate.

Example

You buy a new car for $24,000 cash and receive a $2,000 rebate check from the manufacturer. The $2,000 is not income to you. Your cost is $22,000. This is your basis on which you figure gain or loss if you sell the car, and depreciation if you use it for business.

Court awards and damages. To determine if settlement amounts you receive by compromise or judgment must be included in your income, you must consider the item that the settlement replaces. The character of the income as ordinary income or capital gain depends on the nature of the underlying claim. Include the following as ordinary income.

1. Interest on any award.
2. Compensation for lost wages or lost profits in most cases.
3. Punitive damages, in most cases. It does not matter if they relate to a physical injury or physical sickness.
4. Amounts received in settlement of pension rights (if you did not contribute to the plan).
5. Damages for:
   a) Patent or copyright infringement,
   b) Breach of contract, or
   c) Interference with business operations.
6. Back pay and damages for emotional distress received to satisfy a claim under Title VII of the Civil Rights Act of 1964.
7. Attorney fees and costs (including contingent fees) where the underlying recovery is included in gross income.
8. Attorney fees and costs relating to whistleblower awards where the underlying recovery is included in gross income.

Do not include in your income compensatory damages for personal physical injury or physical sickness (whether received in a lump sum or installments).

Emotional distress. Damages you receive for emotional distress due to a physical injury or sickness are treated as received for the physical injury or sickness. Do not include them in your income. If the emotional distress is due to a personal injury that is unrelated to a physical injury or sickness (for example, employment discrimination or injury to reputation), you must include the damages in your income, except for any damages that are not more than amounts paid for medical care due to that emotional distress. Emotional distress includes physical symptoms that result from emotional distress, such as headaches, insomnia, and stomach disorders.

Credit card insurance. In most cases, if you receive benefits under a credit card disability or unemployment insurance plan, the benefits are taxable to you. These plans make the minimum monthly payment on your credit card account if you cannot make the payment due to injury, illness, disability, or unemployment. Report on Schedule 1 (Form 1040), line 8z, the amount of benefits you received during the year that is more than the amount of the premiums you paid during the year.

Energy conservation subsidies. You can exclude from gross income any subsidy provided, either directly or indirectly, by public utilities for the purchase or installation of an energy conservation measure for a dwelling unit.

Energy conservation measure. This includes installations or modifications that are primarily designed to reduce consumption of electricity or natural gas, or improve the management of energy demand.

Dwelling unit. This includes a house, apartment, condominium, mobile home, boat, or similar property. If a building or structure contains both dwelling and other units, any subsidy must be properly allocated.

Estate and trust income. An estate or trust, unlike a partnership, may have to pay federal income tax. If you are a beneficiary of an estate or trust, you may be taxed on your share of its income distributed or required to be distributed to you. However, there is never a double tax. Estates and trusts file their returns on Form 1041, *U.S. Income Tax Return for Estates and Trusts*, and your share of the income is reported to you on Schedule K-1 of Form 1041.

Current income required to be distributed. If you are the beneficiary of a trust that must distribute all of its current income, you must report your share of the distributable net income, whether or not you actually received it.

Current income not required to be distributed. If you are the beneficiary of an estate or trust and the fiduciary has the choice of whether to distribute all or part of the current income, you must report:

- All income that is required to be distributed to you, whether or not it is actually distributed, plus
- All other amounts actually paid or credited to you,

up to the amount of your share of distributable net income.

Losses. Losses of estates and trusts generally are not deductible by the beneficiaries.

Grantor trust. Income earned by a grantor trust is taxable to the grantor, not the beneficiary, if the grantor keeps certain control over the trust. (The grantor is the one who transferred property to the trust.) This rule applies if the property (or income from the property) put into the trust will or may revert (be returned) to the grantor or the grantor's spouse.

Generally, a trust is a grantor trust if the grantor has a reversionary interest valued (at the date of transfer) at more than 5% of the value of the transferred property.

Fees for services. Include all fees for your services in your income. Examples of these fees are amounts you receive for services you perform as:

- A corporate director,
- An executor, administrator, or personal representative of an estate,
- A manager of a trade or business you operated before declaring Chapter 11 bankruptcy,
- A notary public, or
- An election precinct official.

Nonemployee compensation. If you are not an employee and the fees for your services from the same payer total $600 or more for the year, you may receive a Form 1099-NEC. You may need to report your fees as self-employment income.

Corporate director. Corporate director fees are self-employment income. Report these payments on Schedule C (Form 1040).

Personal representatives. All personal representatives must include in their gross income fees paid to them from an estate. If you are not in the trade or business of being an executor (for instance, you are the executor of a friend's or relative's estate), report these fees on Schedule 1 (Form 1040), line 8z. If you provide the services as a trade or business, report them as self-employment income on Schedule C (Form 1040). The fee is not includible in income if it is waived.

Gambling winnings. You must include your gambling winnings in income on Schedule 1 (Form 1040), line 8b. If you itemize your deductions on Schedule A (Form 1040), you can deduct gambling losses you had during the year, but only up to the amount of your winnings. If you are in the trade or business of gambling, use Schedule C (Form 1040).

Lotteries and raffles. Winnings from lotteries and raffles are gambling winnings. In addition to cash winnings, you must include in your income the fair market value of bonds, cars, houses, and other noncash prizes.

Form W-2G. You may have received a Form W-2G, *Certain Gambling Winnings*, showing the amount of your gambling winnings and any tax taken out of them. Include the amount from box 1 on Schedule 1 (Form 1040), line 8b. Include the amount shown in box 4 on line 25c of Form 1040 or 1040-SR as federal income tax withheld.

Gifts and inheritances. In most cases, property you receive as a gift, bequest, or inheritance is not included in your income. However, if property you receive this way later produces income such as interest, dividends, or rents, that income is taxable to you. If property is given to a trust and the income from it is paid, credited, or distributed to you, that income is also taxable to you. If the gift, bequest, or inheritance is the income from the property, that income is taxable to you.

Inherited pension or IRA. If you inherited a pension or an individual retirement arrangement (IRA), you may have to include part of the inherited amount in your income.

Hobby losses. Losses from a hobby are not deductible from other income. A hobby is an activity from which you do not expect to make a profit. See *Activity not for profit*, earlier.

Interest on qualified savings bonds. You may be able to exclude from income the interest from qualified U.S. savings bonds you redeem if you pay qualified higher educational expenses in the same year.

Job interview expenses. If a prospective employer asks you to appear for an interview and either pays you an allowance or reimburses you for your transportation and other travel expenses, the amount you receive is generally not taxable. You include in income only the amount you receive that is more than your actual expenses.

Jury duty. Jury duty pay you receive must be included in your income on Schedule 1 (Form 1040), line 8h. If you gave any of your jury duty pay to your employer because your employer continued to pay your salary while you served jury duty, include the amount you gave your employer as income adjustment on Schedule 1 (Form 1040), line 24a.

Kickbacks. You must include kickbacks, side commissions, push money, or similar payments you receive in your income on Schedule 1 (Form 1040), line 8z, or on Schedule C (Form 1040), if from your self-employment activity.

Example

You sell cars and help arrange car insurance for buyers. Insurance brokers pay back part of their commissions to you for referring customers to them. You must include the kickbacks in your income.

Medical savings accounts (MSAs). In most cases, you do not include in income amounts you withdraw from your Archer MSA or Medicare Advantage MSA if you use the money to pay for qualified medical expenses. Generally, qualified medical expenses are those you can deduct on Schedule A (Form 1040). For more information about qualified medical expenses, see chapter 22.

Prizes and awards. If you win a prize in a lucky number drawing, television or radio quiz program, beauty contest, or other event, you must include it in your income. For example, if you win a $50 prize in a photography contest, you must report this income on Schedule 1 (Form 1040), line 8i. If you refuse to accept a prize, do not include its value in your income.

Prizes and awards in goods or services must be included in your income at their fair market value.

Employee awards or bonuses. Cash awards or bonuses given to you by your employer for good work or suggestions generally must be included in your income as wages. However, certain noncash employee achievement awards can be excluded from income.

Pulitzer, Nobel, and similar prizes. If you were awarded a prize in recognition of past accomplishments in religious, charitable, scientific, artistic, educational, literary, or civic fields, you generally must include the value of the prize in your income. However, you do not include this prize in your income if you meet ***all*** of the following requirements.

- You were selected without any action on your part to enter the contest or proceeding.
- You are not required to perform substantial future services as a condition to receiving the prize or award.
- The prize or award is transferred by the payer directly to a governmental unit or tax-exempt charitable organization as designated by you.

Qualified Opportunity Fund (QOF). Effective December 22, 2017, Code section 1400Z-2 provides a temporary deferral on inclusion in gross income for capital gains invested in QOFs, and permanent exclusion of capital gains from the sale or exchange of an investment in the QOF if the investment is held for at least 10 years. See the Instructions for Form 8949 on how to report your election to defer eligible gains invested in a QOF. See the instructions for Form 8997, Initial and Annual Statement of Qualified Opportunity Fund (QOF) Investments, for reporting information.

Qualified tuition programs. A qualified tuition program (also known as a 529 program) is a program set up to allow you to either prepay, or contribute to an account established for paying, a student's qualified higher education expenses at an eligible educational institution.

The part of a distribution representing the amount paid or contributed to a QTP is not included in income. This is a return of the investment in the program.

In most cases, the beneficiary does not include in income any earnings distributed from a QTP established and maintained by a state (or an agency or instrumentality of the state) if the total distribution is less than or equal to adjusted qualified higher education expenses.

Sale of home. You may be able to exclude from income all or part of any gain from the sale or exchange of your main home. See chapter 15.

Sale of personal items. If you sold an item you owned for personal use, such as a car, refrigerator, furniture, stereo, jewelry, or silverware, your gain is taxable as a capital gain. Report it on Schedule D (Form 1040). You cannot deduct a loss.

However, if you sold an item you held for investment, such as gold or silver bullion, coins, or gems, any gain is taxable as a capital gain and any loss is deductible as a capital loss.

Scholarships and fellowships. A candidate for a degree can exclude amounts received as a qualified scholarship or fellowship. A qualified scholarship or fellowship is any amount you receive that is for:

- Tuition and fees to enroll at or attend an educational institution, or
- Fees, books, supplies, and equipment required for courses at the educational institution.

Amounts used for room and board do not qualify for the exclusion.

Department of Veterans Affairs (VA) payments. Allowances paid by the VA are not included in your income. These allowances are not considered scholarship or fellowship grants.

Prizes. Scholarship prizes won in a contest are not scholarships or fellowships if you do not have to use the prizes for educational purposes. You must include these amounts in your income on Schedule 1 (Form 1040), line 8i, whether or not you use the amounts for educational purposes.

Union benefits and dues. Amounts deducted from your pay for union dues, assessments, contributions, or other payments to a union cannot be excluded from your income.

Strike and lockout benefits. Benefits paid to you by a union as strike or lockout benefits, including both cash and the fair market value of other property, are usually included in your income as compensation. You can exclude these benefits from your income only when the facts clearly show that the union intended them as gifts to you.

CHAPTER 12: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1.	**You must include unemployment compensation (subject to exclusions) that you receive in your income. Which of the following payments is <u>not</u> a type of unemployment compensation:** **A.** benefits paid from the Federal Unemployment Trust Fund **B.** benefits paid from state unemployment insurance benefits **C.** trade readjustment allowances under the Trade Act of 1974 **D.** payments from a worker's compensation fund for a work-related injury
2.	**Benefits paid to you by a union as strike or lockout benefits are always included in your income as compensation.** **A.** true **B.** false

CHAPTER 12: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. Benefits paid from the Federal Unemployment Trust Fund are categorized as unemployment benefits and must be reported as taxable income, subject to exclusions. **B.** Incorrect. Benefits paid by state unemployment insurance funds are categorized as unemployment benefits and must be reported as taxable income, subject to any exclusions. **C.** Incorrect. Payments made under the 1974 Trade Act are considered unemployment compensation within this context. **D.** **CORRECT**. Disability payments paid as worker's compensation for injury or illness is not unemployment compensation. *(See pages 129 to 130 of the course material.)*
2.	**A.** Incorrect. Usually, benefits paid to you by a union as strike or lockout benefits, including both cash and the fair market value of other property, are included in your income as compensation, but there is an exclusion. **B.** **CORRECT**. You can exclude these benefits from your income when the facts clearly show that the union intended them as gifts to you. *(See page 137 of the course material.)*

PART THREE: GAINS AND LOSSES

The four chapters in this part discuss investment gains and losses, including how to figure your basis in property. They will help you determine if a gain from selling or trading stocks, bonds, or other investment property is taxable and if a loss is or is not deductible. These chapters also discuss gains from selling property you personally use – including the special rules for selling your home. Nonbusiness casualty and theft losses are discussed in Chapter 26 in Part Five.

CHAPTER 13: BASIS OF PROPERTY

Chapter Objective

After completing this chapter, you should be able to:

- Identify the factors to consider in calculating the basis of property.

I. REMINDERS

Special rules for capital gains invested in Qualified Opportunity Funds. Effective December 22, 2017, Code section 1400Z-2 provides a temporary deferral of inclusion in gross income for certain capital gains invested in Qualified Opportunity Funds (QOFs), and a potential permanent exclusion of gains from the sale or exchange of an investment in a QOF if the investment is held for at least 10 years. For more information, see the Instructions for Form 8949.

II. INTRODUCTION

This chapter discusses how to figure your basis in property. It is divided into the following sections.

- Cost basis.
- Adjusted basis.
- Basis other than cost.

Basis is the amount of your investment in property for tax purposes. Use the basis of property to figure gain or loss on the sale, exchange, or other disposition of property. Also use it to figure deductions for depreciation, amortization, depletion, and casualty losses.

If you use property for both business and personal purposes, you must allocate the basis based on the use. Only the basis allocated to the business use of the property can be depreciated.

Your original basis in property is adjusted (increased or decreased) by certain events. If you make improvements to the property, increase your basis. If you take deductions for depreciation or casualty losses, or claim certain credits, reduce your basis.

III. COST BASIS

The basis of property you buy is usually its cost. The cost is the amount you pay in cash, debt obligations, other property, or services. Your cost also includes amounts you pay for the following items.

- Sales tax.

- Freight.
- Installation and testing.
- Excise taxes.
- Legal and accounting fees (when they must be capitalized).
- Revenue stamps.
- Recording fees.
- Real estate taxes (if assumed for the seller).

In addition, you may also have to capitalize (add to basis) certain other costs related to buying or producing property.

Loans with low or no interest. If you buy property on a time-payment plan that charges little or no interest, the basis of your property is your stated purchase price minus any amount considered to be unstated interest. You generally have unstated interest if your interest rate is less than the applicable federal rate.

REAL PROPERTY

Real property, also called real estate, is land and generally anything built on, growing on, or attached to land.

If you buy real property, certain fees and other expenses you pay are part of your cost basis in the property.

Lump sum purchase. If you buy buildings and the land on which they stand for a lump sum, allocate the basis among the land and the buildings so you can figure the allowable depreciation on the buildings. Land is not depreciable. Allocate the cost according to the fair market values of the land and buildings at the time of purchase. Figure the basis of each asset by multiplying the lump sum by a fraction. The numerator is the FMV of that asset and the denominator is the FMV of the whole property at the time of purchase.

Fair market value (FMV) is the price at which the property would change hands between a willing buyer and a willing seller, neither having to buy or sell, and both have reasonable knowledge of all the necessary facts. Sales of similar property on or about the same date may be helpful in figuring the FMV of the property.

Assumption of mortgage. If you buy property and assume (or buy the property subject to) an existing mortgage on the property, your basis includes the amount you pay for the property plus the amount to be paid on the mortgage.

Settlement costs. You can include in the basis of property you buy the settlement fees and closing costs for buying the property. (A fee for buying property is a cost that must be paid even if you buy the property for cash.) You cannot include fees and costs for getting a loan on the property in your basis.

The following are some of the settlement fees or closing costs you can include in the basis of your property.

- Abstract fees (abstract of title fees).
- Charges for installing utility services.
- Legal fees (including title search and preparation of the sales contract and deed).
- Recording fees.
- Survey fees.
- Transfer taxes.
- Owner's title insurance.
- Any amounts the seller owes that you agree to pay, such as back taxes or interest, recording or mortgage fees, charges for improvements or repairs, and sales commissions.

Settlement costs do not include amounts placed in escrow for the future payment of items such as taxes and insurance.

The following are some of the settlement fees and closing costs you cannot include in the basis of property.

1. Casualty insurance premiums.
2. Rent for occupancy of the property before closing.
3. Charges for utilities or other services related to occupancy of the property before closing.
4. Charges connected with getting a loan. The following are examples of these charges.
    a) Points (discount points, loan origination fees).
    b) Mortgage insurance premiums.
    c) Loan assumption fees.
    d) Cost of a credit report.
    e) Fees for an appraisal required by a lender.
5. Fees for refinancing a mortgage.

Real estate taxes. If you pay real estate taxes the seller owed on real property you bought, and the seller did not reimburse you, treat those taxes as part of your basis. You cannot deduct them as an expense.

If you reimburse the seller for taxes the seller paid for you, you can usually deduct that amount as an expense in the year of purchase. Do not include that amount in the basis of your property. If you did not reimburse the seller, you must reduce your basis by the amount of those taxes.

Points. If you pay points to get a loan (including a mortgage, second mortgage, line of credit, or a home equity loan), do not add the points to the basis of the related property. Generally, you deduct the points over the term of the loan. For more information, see *Points* in chapter 24.

Points on home mortgage. Special rules may apply to points you and the seller pay when you get a mortgage to buy your main home. If certain requirements are met, you can deduct the points in full for the year in which they are paid. Reduce the basis of your home by any seller-paid points.

IV. ADJUSTED BASIS

Before figuring gain or loss on a sale, exchange, or other disposition of property or figuring allowable depreciation, depletion, or amortization, you must usually make certain adjustments (increases and decreases) to the cost of the property. The result is the adjusted basis.

INCREASES TO BASIS

Increase the basis of any property by all items properly added to a capital account. Examples of items that increase basis are shown in *Table 13-1*.

TABLE 13-1. EXAMPLES OF ADJUSTMENTS TO BASIS

Increases to Basis	Decreases to Basis
• Capital improvements: Putting an addition on your home Replacing an entire roof Paving your driveway Installing central air conditioning Rewiring your home • Assessments for local improvements: Water connections Sidewalks Roads • Casualty losses: Restoring damaged property • Legal fees: Cost of defending and perfecting a title • Zoning costs	• Exclusion from income of subsidies for energy conservation measures • Casualty or theft loss deductions and insurance reimbursements • Certain vehicle credits • Section 179 deduction • Depreciation • Nontaxable corporate distributions

Improvements. Add to your basis in property the cost of improvements having a useful life of more than one year, that increase the value of the property, lengthen its life, or adapt it to a different use. For example, improvements include putting a recreation room in your unfinished basement, adding another bathroom or bedroom, putting up a fence, putting in new plumbing or wiring, installing a new roof, or paving your driveway.

Assessments for local improvements. Increase the basis of property by assessments for items such as paving roads and building ditches that increase the value of the property assessed. Do not deduct them as taxes. However, you can deduct as taxes charges for maintenance, repairs, or interest charges related to the improvements.

Example

Your city changes the street in front of your store into an enclosed pedestrian mall and assesses you and other affected property owners for the cost of the conversion. Add the assessment to your property's basis. In this example, the assessment is a depreciable asset.

DECREASES TO BASIS

Decrease the basis of any property by all items that represent a return of capital for the period during which you held the property. Examples of items that decrease basis are shown in *Table 13-1*.

Casualty and theft losses. If you have a casualty or theft loss, decrease the basis in your property by any insurance proceeds or other reimbursement and by any deductible loss not covered by insurance.

You must increase your basis in the property by the amount you spend on repairs that restore the property to its pre-casualty condition.

Depreciation and section 179 deduction. Decrease the basis of your qualifying business property by any section 179 deduction you take and the depreciation you deducted, or could have deducted, on your tax returns under the method of depreciation you selected.

Example

You owned a duplex used as rental property that cost you $40,000, of which $35,000 was allocated to the building and $5,000 to the land. You added an improvement to the duplex that cost $10,000. In February last year the duplex was damaged by fire. Up to that time you had been allowed depreciation of $23,000. You sold some salvaged material for $1,300 and collected $19,700 from your insurance company. You deducted a casualty loss of $1,000 on your income tax return for last year. You spent $19,000 of the insurance proceeds for restoration of the duplex, which was completed this year.

Example (continued)

You must use the duplex's adjusted basis after the restoration to determine depreciation for the rest of the property's recovery period. Figure the adjusted basis of the duplex as follows:

Original cost of duplex		$35,000
Addition to duplex		10,000
Total cost of duplex		$45,000
Minus: Depreciation		23,000
Adjusted basis before casualty		$22,000
Minus: Insurance proceeds	$19,700	
Deducted casualty loss	1,000	
Salvage proceeds	1,300	22,000
Adjusted basis after casualty		-0-
Add: Cost of restoring duplex		$19,000
Adjusted basis after restoration		**$19,000**

Note: Your basis in the land is its original cost of $5,000.

Easements. The amount you receive for granting an easement is generally considered to be from the sale of an interest in real property. It reduces the basis of the affected part of the property. If the amount received is more than the basis of the part of the property affected by the easement, reduce your basis in that part to zero and treat the excess as a recognized gain.

Vehicle credits. Unless you elect not to claim the qualified vehicle credit, the alternative motor vehicle credit, or the qualified plug-in electric drive motor vehicle credit, you may have to reduce the basis of each qualified vehicle by certain amounts reported.

Exclusion of subsidies for energy conservation measures. You can exclude from gross income any subsidy you received from a public utility company for the purchase or installation of an energy conservation measure for a dwelling unit. Reduce the basis of the property for which you received the subsidy by the excluded amount. For more information about this subsidy, see chapter 12.

V. BASIS OTHER THAN COST

There are many times when you cannot use cost as basis. In these cases, the fair market value or the adjusted basis of the property can be used. Fair market value (FMV) and adjusted basis were discussed earlier.

TAXABLE EXCHANGES

A taxable exchange is one in which the gain is taxable or the loss is deductible. A taxable gain or deductible loss also is known as a recognized gain or loss. If you receive property in exchange for other property in a taxable exchange, the basis of the property you receive is usually its FMV at the time of the exchange.

NONTAXABLE EXCHANGES

A nontaxable exchange is an exchange in which you are not taxed on any gain and you cannot deduct any loss. If you receive property in a nontaxable exchange, its basis is generally the same as the basis of the property you transferred.

Like-Kind Exchanges

The exchange of property for the same kind of property may qualify as a nontaxable exchange under section 1031. Nontaxable like-kind exchange treatment under section 1031 applies only to exchanges of real property held for use in a trade or business or for investment, other than real property held primarily for sale. Beginning after 2017, nontaxable like-kind exchange treatment under section 1031 applies only to exchanges of real property held for use in a trade or business or for investment other than real property held primarily for sale.

To qualify as a like-kind exchange, you must hold for business or investment purposes both the property you transfer and the property you receive. There also must be an exchange of like-kind property.

The basis of the property you receive generally is the same as the adjusted basis of the property you gave up. If you trade property in a like-kind exchange and also pay money, the basis of the property received is the adjusted basis of the property you gave up increased by the money you paid.

Partially nontaxable exchange. A partially nontaxable exchange is an exchange in which you receive unlike property or money in addition to like property. The basis of the property you receive is the total adjusted basis of the property you gave up, with the following adjustments.

1. Decrease the basis by the following amounts.
    a) Any money you receive.
    b) Any loss you recognize on the exchange.
2. Increase the basis by the following amounts.
    a) Any additional costs you incur.
    b) Any gain you recognize on the exchange.

If the other party to the exchange assumes your liabilities, treat the debt assumption as money you received in the exchange.

Allocation of basis. If you receive like-kind and unlike properties in the exchange, allocate the basis first to the unlike property, other than money, up to its FMV on the date of the exchange. The rest is the basis of the like-kind property.

PROPERTY RECEIVED AS A GIFT

To figure the basis of property you receive as a gift, you must know its adjusted basis to the donor just before it was given to you, its FMV at the time it was given to you, and any gift tax paid on it.

FMV less than donor's adjusted basis. If the FMV of the property at the time of the gift is less than the donor's adjusted basis, your basis depends on whether you have a gain or a loss when you dispose of the property. Your basis for figuring gain is the same as the donor's adjusted basis plus or minus any required adjustments to basis while you held the property. Your basis for figuring loss is its FMV when you received the gift plus or minus any required adjustments to basis while you held the property. See *Adjusted Basis*, earlier.

Example

You received an acre of land as a gift. At the time of the gift, the land had a FMV of $8,000. The donor's adjusted basis was $10,000. After you received the property, no events occurred to increase or decrease your basis. If you later sell the property for $12,000, you will have a $2,000 gain because you must use the donor's adjusted basis at the time of the gift ($10,000) as your basis to figure gain. If you sell the property for $7,000, you will have a $1,000 loss because you must use the FMV at the time of the gift ($8,000) as your basis to figure loss. If the sales price is between $8,000 and $10,000, you have neither gain nor loss.

Business property. If you hold the gift as business property, your basis for figuring any depreciation, depletion, or amortization deduction is the same as the donor's adjusted basis plus or minus any required adjustments to basis while you hold the property.

FMV equal to or greater than donor's adjusted basis. If the FMV of the property is equal to or greater than the donor's adjusted basis, your basis is the donor's adjusted basis at the time you received the gift. Increase your basis by all or part of any gift tax paid, depending on the date of the gift, explained later.

Also, for figuring gain or loss from a sale or other disposition or for figuring depreciation, depletion, or amortization deductions on business property, you must increase or decrease your basis by any required adjustments to basis while you held the property. See *Adjusted Basis*, earlier.

If you received a gift during the tax year, increase your basis in the gift (the donor's adjusted basis) by the part of the gift tax paid on it due to the net increase in value of the gift. Figure the increase by multiplying the gift tax paid by a fraction. The numerator of the fraction is the net increase in value of the gift and the denominator is the amount of the gift.

The net increase in value of the gift is the FMV of the gift minus the donor's adjusted basis. The amount of the gift is its value for gift tax purposes after reduction by any annual exclusion and marital or charitable deduction that applies to the gift.

Example

In 2024, you received a gift of property from your mother that had an FMV of $50,000. Her adjusted basis was $20,000. The amount of the gift for gift tax purposes was $32,000 ($50,000 minus the $18,000 annual exclusion). She paid a gift tax of $6,475 on the property. Your basis is $26,070 figured as follows:

Fair market value	$50,000
Minus: adjusted basis	-20,000
Net increase in value	$30,000
Gift tax paid	$6,475
Multiplied by ($30,000 ÷ $32,000)	x.9375
Gift tax due to net increase in value	$6,070
Adjusted basis of property to your mother	+20,000
Your basis in property	**$26,070**

INHERITED PROPERTY

Your basis in property you inherit from a decedent is generally one of the following.

- The FMV of the property at the date of the decedent's death.
- The FMV on the alternate valuation date if the personal representative for the estate elects to use alternate valuation.
- The value under the special-use valuation method for real property used in farming or a closely held business if elected for estate tax purposes.
- The decedent's adjusted basis in land to the extent of the value excluded from the decedent's taxable estate as a qualified conservation easement.

If a federal estate tax return does not have to be filed, your basis in the inherited property is its appraised value at the date of death for state inheritance or transmission taxes.

PROPERTY CHANGED FROM PERSONAL TO BUSINESS OR RENTAL USE

If you hold property for personal use and then change it to business use or use it to produce rent, you can begin to depreciate at the time of the change. To do so, you must figure its basis for depreciation at the time of the change. An example of changing property held for personal use to business use would be renting out your former main home.

Basis for depreciation. The basis for depreciation is the lesser of the following amounts.

- The FMV of the property on the date of the change.
- Your adjusted basis on the date of the change.

Example

Several years ago, you paid $160,000 to have your house built on a lot that cost $25,000. You paid $20,000 for permanent improvements to the house and claimed a $2,000 casualty loss deduction for damage to the house before changing the property to rental use last year. Because land is not depreciable, you include only the cost of the house when figuring the basis for depreciation.

Your adjusted basis in the house when you changed its use was $178,000 ($160,000 + $20,000 - $2,000). On the same date, your property had an FMV of $180,000, of which $15,000 was for the land and $165,000 was for the house. The basis for figuring depreciation on the house is its FMV on the date of the change ($165,000) because it is less than your adjusted basis ($178,000).

Sale of property. If you later sell or dispose of property changed to business or rental use, the basis you use will depend on whether you are figuring gain or loss.

Gain. The basis for figuring a gain is your adjusted basis in the property when you sell the property.

Example

Assume the same facts as in the previous example except that you sell the property at a gain after being allowed depreciation deductions of $37,500. Your adjusted basis for figuring gain is $165,500 ($178,000 + $25,000 (land) - $37,500).

Loss. Figure the basis for a loss starting with the smaller of your adjusted basis or the FMV of the property at the time of the change to business or rental use. Then adjust this amount for the period after the change in the property's use, as discussed earlier under *Adjusted Basis*.

Example

Assume the same facts as in the previous example, except that you sell the property at a loss after being allowed depreciation deductions of $37,500. In this case, you would start with the FMV on the date of the change to rental use ($180,000), because it is less than the adjusted basis of $203,000 ($178,000 + $25,000) on that date. Reduce that amount ($180,000) by the depreciation deductions to arrive at a basis for loss of $142,500 ($180,000 - $37,500).

STOCKS AND BONDS

The basis of stocks or bonds you buy generally is the purchase price plus any costs of purchase, such as commissions and recording or transfer fees. If you get stocks or bonds other than by purchase, your basis is usually determined by the FMV or the previous owner's adjusted basis, as discussed earlier.

You must adjust the basis of stocks for certain events that occur after purchase. For example, if you receive additional stock from nontaxable stock dividends or stock splits, divide the adjusted basis of the old stock by the number of shares of old and new stock. This rule applies only when the additional stock received is identical to the stock held. Also reduce your basis when you receive nontaxable distributions. The nontaxable distributions are a return of capital.

Example

In 2022 you bought 100 shares of XYZ stock for $1,000 or $10 a share. In 2023 you bought 100 shares of XYZ stock for $1,600 or $16 a share. In 2024 XYZ declared a 2-for-1 stock split. You now have 200 shares of stock with a basis of $5 a share and 200 shares with a basis of $8 a share.

Other basis. There are other ways to figure the basis of stocks or bonds depending on how you acquired them.

Identifying stocks or bonds sold. If you can adequately identify the shares of stock or the bonds you sold, their basis is the cost or other basis of the particular shares of stocks or bonds. If you buy and sell securities at various times in varying quantities and you cannot adequately identify the shares you sell, the basis of the securities you sell is the basis of the securities you acquired first.

Mutual fund shares. If you sell mutual funds you acquired at various times and prices and left on deposit in an account kept by a custodian or agent, you can elect to use an average basis.

Bond premium. If you buy a taxable bond at a premium and choose to amortize the premium, reduce the basis of the bond by the amortized premium you deduct each year. Although you cannot deduct the premium on a tax-exempt bond, you must amortize the premium each year and reduce your basis in the bond by the amortized amount.

Original issue discount (OID) on debt instruments. You must increase your basis in an OID debt instrument by the OID you include in income for that instrument. See *Original Issue Discount* in Chapter 7.

CHAPTER 13: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1.	**The cost basis of property you buy is usually the sum of its costs. Which of the following would <u>not</u> be a cost added to the cost basis:** **A.** the amount you pay in cash **B.** the amount of debt obligations obtained **C.** other property or services provided **D.** charges connected with getting a loan to purchase the property
2.	**A like-kind exchange requires which of the following to be true:** **A.** there must be an exchange of some money **B.** one of the properties involved must be qualifying property **C.** both properties are like-kind property **D.** the cost basis of the old and new property must be the same
3.	**Your basis in stocks or bonds <u>cannot</u> change after purchase.** **A.** true **B.** false

CHAPTER 13: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. The amount of cash paid for a property is part of its cost basis. **B.** Incorrect. Any debt assumed or newly acquired in purchasing property is also a component of its cost basis. **C.** Incorrect. All other property or services provided to a seller to induce them into transferring property is also part of the property's cost basis. **D.** **CORRECT**. Fees and/or charges (for example, points, credit reporting, and loan assumption fees) associated with obtaining a loan used to purchase property are not usually added to the property's cost basis. *(See pages 143 to 145 of the course material.)*
2.	**A.** Incorrect. There is no requirement for the exchange of money. **B.** Incorrect. A like-kind exchange requires that both of the properties involved be "qualifying property" as specified in the tax code, not just one of the properties. **C.** **CORRECT**. A like-kind exchange requires that the property involved be "like-kind property" as specified in the tax code. **D.** Incorrect. Having the cost basis the same is not a condition required for a like-kind exchange to occur. *(See page 149 of the course material.)*
3.	**A.** Incorrect. There are a number of reasons that basis may change after purchase. **B.** **CORRECT**. The basis of stocks or bonds may change after purchase because of nontaxable stock dividends or stock splits or nontaxable distributions. *(See page 153 of the course material.)*

CHAPTER 14: SALE OF PROPERTY

Chapter Objective

After completing this chapter, you should be able to:

- Recognize the taxability of the sale of personal use property.

I. INTRODUCTION

This chapter discusses the tax consequences of selling or trading investment property. It explains:

- What is a sale or trade,
- Figuring gain or loss,
- Nontaxable trades,
- Related party transactions,
- Capital gains or losses,
- Capital assets and noncapital assets, and
- Holding period.

II. SALES AND TRADES

If you sold property such as stocks, bonds, mutual funds, or certain commodities through a broker during the year, you should receive, for each sale, a Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions,* or an equivalent statement from the broker. You should receive a Form 1099-B for 2024 by February 15, 2025. It will show the gross proceeds from the sale. It may also show your basis. The IRS will also get a copy of Form 1099-B from the broker.

Use Form 1099-B received from your broker to complete Form 8949 and/or Schedule D (Form 1040).

Sale and purchase. Ordinarily, a transaction is not a trade when you voluntarily sell property for cash and immediately buy similar property to replace it. The sale and purchase are two separate transactions. But see *Like-kind exchanges* under *Nontaxable Trades*, later.

Redemption of stock. A redemption of stock is treated as a sale or trade and is subject to the capital gain or loss provisions unless the redemption is a dividend or other distribution on stock.

Dividend versus sale or trade. Whether a redemption is treated as a sale, trade, dividend, or other distribution depends on the circumstances in each case. Both direct and indirect ownership of stock will be considered. The redemption is treated as a sale or trade of stock if:

1. The redemption is not essentially equivalent to a dividend (see chapter 8),
2. There is a substantially disproportionate redemption of stock,
3. There is a complete redemption of all the stock of the corporation owned by the shareholder, or
4. The redemption is a distribution in partial liquidation of a corporation.

Redemption or retirement of bonds. A redemption or retirement of bonds or notes at their maturity is generally treated as a sale or trade.

In addition, a significant modification of a bond is treated as a trade of the original bond for a new bond.

Surrender of stock. A surrender of stock by a dominant shareholder who retains control of the corporation is treated as a contribution to capital rather than as an immediate loss deductible from taxable income. The surrendering shareholder must reallocate his or her basis in the surrendered shares to the shares he or she retains.

HOW TO FIGURE GAIN OR LOSS

You figure gain or loss on a sale or trade of property by subtracting the adjusted basis of the property from the amount you realize on the sale or trade.

Gain. If the amount you realize from a sale or trade is more than the adjusted basis of the property you transfer, the difference is a gain.

Loss. If the adjusted basis of the property you transfer is more than the amount you realize, the difference is a loss.

Adjusted basis. The adjusted basis of property is your original cost or other original basis properly adjusted (increased or decreased) for certain items. See chapter 13 for more information about determining the adjusted basis of property.

Amount realized. The amount you realize from a sale or trade of property is everything you receive for the property minus your expenses of sale (such as redemption fees, sales commissions, sales charges, or exit fees). Amount realized includes the money you receive plus the fair market value of any property or services you receive.

If you finance the buyer's purchase of your property and the debt instrument does not provide for adequate stated interest, the unstated interest that you must report as ordinary income will reduce the amount realized from the sale.

Fair market value. Fair market value is the price at which the property would change hands between a buyer and a seller, neither being forced to buy or sell and both having reasonable knowledge of all the relevant facts.

Example

You trade A Company stock with an adjusted basis of $7,000 for B Company stock with a fair market value of $10,000, which is your amount realized. Your gain is $3,000 ($10,000 minus $7,000).

Debt paid off. A debt against the property, or against you, that is paid off as a part of the transaction, or that is assumed by the buyer, must be included in the amount realized. This is true even if neither you nor the buyer is personally liable for the debt. For example, if you sell or trade property that is subject to a nonrecourse loan, the amount you realize generally includes the full amount of the note assumed by the buyer even if the amount of the note is more than the fair market value of the property.

Example

You sell stock that you had pledged as security for a bank loan of $8,000. Your basis in the stock is $6,000. The buyer pays off your bank loan and pays you $20,000 in cash. The amount realized is $28,000 ($20,000 plus $8,000). Your gain is $22,000 ($28,000 minus $6,000).

Payment of cash. If you trade property and cash for other property, the amount you realize is the fair market value of the property you receive. Determine your gain or loss by subtracting the cash you pay plus the adjusted basis of the property you traded in from the amount you realize. If the result is a positive number, it is a gain. If the result is a negative number, it is a loss.

No gain or loss. You may have to use a basis for figuring gain that is different from the basis used for figuring loss. In this case, you may have neither a gain nor a loss. See *Basis Other Than Cost* in chapter 13.

NONTAXABLE TRADES

Note

Per the Tax Cuts and Jobs Act, like-kind exchanges are allowed only for real property after 2017.

Like-kind exchanges. If you trade business or investment property for other business or investment property of a like kind, you do not pay tax on any gain or deduct any loss until you sell or dispose of the property you receive. To be nontaxable, a trade must meet all six of the following conditions.

1. The property must be business or investment property. You must hold both the property you trade and the property you receive for productive use in your trade or business or for investment. Neither property may be property used for personal purposes, such as your home.
2. The property you trade and the property you receive must be real property.
3. There must be a trade of like property. The trade of real estate for real estate is a trade of like property. The trade of an apartment house for a store building is a trade of like property. The trade of a piece of machinery for a store building is not a trade of like property. Real property located in the United States and real property located outside the United States are not like property.
4. The property must not be held primarily for sale. The property you trade and the property you receive must not be property you sell to customers, such as merchandise.
5. The property to be received must be identified within 45 days after the date you transfer the property given up in the trade.
6. The property to be received must be received by the earlier of:
    a) The 180th day after the date on which you transfer the property given up in the trade, or
    b) The due date, including extensions, for your tax return for the year in which the transfer of the property given up occurs.

If you trade property with a related party in a like-kind exchange, a special rule may apply. See *Related Party Transactions*, later in this chapter.

Partly nontaxable exchange. If you receive cash or unlike property in addition to like property, and the above six conditions are met, you have a partially nontaxable trade. You are taxed on any gain you realize, but only up to the amount of the cash and the fair market value of the unlike property you receive. You cannot deduct a loss.

Like property and unlike property transferred. If you give up unlike property in addition to the like property, you must recognize gain or loss on the unlike property you give up. The gain or loss is the difference between the adjusted basis of the unlike property and its fair market value.

Like property and money transferred. If all of the above conditions (1) - (6) are met, you have a nontaxable trade even if you pay money in addition to the like property.

Basis of property received. To figure the basis of the property received, see *Nontaxable Exchanges* in chapter 13.

How to report. You must report the trade of like property on Form 8824. If you figure a recognized gain or loss on Form 8824, report it on Schedule D of (Form 1040) or on Form 4797, *Sales of Business Property*, whichever applies.

Corporate stocks. The following trades of corporate stocks generally do not result in a taxable gain or a deductible loss.

Corporate reorganizations. In some instances, a company will give you common stock for preferred stock, preferred stock for common stock, or stock in one corporation for stock in another corporation. If this is a result of a merger, recapitalization, transfer to a controlled corporation, bankruptcy, corporate division, corporate acquisition, or other corporate reorganization, you do not recognize gain or loss.

Stock for stock of the same corporation. You can exchange common stock for common stock or preferred stock for preferred stock in the same corporation without having a recognized gain or loss. This is true for a trade between two stockholders as well as a trade between a stockholder and the corporation.

Convertible stocks and bonds. You generally will not have a recognized gain or loss if you convert bonds into stock or preferred stock into common stock of the same corporation according to a conversion privilege in the terms of the bond or the preferred stock certificate.

Property for stock of a controlled corporation. If you transfer property to a corporation solely in exchange for stock in that corporation, and immediately after the trade you are in control of the corporation, you ordinarily will not recognize a gain or loss. This rule applies both to individuals and to groups who transfer property to a corporation. It does not apply if the corporation is an investment company.

For this purpose, to be in control of a corporation, you or your group of transferors must own, immediately after the exchange, at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the outstanding shares of each class of nonvoting stock of the corporation.

If this provision applies to you, you may have to attach to your return a complete statement of all facts pertinent to the exchange.

U.S. Treasury notes or bonds. You can trade certain issues of U.S. Treasury obligations for other issues designated by the Secretary of the Treasury, with no gain or loss recognized on the trade.

TRANSFERS BETWEEN SPOUSES

Generally, no gain or loss is recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse, or if incident to a divorce, a former spouse. This nonrecognition rule does not apply if the recipient spouse or former spouse is a nonresident alien. The rule also does not apply if property is transferred in trust and liability exceeds basis. Gains must be recognized to the extent the amount of the liabilities assumed by the trust, plus any liabilities on the property, exceed the adjusted basis of the property.

Any transfer of property to a spouse or former spouse on which gain or loss is not recognized is treated by the recipient as a gift and is not considered a sale or exchange. The recipient's basis in the property will be the same as the adjusted basis of the giver immediately before the transfer. This carryover basis rule applies whether the adjusted basis of the transferred property is less than, equal to, or greater than either its fair market value at the time of transfer or any consideration paid by the recipient. This rule applies for purposes of determining loss as well as gain. Any gain recognized on a transfer in trust increases the basis.

A transfer of property is incident to a divorce if the transfer occurs within 1 year after the date on which the marriage ends, or if the transfer is related to the ending of the marriage.

RELATED PARTY TRANSACTIONS

Special rules apply to the sale or trade of property between related parties.

Gain on sale or trade of depreciable property. Your gain from the sale or exchange of property to a related party may be ordinary income, rather than capital gain, if the property can be depreciated by the party receiving it.

Like-kind exchanges. Generally, if you trade business or investment property for other business or investment property of a like kind, no gain or loss is recognized. See *Like-kind exchanges* earlier under *Nontaxable Trades*.

This rule also applies to trades of property between related parties, defined next under *Losses on sales or trades of property*. However, if either you or the related party disposes of the like property within 2 years after the trade, you both must report any gain or loss not recognized on the original trade on your return filed for the year in which the later disposition occurs.

Losses on sales or trades of property. You cannot deduct a loss on the sale or trade of property, other than a distribution in complete liquidation of a corporation, if the transaction is directly or indirectly between you and the following related parties.

1. Members of your family. This includes only your brothers and sisters, half-brothers and half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.).

2. A partnership in which you directly or indirectly own more than 50% of the capital interest or the profits interest.

3. A corporation in which you directly or indirectly own more than 50% in value of the outstanding stock.

4. A tax-exempt charitable or educational organization that is directly or indirectly controlled, in any manner or by any method, by you or by a member of your family, whether or not this control is legally enforceable.

Multiple property sales or trades. If you sell or trade to a related party a number of blocks of stock or pieces of property in a lump sum, you must figure the gain or loss separately for each block of stock or piece of property. The gain on each item may be taxable. However, you cannot deduct the loss on any item. Also, you cannot reduce gains from the sales of any of these items by losses on the sales of any of the other items.

Indirect transactions. You cannot deduct your loss on the sale of stock through your broker if, under a prearranged plan, a related party buys the same stock you had owned. This does not apply to a trade between related parties through an exchange that is purely coincidental and is not prearranged.

Property received from a related party. If you sell or trade at a gain property that you acquired from a related party, you recognize the gain only to the extent it is more than the loss previously disallowed to the related party. This rule applies only if you are the original transferee and you acquired the property by purchase or exchange. This rule does not apply if the related party's loss was disallowed because of the wash sale rules.

If you sell or trade at a loss property that you acquired from a related party, you cannot recognize the loss that was not allowed to the related party.

Example 1

Your brother sells you stock for $7,600. His cost basis is $10,000. Your brother cannot deduct the loss of $2,400. Later, you sell the same stock to an unrelated party for $10,500, realizing a gain of $2,900. Your reportable gain is $500 – the $2,900 gain minus the $2,400 loss not allowed to your brother.

Example 2

If, in *Example 1*, you sold the stock for $6,900 instead of $10,500, your recognized loss is only $700 (your $7,600 basis minus $6,900). You cannot deduct the loss that was not allowed to your brother.

III. CAPITAL GAINS AND LOSSES

This section discusses the tax treatment of gains and losses from different types of investment transactions.

Character of gain or loss. You need to classify your gains and losses as either ordinary or capital gains or losses. You then need to classify your capital gains and losses as either short-term or long-term. If you have long-term gains and losses, you must identify your 28% rate gains and losses. If you have a net capital gain, you must also identify any unrecaptured section 1250 gain.

The correct classification and identification helps you figure the limit on capital losses and the correct tax on capital gains.

CAPITAL OR ORDINARY GAIN OR LOSS

If you have a taxable gain or a deductible loss from a transaction, it may be either a capital gain or loss or an ordinary gain or loss, depending on the circumstances. Generally, a sale or trade of a capital asset (defined next) results in a capital gain or loss. A sale or trade of a noncapital asset generally results in ordinary gain or loss. Depending on the circumstances, a gain or loss on a sale or trade of property used in a trade or business may be treated as either capital or ordinary. In some situations, part of your gain or loss may be a capital gain or loss, and part may be an ordinary gain or loss.

CAPITAL ASSETS

For the most part, everything you own and use for personal purposes, pleasure, or investment is a capital asset. Some examples are:

- Stocks or bonds held in your personal account,
- A home owned and used by you and your family,
- Household furnishings,
- A car used for pleasure or commuting,
- Coin or stamp collections,
- Gems and jewelry, and
- Gold, silver, or any other metals.

Investment Property

Investment property is a capital asset. Any gain or loss from its sale or trade is generally a capital gain or loss.

Gold, silver, stamps, coins, gems, etc. These are capital assets except when they are held for sale by a dealer. Any gain or loss you have from their sale or trade generally is a capital gain or loss.

Stocks, stock rights, and bonds. All of these (including stock received as a dividend) are capital assets except when held for sale by a securities dealer.

Personal Use Property

Property held for personal use only, rather than for investment, is a capital asset, and you must report a gain from its sale as a capital gain. However, you cannot deduct a loss from selling personal use property.

Discounted Debt Instruments

Treat your gain or loss on the sale, redemption, or retirement of a bond or other debt instrument originally issued at a discount or bought at a discount as capital gain or loss, except as explained in the following discussions.

Short-term government obligations. Treat gains on short-term federal, state, or local government obligations (other than tax-exempt obligations) as ordinary income up to your ratable share of the acquisition discount. This treatment applies to obligations that have a fixed maturity date not more than 1 year from the date of issue. Acquisition discount is the stated redemption price at maturity minus your basis in the obligation.

However, do not treat these gains as income to the extent you previously included the discount in income.

Short-term nongovernment obligations. Treat gains on short-term nongovernment obligations as ordinary income up to your ratable share of original issue discount (OID). This treatment applies to obligations that have a fixed maturity date of not more than 1 year from the date of issue. However, to the extent you previously included the discount in income, you do not have to include it in income again.

Tax-exempt state and local government bonds. If these bonds were originally issued at a discount before September 4, 1982, or you acquired them before March 2, 1984, treat your part of the OID as tax-exempt interest. To figure your gain or loss on the sale or trade of these bonds, reduce the amount realized by your part of the OID.

If the bonds were issued after September 3, 1982, and acquired after March 1, 1984, increase the adjusted basis by your part of the OID to figure gain or loss.

Any gain from market discount is usually taxable on disposition or redemption of tax-exempt bonds. If you bought the bonds before May 1, 1993, the gain from market discount is capital gain. If you bought the bonds after April 30, 1993, the gain is ordinary income.

You figure the market discount by subtracting the price you paid for the bond from the sum of the original issue price of the bond and the amount of accumulated OID from the date of issue that represented interest to any earlier holders.

A loss on the sale or other disposition of a tax-exempt state or local government bond is deductible as a capital loss.

Market discount bonds. If the debt instrument has market discount and you chose to include the discount in income as it accrued, increase your basis in the debt instrument by the accrued discount to figure capital gain or loss on its disposition. If you did not choose to include the discount in income as it accrued, you must report gain as ordinary interest income up to the instrument's accrued market discount. The rest of the gain is capital gain.

Retirement of debt instrument. Any amount that you receive on the retirement of a debt instrument is treated in the same way as if you had sold or traded that instrument.

Deposit in Insolvent or Bankrupt Financial Institution

If you lose money you have on deposit in a bank, credit union, or other financial institution that becomes insolvent or bankrupt, you may be able to deduct your loss as a casualty or as a nonbusiness bad debt short-term capital loss.

Sale of Annuity

The part of any gain on the sale of an annuity contract before its maturity date that is based on interest accumulated on the contract is ordinary income.

LOSSES ON SECTION 1244 (SMALL BUSINESS STOCK)

Subject to the ordinary loss limit, you can deduct as an ordinary loss, rather than as a capital loss, your loss on the sale, trade, or worthlessness of section 1244 stock. Report an ordinary loss from the sale, exchange, or worthlessness of section 1244 stock on Form 4797, line 10. However, if the total loss is more than the maximum amount that can be treated as an ordinary loss, also report the transaction on Form 8949. See the instructions for Forms 4797 and 8949.

Any gain on section 1244 stock is a capital gain if the stock is a capital asset in your hands. Report the gain on Form 8949.

HOLDING PERIOD

If you sold or traded investment property, you must determine your holding period for the property. Your holding period determines whether any capital gain or loss was a short-term or long-term capital gain or loss.

Long term or short term. If you hold investment property more than 1 year, any capital gain or loss is a long-term capital gain or loss. If you hold the property 1 year or less, any capital gain or loss is a short-term capital gain or loss.

To determine how long you held the investment property, begin counting on the date after the day you acquired the property. The day you disposed of the property is part of your holding period.

Example

If you bought investment property on January 31, 2023, and sold it on January 29, 2024, your holding period is not more than 1 year and you have a short-term capital gain or loss. If you sold it on February 6, 2024, your holding period is more than 1 year and you will have a long-term capital gain or loss.

Securities traded on established market. For securities traded on an established securities market, your holding period begins the day after the trade date you bought the securities, and ends on the trade date you sold them.

Example

You are a cash method, calendar year taxpayer. You sold stock at a gain on December 30, 2024. According to the rules of the stock exchange, the sale was closed by delivery of the stock and payment of the sale price in January 2025. Report your gain on your 2024 return, even though you received the payment in 2025. The gain is long term or short term depending on whether you held the stock more than 1 year. Your holding period ended on December 30.

Nontaxable trades. If you acquire investment property in a trade for other investment property and your basis for the new property is determined, in whole or in part, by your basis in the old property, your holding period for the new property begins on the day following the date you acquired the old property.

Property received as a gift. If you receive a gift of property and your basis is determined by the donor's adjusted basis, your holding period is considered to have started on the same day the donor's holding period started.

If your basis is determined by the fair market value of the property, your holding period starts on the day after the date of the gift.

Inherited property. Generally, if you inherit investment property, your capital gain or loss on any later disposition of that property is treated as a long-term capital gain or loss. This is true regardless of how long you actually held the property.

Real property bought. To figure how long you have held real property bought under an unconditional contract, begin counting on the day after you received title to it or on the day after you took possession of it and assumed the burdens and privileges of ownership, whichever happened first. However, taking delivery or possession of real property under an option agreement is not enough to start the holding period. The holding period cannot start until there is an actual contract of sale. The holding period of the seller cannot end before that time.

Stock dividends. The holding period for stock you received as a taxable stock dividend begins on the date of distribution.

The holding period for new stock you received as a nontaxable stock dividend begins on the same day as the holding period of the old stock. This rule also applies to stock acquired in a "spin-off," which is a distribution of stock or securities in a controlled corporation.

Nontaxable stock rights. Your holding period for nontaxable stock rights begins on the same day as the holding period of the underlying stock. The holding period for stock acquired through the exercise of stock rights begins on the date the right was exercised.

NONBUSINESS BAD DEBTS

If someone owes you money that you cannot collect, you have a bad debt. You may be able to deduct the amount owed to you when you figure your tax for the year the debt becomes worthless. A debt must be genuine for you to deduct a loss. A debt is genuine if it arises from a debtor-creditor relationship based on a valid and enforceable obligation to repay a fixed or determinable sum of money.

Generally, nonbusiness bad debts are bad debts that you did not get in the course of operating your trade or business and are deductible as short-term capital losses. To be deductible, nonbusiness bad debts must be totally worthless. You cannot deduct a partly worthless nonbusiness debt.

Basis in bad debt required. To deduct a bad debt, you must have a basis in it – that is, you must have already included the amount in your income or loaned out your cash. For example, you cannot claim a bad debt deduction for court-ordered child support not paid to you by your former spouse. If you are a cash method taxpayer (as most individuals are), you generally cannot take a bad debt deduction for unpaid salaries, wages, rents, fees, interest, dividends, and similar items.

WASH SALES

You cannot deduct losses from sales or trades of stock or securities in a wash sale.

A wash sale occurs when you sell or trade stock or securities at a loss and within 30 days before or after the sale you:

1. Buy substantially identical stock or securities,
2. Acquire substantially identical stock or securities in a fully taxable trade,
3. Acquire a contract or option to buy substantially identical stock or securities, or
4. Acquire substantially identical stock for your individual retirement account (IRA) or Roth IRA.

If your loss was disallowed because of the wash sale rules, add the disallowed loss to the cost of the new stock or securities (except (4) above). The result is your basis in the new stock or securities. This adjustment postpones the loss deduction until the disposition of the new stock or securities. Your holding period for the new stock or securities includes the holding period of the stock or securities sold.

CHAPTER 14: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1.	**Generally, no gain or loss is recognized on the transfer of property from an individual to a spouse. In the case of divorce, such a transfer generally must occur within what time period:** **A.** 3 months of the final divorce date **B.** 1 year of the final divorce date **C.** 2 years of the final divorce date **D.** 3 years of the final divorce date
2.	**To be deductible, a nonbusiness bad debt must meet all of the following conditions <u>except</u>:** **A.** it must be totally worthless **B.** the owner must have a cost basis in the debt **C.** the debt did not arise from running your trade or business **D.** the debt must be less than $10,000

CHAPTER 14: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. Transfers within three months of the final divorce date is not correct. **B.** **CORRECT**. The transfer of property is incident to a divorce if the transfer occurs within one year after the date on which the marriage ends, or if the transfer is related to the ending of the marriage. This carryover basis rule applies whether the adjusted basis of the transferred property is less than, equal to, or greater than either its fair market value at the time of transfer or any consideration paid by the recipient **C.** Incorrect. Transfers within two years of the final divorce date is a longer period of time than allowed. **D.** Incorrect. Transfers within three years of the final divorce date is a longer period of time than allowed. *(See pages 161 to 162 of the course material.)*
2.	**A.** Incorrect. To be deductible, a nonbusiness bad debt must be totally worthless in order to make a claim. **B.** Incorrect. A nonbusiness bad debt must originally have had a cost basis. **C.** Incorrect. To be a nonbusiness deduction, it cannot arise from the operation of a trade or business. **D.** **CORRECT**. A limit to the amount of debt is not a condition required for the deductibility of a nonbusiness bad debt. There is not a fixed amount requirement. *(See page 168 of the course material.)*

CHAPTER 15: SELLING YOUR HOME

Chapter Objective

After completing this chapter, you should be able to:

- Identify the special tax rules related to selling your home.

I. IMPORTANT INFORMATION

Exclusion of forgiven mortgage debt from income. The exclusion of income for mortgage debt canceled or forgiven has been extended through 2025.

II. INTRODUCTION

This chapter explains the tax rules that apply when you sell your main home. In most cases, your main home is the one in which you live most of the time.

If you sold your main home in 2024, you may be able to exclude from income any gain up to a limit of $250,000 ($500,000 on a joint return in most cases). See *Excluding the Gain*, later. Generally, if you can exclude all of the gain, you do not need to report the sale on your tax return.

If you have gain that cannot be excluded, it is taxable. Report it on Form 8949 and Schedule D (Form 1040). You may also have to complete Form 4797, *Sales of Business Property*. See *Reporting the Sale,* later.

If you have a loss on the sale, you cannot deduct it on your return. However, you may need to report it.

The following are main topics in this chapter.

- Figuring gain or loss.
- Basis.
- Excluding the gain.
- Ownership and use tests.
- Reporting the sale.

III. MAIN HOME

Usually, the home you live in most of the time is your main home and can be a:

- House,

- Houseboat,
- Mobile home,
- Cooperative apartment, or
- Condominium.

To exclude gain under the rules of this chapter, you generally must have owned and lived in the property as your main home for at least 2 years during the 5-year period ending on the date of sale.

Land. If you sell the land on which your main home is located, but not the house itself, you cannot exclude any gain you have from the sale of the land. However, if you sell vacant land used as part of your main home and that is adjacent to it, you may be able to exclude the gain from the sale under certain circumstances.

Example

You buy a piece of land and move your main home to it. Then you sell the land on which your main home was located. This sale is not considered a sale of your main home, and you cannot exclude any gain on the sale of the land.

More than one home. If you have more than one home, you can exclude gain only from the sale of your main home. You must include in income the gain from the sale of any other home. If you have two homes and live in both of them, your main home is ordinarily the one you live in most of the time during the year.

Example 1

You own two homes, one in New York and one in Florida. From 2020 through 2024, you live in the New York home for 7 months and in the Florida residence for 5 months of each year. In the absence of facts and circumstances indicating otherwise, the New York home is your main home. You would be eligible to exclude the gain from the sale of the New York home but not of the Florida home in 2024.

Example 2

You own a house, but you live in another house that you rent. The rented house is your main home.

Property used partly as your main home. If you use only part of the property as your main home, the rules discussed in this chapter apply only to the gain or loss on the sale of that part of the property. For details, see *Business Use or Rental of Home*, later.

IV. FIGURING GAIN OR LOSS

To figure the gain or loss on the sale of your main home, you must know the selling price, the amount realized, and the adjusted basis. Subtract the adjusted basis from the amount realized to get your gain or loss.

SELLING PRICE

The selling price is the total amount you receive for your home. It includes money and the fair market value of any other property or any services you receive and all notes, mortgages, or other debts assumed by the buyer as part of the sale.

Payment by employer. You may have to sell your home because of a job transfer. If your employer pays you for a loss on the sale or for your selling expenses, do not include the payment as part of the selling price. Your employer will include it in box 1 of your Form W-2 and you will include it in your gross income as wages on Form 1040 or 1040-SR, line 1.

Option to buy. If you grant an option to buy your home and the option is exercised, add the amount you receive for the option to the selling price of your home. If the option is not exercised, you must report the amount as ordinary income in the year the option expires. Report this amount on Schedule 1 (Form 1040), line 8z.

Form 1099-S. If you received Form 1099-S, *Proceeds From Real Estate Transactions*, box 2 (Gross proceeds) should show the total amount you received for your home.

However, box 2 will not include the fair market value of any property other than cash or notes, or any services, you received or will receive. Instead, box 4 will be checked to indicate your receipt (or expected receipt) of these items.

AMOUNT REALIZED

The amount realized is the selling price minus selling expenses.

Selling expenses. Selling expenses include:

- Commissions,
- Advertising fees,
- Legal fees, and
- Loan charges paid by the seller, such as loan placement fees or “points.”

ADJUSTED BASIS

While you owned your home, you may have made adjustments (increases or decreases) to the basis. This adjusted basis must be determined before you can figure gain or loss on the sale of your home. For information on how to figure your home's adjusted basis, see *Determining Basis* later.

AMOUNT OF GAIN OR LOSS

To figure the amount of gain or loss, compare the amount realized to the adjusted basis.

Gain on sale. If the amount realized is more than the adjusted basis, the difference is a gain and, except for any part you can exclude, in most cases is taxable.

Loss on sale. If the amount realized is less than the adjusted basis, the difference is a loss. A loss on the sale of your main home cannot be deducted.

Jointly owned home. If you and your spouse sell your jointly owned home and file a joint return, you figure your gain or loss as one taxpayer.

Separate returns. If you file separate returns, each of you must figure your own gain or loss according to your ownership interest in the home. Your ownership interest is determined by state law.

Joint owners not married. If you and a joint owner other than your spouse sell your jointly owned home, each of you must figure your own gain or loss according to your ownership interest in the home. Each of you applies the rules discussed in this chapter on an individual basis.

DISPOSITIONS OTHER THAN SALES

Trading (exchanging) homes. If you trade your old home for another home, treat the trade as a sale and a purchase.

Example

You owned and lived in a home that had an adjusted basis of $41,000. A real estate dealer accepted your old home as a trade-in and allowed you $50,000 toward a new home priced at $80,000. This is treated as a sale of your old home for $50,000 with a gain of $9,000 ($50,000 - $41,000).

If the dealer had allowed you $27,000 and assumed your unpaid mortgage of $23,000 on your old home, your sales price would still be $50,000 (the $27,000 trade-in allowed plus the $23,000 mortgage assumed).

Foreclosure or repossession. If your home was foreclosed on or repossessed, you have a disposition.

Transfer to spouse. If you transfer your home to your spouse, or to your former spouse incident to your divorce, you generally have no gain or loss. This is true even if you receive cash or other consideration for the home. As a result, the rules in this chapter do not apply.

DETERMINING BASIS

You need to know your basis in your home to determine any gain or loss when you sell it. Your basis in your home is determined by how you got the home. Generally, your basis is its cost if you bought it or built it. If you got it in some other way (inheritance, gift, etc.), your basis is generally either its fair market value when you received it or the adjusted basis of the previous owner.

While you owned your home, you may have made adjustments (increases or decreases) to your home's basis. The result of these adjustments is your home's adjusted basis, which is used to figure gain or loss on the sale of your home. See *Adjusted Basis*, later.

Cost as Basis

The cost of property is the amount you pay for it in cash, debt obligations, other property, or services.

Purchase. If you bought your home, your basis is its cost to you. This includes the purchase price and certain settlement or closing costs. In most cases, your purchase price includes your down payment and any debt, such as a first or second mortgage or notes you gave the seller in payment for the home. If you build, or contract to build, a new home, your purchase price can include costs of construction.

Settlement fees or closing costs. When you bought your home, you may have paid settlement fees or closing costs in addition to the contract price of the property. You can include in your basis the settlement fees and closing costs you paid for buying the home, but not the fees and costs for getting a mortgage loan. A fee paid for buying the home is any fee you would have had to pay even if you paid cash for the home (that is without the need for financing).

Adjusted Basis

Adjusted basis is your cost or other basis increased or decreased by certain amounts.

Increases to basis. These include any:

- Additions and other improvements that have a useful life of more than 1 year.
- Special assessments for local improvements.
- Amounts you spent after a casualty to restore damaged property.

Improvements. These add to the value of your home, prolong its useful life, or adapt it to new uses. You add the cost of additions and other improvements to the basis of your property.

Example

Putting a recreation room or another bathroom in your unfinished basement, putting up a new fence, putting in new plumbing or wiring, putting on a new roof, or paving your unpaved driveway are improvements. An addition to your house, such as a new deck, a sunroom, or a garage, is also an improvement.

Repairs. These maintain your home in good condition but do not add to its value or prolong its life. You do not add their cost to the basis of your property.

Example

Repainting your house inside or outside, fixing your gutters or floors, repairing leaks or plastering, and replacing broken window panes are examples of repairs.

Decreases to basis. These include the following:

- The amount of qualified principal residence indebtedness that has been excluded from income for discharges before January 1, 2026, or was subject to an arrangement that was entered into and evidenced in writing before January 1, 2026.
- Some or all of the cancellation of debt income that was excluded due to your bankruptcy or insolvency.
- Gain you postponed from the sale of a previous home before May 7, 1997.
- Deductible casualty losses.
- Insurance payments you received or expect to receive for casualty losses.
- Payments you received for granting an easement or right-of-way.
- Depreciation allowed or allowable if you used your home for business or rental purposes.
- Adoption credit you claimed for improvements added to the basis of your home.
- Nontaxable payments from an adoption assistance program of your employer that you used for improvements you added to the basis of your home.
- Energy conservation subsidy excluded from your gross income because you received it (directly or indirectly) from a public utility after 1992 to buy or install any energy conservation measure. An energy conservation measure is an installation or modification that is primarily designed either to reduce consumption of electricity or natural gas or to improve the management of energy demand for a home.
- General sales taxes (beginning in 2004) claimed as an itemized deduction on Schedule A (Form 1040) that were imposed on the purchase of personal property, such as a houseboat used as your home or a mobile home.

V. EXCLUDING THE GAIN

You may qualify to exclude from your income all or part of any gain from the sale of your main home. This means that, if you qualify, you will not have to pay tax on the gain up to the limit described under *Maximum Exclusion*, next. To qualify, you must meet the ownership and use tests described later.

You can choose not to take the exclusion. In that case, you must include in gross income your entire gain in the year of sale.

MAXIMUM EXCLUSION

You can exclude up to $250,000 of the gain (other than gain allocated to periods of nonqualified use) on the sale of your main home if all of the following are true.

1. You meet the ownership test.
2. You meet the use test.
3. During the 2-year period ending on the date of the sale, you did not exclude gain from the sale of another home.

You may be able to exclude up to $500,000 of the gain (other than gain allocated to periods of nonqualified use) on the sale of your main home if you are married and file a joint return and meet the requirements listed in the discussion of the special rules for joint returns, later, under *Married Persons*.

OWNERSHIP AND USE TESTS

To claim the exclusion, you must meet the ownership and use tests. This means that during the 5-year period ending on the date of the sale, you must have:

1. Owned the home for at least 2 years (the ownership test), and
2. Lived in the home as your main home for at least 2 years (the use test).

Exception

If you owned and lived in the property as your main home for less than 2 years, you can still claim an exclusion in some cases. However, the maximum amount you may be able to exclude will be reduced. See *Reduced Maximum Exclusion*, later.

Period of Ownership and Use

The required 2 years of ownership and use during the 5-year period ending on the date of the sale do not have to be continuous, nor do they both have to occur at the same time.

You meet the tests if you can show that you owned and lived in the property as your main home for either 24 full months or 730 days (365 × 2) during the 5-year period ending on the date of sale.

Temporary absence. Short temporary absences for vacations or other seasonal absences, even if you rent the property during the absences, are counted as periods of use.

Example

Professor Paul Beard, who is single, bought and moved into a house on August 19, 2021. He lived in it as his main home continuously until January 5, 2023, when he went abroad for a 1-year sabbatical leave. On February 5, 2024, 1 month after returning from leave, he sold the house at a gain.

Because his leave was not a short temporary absence, he cannot include the period of leave to meet the 2-year use test. He cannot exclude any part of his gain, because he did not use the residence for the required 2 years.

Ownership and use tests met at different times. You can meet the ownership and use tests during different 2-year periods. However, you must meet both tests during the 5-year period ending on the date of the sale.

Example

Beginning in 2013, Helen Jones lived in a rented apartment. The apartment building was later converted to condominiums, and she bought her same apartment on December 2, 2021. In 2022, Helen became ill and on April 14 of that year she moved to her daughter's home. On July 7, 2024, while still living in her daughter's home, she sold her condominium.

Helen can exclude gain on the sale of her condominium because she met the ownership and use tests during the 5-year period from July 8, 2019 to July 7, 2024 (more than 2 years). She owned her condominium from December 2, 2021, to July 7, 2024 (over 2 years). She lived in the property from July 8, 2019 (the beginning of the 5-year period), to April 14, 2022 (over 2 years).

The time Helen lived in her daughter's home during the 5-year period can be counted toward her period of ownership, and the time she lived in her rented apartment during the 5-year period can be counted toward her period of use.

Cooperative apartment. If you sold stock in a cooperative housing corporation, the ownership and use tests are met if, during the 5-year period ending on the date of sale, you:

1. Owned the stock for at least 2 years, and

2. Lived in the house or apartment that the stock entitles you to occupy as your main home for at least 2 years.

Exception for individuals with a disability. There is an exception to the use test if:

1. You become physically or mentally unable to care for yourself, and
2. You owned and lived in your home as your main home for a total of at least 1 year during the 5-year period before the sale of your home.

Under this exception, you are considered to live in your home during any time within the 5-year period that you own the home and live in a facility (including a nursing home) licensed by a state or political subdivision to care for persons in your condition.

If you meet this exception to the use test, you still have to meet the 2-out-of-5-year ownership test to claim the exclusion.

Previous home destroyed or condemned. For the ownership and use tests, you add the time you owned and lived in a previous home that was destroyed or condemned to the time you owned and lived in the home on which you wish to exclude gain. This rule applies if any part of the basis of the home you sold depended on the basis of the destroyed or condemned home. Otherwise, you must have owned and lived in the same home for 2 of the 5 years before the sale to qualify for the exclusion.

Married Persons

If you and your spouse file a joint return for the year of sale and one spouse meets the ownership and use test, you can exclude up to $250,000 of the gain. (But see *Special rules for joint returns,* next.)

Special rules for joint returns. You can exclude up to $500,000 of the gain on the sale of your main home if all of the following are true.

- You are married and file a joint return for the year.
- Either you or your spouse meets the ownership test.
- Both you and your spouse meet the use test.
- During the 2-year period ending on the date of the sale, neither you nor your spouse excluded gain from the sale of another home.

If either spouse does not satisfy all these requirements, the maximum exclusion that can be claimed by the couple is the total of the maximum exclusions that each spouse would qualify for if not married and the amounts were figured separately. For this purpose, each spouse is treated as owning the property during the period that either spouse owned the property.

Example 1

One spouse sells a home. Emily sells her home in June 2024 for a gain of $300,000. She marries Jamie later in the year. She meets the ownership and use tests, but Jamie does not. She can exclude up to $250,000 of gain on a separate or joint return for 2024. The $500,000 maximum exclusion for certain joint filers does not apply because Jamie does not meet the use test.

Example 2

Each spouse sells a home. The facts are the same as in *Example 1* except that Jamie also sells a home in 2024 for a gain of $200,000 before he marries Emily. He meets the ownership and use tests on his home, but Emily does not. Emily can exclude up to $250,000 of gain and Jamie can exclude $200,000 of the gain on the respective sales of their individual homes. However, Emily cannot use Jamie's unused exclusion to exclude more than $250,000 of gain. Therefore, Emily and Jamie must recognize $50,000 of gain on the sale of Emily's home. The $500,000 maximum exclusion for certain joint returns does not apply because Emily and Jamie do not jointly meet the use test for the same home.

Home transferred from spouse. If your home was transferred to you by your spouse (or former spouse if the transfer was incident to divorce), you are considered to have owned it during any period of time when your spouse owned it.

Use of home after divorce. You are considered to have used property as your main home during any period when:

1. You owned it, and
2. Your spouse or former spouse is allowed to live in it under a divorce or separation instrument and uses it as his or her main home.

REDUCED MAXIMUM EXCLUSION

If you fail to meet the requirements to qualify for the $250,000 or $500,000 exclusion, you may still qualify for a reduced exclusion. This applies to those who:

- Fail to meet the ownership and use tests, or
- Have used the exclusion within 2 years of selling their current home.

In both cases, to qualify for a reduced exclusion, the sale of your main home must be due to one of the following reasons.

- A change in place of employment.
- Health.
- Unforeseen circumstances.

Unforeseen circumstances. The sale of your main home is because of an unforeseen circumstance if your primary reason for the sale is the occurrence of an event that you could not reasonably have anticipated before buying and occupying your main home.

VI. BUSINESS USE OR RENTAL OF HOME

You may be able to exclude your gain from the sale of a home that you have used for business or to produce rental income. But you must meet the ownership and use tests.

Example 1

On May 24, 2018, Amy, who is single for all years in this example, bought a house. She moved in on that date and lived in it until May 31, 2020, when she moved out of the house and put it up for rent. The house was rented from June 1, 2020 to March 31, 2022. Amy claimed depreciation deductions in 2020 through 2022 totaling $10,000. Amy moved back into the house on April 1, 2022, and lived there until she sold it on January 28, 2024 for a gain of $200,000. During the 5-year period ending on the date of the sale (January 29, 2019 - January 28, 2024), Amy owned and lived in the house for more than 2 years as shown in the table below.

Five Year Period	Used as Home	Used as Rental
1/29/19 – 5/31/20	16 months	
6/1/20 – 3/31/22		22 months
4/1/22 – 1/28/24	22 months	
	38 months	22 months

Next, Amy must figure how much of her gain is allocated to qualified use.

During the period Amy owned the house (2,076 days), her period of nonqualified use was 670 days. Amy divides 670 by 2,076 and obtains a decimal (rounded to at least three decimal places) of 0.323. To figure her gain attributable to the period of nonqualified use, she multiplies $190,000 (the gain not attributable to the $10,000 depreciation deduction) by 0.323. Because the gain attributable to periods of nonqualified use is $61,370, Amy can exclude $128,630 of her gain.

Example 2

William owned and used a house as his main home from 2018 through 2021. On January 1, 2022, he moved to another state. He rented his house from that date until April 29, 2024, when he sold it. During the 5-year period ending on the date of sale (April 30, 2019 - April 29, 2024), William owned and lived in the house for more than 2 years. He must report the sale on Form 4797 because it was rental property at the time of sale. Because the period of nonqualified use does not include any part of the 5-year period after the last day William lived in the house, he has no period of nonqualified use. Because he met the ownership and use tests, he can exclude gain up to $250,000. However, he cannot exclude the part of the gain equal to the depreciation he claimed or could have claimed for renting the house, as explained next.

Depreciation after May 6, 1997. If you were entitled to take depreciation deductions because you used your home for business purposes or as rental property, you cannot exclude the part of your gain equal to any depreciation allowed as a deduction for periods after May 6, 1997. If you can show by adequate records or other evidence that the depreciation deduction allowed was less than the amount allowable, then you may limit the amount of gain recognized to the depreciation allowed.

VII. REPORTING THE SALE

Do ***not*** report the 2024 sale of your main home on your tax return unless:

- You have a gain and you do not qualify to exclude all of it,
- You have a gain and you choose not to exclude it, or
- You received Form 1099-S.

If any of these conditions apply, report the entire gain. For details on how to report the gain, see the Instructions for Schedule D (Form 1040) and the Instructions for Form 8949.

If you used the home for business or to produce rental income, you may have to use Form 4797 to report the sale of the business or rental part (or the sale of the entire property if used entirely for business or rental).

Installment sale. Some sales are made under arrangements that provide for part or all of the selling price to be paid in a later year. These sales are called “installment sales.” If you finance the buyer’s purchase of your home yourself, instead of having the buyer get a loan or mortgage from a bank, you probably have an installment sale. You may be able to report the part of the gain you cannot exclude on the installment basis.

Use Form 6252, *Installment Sale Income*, to report the sale. Enter your exclusion on line 15 of Form 6252.

CHAPTER 15: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1.	**To figure the gain or loss on the sale of your main home, you must know all of the following except:** **A.** selling price **B.** age of the home **C.** amount realized **D.** adjusted basis
2.	**To qualify for the maximum exclusion on the sale of your main home, the required years to meet the ownership and use tests must be continuous.** **A.** true **B.** false

CHAPTER 15: SOLUTION AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. The selling price is the amount you received for your home. **B.** **CORRECT**. The age of the home does not have any impact on the gain or loss calculation of the sale of a home. **C.** Incorrect. The amount realized is the selling price less the selling expenses. **D.** Incorrect. The adjusted basis is your original basis (determined when you got the home) increased or decreased by certain amounts. *(See page 173 of the course material.)*
2.	**A.** Incorrect. You meet the tests if you can show that you owned and lived in the property as your main home for either 24 full months or 730 days during the 5-year period ending on the date of sale. **B.** **CORRECT**. Not only do the 2 of 5 years not have to be continuous, they do not have to occur at the same time. *(See page 177 of the course material.)*

CHAPTER 16: REPORTING GAINS AND LOSSES

Chapter Objective

After completing this chapter, you should be able to:

- Recall the capital gain rates for the current year.

I. IMPORTANT INFORMATION

Reporting of deferred gain from sale or exchange of QOF investment. If you sold or exchanged your investment in a QOF and you need to report the gain previously deferred, you will need to report the gain on Form 8949. See the instructions for Form 8949 for more information.

II. INTRODUCTION

This chapter discusses how to report capital gains and losses from sales, exchanges, and other dispositions of investment property on Form 8949 and Schedule D (Form 1040). The discussion includes:

- How to report short-term gains and losses,
- How to report long-term gains and losses,
- How to figure capital loss carryovers, and
- How to figure your tax on a net capital gain.

III. REPORTING CAPITAL GAINS AND LOSSES

Generally, report capital gains and losses on Form 8949. Complete Form 8949 before you complete line 1b, 2, 3, 8b, 9, or 10 of Schedule D (Form 1040).

Use Form 8949 to report:

- The sale or exchange of a capital asset not reported on another form or schedule,
- Gains from involuntary conversions (other than from casualty or theft) of capital assets not held for business or profit,
- Nonbusiness bad debts, and
- Securities that become worthless.

Use Schedule D (Form 1040) to report:

- Overall gain or loss from transactions reported on Form 8949;
- Certain transactions you do not have to report on Form 8949;
- Gain from Form 2439 or 6252 or Part I of Form 4797;
- Gain or loss from Form 4684, 6781, or 8824;
- Gain or loss from a partnership, S corporation, estate, or trust;
- Capital gain distributions not reported directly on your Form 1040 or 1040-SR; and
- Capital loss carryover from the previous year to the current year.

On Form 8949, enter all sales and exchanges of capital assets, including stocks, bonds, etc., and real estate (if not reported on Form 4684, 4797, 6252, 6781, 8824 or line 1a or 8a of Schedule D (Form 1040)). Include these transactions even if you did not receive a Form 1099-B or 1099-S for the transaction. Report short-term gains or losses in Part I. Report long-term gains or losses in Part II. Use as many Forms 8949 as you need.

Passive activity gains and losses. If you have gains or losses from a passive activity, you may also have to report them on Form 8582. In some cases, the loss may be limited under the passive activity rules. Refer to Form 8582 and its instructions for more information about reporting capital gains and losses from a passive activity.

Sale expenses. On Form 8949, include in column (g) any expense of sale, such as broker's fees, commissions, state and local transfer taxes, and option premiums, unless you reported the net sales price in column (d). If you include an expense of sale in column (g), enter "E" in column (f).

For more information about adjustments to basis, see chapter 13.

Short-term gains and losses. Capital gain or loss on the sale or trade of investment property held 1 year or less is a short-term capital gain or loss. You report it in Part I of Form 8949.

You combine your share of short-term capital gains or losses from partnerships, S corporations, estates, and trusts, and any short-term capital loss carryover, with your other short-term capital gains and losses to figure your net short-term capital gain or loss on Schedule D (Form 1040), line 7.

Long-term gains and losses. A capital gain or loss on the sale or trade of property held more than 1 year is a long-term capital gain or loss. You report it in Part II of Form 8949.

You also report the following in Part II of Schedule D (Form 1040):

1. Undistributed long-term capital gains from a mutual fund (or other regulated investment company) or real estate investment trust (REIT),
2. Your share of long-term capital gains or losses from partnerships, S corporations, estates, and trusts,
3. All capital gain distributions from mutual funds and REITs not reported directly on Form 1040 or 1040-SR, line 7, and
4. Long-term capital loss carryovers.

The result after combining these items with your other long-term capital gains and losses is your net long-term capital gain or loss on Schedule D (Form 1040), line 15.

CAPITAL LOSSES

If your capital losses are more than your capital gains, you can claim a capital loss deduction. Report the deduction on Form 1040 or 1040-SR, line 7, in parentheses.

Limit on deduction. Your allowable capital loss deduction, figured on Schedule D (Form 1040), is the lesser of:

1. $3,000 ($1,500 if you are married and file a separate return), or
2. Your total net loss as shown on Schedule D (Form 1040), line 16.

You can use your total net loss to reduce your income dollar for dollar, up to the $3,000 limit.

Capital loss carryover. If you have a total net loss on Schedule D (Form 1040), line 16 that is more than the yearly limit on capital loss deductions, you can carry over the unused part to the next year and treat it as if you had incurred it in that next year. If part of the loss is still unused, you can carry it over to later years until it is completely used up.

When you figure the amount of any capital loss carryover to the next year, you must take the current year's allowable deduction into account, whether or not you claimed it, and whether or not you filed a return for the current year.

When you carry over a loss, it remains long term or short term. A long-term capital loss you carry over to the next tax year will reduce that year's long-term capital gains before it reduces that year's short-term capital gains.

Figuring your carryover. The amount of your capital loss carryover is the amount of your total net loss that is more than the lesser of:

1. Your allowable capital loss deduction for the year, or
2. Your taxable income increased by your allowable capital loss deduction for the year.

If your deductions are more than your gross income for the tax year, use your negative taxable income in computing the amount in item (2).

Complete the *Capital Loss Carryover Worksheet* in the Schedule D (Form 1040) instructions to determine the part of your capital losses that you can carry over.

Example

Bob and Gloria sold securities in 2024. The sales resulted in a capital loss of $7,000. They had no other capital transactions. Their taxable income was $26,000. On their joint 2024 return, they can deduct $3,000. The unused part of the loss, $4,000 ($7,000 - $3,000), can be carried over to 2025.

If their capital loss had been $2,000, their capital loss deduction would have been $2,000. They would have no carryover.

Use short-term losses first. When you figure your capital loss carryover, use your short-term capital losses first, even if you incurred them after a long-term capital loss. If you have not reached the limit on the capital loss deduction after using short-term losses, use the long-term losses until you reach the limit.

Decedent's capital loss. A capital loss sustained by a decedent during his or her last tax year (or carried over to that year from an earlier year) can be deducted only on the final income tax return filed for the decedent. The capital loss limits discussed earlier still apply in this situation. The decedent's estate cannot deduct any of the loss or carry it over to following years.

Joint and separate returns. If you and your spouse once filed separate returns and are now filing a joint return, combine your separate capital loss carryovers. However, if you and your spouse once filed a joint return and are now filing separate returns, any capital loss carryover from the joint return can be deducted only on the return of the person who actually had the loss.

CAPITAL GAIN TAX RATES

The tax rates that apply to a net capital gain are generally lower than the tax rates that apply to other income. These lower rates are called the maximum capital gain rates.

The term "net capital gain" means the amount by which your net long-term capital gain for the year is more than your net short-term capital loss.

For 2024, the maximum capital gain rates are 0%, 15%, 20%, 25%, or 28%.

Investment interest deducted. If you claim a deduction for investment interest, you may have to reduce the amount of your net capital gain that is eligible for the capital gain tax rates. Reduce it by the amount of the net capital gain you choose to include in investment income when figuring the limit on your investment interest deduction. This is done on the *Schedule D Tax Worksheet* or the *Qualified Dividends and Capital Gain Tax Worksheet*.

Tax computation using maximum capital gains rates. Use the *Qualified Dividends and Capital Gain Tax Worksheet* or the *Schedule D Tax Worksheet* (whichever applies) to figure your tax if you have qualified dividends or net capital gain. You have net capital gain if Schedule D (Form 1040), lines 15 and 16, are both gains.

CHAPTER 16: TEST YOUR KNOWLEDGE

The following question is designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). It is included as an additional tool to enhance your learning experience and does not need to be submitted in order to receive CPE credit.

We recommend that you answer the question and then compare your response to the suggested solution on the following page before answering the final exam question(s) related to this chapter (assignment).

1.	**What is the maximum amount of a capital loss, in excess of that year's capital gain, that a married couple (filing jointly) can deduct:** **A.** \$1,500 **B.** \$3,000 **C.** \$6,000 **D.** unlimited

CHAPTER 16: SOLUTION AND SUGGESTED RESPONSES

Below is the solution and suggested responses for the question on the previous page. If you choose an incorrect answer, you should review the page(s) as indicated for the question to ensure comprehension of the material.

1.	**A.** Incorrect. The maximum capital loss deduction is greater than $1,500. **B.** CORRECT. The maximum capital loss deduction is $3,000 ($1,500 if married and file separate returns). **C.** Incorrect. Any amounts greater than $3,000 can be carried over to future tax years. **D.** Incorrect. The capital loss deduction is not unlimited in any one year. *(See page 187 of the course material.)*

PART FOUR: ADJUSTMENTS TO INCOME

The four chapters in this part discuss some of the adjustments to income that you can deduct in figuring your adjusted gross income. These chapters cover:

- Contributions you make to traditional and Roth individual retirement arrangements (IRAs) – chapter 17,
- Alimony you pay – Chapter 18,
- Student loan interest you pay – Chapter 19, and
- Business expenses you pay as an Armed Forces reservist, a performing artist, or a fee-basis government official – Chapter 20.

CHAPTER 17: INDIVIDUAL RETIREMENT ARRANGEMENTS (IRAs)

Chapter Objectives

After completing this chapter, you should be able to:

- Recall the thresholds, requirements, and additional taxes related to individual retirement arrangements.

I. WHAT'S NEW

Traditional IRA contribution and deduction limit. The contribution limit to your traditional IRA for 2024 will be the smaller of the following amounts:

- $7,000, or
- Your taxable compensation for the year.

If you were age 50 or older before 2025, the most that can be contributed to your traditional IRA for 2024 will be the smaller of the following amounts:

- $8,000, or
- Your taxable compensation for the year.

Roth IRA contribution limit. If contributions on your behalf are made only to Roth IRAs, your contribution limit for 2024 will generally be the lesser of:

- $7,000, or
- Your taxable compensation for the year.

If you were age 50 or older before 2025 and contributions on your behalf were made only to Roth IRAs, your contribution limit for 2024 will generally be the lesser of:

- $8,000, or
- Your taxable compensation for the year.

However, if your modified adjusted gross income (AGI) is above a certain amount, your contribution limit may be reduced.

Modified AGI limit for traditional IRA contributions increased. For 2024, if you were covered by a retirement plan at work, your deduction for contributions to a traditional IRA is reduced (phased out) if your modified adjusted gross income (AGI) is:

- More than $123,000 but less than $143,000 for a married couple filing a joint return or a qualifying widow(er),
- More than $77,000 but less than $87,000 for a single individual or head of household, or
- Less than $10,000 for a married individual filing a separate return.

If you either lived with your spouse or file a joint return, and your spouse was covered by a retirement plan at work, but you were not, your deduction is phased out if your AGI is more than $230,000 but less than $240,000. If your AGI is $240,000 or more, you cannot take a deduction for contributions to a traditional IRA.

Modified AGI limit for Roth contributions. For 2024, your Roth IRA contribution limit is reduced (phased out) in the following situations.

- Your filing status is married filing jointly or qualifying widow(er) and your modified AGI is at least $230,000. You cannot make a Roth IRA contribution if your modified AGI is $240,000 or more.
- Your filing status is single, head of household, or married filing separately and you did not live with your spouse at any time in 2024, and your modified AGI is at least $146,000. You cannot make a Roth IRA contribution if your modified AGI is $161,000 or more.
- 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 or more.

II. IMPORTANT REMINDERS

SECURE ACT AND SECURE ACT 2.0

Among the provisions of the SECURE Act, for tax years beginning after 2019, the age restriction on contributions to traditional IRAs was repealed, and the age requirement for taking RMDs was increased to 72 (from 70½). Subsequently, among the provisions of the SECURE Act 2.0, signed in December 2022, the age requirement for taking RMDs was increased to 73 for individuals who had not reached age 72 before January 1, 2023.

CORONAVIRUS AID, RELIEF, AND ECONOMIC SECURITY (CARES) ACT

The Coronavirus Aid, Relief, and Economic Security (CARES) Act made additional changes to IRAs and retirement plans. Among the changes are:

- The 10% early distribution penalty for those under 59½ does not apply for coronavirus-related distributions received in 2020 up to $100,000. In addition, the early withdrawal penalty does not apply to qualified birth or adoption distributions up to $5,000.
- The tax on a coronavirus-related distribution can be spread over three years.

- A coronavirus-related distribution can be recontributed within three years.

Statement of required minimum distribution. If a minimum distribution is required from your IRA, the trustee, custodian, or issuer that held the IRA at the end of the preceding year must either report the amount of the required minimum distribution to you, or offer to calculate it for you. The report or offer must include the date by which the amount must be distributed. The report is due January 31 of the year in which the minimum distribution is required. It can be provided with the year-end fair market value statement that you normally get each year. No report is required for IRAs of owners who have died.

IRA interest. Although interest earned from your IRA is generally not taxed in the year earned, it is not tax-exempt interest. Do not report this interest on your tax return as tax-exempt interest.

Net Investment Income Tax. For purposes of the Net Investment Income Tax (NIIT), net investment income does not include distributions from a qualified retirement plan including IRAs (for example 401(a), 403(a), 403(b), 408, 408A, or 457(b) plans). However, these distributions are taken into account when determining the modified adjusted gross income threshold. Distributions from a nonqualified retirement plan are included in net investment income.

Form 8606. To designate contributions as nondeductible, you must file Form 8606, Nondeductible IRAs.

Tip

The term "50 or older" is used several times in this chapter. It refers to an IRA owner who is age 50 or older by the end of the tax year.

III. INTRODUCTION

An individual retirement arrangement (IRA) is a personal savings plan that offers you tax advantages to set aside money for your retirement.

This chapter discusses:

1. The rules for a traditional IRA (any IRA that is not a Roth or SIMPLE IRA), and
2. The Roth IRA, which features nondeductible contributions and tax-free distributions.

Simplified Employee Pensions (SEPs) and Savings Incentive Match Plans for Employees (SIMPLEs) are not discussed in this chapter.

IV. TRADITIONAL IRAs

In this chapter, the original IRA (sometimes called an ordinary or regular IRA) is referred to as a "traditional IRA." Two advantages of a traditional IRA are:

1. You may be able to deduct some or all of your contributions to it, depending on your circumstances, and
2. Generally, amounts in your IRA, including earnings and gains, are not taxed until they are distributed.

HOW MUCH CAN BE CONTRIBUTED?

There are limits and other rules that affect the amount that can be contributed and the amount you can deduct. These limits and some of the other rules are explained below.

General limit. For 2024, the most that can be contributed to your traditional IRA generally is the smaller of the following amounts:

1. $7,000 ($8,000 if you are 50 or older in 2024), or
2. Your taxable compensation (defined earlier) for the year.

This is the most that can be contributed regardless of whether the contributions are to one or more traditional IRAs or whether all or part of the contributions are nondeductible. (See *Nondeductible Contributions*, later.) Qualified reservist payments do not affect this limit.

Example 1

Betty, who is 34 years old and single, earned $24,000 in 2024. Her IRA contributions for 2024 are limited to $7,000.

Example 2

John, an unmarried college student working part time, earned $3,500 in 2024. His IRA contributions for 2024 are limited to $3,500, the amount of his compensation.

Kay Bailey Hutchison Spousal IRA limit. For 2024, if you file a joint return and your taxable compensation is less than that of your spouse, the most that can be contributed for the year to your IRA is the smaller of the following amounts:

1. $8,000 ($8,000 if you are 50 or older).
2. The total compensation includible in the gross income of both you and your spouse for the year, reduced by the following two amounts.
    a) Your spouse's contribution for the year to a traditional IRA.

b) Any contribution for the year to a Roth IRA on behalf of your spouse.

This means that the total combined contributions that can be made for the year to your IRA and your spouse's IRA can be as much as $14,000 ($15,000 if only one of you is 50 or older, or $16,000 if both of you are 50 or older).

WHEN CAN CONTRIBUTIONS BE MADE?

As soon as you open your traditional IRA, contributions can be made to it through your chosen sponsor (trustee or other administrator). Contributions to a traditional IRA must be in the form of money (cash, check, or money order). Property cannot be contributed.

Contributions must be made by due date. Contributions can be made to your traditional IRA for a year at any time during the year or by the due date for filing your return for that year, not including extensions.

Designating year for which contribution is made. If an amount is contributed to your traditional IRA between January 1 and April 15, you should tell the sponsor which year (the current year or the previous year) the contribution is for. If you do not tell the sponsor which year it is for, the sponsor can assume, and report to the IRS, that the contribution is for the current year (the year the sponsor received it).

Filing before a contribution is made. You can file your return claiming a traditional IRA contribution before the contribution is actually made. Generally, the contribution must be made by the due date of your return, not including extensions.

Contributions not required. You do not have to contribute to your traditional IRA for every tax year, even if you can.

HOW MUCH CAN YOU DEDUCT?

Generally, you can deduct the lesser of:

- The contributions to your traditional IRA for the year, or
- The general limit (or the Kay Bailey Hutchison Spousal IRA limit, if it applies).

However, if you or your spouse was covered by an employer retirement plan, you may not be able to deduct this amount. See *Limit If Covered by Employer Plan*, later.

Trustees' fees. Trustees' administrative fees that are billed separately and paid in connection with your traditional IRA are not deductible as IRA contributions. You are also not able to deduct these fees as an itemized deduction.

Brokers' commissions. Brokers' commissions are part of your IRA contribution and, as such, are deductible subject to the limits.

Full deduction. If neither you nor your spouse was covered for any part of the year by an employer retirement plan, you can take a deduction for total contributions to one or more traditional IRAs of up to the lesser of:

1. $7,000 ($8,000 if you are 50 or older in 2024), or
2. 100% of your compensation.

This limit is reduced by any contributions made to a 501(c)(18) plan on your behalf.

Kay Bailey Hutchison Spousal IRA. In the case of a married couple with unequal compensation who file a joint return, the deduction for contributions to the traditional IRA of the spouse with less compensation is limited to the lesser of:

1. $7,000 ($8,000 if 50 or older in 2024), or
2. The total compensation includible in the gross income of both spouses for the year reduced by the following three amounts.
    a) The IRA deduction for the year of the spouse with the greater compensation.
    b) Any designated nondeductible contribution for the year made on behalf of the spouse with the greater compensation.
    c) Any contributions for the year to a Roth IRA on behalf of the spouse with the greater compensation.

This limit is reduced by any contributions to a 501(c)(18) plan on behalf of the spouse with the lesser compensation.

Covered by an employer retirement plan. If you or your spouse was covered by an employer retirement plan at any time during the year for which contributions were made, your deduction may be further limited. This is discussed later under *Limit If Covered by Employer Plan*. Limits on the amount you can deduct do not affect the amount that can be contributed. See *Nondeductible Contributions*, later.

Defined contribution plan. Generally, you are covered by a defined contribution plan for a tax year if amounts are contributed or allocated to your account for the plan year that ends with or within that tax year.

A defined contribution plan is a plan that provides for a separate account for each person covered by the plan. Types of defined contribution plans include profit-sharing plans, stock bonus plans, and money purchase pension plans.

Defined benefit plan. If you are eligible to participate in your employer's defined benefit plan for the plan year that ends within your tax year, you are covered by the plan. This rule applies even if you:

- Declined to participate in the plan,
- Did not make a required contribution, or
- Did not perform the minimum service required to accrue a benefit for the year.

A defined benefit plan is any plan that is not a defined contribution plan. Defined benefit plans include pension plans and annuity plans.

No vested interest. If you accrue a benefit for a plan year, you are covered by that plan even if you have no vested interest in (legal right to) the account or the accrual.

Limit If Covered by Employer Plan

If either you or your spouse was covered by an employer retirement plan, you may be entitled to only a partial (reduced) deduction or no deduction at all, depending on your income and your filing status.

Your deduction begins to decrease (phase out) when your income rises above a certain amount and is eliminated altogether when it reaches a higher amount. These amounts vary depending on your filing status.

To determine if your deduction is subject to phaseout, you must determine your modified adjusted gross income (AGI) and your filing status. Then use *Table 17-1* or *17-2* to determine if the phaseout applies.

TABLE 17-1. EFFECT OF MODIFIED AGI[1] ON DEDUCTION IF YOU ARE COVERED BY RETIREMENT PLAN AT WORK

If you are covered by a retirement plan at work, use this table to determine if your modified AGI affects the amount of your deduction.

IF your filing status is...	AND your modified AGI is...	THEN you can take...
single or head of household	$77,000 or less	a full deduction.
	more than $77,000 but less than $87,000	a partial deduction.
	$87,000 or more	no deduction.
married filing jointly or qualifying widow(er)	$123,000 or less	a full deduction.
	more than $123,000 but less than $143,000	a partial deduction.
	$143,000 or more	no deduction.
married filing separately[2]	less than $10,000	a partial deduction.
	$10,000 or more	no deduction.

1. Modified AGI (adjusted gross income). See Modified adjusted gross income (AGI).
2. If you did not live with your spouse at any time during the year, your filing status is considered Single for this purpose (therefore, your IRA deduction is determined under the "Single" column).

TABLE 17-2. EFFECT OF MODIFIED AGI[1] ON DEDUCTION IF YOU ARE NOT COVERED BY RETIREMENT PLAN AT WORK

If you are not covered by a retirement plan at work, use this table to determine if your modified AGI affects the amount of your deduction.

IF your filing status is...	AND your modified AGI is...	THEN you can take...
single, head of household or qualifying widow(er)	any amount	a full deduction.
married filing jointly or separately with a spouse who **is not** covered by a plan at work	any amount	a full deduction.
married filing jointly with a spouse who **is** covered by a plan at work	$230,000 or less	a full deduction.
	more than $230,000 but less than $240,000	a partial deduction.
	$240,000 or more	no deduction.
married filing separately with a spouse who **is** covered by a plan at work[2]	less than $10,000	a partial deduction.
	$10,000 or more	no deduction.

1. Modified AGI (adjusted gross income). See Modified adjusted gross income (AGI).
2. You are entitled to the full deduction if you did not live with your spouse at any time during the year.

If your spouse is covered. If you are not covered by an employer retirement plan, but your spouse is, and you did not receive any social security benefits, your IRA deduction may be reduced or eliminated entirely depending on your filing status and modified AGI as shown in *Table 17-2*.

Filing status. Your filing status depends primarily on your marital status. For this purpose, you need to know if your filing status is single or head of household, married filing jointly or qualifying widow(er), or married filing separately. If you need more information on filing status, see chapter 2.

Lived apart from spouse. If you did not live with your spouse at any time during the year and you file a separate return, your filing status, for this purpose, is single.

Modified adjusted gross income (AGI). When filing Form 1040 or 1040-SR, refigure the amount on line 11 without taking into account any of the following amounts.

- IRA deduction.
- Student loan interest deduction.

- Foreign earned income exclusion.
- Foreign housing exclusion or deduction.
- Exclusion of qualified savings bond interest shown on Form 8815, *Exclusion of Interest From Series EE and I U.S. Savings Bonds Issued After 1989*.
- Exclusion of employer-paid adoption expenses shown on Form 8839, *Qualified Adoption Expenses*.

This is your modified AGI.

Both contributions for 2024 and distributions in 2024. If all three of the following occurred, any IRA distributions you received in 2024 may be partly tax free and partly taxable.

1. You received distributions in 2024 from one or more traditional IRAs.
2. You made contributions to a traditional IRA for 2024.
3. Some of those contributions may be nondeductible contributions.

If all three of the above occurred, you must figure the taxable part of the traditional IRA distribution before you can figure your modified AGI.

NONDEDUCTIBLE CONTRIBUTIONS

Although your deduction for IRA contributions may be reduced or eliminated, contributions can be made to your IRA up to the general limit or, if it applies, the Kay Bailey Hutchison Spousal IRA limit. The difference between your total permitted contributions and your IRA deduction, if any, is your nondeductible contribution.

Example

Mike is 30 years old and single. In 2024, he was covered by a retirement plan at work. His salary was $72,000. His modified AGI was $90,000. Mike made a $7,000 IRA contribution for 2024. Because he was covered by a retirement plan and his modified AGI was over $87,000, he cannot deduct his $7,000 IRA contribution. He must designate this contribution as a nondeductible contribution by reporting it on Form 8606, as explained next.

Form 8606. To designate contributions as nondeductible, you must file Form 8606.

You do not have to designate a contribution as nondeductible until you file your tax return. When you file, you can even designate otherwise deductible contributions as nondeductible.

You must file Form 8606 to report nondeductible contributions even if you do not have to file a tax return for the year.

Tax on earnings on nondeductible contributions. As long as contributions are within the contribution limits, none of the earnings or gains on those contributions (deductible or nondeductible) will be taxed until they are distributed.

Cost basis. You will have a cost basis in your IRA if there are nondeductible contributions. Your cost basis is the sum of the nondeductible contributions to your IRA minus any withdrawals or distributions of nondeductible contributions.

INHERITED IRAs

If you inherit a traditional IRA, you are called a beneficiary. A beneficiary can be any person or entity the owner chooses to receive the benefits of the IRA after he or she dies. Beneficiaries of a traditional IRA must include in their gross income any taxable distributions they receive.

Inherited from spouse. If you inherit a traditional IRA from your spouse, you generally have the following three choices. You can:

1. Treat it as your own IRA by designating yourself as the account owner.
2. Treat it as your own by rolling it over into your IRA, or to the extent it is taxable, into a:
    a) Qualified employer plan,
    b) Qualified employee annuity plan (section 403(a) plan),
    c) Tax-sheltered annuity plan (section 403(b) plan), or
    d) Deferred compensation plan of a state or local government (section 457 plan).
3. Treat yourself as the beneficiary rather than treating the IRA as your own.

Treating it as your own. You will be considered to have chosen to treat the IRA as your own if:

- Contributions (including rollover contributions) are made to the inherited IRA, or
- You do not take the required minimum distribution for a year as a beneficiary of the IRA.

You will only be considered to have chosen to treat the IRA as your own if:

- You are the sole beneficiary of the IRA, and
- You have an unlimited right to withdraw amounts from it.

However, if you receive a distribution from your deceased spouse's IRA, you can roll that distribution over into your own IRA within the 60-day time limit, as long as the distribution is not a required distribution, even if you are not the sole beneficiary of your deceased spouse's IRA.

Inherited from someone other than spouse. If you inherit a traditional IRA from anyone other than your deceased spouse, you cannot treat the inherited IRA as your own. This means that you cannot make contributions to the IRA and you cannot roll over any amounts out of the inherited IRA. However, you can make a trustee-to-trustee transfer as long as the IRA into which amounts are being moved is set up and maintained in the name of the deceased IRA owner for the benefit of you as beneficiary.

CAN YOU MOVE RETIREMENT PLAN ASSETS?

You can transfer, tax free, assets (money or property) from other retirement plans (including traditional IRAs) to a traditional IRA. You can make the following kinds of transfers.

- Transfers from one trustee to another.
- Rollovers.
- Transfers incident to a divorce.

Transfers to Roth IRAs. Under certain conditions, you can move assets from a traditional IRA or from a designated Roth account to a Roth IRA. You can also move assets from a qualified retirement plan to a Roth IRA. See *Can You Move Amounts Into a Roth IRA?* under *Roth IRAs*, later.

Trustee-to-Trustee Transfer

A transfer of funds in your traditional IRA from one trustee directly to another, either at your request or at the trustee's request, is not a rollover. This includes the situation where the current trustee issues a check to the new trustee but gives it to you to deposit. Because there is no distribution to you, the transfer is tax free. Because it is not a rollover, it is not affected by the 1-year waiting period required between rollovers, discussed later under *Rollover From One IRA Into Another*.

Rollovers

Generally, a rollover is a tax-free distribution to you of cash or other assets from one retirement plan that you contribute (roll over) to another retirement plan. The contribution to the second retirement plan is called a "rollover contribution."

Kinds of rollovers to a traditional IRA. You can roll over amounts from the following plans into a traditional IRA:

1. A traditional IRA,
2. An employer's qualified retirement plan for its employees,
3. A deferred compensation plan of a state or local government (section 457 plan), or
4. A tax-sheltered annuity plan (section 403 plan).

Time limit for making a rollover contribution. You generally must make the rollover contribution by the 60th day after the day you receive the distribution from your traditional IRA or your employer's plan.

The IRS may waive the 60-day requirement where the failure to do so would be against equity or good conscience, such as in the event of a casualty, disaster, or other event beyond your reasonable control.

Extension of rollover period. If an amount distributed to you from a traditional IRA or a qualified employer retirement plan is a frozen deposit at any time during the 60-day period allowed for a rollover, special rules extend the rollover period.

Rollover from One IRA Into Another

You can withdraw, tax free, all or part of the assets from one traditional IRA if you reinvest them within 60 days in the same or another traditional IRA. Because this is a rollover, you cannot deduct the amount that you reinvest in an IRA.

Waiting period between rollovers. Generally, if you make a tax-free rollover of any part of a distribution from a traditional IRA, you cannot, within a 1-year period, make a tax-free rollover of any later distribution from that same IRA. You also cannot make a tax-free rollover of any amount distributed, within the same 1-year period, from the IRA into which you made the tax-free rollover.

The 1-year period begins on the date you receive the IRA distribution, not on the date you roll it over into an IRA. Rules apply to the number of rollovers you can have with your traditional IRAs. See *Application of one-rollover limitation*, below.

Application of one-rollover limitation. You can make only one rollover from an IRA to another (or the same) IRA in any 1-year period, regardless of the number of IRAs you own. The limit applies by aggregating all of an individual's IRAs, including SEP and SIMPLE IRAs, as well as traditional and Roth IRAs, effectively treating them as one IRA for purposes of the limit. However, trustee-to-trustee transfers between IRAs are not limited and rollovers from traditional IRAs to Roth IRAs (conversions) are not limited.

Partial rollovers. If you withdraw assets from a traditional IRA, you can roll over part of the withdrawal tax free and keep the rest of it. The amount you keep will generally be taxable (except for the part that is a return of nondeductible contributions) and may be subject to the 10% additional tax on early distributions, discussed later under *What Acts Result in Penalties or Additional Taxes*.

Required distributions. Amounts that must be distributed during a particular year under the required distribution rules (discussed later) are not eligible for rollover treatment.

Inherited IRAs. If you inherit a traditional IRA from your spouse, you generally can roll it over, or you can choose to make the inherited IRA your own.

Rollover from Employer's Plan Into an IRA

You can roll over into a traditional IRA all or part of an eligible rollover distribution you receive from your (or your deceased spouse's):

1. Employer's qualified pension, profit-sharing or stock bonus plan,
2. Annuity plan,
3. Tax-sheltered annuity plan (section 403(b) plan), or

4. Governmental deferred compensation plan (section 457 plan).

Eligible rollover distribution. Generally, an eligible rollover distribution is any distribution of all or part of the balance to your credit in a qualified retirement plan ***except***:

1. A required minimum distribution.
2. Hardship distributions.
3. Any of a series of substantially equal periodic distributions paid at least once a year over:
    a) Your lifetime or life expectancy,
    b) The lifetimes or life expectancies of you and your beneficiary, or
    c) A period of 10 years or more.
4. Corrective distributions of excess contributions or excess deferrals, and any income allocable to the excess, or of excess annual additions and any allocable gains.
5. A loan treated as a distribution because it does not satisfy certain requirements either when made or later (such as upon default), unless the participant's accrued benefits are reduced (offset) to repay the loan.
6. Dividends on employer securities.
7. The cost of life insurance coverage.

Transfers Incident to Divorce

If an interest in a traditional IRA is transferred from your spouse or former spouse to you by a divorce or separate maintenance decree or a written document related to such a decree, the interest in the IRA, starting from the date of the transfer, is treated as your IRA. The transfer is tax free.

Converting from Any Traditional IRA to a Roth IRA

Allowable conversions. You can withdraw all or part of the assets from a traditional IRA and reinvest them (within 60 days) in a Roth IRA. The amount that you withdraw and timely contribute (convert) to the Roth IRA is called a conversion contribution. If properly (and timely) rolled over, the 10% additional tax on early distributions will not apply.

Required distributions. You cannot convert amounts that must be distributed from your traditional IRA for a particular year (including the calendar year in which you reach age 73) under the required distribution rules (discussed later).

Income. You must include in your gross income distributions from a traditional IRA that you would have to include in income if you had not converted them into a Roth IRA. These amounts are included in income on your return for the year that you converted them from a traditional IRA to a Roth IRA. You do not include in gross income any part of a distribution from a traditional IRA that is a return of your basis, as discussed later.

If you must include any amount in your gross income, you may have to increase your withholding or make estimated tax payments.

Recharacterizations

You may be able to treat a contribution made to one type of IRA as having been made to a different type of IRA. This is called recharacterizing the contribution.

How to recharacterize a contribution. To recharacterize a contribution, you generally must have the contribution transferred from the first IRA (the one to which it was made) to the second IRA in a trustee-to-trustee transfer. If the transfer is made by the due date (including extensions) for your tax return for the year during which the contribution was made, you can elect to treat the contribution as having been originally made to the second IRA instead of to the first IRA. If you recharacterize your contribution, you must do all three of the following.

- Include in the transfer any net income allocable to the contribution. If there was a loss, the net income you must transfer may be a negative amount.
- Report the recharacterization on your tax return for the year during which the contribution was made.
- Treat the contribution as having been made to the second IRA on the date that it was actually made to the first IRA.

No recharacterizations of conversions made in 2018 or later. A conversion of a traditional IRA to a Roth IRA, and a rollover from any other eligible retirement plan to a Roth IRA, made in tax years beginning after December 31, 2017, cannot be recharacterized as having been made to a traditional IRA.

No deduction allowed. You cannot deduct the contribution to the first IRA. Any net income you transfer with the recharacterized contribution is treated as earned in the second IRA.

How do you recharacterize a contribution? To recharacterize a contribution, you must notify both the trustee of the first IRA (the one to which the contribution was actually made) and the trustee of the second IRA (the one to which the contribution is being moved) that you have elected to treat the contribution as having been made to the second IRA rather than the first. You must make the notifications by the date of the transfer. Only one notification is required if both IRAs are maintained by the same trustee. The notification(s) must include all of the following information.

- The type and amount of the contribution to the first IRA that is to be recharacterized.
- The date on which the contribution was made to the first IRA and the year for which it was made.

- A direction to the trustee of the first IRA to transfer in a trustee-to-trustee transfer the amount of the contribution and any net income (or loss) allocable to the contribution to the trustee of the second IRA.
- The name of the trustee of the first IRA and the name of the trustee of the second IRA.
- Any additional information needed to make the transfer.

Reporting a recharacterization. If you elect to recharacterize a contribution to one IRA as a contribution to another IRA, you must report the recharacterization on your tax return as directed by Form 8606 and its instructions. You must treat the contribution as having been made to the second IRA.

WHEN CAN YOU WITHDRAW OR USE IRA ASSETS?

There are rules limiting use of your IRA assets and distributions from it. Violation of the rules generally results in additional taxes in the year of violation. See *What Acts Result in Penalties or Additional Taxes.*

Early distributions tax. The 10% additional tax on distributions made before you reach age 59½ does not apply to contributions returned before the due date of the return. However, the distribution of interest or other income must be reported on Form 5329 and, unless the distribution qualifies as an exception to the age 59½ rule, it will be subject to this tax.

WHEN MUST YOU WITHDRAW IRA ASSETS? (REQUIRED MINIMUM DISTRIBUTIONS)

You cannot keep funds in your traditional IRA indefinitely. Eventually they must be distributed. If there are no distributions, or if the distributions are not large enough, you may have to pay a 25% (previously 50%) excise tax on the amount not distributed as required. See *Excess Accumulations (Insufficient Distributions)*, later. The requirements for distributing IRA funds differ depending on whether you are the IRA owner or the beneficiary of a decedent's IRA.

Distributions not eligible for rollover. Amounts that must be distributed (required distributions) during a particular year are not eligible for rollover treatment.

IRA owners. If you are the owner of a traditional IRA, you must start receiving distributions from your IRA by April 1 of the year following the year in which you reach age 72 (73 if you did not reach age 72 before January 1, 2023). April 1 of the year following the year in which you reach age 72 (73 if applicable) is referred to as the required beginning date.

Distributions by the required beginning date. You must receive at least a minimum amount for each year starting with the year you reach age 72 (73 if you did not reach age 72 before January 1, 2023). If you do not (or did not) receive that minimum amount in the year you became 72 (73 if applicable), then you must receive distributions for the year you become 72 (73 if applicable) by April 1 of the next year. If an IRA owner dies after reaching age 72 (73 if applicable), but before April 1 of the next year, no minimum distribution is required because death occurred before the required beginning date.

Caution!

Even if you begin receiving distributions before you attain age 72 (73 if applicable), you must begin calculating and receiving required minimum distributions by your required beginning date.

Distributions after the required beginning date. The required minimum distribution for any year after the year you turn 72 (73 if applicable) must be made by December 31 of that later year.

Beneficiaries. If you are the beneficiary of a decedent's traditional IRA, the requirements for distributions from that IRA generally depend on whether the IRA owner died before or after the required beginning date for distributions.

ARE DISTRIBUTIONS TAXABLE?

In general, distributions from a traditional IRA are taxable in the year you receive them.

Exceptions

Exceptions to distributions from traditional IRAs being taxable in the year you receive them are:

- Rollovers,
- Qualified charitable distributions, discussed later,
- Tax-free withdrawals of contributions, discussed earlier, and
- The return of nondeductible contributions, discussed later under *Distributions Fully or Partly Taxable.*

Qualified charitable distributions. A qualified charitable distribution (QCD) is generally a nontaxable distribution made directly by the trustee of your IRA to an organization eligible to receive tax-deductible contributions.

Ordinary income. Distributions from traditional IRAs that you include in income are taxed as ordinary income.

No special treatment. In figuring your tax, you cannot use the 10-year tax option or capital gain treatment that applies to lump-sum distributions from qualified retirement plans.

Distributions Fully or Partly Taxable

Distributions from your traditional IRA may be fully or partly taxable, depending on whether your IRA includes any nondeductible contributions.

Fully taxable. If only deductible contributions were made to your traditional IRA (or IRAs, if you have more than one), you have no basis in your IRA. Because you have no basis in your IRA, any distributions are fully taxable when received.

Partly taxable. If you made nondeductible contributions or rolled over any after-tax amounts to any of your traditional IRAs, you have a cost basis (investment in the contract) equal to the amount of those contributions. These nondeductible contributions are not taxed when they are distributed to you. They are a return of your investment in your IRA.

Only the part of the distribution that represents nondeductible contributions and rolled over after-tax amounts (your cost basis) is tax free. If nondeductible contributions have been made or after-tax amounts have been rolled over to your IRA, distributions consist partly of nondeductible contributions (basis) and partly of deductible contributions, earnings, and gains (if there are any). Until all of your basis has been distributed, each distribution is partly nontaxable and partly taxable.

IRA distributions delivered outside the United States. In general, if you are a U.S. citizen or resident alien and your home address is outside the United States or its possessions, you cannot choose exemption from withholding on distributions from your traditional IRA.

WHAT ACTS RESULT IN PENALTIES OR ADDITIONAL TAXES?

The tax advantages of using traditional IRAs for retirement savings can be offset by additional taxes and penalties if you do not follow the rules. There are additions to the regular tax for using your IRA funds in prohibited transactions. There are also additional taxes for the following activities.

- Investing in collectibles.
- Having unrelated business income.
- Making excess contributions.
- Taking early distributions.
- Allowing excess amounts to accumulate (failing to take required distributions).

There are penalties for overstating the amount of nondeductible contributions and for failure to file a Form 8606, if required.

Prohibited Transactions

Generally, a prohibited transaction is any improper use of your traditional IRA by you, your beneficiary, or any disqualified person.

Disqualified persons include your fiduciary and members of your family (spouse, ancestor, lineal descendant, and any spouse of a lineal descendant).

The following are examples of prohibited transactions with a traditional IRA.

- Borrowing money from it.

- Selling property to it.
- Using it as security for a loan.
- Buying property for personal use (present or future) with IRA funds.

Effect on an IRA account. Generally, if you or your beneficiary engages in a prohibited transaction in connection with your traditional IRA account at any time during the year, the account stops being an IRA as of the first day of that year.

Taxes on prohibited transactions. If someone other than the owner or beneficiary of a traditional IRA engages in a prohibited transaction, that person may be liable for certain taxes. In general, there is a 15% tax on the amount of the prohibited transaction and a 100% additional tax if the transaction is not corrected.

Investment in Collectibles

If your traditional IRA invests in collectibles, the amount invested is considered distributed to you in the year invested. You may have to pay the 10% additional tax on early distributions, discussed later.

Collectibles. These include:

- Artworks,
- Rugs,
- Antiques,
- Metals,
- Gems,
- Stamps,
- Coins,
- Alcoholic beverages, and
- Certain other tangible personal property.

Exception

Your IRA can invest in one, one-half, one-quarter, or one-tenth ounce U.S. gold coins, or one-ounce silver coins minted by the Treasury Department. It can also invest in certain platinum coins and certain gold, silver, palladium, and platinum bullion.

Early Distributions

You must include early distributions of taxable amounts from your traditional IRA in your gross income. Early distributions are also subject to an additional 10% tax.

Early distributions defined. Early distributions are amounts distributed from your traditional IRA account or annuity before you are age 59½.

Age 59½ rule. Generally, if you are under age 59½, you must pay a 10% additional tax on the distribution of any assets (money or other property) from your traditional IRA. Distributions before you are age 59½ are called early distributions.

The 10% additional tax applies to the part of the distribution that you have to include in gross income. It is in addition to any regular income tax on that amount.

Exceptions

There are several exceptions to the age 59½ rule. Even if you receive a distribution before you are age 59½, you may not have to pay the 10% additional tax if you are in one of the following situations.

- You have unreimbursed medical expenses that are more than 7.5% of your adjusted gross income.
- The distributions are not more than the cost of your medical insurance due to a period of unemployment.
- You are totally and permanently disabled.
- You have been certified as having a terminal illness.
- You are the beneficiary of a deceased IRA owner.
- You are receiving distributions in the form of a series of substantially equal periodic payments.
- The distributions are for your qualified higher education expenses.
- You use the distributions to buy, build, or rebuild a first home.

Exceptions (continued)

- The distribution is due to an IRS levy of the qualified plan.
- The distribution is a qualified reservist distribution.
- The distribution is a qualified birth or adoption distribution.
- The distribution is a qualified disaster distribution or qualified disaster recovery distribution.
- The distribution is a corrective distribution.

Additional 10% tax. The additional tax on early distributions is 10% of the amount of the early distribution that you must include in your gross income. This tax is in addition to any regular income tax resulting from including the distribution in income.

Nondeductible contributions. The tax on early distributions does not apply to the part of a distribution that represents a return of your nondeductible contributions (basis).

Excess Accumulations (Insufficient Distributions)

You cannot keep amounts in your traditional IRA indefinitely. Generally, you must begin receiving distributions by April 1 of the year following the year in which you reach age 72 (73 if you did not reach age 72 before January 1, 2023). The required minimum distribution for any year after you reach age 72 (73 if applicable) must be made by December 31 of that later year.

Tax on excess. If distributions are less than the required minimum distribution for the year, you may have to pay a 25% excise tax (and possibly 10% if the RMD is timely corrected within 2 years) for that year on the amount not distributed as required.

Note

The penalty for insufficient distributions was reduced in 2023 from 50% by the passage of the SECURE Act 2.0.

V. ROTH IRAs

Regardless of your age, you may be able to establish and make nondeductible contributions to a retirement plan called a Roth IRA.

Contributions not reported. You do not report Roth IRA contributions on your return.

WHAT IS A ROTH IRA?

A Roth IRA is an individual retirement plan that, except as explained in this chapter, is subject to the rules that apply to a traditional IRA. It can be either an account or an annuity.

To be a Roth IRA, the account or annuity must be designated as a Roth IRA when it is opened. A deemed IRA can be a Roth IRA, Roth SEP IRA, or a Roth SIMPLE IRA.

Unlike a traditional IRA, you cannot deduct contributions to a Roth IRA. But, if you satisfy the requirements, qualified distributions (discussed later) are tax free. Contributions can be made to your Roth IRA at any age. You can leave amounts in your Roth IRA as long as you live.

WHEN CAN A ROTH IRA BE OPENED?

You can open a Roth IRA at any time. However, the time for making contributions for any year is limited. See *When Can You Make Contributions*, later under *Can You Contribute to a Roth IRA*.

CAN YOU CONTRIBUTE TO A ROTH IRA?

Generally, you can contribute to a Roth IRA if you have taxable compensation (defined later) and your modified AGI (defined later) is less than:

- $240,000 for married filing jointly, or qualifying surviving spouse,
- $161,000 for single, head of household, or married filing separately and you did not live with your spouse at any time during the year, and
- $10,000 for married filing separately and you lived with your spouse at any time during the year.

Is there an age limit for contributions? Contributions can be made to your Roth IRA regardless of your age.

Can you contribute to a Roth IRA for your spouse? You can contribute to a Roth IRA for your spouse provided the contributions satisfy the Kay Bailey Hutchison Spousal IRA limit (discussed in *How Much Can Be Contributed?* under *Traditional IRAs*), you file jointly, and your modified AGI is less than $240,000.

Compensation. Compensation includes wages, salaries, tips, professional fees, bonuses, and other amounts received for providing personal services. It also includes commissions, self-employment income, nontaxable combat pay, military differential pay, taxable alimony and separate maintenance payments, and taxable non-tuition fellowship and stipend payments.

Modified AGI. Your modified AGI for Roth IRA purposes is your adjusted gross income (AGI) as shown on your return with some adjustments.

How Much Can Be Contributed?

The contribution limit for Roth IRAs generally depends on whether contributions are made only to Roth IRAs or to both traditional IRAs and Roth IRAs.

Roth IRAs only. If contributions are made only to Roth IRAs, your contribution limit generally is the lesser of:

- $7,000 ($8,000 if you are 50 or older in 2024), or
- Your taxable compensation.

However, if your modified AGI is above a certain amount, your contribution limit may be reduced, as explained later under *Contribution limit reduced*.

Roth IRAs and traditional IRAs. If contributions are made to both Roth IRAs and traditional IRAs established for your benefit, your contribution limit for Roth IRAs generally is the same as your limit would be if contributions were made only to Roth IRAs, but then reduced by all contributions for the year to all IRAs other than Roth IRAs. Employer contributions under a SEP or SIMPLE IRA plan do not affect this limit.

This means that your contribution limit is generally the lesser of:

- $7,000 ($8,000 if you are 50 or older in 2024) minus all contributions (other than employer contributions under a SEP or SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs, or
- Your taxable compensation minus all contributions (other than employer contributions under a SEP or SIMPLE IRA plan) for the year to all IRAs other than Roth IRAs.

However, if your modified AGI is above a certain amount, your contribution limit may be reduced, as explained next under *Contribution limit reduced*.

Contribution limit reduced. If your modified AGI is above a certain amount, your contribution limit is gradually reduced. Use Table 17-3 to determine if this reduction applies to you.

TABLE 17-3. EFFECT OF MODIFIED AGI ON ROTH IRA CONTRIBUTION

This table shows whether your contribution to a Roth IRA is affected by the amount of your modified adjusted gross income (modified AGI).

IF you have taxable compensation and your filing status is…	AND your modified AGI is…	THEN…
married filing jointly, or qualifying widow(er)	less than $230,000	you can contribute up to $7,000 ($8,000 if you are 50 or older in 2024).
	at least $230,000 but less than $240,000	the amount you can contribute is reduced as explained under *Contribution limit reduced* in Publication 590-A.
	$240,000 or more	you cannot contribute to a Roth IRA.

IF you have taxable compensation and your filing status is...	AND your modified AGI is...	THEN...
married filing separately and you lived with your spouse at any time during the year	zero (-0-)	you can contribute up to $7,000 ($8,000 if you are 50 or older in 2024).
	more than zero (-0-) but less than $10,000	the amount you can contribute is reduced as explained under *Contribution limit reduced* in Publication 590-A.
	$10,000 or more	you cannot contribute to a Roth IRA.
single, head of household, or married filing separately and you did not live with your spouse at any time during the year	less than $146,000	you can contribute up to $7,000 ($8,000 if you are 50 or older in 2024.
	at least $146,000 but less than $161,000	the amount you can contribute is reduced as explained under *Contribution limit reduced* in Publication 590-A
	$161,000 or more	you cannot contribute to a Roth IRA.

When Can You Make Contributions?

You can make contributions to a Roth IRA for a year at any time during the year or by the due date of your return for that year (not including extensions).

What If You Contribute Too Much?

A 6% excise tax applies to any excess contribution to a Roth IRA.

Excess contributions. These are the contributions to your Roth IRAs for a year that equal the ***total*** of:

1. Amounts contributed for the tax year to your Roth IRAs (other than amounts properly and timely rolled over from a Roth IRA or properly converted from a traditional IRA or rolled over from a qualified retirement plan, as described later) that are more than your contribution limit for the year, plus

2. Any excess contributions for the preceding year, reduced by the total of:

   a) Any distributions out of your Roth IRAs for the year, plus

   b) Your contribution limit for the year minus your contributions to all your IRAs for the year.

CAN YOU MOVE AMOUNTS INTO A ROTH IRA?

Conversions

You may be able to convert amounts from either a traditional, SEP, or SIMPLE IRA into a Roth IRA. You may be able to roll amounts over from a qualified retirement plan to a Roth IRA. You may be able to recharacterize contributions made to one IRA as having been made directly to a different IRA. You can roll amounts over from a designated Roth account or from one Roth IRA to another Roth IRA.

Conversion methods. You can convert amounts from a traditional IRA to a Roth IRA in ***any*** of the following three ways.

1. ***Rollover.*** You can receive a distribution from a traditional IRA and roll it over (contribute it) to a Roth IRA within 60 days after the distribution.

2. ***Trustee-to-trustee transfer.*** You can direct the trustee of the traditional IRA to transfer an amount from the traditional IRA to the trustee of the Roth IRA.

3. ***Same trustee transfer.*** If the trustee of the traditional IRA also maintains the Roth IRA, you can direct the trustee to transfer an amount from the traditional IRA to the Roth IRA.

Same trustee. Conversions made with the same trustee can be made by redesignating the traditional IRA as a Roth IRA, rather than opening a new account or issuing a new contract.

Rollover from employer's plan into a Roth IRA. You can roll over into a Roth IRA all or part of an eligible rollover distribution you receive from your (or your deceased spouse's):

- Employer's qualified pension, profit-sharing or stock bonus plan,
- Annuity plan,
- Tax-sheltered annuity plan (section 403(b) plan), or
- Governmental deferred compensation plan (section 457 plan).

Any amount rolled over is subject to the same rules for converting a traditional IRA into a Roth IRA. Also, the rollover contribution must meet the rollover requirements that apply to the specific type of retirement plan.

Income. You must include in your gross income distributions from a qualified retirement plan that you would have had to include in income if you had not rolled them over into a Roth IRA. You do not include in gross income any part of a distribution from a qualified retirement plan that is a return of contributions (after-tax contributions) to the plan that were taxable to you when paid. These amounts are normally included in income on your return for the year you rolled them over from the employer plan to a Roth IRA.

Caution!

If you must include any amount in your gross income, you may have to increase your withholding or make estimated tax payments.

Converting from a SIMPLE IRA. Generally, you can convert an amount in your SIMPLE IRA to a Roth IRA under the same rules explained earlier under *Converting from any traditional IRA to a Roth IRA*.

However, you cannot convert any amount distributed from the SIMPLE IRA during the 2-year period beginning on the date you first participated in any SIMPLE IRA plan maintained by your employer.

Rollover from a Roth IRA

You can withdraw, tax free, all or part of the assets from one Roth IRA if you contribute them within 60 days to another Roth IRA. Most of the rules for rollovers explained under *Rollover From One IRA Into Another* under *Traditional IRAs*, earlier, apply to these rollovers.

Rollover from designated Roth account. A rollover from a designated Roth account can only be made to another designated Roth account or to a Roth IRA.

ARE DISTRIBUTIONS TAXABLE?

You do not include in your gross income qualified distributions or distributions that are a return of your regular contributions from your Roth IRA(s). You also do not include distributions from your Roth IRA that you roll over tax free into another Roth IRA. You may have to include part of other distributions in your income. See *Ordering rules for distributions*, later.

What are qualified distributions? A qualified distribution is any payment or distribution from your Roth IRA that meets the following requirements.

1. It is made after the 5-year period beginning with the first taxable year for which a contribution was made to a Roth IRA set up for your benefit, and
2. The payment or distribution is:
    a) Made on or after the date you reach age 59½,
    b) Made because you are disabled,
    c) Made to a beneficiary or to your estate after your death, or
    d) To pay up to $10,000 (lifetime limit) of certain qualified first-time homebuyer amounts.

Additional tax on distributions of conversion and certain rollover contributions within 5-year period. If, within the 5-year period starting with the first day of your tax year in which you convert an amount from a traditional IRA or rollover an amount from a qualified retirement plan to a Roth IRA, you take a distribution from a Roth IRA, you may have to pay the 10% additional tax on early distributions. You generally must pay the 10% additional tax on any amount attributable to the part of the amount converted or rolled over (the conversion or rollover contribution) that you had to include in income. A separate 5-year period applies to each conversion and rollover. See *Ordering rules for distributions,* later, to determine the amount, if any, of the distribution that is attributable to the part of the conversion or rollover contribution that you had to include in income.

Additional tax on other early distributions. Unless an exception applies, you must pay the 10% additional tax on the taxable part of any distributions that are not qualified distributions.

Ordering rules for distributions. If you receive a distribution from your Roth IRA that is not a qualified distribution, part of it may be taxable. There is a set order in which contributions (including conversion contributions) and earnings are considered to be distributed from your Roth IRA. Regular contributions are distributed first.

Must you withdraw or use Roth IRA assets? You are not required to take distributions from your 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. However, after the death of a Roth IRA owner, certain of the minimum distribution rules that apply to traditional IRAs also apply to Roth IRAs.

CHAPTER 17: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1.	**An advantage of a traditional IRA is that generally the amounts in the account, including all earnings and gains, are which of the following:** **A.** always made up of fully deductible pre-tax contributions **B.** never required to be withdrawn by the owner **C.** excluded from all taxes by the person inheriting the account from a parent **D.** not taxed until the funds are distributed
2.	**Which of the following statements is <u>not</u> correct regarding when or how contributions to your traditional IRA can be made for 2024:** **A.** between January 1st and April 15th an account holder can designate the tax year for the contribution **B.** filing a tax return extension request will also extend the deadline for an IRA contribution for the same tax year **C.** IRA contributions can be made at any age **D.** IRA contributions can be skipped for some years and made during others
3.	**To designate nondeductible contributions made to a traditional IRA, you would need to complete and file which form:** **A.** Form 1099-R **B.** Form 8606 **C.** Form W-2 **D.** Form W-4

4.	**If you inherit a traditional IRA from your spouse, which of the following is <u>not</u> a valid option for handling the account receipt:** **A.** treat it as your own by designating yourself as the account owner **B.** treat required distributions received as additional contributions to your own IRA **C.** treat it as your own by rolling it over into your traditional IRA **D.** treat yourself as the beneficiary rather than treating the IRA as your own
5.	**In a typical situation, what is the required waiting period before tax-free IRA rollover funds can be moved tax-free again:** **A.** six months, starting from the date you receive the IRA distribution **B.** one year, starting from the date you receive the IRA distribution **C.** eighteen months, starting from the date you receive the IRA distribution **D.** two years, starting from the date you receive the IRA distribution
6.	**You cannot deduct contributions to a Roth IRA <u>except</u> under which of the following situations:** **A.** after age 72 (73 if applicable) **B.** after age 59 and before 72 (73 if applicable) **C.** if you satisfy other requirements **D.** never; Roth contributions are not deductible
7.	**What is the final date contributions can be made to a Roth IRA:** **A.** December 31 of the tax year **B.** the due date of the return for that year (not including extensions) **C.** the due date of the return for that year including extensions **D.** December 31 of the year following the tax year

CHAPTER 17: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. Depending upon the taxpayer's financial circumstances, not all contributions to traditional IRA accounts will be deductible against taxable income. **B.** Incorrect. Required distributions from traditional IRA accounts must begin upon the owner reaching the age of 72 (73 if the individual had not reached age 72 before January 1, 2023). **C.** Incorrect. Special rules apply to inherited IRAs, however, ultimately the new owner will pay tax on IRA assets once distributions begin. **D.** **CORRECT**. A major advantage of a traditional IRA is that contributions and earnings are not taxed until the funds are distributed. *(See pages 197 to 198 of the course material.)*
2.	**A.** Incorrect. An IRA account holder can designate the tax year for his or her contribution when it is made between January 1st and April 15th by telling the sponsor. If the tax year is not specified, the sponsor will assume that the reportable tax year equals the date of the receipt of the funds. **B.** **CORRECT**. Contributions can be made to your traditional IRA for a year at any time during the year or by the due date for filing your return for that year, but not including extensions. **C.** Incorrect. Contributions can be made to a traditional IRA for the year, regardless of the individual's age. **D.** Incorrect. Contributions are not required to be made each tax year to your existing traditional IRA account, even if you otherwise qualify that year. *(See pages 198 to 199 of the course material.)*
3.	**A.** Incorrect. The 1099-R document is issued by the payer of the IRA. **B.** **CORRECT**. Form 8606 must be completed and attached to your return if you made nondeductible contributions. Filing this form is required even if no tax return is due during that tax year. **C.** Incorrect. Form W-2 has no relationship to IRA contributions. **D.** Incorrect. Form W-4 has no relationship to IRA contributions. *(See page 203 of the course material.)*

4.	**A.** Incorrect. Designating yourself as the account owner is one of three valid choices for handling an inherited IRA from your spouse. **B.** CORRECT. Utilizing required distributions to fund contributions to another IRA is not generally one of the three valid choices for handling an inherited IRA from a spouse. **C.** Incorrect. Rolling the IRA over into your own traditional IRA is one of three valid choices for handling an inherited IRA from a spouse. **D.** Incorrect. Treating yourself as the beneficiary rather than as owner of the inherited IRA is a valid option and complies with special rules applicable to spouse-inherited IRAs. *(See page 204 of the course material.)*
5.	**A.** Incorrect. Typically, you must wait longer than six months before tax-free IRA rollover funds can be moved tax-free again. **B.** CORRECT. Typically, the waiting period before tax-free IRA rollover funds can be moved tax-free again is one year from the date you receive the IRA distribution. You also cannot make a tax-free rollover of any amount distributed, within the same 1-year period, from the IRA into which you made the tax-free rollover. The 1-year period begins on the date you receive the IRA distribution, not on the date you roll it over into an IRA. **C.** Incorrect. The waiting period before tax-free IRA rollover funds can be moved tax-free again is less than eighteen months from the date you receive the IRA distribution. **D.** Incorrect. The waiting period before tax-free IRA rollover funds can be moved tax-free again is less than two years from the date you receive the IRA distribution. *(See page 206 of the course material.)*
6.	**A.** Incorrect. Contributions to Roth IRAs are never deductible, regardless of the account owner's age. **B.** Incorrect. Contributions to Roth IRAs are never deductible, regardless of age. **C.** Incorrect. There are no other requirements to satisfy which can make contributions to Roth IRAs deductible. **D.** CORRECT. Contributions to Roth IRAs are not deductible, but if you satisfy the requirements, qualified distributions are tax free. *(See page 215 of the course material.)*

7.	**A.** Incorrect. Contributions can be made later than this date. **B.** CORRECT. Excess contributions, if any, will be subject to an excise tax. **C.** Incorrect. The due date for contributions does not allow for extensions of the return filing. **D.** Incorrect. The due date is much earlier than the end of the following year. *(See page 217 of the course material.)*

CHAPTER 18: ALIMONY

Chapter Objective

After completing this chapter, you should be able to:

- Recognize what is and is not alimony.

I. REMINDER

Nondeductibility of alimony. Generally, for divorce or separation agreements executed after December 31, 2018, you may no longer deduct an amount equal to the alimony or separate maintenance payments paid during the tax year, nor will the alimony or separate maintenance payments be included in the gross income of the recipient spouse.

II. INTRODUCTION

This chapter discusses the rules that apply if you pay or receive alimony. It covers the following topics:

- What payments are alimony,
- What payments are not alimony, such as child support, and
- Whether you must recapture the tax benefits of alimony. Recapture means adding back in your income all or part of a deduction you took in a prior year.

Alimony is a payment to or for a spouse or former spouse under a divorce or separation instrument. It does not include voluntary payments that are not made under a divorce or separation instrument.

For divorce or separation agreements executed before January 1, 2019, alimony is deductible by the payer and must be included in the spouse's or former spouse's income. Although this chapter is generally written for the payer of the alimony, the recipient can use the information to determine whether an amount received is alimony.

To be alimony, a payment must meet certain requirements. Different requirements apply to payments under instruments executed after 1984 and to payments under instruments executed before 1985. This chapter discusses the rules for payments under instruments executed after 1984.

Use *Table 18-1* in this chapter as a guide to determine whether certain payments are considered alimony.

TABLE 18-1. ALIMONY REQUIREMENTS (INSTRUMENTS EXECUTED AFTER 1984 AND BEFORE 2019)

Payments ARE alimony if all of the following are true:	Payments are NOT alimony if any of the following are true:
Payments are required by a divorce or separation instrument.	Payments are not required by a divorce or separation instrument.
Payer and recipient spouse do not file a joint return with each other.	Payer and recipient spouse file a joint return with each other.
Payment is in cash (including checks or money orders).	Payment is: • Not in cash, • A noncash property settlement, • Spouse's part of community income, or • To keep up the payer's property.
Payment is not designated in the instrument as not alimony.	Payment is designated in the instrument as not alimony.
Spouses legally separated under a decree of divorce or separate maintenance are not members of the same household.	Spouses legally separated under a decree of divorce or separate maintenance are members of the same household.
Payments are not required after death of the recipient spouse.	Payments are required after death of the recipient spouse.
Payment is not treated as child support.	Payment is treated as child support.
These payments are deductible by the payer and includible in income by the recipient.	*These payments are neither deductible by the payer nor includible in income by the recipient.*

Definitions. The following definitions apply throughout this chapter.

Spouse or former spouse. Unless stated otherwise in the following discussions about alimony, the term "spouse" includes former spouse.

Divorce or separation instrument. The term "divorce or separation instrument" means:

1. A decree of divorce or separate maintenance or a written instrument incident to that decree,
2. A written separation agreement, or
3. A decree or any type of court order requiring a spouse to make payments for the support or maintenance of the other spouse. This includes a temporary decree, an interlocutory (not final) decree, and a decree of alimony pendente lite (while awaiting action on the final decree or agreement).

III. GENERAL RULES

For divorce or separation agreements executed after December 31, 2018, you may no longer deduct an amount equal to the alimony or separate maintenance payments paid during the tax year, nor will the alimony or separate maintenance payments be included in the gross income of the recipient spouse. For divorce or separation agreements executed before January 1, 2019, the following rules apply to alimony.

Payments not alimony. Not all payments under a divorce or separation instrument are alimony. Alimony does not include any of the following.

1. Child support.
2. Noncash property settlements.
3. Payments that are your spouse's part of community income.
4. Payments to keep up the payer's property.
5. Use of the payer's property.

Payments to a third party. Cash payments, checks, or money orders to a third party on behalf of your spouse under the terms of your divorce or separation instrument can be alimony if they otherwise qualify. These include payments for your spouse's medical expenses, housing costs (rent, utilities, etc.), taxes, tuition, etc. The payments are treated as received by your spouse and then paid to the third party.

Life insurance premiums. Alimony includes premiums you must pay under your divorce or separation instrument for insurance on your life to the extent your spouse owns the policy.

Payments for jointly-owned home. If your divorce or separation instrument states that you must pay expenses for a home owned by you and your spouse or former spouse, some of your payments may be alimony.

Mortgage payments. If you must pay all the mortgage payments (principal and interest) on a jointly-owned home, and they otherwise qualify, you can deduct one-half of the total payments as alimony. If you itemize deductions and the home is a qualified home, you can claim half of the interest in figuring your deductible interest. Your spouse must report one-half of the payments as alimony received. If your spouse itemizes deductions and the home is a qualified home, he or she can claim one-half of the interest on the mortgage in figuring deductible interest.

Taxes and insurance. If you must pay all the real estate taxes or insurance on a home held as ***tenants in common***, you can deduct one-half of these payments as alimony. Your spouse must report one-half of these payments as alimony received. If you and your spouse itemize deductions, you can each claim one-half of the real estate taxes and none of the home insurance.

If your home is held as tenants by the entirety or joint tenants, none of your payments for taxes or insurance are alimony. But if you itemize deductions, you can claim all of the real estate taxes and none of the home insurance.

IV. INSTRUMENTS EXECUTED AFTER 1984 AND BEFORE 2019

The following rules for alimony apply to payments under divorce or separation instruments executed after 1984, and before 2019.

Alimony requirements. A payment to or for a spouse under a divorce or separation instrument is alimony if the spouses do not file a joint return with each other and all the following requirements are met.

1. The payment is in cash.
2. The instrument does not designate the payment as not alimony.
3. The spouses are not members of the same household at the time the payments are made. This requirement applies only if the spouses are legally separated under a decree of divorce or separate maintenance.
4. There is no liability to make any payment (in cash or property) after the death of the recipient spouse.
5. The payment is not treated as child support.

Cash payment requirement. Only cash payments, including checks and money orders, qualify as alimony. The following do not qualify as alimony.

- Transfers of services or property (including a debt instrument of a third party or an annuity contract).
- Execution of a debt instrument by the payer.
- The use of the payer's property.

Payments to a third party. Cash payments to a third party under the terms of your divorce or separation instrument can qualify as a cash payment to your spouse. See *Payments to a third party* under *General Rules*, earlier.

Also, cash payments made to a third party at the written request of your spouse qualify as alimony if all the following requirements are met.

1. The payments are in lieu of payments of alimony directly to your spouse.
2. The written request states that both spouses intend the payments to be treated as alimony.
3. You receive the written request from your spouse before you file your return for the year you made the payments.

Child support. A payment that is specifically designated as child support or treated as specifically designated as child support under your divorce or separation instrument is not alimony. The amount of child support may vary from time to time. Child support payments are not deductible by the payer and are not taxable to the recipient.

Specifically designated as child support. A payment will be treated as specifically designated as child support to the extent that the payment is reduced either:

1. On the happening of a contingency relating to your child, or
2. At a time that can be clearly associated with the contingency.

A payment may be treated as specifically designated as child support even if other separate payments are specifically designated as child support.

V. RECAPTURE RULE

If your alimony payments decrease or end during the first 3 calendar years, you may be subject to the recapture rule. If you are subject to this rule, you have to include in income in the third year part of the alimony payments you previously deducted. Your spouse can deduct in the third year part of the alimony payments he or she previously included in income.

The 3-year period starts with the first calendar year you make a payment qualifying as alimony under a decree of divorce or separate maintenance or a written separation agreement. Do not include any time in which payments were being made under temporary support orders. The second and third years are the next 2 calendar years, whether or not payments are made during those years.

The reasons for a reduction or termination of alimony payments that can require a recapture include:

- A change in your divorce or separation instrument,
- A failure to make timely payments,
- A reduction in your ability to provide support, or
- A reduction in your spouse’s support needs.

When to apply the recapture rule. You are subject to the recapture rule in the third year if the alimony you pay in the third year decreases by more than $15,000 from the second year or the alimony you pay in the second and third years decreases significantly from the alimony you pay in the first year.

When you figure a decrease in alimony, do not include the following amounts.

1. Payments made under a temporary support order.
2. Payments required over a period of at least 3 calendar years of a fixed part of your income from a business or property, or from compensation for employment or self-employment.
3. Payments that decrease because of the death of either spouse or the remarriage of the spouse receiving the payments before the end of the third year.

Including the recapture in income. If you must include a recapture amount in income, show it on Schedule 1 (Form 1040), line 2a ("Alimony received"). Cross out "received" and enter "recapture." On the dotted line next to the amount, enter your spouse's last name and SSN or ITIN.

Deducting the recapture. If you can deduct a recaptured amount, show it on Schedule 1 (Form 1040), line 19a ("Alimony paid"). Cross out "paid" and enter "recapture." In the space provided, enter your spouse's SSN or ITIN.

CERTAIN RULES FOR INSTRUMENTS EXECUTED OR MODIFIED AFTER 2018

Amounts paid as alimony or separate maintenance payments under a divorce or separation instrument executed after 2018 will not be deductible by the payer. Such amounts also will not be includible in the income of the recipient. The same is true of alimony paid under a divorce or separation instrument executed before 2019 and modified after 2018 if the modification expressly states that the alimony is not deductible to the payer or includible in the income of the recipient. The examples below illustrate the tax treatment of alimony payments under the post-2018 alimony rules. In each of the examples, assume the payments qualify as alimony under the Internal Revenue Code of 1986.

Example 1

On December 2, 2016, a court executed a divorce decree providing for monthly alimony payments beginning January 1, 2017, for a period of 9 years. On May 15, 2024, the court modified the divorce decree to increase the amount of monthly alimony payments. The first increased alimony payment was due on June 1, 2024. The modification did not expressly provide that the post-2018 alimony rules apply to alimony payments made after the date of the modification. Therefore, all alimony payments made in 2024 are includible in the recipient's income and deductible from the payer's income.

Example 2

Assume the same facts as in Example 1 above, except the modification expressly provided that the post-2018 alimony rules apply. The alimony payments made in January 2024 through May 2024 are includible in the recipient's income and deductible from the payer's income. The alimony payments made in June 2024 through December 2024 are neither includible in the recipient's income nor deductible from the payer's income.

Example 3

On December 2, 2016, a couple executed a written separation agreement providing for monthly alimony payments on the first day of each month, beginning January 1, 2017, for a period of 9 years. The written separation agreement set forth that it expires upon the execution of a divorce decree dissolving the couple's marriage. On May 27, 2024, a court executed the divorce decree awarding alimony under the same terms as described in the couple's separation agreement. The alimony payments made in January 2024 through May 2024 under the written separation agreement are includible in the recipient's income and deductible from the payer's income. The court executed the divorce decree after December 31, 2018; therefore, alimony payments made in June 2024 through December 2024 under the divorce decree are neither includible in the recipient's income nor deductible from the payer's income.

Example 4

On October 1, 2018, a couple executed a written separation agreement subject to the laws of State X. The written separation agreement requires a $1,000 monthly alimony payment on the last business day of a month for a period of 6 years. Under the laws of State X, at the time of divorce, a written separation agreement may survive as an independent contract. In the process of obtaining their divorce, the couple decided their separation agreement will remain an independent contract and won't be incorporated or merged into their divorce decree. The court, after acknowledging the separation agreement as fair and equitable, executed a divorce decree on April 1, 2024, dissolving the couple's marriage. The divorce decree did not mention alimony. All alimony payments made in 2024 are includible in the recipient's income and deductible from the payer's income because the alimony payments were made under the written separation agreement that was executed on or before December 31, 2018.

CHAPTER 18: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1.	**Not all payments under a divorce or separation instrument are alimony. Generally, alimony does <u>not</u> include which of the following:** **A.** a cash payment required by a separation instrument to your former spouse **B.** a cash payment required by a separation instrument to a third party such as a medical insurance company **C.** a noncash property settlement required in the divorce decree **D.** life insurance premiums you must pay under a divorce agreement
2.	**All payments under a divorce or separation agreement are considered alimony.** **A.** true **B.** false

CHAPTER 18: SOLUTION AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. A cash payment required by a separation instrument paid to your former spouse with whom you do not file a joint return is considered alimony and is deductible on the payer's tax return. **B.** Incorrect. A cash payment required by a separation instrument and paid to a third party for the benefit of a former spouse is generally considered alimony. **C.** **CORRECT**. A noncash property settlement required by either a divorce decree or separation instrument is generally not defined as alimony. It therefore cannot be deducted as an alimony payment. **D.** Incorrect. Life insurance premiums can be considered alimony in certain situations. *(See pages 228 to 229 of the course material.)*
2.	**A.** Incorrect. There are several types of payments under a divorce or separation agreement that are not considered alimony. **B.** **CORRECT**. Child support, noncash property settlements, payments that are the spouse's part of community income, payments to keep up the payer's property, and use of the payer's property are not considered alimony. *(See page 229 of the course material.)*

CHAPTER 19: EDUCATION-RELATED ADJUSTMENTS

Chapter Objective

After completing this chapter, you should be able to:

- Identify education-related adjustments that can be made to income.

I. EDUCATOR EXPENSES

If you were an eligible educator in 2024, you can deduct up to $300 of qualified expenses you paid in 2024 as an adjustment to gross income on Schedule 1 (Form 1040), line 11.

If you and your spouse are filing jointly and both of you were eligible educators, the maximum deduction is $600. However, neither spouse can deduct more than $300 of his or her qualified expenses.

Eligible educator. An eligible educator is a kindergarten through grade 12 teacher, instructor, counselor, principal, or aide in a school for at least 900 hours during a school year.

Qualified expenses. Qualified expenses include ordinary and necessary expenses paid in connection with books, supplies, equipment (including computer equipment, software, and services), and other materials used in the classroom. An ordinary expense is one that is common and accepted in your educational field. A necessary expense is one that is helpful and appropriate for your profession as an educator. An expense does not have to be required to be considered necessary.

Qualified expenses also include those expenses you incur while participating in professional development courses related to the curriculum in which you provide instruction. It also includes those expenses related to those students for whom you provide that instruction.

Qualified expenses do not include expenses for home schooling or for nonathletic supplies for courses in health or physical education. Educator expenses also include the cost of personal protective equipment, disinfectant, and other supplies used for the prevention of the spread of COVID-19 in the classroom.

You must reduce your qualified expenses by the following amounts.

- Excludable U.S. series EE and I savings bond interest from Form 8815.
- Nontaxable qualified tuition program earnings.
- Nontaxable earnings from a Coverdell education savings account (ESA).
- Any reimbursements you received for these expenses that were not reported to you in box 1 of your Form W-2.

II. STUDENT LOAN INTEREST DEDUCTION

Generally, personal interest you pay, other than certain mortgage interest, is not deductible on your tax return. However, if your modified adjusted gross income (MAGI) is less than $95,000 ($195,000 if filing a joint return) there is a special deduction allowed for paying interest on a student loan (also known as an education loan) used for higher education. For most taxpayers, MAGI is the adjusted gross income as figured on their federal income tax return before subtracting any deduction for student loan interest. This deduction can reduce the amount of your income subject to tax by up to $2,500. *Table 19-1* summarizes the features of the student loan interest deduction.

TABLE 19-1. STUDENT LOAN INTEREST DEDUCTION AT A GLANCE

Do not rely on this table alone. Refer to the text for more details.

Feature	Description
Maximum benefit	You can reduce your income subject to tax by up to $2,500.
Loan qualifications	Your student loan: • Must have been taken out solely to pay qualified education expenses, and • Cannot be from a related person or made under a qualified employer plan.
Student qualifications	The student must be: • You, your spouse, or your dependent, and • Enrolled at least half-time in a program leading to a degree, certificate, or other recognized educational credential at an eligible educational institution.
Limit on modified adjusted gross income (MAGI)	$195,000 if married filing a joint return; $95,000 if single, head of household, or qualifying widow(er)

STUDENT LOAN INTEREST DEFINED

Student loan interest is interest you paid during the year on a qualified student loan. It includes both required and voluntary interest payments.

Qualified Student Loan

This is a loan you took out solely to pay qualified education expenses (defined later) that were:

- For you, your spouse, or a person who was your dependent (defined in chapter 3) when you took out the loan,
- Paid or incurred within a reasonable period of time before or after you took out the loan, and
- For education provided during an academic period when the student is an eligible student.

Loans from the following sources are not qualified student loans:

- A related person.
- A qualified employer plan.

Reasonable period of time. Qualified education expenses are treated as paid or incurred within a reasonable period of time before or after you take out the loan if they are paid with the proceeds of student loans that are part of a federal postsecondary education loan program.

Even if not paid with the proceeds of that type of loan, the expenses are treated as paid or incurred within a reasonable period of time if both of the following requirements are met.

1. The expenses relate to a specific academic period, and
2. The loan proceeds are disbursed within a period that begins 90 days before the start of that academic period and ends 90 days after the end of that academic period.

If neither of the above situations applies, the reasonable period of time usually is determined based on all the relevant facts and circumstances.

Academic period. An academic period includes a semester, trimester, quarter, or other period of study (such as a summer school session) as reasonably determined by an educational institution. If an educational institution that uses credit hours or clock hours and does not have academic terms, each payment period can be treated as an academic period.

Eligible student. An eligible student is a student who was enrolled at least half-time in a program leading to a degree, certificate, or other recognized educational credential.

Enrolled at least half-time. A student was enrolled at least half-time if the student was taking at least half the normal full-time work load for his or her course of study.

The standard for what is half of the normal full-time work load is determined by each eligible educational institution. However, the standard may not be lower than any of those established by the Department of Education under the Higher Education Act of 1965.

Qualified employer plan. You cannot deduct interest on a loan made under a qualified employer plan or under a contract purchased under such a plan.

Qualified Education Expenses

Generally, for purposes of the student loan interest deduction, these expenses are the total costs of attending an eligible educational institution, including graduate school. They include amounts paid for the following items.

- Tuition and fees.
- Room and board.
- Books, supplies, and equipment.

- Other necessary expenses (such as transportation).

The cost of room and board qualified only to the extent that it is not more than:

- The allowance for room and board, as determined by the eligible educational institution, that was included in the cost of attendance (for federal financial aid purposes) for a particular academic period and living arrangement of the student.
- If greater, the actual amount charged if the student is residing in housing owned or operated by the eligible educational institution.

Include as Interest

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

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

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

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

Interest on refinanced and consolidated student loans. This includes interest on a loan used solely to refinance a qualified student loan of the same borrower. It also includes a single consolidation loan used solely to refinance two or more qualified student loans of the same borrower.

Caution!

If you refinance a qualified student loan for more than your original loan and you use the additional amount for any purpose other than qualified education expenses, you cannot deduct any interest paid on the refinanced loan.

Do Not Include as Interest

You cannot claim a student loan interest deduction for any of the following items:

- Interest you paid on a loan if, under the terms of the loan, you are not legally obligated to make interest payments.

- Loan origination fees that are payments for property or services provided by the lender, such as commitment fees or processing costs.
- Interest you paid on a loan to the extent payments were made through your participation in the National Health Service Corps Loan Repayment Program (the "NHSC Loan Repayment Program") or certain other loan repayment assistance programs.

HOW MUCH CAN YOU DEDUCT

Your student loan interest deduction for 2024 is generally the smaller of:

- $2,500, or
- The interest you paid in 2024.

However, the amount determined above is phased out (gradually reduced) if your MAGI is between $80,000 and $95,000 ($165,000 and $195,000 if you file a joint return). You cannot take a student loan interest deduction if your MAGI is $95,000 or more ($195,000 or more if you file a joint return).

III. TUITION AND FEES DEDUCTION

Note

The tuition and fees deduction was repealed by the Further Consolidated Appropriations Act, 2021. However, there are other educational tax-savers available in 2024, including the American opportunity credit and the lifetime learning credit (discussed in Chapter 34).

CHAPTER 19: TEST YOUR KNOWLEDGE

The following question is designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). It is included as an additional tool to enhance your learning experience and does not need to be submitted in order to receive CPE credit.

We recommend that you answer the question and then compare your response to the suggested solution on the following page before answering the final exam question(s) related to this chapter (assignment).

1.	**A deduction for student loan interest paid can be claimed for taxpayers with a MAGI of less than how much:** **A.** $95,000 for single filing taxpayers **B.** $195,000 if filing a joint return **C.** both A and B are correct **D.** none of the above; student loan interest is considered personal interest that is not deductible

CHAPTER 19: SOLUTION AND SUGGESTED RESPONSES

Below is the solution and suggested responses for the question on the previous page. If you choose an incorrect answer, you should review the page(s) as indicated for the question to ensure comprehension of the material.

1.	**A.** Incorrect. This MAGI amount (less than $95,000) is correct for a single filer, but this is not the best answer. **B.** Incorrect. This MAGI amount (less than $195,000) is correct for married joint filers, but this is not the best answer. **C.** **CORRECT**. The student loan interest deduction is limited to taxpayers whose MAGI is less than $95,000 for single filers and $195,000 for married filing jointly. **D.** Incorrect. If a taxpayer meets certain caps mentioned previously, a special deduction is allowed for paying interest on a student/educational loan used for higher education. *(See page 238 of the course material.)*

CHAPTER 20: OTHER ADJUSTMENTS TO INCOME

Chapter Objective

After completing this chapter, you should be able to:

- Identify what business-related expenses associated with travel, transportation, and gifts are deductible.

I. WHAT'S NEW/REMINDERS

Deduction for miscellaneous itemized deductions suspended. For tax years beginning after 2017, the deduction for job-related or other miscellaneous itemized deductions subject to the 2%-of-adjusted-gross-income floor is suspended. Armed Forces reservists, qualified performing artists, and fee-based state or local government officials can continue to claim eligible business expenses as adjustments in determining adjusted gross income. Employees with impairment-related work expenses can continue to claim eligible impairment-related work expenses as itemized deductions.

Deduction for moving expenses suspended. For tax years beginning after 2017, the deduction for moving expenses is suspended unless you are a member of the Armed Forces who moves pursuant to a military order and incident to a permanent change of station.

Standard mileage rate. For 2024, the standard mileage rate for the cost of operating your car for business use is 67.0 cents per mile.

Car expenses and use of the standard mileage rate are explained under *Transportation Expenses*, later.

Depreciation limits on cars, trucks, and vans. The first-year limit on depreciation, the special depreciation allowance, and the section 179 deduction for vehicles acquired in 2024 is $20,400. If you elect not to claim a special depreciation allowance for a vehicle placed in service in 2024, the first-year limit is $12,400.

Special depreciation allowance. For 2024, the first-year special ("bonus") depreciation allowance on qualified property (including cars, trucks, and vans) is 60% for qualified property acquired and placed in service after December 31, 2023 and before January 1, 2025.

Meals and entertainment. In 2024, entertainment expenses generally are not deductible. Only non-entertainment-related meals are deductible, and the 50% limitation on the deduction of meals has not changed.

II. INTRODUCTION

You may be able to deduct the ordinary and necessary business-related expenses you have for:

- Travel,

- Non-entertainment-related meals,
- Gifts, or
- Transportation.

An ordinary expense is one that is common and accepted in your trade or business. A necessary expense is one that is helpful and appropriate for your business. An expense does not have to be required to be considered necessary.

This chapter explains the following.

- What expenses are deductible.
- How to report your expenses on your return.
- What records you need to prove your expenses.
- How to treat any expense reimbursements you may receive.

Who does not need to use this chapter. The information in this chapter does not apply to you if you are an employee and all of the following are true.

- You fully accounted to your employer for your work-related expenses.
- You received full reimbursement for your expenses.
- Your employer required you to return any excess reimbursement and you did so.
- There is no amount shown with a code L in box 12 of your Form W-2, Wage and Tax Statement.

If you meet all of these conditions, there is no need to show the expenses or the reimbursements on your return. See *Reimbursements*, later, if you would like more information on reimbursements and accounting to your employer.

Tip

If you meet these conditions and your employer included reimbursements on your Form W-2 in error, ask your employer for a corrected Form W-2.

III. TRAVEL EXPENSES

If you temporarily travel away from your tax home, you can use this section to determine if you have deductible travel expenses. This section discusses:

- Traveling away from home,

- Tax home,
- Temporary assignment or job, and
- What travel expenses are deductible.

It also discusses the standard meal allowance, rules for travel inside and outside the United States, and deductible convention expenses.

Travel expenses defined. For tax purposes, travel expenses are the ordinary and necessary expenses (defined earlier) of traveling away from home for your business, profession, or job. You will find examples of deductible travel expenses in Table 20-1.

TABLE 20-1. TRAVEL EXPENSES YOU CAN DEDUCT.

This chart summarizes expenses you can deduct when you travel away from home for business purposes.

IF you have expenses for…	THEN you can deduct the cost of…
transportation	travel by airplane, train, bus, or car between your home and your business destination. If you were provided with a ticket or you are riding free as a result of a frequent traveler or similar program, your cost is zero. If you travel by ship, see *Luxury Water Travel* and *Cruise Ships* (under *Conventions*) in Pub. 463 for additional rules and limits.
taxi, commuter bus, and airport limousine	fares for these and other types of transportation that take you between: • The airport or station and your hotel; and • The hotel and the work location of your customers or clients, your business meeting place, or your temporary work location.
baggage and shipping	sending baggage and sample or display material between your regular and temporary work locations.
car	operating and maintaining your car when traveling away from home on business. You can deduct actual expenses or the standard mileage rate as well as business-related tolls and parking. If you rent a car while away from home on business, you can deduct only the business-use portion of the expenses.
lodging and meals	your lodging and non-entertainment-related meals if your business trip is overnight or long enough that you need to stop for sleep or rest to properly perform your duties. Meals include amounts spent for food, beverages, taxes, and related tips. See *Meals and Incidental Expenses*, earlier, for additional rules and limits.
cleaning	dry cleaning and laundry.

IF you have expenses for…	THEN you can deduct the cost of…
telephone	business calls while on your business trip. This includes business communication by fax machine or other communication devices.
tips	tips you pay for any expenses in this chart.
other	other similar ordinary and necessary expenses related to your business travel. These expenses might include transportation to or from a business meal, public stenographer's fees, computer rental fees, and operating and maintaining a house trailer.

TRAVELING AWAY FROM HOME

You are traveling away from home if:

- Your duties require you to be away from the general area of your tax home (defined later) substantially longer than an ordinary day's work, and
- You need to sleep or rest to meet the demands of your work while away from home.

This rest requirement is not satisfied by merely napping in your car. You do not have to be away from your tax home for a whole day or from dusk to dawn as long as your relief from duty is long enough to get necessary sleep or rest.

Example 1

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 2

You are a truck driver. You leave your terminal and return to it later the same day. You get an hour off at your turn-around 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 traveling away from home.

Members of the Armed Forces. If you are a member of the U.S. Armed Forces on a permanent duty assignment overseas, you are not traveling away from home. You cannot deduct your expenses for meals and lodging. You cannot deduct these expenses even if you have to maintain a home in the United States for your family members who are not allowed to accompany you overseas. If you are transferred from one permanent duty station to another, you may have deductible moving expenses, which are explained in Pub. 521, Moving Expenses.

A naval officer assigned to permanent duty aboard a ship that has regular eating and living facilities has a tax home aboard ship for travel expense purposes.

TAX HOME

To determine whether you are traveling away from home, you must first determine the location of your tax home.

Generally, your tax home is your regular place of business or post of duty, regardless of where you maintain your family home. It includes the entire city or general area in which your business or work is located.

If you have more than one regular place of business, your tax home is your main place of business. See *Main place of business or work*, later.

If you do not have a regular or a main place of business because of the nature of your work, then your tax home may be the place where you regularly live. See *No main place of business or work*, later.

If you do not have a regular or a main place of business or post of duty and there is no place where you regularly live, you are considered an itinerant (a transient) and your tax home is wherever you work. As an itinerant, you cannot claim a travel expense deduction because you are never considered to be traveling away from home.

Main place of business or work. If you have more than one place of business or work, consider the following when determining which one is your main place of business or work.

- The total time you ordinarily spend in each place.
- The level of your business activity in each place.
- Whether your income from each place is significant or insignificant.

Example

You live in Cincinnati where you have a seasonal job for 8 months each year and earn $40,000. You work the other 4 months in Miami, also at a seasonal job, and earn $15,000. Cincinnati is your main place of work because you spend most of your time there and earn most of your income there.

No main place of business or work. You may have a tax home even if you do not have a regular or main place of business or work. Your tax home may be the home where you regularly live.

Factors used to determine tax home. If you do not have a regular or main place of business or work, use the following three factors to determine where your tax home is.

1. You perform part of your business in the area of your main home and use that home for lodging while doing business in the area.

2. You have living expenses at your main home that you duplicate because your business requires you to be away from that home.

3. You have not abandoned the area in which both your historical place of lodging and your claimed main home are located; you have a member or members of your family living at your main home; or you often use that home for lodging.

If you satisfy all three factors, your tax home is the home where you regularly live. If you satisfy only two factors, you may have a tax home depending on all the facts and circumstances. If you satisfy only one factor, you are an itinerant; your tax home is wherever you work and you cannot deduct travel expenses.

Example

You are single and live in Boston in an apartment you rent. You have worked for your employer in Boston for a number of years. Your employer enrolls you in a 12-month executive training program. You do not expect to return to work in Boston after you complete your training.

During your training, you do not do any work in Boston. Instead, you receive classroom and on-the-job training throughout the United States. You keep your apartment in Boston and return to it frequently. You use your apartment to conduct your personal business. You also keep up your community contacts in Boston. When you complete your training, you are transferred to Los Angeles.

You do not satisfy factor (1) because you did not work in Boston. You satisfy factor (2) because you had duplicate living expenses. You also satisfy factor (3) because you did not abandon your apartment in Boston as your main home, you kept your community contacts, and you frequently returned to live in your apartment. Therefore, you have a tax home in Boston.

Tax home different from family home. If you (and your family) do not live at your tax home (defined earlier), you cannot deduct the cost of traveling between your tax home and your family home. You also cannot deduct the cost of meals and lodging while at your tax home. See Example 1 below.

If you are working temporarily in the same city where you and your family live, you may be considered as traveling away from home. See Example 2 below.

Example 1

You are a truck driver and you and your family live in Tucson. You are employed by a trucking firm that has its terminal in Phoenix. At the end of your long runs, you return to your home terminal in Phoenix and spend one night there before returning home. You cannot deduct any expenses you have for meals and lodging in Phoenix or the cost of traveling from Phoenix to Tucson. This is because Phoenix is your tax home.

Example 2

Your family home is in Pittsburgh, where you work 12 weeks a year. The rest of the year you work for the same employer in Baltimore. In Baltimore, you eat in restaurants and sleep in a rooming house. Your salary is the same whether you are in Pittsburgh or Baltimore.

Because you spend most of your working time and earn most of your salary in Baltimore, that city is your tax home. You cannot deduct any expenses you have for meals and lodging there. However, when you return to work in Pittsburgh, you are away from your tax home even though you stay at your family home. You can deduct the cost of your round trip between Baltimore and Pittsburgh. You can also deduct your part of your family's living expenses for non-entertainment-related meals and lodging while you are living and working in Pittsburgh.

TEMPORARY ASSIGNMENT OR JOB

You may regularly work at your tax home and also work at another location. It may not be practical to return to your tax home from this other location at the end of each work day.

Temporary assignment vs. indefinite assignment. If your assignment or job away from your main place of work is temporary, your tax home does not change. You are considered to be away from home for the whole period you are away from your main place of work. You can deduct your travel expenses if they otherwise qualify for deduction. Generally, a temporary assignment in a single location is one that is realistically expected to last (and does in fact last) for 1 year or less.

However, if your assignment or job is indefinite, the location of the assignment or job becomes your new tax home and you cannot deduct your travel expenses while there. An assignment or job in a single location is considered indefinite if it is realistically expected to last for more than 1 year, whether or not it actually lasts for more than 1 year.

If your assignment is indefinite, you must include in your income any amounts you receive from your employer for living expenses, even if they are called travel allowances and you account to your employer for them.

Exception for federal crime investigations or prosecutions. If you are a federal employee participating in a federal crime investigation or prosecution, you are not subject to the 1-year rule. This means you may be able to deduct travel expenses even if you are away from your tax home for more than 1 year, provided you meet the other requirements for deductibility.

For you to qualify, the Attorney General (or his or her designee) must certify that you are traveling:

- For the federal government;
- In a temporary duty status; and
- To investigate or prosecute, or provide support services for the investigation or prosecution of, a federal crime.

Determining temporary or indefinite. You must determine whether your assignment is temporary or indefinite when you start work. If you expect an assignment or job to last for 1 year or less, it is temporary unless there are facts and circumstances that indicate otherwise. An assignment or job that is initially temporary may become indefinite due to changed circumstances. A series of assignments to the same location, all for short periods but that together cover a long period, may be considered an indefinite assignment.

Going home on days off. If you go back to your tax home from a temporary assignment on your days off, you aren't considered away from home while you are in your hometown. You can't deduct the cost of your meals and lodging there. However, you can deduct your travel expenses, including meals and lodging, while traveling between your temporary place of work and your tax home. You can claim these expenses up to the amount it would have cost you to stay at your temporary place of work.

If you keep your hotel room during your visit home, you can deduct the cost of your hotel room. In addition, you can deduct your expenses of returning home up to the amount you would have spent for meals had you stayed at your temporary place of work.

Probationary work period. If you take a job that requires you to move, with the understanding that you will keep the job if your work is satisfactory during a probationary period, the job is indefinite. You cannot deduct any of your expenses for meals and lodging during the probationary period.

WHAT TRAVEL EXPENSES ARE DEDUCTIBLE?

Once you have determined that you are traveling away from your tax home, you can determine what travel expenses are deductible.

You can deduct ordinary and necessary expenses you have when you travel away from home on business. The type of expense you can deduct depends on the facts and your circumstances.

Table 20-1 summarizes travel expenses you may be able to deduct. You may have other deductible travel expenses that are not covered there, depending on the facts and your circumstances.

Tip

When you travel away from home on business, you should keep records of all the expenses you have and any advances you receive from your employer. You can use a log, diary, notebook, or any other written record to keep track of your expenses. The types of expenses you need to record, along with supporting documentation, are described in Table 20-2.

TABLE 20-2. HOW TO PROVE CERTAIN BUSINESS EXPENSES

IF you have expenses for…	THEN you must keep records that show details of the following elements…			
	Amount	**Time**	**Place or Description**	**Business Purpose and Business Relationship**
Travel	Cost of each separate expense for travel, lodging, and meals. Incidental expenses may be totaled in reasonable categories such as taxis, fees and tips, etc.	Dates you left and returned for each trip and number of days spent on business.	Destination or area of your travel (name of city, town, or other designation).	Purpose: Business purpose for the expense or the business benefit gained or expected to be gained. Relationship: N/A
Gifts	Cost of the gift.	Date of the gift.	Description of the gift.	
Transportation	Cost of each separate expense. For car expenses, the cost of the car and any improvements, the date you started using it for business, the mileage for each business use, and the total miles for the year.	Date of the expense. For car expenses, the date of the use of the car.	Your business destination.	Purpose: Business purpose for the expense. Relationship: N/A

Separating costs. If you have one expense that includes the costs of non-entertainment-related meals and other services (such as lodging or transportation), you must allocate that expense between the cost of non-entertainment-related meals and the cost of other services. You must have a reasonable basis for making this allocation. For example, you must allocate your expenses if a hotel includes one or more meals in its room charge.

Travel expenses for another individual. If a spouse, dependent, or other individual goes with you (or your employee) on a business trip or to a business convention, you generally cannot deduct his or her travel expenses.

Employee. You can deduct the travel expenses of someone who goes with you if that person:

1. Is your employee,

2. Has a bona fide business purpose for the travel, and

3. Would otherwise be allowed to deduct the travel expenses.

Business associate. If a business associate travels with you and meets the conditions in (2) and (3) above, you can deduct the travel expenses you have for that person. A business associate is someone with whom you could reasonably expect to engage or deal in the active conduct of your business. A business associate can be a current or prospective (likely to become) customer, client, supplier, employee, agent, partner, or professional advisor.

Bona fide business purpose. A bona fide business purpose exists if you can prove a real business purpose for the individual's presence. Incidental services, such as typing notes or assisting in entertaining customers, are not enough to make the expenses deductible.

Example

Jerry drives to Chicago on business and takes his wife, Linda, with him. Linda is not Jerry's employee. Linda occasionally types notes, performs similar services, and accompanies Jerry to luncheons and dinners. The performance of these services does not establish that her presence on the trip is necessary to the conduct of Jerry's business. Her expenses are not deductible.

Jerry pays $199 a day for a double room. A single room costs $149 a day. He can deduct the total cost of driving his car to and from Chicago, but only $149 a day for his hotel room. If both Jerry and Linda use public transportation, Jerry can deduct only his fare.

Meals and Incidental Expenses

You can deduct the cost of meals if it is necessary for you to stop for substantial sleep or rest to properly perform your duties while traveling away from home on business.

The elimination of the deduction for entertainment expenses is discussed under *Meals and Entertainment Expenses*, later. The following discussion deals with meals (and incidental expenses).

50% limit on meals. You can figure your meal expenses using either of the following methods.

- Actual cost.
- The standard meal allowance.

Both of these methods are explained below. But, regardless of the method you use, you generally can deduct only 50% of the unreimbursed cost of your meals.

If you are reimbursed for the cost of your meals, how you apply the 50% limit depends on whether your employer's reimbursement plan was accountable or nonaccountable. If you are not reimbursed, the 50% limit applies even if the unreimbursed meal expense is for business travel. The 50% limit is explained later under *Meals and Entertainment Expenses*. Accountable and nonaccountable plans are discussed later under *Reimbursements*.

Actual cost. You can use the actual cost of your meals to figure the amount of your expense before reimbursement and application of the 50% deduction limit. If you use this method, you must keep records of your actual cost.

Standard meal allowance. Generally, you can use the "standard meal allowance" method as an alternative to the actual cost method. It allows you to use a set amount for your daily meals and incidental expenses (M&IE), instead of keeping records of your actual costs. The set amount varies depending on where and when you travel. In this chapter, "standard meal allowance" refers to the federal rate for M&IE, discussed later under *Amount of standard meal allowance*. If you use the standard meal allowance, you still must keep records to prove the time, place, and business purpose of your travel. See *Recordkeeping*, later.

Incidental expenses. The term "incidental expenses" means fees and tips given to porters, baggage carriers, hotel staff, and staff on ships. Incidental expenses do not include expenses for laundry, cleaning and pressing of clothing, lodging taxes, costs of telegrams or telephone calls, transportation between places of lodging or business and places where meals are taken, or the mailing cost of filing travel vouchers and paying employer-sponsored charge card billings.

Incidental-expenses-only method. You can use an optional method (instead of actual cost) for deducting incidental expenses only. The amount of the deduction is $5 a day. You can use this method only if you did not pay or incur any meal expenses. You cannot use this method on any day that you use the standard meal allowance.

Caution!

Federal employees should refer to the Federal Travel Regulations at GSA.gov. Find "Policy and Regulations" and click on "Regulations" for links to Federal Travel Regulation (FTR) for changes affecting claims for reimbursement.

50% limit may apply. If you use the standard meal allowance method for non-entertainment-related meal expenses and you are not reimbursed or you are reimbursed under a nonaccountable plan, you can generally deduct only 50% of the standard meal allowance. If you are reimbursed under an accountable plan and you are deducting amounts that are more than your reimbursements, you can deduct only 50% of the excess amount. The 50% limit is explained later under *Meals and Entertainment Expenses*. Accountable and nonaccountable plans are discussed later under *Reimbursements*.

Caution!

There is no optional standard lodging amount similar to the standard meal allowance. Your allowable lodging expense deduction is your actual cost.

Who can use the standard meal allowance. You can use the standard meal allowance whether you are an employee or self-employed, and whether or not you are reimbursed for your traveling expenses.

Use of the standard meal allowance for other travel. You can use the standard meal allowance to figure your meal expenses when you travel in connection with investment and other income-producing property. You can also use it to figure your meal expenses when you travel for qualifying educational purposes. You cannot use the standard meal allowance to figure the cost of your meals when you travel for medical or charitable purposes.

Amount of standard meal allowance. The standard meal allowance is the federal M&IE rate. The travel rate for most small localities in the United States is $68 a day.

Most major cities and many other localities in the United States are designated as high-cost areas, qualifying for higher standard meal allowances. You can find this information (organized by year and location) on the Internet at GSA.gov/perdiem.

If you travel to more than one location in one day, use the rate in effect for the area where you stop for sleep or rest. If you work in the transportation industry, however, see *Special rate for transportation workers*, later.

Standard meal allowance for areas outside the continental United States. The standard meal allowance rates above do not apply to travel in Alaska, Hawaii, or any other location outside the continental United States. The Department of Defense establishes per diem rates for Alaska, Hawaii, Puerto Rico, American Samoa, Guam, Midway, the Northern Mariana Islands, the U.S. Virgin Islands, Wake Island, and other non-foreign areas outside the continental United States. The Department of State establishes per diem rates for all other foreign areas.

Note

You can access per diem rates for non-foreign areas outside the continental United States at www.Defensetravel.dod.mil/site/perdiemCalc.cfm. You can access all other foreign per diem rates at State.gov/travel/. Click on "Travel Per Diem Allowances for Foreign Areas" under "Foreign Per Diem Rates" to obtain the latest foreign per diem rates.

Special rate for transportation workers. You can use a special standard meal allowance if you work in the transportation industry. You are in the transportation industry if your work:

- Directly involves moving people or goods by airplane, barge, bus, ship, train, or truck; and
- Regularly requires you to travel away from home and, during any single trip, usually involves travel to areas eligible for different standard meal allowance rates.

If this applies to you, you can claim a standard daily meal allowance of $69 a day ($74 for travel outside the continental United States) for travel in 2024.

Using the special rate for transportation workers eliminates the need for you to determine the standard meal allowance for every area where you stop for sleep or rest. If you choose to use the special rate for any trip, you must use the special rate (and not use the regular standard meal allowance rates) for all trips you take that year.

Travel for days you depart and return. For both the day you depart for and the day you return from a business trip, you must prorate the standard meal allowance (figure a reduced amount for each day). You can do so by one of two methods.

- Method 1: You can claim 3/4 of the standard meal allowance.
- Method 2: You can prorate using any method that you consistently apply and that is in accordance with reasonable business practice.

Example

Jen is employed in New Orleans as a convention planner. In March, her employer sent her on a 3-day trip to Washington, DC, to attend a planning seminar. She left her home in New Orleans at 10 a.m. on Wednesday and arrived in Washington, DC, at 5:30 p.m. After spending two nights there, she flew back to New Orleans on Friday and arrived back home at 8 p.m. Jen's employer gave her a flat amount to cover her expenses and included it with her wages.

Example (continued)

Under Method 1, Jen can claim 2½ days of the standard meal allowance for Washington, DC: ¾ of the daily rate for Wednesday and Friday (the days she departed and returned), and the full daily rate for Thursday.

Under Method 2, Jen could also use any method that she applies consistently and that is in accordance with reasonable business practice. For example, she could claim 3 days of the standard meal allowance even though a federal employee would have to use Method 1 and be limited to only 2½ days.

TRAVEL IN THE UNITED STATES

The following discussion applies to travel in the United States. For this purpose, the United States includes only the 50 states and the District of Columbia. The treatment of your travel expenses depends on how much of your trip was business related and on how much of your trip occurred within the United States. See *Part of Trip Outside the United States*, later.

Trip Primarily for Business

You can deduct all your travel expenses if your trip was entirely business related. If your trip was primarily for business and, while at your business destination, you extended your stay for a vacation, made a personal side trip, or had other personal activities, you can deduct your business-related travel expenses. These expenses include the travel costs of getting to and from your business destination and any business-related expenses at your business destination.

Example

You work in Atlanta and take a business trip to New Orleans in May. Your business travel totals 900 miles round trip. On your way home, you stop in Mobile to visit your parents. You spend $2,165 for the 9 days you are away from home for travel, non-entertainment-related meals, lodging, and other travel expenses. If you had not stopped in Mobile, you would have been gone only 6 days, and your total cost would have been $1,633.50. You can deduct $1,633.50 for your trip, including the cost of round-trip transportation to and from New Orleans. The deduction for your non-entertainment-related meals is subject to the 50% limit on meals mentioned earlier.

Trip Primarily for Personal Reasons

If your trip was primarily for personal reasons, such as a vacation, the entire cost of the trip is a nondeductible personal expense. However, you can deduct any expenses you have while at your destination that are directly related to your business.

A trip to a resort or on a cruise ship may be a vacation even if the promoter advertises that it is primarily for business. The scheduling of incidental business activities during a trip, such as viewing videotapes or attending lectures dealing with general subjects, will not change what is really a vacation into a business trip.

Part of Trip Outside the United States

If part of your trip is outside the United States, use the rules described later under *Travel Outside the United States* for that part of the trip. For the part of your trip that is inside the United States, use the rules for travel in the United States. Travel outside the United States does not include travel from one point in the United States to another point in the United States. The following discussion can help you determine whether your trip was entirely within the United States.

Public transportation. If you travel by public transportation, any place in the United States where that vehicle makes a scheduled stop is a point in the United States. Once the vehicle leaves the last scheduled stop in the United States on its way to a point outside the United States, you apply the rules under *Travel Outside the United States*, later.

Example

You fly from New York to Puerto Rico with a scheduled stop in Miami. You return to New York nonstop. The flight from New York to Miami is in the United States, so only the flight from Miami to Puerto Rico is outside the United States. Because there are no scheduled stops between Puerto Rico and New York, all of the return trip is outside the United States.

Private car. Travel by private car in the United States is travel between points in the United States, even when you are on your way to a destination outside the United States.

Example

You travel by car from Denver to Mexico City and return. Your travel from Denver to the border and from the border back to Denver is travel in the United States, and the rules in this section apply. The rules below under *Travel Outside the United States* apply to your trip from the border to Mexico City and back to the border.

TRAVEL OUTSIDE THE UNITED STATES

If any part of your business travel is outside the United States, some of your deductions for the cost of getting to and from your destination may be limited. For this purpose, the United States includes only the 50 states and the District of Columbia.

How much of your travel expenses you can deduct depends in part upon how much of your trip outside the United States was business related.

Travel Entirely for Business or Considered Entirely for Business

You can deduct all your travel expenses of getting to and from your business destination if your trip is entirely for business or considered entirely for business.

Travel entirely for business. If you travel outside the United States and you spend the entire time on business activities, you can deduct all of your travel expenses.

Travel considered entirely for business. Even if you did not spend your entire time on business activities, your trip is considered entirely for business if you meet at least one of the following four exceptions.

Exception 1—No substantial control. Your trip is considered entirely for business if you did not have substantial control over arranging the trip. The fact that you control the timing of your trip does not, by itself, mean that you have substantial control over arranging your trip.

You do not have substantial control over your trip if you:

- Are an employee who was reimbursed or paid a travel expense allowance,
- Are not related to your employer, or
- Are not a managing executive.

“Related to your employer” is defined later in this chapter under *Per Diem and Car Allowances*.

A “managing executive” is an employee who has the authority and responsibility, without being subject to the veto of another, to decide on the need for the business travel.

A self-employed person generally has substantial control over arranging business trips.

Exception 2—Outside United States no more than a week. Your trip is considered entirely for business if you were outside the United States for a week or less, combining business and nonbusiness activities. One week means 7 consecutive days. In counting the days, do not count the day you leave the United States, but do count the day you return to the United States.

Exception 3—Less than 25% of time on personal activities. Your trip is considered entirely for business if:

- You were outside the United States for more than a week, and
- You spent less than 25% of the total time you were outside the United States on nonbusiness activities.

For this purpose, count both the day your trip began and the day it ended.

Exception 4—Vacation not a major consideration. Your trip is considered entirely for business if you can establish that a personal vacation wasn't a major consideration, even if you have substantial control over arranging the trip.

Travel Primarily for Business

If you travel outside the United States primarily for business but spend some of your time on nonbusiness activities, you generally cannot deduct all of your travel expenses. You only can deduct the business portion of your cost of getting to and from your destination. You must allocate the costs between your business and nonbusiness activities to determine your deductible amount.

Tip

You do not have to allocate your travel expense deduction if you meet one of the four exceptions listed earlier under *Travel considered entirely for business*. In those cases, you can deduct the total cost of getting to and from your destination.

Travel Primarily for Personal Reasons

If you travel outside the United States primarily for vacation or for investment purposes, the entire cost of the trip is a nondeductible personal expense. If you spend some time attending brief professional seminars or a continuing education program, you can deduct your registration fees and other expenses you have that are directly related to your business.

CONVENTIONS

You can deduct your travel expenses when you attend a convention if you can show that your attendance benefits your trade or business. You cannot deduct the travel expenses for your family. If the convention is for investment, political, social, or other purposes unrelated to your trade or business, you cannot deduct the expenses.

Caution!

Your appointment or election as a delegate does not, in itself, determine whether you can deduct travel expenses. You can deduct your travel expenses only if your attendance is connected to your own trade or business.

Convention agenda. The convention agenda or program generally shows the purpose of the convention. You can show your attendance at the convention benefits your trade or business by comparing the agenda with the official duties and responsibilities of your position. The agenda does not have to deal specifically with your official duties and responsibilities; it will be enough if the agenda is so related to your position that it shows your attendance was for business purposes.

Conventions held outside the North American area. See chapter 1 of Pub. 463 for information on conventions held outside the North American area.

IV. MEALS AND ENTERTAINMENT EXPENSES

You can no longer take a deduction for any expense related to activities generally considered, entertainment, amusement, or recreation. You can continue to deduct 50% of the cost of business meals if you (or your employee) is present and the food or beverages are not considered lavish or extravagant.

Tip

If food or beverages are provided during or at an entertainment event, and the food and beverages were purchased separately from the entertainment or the cost of the food and beverages was stated separately from the cost of the entertainment on one or more bills, invoices, or receipts, you may be able to deduct the separately stated costs as a meal expense. For more information, see Regulations section 1.274-11(d)(2), Example 2.

50% LIMIT ON MEALS

In general, you can deduct only 50% of your business-related meal, unless an exception applies. (If you are subject to the Department of Transportation's "hours of service" limits, you can deduct 80% of your business-related meal and entertainment expenses. See *Individuals subject to "hours of service" limits*, later.)

Note

The special allowance of 100% of your meal expenses if the meals were food and beverages provided by a restaurant, and paid or incurred during 2021 and 2022 has expired.

The 50% limit applies to employees or their employers, and to self-employed persons (including independent contractors) or their clients, depending on whether the expenses are reimbursed.

Examples of meals might include:

- Meals while traveling away from home (whether eating alone or with others) on business, and

- Meals at a business convention or business league meeting.

Included expenses. Taxes and tips relating to a business meal are included as a cost of the meal and are subject to the 50% limit. However, the cost of transportation to and from a business meal would not be subject to the 50% limit.

Application of 50% limit. The 50% limit on meal expenses applies if the expense is otherwise deductible and isn't covered by one of the exceptions discussed later in this section.

The 50% limit also applies to certain meal expenses that aren't business related. It applies to meal expenses you have for the production of income, including rental or royalty income. It also applies to the cost of meals included in deductible educational expenses.

When to apply the 50% limit. You apply the 50% limit after determining the amount that would otherwise qualify for a deduction. You first have to determine the amount of meal expenses that would be deductible under the other rules discussed in this chapter.

Example 1

You spend $200 (including tax and tip) for a business meal. If $110 of that amount is not allowable because it is lavish and extravagant, the remaining $90 is subject to the 50% limit. Your deduction cannot be more than $45 (50% (0.50) × $90).

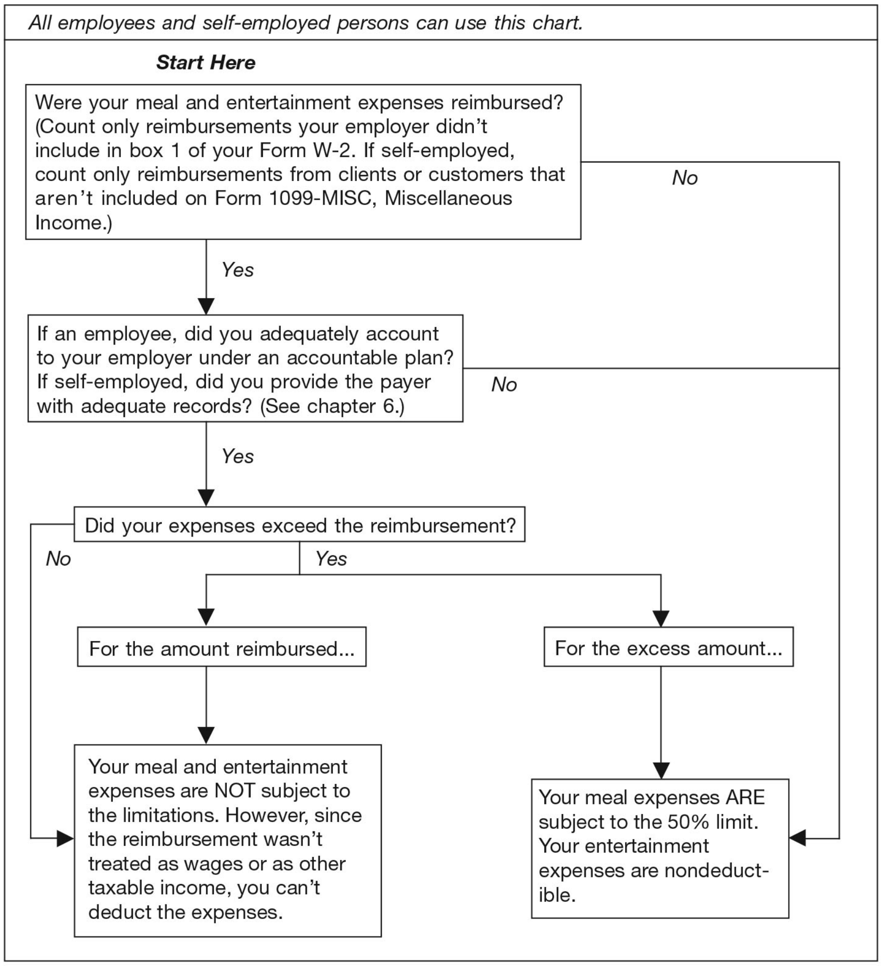
Example 2

You purchase two tickets to a concert for you and your client. Your deduction is zero because no deduction is allowed for entertainment expenses.

Figure 20-A can help you determine if the 50% limit applies to you.

FIGURE 20-A. DOES THE 50% LIMIT APPLY TO YOUR EXPENSES?

There are exceptions to these rules. See Exceptions to the 50% Limit.



Exceptions to the 50% Limit

Your meal expense is not subject to the 50% limit if the expense meets one of the following exceptions.

Expenses treated as compensation. In general, expenses for goods, services, and facilities are not subject to the 50% limit to the extent the expenses are treated by the taxpayer with respect to entertainment, amusement, or recreation, as compensation to an employee and as wages to the employee for tax purposes.

Employee's reimbursed expenses. If you are an employee, you are not subject to the 50% limit on expenses for which your employer reimburses you under an accountable plan. Accountable plans are discussed later under *Reimbursements*.

Individuals subject to "hours of service" limits. You can deduct a higher percentage of your meal expenses while traveling away from your tax home if the meals take place during or incident to any period subject to the Department of Transportation's "hours of service" limits. The percentage is 80%.

Individuals subject to the Department of Transportation's "hours of service" limits include the following persons.

- Certain air transportation workers (such as pilots, crew, dispatchers, mechanics, and control tower operators) who are under Federal Aviation Administration regulations.
- Interstate truck operators and bus drivers who are under Department of Transportation regulations.
- Certain railroad employees (such as engineers, conductors, train crews, dispatchers, and control operations personnel) who are under Federal Railroad Administration regulations.
- Certain merchant mariners who are under Coast Guard regulations.

Other exceptions. There are also exceptions for the self-employed; expenses for recreational, social, or similar activities (such as a holiday party); meals furnished as advertising expenses; and selling meals.

V. GIFT EXPENSES

If you give gifts in the course of your trade or business, you can deduct all or part of the cost. This section explains the limits and rules for deducting the costs of gifts.

$25 limit. You can deduct no more than $25 for business gifts you give directly or indirectly to each person during your tax year. A gift to a company that is intended for the eventual personal use or benefit of a particular person or a limited class of people will be considered an indirect gift to that particular person or to the individuals within that class of people who receive the gift.

If you give a gift to a member of a customer's family, the gift is generally considered to be an indirect gift to the customer. This rule does not apply if you have a bona fide independent business connection with that family member and the gift is not intended for the customer's eventual use or benefit.

If you and your spouse both give gifts, both of you are treated as one taxpayer. It does not matter whether you have separate businesses, are separately employed, or whether each of you has an independent connection with the recipient. If a partnership gives gifts, the partnership and the partners are treated as one taxpayer.

Incidental costs. Incidental costs, such as engraving on jewelry, or packaging, insuring, and mailing, are generally not included in determining the cost of a gift for purposes of the $25 limit.

A cost is incidental only if it does not add substantial value to the gift. For example, the cost of customary gift wrapping is an incidental cost. However, the purchase of an ornamental basket for packaging fruit is not an incidental cost if the value of the basket is substantial compared to the value of the fruit.

Exceptions. The following items are not considered gifts for purposes of the $25 limit.

1. An item that costs $4 or less and:

   a) Has your name clearly and permanently imprinted on the gift, and

   b) Is one of a number of identical items you widely distribute. Examples include pens, desk sets, and plastic bags and cases.

2. Signs, display racks, or other promotional material to be used on the business premises of the recipient.

Gift or entertainment. Any item that might be considered either a gift or entertainment generally will be considered entertainment. You cannot deduct entertainment expenses. However, if you give a customer packaged food or beverages you intend the customer to use at a later date, treat it as a gift.

VI. TRANSPORTATION EXPENSES

This section discusses expenses you can deduct for business transportation when you are not traveling away from home as defined earlier under *Travel Expenses*. These expenses include the cost of transportation by air, rail, bus, taxi, etc., and the cost of driving and maintaining your car.

Transportation expenses include the ordinary and necessary costs of all of the following.

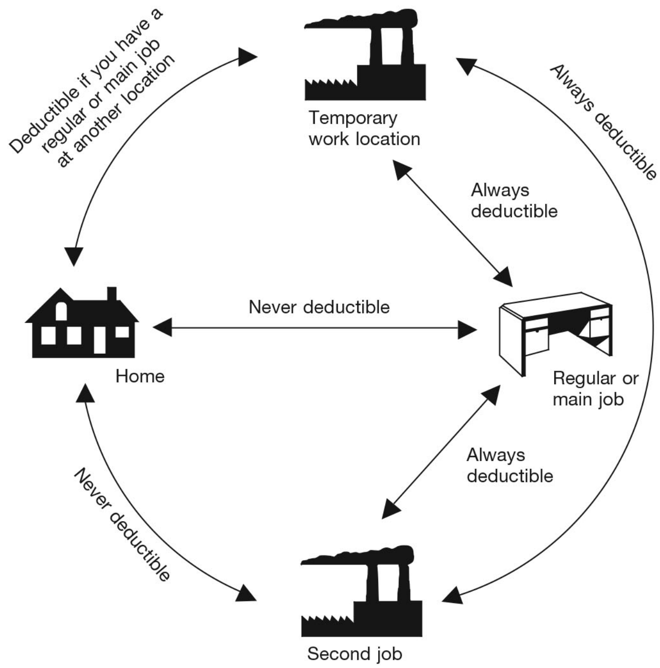
- Getting from one workplace to another in the course of your business or profession when you are traveling within the area of your tax home. (Tax home is defined earlier under *Travel Expenses*.)
- Visiting clients or customers.
- Going to a business meeting away from your regular workplace.
- Getting from your home to a temporary workplace when you have one or more regular places of work. These temporary workplaces can be either within the area of your tax home or outside that area.

Transportation expenses do not include expenses you have while traveling away from home overnight. Those expenses are travel expenses, discussed earlier. However, if you use your car while traveling away from home overnight, use the rules in this section to figure your car expense deduction. See *Car Expenses*, later.

Illustration of transportation expenses. Figure 20-B illustrates the rules for when you can deduct transportation expenses when you have a regular or main job away from your home. You may want to refer to it when deciding whether you can deduct your transportation expenses. Daily transportation expenses you incur while traveling from home to one or more regular places of business are generally nondeductible commuting expenses. However, there are many exceptions for deducting transportation expenses, like whether your work location is temporary (inside or outside the metropolitan area), traveling for the same trade or business, or if you have a home office.

FIGURE 20-B. WHEN ARE TRANSPORTATION EXPENSES DEDUCTIBLE?

Most employees and self-employed persons can use this chart. (Don't use this chart if your home is your principal place of business. See (Office in the home.)



Home: The place where you reside. Transportation expenses between your home and your main or regular place of work are personal commuting expenses.

Regular or main job: Your principal place of business. If you have more than one job, you must determine which one is your regular or main job. Consider the time you spend at each, the activity you have at each, and the income you earn at each.

Temporary work location: A place where your work assignment is realistically expected to last (and does in fact last) one year or less. Unless you have a regular place of business, you can only deduct your transportation expenses to a temporary work location outside your metropolitan area.

Second job: If you regularly work at two or more places in one day, whether or not for the same employer, you can deduct your transportation expenses of getting from one workplace to another. If you do not go directly from your first job to your second job, you can only deduct the transportation expenses of going directly from your first job to your second job. You cannot deduct your transportation expenses between your home and a second job on a day off from your main job.

Temporary work location. If you have one or more regular work locations away from your home and you commute to a temporary work location in the same trade or business, you can deduct the expenses of the daily round-trip transportation between your home and the temporary location, regardless of distance.

If your 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.

If your 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, regardless of whether it actually lasts for more than 1 year.

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 (unless there are facts and circumstances that would indicate otherwise) until your expectation changes. It will not be treated as temporary after the date you determine it will last more than 1 year.

If the temporary work location is beyond the general area of your regular place of work and you stay overnight, you are traveling away from home. You may have deductible travel expenses as discussed earlier in this chapter.

No regular place of work. If you have no regular place of work but ordinarily work in the metropolitan area where you live, you can deduct daily transportation costs between home and a temporary work site outside that metropolitan area.

Generally, a metropolitan area includes the area within the city limits and the suburbs that are considered part of that metropolitan area.

You cannot deduct daily transportation costs between your home and temporary work sites within your metropolitan area. These are nondeductible commuting expenses.

Two places of work. If you work at two places in one day, whether or not for the same employer, you can deduct the expense of getting from one workplace to the other. However, if for some personal reason you do not go directly from one location to the other, you cannot deduct more than the amount it would have cost you to go directly from the first location to the second.

Transportation expenses you have in going between home and a part-time job on a day off from your main job are commuting expenses. You cannot deduct them.

Armed Forces reservists. A meeting of an Armed Forces reserve unit is a second place of business if the meeting is held on a day on which you work at your regular job. You can deduct the expense of getting from one workplace to the other as just discussed under *Two places of work*, earlier.

You usually cannot deduct the expense if the reserve meeting is held on a day on which you do not work at your regular job. In this case, your transportation generally is a nondeductible commuting expense. However, you can deduct your transportation expenses if the location of the meeting is temporary and you have one or more regular places of work.

If you ordinarily work in a particular metropolitan area but not at any specific location and the reserve meeting is held at a temporary location outside that metropolitan area, you can deduct your transportation expenses.

If you travel away from home overnight to attend a guard or reserve meeting, you can deduct your travel expenses. These expenses are discussed earlier under *Travel Expenses*.

If you travel more than 100 miles away from home in connection with your performance of services as a member of the reserves, you may be able to deduct some of your reserve-related travel costs as an adjustment to income rather than as an itemized deduction. See *Armed Forces reservists traveling more than 100 miles from home* under *Special Rules*, later.

Commuting expenses. You cannot deduct the costs of taking a bus, trolley, subway, or taxi, or of driving a car between your home and your main or regular place of work. These costs are personal commuting expenses. You cannot deduct commuting expenses no matter how far your home is from your regular place of work. You cannot deduct commuting expenses even if you work during the commuting trip.

Example

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 do not change the trip from personal to business. You cannot deduct your commuting expenses.

Parking fees. Fees you pay to park your car at your place of business are nondeductible commuting expenses. You can, however, deduct business-related parking fees when visiting a customer or client.

Advertising display on car. Putting display material that advertises your business on your car does not change the use of your car from personal use to business use. If you use this car for commuting or other personal uses, you still cannot deduct your expenses for those uses.

Car pools. You cannot deduct the cost of using your car in a nonprofit car pool. Do not include payments you receive from the passengers in your income. These payments are considered reimbursements of your expenses. However, if you operate a car pool for a profit, you must include payments from passengers in your income. You can then deduct your car expenses (using the rules in this chapter).

Hauling tools or instruments. Hauling tools or instruments in your car while commuting to and from work does not make your car expenses deductible. However, you can deduct any additional costs you have for hauling tools or instruments (such as for renting a trailer you tow with your car).

Union members' trips from a union hall. If you get your work assignments at a union hall and then go to your place of work, the costs of getting from the union hall to your place of work are nondeductible commuting expenses. Although you need the union to get your work assignments, you are employed where you work, not where the union hall is located.

Office in the home. If you have an office in your home that qualifies as a principal place of business, you can deduct your daily transportation costs between your home and another work location in the same trade or business. (See Pub. 587 for information on determining if your home office qualifies as a principal place of business.)

Examples of deductible transportation. The following examples show when you can deduct transportation expenses based on the location of your work and your home.

Example 1

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.

Example 2

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.

Example 3

You have no regular office, and you do not 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 cannot deduct the costs of these first and last trips, you can deduct the costs of going from one client or customer to another.

CAR EXPENSES

If you use your car for business purposes, you may be able to deduct car expenses. You generally can use one of the following two methods to figure your deductible expenses.

- Standard Mileage Rate.
- Actual Car Expenses.

If you use actual car expenses to figure your deduction for a car you lease, there are rules that affect the amount of your lease payments you can deduct. See *Leasing a car* under *Actual Car Expenses*, later.

In this chapter, the term "car" includes a van, pickup, or panel truck.

Standard Mileage Rate

You may be able to use the standard mileage rate to figure the deductible costs of operating your car for business purposes. For 2024, the standard mileage rate for business use is 67.0 cents (0.67) per mile.

Caution!

If you use the standard mileage rate for a year, you cannot deduct your actual car expenses for that year, but see *Parking fees and tolls*, later.

You generally can use the standard mileage rate whether or not you are reimbursed and whether or not any reimbursement is more or less than the amount figured using the standard mileage rate. See *Reimbursements* under *How To Report*, later.

Choosing the standard mileage rate. If you want to use the standard mileage rate for a car you own, you must choose to use it in the first year the car is available for use in your business. Then, in later years, you can choose to use either the standard mileage rate or actual expenses.

If you want to use the standard mileage rate for a car you lease, you must use it for the entire lease period.

You must make the choice to use the standard mileage rate by the due date (including extensions) of your return. You cannot revoke the choice. However, in a later year, you can switch from the standard mileage rate to the actual expenses method. If you change to the actual expenses method in a later year, but before your car is fully depreciated, you have to estimate the remaining useful life of the car and use straight line depreciation.

For more information about depreciation included in the standard mileage rate, see the exception in *Methods of depreciation* under *Depreciation Deduction* in chapter 4 of Pub. 463.

Standard mileage rate not allowed. You can't use the standard mileage rate if you:

- Use five or more cars at the same time (as in fleet operations),
- Claimed a depreciation deduction for the car using any method other than straight line depreciation,
- Claimed a section 179 deduction on the car,
- Claimed the special depreciation allowance on the car, or
- Claimed actual car expenses after 1997 for a car you leased.

Five or more cars. If you own or lease five or more cars that are used for business at the same time, you can't use the standard mileage rate for the business use of any car. However, you may be able to deduct your actual expenses for operating each of the cars in your business. See *Actual Car Expenses* in chapter 4 of Pub. 463 for information on how to figure your deduction.

You are not using five or more cars for business at the same time if you alternate using (use at different times) the cars for business.

Parking fees and tolls. In addition to using the standard mileage rate, you can deduct any business-related parking fees and tolls. (Parking fees you pay to park your car at your place of work are nondeductible commuting expenses.)

Actual Car Expenses

If you do not use the standard mileage rate, you may be able to deduct your actual car expenses.

Tip

If you qualify to use both methods, you may want to figure your deduction both ways to see which gives you a larger deduction.

Actual car expenses include:

Depreciation	Lease payments	Registration fees
Licenses	Insurance	Repairs
Gas	Garage rent	Tires
Oil	Parking fees	Tolls

Business and personal use. If you use your car for both business and personal purposes, you must divide your expenses between business and personal use. You can divide your expenses based on the miles driven for each purpose.

Example

You are a contractor and drive your car 20,000 miles during the year: 12,000 miles for business use and 8,000 miles for personal use. You can claim only 60% (12,000 ÷ 20,000) of the cost of operating your car as a business expense.

Interest on car loans. If you are an employee, you cannot deduct any interest paid on a car loan. This interest is treated as personal interest and is not deductible. However, if you are self-employed and use your car in that business, see chapter 4 of Pub. 535.

Taxes paid on your car. If you are an employee, you can deduct personal property taxes paid on your car if you itemize deductions. Enter the amount paid on line 5c of Schedule A (Form 1040). (See chapter 23 for more information on taxes.) If you are not an employee, see your form instructions for information on how to deduct personal property taxes paid on your car.

Sales taxes. Generally, sales taxes on your car are part of your car's basis and are recovered through depreciation, discussed later.

Fines and collateral. You cannot deduct fines you pay and collateral you forfeited for traffic violations.

Depreciation and section 179 deductions. Generally, the cost of a car, plus sales tax and improvements, is a capital expense. Because the benefits last longer than 1 year, you generally cannot deduct a capital expense. However, you can recover this cost through the section 179 deduction and depreciation deductions. Depreciation allows you to recover the cost over more than 1 year by deducting part of it each year. The section 179 deduction and the depreciation deductions are discussed in more detail in chapter 4 of Pub. 463.

Generally, there are limits on these deductions. Special rules apply if you use your car 50% or less in your work or business.

Leasing a car. If you lease a car, truck, or van that you use in your business, you can use the standard mileage rate or actual expenses to figure your deductible car expense.

Deductible payments. If you choose to use actual expenses, you can deduct the part of each lease payment that is for the use of the vehicle in your business. You cannot deduct any part of a lease payment that is for personal use of the vehicle, such as commuting.

You must spread any advance payments over the entire lease period. You cannot deduct any payments you make to buy a vehicle, even if the payments are called lease payments.

If you lease a car, truck, or van for 30 days or more, you may have to reduce your lease payment deduction by an "inclusion amount." For information on reporting lease inclusion amounts, see *Leasing a Car* in chapter 4 of Pub. 463.

Disposition of a Car

If you dispose of your car, you may have a taxable gain or a deductible loss. This is true whether you used the standard mileage rate or actual car expenses to deduct the business use of your car. Pub. 544 has information on sales of property used in a trade or business, and details on how to report the disposition.

VII. RECORDKEEPING

If you deduct travel, gift, or transportation expenses, you must be able to prove (substantiate) certain elements of the expense. This section discusses the records you need to keep to prove these expenses.

Tip

If you keep timely and accurate records, you will have support to show the IRS if your tax return is ever examined. You will also have proof of expenses that your employer may require if you are reimbursed under an accountable plan. These plans are discussed later under *Reimbursements*.

HOW TO PROVE EXPENSES

Table 20-2 is a summary of records you need to prove each expense discussed in this chapter. You must be able to prove the elements listed across the top portion of the table. You prove them by having the information and receipts (where needed) for the expenses listed in the first column.

Caution!

You cannot deduct amounts that you approximate or estimate.

You should keep adequate records to prove your expenses or have sufficient evidence that will support your own statement. You must generally prepare a written record for it to be considered adequate. This is because written evidence is more reliable than oral evidence alone.

Tip

However, if you contemporaneously prepare a record on a computer, it is considered an adequate record.

What Are Adequate Records?

You should keep the proof you need in an account book, diary, statement of expense, or similar record. You should also keep documentary evidence that, together with your records, will support each element of an expense.

Documentary evidence. You generally must have documentary evidence, such as receipts, canceled checks, or bills, to support your expenses.

Exception. Documentary evidence is not needed if any of the following conditions apply.

- You have meals or lodging expenses while traveling away from home for which you account to your employer under an accountable plan and you use a per diem allowance method that includes meals and/or lodging. (Accountable plans and per diem allowances are discussed later under *Reimbursements*.)
- Your expense, other than lodging, is less than $75.
- You have a transportation expense for which a receipt is not readily available.

Adequate evidence. Documentary evidence ordinarily will be considered adequate if it shows the amount, date, place, and essential character of the expense.

For example, a hotel receipt is enough to support expenses for business travel if it has all of the following information.

- The name and location of the hotel.
- The dates you stayed there.
- Separate amounts for charges such as lodging, meals, and telephone calls.

A restaurant receipt is enough to prove an expense for a business meal if it has all of the following information.

- The name and location of the restaurant.
- The number of people served.
- The date and amount of the expense.

If a charge is made for items other than food and beverages, the receipt must show that this is the case.

Canceled check. A canceled check, together with a bill from the payee, ordinarily establishes the cost. However, a canceled check by itself does not prove a business expense without other evidence to show that it was for a business purpose.

Duplicate information. You do not have to record information in your account book or other record that duplicates information shown on a receipt as long as your records and receipts complement each other in an orderly manner.

You do not have to record amounts your employer pays directly for any ticket or other travel item. However, if you charge these items to your employer, through a credit card or otherwise, you must keep a record of the amounts you spend.

Timely kept records. You should record the elements of an expense or of a business use at or near the time of the expense or use and support it with sufficient documentary evidence. A timely kept record has more value than a statement prepared later when generally there is a lack of accurate recall.

You do not need to write down the elements of every expense on the day of the expense. If you maintain a log on a weekly basis which accounts for use during the week, the log is considered a timely kept record.

If you give your employer, client, or customer an expense account statement, it can also be considered a timely kept record. This is true if you copy it from your account book, diary, statement of expense, or similar record.

Proving business purpose. You must generally provide a written statement of the business purpose of an expense. However, the degree of proof varies according to the circumstances in each case. If the business purpose of an expense is clear from the surrounding circumstances, then you don't need to give a written explanation.

Confidential information. You do not need to put confidential information relating to an element of a deductible expense (such as the place, business purpose, or business relationship) in your account book, diary, or other record. However, you do have to record the information elsewhere at or near the time of the expense and have it available to fully prove that element of the expense.

What If I Have Incomplete Records?

If you do not have complete records to prove an element of an expense, then you must prove the element with:

- Your own written or oral statement, containing specific information about the element; and
- Other supporting evidence that is sufficient to establish the element.

Destroyed records. If you cannot produce a receipt because of reasons beyond your control, you can prove a deduction by reconstructing your records or expenses. Reasons beyond your control include fire, flood, and other casualties.

Separating and Combining Expenses

This section explains when expenses must be kept separate and when expenses can be combined.

Separating expenses. Each separate payment is generally considered a separate expense. For example, if you travel to a business meeting and have a non-entertainment-related meal, you have two separate expenses. You must record them separately in your records.

Combining items. You can make one daily entry in your record for reasonable categories of expenses. Examples are taxi fares, telephone calls, or other incidental travel costs. Non-entertainment-related meals should be in a separate category. You can include tips for meal-related services with the costs of the meals.

Expenses of a similar nature occurring during the course of a single event are considered a single expense.

Allocating total cost. If you can prove the total cost of travel but you cannot prove how much it cost for each person who participated in the event, you may have to allocate the total cost among you and your guests on a pro rata basis. An allocation would be needed, for example, if you did not have a business relationship with all of your guests.

If your return is examined. If your return is examined, you may have to provide additional information to the IRS. This information could be needed to clarify or to establish the accuracy or reliability of information contained in your records, statements, testimony, or documentary evidence before a deduction is allowed.

HOW LONG TO KEEP RECORDS AND RECEIPTS

You must keep records as long as they may be needed for the administration of any provision of the Internal Revenue Code. Generally, this means you must keep your records that support your deduction (or an item of income) for 3 years from the date you file the income tax return on which the deduction is claimed. A return filed early is considered filed on the due date. For a more complete explanation, see Pub. 583, Starting a Business and Keeping Records.

Reimbursed for expenses. Employees who give their records and documentation to their employers and are reimbursed for their expenses generally don't have to keep copies of this information. However, you may have to prove your expenses if any of the following conditions apply.

- You claim deductions for expenses that are more than reimbursements.
- Your expenses are reimbursed under a nonaccountable plan.
- Your employer does not use adequate accounting procedures to verify expense accounts.
- You are related to your employer, as defined later under *Related to employer*.

See the next section, *How To Report*, for a discussion of reimbursements, adequate accounting, and nonaccountable plans.

VIII. HOW TO REPORT

This section explains where and how to report the expenses discussed in this chapter. It discusses reimbursements and how to treat them under accountable and nonaccountable plans. It also explains rules for independent contractors and clients, fee-basis officials, certain performing artists, Armed Forces reservists, and certain disabled employees. This section ends with an illustration of how to report travel, gift, and car expenses on Form 2106.

Self-employed. You must report your income and expenses on Schedule C (Form 1040) if you are a sole proprietor, or on Schedule F (Form 1040) if you are a farmer. You do not use Form 2106. See your form instructions for information on how to complete your tax return. You can also find information in Pub. 535 if you are a sole proprietor, or in Pub. 225, Farmer's Tax Guide, if you are a farmer.

Both self-employed and an employee. If you are both self-employed and an employee, you must keep separate records for each business activity. Report your business expenses for self-employment on Schedule C or F (Form 1040), as discussed earlier. Report your business expenses for your work as an employee on Form 2106, as discussed next.

Caution!

Form 2106 is only used by Armed Forces reservists, qualified performing artists, fee-based state or local government officials, and employees with impairment-related work expenses. Due to the suspension of miscellaneous itemized deductions subject to the 2% floor under section 67(a), employees who do not fit into one of the listed categories may not use Form 2106.

Employees. If you are an employee, you generally must complete Form 2106 to deduct your travel and transportation expenses.

For more information on how to report your expenses on Form 2106, see *Completing Form 2106*, later.

Statutory employees. If you received a Form W-2 and the "Statutory employee" box in box 13 was checked, report your income and expenses related to that income on Schedule C (Form 1040). Do not complete Form 2106.

Statutory employees include full-time life insurance salespersons, certain agent or commission drivers, traveling salespersons, and certain homeworkers.

Caution!

If you are entitled to a reimbursement from your employer but you do not claim it, you cannot claim a deduction for the expenses to which that unclaimed reimbursement applies.

Reimbursement for personal expenses. If your employer reimburses you for nondeductible personal expenses, such as for vacation trips, your employer must report the reimbursement as wage income in box 1 of your Form W-2. You cannot deduct personal expenses.

REIMBURSEMENTS

This section explains what to do when you receive an advance or are reimbursed for any of the employee business expenses discussed in this chapter.

If you received an advance, allowance, or reimbursement for your expenses, how you report this amount and your expenses depends on whether your employer reimbursed you under an accountable plan or a nonaccountable plan.

This section explains the two types of plans, how per diem and car allowances simplify proving the amount of your expenses, and the tax treatment of your reimbursements and expenses.

No reimbursement. You are not reimbursed or given an allowance for your expenses if you are paid a salary or commission with the understanding that you will pay your own expenses. In this situation, you have no reimbursement or allowance arrangement, and this section on reimbursements does not apply to you. Instead, see *Completing Form 2106*, later, for information on completing your tax return.

Reimbursement, allowance, or advance. A reimbursement or other expense allowance arrangement is a system or plan that an employer uses to pay, substantiate, and recover the expenses, advances, reimbursements, and amounts charged to the employer for employee business expenses. Arrangements include per diem and car allowances.

A per diem allowance is a fixed amount of daily reimbursement your employer gives you for your lodging, meal, and incidental expenses when you are away from home on business. (The term “incidental expenses” is defined earlier under *Meals and Incidental Expenses*.) A car allowance is an amount your employer gives you for the business use of your car.

Your employer should tell you what method of reimbursement is used and what records you must provide.

Accountable Plans

To be an accountable plan, your employer’s reimbursement or allowance arrangement must include all of the following rules.

1. Your expenses must have a business connection—that is, you must have paid or incurred deductible expenses while performing services as an employee of your employer.
2. You must adequately account to your employer for these expenses within a reasonable period of time.
3. You must return any excess reimbursement or allowance within a reasonable period of time.

See *Adequate Accounting* and *Returning Excess Reimbursements*, later.

An excess reimbursement or allowance is any amount you are paid that is more than the business-related expenses that you adequately accounted for to your employer.

Reasonable period of time. The definition of a reasonable period of time depends on the facts and circumstances of your situation. However, regardless of the facts and circumstances of your situation, actions that take place within the times specified in the following list will be treated as taking place within a reasonable period of time.

- You receive an advance within 30 days of the time you have an expense.
- You adequately account for your expenses within 60 days after they were paid or incurred.
- You return any excess reimbursement within 120 days after the expense was paid or incurred.
- You are given a periodic statement (at least quarterly) that asks you to either return or adequately account for outstanding advances and you comply within 120 days of the statement.

Employee meets accountable plan rules. If you meet the three rules for accountable plans, your employer should not include any reimbursements in your income in box 1 of your Form W-2. If your expenses equal your reimbursement, you do not complete Form 2106. You have no deduction since your expenses and reimbursement are equal.

Tip

If your employer included reimbursements in box 1 of your Form W-2 and you meet all the rules for accountable plans, ask your employer for a corrected Form W-2.

Accountable plan rules not met. Even though you are reimbursed under an accountable plan, some of your expenses may not meet all the rules. Those expenses that fail to meet all three rules for accountable plans are treated as having been reimbursed under a nonaccountable plan (discussed later).

Reimbursement of nondeductible expenses. You may be reimbursed under your employer's accountable plan for expenses related to that employer's business, some of which are deductible as employee business expenses and some of which are not deductible. The reimbursements you receive for the nondeductible expenses do not meet rule (1) for accountable plans, and they are treated as paid under a nonaccountable plan.

Example

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.

Tip

The employer makes the decision whether to reimburse employees under an accountable plan or a nonaccountable plan. If you are an employee who receives payments under a nonaccountable plan, you cannot convert these amounts to payments under an accountable plan by voluntarily accounting to your employer for the expenses and voluntarily returning excess reimbursements to the employer.

Adequate Accounting

One of the rules for an accountable plan is that you must adequately account to your employer for your expenses. You adequately account by giving your employer a statement of expense, an account book, a diary, or a similar record in which you entered each expense at or near the time you had it, along with documentary evidence (such as receipts) of your travel, mileage, and other employee business expenses. (See Table 20-2 for details you need to enter in your record and documents you need to prove certain expenses.) A per diem or car allowance satisfies the adequate accounting requirement under certain conditions. See *Per Diem and Car Allowances*, later.

You must account for all amounts you received from your employer during the year as advances, reimbursements, or allowances. This includes amounts you charged to your employer by credit card or other method. You must give your employer the same type of records and supporting information that you would have to give to the IRS if the IRS questioned a deduction on your return. You must pay back the amount of any reimbursement or other expense allowance for which you do not adequately account or that is more than the amount for which you accounted.

Per Diem and Car Allowances

If your employer reimburses you for your expenses using a per diem or car allowance, you can generally use the allowance as proof of the amount of your expenses. A per diem or car allowance satisfies the adequate accounting requirements for the amount of your expenses only if all the following conditions apply.

- Your employer reasonably limits payments of your expenses to those that are ordinary and necessary in the conduct of the trade or business.
- The allowance is similar in form to and not more than the federal rate (discussed later).

- You prove the time (dates), place, and business purpose of your expenses to your employer (as explained in Table 20-2) within a reasonable period of time.
- You are not related to your employer (as defined next). If you are related to your employer, you must be able to prove your expenses to the IRS even if you have already adequately accounted to your employer and returned any excess reimbursement.

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 for per diem amounts), you will not be considered to have accounted to your employer. In this case, you must be able to prove your expenses to the IRS.

Related to employer. You are related to your employer if:

1. Your employer is your brother or sister, half brother or half sister, spouse, ancestor, or lineal descendant;
2. Your employer is a corporation in which you own, directly or indirectly, more than 10% in value of the outstanding stock; or
3. Certain relationships (such as grantor, fiduciary, or beneficiary) exist between you, a trust, and your employer.

You may be considered to indirectly own stock, for purposes of (2), if you have an interest in a corporation, partnership, estate, or trust that owns the stock or if a member of your family or your partner owns the stock.

The federal rate. The federal rate can be figured using any one of the following methods.

1. For per diem amounts:
   a) The regular federal per diem rate.
   b) The standard meal allowance.
   c) The high-low rate.
2. For car expenses:
   a) The standard mileage rate.
   b) A fixed and variable rate (FAVR).

Tip

For per diem amounts, use the rate in effect for the area where you stop for sleep or rest.

Regular federal per diem rate. The regular federal per diem rate is the highest amount that the federal government will pay to its employees for lodging, meal, and incidental expenses (or meal and incidental expenses only) while they are traveling away from home in a particular area. The rates are different for different locations. Your employer should have these rates available. (They are also available at GSA.gov/travel/plan-book/per-diem-rates.)

The standard meal allowance. The standard meal allowance (discussed earlier) is the federal rate for meals and incidental expenses (M&IE). For travel in 2024, the rate for most small localities in the United States is $68 a day. Most major cities and many other localities qualify for higher rates. You can find this information at GSA.gov/travel/plan-book/per-diem-rates.

You receive an allowance only for meals and incidental expenses when your employer does one of the following.

- Provides you with lodging (furnishes it in kind).
- Reimburses you, based on your receipts, for the actual cost of your lodging.
- Pays the hotel, motel, etc., directly for your lodging.
- Does not have a reasonable belief that you had (or will have) lodging expenses, such as when you stay with friends or relatives or sleep in the cab of your truck.
- Figures the allowance on a basis similar to that used in figuring your compensation, such as number of hours worked or miles traveled.

High-low rate. This is a simplified method of figuring the federal per diem rate for travel within the continental United States. It eliminates the need to keep a current list of the per diem rate for each city.

Under the high-low method, the per diem amount for travel in 2024 beginning October 1 is $319 for certain high-cost locations. All other areas have a per diem amount of $225.

Prorating the standard meal allowance on partial days of travel. The standard meal allowance is for a full 24-hour day of travel. If you travel for part of a day, such as on the days you depart and return, you must prorate the full-day M&IE rate. This rule also applies if your employer uses the regular federal per diem rate or the high-low rate.

You can use either of the following methods to figure the federal M&IE for that day.

1. *Method 1*:
   a) For the day you depart, add ¾ of the standard meal allowance amount for that day.
   b) For the day you return, add ¾ of the standard meal allowance amount for the preceding day.
2. *Method 2*: Prorate the standard meal allowance using any method you consistently apply in accordance with reasonable business practice.

The standard mileage rate. This is a set rate per mile that you can use to figure your deductible car expenses. For 2024, the standard mileage rate for the cost of operating your car is 67.0 cents (0.67) per mile.

Fixed and variable rate (FAVR). This is an allowance your employer may use to reimburse your car expenses. Under this method, your employer pays an allowance that includes a combination of payments covering fixed and variable costs, such as a cents-per-mile rate to cover your variable operating costs (such as gas, oil, etc.) plus a flat amount to cover your fixed costs (such as depreciation (or lease payments), insurance, etc.). If your employer chooses to use this method, your employer will request the necessary records from you.

Reporting your expenses with a per diem or car allowance. If your reimbursement is in the form of an allowance received under an accountable plan, the following facts affect your reporting.

- The federal rate.
- Whether the allowance or your actual expenses were more than the federal rate.

The following discussions explain where to report your expenses depending upon how the amount of your allowance compares to the federal rate.

Allowance less than or equal to the federal rate. If your allowance is less than or equal to the federal rate, the allowance will not be included in box 1 of your Form W-2. You do not need to report the related expenses or the allowance on your return if your expenses are equal to or less than the allowance.

However, if your actual expenses are more than your allowance, you can complete Form 2106 and deduct the excess amount if you are an Armed Forces reservist, fee-based state or local government official, qualified performing artist, or disabled employee with impairment-related work expenses. If you are using actual expenses, you must be able to prove to the IRS the total amount of your expenses and reimbursements for the entire year. If you are using the standard meal allowance or the standard mileage rate, you don't have to prove that amount.

Example

Nicole, a fee-basis state government official, drives 10,000 miles in 2024 for business. Under her employer's accountable plan, she accounts for the time (dates), place, and business purpose of each trip. Her employer pays her a mileage allowance of 40 cents (0.40) a mile.

Since Nicole's $6,700 expense figured under the standard mileage rate (10,000 miles x 67.0 cents (0.67)) is more than her $4,000 reimbursement (10,000 miles × 40 cents (0.40)), she itemizes her deductions to claim the excess expense. Nicole completes Form 2106 (showing all her expenses and reimbursements) and enters $2,700 ($6,700 – $4,000) as an itemized deduction.

Allowance more than the federal rate. If your allowance is more than the federal rate, your employer must include the allowance amount up to the federal rate under code L in box 12 of your Form W-2. This amount is not taxable. However, the excess allowance will be included in box 1 of your Form W-2. You must report this part of your allowance as if it were wage income.

If your actual expenses are less than or equal to the federal rate, you do not complete Form 2106 or claim any of your expenses on your return.

However, if your actual expenses are more than the federal rate, you can complete Form 2106 and deduct those excess expenses. You must report on Form 2106 your reimbursements up to the federal rate (as shown under code L in box 12 of your Form W-2) and all your expenses. You should be able to prove these amounts to the IRS.

Example

Joe, a performing artist, lives and works in Austin. In May, his employer sent him to San Diego for 4 days and paid the hotel directly for Joe's hotel bill. The employer reimbursed Joe $75 a day for his meals and incidental expenses. The federal rate for San Diego is $74 a day.

Joe can prove that his actual non-entertainment-related meal expenses totaled $380. His employer's accountable plan will not pay more than $75 a day for travel to San Diego, so Joe does not give his employer the records that prove that he actually spent $380. However, he does account for the time, place, and business purpose of the trip. This is Joe's only business trip this year.

Joe was reimbursed $300 ($75 × 4 days), which is $4 more than the federal rate of $296 ($74 × 4 days). His employer includes the $4 as income on Joe's Form W-2 in box 1. His employer also enters $296 under code L in box 12 of Joe's Form W-2.

Joe completes Form 2106 to figure his deductible expenses. He enters the total of his actual expenses for the year ($380) on Form 2106. He also enters the reimbursements that were not included in his income ($296). His total deductible expense, before the 50% limit, is $84. After he figures the 50% limit on his unreimbursed meals, he will include the balance, $42, as an itemized deduction.

RETURNING EXCESS REIMBURSEMENTS

Under an accountable plan, you are required to return any excess reimbursement or other expense allowances for your business expenses to the person paying the reimbursement or allowance. Excess reimbursement means any amount for which you did not adequately account within a reasonable period of time. For example, if you received a travel advance and you did not spend all the money on business-related expenses or you do not have proof of all your expenses, you have an excess reimbursement.

For more information, see *Adequate Accounting*, earlier.

Travel advance. You receive a travel advance if your employer provides you with an expense allowance before you actually have the expense, and the allowance is reasonably expected to be no more than your expense. Under an accountable plan, you are required to adequately account to your employer for this advance and to return any excess within a reasonable period of time.

If you do not adequately account for or do not return any excess advance within a reasonable period of time, the amount you do not account for or return will be treated as having been paid under a nonaccountable plan (discussed later).

Unproven amounts. If you do not prove that you actually traveled on each day for which you received a per diem or car allowance (proving the elements described in Table 20-2), you must return this unproven amount of the travel advance within a reasonable period of time. If you do not do this, the unproven amount will be considered paid under a nonaccountable plan (discussed later).

Per diem allowance more than federal rate. If your employer's accountable plan pays you an allowance that is higher than the federal rate, you do not have to return the difference between the two rates for the period you can prove business-related travel expenses. However, the difference will be reported as wages on your Form W-2. This excess amount is considered paid under a nonaccountable plan (discussed later).

Example

Your employer sends you on a 5-day business trip to Phoenix in March 2024 and gives you a $425 ($85 × 5 days) advance to cover your meals and incidental expenses. The federal per diem for meals and incidental expenses for Phoenix is $74. Your trip lasts only 3 days. Under your employer's accountable plan, you must return the $170 ($85 × 2 days) advance for the 2 days you did not travel. For the 3 days you did travel, you do not have to return the $33 difference between the allowance you received and the federal rate for Phoenix (($85 – $74) × 3 days). However, the $33 will be reported on your Form W-2 as wages.

Nonaccountable Plans

A nonaccountable plan is a reimbursement or expense allowance arrangement that does not meet one or more of the three rules listed earlier under *Accountable Plans*.

In addition, even if your employer has an accountable plan, the following payments will be treated as being paid under a nonaccountable plan.

- Excess reimbursements you fail to return to your employer.
- Reimbursement of nondeductible expenses related to your employer's business. See *Reimbursement of nondeductible expenses* under *Accountable Plans*, earlier.

If you are not sure if the reimbursement or expense allowance arrangement is an accountable or nonaccountable plan, ask your employer.

Reporting your expenses under a nonaccountable plan. Your employer will combine the amount of any reimbursement or other expense allowance paid to you under a nonaccountable plan with your wages, salary, or other pay. Your employer will report the total in box 1 of your Form W-2.

You must be an Armed Forces reservist, fee-based state or local government official, qualified performing artist, or disabled employee with impairment-related work expenses and complete Form 2106 to deduct your expenses for travel, transportation, or meals. Your non-entertainment-related meal expenses will be subject to the 50% limit discussed earlier under *Meals and Entertainment Expenses*.

Example

Kim's employer gives her $1,000 a month ($12,000 for the year) for her business expenses. Kim does not have to provide any proof of her expenses to her employer, and Kim can keep any funds that she does not spend.

Kim, a performing artist, is being reimbursed under a nonaccountable plan. Her employer will include the $12,000 on Kim's Form W-2 as if it were wages. If Kim wants to deduct her business expenses, she must complete Form 2106 and itemize her deductions.

COMPLETING FORM 2106

This section briefly describes how employees complete Form 2106. Table 20-3 explains what the employer reports on Form W-2 and what the employee reports on Form 2106. The instructions for the forms have more information on completing them.

Caution!

If you are self-employed, do not file Form 2106. Report your expenses on Schedule C (Form 1040) or F (Form 1040). See the instructions for the form that you must file.

TABLE 20-3. REPORTING TRAVEL, NON-ENTERTAINMENT-RELATED MEAL, GIFT, AND CAR EXPENSES AND REIMBURSEMENTS

IF the type of reimbursement (or other expense allowance) arrangement is under...	THEN the employer reports on Form W-2...	AND the employee reports on Form 2106...
An accountable plan with:		
Actual expense reimbursement: Adequate accounting made and excess returned.	No amount.	No amount.
Actual expense reimbursement: Adequate accounting and return of excess both required but excess not returned.	The excess amount as wages in box 1.	No amount.
Per diem or mileage allowance up to the federal rate: Adequate accounting made and excess returned.	No amount.	All expenses and reimbursements only if excess expenses are claimed. Otherwise, form isn't filed.
Per diem or mileage allowance up to the federal rate: Adequate accounting and return of excess both required but excess not returned.	The excess amount as wages in box 1. The amount up to the federal rate is reported only in box 12—it is not reported in box 1.	No amount.
Per diem or mileage allowance exceeds the federal rate: Adequate accounting up to the federal rate only and excess not returned.	The excess amount as wages in box 1. The amount up to the federal rate is reported only in box 12—it isn't reported in box 1.	All expenses (and reimbursement reported on Form W-2, box 12) only if expenses in excess of the federal rate are claimed. Otherwise, form isn't required.
A nonaccountable plan with:		
Either adequate accounting or return of excess, or both, not required by plan	The entire amount as wages in box 1.	All expenses.
No reimbursement plan:	The entire amount as wages in box 1.	All expenses.

Car expenses. If you used a car to perform your job as an employee, you may be able to deduct certain car expenses. These are generally figured on Form 2106, Part II, and then claimed on Form 2106, Part I, line 1, column A.

Transportation expenses. Show your transportation expenses that did not involve overnight travel on Form 2106, line 2, column A. Also include on this line business expenses you have for parking fees and tolls. Do not include expenses of operating your car or expenses of commuting between your home and work.

Employee business expenses other than non-entertainment-related meals. Show your other employee business expenses on Form 2106, lines 3 and 4, column A. Do not include expenses for non-entertainment-related meals on those lines. Line 4 is for expenses such as gifts, educational expenses (tuition and books), office-in-the-home expenses, and trade and professional publications.

Non-entertainment-related meal expenses. Show the full amount of your expenses for non-entertainment-related meals on Form 2106, line 5, column B. Include meals while away from your tax home overnight and other business meals. See the *Meals Deduction From Restaurants Worksheet* in the 2023 Instructions to Form 2106 for reporting information.

"Hours of service" limits. If you are subject to the Department of Transportation's "hours of service" limits, use 80% instead of 50% for meals while away from your tax home.

Reimbursements. Enter on Form 2106, line 7, the amounts your employer (or third party) reimbursed you that were not included in box 1 of your Form W-2. This includes any reimbursement reported under code L in box 12 of Form W-2.

Allocating your reimbursement. If you were reimbursed under an accountable plan and want to deduct excess expenses that were not reimbursed, you may have to allocate your reimbursement. This is necessary if your employer pays your reimbursement in the following manner.

- Pays you a single amount that covers non-entertainment-related meals, as well as other business expenses.
- Does not clearly identify how much is for deductible non-entertainment-related meals.

You must allocate that single payment so that you know how much to enter on Form 2106, line 7, column A and column B.

Example

Rob's employer paid him an expense allowance of $12,000 this year under an accountable plan. The $12,000 payment consisted of $5,000 for airfare and $7,000 for non-entertainment-related meals and car expenses. Rob's employer did not clearly show how much of the $7,000 was for the cost of deductible non-entertainment related meals. Rob actually spent $14,000 during the year ($5,500 for airfare, $4,500 for non-entertainment-related meals, and $4,000 for car expenses).

Since the airfare allowance was clearly identified, Rob knows that $5,000 of the payment goes in column A, line 7 of Form 2106. To allocate the remaining $7,000, Rob uses the worksheet from the instructions for Form 2106. His completed worksheet follows.

Example (continued)

Reimbursement Allocation Worksheet (keep for your records)

1.	Enter the total amount of reimbursements your employer gave you that were not reported to you in box 1 of Form W-2	$7,000
2.	Enter the total amount of your expenses for the periods covered by this reimbursement ($4,500 for non-entertainment related meals and $4,000 for car expenses)	8,500
3.	Enter the part of the amount on line 2 that was your total expense for non-entertainment-related meals.	4,500
4.	Divide line 3 by line 2. Enter the result as a decimal (rounded to at least three places)	0.529
5.	Multiply line 1 by line 4. Enter the result here and in column B, line 7	3,703
6.	Subtract line 5 from line 1. Enter the result here and in column A, line 7	$3,297

On line 7 of Form 2106, Rob enters $8,297 ($5,000 airfare and $3,297 of the $7,000) in column A and $3,703 (of the $7,000) in column B.

After you complete the form. If you are a government official paid on a fee basis, a performing artist, an Armed Forces reservist, or a disabled employee with impairment-related work expenses, see *Special Rules*, later.

Limits on employee business expenses. Your employee business expenses may be subject to either of the limits described next.

These limits are figured in the following order on the specified form.

1. ***Limit on meals.*** Certain non-entertainment-related meal expenses are subject to a 50% limit. Entertainment expenses paid or incurred after 2017 are not deductible. If you are an employee, you figure the 50% limit on line 9 of Form 2106. See *50% Limit on Meals* under *Meals and Entertainment Expenses*, earlier.

2. ***Limit on total itemized deductions.*** Limitations on itemized deductions are suspended for tax years beginning after 2017, and before tax year January 2026.

SPECIAL RULES

This section discusses special rules that apply to Armed Forces reservists, government officials who are paid on a fee basis, performing artists, and disabled employees with impairment-related work expenses. For tax years beginning after 2017, they are the only taxpayers that can use Form 2106.

Armed Forces reservists traveling more than 100 miles from home. If you are a member of a reserve component of the Armed Forces of the United States and you travel more than 100 miles away from home in connection with your performance of services as a member of the reserves, you can deduct your travel expenses as an adjustment to gross income. The amount of expenses you can deduct as an adjustment to gross income is limited to the regular federal per diem rate (for lodging, meals, and incidental expenses) and the standard mileage rate (for car expenses) plus any parking fees, ferry fees, and tolls. The federal rate is explained earlier under *Per Diem and Car Allowances*. Any expenses in excess of these amounts can't be deducted.

Member of a reserve component. You are a member of a reserve component of the Armed Forces of the United States if you are in the Army, Navy, Marine Corps, Air Force, or Coast Guard Reserve, the Army National Guard of the United States, the Air National Guard of the United States, or the Reserve Corps of the Public Health Service.

How to report. If you have reserve-related travel that takes you more than 100 miles from home, you should first complete Form 2106. Then include your expenses for reserve travel over 100 miles from home, up to the federal rate, from Form 2106, line 10, in the total on Schedule 1 (Form 1040), line 12.

You cannot deduct expenses of travel that does not take you more than 100 miles from home as an adjustment to gross income.

Officials paid on a fee basis. Certain fee-basis officials can claim their employee business expenses on Form 2106.

Fee-basis officials are persons who are employed by a state or local government and who are paid in whole or in part on a fee basis. They can deduct their business expenses in performing services in that job as an adjustment to gross income.

If you are a fee-basis official, include your employee business expenses from Form 2106, line 10, on Schedule 1 (Form 1040), line 12.

Expenses of certain performing artists. If you are a performing artist, you may qualify to deduct your employee business expenses as an adjustment to gross income. To qualify, you must meet all of the following requirements.

1. During the tax year, you perform services in the performing arts as an employee for at least two employers.
2. You receive at least $200 each from any two of these employers.
3. Your related performing-arts business expenses are more than 10% of your gross income from the performance of those services.
4. Your adjusted gross income is not more than $16,000 before deducting these business expenses.

Special rules for married persons. If you are married, you must file a joint return unless you lived apart from your spouse at all times during the tax year.

If you file a joint return, you must figure requirements (1), (2), and (3) separately for both you and your spouse. However, requirement (4) applies to your and your spouse's combined adjusted gross income.

Where to report. If you meet all of the above requirements, you should first complete Form 2106. Then you include your performing-arts-related expenses from line 10 of Form 2106 in the total on Schedule 1 (Form 1040), line 12.

If you do not meet all of the above requirements, you do not qualify to deduct your expenses as an adjustment to gross income.

Impairment-related work expenses of disabled employees. If you are an employee with a physical or mental disability, you can deduct your impairment-related work expenses. After you complete Form 2106, enter your impairment-related work expenses from Form 2106, line 10, on Schedule A (Form 1040), line 16, and identify the type and amount of this expense on the line next to line 16. You cannot deduct your employee business expenses.

Impairment-related work expenses are your allowable expenses for attendant care at your workplace and other expenses you have in connection with your workplace that are necessary for you to be able to work. For more information, see Chapter 22.

CHAPTER 20: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1.	**When determining your tax home, an assignment is considered temporary if it is expected to last how long:** **A.** 6 months or less **B.** 12 months or less **C.** 18 months or less **D.** 24 months or less
2.	**If you meet the requirements to be considered an employee in the transportation industry, how much can you claim a day in standard meal allowances for travel within the continental U.S. in January 2024:** **A.** $51 **B.** $55 **C.** $69 **D.** $74
3.	**Business-related meal expenses can generally be deducted up to which limit:** **A.** 50% of the total costs **B.** 60% of the total costs **C.** 75% of the total costs **D.** 100% of the business related total costs

4.	**Which of the following is correct regarding the deductibility of gifts:** **A.** all business gifts are deductible expenses **B.** a gift to a company that is intended for the eventual personal use or benefit of a particular person is considered an indirect gift to that person **C.** if both you and your spouse give gifts, you are treated as separate taxpayers **D.** if a partnership gives gifts, it is treated separate from the partners
5.	**Generally, you must keep records and receipts that support your deduction (or an item of income) for how long:** **A.** 1 year from the date you file the income tax return on which the deduction is claimed **B.** 2 years from the date you made the purchase/expense **C.** 3 years from the date you file the income tax return on which the deduction is claimed **D.** 4 years from the date you made the purchase/expense

CHAPTER 20: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. A work assignment can last for more time than this period without affecting the taxpayer's tax home. **B.** **CORRECT**. An assignment is considered temporary if it is expected to last 12 months or less. You must determine whether your assignment is temporary or indefinite when you start work. If your assignment is temporary, your tax home does not change. **C.** Incorrect. A work assignment that is realistically expected to last more than 12 months at a single location is considered indefinite. In such a case, your tax home becomes the same as your new location. **D.** Incorrect. This time period is too long. *(See page 251 of the course material.)*
2.	**A.** Incorrect. You can actually claim more than $51 a day; you can claim a $69 a day meal allowance. **B.** Incorrect. If you meet the requirements to be considered an employee in the transportation industry, you can claim more than $55 a day standard meal allowance for travel inside the continental U.S. **C.** **CORRECT**. If you meet the requirements to be considered an employee in the transportation industry, you can claim $69 a day standard meal allowance for travel within the continental U.S. **D.** Incorrect. The standard meal allowance for travel outside of the continental U.S. is limited to $74 per day. *(See page 257 of the course material.)*
3.	**A.** **CORRECT**. The 50% limit applies to certain employees or their employers, and to self-employed persons or their clients, depending on whether the expenses are reimbursed. **B.** Incorrect. The limit of deductibility of business-related meal expenses is not 60%. **C.** Incorrect. The deductibility limit for business-related meal expenses is not 75%. **D.** Incorrect. The correct percentage is less than 100%. *(See page 262 of the course material.)*

4.	**A.** Incorrect. Gifts are limited as to deductibility. **B.** **CORRECT**. Therefore, a gift to the company cannot be deductible if a gift has already been given to the person at or above the deductible limit. **C.** Incorrect. Spouses are treated as one taxpayer. **D.** Incorrect. Partnerships and partners are treated as one taxpayer. *(See page 265 of the course material.)*
5.	**A.** Incorrect. You should generally keep records and receipts that support your deduction for longer than one year from the date you file the income tax return. **B.** Incorrect. You should generally keep records and receipts that support your deduction for longer than two years from the date you made the purchase/expense. **C.** **CORRECT**. You must keep records for as long as they may be needed for the administration of any provision of the Internal Revenue Code. Generally, you must keep your records that support your deduction (or any item of income) for three years from the date you file the income tax return on which the deduction was claimed. **D.** Incorrect. You must keep records for as long as they may be needed for the administration of any provision of the Internal Revenue Code. This is typically for three years from the date you file the income tax return on which the deduction was claimed, not four years after the purchase/expense was made. *(See page 277 of the course material.)*

PART FIVE: STANDARD DEDUCTION AND OTHER DEDUCTIONS

After you have figured your adjusted gross income, you are ready to subtract the deductions used to figure taxable income. You can subtract either the standard deduction or itemized deductions, and, if you qualify, the qualified business income deduction. Itemized deductions are deductions for certain expenses that are listed on Schedule A (Form 1040). The eight chapters in this part discuss the standard deduction and each itemized deduction. See Chapter 21 for the factors to consider when deciding whether to subtract the standard deduction or itemized deductions. See Chapter 28 for information on the new qualified business income deduction.

CHAPTER 21: STANDARD DEDUCTION

Chapter Objective

After completing this chapter, you should be able to:

- Recall the standard deduction amounts for the current year.

I. IMPORTANT CHANGES

Increase in standard deduction. The standard deduction for some taxpayers who do not itemize deductions on Schedule A of Form 1040 has been increased for all filers. The amount depends on your filing status. The 2024 standard deduction is increased to:

- Single or married separate – $14,600
- Married joint or qualifying surviving spouse – $29,200
- Head of household – $21,900

Changes to itemized deductions. For the years 2018 through 2025, your itemized deductions are no longer limited if your AGI is over a certain limit. However, your deduction for state and local income, sales, real estate, and property taxes is limited to a combined total deduction of $10,000 ($5,000 if married filing separately). Also, you can no longer deduct job-related expenses or other miscellaneous itemized deductions that were subject to the 2%-of-adjusted-gross-income floor. These changes will impact your choice of whether to take a standard deduction or to itemize deductions. There may be other changes that impact the amount of your itemized deductions.

II. INTRODUCTION

This chapter discusses:

- How to figure the amount of your standard deduction,
- The standard deduction for dependents, and
- Who should itemize deductions.

Most taxpayers have a choice of either taking a standard deduction or itemizing their deductions. If you have a choice, you can use the method that gives you the lower tax. The standard deduction is a dollar amount that reduces your taxable income. It is a benefit that eliminates the need for many taxpayers to itemize actual deductions, such as medical expenses, charitable contributions, and taxes, on Schedule A (Form 1040). The standard deduction is higher for taxpayers who:

- Are 65 or older, or
- Are blind.

Note

The additional standard deduction for age and/or blindness is $1,550 for married individuals, and $1,950 for singles and heads of household. If a taxpayer is both 65 or older and blind, he or she is eligible to double the additional amount.

Tip

You benefit from the standard deduction if your standard deduction is more than the total of your allowable itemized deductions.

Persons not eligible for the standard deduction. Your standard deduction is zero and you should itemize any deductions you have if:

- Your filing status is married filing separately, and your spouse itemizes deductions on his or her return;
- You are filing a tax return for a short tax year because of a change in your annual accounting period; or
- You are a nonresident or dual-status alien during the year. You are considered a dual-status alien if you were both a nonresident and resident alien during the year.

If you are a nonresident alien who is married to a U.S. citizen or resident alien at the end of the year, you can choose to be treated as a U.S. resident. If you make this choice, you can take the standard deduction.

Caution!

If you can be claimed as a dependent on another person's return (such as your parents' return), your standard deduction may be limited.

III. STANDARD DEDUCTION AMOUNT

The standard deduction amount depends on your filing status, whether you are 65 or older or blind, and whether another taxpayer can claim you as a dependent. Generally, the standard deduction amounts are adjusted each year for inflation.

Decedent's final return. The amount of the standard deduction for a decedent's final return is the same as it would have been had the decedent continued to live. However, if the decedent was not 65 or older at the time of death, the higher standard deduction for age cannot be claimed.

HIGHER STANDARD DEDUCTION FOR AGE (65 OR OLDER)

If you are age 65 or older on the last day of the year and do not itemize deductions, you are entitled to a higher standard deduction. You are considered 65 on the day before your 65th birthday. Therefore, you can take a higher standard deduction for 2024 if you were born before January 2, 1960.

HIGHER STANDARD DEDUCTION FOR BLINDNESS

If you are blind on the last day of the year and you do not itemize deductions, you are entitled to a higher standard deduction.

Not totally blind. If you are not totally blind, you must get a certified statement from an eye doctor (ophthalmologist or optometrist) that:

1. You cannot see better than 20/200 in the better eye with glasses or contact lenses, or
2. Your field of vision is 20 degrees or less.

If your eye condition is not likely to improve beyond these limits, the statement should include this fact. Keep the statement in your records.

If your vision can be corrected beyond these limits only by contact lenses that you can wear only briefly because of pain, infection, or ulcers, you can take the higher standard deduction for blindness if you otherwise qualify.

SPOUSE 65 OR OLDER OR BLIND

You can take the higher standard deduction if your spouse is age 65 or older or blind and:

1. You file a joint return, or
2. You file a separate return and can claim an exemption for your spouse because your spouse had no gross income and cannot be claimed as a dependent by another taxpayer.

Caution!

You cannot claim the higher standard deduction for an individual other than yourself and your spouse.

IV. STANDARD DEDUCTION FOR DEPENDENTS

The standard deduction for an individual who can be claimed as a dependent on another person's tax return is generally limited to the greater of:

- $1,300, or
- The individual's earned income for the year plus $450 (but not more than the regular standard deduction amount, generally $14,600).

However, if the individual is 65 or older or blind, the standard deduction may be higher.

CHAPTER 21: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1.	**Which of the following is correct regarding the standard deduction amount:** **A.** it is the same for all filing statuses **B.** it is the same regardless of the taxpayer's age **C.** the amount depends on the taxpayer's filing status **D.** the amount was significantly reduced by the TCJA
2.	**The standard deduction for an individual who can be claimed as a dependent on another person's tax return is generally limited to which of the following:** **A.** $1,300 **B.** the individual's earned income for the year plus $450, but not more than the regular standard deduction amount **C.** the greater of A and B above **D.** the lesser of A and B above

CHAPTER 21: SOLUTION AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. The standard deduction amount varies among the different filing statuses. **B.** Incorrect. There is an additional deduction amount for taxpayers or their spouses over age 65. **C.** **CORRECT**. The amounts vary by filing status and are set to adjust annually based on inflation. **D.** Incorrect. The TCJA significantly increased the standard deduction amounts. *(See pages 299 to 300 of the course material.)*
2.	**A.** Incorrect. This may be the limit, but there is a better answer. **B.** Incorrect. This may be the limit, but there is a better answer. **C.** **CORRECT**. If the individual is 65 or older or blind, the standard deduction may be higher. **D.** Incorrect. The limit can be higher than the lesser of these two amounts. *(See page 302 of the course material.)*

CHAPTER 22: MEDICAL AND DENTAL EXPENSES

Chapter Objective

After completing this chapter, you should be able to:

- Recognize the deductibility characteristics of medical and dental expenses.

I. IMPORTANT

Medical expense floor. In 2024, you can deduct only the part of your medical and dental expenses that exceed 7.5% of adjusted gross income (AGI).

Standard mileage rate. The standard mileage rate allowed for operating expenses for a car when you use it for medical reasons is 21.0 cents per mile for 2024.

II. INTRODUCTION

This chapter will help you determine:

- What medical expenses are,
- What expenses you can include this year,
- How much of the expenses you can deduct,
- Whose medical expenses you can include,
- What medical expenses are includible,
- How to treat reimbursements,
- How to report the deduction on your tax return,
- How to report impairment-related work expenses, and
- How to report health insurance costs if you are self-employed.

III. WHAT ARE MEDICAL EXPENSES?

Medical expenses are the costs of diagnosis, cure, mitigation, treatment, or prevention of disease, and the cost for treatments affecting any part or function of the body. These expenses include payments for legal medical services rendered by physicians, surgeons, dentists, and other medical practitioners. They include the costs of equipment, supplies, and diagnostic devices needed for these purposes.

IV. WHAT EXPENSES CAN BE INCLUDED THIS YEAR?

You can include only the medical and dental expenses you paid this year, but generally not payments for medical or dental care you will receive in a future year. If you pay medical expenses by check, the day you mail or deliver the check generally is the date of payment. If you use a “pay-by-phone” or “online” account to pay your medical expenses, the date reported on the statement of the financial institution showing when payment was made is the date of payment. You can include medical expenses you charge to your credit card in the year the charge is made, not when you actually pay the amount charged.

V. HOW MUCH OF THE EXPENSES CAN BE DEDUCTED?

Generally, you can deduct on Schedule A (Form 1040) only the amount of your medical and dental expenses that is more than 7.5% of your adjusted gross income (AGI).

VI. WHOSE MEDICAL EXPENSES CAN BE INCLUDED?

You can generally include medical expenses you pay for yourself, as well as those you pay for someone who was your spouse or your dependent either when the services were provided or when you paid for them. There are different rules for decedents and for individuals who are the subject of multiple support agreements.

Spouse. You can include medical expenses you paid for your spouse. To include these expenses, you must have been married either at the time your spouse received the medical services or at the time you paid the medical expenses.

Example 1

Mary received medical treatment before she married Bill. Bill paid for the treatment after they married. Bill can include these expenses in figuring his medical expense deduction even if Bill and Mary file separate returns.

If Mary had paid the expenses before she and Bill married, Bill could not include Mary’s expenses in his separate return. Mary would include the amounts she paid during the year in her separate return. If they filed a joint return, the medical expenses both paid during the year would be used to figure their medical expense deduction.

Example 2

This year, John paid medical expenses for his wife, Louise, who died last year. John married Belle this year, and they file a joint return. Because John was married to Louise when she received the medical services, he can include those expenses in figuring his medical expense deduction for this year.

Dependent. You can include medical expenses you paid for your dependent. To claim these expenses, the person must have been your dependent either at the time the medical services were provided or at the time you paid the expenses. A person generally qualifies as your dependent for purposes of the medical expense deduction if both of the following requirements are met:

1. The person was a qualifying child or a qualifying relative, and
2. The person was a U.S. citizen or national, or a resident of the United States, Canada, or Mexico.

You can include medical expenses you paid for an individual that would have been your dependent except that:

1. He or she received gross income of $5,050 or more in 2024;
2. He or she filed a joint return for 2024; or
3. You, or your spouse if filing jointly, could be claimed as a dependent on someone else's 2024 return.

Support claimed under a multiple support agreement. A multiple support agreement is used when two or more people provide more than half of a person's support, but no one alone provides more than half. If you are considered to have provided more than half of a qualifying relative's support under a multiple support agreement, you can include medical expenses you pay for that person.

Any medical expenses paid by others who joined you in the agreement cannot be included as medical expenses by anyone. However, you can include the entire unreimbursed amount you paid for medical expenses.

Example

You and your three brothers each provide one-fourth of your mother's total support. Under a multiple support agreement, you claim your mother as a dependent. You paid all of her medical expenses. Your brothers repaid you for three-fourths of these expenses. In figuring your medical expense deduction, you can include only one-fourth of your mother's medical expenses. Your brothers cannot include any part of the expenses. However, if you and your brothers share the nonmedical support items and you separately pay all of your mother's medical expenses, you can include the amount you paid for her medical expenses in your medical expenses.

VII. WHAT MEDICAL EXPENSES ARE INCLUDIBLE?

Use *Table 22-1* in this chapter as a guide to determine which medical and dental expenses you can include on Schedule A (Form 1040).

This table does not include all possible medical expenses. To determine if an expense not listed can be included in figuring your medical expenses, see *What Are Medical Expenses*, earlier.

TABLE 22-1. MEDICAL AND DENTAL EXPENSES CHECKLIST

You can include:	You cannot include:

• Bandages
• Birth control pills prescribed by your doctor
• Body scan
• Braille books
• Breast pump and supplies
• Capital expenses for equipment or improvements to your home needed for medical care (see the worksheet in Publication 502)
• Diagnostic devices
• Expenses of an organ donor
• Eye surgery - to promote the correct function of the eye
• Fertility enhancement, certain procedures
• Guide dogs or other animals aiding the blind, deaf, and disabled.
• Hospital services fees (lab work, therapy, nursing services, surgery, etc.)
• Lead-based paint removal
	• Baby sitting and childcare
	• Bottled water
	• Contributions to Archer MSAs (see Publication 969)
	• Diaper service
	• Expenses for your general health (even if following your doctor's advice) such as -
	  ◦ Health club dues
	  ◦ Household help (even if recommended by a doctor)
	  ◦ Social activities, such as dancing or swimming lessons
	  ◦ Trip for general health improvement
	• Flexible spending account reimbursements for medical expenses (if contributions were on a pre-tax basis)
	• Funeral, burial, or cremation expenses
	• Health savings account payments for medical expenses

You can include:	You cannot include:
• Legal abortion • Legal operation to prevent having children such as a vasectomy or tubal ligation • Long-term care contracts, qualified • Meals and lodging provided by a hospital during medical treatment • Medical services fees (from doctors, dentists, surgeons, specialists, and other medical practitioners) • Medicare Part D premiums • Medical and hospital insurance premiums • Nursing services • Oxygen equipment and oxygen • Part of life-care fee paid to retirement home designated for medical care • Physical examination • Pregnancy test kit • Prescription medicines (prescribed by a doctor) and insulin • Psychiatric and psychological treatment • Social security tax, Medicare tax, FUTA, and state employment tax for worker providing medical care (see *Wages for nursing services*, below) • Special items (artificial limbs, false teeth, eye-glasses, contact lenses, hearing aids, crutches, wheelchair, etc.) • Special education for mentally or physically disabled persons • Stop-smoking programs • Transportation for needed medical care • Treatment at a drug or alcohol center (includes meals and lodging provided by the center) • Wages for nursing services • Weight-loss, certain expenses for obesity	• Operation, treatment, or medicine that is illegal under federal or state law • Life insurance or income protection policies, or policies providing payment for loss of life, limb, sight, etc. • Maternity clothes • Medical insurance included in a car insurance policy covering all persons injured in or by your car • Medicine you buy without a prescription • Nursing care for a healthy baby • Prescription drugs you brought in (or ordered shipped) from another country, in most cases • Nutritional supplements, vitamins, herbal supplements, “natural medicines,” etc., unless recommended by a medical practitioner as a treatment for a specific medical condition diagnosed by a physician • Surgery for purely cosmetic reasons • Toothpaste, toiletries, cosmetics, etc. • Teeth whitening • Weight-loss expenses not for the treatment of obesity or other disease

INSURANCE PREMIUMS

You can include in medical expenses insurance premiums you pay for policies that cover medical care. Medical care policies can provide payment for treatment that includes:

- Hospitalization, surgical fees, X-rays,
- Prescription drugs and insulin,
- Dental care,
- Replacement of lost or damaged contact lenses, and
- Long-term care (subject to additional limitations).

If you have a policy that provides payments for other than medical care, you 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 part must be separately stated in the insurance contract or given to you in a separate statement.

Long-term care services. Contributions made by your employer to provide coverage for qualified long-term care services under a flexible spending or similar arrangement must be included in your income. This amount will be reported as wages on your Form W-2.

Health reimbursement arrangement (HRA). If you have medical expenses that are reimbursed by a health reimbursement arrangement, you cannot include those expenses in your medical expenses. This is because an HRA is funded solely by the employer.

Medicare A. If you are covered under social security (or if you are a government employee who paid Medicare tax), you are enrolled in Medicare A. The payroll tax paid for Medicare A is not a medical expense. If you are not covered under social security (or were not a government employee who paid Medicare tax), you can voluntarily enroll in Medicare A. In this situation the premiums paid for Medicare A can be included as a medical expense.

Medicare B. Medicare B is a supplemental medical insurance. Premiums you pay for Medicare B are a medical expense. Check the information you received from the Social Security Administration to find out your premium.

Medicare D. Medicare D is a voluntary prescription drug insurance program for persons with Medicare A or B. You can include as a medical expense premiums you pay for Medicare D.

MEALS AND LODGING

You can include in medical expenses the cost of meals and lodging at a hospital or similar institution if a principal reason for being there is to receive medical care.

TRANSPORTATION

Include in medical expenses amounts paid for transportation primarily for, and essential to, medical care.

You can include:

- Bus, taxi, train, or plane fares, or ambulance service,
- Transportation expenses of a parent who must go with a child who needs medical care,
- Transportation expenses of a nurse or other person who can give injections, medications, or other treatment required by a patient who is traveling to get medical care and is unable to travel alone, and
- Transportation expenses for regular visits to see a mentally ill dependent, if these visits are recommended as a part of treatment.

Car expenses. You can include out-of-pocket expenses for your car, such as gas and oil, when you use your car for medical reasons. You cannot include depreciation, insurance, general repair, or maintenance expenses.

If you do not want to use your actual expenses for 2024, you can use the standard medical mileage rate of 21.0 cents per mile.

You can also include the cost of parking fees and tolls. You can add these fees and tolls to your medical expenses whether you use actual expenses or use the standard mileage rate.

DISABLED DEPENDENT CARE EXPENSES

Some disabled dependent care expenses may qualify as either medical expenses or as work-related expenses for purposes of taking a credit for dependent care. (See chapter 31.) You can choose to apply them either way as long as you do not use the same expenses to claim both a credit and a medical expense deduction.

VIII. HOW TO TREAT REIMBURSEMENTS

You can include in medical expenses only those amounts paid during the taxable year for which you received no insurance or other reimbursement.

INSURANCE REIMBURSEMENT

You must reduce your total medical expenses for the year by all reimbursements for medical expenses that you receive from insurance or other sources during the year. This includes payments from Medicare.

Even if a policy provides reimbursement for only certain specific medical expenses, you must use amounts you receive from that policy to reduce your total medical expenses, including those it does not reimburse.

Health reimbursement arrangement (HRA). A health reimbursement arrangement is an employer-funded plan that reimburses employees for medical care expenses and allows unused amounts to be carried forward. An HRA is funded solely by the employer and the reimbursements for medical expenses, up to a maximum dollar amount for a coverage period, are not included in your income.

Premiums paid by you. If you pay either the entire premium for your medical insurance or all of the costs of a plan similar to medical insurance and your insurance payments or other reimbursements are more than your total medical expenses for the year, you have an excess reimbursement. You generally do not include an excess reimbursement in your gross income.

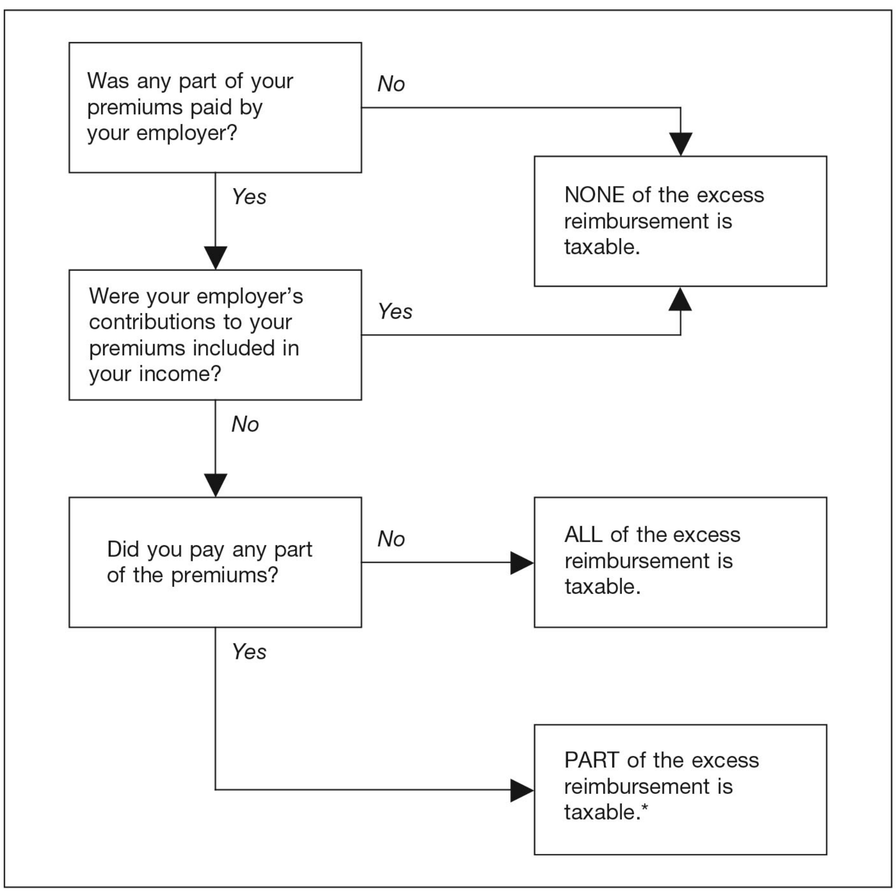
Medical expenses not deducted. If you did not deduct a medical expense in the year you paid it because your medical expenses were not more than 7.5% of your adjusted gross income, or because you did not itemize deductions, do not include the reimbursement up to the amount of the expense in income.

IX. DAMAGES FOR PERSONAL INJURIES

If you receive an amount in settlement of a personal injury suit, part of that award may be for medical expenses that you deducted in an earlier year. If it is, you must include that part in your income in the year you receive it to the extent it reduced your taxable income in the earlier year.

Future medical expenses. If you receive an amount in settlement of a damage suit for personal injuries, part of that award may be for future medical expenses. If it is, you must reduce any future medical expenses for these injuries until the amount you received has been completely used.

FIGURE 22-A. IS YOUR EXCESS MEDICAL REIMBURSEMENT TAXABLE?



**See Premiums paid by you and your employer in this chapter.*

X. HOW TO FIGURE AND REPORT DEDUCTIONS ON A TAX RETURN

Once you have determined which medical care expenses you can include, you figure and report the deduction on your tax return.

WHAT TAX FORM DO YOU USE?

You figure your medical expense deduction on Schedule A (Form 1040). If you need more information on itemized deductions, or you are not sure if you can itemize, see chapter 21.

XI. IMPAIRMENT-RELATED WORK EXPENSES (BUSINESS OR MEDICAL)

If you are a person with a disability, you can take a business deduction for expenses that are necessary for you to be able to work. If you take a business deduction for these impairment-related work expenses, they are not subject to the 7.5% limit that applies to medical expenses.

You have a disability if you have:

- A physical or mental disability (for example, blindness or deafness) that functionally limits your being employed, or
- A physical or mental impairment (for example, a sight or hearing impairment) that substantially limits one or more of your major life activities, such as performing manual tasks, walking, speaking, breathing, learning, or working.

Impairment-related expenses defined. Impairment-related expenses are those ordinary and necessary business expenses that are:

- Necessary for you to do your work satisfactorily,
- For goods or services not required or used, other than incidentally, in your personal activities, and
- Not specifically covered under other income tax laws.

XII. HEALTH INSURANCE COSTS FOR SELF-EMPLOYED PERSONS

If you were self-employed and had a net profit for the year, you may be able to deduct, as an adjustment to income, amounts paid for medical and qualified long-term care insurance on behalf of yourself, your spouse, your dependents, and your children who were under age 27 at the end of 2024.

For this purpose, you were self-employed if you were a general partner (or a limited partner receiving guaranteed payments) or you received wages from an S corporation in which you were more than a 2% shareholder.

The insurance plan must be established under your trade or business, and the deduction cannot be more than your earned income from that trade or business.

You cannot deduct payments for medical insurance for any month in which you were eligible to participate in a health plan subsidized by your employer, your spouse's employer, or an employer of your dependent child or your child under age 27 at the end of 2024. You cannot deduct payments for a qualified long-term care insurance contract for any month in which you were eligible to participate in a long-term care insurance plan subsidized by your employer or your spouse's employer.

If you qualify to take the deduction, use the Self-Employed Health Insurance Deduction Worksheet in the Form 1040 or 1040-SR instructions to figure the amount you can deduct. But if any of the following applies, do not use the worksheet.

- You had more than one source of income subject to self-employment tax.
- You file Form 2555, *Foreign Earned Income*.
- You are using amounts paid for qualified long-term care insurance to figure the deduction.

If you cannot use the worksheet in the instructions for Forms 1040 and 1040-SR, use the worksheet in Publication 535, Business Expenses, to figure your deduction.

Use Publication 974 instead of the worksheet in the Form 1040 or 1040-SR instructions if you, your spouse, or a dependent enrolled in health insurance through the Health Insurance Marketplace and you are claiming the premium tax credit.

CHAPTER 22: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1.	**In 2024, if your AGI is $60,000, you are able to deduct medical expenses you paid that are more than what amount:** **A.** $3,000 **B.** $3,750 **C.** $4,500 **D.** $6,000
2.	**Payments that can be included as a medical and dental expense deduction <u>exclude</u> which of the following:** **A.** medical and hospital insurance premiums **B.** long-term care contracts **C.** stop-smoking programs **D.** health club dues

CHAPTER 22: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. You are only able to deduct medical expenses you incurred that are more than 7.5% of your AGI. 7.5% of $60,000 is greater than $3,000. **B.** Incorrect. You are only able to deduct medical expenses that are more than 7.5% of your AGI. 7.5% of $60,000 is greater than $3,750. **C.** **CORRECT**. If your AGI is $60,000, the first $4,500 of medical expenses are not deductible, which is equal to $60,000 x 7.5%. **D.** Incorrect. You are only able to deduct medical expenses that are more than 7.5% of your AGI. 7.5% of $60,000 is less than $6,000. *(See page 306 of the course material.)*
2.	**A.** Incorrect. Payments made for medical and hospital insurance premiums are deductible expenses. **B.** Incorrect. Payments made for long-term care contracts are deductible as medical expenses in the year that the payment was made. **C.** Incorrect. Expenditures for stop-smoking programs are deductible medical expenses. **D.** **CORRECT**. Health club dues are generally not deductible medical expenses because they do not meet the test for such expenses. Specifically, medical care expenses must be primarily to alleviate or prevent a physical or mental defect or illness. *(See pages 308 to 309 of the course material.)*

CHAPTER 23: TAXES

Chapter Objective

After completing this chapter, you should be able to:

- Recognize what taxes you can deduct if you itemize deductions.

I. IMPORTANT

Limitation on deduction for state and local taxes. The Tax Cuts and Jobs Act provides for the temporary limitation of deductions for state and local taxes. See *Limitation on deduction for state and local taxes*, later.

No deduction for foreign taxes paid for real estate. You can no longer deduct foreign taxes you paid on real estate.

II. INTRODUCTION

This chapter discusses which taxes you can deduct if you itemize deductions on Schedule A (Form 1040). It also explains which taxes you can deduct on other schedules or forms and which taxes you cannot deduct.

This chapter covers:

- Income taxes (federal, state, local, and foreign),
- General sales taxes (state and local),
- Real estate taxes (state, local, and foreign),
- Personal property taxes (state and local), and
- Taxes and fees you cannot deduct.

Use *Table 23-1* as a guide to determine which taxes you can deduct.

At the end of the chapter is a section that explains which form you use to deduct the different types of taxes.

Business taxes. You can deduct certain taxes only if they are ordinary and necessary expenses of your trade or business or of producing income.

State or local taxes. These are taxes imposed by the 50 states, U.S. possessions, or any of their political subdivisions (such as a county or city), or by the District of Columbia.

Indian tribal government. An Indian tribal government that is recognized by the Secretary of the Treasury as performing substantial government functions will be treated as a state for purposes of claiming a deduction for taxes. Income taxes, real estate taxes, and personal property taxes imposed by that Indian tribal government (or by any of its subdivisions that are treated as political subdivisions of a state) are deductible.

General sales taxes. These are taxes imposed at one rate on retail sales of a broad range of classes of items.

Foreign taxes. These are taxes imposed by a foreign country or any of its political subdivisions.

III. TESTS TO DEDUCT ANY TAX

The following two tests must be met for any tax to be deductible by you.

1. The tax must be imposed on you.
2. The tax must be paid during your tax year.

The tax must be imposed on you. Generally, you can deduct only taxes that are imposed on you.

Generally, you can deduct property taxes only if you are the owner of the property. If your spouse owns property and pays real estate taxes on it, the taxes are deductible on your spouse's separate return or on your joint return.

The tax must be paid during your tax year. If you are a cash basis taxpayer, you can deduct only those taxes actually paid during your tax year. If you pay your taxes by check, the day you mail or deliver the check is generally the date of payment. If you use a pay-by-phone account (such as a credit card or electronic funds withdrawal), the date reported on the statement of the financial institution showing when payment was made is the date of payment. If you contest a tax liability and are a cash basis taxpayer, you can deduct the tax only in the year you actually pay it (or transfer money or other property to provide for satisfaction of the contested liability).

TABLE 23-1. WHICH TAXES CAN YOU DEDUCT?

Type of Tax	You Can Deduct	You Cannot Deduct
Fees and Charges	Fees and charges that are expenses of your trade or business or of producing income.	Fees and charges that are not expenses of your trade or business or of producing income, such as fees for driver's licenses, car inspections, parking, or charges for water bills. Fines and penalties.

Type of Tax	You Can Deduct	You Cannot Deduct
General Sales Taxes	State and local general sales taxes, including compensating use taxes.	State and local income taxes if you choose to deduct state and local general sales taxes.
Income Taxes	State and local income taxes. Foreign income taxes. Employee contributions to state funds listed under *Contributions to state benefit funds*.	Federal income taxes. Employee contributions to private or voluntary disability plans. State and local general sales taxes if you choose to deduct state and local income taxes.
Other Taxes	Taxes that are expenses of your trade or business. Taxes on property producing rent or royalty income. One-half of self-employment tax paid.	Federal excise taxes, such as tax on gasoline, that are not expenses of your trade or business or of producing income. Per capita taxes.
Personal Property Taxes	State and local personal property taxes.	Customs duties that are not expenses of your trade or business or of producing income
Real Estate Taxes	State and local real estate taxes. Tenant's share of real estate taxes paid by cooperative housing corporation.	Real estate taxes that are treated as imposed on someone else (see *Division of real estate taxes between buyers and sellers*). Foreign real estate taxes. Taxes for local benefits (with exceptions). Trash and garbage pick up fees (with exceptions). Rent increase due to higher real estate taxes. Homeowners' association charges.

IV. INCOME TAXES

This section discusses the deductibility of state and local income taxes (including employee contributions to state benefit funds) and foreign income taxes.

STATE AND LOCAL INCOME TAXES

You can deduct state and local income taxes.

Exception

You cannot deduct state and local income taxes you pay on income that is exempt from federal income tax, unless the exempt income is interest income. For example, you cannot deduct the part of a state's income tax that is on a cost-of-living allowance that is exempt from federal income tax.

What to Deduct

Your deduction may be for withheld taxes, estimated tax payments, or other tax payments as follows.

Withheld taxes. You can deduct state and local income taxes withheld from your salary in the year they are withheld. Your Form(s) W-2 will show these amounts. Forms W-2G, 1099-B, 1099-DIV, 1099-G, 1099-K, 1099-MISC, 1099-NEC, 1099-OID, and 1099-R may also show state and local income taxes withheld.

Estimated tax payments. You can deduct estimated tax payments you made during the year under a pay-as-you-go plan of a state or local government. However, you must have a reasonable basis for making the estimated tax payments. Any estimated state or local tax payments that are not made in good faith at the time of payment are not deductible.

Example

You made an estimated state income tax payment. However, the estimate of your state tax liability shows that you will get a refund of the full amount of your estimated payment. You had no reasonable basis to believe you had any additional liability for state income taxes and you cannot deduct the estimated tax payment.

Refund applied to taxes. You can deduct any part of a refund of prior-year state or local income taxes that you chose to have credited to your 2024 estimated state or local income taxes.

Do not reduce your deduction by either of the following items.

- Any state or local income tax refund (or credit) you expect to receive for 2024.
- Any refund of (or credit for) prior-year state and local income taxes you actually received in 2024.

However, part or all of this refund (or credit) may be taxable.

Separate federal returns. If you and your spouse file separate state, local, and federal income tax returns, you each can deduct on your federal return only the amount of your own state and local income tax that you paid during the tax year.

Joint state and local returns. If you and your spouse file joint state and local returns and separate federal returns, each of you can deduct on your separate federal return part of the state and local income taxes paid during the tax year. You can deduct only the amount of the total taxes that is proportionate to your gross income compared to the combined gross income of you and your spouse. However, you cannot deduct more than the amount you actually paid during the year. You can avoid this calculation if you and your spouse are jointly and individually liable for the full amount of the state and local income taxes. If so, you and your spouse can deduct on your separate federal returns the amount you each actually paid.

Joint federal return. If you file a joint federal return, you can deduct the total of the state and local income taxes both of you paid.

Contributions to state benefit funds. As an employee, you can deduct mandatory contributions to state benefit funds withheld from your wages that provide protection against loss of wages. Mandatory payments made to the following state benefit funds are deductible as state income taxes on Schedule A (Form 1040), line 5a.

- Alaska Unemployment Compensation Fund.
- California Nonoccupational Disability Benefit Fund.
- New Jersey Nonoccupational Disability Benefit Fund.
- New Jersey Unemployment Compensation Fund.
- New York Nonoccupational Disability Benefit Fund.
- Pennsylvania Unemployment Compensation Fund.
- Rhode Island Temporary Disability Benefit Fund.
- Washington State Supplemental Workmen's Compensation Fund.

FOREIGN INCOME TAXES

Generally, you take either a deduction or a credit for income taxes imposed on you by a foreign country or a U.S. possession. However, you cannot take a deduction or credit for foreign income taxes paid on income that is exempt from U.S. tax under the foreign earned income exclusion or the foreign housing exclusion.

V. STATE AND LOCAL GENERAL SALES TAXES

You can elect to deduct state and local general sales taxes instead of state and local income taxes, as an itemized deduction on Schedule A (Form 1040), line 5a. You can use either your actual expenses or the state and local sales tax tables to figure your sales tax deduction.

Actual expenses. Generally, you can deduct the actual state and local general sales taxes (including compensating use taxes) if the tax rate was the same as the general sales tax rate. However, sales taxes on food, clothing, medical supplies, and motor vehicles are deductible as a general sales tax even if the tax rate was less than the general sales tax rate. If you paid sales tax on a motor vehicle at a rate higher than the general sales tax rate, you can deduct only the amount of tax that you would have paid at the general sales tax rate on that vehicle. If you use the actual expenses method, you must have receipts to show the general sales taxes paid. Do not include sales taxes paid on items in your trade or business on Schedule A (Form 1040).

Optional sales tax tables. Instead of using your actual expenses, you can figure your state and local general sales tax deduction using the state and local sales tax tables in the Instructions for Schedule A (Form 1040). You may also be able to add the state and local general sales taxes paid on certain specified items.

Your applicable table amount is based on the state where you live, your income, and the number of dependents claimed on your tax return. Your income is your adjusted gross income plus any nontaxable items such as the following.

- Tax-exempt interest.
- Veterans' benefits.
- Nontaxable combat pay.
- Workers' compensation.
- Nontaxable part of social security and railroad retirement benefits.
- Nontaxable part of IRA, pension, or annuity distributions, excluding rollovers.
- Public assistance payments.

If you lived in different states during the same tax year, you must prorate your applicable table amount for each state based on the days you lived in each state. See the Instructions for Schedule A (Form 1040), line 5a, for details.

VI. STATE AND LOCAL REAL ESTATE TAXES

Deductible real estate taxes are any state and local taxes on real property levied for the general public welfare. You can deduct these taxes only if they are assessed uniformly against all property under the jurisdiction of the taxing authority. The proceeds must be for general community or governmental purposes and not be payment for a special privilege granted or service rendered to you.

Deductible real estate taxes generally do not include taxes charged for local benefits and improvements that increase the value of the property. They also do not include itemized charges for services (such as trash collection) against specific property or certain people, even if the charge is paid to the taxing authority. For more information about taxes and charges that are not deductible, see *Real Estate-Related Items You Cannot Deduct*, later.

Tenant-shareholders in a cooperative housing corporation. Generally, if you are a tenant-stockholder in a cooperative housing corporation, you can deduct the amount paid to the corporation that represents your share of the real estate taxes the corporation paid or incurred for your dwelling unit. The corporation should provide you with a statement showing your share of the taxes.

Division of real estate taxes between buyers and sellers. If you bought or sold real estate during the 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 is treated as paying the taxes up to, but not including, the date of sale. The buyer is treated as paying the taxes beginning with the date of sale. This applies regardless of the lien dates under local law. Generally, this information is included on the settlement statement provided at the closing.

If you (the seller) cannot deduct taxes until they are paid because you use the cash method of accounting, and the buyer of your property is personally liable for the tax, you are considered to have paid your part of the tax at the time of the sale. This lets you deduct the part of the tax to the date of sale even though you did not actually pay it. However, you must also include the amount of that tax in the selling price of the property. The buyer must include the same amount in his or her cost of the property.

WORKSHEET 23-1. FIGURING YOUR STATE AND LOCAL REAL ESTATE TAX DEDUCTION

You figure your deduction for taxes on each property bought or sold during the real property tax year as follows:

1.	Enter the total state and local real estate taxes for the real property tax year	________
2.	Enter the number of days in the real property tax year that you owned the property…	________
3.	Divide line 2 by 365 (for leap years, divide line 2 by 366)	________
4.	Multiple line 1 by line 3. This is your deduction. Enter it on Schedule A (Form 1040), line 5b	________

Repeat steps 1 through 4 for each property you bought or sold during the real property tax year. Your total deduction is the sum of the line 4 amounts for all of the properties.

Real estate taxes for prior years. Do not divide delinquent taxes between the buyer and seller if the taxes are for any real property tax year before the one in which the property is sold. Even if the buyer agrees to pay the delinquent taxes, the buyer cannot deduct them. The buyer must add them to the cost of the property. The seller can deduct these taxes paid by the buyer. However, the seller must include them in the selling price.

Examples. The following examples illustrate how real estate taxes are divided between buyer and seller.

Example 1

Dennis and Beth White's real property tax year for both their old home and their new home is the calendar year, with payment due August 1. The tax on their old home, sold on May 7, was $620. The tax on their new home, bought on May 3, was $732. Dennis and Beth are considered to have paid a proportionate share of the real estate taxes on the old home even though they did not actually pay them to the taxing authority. On the other hand, they can claim only a proportionate share of the taxes they paid on their new property even though they paid the entire amount.

Dennis and Beth owned their old home during the real property tax year for 126 days (January 1 to May 6, the day before the sale). They figure their deduction for taxes on their old home as follows.

Taxes on Old Home

1.	Enter the total state and local real estate taxes for the real property tax year	$620
2.	Enter the number of days in the real property tax year that you owned the property	126
3.	Divide line 2 by 365 (for leap years, divide line 2 by 366)	.3452
4.	Multiple line 1 by line 3. This is your deduction. Enter it on Schedule A (Form 1040), line 5b	$214

Since the buyers of their old home paid all of the taxes, Dennis and Beth also include the $214 in the selling price of the old home. (The buyers add the $214 to their cost of the home.)

Dennis and Beth owned their new home during the real property tax year for 243 days (May 3 to December 31, including their date of purchase). They figure their deduction for taxes on their new home as follows:

Example 1 (continued)

Taxes on New Home

1.	Enter the total state and local real estate taxes for the real property tax year	$732
2.	Enter the number of days in the real property tax year that you owned the property	243
3.	Divide line 2 by 365 (for leap years, divide line 2 by 366)	.6658
4.	Multiple line 1 by line 3. This is your deduction. Enter it on Schedule A (Form 1040), line 5b	$487

Since Dennis and Beth paid all of the taxes on the new home, they add $245 ($732 paid less $487 deduction) to their cost of the new home. (The sellers add this $245 to their selling price and deduct the $245 as a real estate tax.)

Dennis and Beth's real estate tax deduction for their old and new homes is the sum of $214 and $487, or $701. They will enter this amount on Schedule A (Form 1040), line 5b.

Example 2

George and Helen Brown bought a new home on May 3, 2024. Their real property tax year for the new home is the calendar year. Real estate taxes for 2023 were assessed in their state on January 1, 2024. The taxes became due on May 31, 2024 and October 31, 2024.

The Browns agreed to pay all taxes due after the date of purchase. Real estate taxes for 2023 were $680. They paid $340 on May 31, 2024, and $340 on October 31, 2024. These taxes were for the 2023 real property tax year. The Browns cannot deduct them since they did not own the property until 2024. Instead, they must add $680 to the cost of their new home.

In January 2025, the Browns receive their 2024 property tax statement for $752, which they will pay in 2025. The Browns owned their new home during the 2024 real property tax year for 243 days (May 3 to December 31). They will figure their 2025 deduction for taxes as follows.

Example 2 (continued)

1.	Enter the total state and local real estate taxes for the real property tax year	$752
2.	Enter the number of days in the real property tax year that you owned the property	243
3.	Divide line 2 by 365 (for leap years, divide line 2 by 366)	.6658
4.	Multiple line 1 by line 3. This is your deduction. Enter it on Schedule A (Form 1040), line 5b	$501

The remaining $251 ($752 paid less $501 deduction) of taxes paid in 2025, along with the $680 paid in 2024, is added to the cost of their new home.

Because the taxes up to the date of sale are considered paid by the seller on the date of sale, the seller is entitled to a 2024 tax deduction of $931. This is the sum of the $680 for 2023 and the $251 for the 122 days the seller owned the home in 2024. The seller must also include the $931 in the selling price when he or she figures the gain or loss on the sale. The seller should contact the Browns in January 2025 to find out how much real estate tax is due for 2024.

Form 1099-S. For certain sales or exchanges of real estate, the person responsible for closing the sale (generally the settlement agent) prepares Form 1099-S, *Proceeds From Real Estate Transactions*, to report certain information to the IRS and to the seller of the property. Box 2 of Form 1099-S is for the gross proceeds of the sale and should include the portion of the seller's real estate tax liability that the buyer will pay after the date of sale. The buyer includes these taxes in the cost basis of the property, and the seller both deducts this amount as a tax paid and includes it in the sales price of the property.

For a real estate transaction that involves a home, any real estate tax the seller paid in advance but that is the liability of the buyer appears in box 6 of Form 1099-S. The buyer deducts this amount as a real estate tax, and the seller reduces his or her real estate tax deduction (or includes it in income) by the same amount. See *Refund (or rebate)*, later.

Taxes placed in escrow. If your monthly mortgage payment includes an amount placed in escrow (put in the care of a third party) for real estate taxes, you may not be able to deduct the total amount placed in escrow. You can deduct only the real estate tax that the third party actually paid to the taxing authority. If the third party does not notify you of the amount of real estate tax that was paid for you, contact the third party or the taxing authority to find the proper amount to show on your return.

Tenants by the entirety. If you and your spouse held property as tenants by the entirety and you file separate returns, each of you can deduct only the taxes each of you paid on the property.

Divorced individuals. If your divorce or separation agreement states that you must pay the real estate taxes for a home owned by you and your spouse, part of your payments may be deductible as alimony and part as real estate taxes. See *Taxes and insurance*, in chapter 18, for more information.

Minister's and military personnel housing allowances. If you are a minister or a member of the uniformed services and receive a housing allowance that you can exclude from income, you still can deduct all of the real estate taxes you pay on your home.

Refund (or rebate). If you received a refund or rebate in 2024 of real estate taxes you paid in 2024, you must reduce your deduction by the amount refunded to you. If you received a refund or rebate in 2024 of real estate taxes you deducted in an earlier year, you generally must include the refund or rebate in income in the year you receive it. However, you only need to include the amount of the deduction that reduced your tax in the earlier year. For more information, see *Recoveries* in chapter 12.

REAL ESTATE-RELATED ITEMS YOU CANNOT DEDUCT

Payments for the following items generally are not deductible as real estate taxes.

- Taxes for local benefits.
- Itemized charges for services (such as trash and garbage pickup fees).
- Transfer taxes (or stamp taxes).
- Rent increases due to higher real estate taxes.
- Homeowners' association charges.

Taxes for local benefits. Deductible real estate taxes generally do not include taxes charged for local benefits and improvements that increase the value of your property. These include assessments for streets, sidewalks, water mains, sewer lines, public parking facilities, and similar improvements. You should increase the basis of your property by the amount of the assessment.

Local benefit taxes are deductible only if they are for maintenance, repair, or interest charges related to those benefits. If only a part of the taxes is for maintenance, repair, or interest, you must be able to show the amount of that part to claim the deduction. If you cannot determine what part of the tax is for maintenance, repair, or interest, none of it is deductible.

Taxes for local benefits may be included in your real estate tax bill. If your taxing authority (or mortgage lender) does not furnish you a copy of your real estate tax bill, ask for it. You should use the rules above to determine if the local benefit tax is deductible.

Itemized charges for services. An itemized charge for services assessed against specific property or certain people is not a tax, even if the charge is paid to the taxing authority. For example, you cannot deduct the charge as a real estate tax if it is:

- A unit fee for the delivery of a service (such as a $5 fee charged for every 1,000 gallons of water you use),

- A periodic charge for a residential service (such as a $20 per month or $240 annual fee charged to each homeowner for trash collection), or

- A flat fee charged for a single service provided by your government (such as a $30 charge for mowing your lawn because it was allowed to grow higher than permitted under your local ordinance).

Caution!

You must look at your real estate tax bill to determine if any nondeductible itemized charges, such as those listed above, are included in the bill. If your taxing authority (or mortgage lender) does not furnish you a copy of your real estate tax bill, ask for it.

Exception

Service charges used to maintain or improve services (such as trash collection or police and fire protection) are deductible as real estate taxes if:

- The fees or charges are imposed at a like rate against all property in the taxing jurisdiction,

- The funds collected are not earmarked; instead, they are commingled with general revenue funds, and

- Funds used to maintain or improve services are not limited to or determined by the amount of these fees or charges collected.

Transfer taxes (or stamp taxes). Transfer taxes and similar taxes and charges on the sale of a personal home are not deductible. If they are paid by the seller, 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.

Rent increase due to higher real estate taxes. If your landlord increases your rent in the form of a tax surcharge because of increased real estate taxes, you cannot deduct the increase as taxes.

Homeowners' association charges. These charges are not deductible because they are imposed by the homeowners' association, rather than the state or local government.

VII. PERSONAL PROPERTY TAXES

Personal property tax is deductible if it is a state or local tax that is:

1. Charged on personal property,
2. Based only on the value of the personal property, and
3. Charged on a yearly basis, even if it is collected more than once a year, or less than once a year.

A tax that meets the above requirements can be 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 even if it is called a registration fee and is for the privilege of registering motor vehicles or using them on the highways.

If the tax is partly based on value and partly based on other criteria, it may qualify in part.

Example

Your state charges a yearly motor vehicle registration tax of 1% of value plus 50 cents per hundredweight. You paid $32 based on the value ($1,500) and weight (3,400 lbs.) of your car. You can deduct $15 (1% × $1,500) as a personal property tax, since it is based on the value. The remaining $17 ($.50 × 34), based on the weight, is not deductible.

VIII. TAXES AND FEES THAT CANNOT BE DEDUCTED

Many federal, state, and local government taxes are not deductible because they do not fall within the categories discussed earlier. Other taxes and fees, such as federal income taxes, are not deductible because the tax law specifically prohibits a deduction for them.

Taxes and fees that are generally not deductible include the following items.

- ***Employment taxes.*** This includes social security, Medicare, and railroad retirement taxes withheld from your pay. However, you can take a deduction for the deductible part of self-employment tax. In addition, the social security and other employment taxes you pay on the wages of a household worker may be included in medical expenses that you can deduct or childcare expenses that allow you to claim the child and dependent care credit. For more information, see chapters 22 and 31.
- ***Estate, inheritance, legacy, or succession taxes.*** You can deduct the estate tax attributable to income in respect of a decedent if you, as a beneficiary, must include that income in your gross income. In that case, deduct the estate tax on Schedule A (Form 1040), line 16.
- ***Federal income taxes.*** This includes taxes withheld from your pay.

- ***Fines and penalties.*** You cannot deduct fines and penalties paid to a government for violation of any law, including related amounts forfeited as collateral deposits.
- ***Foreign personal or real property taxes.***
- ***Gift taxes.***
- ***License fees.*** You cannot deduct license fees for personal purposes (such as marriage, driver's, and pet license fees).
- ***Per capita taxes.*** You cannot deduct state or local per capita taxes.

Many taxes and fees other than those listed above are also nondeductible, unless they are ordinary and necessary expenses of a business or income producing activity. For other nondeductible items, see *Real Estate-Related Items You Cannot Deduct*, earlier.

IX. WHERE TO DEDUCT

You deduct taxes on the following schedules.

State and local income taxes. These taxes are deducted on Schedule A (Form 1040), line 5a even if your only source of income is from business, rents, or royalties.

Limitation on deduction for state and local taxes. The deduction for state and local taxes is limited to $10,000 ($5,000 if married filing married separately). State and local taxes are the taxes that you include on Schedule A (Form 1040), lines 5a, 5b, and 5c. Include taxes imposed by a U.S. possession with your state and local taxes on Schedule A (Form 1040), lines 5a, 5b, and 5c. However, do not include any U.S. possession taxes you paid that are allocable to excluded income.

Tip

You may want to take a credit for U.S. possession tax instead of a deduction. See the instructions for Schedule 3 (Form 1040), line 1, for details.

General sales taxes. Sales taxes are deducted on Schedule A (Form 1040), line 5a. You must check the box on line 5a. If you elect to deduct sales taxes, you cannot deduct state and local income taxes on Schedule A (Form 1040), line 5a.

Foreign income taxes. Generally, income taxes you pay to a foreign country or U.S. possession can be claimed as an itemized deduction on Schedule A (Form 1040), line 6, or as a credit against your U.S. income tax on Schedule 3 (Form 1040), line 1. To claim the credit, you may have to complete and attach Form 1116.

Real estate taxes and personal property taxes. These taxes are deducted on Schedule A (Form 1040), lines 5b and 5c, respectively, unless they are paid on property used in your business, in which case they are deducted on Schedule C (Form 1040) or Schedule F (Form 1040). Taxes on property that produces rent or royalty income are deducted on Schedule E (Form 1040).

Self-employment tax. Deduct one-half of the self-employment tax on Schedule 1 (Form 1040), line 15.

Other taxes. All other deductible taxes are deducted on Schedule A (Form 1040), line 6.

CHAPTER 23: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1.	**Which of the following income taxes are not deductible:** **A.** federal income taxes **B.** state income taxes **C.** local income taxes **D.** foreign income taxes
2.	**Which of the following taxes are generally not deductible:** **A.** federal excise taxes **B.** taxes that are expenses of your trade or business **C.** personal property taxes **D.** taxes on property producing rental income
3.	**Deductible real estate taxes generally do not include taxes charged for local benefits and improvements that increase the value of your property.** **A.** true **B.** false

CHAPTER 23: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** CORRECT. Federal income taxes paid are not deductible on federal personal income tax returns – Form 1040 or 1040-SR. **B.** Incorrect. State income taxes, among other types of taxes and fees, are deductible for federal income tax purposes up to the SALT limitation. **C.** Incorrect. Local income taxes can be deducted up to the SALT limitation. **D.** Incorrect. Foreign income taxes are generally deductible on a U.S. Form 1040 return up to the SALT limitation. This deduction assumes that foreign income taxes were paid on income that is not already exempt from U.S. tax under the foreign earned income exclusion or the foreign housing exclusion. *(See pages 318 to 319 of the course material.)*
2.	**A.** CORRECT. These would include taxes such as on gasoline that are not expenses of your trade or business or of producing income. **B.** Incorrect. Taxes that are expenses of your trade or business are deductible. **C.** Incorrect. Personal property taxes are deductible. They are lumped in with state and local taxes. **D.** Incorrect. Taxes incurred on property that produces rent or royalty income is deductible. *(See pages 318 to 319 of the course material.)*
3.	**A.** CORRECT. These include assessments for streets, sidewalks, water mains, sewer lines, public parking facilities, and similar improvements. You should increase the basis of your property by the amount of the assessment. **B.** Incorrect. Local benefit taxes are deductible only if they are for maintenance, repair, or interest charges related to those benefits. *(See page 327 of the course material.)*

CHAPTER 24: INTEREST EXPENSE

Chapter Objective

After completing this chapter, you should be able to:

- Recall what types of interest you can and cannot deduct.

I. REMINDERS

Home equity loan interest. No matter when the indebtedness was incurred, you can no longer deduct the interest from a loan secured by your home to the extent the loan proceeds were not used to buy, build, or substantially improve your home.

Home mortgage interest. You can deduct mortgage interest on the first $750,000 ($375,000 if married filing separately) of indebtedness. However, higher limitations ($1 million ($500,000 if filing separately)) apply if you are deducting mortgage interest from indebtedness incurred before December 16, 2017.

Mortgage insurance premiums. The itemized deduction for mortgage insurance premiums expired on December 31, 2021.

II. INTRODUCTION

This chapter discusses what interest expenses you can deduct. Interest is the amount you pay for the use of borrowed money.

The types of interest you can deduct as itemized deductions on Schedule A (Form 1040) are:

- Home mortgage interest, including certain points and mortgage insurance premiums, and
- Investment interest.

This chapter explains these deductions. It also explains where to deduct other types of interest and lists some types of interest you cannot deduct.

Use *Table 24-1* to find out where to get more information on various types of interest, including investment interest.

III. HOME MORTGAGE INTEREST

Generally, home mortgage interest is any interest you pay on a loan secured by your home (main home or a second home). The loan may be a mortgage to buy your home or a second mortgage.

You can deduct home mortgage interest only if you meet all the following conditions.

- You file Form 1040 or 1040-SR and itemize deductions on Schedule A (Form 1040).
- The mortgage is a secured debt on a qualified home in which you have an ownership interest. (Generally, your mortgage is a secured debt if you put your home up as collateral to protect the interests of the lender. The term “qualified home” means your main home or second home.)

Both you and the lender must intend that the loan be repaid.

AMOUNT DEDUCTIBLE

Note

Interest on home equity loans and lines of credit are deductible only if the borrowed funds are used to buy, build, or substantially improve the taxpayer’s home that secures the loan. The loan must be secured by the taxpayer’s main home or second home (qualified residence), not exceed the cost of the home, and meet other requirements.

In most cases, you will be able to deduct all of your home mortgage interest. How much you can deduct depends on the date of the mortgage, the amount of the mortgage, and how you use the mortgage proceeds.

Fully deductible interest. If all of your mortgages fit into one or more of the following three categories at all times during the year, you can deduct all of the interest on those mortgages. (If any one mortgage fits into more than one category, add the debt that fits in each category to your other debt in the same category.)

The three categories are as follows:

1. Mortgages you took out on or before October 13, 1987 (called grandfathered debt).
2. Mortgages you (or your spouse if married filing a joint return) took out after October 13, 1987, and prior to December 16, 2017 (but see binding contract exception below) to buy, build, or substantially improve your home (called home acquisition debt), but only if throughout 2024 these mortgages plus any grandfathered debt totaled $1 million or less ($500,000 or less if married filing separately).

   Exception. A taxpayer who enters into a written binding contract before December 15, 2017, to close on the purchase of a principal residence before January 1, 2018, and who purchases such residence before April 1, 2018, is considered to have incurred the home acquisition debt prior to December 16, 2017.

3. Mortgages you (or your spouse if married filing a joint return) took out after December 15, 2017, to buy, build, or substantially improve your home (called home acquisition debt), but only if throughout 2024 these mortgages plus any grandfathered debt totaled $750,000 or less ($375,000 or less if married filing separately).

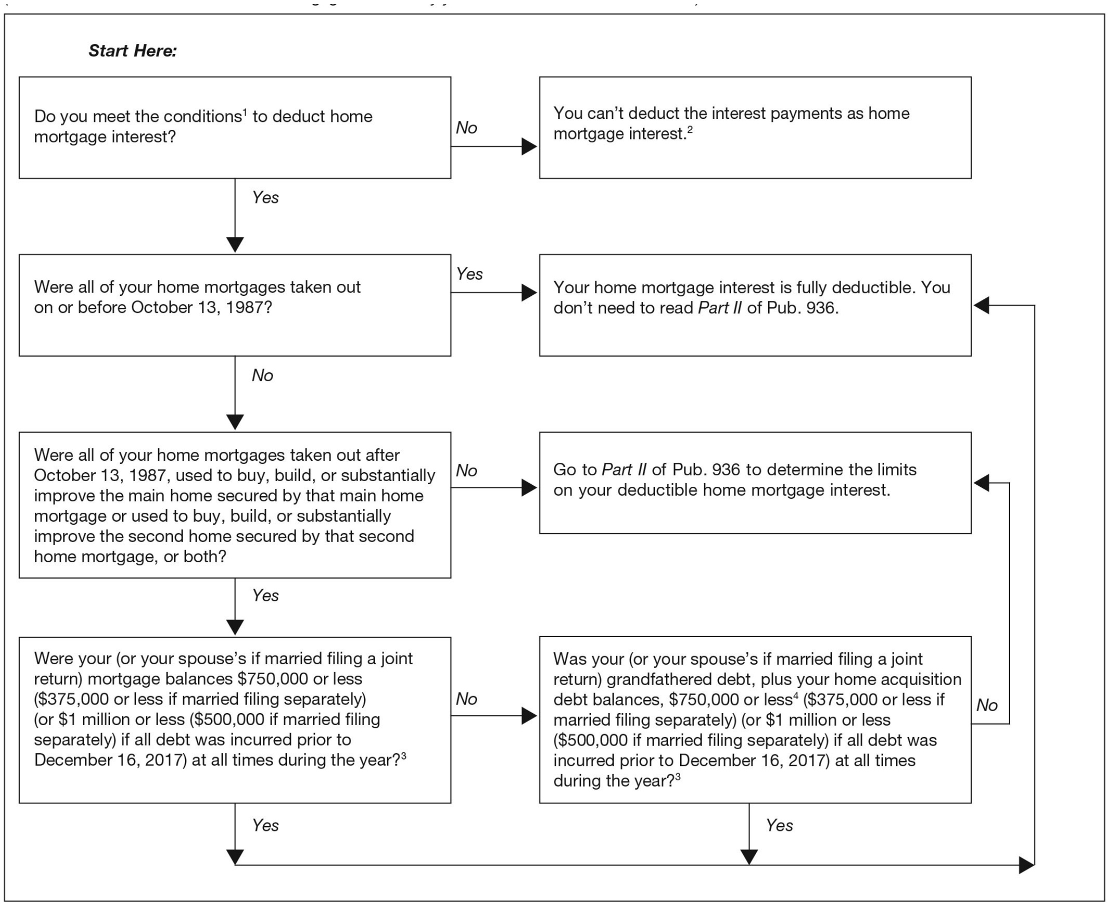
The dollar limits for the second and third categories apply to the combined mortgages on your main home and second home.

You can use *Figure 24-A* to check whether your home mortgage interest is fully deductible.

Limits on deduction. You cannot fully deduct interest on a mortgage that does not fit into any of the three categories listed above.

FIGURE 24-A. IS MY HOME MORTGAGE FULLY DEDUCTIBLE?

(Instructions: Include balances of ALL mortgages secured by your main home and second home.)



[1] You must itemize deductions on Schedule A (Form 1040 or 1040-SR). The loan must be a secured debt on a qualified home. See *Home Mortgage Interest* in *Part I* of Pub. 936.
[2] See Table 2 in *Part II* of Pub. 936 for where to deduct other types of interest payments.
[3] A taxpayer who enters into a written binding contract before December 15, 2017, to close on the purchase of a principal residence before January 1, 2018, and who purchases such residence before April 1, 2018, is considered to have incurred the home acquisition debt prior to December 16, 2017, and may use the 2017 threshold amounts of $1,000,000 ($500,000 if married filing separately).
[4] See *Part II* of Pub. 936 for more information about grandfathered debt and home acquisition debt.

Special Situations

This section describes certain items that can be included as home mortgage interest and others that cannot. It also describes certain special situations that may affect your deduction.

Late payment charge on mortgage payment. You can deduct as home mortgage interest a late payment charge if it was not for a specific service performed in connection with your mortgage loan.

Mortgage prepayment penalty. If you pay off your home mortgage early, you may have to pay a penalty. You can deduct that penalty as home mortgage interest provided the penalty is not for a specific service performed or cost incurred in connection with your mortgage loan.

Sale of home. If you sell your home, you can deduct your home mortgage interest (subject to any limits that apply) paid up to, but not including, the date of sale.

Example

John and Peggy Harris sold their home on May 7. Through April 30, they made home mortgage interest payments of $1,220. The settlement sheet for the sale of the home showed $50 interest for the 6-day period in May up to, but not including, the date of sale. Their mortgage interest deduction is $1,270 ($1,220 + $50).

Prepaid interest. If you pay interest in advance for a period that goes beyond the end of the tax year, you must spread this interest over the tax years to which it applies. You can deduct in each year only the interest that qualifies as home mortgage interest for that year. However, see *Points*, later.

Mortgage interest credit. You may be able to claim a mortgage interest credit if you were issued a mortgage credit certificate (MCC) by a state or local government. Figure the credit on Form 8396, *Mortgage Interest Credit*. If you take this credit, you must reduce your mortgage interest deduction by the amount of the credit.

Ministers' and military housing allowance. If you are a minister or a member of the uniformed services and receive a housing allowance that is not taxable, you can still deduct your home mortgage interest.

Mortgage assistance payments. If you qualify for mortgage assistance payments for lower-income families under section 235 of the National Housing Act, part or all of the interest on your mortgage may be paid for you. You cannot deduct the interest that is paid for you.

No other effect on taxes. Do not include these mortgage assistance payments in your income. Also, do not use these payments to reduce other deductions, such as real estate taxes.

Divorced or separated individuals. If a qualified pre-2019 divorce or separation agreement requires you or your spouse or former spouse to pay home mortgage interest on a home owned by both of you, the payment of interest may be alimony. See the discussion of *Payments for jointly-owned home* in chapter 18.

Redeemable ground rents. If you make annual or periodic rental payments on a redeemable ground rent, you can deduct them as mortgage interest.

Payments made to end the lease and to buy the lessor's entire interest in the land are not deductible as mortgage interest.

Nonredeemable ground rents. Payments on a nonredeemable ground rent are not mortgage interest. You can deduct them as rent if they are a business expense or if they are for rental property.

Reverse mortgages. A reverse mortgage is a loan where the lender pays you (in a lump sum, a monthly advance, a line of credit, or a combination of all three) while you continue to live in your home. With a reverse mortgage, you retain title to your home. Depending on the plan, your reverse mortgage becomes due with interest when you move, sell your home, reach the end of a pre-selected loan period, or die. Because reverse mortgages are considered loan advances and not income, the amount you receive is not taxable. Generally, any interest (including original issue discount) accrued on a reverse mortgage is considered home equity debt and is not deductible.

Rental payments. If you live in a house before final settlement on the purchase, any payments you make for that period are rent and not interest. This is true even if the settlement papers call them interest. You cannot deduct these payments as home mortgage interest.

Mortgage proceeds invested in tax-exempt securities. You cannot deduct the home mortgage interest on grandfathered debt or home equity debt if you used the proceeds of the mortgage to buy securities or certificates that produce tax-free income.

Refunds of interest. If you receive a refund of interest in the same tax year you paid it, you must reduce your interest expense by the amount refunded to you. If you receive a refund of interest you deducted in an earlier year, you generally must include the refund in income in the year you receive it. However, you need to include it only up to the amount of the deduction that reduced your tax in the earlier year. This is true whether the interest overcharge was refunded to you or was used to reduce the outstanding principal on your mortgage. If you need to include the refund in income, report it on Schedule 1 (Form 1040), line 8z.

If you received a refund of interest you overpaid in an earlier year, you generally will receive a Form 1098, *Mortgage Interest Statement,* showing the refund in box 4. For information about Form 1098, see *Mortgage Interest Statement*, later.

POINTS

The term "points" is used to describe certain charges paid, or treated as paid, by a borrower to obtain a home mortgage. Points may also be called loan origination fees, maximum loan charges, loan discount, or discount points.

A borrower is treated as paying any points that a home seller pays for the borrower's mortgage. See *Points paid by the seller*, later.

General rule. You generally cannot deduct the full amount of points in the year paid. Because they are prepaid interest, you generally must deduct them over the life (term) of the mortgage. If the loan is a home equity, line of credit, or credit card loan and the proceeds from the loan are not used to buy, build, or substantially improve the home, the points are not deductible.

Deduction Allowed in Year Paid

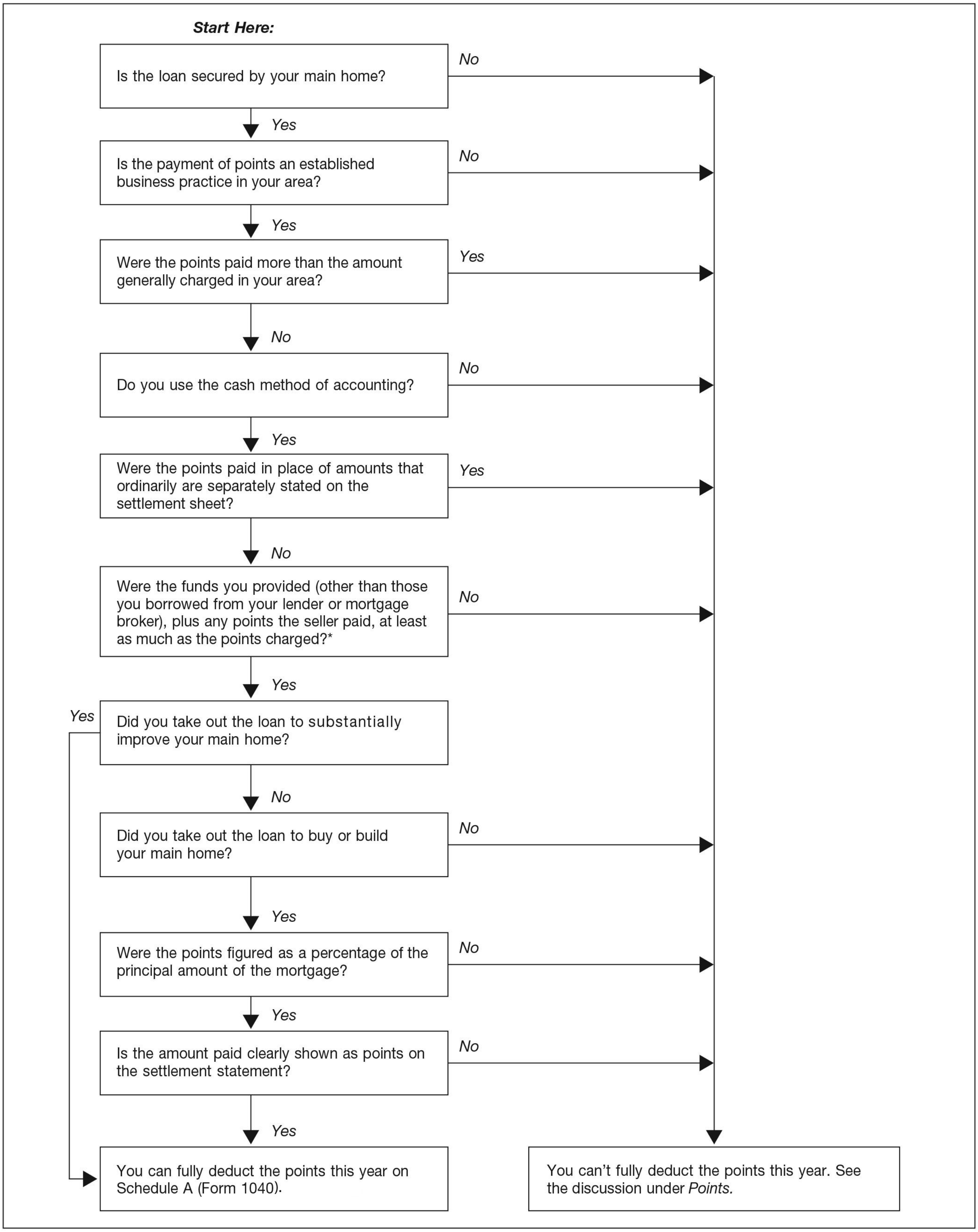
You can fully deduct points in the year paid if you meet all the following tests. (You can use *Figure 24-B* as a quick guide to see whether your points are fully deductible in the year paid.)

1. Your loan is secured by your main home. (Your main home is the one you ordinarily live 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. You use the cash method of accounting. This means you report income in the year you receive it and deduct expenses in the year you pay them.
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, attorney fees, and property taxes.
6. The funds you provided at or before closing, plus any points the seller paid, were at least as much as the points charged. The funds you provided are not required to have been applied to the points. They can include a down payment, an escrow deposit, earnest money, and other funds you paid at or before closing for any purpose. You cannot have borrowed these funds from your lender or mortgage broker.
7. You use your loan to buy or build your main home.
8. The points were figured as a percentage of the principal amount of the mortgage.
9. The amount is clearly shown on the settlement statement (such as the Uniform Settlement Statement, Form HUD-1) as points charged for the mortgage. The points may be shown as paid from either your funds or the seller's.

Note

If you meet all of these tests, you can choose to either fully deduct the points in the year paid, or deduct them over the life of the loan.

FIGURE 24-B. ARE MY POINTS FULLY DEDUCTIBLE THIS YEAR?



* The funds you provided aren't required to have been applied to the points. They can include a down payment, an escrow deposit, earnest money, and other funds you paid at or before closing for any purpose.

Home improvement loan. You can also fully deduct in the year paid points paid on a loan to improve your main home, if tests (1) through (6) are met.

Caution!

Second home. You cannot fully deduct in the year paid points you pay on loans secured by your second home. You can deduct these points only over the life of the loan.

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

However, if you use part of the refinanced mortgage proceeds to improve your main home and you meet the first six tests listed under *Deduction Allowed in Year Paid*, earlier, you can fully deduct the part of the points related to the improvement in the year you paid them with your own funds. You can deduct the rest of the points over the life of the loan.

Example 1

In 2001, Bill Fields got a mortgage to buy a home. In 2024, Bill refinanced that mortgage with a 15-year $100,000 mortgage loan. The mortgage is secured by his home. To get the new loan, he had to pay three points ($3,000). Two points ($2,000) were for prepaid interest, and one point ($1,000) was charged for services, in place of amounts that ordinarily are stated separately on the settlement statement. Bill paid the points out of his private funds, rather than out of the proceeds of the new loan. The payment of points is an established practice in the area, and the points charged are not more than the amount generally charged there. Bill's first payment on the new loan was due July 1. He made six payments on the loan in 2024 and is a cash-basis taxpayer.

Bill used the funds from the new mortgage to repay his existing mortgage. Although the new mortgage loan was for Bill's continued ownership of his main home, it was not for the purchase or improvement of that home. He cannot deduct all of the points in 2024. He can deduct two points ($2,000) ratably over the life of the loan. He deducts $67 [($2,000 ÷ 180 months) × 6 payments] of the points in 2024. The other point ($1,000) was a fee for services and is not deductible.

Example 2

The facts are the same as in *Example 1*, except that Bill used $25,000 of the loan proceeds to improve his home and $75,000 to repay his existing mortgage. Bill deducts 25% ($25,000 ÷ $100,000) of the points ($2,000) in 2024. His deduction is $500 ($2,000 × 25%).

Bill also deducts the ratable part of the remaining $1,500 ($2,000 - $500) that must be spread over the life of the loan. This is $50 [($1,500 ÷ 180 months) × 6 payments] in 2024. The total amount Bill deducts in 2023 is $550 ($500 + $50).

Deduction Allowed Ratably

If you do not meet the tests listed under *Deduction Allowed in Year Paid*, earlier, the loan is not a home improvement loan, or you choose not to deduct your points in full in the year paid, you can deduct the points ratably (equally) over the life of the loan if you meet all the following tests.

1. You use the cash method of accounting. This means you report income in the year you receive it and deduct expenses in the year you pay them. Most individuals use this method.
2. Your loan is secured by a home. (The home does not need to be your main home.)
3. Your loan period is not more than 30 years.
4. If your loan period is more than 10 years, the terms of your loan are the same as other loans offered in your area for the same or longer period.
5. Either your loan amount is $250,000 or less, or the number of points is not more than:
    a) 4, if your loan period is 15 years or less, or
    b) 6, if your loan period is more than 15 years.

Special Situations

This section describes certain special situations that may affect your deduction of points.

Original issue discount. If you do not qualify to either deduct the points in the year paid or deduct them ratably over the life of the loan, or if you choose not to use either of these methods, the points reduce the issue price of the loan. This reduction results in original issue discount.

Amounts charged for services. Amounts charged by the lender for specific services connected to the loan are not interest. Examples of these charges are:

1. Appraisal fees,
2. Notary fees,

3. Preparation costs for the mortgage note or deed of trust,
4. Mortgage insurance premiums, and
5. Department of Veterans Affairs (VA) funding fees.

You cannot deduct these amounts as points either in the year paid or over the life of the mortgage.

Points paid by the seller. The term "points" includes loan placement fees that the seller pays to the lender to arrange financing for the buyer.

Treatment by seller. The seller cannot deduct these fees as interest. But they are a selling expense that reduces the amount realized by the seller. See chapter 15 for information on the sale of your home.

Treatment by buyer. The buyer reduces the basis of the home by the amount of the seller-paid points and treats the points as if he or she had paid them. If all the tests under *Deductible Allowed in Year Paid*, earlier, are met, the buyer can deduct the points in the year paid. If any of those tests are not met, the buyer deducts the points over the life of the loan. For information about basis, see chapter 13.

Funds provided are less than points. If you meet all the tests in *Deduction Allowed in Year Paid*, earlier, except that the funds you provided were less than the points charged to you (test 6), you can deduct the points in the year paid, up to the amount of funds you provided. In addition, you can deduct any points paid by the seller.

Example 1

When you took out a $100,000 mortgage loan to buy your home in December, you were charged one point ($1,000). You meet all the tests for deducting points in the year paid, except the only funds you provided were a $750 down payment. Of the $1,000 charged for points, you can deduct $750 in the year paid. You spread the remaining $250 over the life of the mortgage.

Example 2

The facts are the same as in *Example 1*, except that the person who sold you your home also paid one point ($1,000) to help you get your mortgage. In the year paid, you can deduct $1,750 ($750 of the amount you were charged plus the $1,000 paid by the seller). You spread the remaining $250 over the life of the mortgage. You must reduce the basis of your home by the $1,000 paid by the seller.

Excess points. If you meet all the tests in *Deduction Allowed in Year Paid*, earlier, except that the points paid were more than are generally paid in your area (test 3), you deduct in the year paid only the points that are generally charged. You must spread any additional points over the life of the mortgage.

Mortgage ending early. If you spread your deduction for points over the life of the mortgage, you can deduct any remaining balance in the year the mortgage ends. However, if you refinance the mortgage with the same lender, you cannot deduct any remaining balance of spread points. Instead, deduct the remaining balance over the term of the new loan.

A mortgage may end early due to a prepayment, refinancing, foreclosure, or similar event.

Example

Dan paid $3,000 in points in 2012 that he had to spread out over the 15-year life of the mortgage. He deducts $200 of the points per year. Through 2024, Dan has deducted $2,200 of the points.

Dan prepaid his mortgage in full in 2024. He can deduct the remaining $800 of points in 2024.

Limits on deduction. You cannot fully deduct points on a mortgage unless the mortgage fits into one of the categories listed earlier under *Fully deductible interest*.

FORM 1098, MORTGAGE INTEREST STATEMENT

If you paid $600 or more of mortgage interest (including certain points) during the year on any one mortgage, you generally will receive a Form 1098, *Mortgage Interest Statement,* or a similar statement from the mortgage holder. You will receive the statement if you pay 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.

You should receive the statement for each year by January 31 of the following year. A copy of this form will also be sent to the IRS.

The statement will show the total interest you paid during the year, and if you purchased a principal residence during the year, it will also show the points paid during the year, including seller-paid points that are deductible as interest to the extent you do not exceed the home acquisition debt limit. However, it should not show any interest that was paid for you by a government agency.

As a general rule, Form 1098 will include only points that you can fully deduct in the year paid. However, it may report points that you cannot deduct, particularly if you are filing married filing separately or have mortgages for multiple properties. You must take care to deduct only those points legally allowable. Additionally, certain points not included on Form 1098 also may be deductible, either in the year paid or over the life of the loan. See *Points*, earlier, to determine whether you can deduct points not shown on Form 1098.

Prepaid interest on Form 1098. If you prepaid interest in 2024 that accrued in full by January 15, 2025, this prepaid interest may be included in box 1 of Form 1098. However, you cannot deduct the prepaid amount for January 2025 in 2024. (See *Prepaid interest*, earlier.) You will have to figure the interest that accrued for 2025 and subtract it from the amount in box 1. You will include the interest for January 2025 with the other interest you pay for 2025. See *How to Report*, later.

IV. INVESTMENT INTEREST

This section discusses the interest expenses you may be able to deduct as an investor.

If you borrow money to buy property you hold for investment, the interest you pay is investment interest. You can deduct investment interest subject to the limit discussed later. However, you cannot deduct interest you incurred to produce tax-exempt income. Nor can you deduct interest expenses on straddles.

Investment interest does not include any qualified home mortgage interest or any interest taken into account in computing income or loss from a passive activity.

INVESTMENT PROPERTY

Property held for investment includes property that produces interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business. It also includes property that produces gain or loss (not derived in the ordinary course of a trade or business) from the sale or trade of property producing these types of income or held for investment (other than an interest in a passive activity). Investment property also includes an interest in a trade or business activity in which you did not materially participate (other than a passive activity).

Partners, shareholders, and beneficiaries. To determine your investment interest, combine your share of investment interest from a partnership, S corporation, estate, or trust with your other investment interest.

ALLOCATION OF INTEREST EXPENSE

If you borrow money for business or personal purposes as well as for investment, you must allocate the debt among those purposes. Only the interest expense on the part of the debt used for investment purposes is treated as investment interest. The allocation is not affected by the use of property that secures the debt.

LIMIT ON DEDUCTION

Generally, your deduction for investment interest expense is limited to the amount of your net investment income.

You can carry over the amount of investment interest that you could not deduct because of this limit to the next tax year. The interest carried over is treated as investment interest paid or accrued in that next year.

You can carry over disallowed investment interest to the next tax year even if it is more than your taxable income in the year the interest was paid or accrued.

Net Investment Income

Determine the amount of your net investment income by subtracting your investment expenses (other than interest expense) from your investment income.

Investment income. This generally includes your gross income from property held for investment (such as interest, dividends, annuities, and royalties). Investment income does not include Alaska Permanent Fund dividends. It also does not include qualified dividends or net capital gain unless you choose to include them.

Choosing to include qualified dividends. Investment income generally does not include qualified dividends, discussed in chapter 8. However, you can choose to include all or part of your qualified dividends in investment income.

You make this choice by completing Form 4952, line 4g, according to its instructions.

If you choose to include any amount of your qualified dividends in investment income, you must reduce your qualified dividends that are eligible for the lower capital gains tax rates by the same amount.

Choosing to include net capital gain. Investment income generally does not include net capital gain from disposing of investment property (including capital gain distributions from mutual funds). However, you can choose to include all or part of your net capital gain in investment income. You make this choice by completing line 4g of Form 4952 according to its instructions.

If you choose to include any amount of your net capital gain in investment income, you must reduce your net capital gain that is eligible for the lower capital gains tax rates by the same amount.

Tip

Before making either choice, consider the overall effect on your tax liability. Compare your tax if you make one or both of these choices with your tax if you do not make either choice.

Investment income of child reported on parent's return. Investment income includes the part of your child's interest and dividend income that you choose to report on your return. If the child does not have qualified dividends, Alaska Permanent Fund dividends, or capital gain distributions, this is the amount on line 6 of Form 8814, *Parents' Election To Report Child's Interest and Dividends*. Include it on line 4a of Form 4952.

Child's qualified dividends. If part of the amount you report is your child's qualified dividends, that part (which is reported on Form 1040, line 3a) generally does not count as investment income. However, you can choose to include all or part of it in investment income, as explained under *Choosing to include qualified dividends*, earlier.

Your investment income also includes the amount on Form 8814, line 12 (or, if applicable, the reduced amount figured next under *Child's Alaska Permanent Fund dividends*).

Child's Alaska Permanent Fund dividends. If part of the amount you report is your child's Alaska Permanent Fund dividends, that part does not count as investment income. To figure the amount of your child's income that you can consider your investment income, start with the amount on Form 8814, line 6. Multiply that amount by a percentage that is equal to the Alaska Permanent Fund dividends divided by the total amount on Form 8814, line 4. Subtract the result from the amount on Form 8814, line 12.

Child's capital gain distributions. If part of the amount you report is your child's capital gain distributions, that part (which is reported on Schedule D (Form 1040), line 13, or Form 1040, line 7) generally does not count as investment income. However, you can choose to include all or part of it in investment income. Your investment income also includes the amount on line 12 of Form 8814.

Form 4952

Use Form 4952, *Investment Interest Expense Deduction*, to figure your deduction for investment interest.

Exception to use of Form 4952. You do not have to complete Form 4952 or attach it to your return if you meet all of the following tests.

- Your investment income from interest and ordinary dividends minus any qualified dividends is more than your investment interest expense.
- You have no other deductible investment expenses.
- You have no carryover of investment interest expense from 2023.

If you meet all of these tests, you can deduct all of your investment interest.

V. ITEMS YOU CANNOT DEDUCT

Some interest payments are not deductible. Certain expenses similar to interest also are not deductible. Nondeductible expenses include the following items.

- Personal interest (discussed later).
- Annual fees for credit cards.
- Loan fees.
- Credit investigation fees.
- VA funding fees.
- Interest to purchase or carry tax-exempt securities.

Penalties. You cannot deduct fines and penalties paid to a government for violations of law, regardless of their nature.

PERSONAL INTEREST

Personal interest is not deductible. Personal interest is any interest that is not home mortgage interest, investment interest, business interest, or other deductible interest. It includes the following items.

- Interest on car loans (unless you use the car for business).
- Interest on federal, state, or local income tax.
- Finance charges on credit cards, retail installment contracts, and revolving charge accounts incurred for personal expenses.
- Late payment charges by a public utility.

Tip

You may be able to deduct interest you pay on a qualified student loan.

VI. ALLOCATION OF INTEREST

If you use the proceeds of a loan for more than one purpose (for example, personal and business), you must allocate the interest on the loan to each use. However, you do not have to allocate home mortgage interest if it is fully deductible, regardless of how the funds are used.

You allocate interest (other than fully deductible home mortgage interest) on a loan in the same way as the loan itself is allocated. You do this by tracing disbursements of the debt proceeds to specific uses.

VII. HOW TO REPORT

You must file Form 1040 or 1040-SR to deduct any home mortgage interest expense on your tax return. Where you deduct your interest expense generally depends on how you use the loan proceeds. See *Table 24-1* for a summary of where to deduct your interest expense.

TABLE 24-1. WHERE TO DEDUCT YOUR INTEREST EXPENSE

IF you have...	THEN deduct it on...
Deductible student loan interest	Schedule 1 (Form 1040), line 21
Deductible home mortgage interest and points reported on Form 1098	Schedule A (Form 1040), line 8a
Deductible home mortgage interest not reported on Form 1098	Schedule A (Form 1040), line 8b
Deductible points not reported on Form 1098	Schedule A (Form 1040), line 8c
Deductible investment interest (other than interest incurred to produce rents or royalties)	Schedule A (Form 1040), line 9
Deductible business interest (non-farm)	Schedule C (Form 1040)
Deductible farm business interest	Schedule F (Form 1040)
Deductible interest incurred to produce rents or royalties	Schedule E (Form 1040)
Personal interest	Not Deductible

Home mortgage interest and points. Generally, you can deduct the home mortgage interest and points reported to you on Form 1098 on Schedule A (Form 1040), line 8a. However, any interest showing in box 1 of Form 1098 from a home equity loan, or a line of credit or credit card loan secured by the property is not deductible if the proceeds were not used to buy, build, or substantially improve a qualified home. If you paid more deductible interest to the financial institution than the amount shown on Form 1098, show the portion of the deductible interest that was omitted from Form 1098 on line 8b. Attach a statement explaining the difference and enter "See attached" next to line 8b.

If you can take a deduction for points that were not reported to you on Form 1098, deduct those points on line 8c of Schedule A (Form 1040).

More than one borrower. If you and at least one other person (other than your spouse if you file a joint return) were liable for and paid interest on a mortgage that was for your home, and the other person received a Form 1098 showing the interest that was paid during the year, attach a statement to your return explaining this. Show how much of the interest each of you paid, and give the name and address of the person who received the form. Deduct your share of the interest on Schedule A (Form 1040), line 8b, and enter "See attached" next to the line.

Similarly, if you are the payer of record on a mortgage on which there are other borrowers entitled to a deduction for the interest shown on the Form 1098 you received, deduct only your share of the interest on Schedule A (Form 1040), line 8a. You should let each of the other borrowers know what his or her share is.

Mortgage proceeds used for business. If your home mortgage interest deduction is limited but all or part of the mortgage proceeds were used for business or other deductible activities, see *Table 24-1*. It shows where to deduct the part of your excess interest that is for those activities.

Investment interest. Deduct investment interest, subject to certain limits, on Schedule A (Form 1040), line 9.

Amortization of bond premium. There are various ways to treat the premium you pay to buy taxable bonds.

Income-producing rental or royalty interest. Deduct interest on a loan for income-producing rental or royalty property that is not used in your business in Part I of Schedule E (Form 1040).

Example

You rent out part of your home and borrow money to make repairs. You can deduct only the interest payment for the rented part in Part I of Schedule E (Form 1040). Deduct the rest of the interest payment on Schedule A (Form 1040) if it is deductible home mortgage interest.

CHAPTER 24: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1. **Home mortgage interest is fully deductible if all of the following conditions are met except:**

A. you file Form 1040 or 1040-SR and itemize deductions on Schedule A

B. both you and the lender must intend that the loan be repaid

C. the mortgage must be a secured debt on a qualified home

D. the mortgage(s) have a combined balance exceeding $1 million

2. **Why are points paid to obtain a home mortgage generally not deductible in the year paid:**

A. because points are not an established business practice

B. because points are not computed as a percentage of the principal amount of the mortgage

C. because points are listed on the Uniform Settlement Statement

D. because points are prepaid interest and should be deducted over the life of the mortgage

3. **Generally, what is your deduction for investment interest expense limited to:**

A. your AGI

B. your taxable income

C. your net investment income

D. your net capital gain

CHAPTER 24: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. You may be able to fully deduct home mortgage interest if certain conditions are met. Filing Form 1040 or 1040-SR with itemized deductions is one of the necessary conditions. **B.** Incorrect. The condition of intention of repayment for the home mortgage loan is a necessary condition for claiming the home mortgage interest deduction. **C.** Incorrect. The mortgage producing the intended interest expense to be deducted must be secured by a qualified home. **D.** **CORRECT**. Mortgage interest paid resulting from mortgage balances exceeding $1 million ($500,000 for married filing separately) do not qualify for full deductibility. The $1 million was lowered to $750,000 ($375,000 for married filing separately) for new mortgages taken out after December 15, 2017. *(See pages 336 to 337 of the course material.)*
2.	**A.** Incorrect. The deductibility of points is not directly related to a local business practice. **B.** Incorrect. Points are computed as a percentage of the principal amount of the borrowed funds, or mortgage. This calculation however has no relationship to the deductibility of these costs on a federal tax return. **C.** Incorrect. The listing of "points" on a standard closing statement (Form HUD-1) has no connection to their deductibility. **D.** **CORRECT**. The general rule is that points represent prepaid interest and therefore must be claimed over the life of the mortgage. However, a nine-point exception test exists that upon meeting all such conditions will allow a taxpayer to fully deduct all points paid in the same year as they were paid. *(See pages 339 to 340 of the course material.)*

3.	**A.** Incorrect. Generally, your deduction for investment interest expense is not limited to the amount of your AGI, but rather your net investment income. **B.** Incorrect. Generally, your deduction for investment interest expense is not limited to the amount of your taxable income, but rather your net investment income. **C.** **CORRECT**. Your deduction for investment interest expense is limited to the amount of your net investment income. You can carry over the amount of investment interest that you could not deduct in the current year because of this limit to the next tax year. **D.** Incorrect. Generally, your deduction for investment interest expense is not limited to t he amount of your net capital gain, but rather your net investment income. *(See page 346 of the course material.)*

CHAPTER 25: CONTRIBUTIONS

Chapter Objective

After completing this chapter, you should be able to:

- Recall the types of charitable contributions you can deduct and the records you should keep.

I. INTRODUCTION

This chapter explains how to claim a deduction for your charitable contributions. It discusses:

- The types of organizations to which you can make deductible charitable contributions,
- The types of contributions you can deduct,
- How much you can deduct,
- What records to keep, and
- How to report your charitable contributions.

A charitable contribution is a donation or gift to, or for the use of, a qualified organization. It is voluntary and is made without getting, or expecting to get, anything of equal value.

Schedule A (Form 1040) required. To deduct a charitable contribution, you must itemize deductions on Schedule A (Form 1040). The amount of your deduction may be limited if certain rules and limits explained in this chapter apply to you.

II. ORGANIZATIONS THAT QUALIFY TO RECEIVE DEDUCTIBLE CONTRIBUTIONS

You can deduct your contributions only if you make them to a qualified organization. Most organizations, other than churches and governments, must apply to the IRS to become a qualified organization.

TYPES OF QUALIFIED ORGANIZATIONS

Generally, only the following types of organizations can be qualified organizations.

1. 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 (including Puerto Rico). It must, however, be organized and operated only for charitable, religious, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals. Certain organizations that foster national or international amateur sports competition also qualify.

2. War veterans' organizations, including posts, auxiliaries, trusts, or foundations, organized in the United States or any of its possessions (including Puerto Rico).
3. Domestic fraternal societies, orders, and associations operating under the lodge system.
4. Certain nonprofit cemetery companies or corporations.
5. The United States or any state, the District of Columbia, a U.S. possession (including Puerto Rico), a political subdivision of a state or U.S. possession, or an Indian tribal government or any of its subdivisions that perform substantial government functions.

Qualified organizations include:

- Churches, a convention or association of churches, temples, synagogues, mosques, and other religious organizations.
- Most nonprofit charitable organizations such as the American Red Cross and the United Way.
- Most nonprofit educational organizations, including the Boy Scouts of America, Girl Scouts of America, colleges, and museums. This also includes nonprofit daycare centers that provide childcare to the general public if substantially all the childcare is provided to enable parents and guardians to be gainfully employed. However, if your contribution is a substitute for tuition or other enrollment fee, it is not deductible as a charitable contribution, as explained later under *Contributions You Cannot Deduct.*
- Nonprofit hospitals and medical research organizations.
- Utility company emergency energy programs, if the utility company is an agent for a charitable organization that assists individuals with emergency energy needs.
- Nonprofit volunteer fire companies.
- Nonprofit organizations that develop and maintain public parks and recreation facilities.
- Civil defense organizations.

III. CONTRIBUTIONS YOU CAN DEDUCT

Generally, you can deduct your contributions of money or property that you make to, or for the use of, a qualified organization. A contribution is "for the use of" a qualified organization when it is held in a legally enforceable trust for the qualified organization or in a similar legal arrangement. The contributions must be made to a qualified organization and not set aside for use by a specific person.

If you give property to a qualified organization, you generally can deduct the fair market value of the property at the time of the contribution. See *Contributions of Property*, later in this chapter.

Your deduction for charitable contributions generally cannot be more than 60% of your adjusted gross income, but in some cases 20%, 30%, or 50% limits may apply.

Table 25-1 lists some examples of contributions you can deduct and some that you cannot deduct.

TABLE 25-1. EXAMPLES OF CHARITABLE CONTRIBUTIONS – A QUICK CHECK

Use the following lists for a quick check of contributions you can or cannot deduct. See the rest of this chapter for more information and additional rules and limits that may apply.

Deductible as Charitable Contributions	Not Deductible as Charitable Contributions
Money or property you give to: • Churches, synagogues, temples, mosques, and other religious organizations • Federal, state and local governments, if your contribution is solely for public purposes (for example, a gift to reduce the public debt or maintain a public park) • Nonprofit schools and hospitals • Salvation Army, American Red Cross, CARE, Goodwill Industries, United Way, Boy Scouts of America, Girl Scouts of America, Boys and Girls Clubs of America, etc. • War veterans groups Expenses paid for a student living with you, sponsored by a qualified organization Out-of-pocket expenses when you serve a qualified organization as a volunteer	Money or property you give to: • Civic leagues, social and sports clubs, labor unions, and chambers of commerce • Foreign organizations (except certain Canadian, Israeli, and Mexican charities) • Groups that are run for personal profit • Groups whose purpose is to lobby for law changes • Homeowners' associations • Individuals • Political groups or candidates for public office Cost of raffle, bingo, or lottery tickets Dues, fees, or bills paid to country clubs, lodges, fraternal orders, or similar groups Tuition Value of your time or services Value of blood given to a blood bank

CONTRIBUTIONS FROM WHICH YOU BENEFIT

If you receive a benefit as a result of making a contribution to a qualified organization, you can deduct only the amount of your contribution that is more than the value of the benefit you receive.

If you pay more than fair market value to a qualified organization for goods or services, the excess may be a charitable contribution. For the excess amount to qualify, you must pay it with the intent to make a charitable contribution.

Example 1

You pay $65 for a ticket to a dinner dance at a church. Your entire $65 payment goes to the church. The ticket to the dinner-dance has a fair market value of $25. When you buy your ticket, you know that its value is less than your payment. To figure the amount of your charitable contribution, you subtract the value of the benefit you receive ($25) from your total payment ($65). You can deduct $40 as a contribution to the church.

Example 2

At a fundraising auction conducted by a charity, you pay $600 for a week's stay at a beach house. The amount you pay is no more than the fair rental value. You have not made a deductible charitable contribution.

Charity benefit events. If you pay a qualified organization more than fair market value for the right to attend a charity ball, banquet, show, sporting event, or other benefit event, you can deduct only the amount that is more than the value of the privileges or other benefits you receive.

If there is an established charge for the event, that charge is the value of your benefit. If there is no established charge, the reasonable value of the right to attend the event is the value of your benefit. Whether you use the tickets or other privileges has no effect on the amount you can deduct. However, if you return the ticket to the qualified organization for resale, you can deduct the entire amount you paid for the ticket.

Example

You pay $40 to see a special showing of a movie for the benefit of a qualified organization. Printed on the ticket is "Contribution – $40." If the regular price for the movie is $8, your contribution is $32 ($40 payment - $8 regular price).

State or local tax credit or deduction. If you receive or expect to receive a state or local tax credit or a state or local tax deduction for a charitable contribution, then the amount treated as a charitable deduction may be reduced.

Membership fees or dues. You may be able to deduct membership fees or dues you pay to a qualified organization. However, you can deduct only the amount that is more than the value of the benefits you receive. You cannot deduct dues, fees, or assessments paid to country clubs and other social organizations. They are not qualified organizations.

Certain membership benefits can be disregarded. Both you and the organization can disregard the following membership benefits if you receive them in return for an annual payment of $75 or less:

1. Any rights or privileges that you can use frequently while you are a member, such as:
    a) Free or discounted admission to the organization's facilities or events,
    b) Free or discounted parking,
    c) Preferred access to goods or services, and
    d) Discounts on the purchase of goods and services.
2. Admission, while you are a member, to events that are open only to members of the organization, if the organization reasonably projects that the cost per person (excluding any allocated overhead) is not more than $12.50.

Token items. You do not have to reduce your contribution by the value of any benefit you receive if both of the following are true.

1. You receive only a small item or other benefit of token value.
2. The qualified organization correctly determines that the value of the item or benefit you received is not substantial and informs you that you can deduct your payment in full.

Written statement. A qualified organization must give you a written statement if you make a payment of more than $75 that is partly for goods or services. The statement must say that you can deduct only the amount of your payment that is more than the value of the goods or services you received. It must also give you a good faith estimate of the value of those goods or services.

The organization can give you the statement either when it solicits or when it receives the payment from you.

Exception

An organization will not have to give you this statement if one of the following is true.

1. The organization is:
    - A governmental organization described in (5) under *Types of Qualified Organizations*, earlier, or
    - An organization formed only for religious purposes, and the only benefit you receive is an intangible religious benefit (such as admission to a religious ceremony) that generally is not sold in commercial transactions outside the donative context.
2. You receive only items whose value is not substantial. See *Token items*, earlier.
3. You receive only membership benefits that can be disregarded, as described earlier.

EXPENSES PAID FOR STUDENT LIVING WITH YOU

You may be able to deduct some expenses of having a student live with you. You can deduct qualifying expenses for a foreign or American student who:

1. Lives in your home under a written agreement between you and a qualified organization as part of a program of the organization to provide educational opportunities for the student,
2. Is not your dependent or relative, and
3. Is a full-time student in the twelfth or any lower grade at a school in the United States.

You can deduct up to $50 a month for each full calendar month the student lives with you. Any month when conditions (1) through (3) above are not met for 15 days or more counts as a full month.

Mutual exchange program. You cannot deduct the costs of a foreign student living in your home under a mutual exchange program through which your child will live with a family in a foreign country.

OUT-OF-POCKET EXPENSES IN GIVING SERVICES

Although you cannot deduct the value of your services given to a qualified organization, you may be able to deduct some amounts you pay in giving services to a qualified organization. The amounts must be:

- Unreimbursed,
- Directly connected with the services,
- Expenses you had only because of the services you gave, and
- Not personal, living, or family expenses.

Table 25-2 contains questions and answers that apply to some individuals who volunteer their services.

TABLE 25-2. VOLUNTEERS' QUESTIONS AND ANSWERS

If you volunteer for a qualified organization, the following questions and answers may apply to you. All of the rules explained in this chapter also apply. See, in particular, *Out-of-Pocket Expenses in Giving Services*.

Question	Answer
I volunteer 6 hours a week in the office of a qualified organization. The receptionist is paid $10 an hour to do the same work I do. Can I deduct $60 a week for my time?	No, you cannot deduct the value of your time or services.

Question	Answer
The office is 30 miles from my home. Can I deduct any of my car expenses for these trips?	Yes, you can deduct the costs of gas and oil that are directly related to getting to and from the place where you are a volunteer. If you don't want to figure your actual costs, you can deduct 14 cents for each mile.
I volunteer as a Red Cross nurse's aide at a hospital. Can I deduct the cost of uniforms that I must wear?	Yes, you can deduct the cost of buying and cleaning your uniforms if the hospital is a qualified organization, the uniforms are not suitable for everyday use, and you must wear them when volunteering.
I pay a babysitter to watch my children while I do volunteer work for a qualified organization. Can I deduct these costs?	No, you cannot deduct payments for child care expenses as a charitable contribution, even if they are necessary so you can do volunteer work for a qualified organization. (If you have child care expenses so you can work for pay, see chapter 31.)

Conventions. If a qualified organization selects you to attend a convention as its representative, you can deduct unreimbursed expenses for travel, including a reasonable amount for meals and lodging, while away from home overnight in connection with the convention. However, see *Travel*, later.

You cannot deduct personal expenses for sightseeing, fishing parties, theater tickets, or nightclubs. You also cannot deduct transportation, meals and lodging, and other expenses for your spouse or children.

You cannot deduct your expenses in attending a church convention if you go only as a member of your church rather than as a chosen representative. You can deduct unreimbursed expenses that are directly connected with giving services for your church during the convention.

Uniforms. You can deduct the cost and upkeep of uniforms that are not suitable for everyday use and that you must wear while performing donated services for a charitable organization.

Foster parents. You may be able to deduct as a charitable contribution some of the costs of being a foster parent (foster care provider) if you have no profit motive in providing the foster care and are not, in fact, making a profit. A qualified organization must designate the individuals you take into your home for foster care.

You can deduct expenses that meet both of the following requirements.

1. They are unreimbursed out-of-pocket expenses to feed, clothe, and care for the foster child.
2. They are incurred primarily to benefit the qualified organization.

Unreimbursed expenses that you cannot deduct as charitable contributions may be considered support provided by you in determining whether you can claim the foster child as a dependent. For details, see chapter 3.

Example

You cared for a foster child because you wanted to adopt her, not to benefit the agency that placed her in your home. Your unreimbursed expenses are not deductible as charitable contributions.

Car expenses. You can deduct as a charitable contribution any unreimbursed out-of-pocket expenses, such as the cost of gas and oil, that are directly related to the use of your car in giving services to a charitable organization. You cannot deduct any part of general repair and maintenance expenses, depreciation, registration fees, or the costs of tires or insurance.

If you do not want to deduct your actual expenses, you can use a standard mileage rate of 14 cents a mile to figure your contribution.

You can deduct parking fees and tolls whether you use your actual expenses or the standard mileage rate.

You must keep reliable written records of your car expenses. For more information, see *Car expenses* under *Records to Keep*, later.

Travel. Generally, you can claim a charitable contribution deduction for travel expenses necessarily incurred while you are away from home performing services for a charitable organization only if there is no significant element of personal pleasure, recreation, or vacation in the travel. This applies whether you pay the expenses directly or indirectly. You are paying the expenses indirectly if you make a payment to the charitable organization and the organization pays for your travel expenses.

The deduction for travel expenses will not be denied simply because you enjoy providing services to the charitable organization. Even if you enjoy the trip, you can take a charitable contribution deduction for your travel expenses if you are on duty in a genuine and substantial sense throughout the trip. However, if you have only nominal duties, or if for significant parts of the trip you do not have any duties, you cannot deduct your travel expenses.

Example 1

You are a troop leader for a tax-exempt youth group and take the group on a camping trip. You are responsible for overseeing the setup of the camp and for providing the adult supervision for the other activities during the entire trip. You participate in the activities of the group and really enjoy your time with them. You oversee the breaking of camp and you transport the group home. You can deduct your travel expenses.

Example 2

You sail from one island to another and spend 8 hours a day counting whales and other forms of marine life. The project is sponsored by a charitable organization. In most circumstances, you cannot deduct your expenses.

Example 3

You work for several hours each morning on an archaeological dig sponsored by a charitable organization. The rest of the day is free for recreation and sightseeing. You cannot take a charitable contribution deduction even though you work very hard during those few hours.

Example 4

You spend the entire day attending a charitable organization's regional meeting as a chosen representative. In the evening you go to the theater. You can claim your travel expenses as charitable contributions, but you cannot claim the cost of your evening at the theater.

Daily allowance (per diem). If you provide services for a charitable organization and receive a daily allowance to cover reasonable travel expenses, including meals and lodging while away from home overnight, you must include in income the amount of the allowance that is more than your deductible travel expenses. You may be able to deduct any necessary travel expenses that are more than the allowance.

Deductible travel expenses. These include:

- Air, rail, and bus transportation,
- Out-of-pocket expenses for your car,
- Taxi fares or other costs of transportation between the airport or station and your hotel,
- Lodging costs, and
- The cost of meals.

Because these travel expenses are not business related, they are not subject to the same limits as business-related expenses. For information on business travel expenses, see *Travel Expenses* in chapter 20.

IV. CONTRIBUTIONS YOU CANNOT DEDUCT

There are some contributions that you cannot deduct, such as those made to individuals and those made to nonqualified organizations. (See *Contributions to Individuals* and *Contributions to Nonqualified Organizations*, next). There are others that you can deduct only part of, as discussed later under *Contributions From Which You Benefit*.

CONTRIBUTIONS TO INDIVIDUALS

You cannot deduct contributions to specific individuals, including the following.

- Contributions to fraternal societies made for the purpose of paying medical or burial expenses of deceased members.
- Contributions to individuals who are needy or worthy. This includes contributions to a qualified organization if you indicate that your contribution is for a specific person. But you can deduct a contribution that you give to a qualified organization that in turn helps needy or worthy individuals if you do not indicate that your contribution is for a specific person.
- Payments to a member of the clergy that can be spent as he or she wishes, such as for personal expenses.
- Expenses you paid for another person who provided services to a qualified organization.

Example

Your son does missionary work. You pay his expenses. You cannot claim a deduction for your son's unreimbursed expenses related to his contribution of services.

- Payments to a hospital that are for services for a specific patient. You cannot deduct these payments even if the hospital is operated by a city, a state, or other qualified organization.

CONTRIBUTIONS TO NONQUALIFIED ORGANIZATIONS

You cannot deduct contributions to organizations that are not qualified to receive tax-deductible contributions, including the following.

1. Certain state bar associations if:
   a) The state bar is not a political subdivision of a state,
   b) The bar has private, as well as public, purposes, such as promoting the professional interests of members, and
   c) Your contribution is unrestricted and can be used for private purposes.
2. Chambers of commerce and other business leagues or organizations.

3. Civic leagues and associations.
4. Country clubs and other social clubs.
5. Most foreign organizations.
6. Homeowners' associations.
7. Labor unions.
8. Political organizations and candidates.

CONTRIBUTIONS FROM WHICH YOU BENEFIT

If you receive or expect to receive a financial or economic benefit as a result of making a contribution to a qualified organization, you cannot deduct the part of the contribution that represents the value of the benefit you receive or expect to receive. These contributions include the following.

- Contributions to a college or university if the amount paid is to (or for the benefit of) a college or university in exchange for tickets (or the right to buy tickets) to an athletic event in an athletic stadium of the college or university.
- Contributions from which you receive or expect to receive a credit or deduction against state or local taxes unless an exception applies.
- Contributions for lobbying. This includes amounts that you earmark for use in, or in connection with, influencing specific legislation.
- Contributions to a retirement home that are clearly for room, board, maintenance, or admittance. Also, if the amount of your contribution depends on the type or size of apartment you will occupy, it is not a charitable contribution.
- Costs of raffles, bingo, lottery, etc. You cannot deduct as a charitable contribution amounts you pay to buy raffle or lottery tickets or to play bingo or other games of chance. For information on how to report gambling winnings and losses, see chapter 12 and chapter 27.
- Dues to fraternal orders and similar groups. However, see *Membership fees or dues*, earlier, under *Contributions You Can Deduct*.
- Tuition, or amounts you pay instead of tuition. You also cannot deduct any fixed amount you may be required to pay in addition to the tuition to enroll in a private school, even if it is designated as a "donation."

QUALIFIED CHARITABLE DISTRIBUTIONS

A qualified charitable distribution (QCD) is a distribution made directly by the trustee of your individual retirement arrangement (IRA), other than a SEP or SIMPLE IRA, to certain qualified organizations. You must have been at least age 70½ when the distribution was made. Your total QCDs for the year cannot be more than $100,000. If all the requirements are met, a QCD is nontaxable, but you cannot claim a charitable contribution deduction for a QCD.

Qualified charitable distribution one-time election. Beginning in 2023, you can elect to make a one-time distribution up to $50,000 from an individual retirement account to charities through a charitable remainder annuity trust, a charitable remainder unitrust, or a charitable gift annuity, each of which is funded only by qualified charitable distributions.

VALUE OF TIME OR SERVICES

You cannot deduct the value of your time or services, including:

- Blood donations to the American Red Cross or to blood banks, and
- The value of income lost while you work as an unpaid volunteer for a qualified organization.

PERSONAL EXPENSES

You cannot deduct personal, living, or family expenses, such as:

- The cost of meals you eat while you perform services for a qualified organization unless it is necessary for you to be away from home overnight while performing the services, or
- Adoption expenses, including fees paid to an adoption agency and the costs of keeping a child in your home before adoption is final (but see *Adoption Credit* in chapter 37 and the instructions for Form 8839, *Qualified Adoption Expenses*).

V. CONTRIBUTIONS OF PROPERTY

If you contribute property to a qualified organization, the amount of your charitable contribution is generally the fair market value of the property at the time of the contribution. However, if the property has increased in value, you may have to make some adjustments to the amount of your deduction. See *Giving Property That Has Increased in Value*, later.

For information about the records you must keep and the information you must furnish with your return if you donate property, see *Records To Keep and How To Report*, later.

Clothing and household items. You cannot take a deduction for clothing or household items you donate, unless the clothing or household items are in good used condition or better.

Exception

You can take a deduction for a contribution of an item of clothing or household item that is not in good used condition or better if you deduct more than $500 for it and include a qualified appraisal of it with your return.

Household items. Household items include:

- Furniture,
- Furnishings,
- Electronics,
- Appliances,
- Linens, and
- Other similar items.

Household items do not include:

- Food,
- Paintings, antiques, and other objects of art,
- Jewelry and gems, and
- Collections.

Cars, boats, and airplanes. The following rules apply to any donation of a qualified vehicle.

A qualified vehicle is:

- A car or any motor vehicle manufactured mainly for use on public streets, roads, and highways,
- A boat, or
- An airplane.

Deduction more than $500. If you donate a qualified vehicle to a qualified organization and you claim a deduction of more than $500, you can deduct the smaller of:

- The gross proceeds from the sale of the vehicle by the organization, or
- The vehicle's fair market value on the date of the contribution. If the vehicle's fair market value was more than your cost or other basis, you may have to reduce the fair market value to get the deductible amount, as described under *Giving Property That Has Increased in Value*, later.

Form 1098-C. You must attach to your return the copy of the Form 1098-C, *Contributions of Motor Vehicles, Boats, and Airplanes*, (or other statement containing the same information as Form 1098-C) you received from the organization. The Form 1098-C (or other statement) will show the gross proceeds from the sale of the vehicle.

If you e-file your return, you must: (a) attach Copy B of Form 1098-C to Form 8453 and mail the forms to the IRS, or (b) include Copy B of Form 1098-C as a PDF attachment if your software program allows it.

If you do not attach Form 1098-C (or other statement), you cannot deduct your contribution. You must get Form 1098-C (or other statement) within 30 days of the sale of the vehicle. But if exception 1 or 2 (described next) applies, you must get Form 1098-C (or other statement) within 30 days of your donation.

Exceptions. There are two exceptions to the rules just described for deductions of more than $500.

Exception 1

Vehicle used or improved by organization. If the qualified organization makes a significant intervening use of or material improvement to the vehicle before transferring it, you generally can deduct the vehicle's fair market value at the time of the contribution. But if the vehicle's fair market value was more than your cost or other basis, you may have to reduce the fair market value to get the deductible amount, as described under *Giving Property That Has Increased in Value*, later. The Form 1098-C (or other statement) will show whether this exception applies.

Exception 2

Vehicle given or sold to needy individual. If the qualified organization will give the vehicle, or sell it for a price well below fair market value, to a needy individual to further the organization's charitable purpose, you generally can deduct the vehicle's fair market value at the time of the contribution. But if the vehicle's fair market value was more than your cost or other basis, you may have to reduce the fair market value to get the deductible amount, as described under *Giving Property That Has Increased in Value*, later. The Form 1098-C (or other statement) will show whether this exception applies.

This exception does not apply if the organization sells the vehicle at auction. In that case, you cannot deduct the vehicle's fair market value.

Example

Anita donates a used car to a qualified organization. She bought it 3 years ago for $9,000. A used car guide shows the fair market value for this type of car is $6,000. However, Anita gets a Form 1098-C from the organization showing the car was sold for $2,900. Neither exception 1 nor exception 2 applies. If Anita itemizes her deductions, she can deduct $2,900 for her donation. She must attach the Form 1098-C and Form 8283 to her return.

Deduction $500 or less. If the qualified organization sells the vehicle for $500 or less and exceptions 1 and 2 do not apply, you can deduct the smaller of:

- $500, or
- The vehicle's fair market value on the date of the contribution. But if the vehicle's fair market value was more than your cost or other basis, you may have to reduce the fair market value to get the deductible amount, as described under *Giving Property That Has Increased in Value*, later.

If the vehicle's fair market value is at least $250 but not more than $500, you must have a written statement from the qualified organization acknowledging your donation. The statement must contain the information and meet the tests for an acknowledgment described under *Deductions of At Least $250 But Not More Than $500* under *Records to Keep*, later.

DETERMINING FAIR MARKET VALUE

This section discusses general guidelines for determining the fair market value of various types of donated property. Fair market value is the price at which property would change hands between a willing buyer and a willing seller, neither having to buy or sell, and both having reasonable knowledge of all the relevant facts.

Used clothing and household items. Generally, the fair market value of used clothing and household goods is far less than what you paid for them when they were new.

For used clothing, you should claim as the value the price that buyers of used items actually pay in used clothing stores, such as consignment or thrift shops.

Example

Dawn Greene donated a coat to a thrift store operated by her church. She paid $300 for the coat 3 years ago. Similar coats in the thrift store sell for $50. The fair market value of the coat is reasonably determined to be $50. Dawn's donation is limited to $50.

Cars, boats, and airplane. If you contribute a car, boat, or airplane to a charitable organization, you must determine its fair market value.

Certain commercial firms and trade organizations publish guides, commonly called "blue books," containing complete dealer sale prices or dealer average prices for recent model years. The guides may be published monthly or seasonally and for different regions of the country. These guides also provide estimates for adjusting for unusual equipment, unusual mileage, and physical condition. The prices are not "official" and these publications are not considered an appraisal of any specific donated property. But they do provide clues for making an appraisal and suggest relative prices for comparison with current sales and offerings in your area.

Large quantities. If you contribute a large number of the same item, fair market value is the price at which comparable numbers of the item are being sold.

GIVING PROPERTY THAT HAS DECREASED IN VALUE

If you contribute property with a fair market value that is less than your basis in it, your deduction is limited to its fair market value. You cannot claim a deduction for the difference between the property's basis and its fair market value.

GIVING PROPERTY THAT HAS INCREASED IN VALUE

If you contribute property with a fair market value that is more than your basis in it, you may have to reduce the fair market value by the amount of appreciation (increase in value) when you figure your deduction.

Your basis in property is generally what you paid for it. See chapter 13 if you need more information about basis.

Different rules apply to figuring your deduction, depending on whether the property is:

1. Ordinary income property, or
2. Capital gain property.

Ordinary income property. Property is ordinary income property if you would have recognized ordinary income or short-term capital gain had you sold it at fair market value on the date it was contributed. Examples of ordinary income property are inventory, works of art created by the donor, manuscripts prepared by the donor, and capital assets held 1 year or less.

Amount of deduction. The amount you can deduct for a contribution of ordinary income property is its fair market value minus the amount that would be ordinary income or short-term capital gain if you sold the property for its fair market value. Generally, this rule limits the deduction to your basis in the property.

Example

You donate stock that you held for 5 months to your church. The fair market value of the stock on the day you donate it is $1,000, but you paid only $800 (your basis). Because the $200 of appreciation would be short-term capital gain if you sold the stock, your deduction is limited to $800 (fair market value less the appreciation).

Capital gain property. Property is capital gain property if it would have resulted in long-term capital gain had you sold it at fair market value on the date of the contribution. It includes capital assets held more than 1 year, as well as certain real property and depreciable property used in your trade or business and, generally, held more than 1 year.

Amount of deduction – general rule. When figuring your deduction for a contribution of capital gain property, you usually can use the fair market value of the property.

Exception

In certain situations, you must reduce the fair market value by any amount that would have been long-term capital gain if you had sold the property for its fair market value. Generally, this means reducing the fair market value to the property's cost or other basis.

Bargain sales. A bargain sale of property is a sale or exchange for less than the property's fair market value. A bargain sale to a qualified organization is partly a charitable contribution and partly a sale or exchange. A bargain sale may result in a taxable gain.

VI. WHEN TO DEDUCT

You can deduct your contributions only in the year you actually make them in cash or other property (or in a later carryover year, as explained later under *Carryovers*). This applies whether you use the cash or an accrual method of accounting.

Time of making contribution. Usually, you make a contribution at the time of its unconditional delivery.

Checks. A check that you mail to a charity is considered delivered on the date you mail it.

Text message. Contributions made by text message are deductible in the year you send the text message if the contribution is charged to your telephone or wireless account.

Credit card. Contributions charged on your bank credit card are deductible in the year you make the charge.

Pay-by-phone account. Contributions made through a pay-by-phone account are considered delivered on the date the financial institution pays the amount.

Stock certificate. A properly endorsed stock certificate is considered completed on the date of mailing or other delivery to the charity or to the charity's agent. However, if you give a stock certificate to your agent or to the issuing corporation for transfer to the name of the charity, your contribution is not delivered until the date the stock is transferred on the books of the corporation.

Promissory note. If you issue and deliver a promissory note to a charitable organization as a contribution, it is not a contribution until you make the note payments.

Option. If you grant a charity an option to buy real property at a bargain price, it is not a contribution until the organization exercises the option.

Borrowed funds. If you contribute borrowed funds, you can deduct the contribution in the year you deliver the funds to the charity, regardless of when you repay the loan.

VII. LIMITS ON DEDUCTIONS

Generally, the amount you can deduct for charitable contributions cannot be more than 60% of your adjusted gross income (AGI). Your deduction may be further limited to 50%, 30%, or 20% of your AGI, depending on the type of property you give and the type of organization you give it to.

For 2024, your deduction for cash contributions is limited to 60% of your AGI minus your deductions for all other contributions.

CARRYOVERS

You can carry over your contributions that you cannot deduct in the current year because they exceed your adjusted-gross-income limits. Except for qualified conservation contributions, you can deduct the excess in each of the next 5 years until it is used up, but not beyond that time.

VIII. RECORDS TO KEEP

You must keep records to prove the amount of the contributions you make during the year. The kind of records you must keep depends on the amount of your contributions and whether they are:

- Cash contributions,
- Noncash contributions, or
- Out-of-pocket expenses when donating your services.

Note

An organization generally must give you a written statement if it receives a payment from you that is more than $75 and is partly a contribution and partly for goods or services. See *Contributions From Which You Benefit* under *Contributions You Can Deduct*, earlier). Keep the statement for your records. It may satisfy all or part of the recordkeeping and requirements explained in the following discussions.

CASH CONTRIBUTIONS

Cash contributions include those paid by cash, check, electronic funds transfer, online payment service, credit card, payroll deduction, or transfer of a gift card redeemable for cash.

You cannot deduct a cash contribution, regardless of the amount, unless you keep one of the following.

1. A bank record that shows the name of the qualified organization, the date of the contribution, and the amount of the contribution. Bank records may include:
   a) A canceled check,
   b) A bank or credit union statement,

c) A credit card statement,

d) An electronic fund transfer receipt, or

e) A scanned image of both sides of a canceled check obtained from a bank or credit union website.

2. A receipt (or letter or other written communication) from the qualified organization showing the name of the organization, the date of the contribution, and the amount of the contribution.

3. The payroll deduction records described next.

Payroll deductions. If you can make a contribution by payroll deduction, you must keep:

1. A pay stub, Form W-2, or other document furnished by your employer that shows the date and amount of the contribution, and

2. A pledge or other document prepared by you for the qualified organization that shows the name of the organization and states the organization does not provide goods or services in return for any contribution made to it by payroll deduction.

If your employer withheld $250 or more from a single paycheck, see *Contributions of $250 or More*, next.

Contributions of $250 or More

You can claim a deduction for a contribution of $250 or more only if you have a contemporaneous written acknowledgment of your contribution from the qualified organization or certain payroll deduction records.

If you made more than one contribution of $250 or more, you must have either a separate acknowledgment for each or one acknowledgment that lists each contribution and the date of each contribution and shows your total contributions.

Amount of contribution. In figuring whether your contribution is $250 or more, do not combine separate contributions. For example, if you gave your church $25 each week, your weekly payments do not have to be combined. Each payment is a separate contribution.

If contributions are made by payroll deduction, the deduction from each paycheck is treated as a separate contribution.

If you made a payment that is partly for goods and services, as described earlier under *Contributions From Which You Benefit*, your contribution is the amount of the payment that is more than the value of the goods and services.

Acknowledgment. The acknowledgment must meet these tests.

1. It must be written.

2. It must include:

a) The amount of cash you contributed,

b) Whether the qualified organization gave you any goods or services as a result of your contribution (other than certain token items and membership benefits), and

c) A description and good faith estimate of the value of any goods or services described in (b). If the only benefit you 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. You must get it on or before the earlier of:

    a) The date you file your return for the year you make the contribution, or

    b) The due date, including extensions, for filing the return.

If the acknowledgment does not show the date of the contribution, you must also have a bank record or receipt, as described earlier, that does show the date of the contribution. If the acknowledgment does show the date of the contribution and meets the other tests just described, you do not need any other records.

Contemporaneous written acknowledgment (CWA). Organizations typically send written acknowledgments to donors no later than January 31 of the year following the donation. For the written acknowledgment to be considered contemporaneous with the contribution, it must meet both of the following requirements:

1. Meet all the tests described under *Acknowledgment*, earlier, and

2. You must get it on or before the earlier of:

    a) The date you file your return for the year you make the contribution, or

    b) The due date, including extensions, for filing the return.

Payroll deductions. If you make a contribution by payroll deduction and your employer withheld $250 or more from a single paycheck, you must keep:

1. A pay stub, Form W-2, or other document furnished by your employer that shows the amount withheld as a contribution, and

2. A pledge card or other document prepared by or for the qualified organization that shows the name of the organization and states the organization does not provide goods or services in return for any contribution made to it by payroll deduction.

A single pledge card may be kept for all contributions made by payroll deduction regardless of amount as long as it contains all the required information.

If the pay stub, Form W-2, pledge card, or other document does not show the date of the contribution, you must also have another document that does show the date of the contribution. If the pay stub, Form

W-2, pledge card, or other document does show the date of the contribution, you do not need any other records except those just described in (1) and (2).

NONCASH CONTRIBUTIONS

For a contribution not made in cash, the records you must keep depend on whether your 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.

Amount of deduction. In figuring whether your deduction is $500 or more, combine your claimed deductions for all similar items of property donated to any charitable organization during the year. If you received goods or services in return, as described earlier in *Contributions From Which You Benefit,* reduce your contribution by the value of those goods or services. If you figure your deduction by reducing the fair market value of the donated property by its appreciation, as described earlier in *Giving Property That Has Increased in Value*, your contribution is the reduced amount.

Deductions of Less Than $250

If you make any noncash contribution, you must get and keep a receipt from the charitable organization showing:

1. The name and address of the charitable organization,
2. The date and location of the charitable contribution, and
3. A reasonably detailed description of the property.
4. For a security, the name of the issuer, the type of security, and whether it is publicly traded as of the date of the contribution. For example, a security is generally considered to be publicly traded if the security is (a) listed on a recognized stock exchange whose quotations are published daily, (b) regularly traded on a national or regional over-the-counter market, or (c) quoted daily in a national newspaper of general circulation in the case of mutual fund shares.

A letter or other written communication from the charitable organization acknowledging receipt of the contribution and containing the information in (1), (2), (3), and (4) will serve as a receipt.

You are not required to have a receipt where it is impractical to get one (for example, if you leave property at a charity's unattended drop site).

Additional records. You must also keep reliable written records for each item of donated property. Your written records must include the following information.

1. The information in (1), (2), (3), and (4) above.
2. If you claim a deduction for clothing or a household item, a description of the condition of the clothing or item.
3. The fair market value of the property at the time of the contribution and how you figured the fair market value. If it was determined by appraisal, keep a signed copy of the appraisal.

Deductions of at Least $250 but Not More Than $500

If you claim a deduction of at least $250 but not more than $500 for a noncash charitable contribution, you must get and keep a contemporaneous written acknowledgment of your contribution from the qualified organization. If you made more than one contribution of $250 or more, you must have either a separate acknowledgment for each or one acknowledgment that shows your total contributions.

The acknowledgment must contain the information in items (1) through (3) listed under *Deductions of Less Than $250*, earlier, and your written records must include the information listed in that discussion under *Additional records*.

The acknowledgment must also meet these tests.

1. It must be written.
2. It must include:
    a) A description (but not necessarily the value) of any property you contributed,
    b) Whether the qualified organization gave you any goods or services as a result of your contribution (other than certain token items and membership benefits), and
    c) A description and good faith estimate of the value of any goods or services described in (b). If the only benefit you 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. You must get it on or before the earlier of:
    a) The date you file your return for the year you make the contribution, or
    b) The due date, including extensions, for filing the return.

Deductions Over $500 but Not Over $5,000

If you claim a deduction over $500 but not over $5,000 for a noncash charitable contribution, you must complete Form 8283 and have the *CWA*, earlier. Your completed Form 8283 must include:

1. Your name and taxpayer identification number,
2. The name and address of the qualified organization,

3. The date of the charitable contribution, and

4. The following information about the contributed property:

    a) A description of the property in sufficient detail under the circumstances (taking into account the value of the property) for a person not generally familiar with the type of property to understand that the description is of the contributed property;

    b) The FMV of the property on the contribution date and the method used in figuring the FMV;

    c) In the case of real or tangible property, its condition;

    d) In the case of tangible personal property, whether the donee has certified it for a use related to the purpose or function constituting the donee's basis for exemption under Section 501 of the Internal Revenue Code or, in the case of a governmental unit, an exclusively public purpose;

    e) In the case of securities, the name of the issuer, the type of securities, and whether they were publicly traded as of the date of the contribution;

    f) How you got the property, for example, by purchase, gift, bequest, inheritance, or exchange;

    g) The approximate date you got the property or, if created, produced, or manufactured by or for you, the approximate date the property was substantially completed; and

    h) 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. This requirement, however, doesn't apply to publicly traded securities.

Deductions Over $5,000

If you claim a deduction of over $5,000 for a noncash charitable contribution, you must have the *CWA*, earlier, obtain a qualified written appraisal of the donated property from a qualified appraiser, and complete Form 8283. A qualified appraisal is not required for contributions of qualified vehicles for which you obtain a CWA, certain inventory, publicly traded securities, or certain intellectual property.

In addition to, or in lieu of, the items described in *Deductions Over $500 but Not Over $5,000* earlier, your completed Form 8283 must include:

1. The qualified organization's taxpayer identification number, signature, the date signed by the qualified organization, and the date the qualified organization received the property;

2. The appraiser's name, address, taxpayer identification number, appraiser declaration, signature, and the date signed by the appraiser; and

3. The following additional information about the contributed property:

a) The FMV on the valuation effective date; and

b) A statement explaining whether the charitable contribution was made by means of a bargain sale and, if so, the amount of any consideration received for the contribution.

OUT-OF-POCKET EXPENSES

If you give services to a qualified organization and have unreimbursed out-of-pocket expenses, considered separately, of $250 or more, related to those services, the following two rules apply.

1. You must have adequate records to prove the amount of the expenses.

2. You must get an acknowledgment from the qualified organization that contains:

   a) A description of the services you provided,

   b) A statement of whether or not the organization provided you any goods or services to reimburse you for the expenses you incurred,

   c) A description and a good faith estimate of the value of any goods or services (other than intangible religious benefits) provided to reimburse you, and

   d) A statement that the only benefit you received was an intangible religious benefit, if that was the case. The acknowledgment does not need to describe or estimate the value of an intangible religious benefit (defined earlier under *Acknowledgment*).

You must get the acknowledgment on or before the earlier of:

1. The date you file your return for the year you make the contribution, or

2. The due date, including extensions, for filing the return.

Car expenses. If you claim expenses directly related to use of your car in giving services to a qualified organization, you must keep reliable written records of your expenses. Whether your records are considered reliable depends on all the facts and circumstances. Generally, they may be considered reliable if you made them regularly and at or near the time you had the expenses.

For example, your records might show the name of the organization you were serving and the date each time you used your car for a charitable purpose. If you use the standard mileage rate of 14 cents a mile, your records must show the miles you drove your car for the charitable purpose. If you deduct your actual expenses, your records must show the costs of operating the car that are directly related to a charitable purpose.

See *Car expenses* under *Out-of-Pocket Expenses in Giving Services*, earlier, for the expenses you can deduct.

IX. HOW TO REPORT

Report your charitable contributions on Schedule A (Form 1040), lines 11 through 14. If you made noncash contributions for the year is over $500, you may also be required to fill out parts of Form 8283.

CHAPTER 25: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1.	**Claiming deductions for charitable contributions are generally limited to gifts given to qualifying organizations, such as which of the following:** **A.** country clubs and other social clubs **B.** churches and religious organizations **C.** homeowners' associations **D.** political organizations and candidates
2.	**You can deduct dues paid to country clubs and other social organizations.** **A.** true **B.** false
3.	**In regards to contributions of property to a qualified organization, household items include which of the following:** **A.** food **B.** appliances **C.** paintings **D.** jewelry

CHAPTER 25: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. You cannot deduct contributions to organizations that are not qualified to receive tax-deductible contributions such as country clubs or other social organizations. **B.** **CORRECT**. Churches and religious organizations are generally qualified organizations for accepting tax-deductible charitable contributions. **C.** Incorrect. Homeowners' associations are not qualified organizations with regard to accepting tax-deductible charitable contributions. **D.** Incorrect. Political organizations and candidates are generally not recognized as charitable organizations for tax deductibility purposes. *(See page 359 of the course material.)*
2.	**A.** Incorrect. You may be able to deduct membership fees and dues you pay to certain qualified organizations, but country clubs and other social organizations are not qualified organizations. **B.** **CORRECT**. You cannot deduct dues, fees, or assessments paid to country clubs and other social organizations. *(See page 360 of the course material.)*
3.	**A.** Incorrect. Household items do not include food. **B.** **CORRECT**. Household items include appliances as well as furniture, furnishings, electronics, linens, and other similar items. **C.** Incorrect. Paintings, antiques, and other objects of art are not included as household items. **D.** Incorrect. Household items do not include jewelry and gems. *(See pages 368 to 369 of the course material.)*

CHAPTER 26: NONBUSINESS CASUALTY AND THEFT LOSSES

Chapter Objective

After completing this chapter, you should be able to:

- Recall the tax treatment of personal casualty and theft losses.

I. WHAT'S NEW/REMINDERS

Limitation on personal casualty and theft losses. As a result of the TCJA, 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 your adjusted gross income (AGI) limitations unless they are attributable to a qualified disaster loss. Personal casualty and theft losses attributable to a qualified disaster loss are not subject to the 10% of AGI tax reduction, and the $100 reduction is increased to $500.

An exception to the rule above, limiting the personal casualty and theft loss deduction to losses attributable to a federally declared disaster, applies if you have personal casualty gains for the tax year.

Special rules for capital gains invested in qualified opportunity funds (QOFs). If you have a capital gain for 2024, you can invest that gain into a qualified opportunity fund (QOF) and elect to defer part or all of the gain that you would otherwise include in income until December 31, 2026. You may also be able to permanently exclude gain from the sale or exchange of an investment in a QOF if the investment is held for at least 10 years. For information about how to elect to use these special rules, see the Instructions for Form 8949, Sales and Other Dispositions of Capital Assets. For additional information, see *Opportunity Zones Frequently Asked Questions* on IRS.gov.

Deferral of gain invested in a QOF. If you realize a gain from an actual, or deemed, sale or exchange with an unrelated person and during the 180-day period beginning on the date realizing the gain, invested an amount of the gain in a QOF, you may be able to elect to temporarily defer part or all of the gain that would otherwise be included in income. If you make the election, the gain is included in taxable income only to the extent, if any, that the amount of realized gain exceeds the aggregate amount invested in a QOF during the 180-day period beginning on the date the gain was realized.

How to report. Report the gain as it would otherwise be reported if you were not making the election. Report the election for the amount invested in a QOF on Form 8949. See the Instructions for Form 8949 for information on how to make the election. You will need to attach Form 8997 annually until you dispose of the QOF investment. See the Form 8997 instructions for more information.

QOF investment. If you held a qualified investment in a QOF at any time during the year, you must file your return with Form 8997 attached. See the Form 8997 instructions.

II. INTRODUCTION

This chapter explains the tax treatment of personal (not business related) casualty losses, theft losses, and losses on deposits.

The chapter also explains the following topics:

- How to figure the amount of your loss.
- How to treat insurance and other reimbursements you receive.
- The deduction limits.
- When and how to report a casualty or theft.
- The special rules for disaster area losses.

Forms to file. When you have a casualty or theft, you have to file Form 4684. You will also have to file one or more of the following forms:

- Schedule A (Form 1040).
- Schedule A (Form 1040-NR) (for nonresident aliens).
- Schedule D (Form 1040).
- Form 4797.

III. CASUALTY

A casualty is the damage, destruction, or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual:

- A ***sudden*** event is one that is swift, not gradual or progressive.
- An ***unexpected*** event is one that is ordinarily unanticipated and unintended.
- An ***unusual*** event is one that is not a day-to-day occurrence and that is not typical of the activity in which you were engaged.

Casualty losses are deductible during the tax year that the loss is sustained. This is generally the tax year that the loss occurred. However, a casualty loss may be sustained in a year after the casualty occurred. See *When To Report Gains and Losses*, later.

Definitions. Three types of casualty losses are mentioned in this chapter:

1. Federal casualty losses,

2. Disaster losses, and
3. Qualified disaster losses.

All three types of losses refer to federally declared disasters, but the requirements for each loss vary. A federally declared disaster is a disaster determined by the President of the United States to warrant assistance by the federal government under the Stafford Act. A federally declared disaster includes (a) a major disaster declaration or (b) an emergency declaration under the Stafford Act.

Federal casualty loss. A federal casualty loss is an individual's casualty or theft loss of personal-use property that is attributable to a federally declared disaster. The casualty loss must occur in a state receiving a federal disaster declaration. If you suffered a federal casualty loss, you are eligible to claim a casualty loss deduction. If you suffered a casualty or theft loss of personal-use property that was not attributable to federally declared disaster, it is not a federal casualty loss, and you may not claim a casualty loss deduction unless the exception applies. See the *Caution* under *Deductible losses*, later.

Disaster loss. A disaster loss is a loss that is attributable to a federally declared disaster and that occurs in an area eligible for assistance pursuant to the Presidential declaration. The disaster loss must occur in a county eligible for public or individual assistance (or both). Disaster losses are not limited to individual personal-use property and may be claimed for individual business or income-producing property and by corporations, S corporations, and partnerships. If you suffered a disaster loss, you are eligible to claim a casualty loss deduction and to elect to claim the loss in the preceding tax year. See *Disaster Area Loss*, later.

Qualified disaster loss. A qualified disaster loss is an individual's casualty or theft loss of personal-use property that is attributable to a major disaster declared by the President.

If you suffered a qualified disaster loss, you are eligible to claim a casualty loss deduction, to elect to claim the loss in the preceding tax year, and to deduct the loss without itemizing other deductions on Schedule A (Form 1040).

Deductible losses. For tax years 2018 through 2025, if you are an individual, casualty losses of personal-use property are deductible only if the loss is attributable to a federally declared disaster (federal casualty loss). If the event causing you to suffer a personal casualty loss occurred before January 1, 2018, but the casualty loss was not sustained until January 1, 2018, or later, the casualty loss is not deductible. See *When To Report Gains and Losses*, later, for more information on when a casualty loss is sustained.

Caution!

An exception to the rule limiting the deduction for personal casualty and theft losses to federal casualty losses applies where you have personal casualty gains. In this case, you may deduct personal casualty losses that are not attributable to a federally declared disaster to the extent they do not exceed your personal casualty gains.

Casualty losses can result from a number of different causes, including the following:

- Car accidents (but see *Nondeductible losses* next for exceptions).
- Earthquakes.
- Fires (but see *Nondeductible losses* next for exceptions).
- Floods.
- Government-ordered demolition or relocation of a home that is unsafe to use because of a disaster.
- Mine cave-ins.
- Shipwrecks.
- Sonic booms.
- Storms, including hurricanes and tornadoes.
- Terrorist attacks.
- Vandalism.
- Volcanic eruptions.

Nondeductible losses. A casualty loss is not deductible, even to the extent the loss does not exceed your personal casualty gains, if the damage or destruction is caused by the following:

- Accidentally breaking articles, such as glassware or china under normal conditions.
- A family pet (explained below).
- A fire if you willfully set it or pay someone else to set it.
- A car accident if your willful negligence or willful act caused it. The same is true if the willful act or willful negligence of someone acting for you caused the accident.
- Progressive deterioration (explained later).

Family pet. Loss of property due to damage by a family pet is not deductible as a casualty loss unless the requirements discussed earlier under *Casualty* are met.

Example

Your antique oriental rug was damaged by your new puppy before it was housebroken. Because the damage was not unexpected and unusual, the loss is not deductible as a casualty loss.

Progressive deterioration. Loss of property due to progressive deterioration is not deductible as a casualty loss. This is because the damage results from a steadily operating cause or a normal process, rather than from a sudden event. The following are examples of damage due to progressive deterioration:

- The steady weakening of a building due to normal wind and weather conditions.
- The deterioration and damage to a water heater that bursts. However, the rust and water damage to rugs and drapes caused by the bursting of a water heater does qualify as a casualty.
- Most losses of property caused by droughts. To be deductible, a drought-related loss generally must be incurred in a trade or business or in a transaction entered into for profit.
- Termite or moth damage.
- The damage or destruction of trees, shrubs, or other plants by a fungus, disease, insects, worms, or similar pests. However, a sudden destruction due to an unexpected or unusual infestation of beetles or other insects may result in a casualty loss.

IV. THEFT

A theft is the taking and removing of money or property with the intent to deprive the owner of it. The taking of property must be illegal under the laws of the state where it occurred and it must have been done with criminal intent. You do not need to show a conviction for theft.

Theft includes the taking of money or property by the following means:

- Blackmail.
- Burglary.
- Embezzlement.
- Extortion.
- Kidnapping for ransom.
- Larceny.
- Robbery.

The taking of money or property through fraud or misrepresentation is theft if it is illegal under state or local law.

Theft loss deduction limited. For tax years 2018 through 2025, if you are an individual, casualty and theft losses of personal-use property are deductible only if the losses are attributable to a federally declared disaster (federal casualty loss).

Caution!

An exception to the rule limiting the deduction for personal casualty and theft losses to federal casualty losses applies where you have personal casualty gains. In this case, you may deduct personal casualty losses that are not attributable to a federally declared disaster to the extent they do not exceed your personal casualty gains.

Example

Martin and Grace experienced multiple personal casualties in 2024. Grace's diamond necklace was stolen, resulting in a $15,500 casualty loss. Martin and Grace also lost their camper as a result of a lightning strike. They have replacement-value insurance on the camper, so they have a $13,000 gain. Finally, they lost their car in a flood determined to be a federally declared disaster, resulting in a casualty loss of $25,000. Because Martin and Grace experienced a $13,000 personal casualty gain as a result of the replacement-value insurance, they can offset that gain with a portion of their loss attributable to the stolen necklace and claim the full federal casualty loss of $25,000 subject to the 10% of AGI and $100 limitations.

Decline in market value of stock. You cannot deduct as a theft loss the decline in market value of stock acquired on the open market for investment if the decline is caused by disclosure of accounting fraud or other illegal misconduct by the officers or directors of the corporation that issued the stock. However, you may be able to deduct it as a capital loss on Schedule D (Form 1040) if the stock is sold or exchanged or becomes completely worthless.

Mislaid or lost property. The simple disappearance of money or property is not a theft. However, an accidental loss or disappearance of property can qualify as a casualty if it results from an identifiable event that is sudden, unexpected, or unusual. Sudden, unexpected, and unusual events are defined earlier.

Example

A car door is accidentally slammed on your hand, breaking the setting of your diamond ring. The diamond falls from the ring and is never found. The loss of the diamond is a casualty.

Losses from Ponzi-type investment schemes. If you had a loss from a Ponzi-type investment scheme, see the following:

- Revenue Ruling 2009-9, 2009-14 I.R.B. 735.
- Revenue Procedure 2009-20, 2009-14 I.R.B. 749.

- Revenue Procedure 2011-58, 2011-50 I.R.B. 849.

If you qualify to use Revenue Procedure 2009-20, as modified by Revenue Procedure 2011-58, and you choose to follow the procedures in the guidance, first fill out Section C of Form 4684 to determine the amount to enter on Section B, line 28. Skip lines 19 through 27. Section C of Form 4684 replaces Appendix A in Revenue Procedure 2009-20. You do not need to complete Appendix A. For more information, see the above revenue ruling and revenue procedures, and the Instructions for Form 4684.

If you choose not to use the procedures in Revenue Procedure 2009-20, as modified by Revenue Procedure 2011-58, you may claim your theft loss by filling out Section B, lines 19 through 39, as appropriate.

V. LOSS ON DEPOSITS

A loss on deposits can occur when a bank, credit union, or other financial institution becomes insolvent or bankrupt. If you incurred this type of loss, you can choose one of the following ways to deduct the loss:

- As a casualty loss (to the extent the loss does not exceed your personal casualty gains).
- As a nonbusiness bad debt.

Caution!

You can no longer claim any miscellaneous itemized deductions, including the deduction for an ordinary loss on deposits in insolvent or bankrupt financial institutions.

Casualty loss. You can choose to deduct a loss on deposits as a casualty loss for any year in which you can reasonably estimate how much of your deposits you have lost in an insolvent or bankrupt financial institution. The choice is generally made on the return you file for that year and applies to all your losses on deposits for the year in that particular financial institution. If you treat the loss as a casualty loss, you cannot treat the same amount of the loss as a nonbusiness bad debt when it actually becomes worthless. However, you can take a nonbusiness bad debt deduction for any amount of loss that is more than the estimated amount you deducted as a casualty or ordinary loss. Once you make this choice, you cannot change it without permission from the IRS.

Casualty loss limitation. If you are an individual, casualty losses of personal-use property are deductible only if the loss is attributable to a federally declared disaster. An exception to the rule limiting the deduction for personal casualty and theft losses to federal casualty losses applies where you have personal casualty gains. Because a loss on deposits is not attributable to a federally declared disaster, you may deduct losses on deposits as personal casualty losses only to the extent they do not exceed your personal casualty gains.

Nonbusiness bad debt. If you do not choose to claim the loss as a casualty loss for purposes of offsetting gains, you must wait until the year the actual loss is determined and deduct the loss as a nonbusiness bad debt in that year.

How to report. The kind of deduction you choose for your loss on deposits determines how you report your loss:

- Casualty loss—report it on Form 4684 and Schedule A (Form 1040).
- Nonbusiness bad debt—report it on Form 8949 first and Schedule D (Form 1040).

VI. PROOF OF LOSS

To deduct a casualty or theft loss, you must be able to prove that you had a casualty or theft. You also must be able to support the amount you take as a deduction.

Casualty loss proof. For a casualty loss, your records should show all the following:

- That you were the owner of the property or, if you leased the property from someone else, that you were contractually liable to the owner for the damage.
- The type of casualty (car accident, fire, storm, etc.) and when it occurred.
- That the loss was a direct result of the casualty.
- Whether a claim for reimbursement exists for which there is a reasonable expectation of recovery.

Theft loss proof. For a theft loss, your records should show all the following:

- That you were the owner of the property.
- That your property was stolen.
- When you discovered that your property was missing.
- Whether a claim for reimbursement exists for which there is a reasonable expectation of recovery.

VII. FIGURING A LOSS

Figure the amount of your loss using the following steps:

1. Determine your adjusted basis in the property before the casualty or theft.
2. Determine the decrease in fair market value (FMV) of the property as a result of the casualty or theft.
3. From the smaller of the amounts you determined in (1) and (2), subtract any insurance or other reimbursement you received or expect to receive.

For personal-use property, apply the deduction limits, discussed later, to determine the amount of your deductible loss.

Gain from reimbursement. If your reimbursement is more than your adjusted basis in the property, you have a gain. This is true even if the decrease in the FMV of the property is smaller than your adjusted basis. If you have a gain, you may have to pay tax on it, or you may be able to postpone reporting the gain.

Leased property. If you are liable for casualty damage to property you lease, your loss is the amount you must pay to repair the property minus any insurance or other reimbursement you receive or expect to receive.

DECREASE IN FMV

FMV is the price for which you could sell your property to a willing buyer when neither of you has to sell or buy and both of you know all the relevant facts.

The decrease in FMV used to figure the amount of a casualty or theft loss is the difference between the property's FMV immediately before and immediately after the casualty or theft.

FMV of stolen property. The FMV of property immediately after a theft is considered to be zero because you no longer have the property.

Example

Several years ago, you purchased silver dollars at face value for $150. This is your adjusted basis in the property. Your silver dollars were stolen this year. The FMV of the coins was $1,000 just before they were stolen, and insurance did not cover them. Your theft loss is $150.

Recovered stolen property. Recovered stolen property is your property that was stolen and later returned to you. If you recovered property after you had already taken a theft loss deduction, you must refigure your loss using the smaller of the property's adjusted basis (explained later) or the decrease in FMV from the time just before it was stolen until the time it was recovered. Use this amount to refigure your total loss for the year in which the loss was deducted.

If your refigured loss is less than the loss you deducted, you generally have to report the difference as income in the recovery year. But report the difference only up to the amount of the loss that reduced your tax.

Figuring Decrease in FMV—Items To Consider

To figure the decrease in FMV because of a casualty or theft, you generally need a competent appraisal. However, other measures can also be used to establish certain decreases.

Appraisal. An appraisal to determine the difference between the FMV of the property immediately before a casualty or theft and immediately afterward should be made by a competent appraiser. The appraiser must recognize the effects of any general market decline that may occur along with the casualty. This information is needed to limit any deduction to the actual loss resulting from damage to the property.

Several factors are important in evaluating the accuracy of an appraisal, including the following:

- The appraiser's familiarity with your property before and after the casualty or theft.
- The appraiser's knowledge of sales of comparable property in the area.
- The appraiser's knowledge of conditions in the area of the casualty.
- The appraiser's method of appraisal.

Tip

You may be able to use an appraisal that you used to get a federal loan (or a federal loan guarantee) as the result of a federally declared disaster to establish the amount of your disaster loss.

Cost of cleaning up or making repairs. The cost of repairing damaged property is not part of a casualty loss. Neither is the cost of cleaning up after a casualty. But you can use the cost of cleaning up or making repairs after a casualty as a measure of the decrease in FMV if you meet all the following conditions:

- The repairs are actually made.
- The repairs are necessary to bring the property back to its condition before the casualty.
- The amount spent for repairs is not excessive.
- The repairs take care of the damage only.
- The value of the property after the repairs is not, due to the repairs, more than the value of the property before the casualty.

Landscaping. The cost of restoring landscaping to its original condition after a casualty may indicate the decrease in FMV. You may be able to measure your loss by what you spend on the following:

- Removing destroyed or damaged trees and shrubs minus any salvage you receive.
- Pruning and other measures taken to preserve damaged trees and shrubs.
- Replanting necessary to restore the property to its approximate value before the casualty.

Car value. Books issued by various automobile organizations that list the manufacturer and the model of your car may be useful in figuring the value of your car. You can use the retail value for your car listed in the book and modify it by such factors as mileage and the condition of your car to determine its value. The prices are not official, but they may be useful in determining value and suggesting relative prices for comparison with current sales and offerings in your area. If your car is not listed in the books, determine its value from other sources. A dealer's offer for your car as a trade-in on a new car is not usually a measure of its true value.

Safe harbor procedures to determine casualty and theft loss deduction. Safe harbor procedures allow filers to determine their casualty and theft loss deductions for personal-use residential real property and personal belongings resulting from a federally declared disaster without an appraisal.

Figuring Decrease in FMV—Items Not To Consider

You generally should not consider the following items when attempting to establish the decrease in FMV of your property.

Cost of protection. The cost of protecting your property against a casualty or theft is not part of a casualty or theft loss. The amount you spend on insurance or to board up your house against a storm is not part of your loss.

If you make permanent improvements to your property to protect it against a casualty or theft, add the cost of these improvements to your basis in the property. An example would be the cost of a dike to prevent flooding.

Exception. You cannot increase your basis in the property by, or deduct as a business expense, any expenditures you made with respect to qualified disaster mitigation payments.

Related expenses. Any incidental expenses due to a casualty or theft, such as expenses for the treatment of personal injuries, for temporary housing, or for a rental car, are not part of your casualty or theft loss.

Replacement cost. The cost of replacing stolen or destroyed property is not part of a casualty or theft loss.

Sentimental value. Do not consider sentimental value when determining your loss. If a family portrait, heirloom, or keepsake is damaged, destroyed, or stolen, you must base your loss on its FMV, as limited by your adjusted basis in the property.

Decline in market value of property in or near casualty area. A decrease in the value of your property because it is in or near an area that suffered a casualty, or that might again suffer a casualty, is not to be taken into consideration. You have a loss only for actual casualty damage to your property. However, if your home is in a federally declared disaster area, see *Disaster Area Losses* in Pub. 547.

Costs of photographs and appraisals. Photographs taken after a casualty will be helpful in establishing the condition and value of the property after it was damaged. Photographs showing the condition of the property after it was repaired, restored, or replaced may also be helpful.

Appraisals are used to figure the decrease in FMV because of a casualty or theft.

The costs of photographs and appraisals used as evidence of the value and condition of property damaged as a result of a casualty are not a part of the loss. They are expenses in determining your tax liability. For tax years 2018 through 2025, they can no longer be deducted as miscellaneous itemized deductions.

ADJUSTED BASIS

Adjusted basis is your basis in the property (usually cost) increased or decreased by various events, such as improvements and casualty losses.

INSURANCE AND OTHER REIMBURSEMENTS

If you receive an insurance payment or other type of reimbursement, you must subtract the reimbursement when you figure your loss. You do not have a casualty or theft loss to the extent you are reimbursed.

If in the year of the casualty there is a claim for reimbursement with a reasonable prospect of recovery, the loss is not sustained until you know with reasonable certainty whether such reimbursement will be received. If you expect to be reimbursed for part or all of your loss, you must subtract the expected reimbursement when you figure your loss. You must reduce your loss even if you do not receive payment until a later tax year.

Failure to file a claim for reimbursement. If your property is covered by insurance, you must file a timely insurance claim for reimbursement of your loss. Otherwise, you cannot deduct this loss as a casualty or theft loss. However, this rule does not apply to the portion of the loss not covered by insurance (for example, a deductible).

Example

Your car insurance policy includes comprehensive coverage with a $1,000 deductible. Because your insurance does not cover the first $1,000 of damages resulting from a storm, the $1,000 is deductible (subject to the deduction limits discussed later). This is true even if you do not file an insurance claim, because your insurance policy will not reimburse you for the deductible.

Types of Reimbursements

The most common type of reimbursement is an insurance payment for your stolen or damaged property. Other types of reimbursements are discussed next. Also see the Instructions for Form 4684.

Employer's emergency disaster fund. If you receive money from your employer's emergency disaster fund and you must use that money to rehabilitate or replace property on which you are claiming a casualty loss deduction, you must take that money into consideration in figuring the casualty loss deduction. Take into consideration only the amount you used to replace your destroyed or damaged property.

Example

Your home was extensively damaged by a tornado. Your loss after reimbursement from your insurance company was $10,000. Your employer set up a disaster relief fund for its employees. Employees receiving money from the fund had to use it to rehabilitate or replace their damaged or destroyed property. You received $4,000 from the fund and spent the entire amount on repairs to your home. In figuring your casualty loss, you must reduce your unreimbursed loss ($10,000) by the $4,000 you received from your employer's fund. Your casualty loss before applying the deduction limits is $6,000.

Cash gifts. If you receive excludable cash gifts as a disaster victim and there are no limits on how you can use the money, you do not reduce your casualty loss by these excludable cash gifts. This applies even if you use the money to pay for repairs to property damaged in the disaster.

Example

Your home was damaged by a hurricane. Relatives and neighbors made cash gifts to you that were excludable from your income. You used part of the cash gifts to pay for repairs to your home. There were no limits or restrictions on how you could use the cash gifts. Because it was an excludable gift, the money you received and used to pay for repairs to your home does not reduce your casualty loss on the damaged home.

Insurance payments for living expenses. You do not reduce your casualty loss by insurance payments you receive to cover living expenses in either of the following situations:

- You lose the use of your main home because of a casualty.
- Government authorities do not allow you access to your main home because of a casualty or threat of one.

Inclusion in income. If these insurance payments are more than the temporary increase in your living expenses, you must include the excess in your income. Report this amount on Schedule 1 (Form 1040), line 8z. However, if the casualty occurs in a federally declared disaster area, none of the insurance payments are taxable.

A temporary increase in your living expenses is the difference between the actual living expenses you and your family incurred during the period you could not use your home and your normal living expenses for that period. Actual living expenses are the reasonable and necessary expenses incurred because of the loss of your main home. Generally, these expenses include the amounts you pay for the following:

- Rent for suitable housing.
- Transportation.
- Food.

- Utilities.
- Miscellaneous services.

Normal living expenses consist of these same expenses that you would have incurred but did not because of the casualty or the threat of one.

Example

As a result of a hurricane, you vacated your apartment for a month and moved to a motel. You normally pay $525 a month for rent. None was charged for the month the apartment was vacated. Your motel rent for this month was $1,200. You normally pay $200 a month for food. Your food expenses for the month you lived in the motel were $400. You received $1,100 from your insurance company to cover your living expenses. You determine the payment you must include in income as follows:

1)	Insurance payment for living expenses		$1,100
2)	Actual expenses during the month you are unable to use your home because of the hurricane	$1,600	
3)	Normal living expenses	725	
4)	Temporary increase in living expenses: Subtract line 3 from line 2		875
5)	**Amount of payment includible in income: Subtract line 4 from line 1**		**$225**

Tax year of inclusion. You include the taxable part of the insurance payment in income for the year you regain the use of your main home or, if later, for the year you receive the taxable part of the insurance payment.

Example

Your main home was destroyed by a tornado in June 2022. You regained use of your home in November 2023. The insurance payments you received in 2022 and 2023 were $1,500 more than the temporary increase in your living expenses during those years. You include this amount in income on your 2023 Form 1040. If, in 2024, you receive further payments to cover the living expenses you had in 2022 and 2023, you must include those payments in income on your 2024 Form 1040 or 1040-SR.

Disaster relief. Food, medical supplies, and other forms of assistance you receive do not reduce your casualty loss unless they are replacements for lost or destroyed property.

Tip

Qualified disaster relief payments you receive for expenses you incurred as a result of a federally declared disaster are not taxable income to you.

Disaster unemployment assistance payments are unemployment benefits that are taxable.

Generally, disaster relief grants received under the Stafford Act are not includible in your income.

Reimbursement Received After Deducting Loss

If you figured your casualty or theft loss using the amount of your expected reimbursement, you may have to adjust your tax return for the tax year in which you receive your actual reimbursement. This section explains the adjustment you may have to make.

Actual reimbursement less than expected. If you later receive less reimbursement than you expected, include that difference as a loss with your other losses (if any) on your return for the year in which you can reasonably expect no more reimbursement.

Example

Your personal car had an FMV of $2,000 when it was destroyed in a collision with another car in 2023. The accident was due to the negligence of the other driver. At the end of 2023, there was a reasonable prospect that the owner of the other car would reimburse you in full. You did not have a deductible loss in 2023.

In January 2024, the court awarded you a judgment of $2,000. However, in July it became apparent that you will be unable to collect any amount from the other driver. You can deduct the loss in 2024 (to the extent it does not exceed your 2024 personal casualty gains) subject to the deduction limits discussed later.

Actual reimbursement more than expected. If you later receive a larger reimbursement amount than you expected, after you claimed a deduction for the loss, you may have to include the extra reimbursement amount in your income for the year you receive it. However, if any part of the original deduction did not reduce your tax for the earlier year, do not include that part of the reimbursement amount in your income. You do not refigure your tax for the year you claimed the deduction.

Caution!

If the total of all the reimbursements you receive is more than your adjusted basis in the destroyed or stolen property, you will have a gain on the casualty or theft. If you have already taken a deduction for a loss and you receive the reimbursement in a later year, you may have to include the gain in your income for the later year. Include the gain as ordinary income up to the amount of your deduction that reduced your tax for the earlier year.

Actual reimbursement same as expected. If you later receive exactly the reimbursement you expected to receive, you do not have to include any of the reimbursement in your income and you cannot deduct any additional loss.

Example

In December 2024, your personal car was damaged in a flood that was a federally declared disaster. Repairs to the car cost $950. You had $100 deductible comprehensive insurance. Your insurance company agreed to reimburse you for the rest of the damage. Because you expected a reimbursement from the insurance company, you did not have a casualty loss deduction in 2024.

Due to the $100 rule (discussed later under *Deduction Limits*), you cannot deduct the $100 you paid as the deductible. When you receive the $850 from the insurance company in 2025, do not report it as income.

VIII. DEDUCTION LIMITS

After you have figured the amount of your casualty or theft loss, you must figure how much of the loss you can deduct.

The deduction for casualty and theft losses of personal-use property is limited. For tax years beginning after 2017 and before 2026, personal casualty and theft losses of an individual are deductible only to the extent they are attributable to a federally declared disaster. The loss deduction is subject to the $100 and 10% rules, discussed later.

An exception to the rule above limiting the personal casualty and theft loss deduction to losses attributable to a federally declared disaster applies if you have personal casualty gains for the tax year. In this case, you may reduce your personal casualty gains by any casualty losses not attributable to a federally declared disaster. Any excess gain is used to reduce losses from a federally declared disaster. The 10% rule is applied to any federal disaster losses that remain.

You make these reductions on Form 4684.

These rules are explained next and Table 26-1 summarizes how to apply the $100 rule and the 10% rule in various situations.

TABLE 26-1 HOW TO APPLY THE DEDUCTION LIMITS FOR PERSONAL-USE PROPERTY

<table>
<tr><th colspan="2"></th><th>$100 Rule</th><th>10% Rule</th></tr>
<tr><td colspan="2">General Application</td><td>You must reduce each casualty or theft loss by $100 when figuring your deduction. Apply this rule after you have figured the amount of your loss.*</td><td>You must reduce your total casualty or theft loss attributable to a federally declared disaster by 10% of your AGI. Apply this rule after you reduce each loss by $100 ($100 rule).**</td></tr>
<tr><td colspan="2">Single Event</td><td>Apply this rule only once, even if many pieces of property are affected.</td><td>Apply this rule only once, even if many pieces of property are affected.</td></tr>
<tr><td colspan="2">More Than One Event</td><td>Apply to the loss from each event.</td><td>Apply to the total of all your losses from all federally declared disasters.</td></tr>
<tr><td colspan="2">More Than One Person- With Loss from the Same Event (other than a married couple filing jointly)</td><td>Apply separately to each person.</td><td>Apply separately to each person.</td></tr>
<tr><td rowspan="2">Married Couple- With Loss From the Same Event</td><td>Filing Jointly</td><td>Apply as if you were one person.</td><td>Apply as if you were one person.</td></tr>
<tr><td>Filing Separately</td><td>Apply separately to each spouse.</td><td>Apply separately to each spouse.</td></tr>
<tr><td colspan="2">More Than One Owner (other than a married couple filing jointly)</td><td>Apply separately to each owner of jointly owned property</td><td>Apply separately to each owner of jointly owned property</td></tr>
<tr><td colspan="4">*Qualified disaster losses must be reduced by $500 when figuring your deduction.</td></tr>
<tr><td colspan="4">**The 10% rule does not apply to qualified disaster losses.</td></tr>
</table>

Property used partly for business and partly for personal purposes. When property is used partly for personal purposes and partly for business or income-producing purposes, the casualty or theft loss deduction must be figured separately for the personal-use part and for the business or income-producing part. You must figure each loss separately because the $100 rule and the 10% rule apply only to the loss on the personal-use part of the property.

$100 RULE

After you have figured your casualty or theft loss on personal-use property, you must reduce that loss by $100. This reduction applies to each total casualty or theft loss, including those losses not attributable to a federally declared disaster that are applied to reduce your personal casualty gains. It does not matter how many pieces of property are involved in an event. Only a single $100 reduction applies.

Example

You have $750 deductible collision insurance on your car. The car is damaged in a collision. The insurance company pays you for the damage minus the $750 deductible. The amount of the casualty loss is based solely on the deductible. The casualty loss is $650 ($750 - $100) because the first $100 of a casualty loss on personal-use property is not deductible.

Caution!

Qualified disaster losses must be reduced by $500 instead of $100. See Pub. 976 and the Instructions for Form 4684 for more information.

Single event. Generally, events closely related in origin cause a single casualty. It is a single casualty when the damage is from two or more closely related causes, such as wind and flood damage caused by the same storm.

10% RULE

You must reduce your total federal casualty losses by 10% of your AGI. Apply this rule after you reduce each loss by $100. If you have both gains and losses from casualties or thefts, see *Gains and losses*, later.

Example 1

In September, your house was damaged by a tropical storm that was a federally declared disaster. Your loss after insurance reimbursement was $2,000. Your AGI for the year the loss was sustained is $29,500. You first apply the $100 rule and then the 10% rule. Figure your casualty loss deduction as follows:

1)	Loss after insurance	$2,000
2)	Subtract $100	100
3)	Loss after $100 rule	$1,900
4)	Subtract 10% × $29,500 AGI	2,950
5)	**Casualty loss deduction**	**-0-**

You do not have a casualty loss deduction because your loss after you apply the $100 rule ($1,900) is less than 10% of your AGI ($2,950).

Caution!

The 10% rule does not apply to qualified disaster losses.

More than one loss. If you have more than one casualty or theft loss during your tax year, reduce each loss by any reimbursement and by $100. Then, you must reduce your total federal casualty losses by 10% of your AGI.

Example 2

In March, your car was destroyed in a flood that was a federally declared disaster. You did not have insurance on your car, so you did not receive any insurance reimbursement. Your loss on the car was $1,800. In November, another flood, which also was a federally declared disaster, damaged your basement and totally destroyed the furniture, washer, dryer, and other items stored there. Your loss on the basement items after reimbursement from your insurer was $2,100. Your AGI for the year that the floods occurred is $25,000. You figure your casualty loss deduction as follows:

		Car	Basement
1)	Loss	$1,800	$2,100
2)	Subtract $100 per incident	100	100
3)	Loss after $100 rule	$1,700	$2,000
4)	Total loss		$3,700
5)	Subtract 10% × $25,000 AGI		2,500
6)	**Casualty loss deduction**		**$1,200**

Gains and losses. If you had both gains and losses from casualties or thefts to your personal-use property, you must compare your total gains to your total losses. Do this after you have reduced each loss by any reimbursements and by $100, but before you have reduced the federal casualty losses by 10% of your AGI.

Caution!

Casualty or theft gains do not include gains you choose to postpone.

Losses more than gains. If your losses are more than your recognized gains, subtract your gains from your losses and reduce the result by 10% of your AGI. The rest, if any, is your deductible loss from personal-use property. If you have losses not attributable to a federally declared disaster, see Line 14 in the Instructions for Form 4684. Losses not attributable to a federally declared disaster can only be used to offset gains.

Gains more than losses. If your recognized gains are more than your losses, subtract your losses from your gains. The difference is treated as capital gain and must be reported on Schedule D (Form 1040). The 10% rule does not apply to your gains. If you have losses not attributable to a federally declared disaster, see Line 14 in the Instructions for Form 4684.

IX. WHEN TO REPORT GAINS AND LOSSES

Gains. If you receive an insurance or other reimbursement that is more than your adjusted basis in the destroyed or stolen property, you have a gain from the casualty or theft. You must include this gain in your income in the year you receive the reimbursement, unless you choose to postpone reporting the gain.

Losses. Generally, you can deduct a casualty loss that is not reimbursable only in the tax year in which the casualty occurred. This is true even if you do not repair or replace the damaged property until a later year. (However, see *Disaster Area Loss*, later, for an exception.)

You can deduct theft losses that are not reimbursable only in the year you discover your property was stolen.

If in the year of the casualty there is a claim for reimbursement with a reasonable prospect of recovery, the loss is not sustained until you know with reasonable certainty whether such reimbursement will be received. If you are not sure whether part of your casualty or theft loss will be reimbursed, do not deduct that part until the tax year when you become reasonably certain that it will not be reimbursed. This later tax year is when your loss is sustained.

If you have a loss, see Table 26-2.

TABLE 26-2. WHEN TO DEDUCT A LOSS

IF you have a loss...*	THEN deduct it in the...
from a casualty*	year the loss occurred.
in a federally declared disaster area	disaster year or the year immediately before the disaster year.
from a theft	year the theft was discovered.
on a deposit treated as a casualty	year a reasonable estimate can be made.
If you are an individual, casualty and theft losses of personal-use property are deductible only if the loss is attributable to a federally declared disaster. An exception applies where you have personal casualty gains.	

Loss on deposits. If your loss is a loss on deposits in an insolvent or bankrupt financial institution, see *Loss on Deposits*, earlier.

DISASTER AREA LOSSES

A disaster loss is a loss that occurred in an area determined by the President of the United States to warrant assistance by the Federal government under the Stafford Act and that is attributable to a federally declared disaster. Disaster area includes areas warranting public or individual assistance (or both). A federally declared disaster includes a major disaster or emergency declaration.

You generally must deduct a casualty loss in the year it occurred. However, if you have a casualty loss from a federally declared disaster that occurred in an area warranting public or individual assistance (or both), you can elect to deduct the loss on your tax return or amended return for either of the following years:

- The year the loss was sustained (the disaster year).
- The year immediately preceding the disaster year.

You must make the election to take your casualty loss for the disaster in the preceding year on or before the date that is 6 months after the regular due date for filing your original return (without extensions) for the disaster year.

If you claimed a deduction for a disaster loss in the disaster year and you wish to deduct the loss in the preceding year, you must file an amended return to remove the previously deducted loss on or before you file the return or amended return for the preceding year that includes the disaster loss deduction.

Gains. Special rules apply if you choose to postpone reporting gain on property damaged or destroyed in a federally declared disaster area.

Postponed tax deadlines. The IRS may postpone for up to 1 year certain tax deadlines of taxpayers who are affected by a federally declared disaster. The tax deadlines the IRS may postpone include those for filing income and employment tax returns, paying income and employment taxes, and making contributions to a traditional IRA or Roth IRA.

If any tax deadline is postponed, the IRS will publicize the postponement in your area and publish a news release, and, where necessary, in a revenue ruling, revenue procedure, notice, announcement, or other guidance in the Internal Revenue Bulletin (IRB).

Who is eligible. If the IRS postpones a tax deadline, the following taxpayers are eligible for the postponement:

- Any individual whose main home is located in a covered disaster area (defined next).
- Any business entity or sole proprietor whose principal place of business is located in a covered disaster area.
- Any individual who is a relief worker affiliated with a recognized government or philanthropic organization who is assisting in a covered disaster area.

- Any individual, business entity, or sole proprietorship whose records are needed to meet a postponed tax deadline, provided those records are maintained in a covered disaster area. The main home or principal place of business does not have to be located in the covered disaster area.
- Any estate or trust that has tax records necessary to meet a postponed tax deadline, provided those records are maintained in a covered disaster area.
- The spouse on a joint return with a taxpayer who is eligible for postponements.
- Any individual, business entity, or sole proprietorship not located in a covered disaster area, but whose records necessary to meet a postponed tax deadline are located in the covered disaster area.
- Any individual visiting the covered disaster area who was killed or injured as a result of the disaster.
- Any other person determined by the IRS to be affected by a federally declared disaster.

Covered disaster area. This is an area of a federally declared disaster in which the IRS has decided to postpone tax deadlines for up to 1 year.

Abatement of interest and penalties. The IRS may abate the interest and penalties on underpaid income tax for the length of any postponement of tax deadlines.

X. HOW TO REPORT GAINS AND LOSSES

Use Form 4684 to report a gain or a deductible loss from a casualty or theft. If you have more than one casualty or theft, use a separate Form 4684 to determine your gain or loss for each event. Combine the gains and losses on one Form 4684. Follow the form instructions as to which lines to fill out. In addition, you must use the appropriate schedule to report a gain or loss. The schedule you use depends on whether you have a gain or loss.

If you have a:	Report it on:
Gain	Schedule D (Form 1040)
Loss	Schedule A (Form 1040)

Adjustments to basis. If you have a casualty or theft loss, you must decrease your basis in the property by any insurance or other reimbursement you receive, and by any deductible loss. If you make either of the basis adjustments described above, amounts you spend on repairs to restore your property to its pre-casualty condition increase your adjusted basis.

Net operating loss (NOL). If your casualty or theft loss deduction causes your deductions for the year to be more than your income for the year, you may have an NOL. You do not have to be in business to have an NOL from a casualty or theft loss.

CHAPTER 26: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1.	**Casualty and theft loss deductions were suspended for 2018-2025 unless in a federally declared disaster area or to the extent of a casualty gain.** **A.** true **B.** false
2.	**Items to consider when figuring the decrease in FMV because of a casualty or theft include which of the following:** **A.** an appraisal **B.** the cost of protection **C.** the replacement cost **D.** any sentimental value

CHAPTER 26: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** CORRECT. This law change was a part of the TCJA of 2017. **B.** Incorrect. The TCJA of 2017 eliminated many deductions, including all miscellaneous itemized deductions subject to the 2% of AGI limitation. *(See page 383 of the course material.)*
2.	**A.** CORRECT. An appraisal should be used to determine the difference between the FMV of the property immediately before a casualty or theft and immediately afterward. The appraiser must recognize the effects of any general market decline that may occur along with the casualty. This information is needed to limit any deduction to the actual loss resulting from damage to the property. **B.** Incorrect. The cost of protecting your property against a casualty or theft is not part of a casualty or theft loss. For example, the amount you spend on insurance or to board up your house against a storm is not part of your loss. **C.** Incorrect. The cost of replacing stolen or destroyed property is not part of a casualty or theft loss. **D.** Incorrect. Do not consider sentimental value when determining your loss. You must base your loss only on an item's FMV. *(See pages 391 to 393 of the course material.)*

CHAPTER 27: OTHER ITEMIZED DEDUCTIONS

Chapter Objective

After completing this chapter, you should be able to:

- Identify types of other itemized deductions allowable to reduce adjusted gross income.

I. WHAT'S NEW/REMINDERS

No miscellaneous itemized deductions allowed. You can no longer claim any miscellaneous itemized deductions. See *Miscellaneous Itemized Deductions*, later.

Standard mileage rate. The 2024 rate for business use of a vehicle is 67.0 cents per mile.

II. INTRODUCTION

This chapter explains that you can no longer claim any miscellaneous itemized deductions, unless you fall into one of the qualified categories of employment claiming a deduction relating to unreimbursed employee expenses. Miscellaneous itemized deductions are those deductions that would have been subject to the 2% of adjusted gross income limitation. You can still claim certain expenses as itemized deductions on Schedule A (Form 1040), Schedule A (Form 1040-NR), or as an adjustment to income on Form 1040 or 1040-SR. This chapter covers the following topics.

- Miscellaneous itemized deductions.
- Expenses you cannot deduct.
- Expenses you can deduct.
- How to report your deductions.

Tip

You must keep records to verify your deductions. You should keep receipts, canceled checks, substitute checks, financial account statements, and other documentary evidence.

III. MISCELLANEOUS ITEMIZED DEDUCTIONS

You can no longer claim any miscellaneous itemized deductions that are subject to the 2% of adjusted gross income limitation, including unreimbursed employee expenses. However, you may be able to deduct certain unreimbursed employee business expenses if you fall into one of the following categories of employment listed under *Unreimbursed Employee Expenses*, next.

UNREIMBURSED EMPLOYEE EXPENSES

You can no longer claim a deduction for unreimbursed employee expenses unless you fall into one of the following categories of employment.

- Armed Forces reservists.
- Qualified performing artists.
- Fee-basis state or local government officials.
- Employees with impairment-related work expenses.

CATEGORIES OF EMPLOYMENT

You can deduct unreimbursed employee expenses only if you qualify as an Armed Forces reservist, qualified performing artist, fee-basis state or local government official, and employee with impairment-related work expenses.

Armed Forces reservist (member of a reserve component). You are a member of a reserve component of the Armed Forces of the United States if you are in the Army, Navy, Marine Corps, Air Force, or Coast Guard Reserve; the Army National Guard of the United States; or the Reserve Corps of the Public Health Service.

Qualified performing artist. You are a qualified performing artist if you:

1. Performed services in the performing arts as an employee for at least two employers during the tax year,
2. Received from at least two of the employers' wages of $200 or more per employer,
3. Had allowable business expenses attributable to the performing arts of more than 10% of gross income from the performing arts, and
4. Had adjusted gross income of $16,000 or less before deducting expenses as a performing artist.

Fee-basis state or local government official. You are a qualifying fee-basis official if you are employed by a state or political subdivision of a state and are compensated, in whole or in part, on a fee basis.

Employee with impairment-related work expenses. Impairment-related work expenses are the allowable expenses of an individual with physical or mental disabilities for attendant care at his or her place of employment. They also include other expenses in connection with the place of employment that enable the employee to work.

Allowable unreimbursed employee expenses. If you qualify as an employee in one of the categories mentioned above, you may be able to deduct the following items as unreimbursed employee expenses.

Unreimbursed employee expenses for individuals in these categories of employment are deducted as adjustments to gross income. Qualified employees listed in one of the categories above must complete Form 2106 to take the deduction.

You can deduct only unreimbursed employee expenses that are:

- Paid or incurred during your tax year,
- For carrying on your trade or business of being an employee, and
- Ordinary and necessary.

An expense is ordinary if it is common and accepted in your trade, business, or profession. An expense is necessary if it is appropriate and helpful to your business. An expense does not have to be required to be considered necessary.

EDUCATOR EXPENSES

If you were an eligible educator in 2024, you can deduct up to $300 of qualified expenses you paid in 2024 as an adjustment to gross income on Schedule 1 (Form 1040), line 11, rather than as a miscellaneous itemized deduction. If you and your spouse are filing jointly and both of you were eligible educators, the maximum deduction is $600. However, neither spouse can deduct more than $300 of his or her qualified expenses.

EXPENSES YOU CANNOT DEDUCT

Because of the suspension of miscellaneous itemized deductions, there are two categories of expenses you cannot deduct: Miscellaneous itemized deductions subject to the 2% AGI limitation, and those expenses that are traditionally nondeductible under the Internal Revenue Code. Both categories of deduction are discussed next.

Miscellaneous Deductions Subject to 2% AGI

Unless you fall into one of the qualified categories of employment under *Unreimbursed Employee Expenses*, earlier, miscellaneous itemized deductions that are subject to the 2% of adjusted gross income limitation can no longer be claimed. For expenses not related to unreimbursed employee expenses, you generally cannot deduct the following expenses, even if you fall into one of the qualified categories of employment listed earlier.

Appraisal Fees

Appraisal fees you pay to figure a casualty loss or the fair market value of donated property are miscellaneous itemized deductions and can no longer be deducted.

Casualty and Theft Losses

Damaged or stolen property used in performing services as an employee is a miscellaneous deduction and can no longer be deducted. For other casualty and theft losses, see chapter 26.

Clerical Help and Office Rent

Office expenses, such as rent and clerical help, you pay in connection with your investments and collecting taxable income on those investments are miscellaneous itemized deductions and are no longer deductible.

Credit or Debit Card Convenience Fees

The convenience fee charged by the card processor for paying your income tax (including estimated tax payments) by credit or debit card is a miscellaneous itemized deduction and is no longer deductible.

Depreciation on Home Computer

If you use your home computer to produce income (for example, to manage your investments that produce taxable income), the depreciation of the computer for that part of the usage of the computer is a miscellaneous itemized deduction and is no longer deductible.

Fees To Collect Interest and Dividends

Fees you pay to a broker, bank, trustee, or similar agent to collect your taxable bond interest or dividends on shares of stock are miscellaneous itemized deductions and can no longer be deducted.

Hobby Expenses

A hobby is not a business because it is not carried on to make a profit. Hobby expenses are miscellaneous itemized deductions and can no longer be deducted.

Indirect Deductions of Pass-Through Entities

Pass-through entities include partnerships, S corporations, and mutual funds that are not publicly offered. Deductions of pass-through entities are passed through to the partners or shareholders. The partners or shareholders share of passed-through deductions for investment expenses are miscellaneous itemized deductions and can no longer be deducted.

Nonpublicly offered mutual funds. These funds will send you a Form 1099-DIV, Dividends and Distributions, or a substitute form, showing your share of gross income and investment expenses. The investment expenses reported on Form 1099-DIV are a miscellaneous itemized deduction and are no longer deductible.

Investment Fees and Expenses

Investment fees, custodial fees, trust administration fees, and other expenses you paid for managing your investments that produce taxable income are miscellaneous itemized deductions and are no longer deductible.

Legal Expenses

You usually can deduct legal expenses that you incur in attempting to produce or collect taxable income or that you pay in connection with the determination, collection, or refund of any tax.

Legal expenses that you incur in attempting to produce or collect taxable income, or that you pay in connection with the determination, collection, or refund of any tax are miscellaneous itemized deductions and are no longer deductible.

You can deduct expenses of resolving tax issues relating to profit or loss from business (Schedule C), rentals or royalties (Schedule E), or farm income and expenses (Schedule F) on the appropriate schedule. Expenses for resolving nonbusiness tax issues are miscellaneous itemized deductions and are no longer deductible.

Loss on Deposits

For information on whether, and if so, how, you may deduct a loss on your deposit in a qualified financial institution, see *Loss on Deposits* in chapter 26.

Repayments of Income

Generally, repayments of amounts that you included in income in an earlier year is a miscellaneous itemized deduction and can no longer be deducted. If you had to repay more than $3,000 that you included in your income in an earlier year, you may be able to deduct the amount. See *Repayments Under Claim of Right*, later.

Repayments of Social Security Benefits

For information on how to deduct your repayments of certain social security benefits, see *Repayments More Than Gross Benefits* in chapter 11.

Safe Deposit Box Rent

Rent you pay for a safety deposit box you use to store taxable income-producing stocks, bonds, or investment related papers is a miscellaneous itemized deduction and can no longer be deducted. You cannot deduct the rent if you use the box only for jewelry, other personal items, or tax-exempt securities.

Service Charges on Dividend Reinvestment Plans

Service charges you pay as a subscriber in a dividend reinvestment plan are a miscellaneous itemized deduction and can no longer be deducted. These service charges include payments for:

- Holding shares acquired through a plan,
- Collecting and reinvesting cash dividends, and
- Keeping individual records and providing detailed statements of accounts.

Tax Preparation Fees

Tax preparation fees on the return for the year in which you pay them are a miscellaneous itemized deduction and can no longer be deducted. These fees include the cost of tax preparation software programs and tax publications. They also include any fee you paid for electronic filing of your return.

Trustee's Administrative Fees for IRA

Trustee's administrative fees that are billed separately and paid by you in connection with your IRA are a miscellaneous itemized deduction and can no longer be deducted. For more information about IRAs, see chapter 17.

IV. NONDEDUCTIBLE EXPENSES

In addition to the miscellaneous itemized deductions discussed earlier, you cannot deduct the following expenses.

LIST OF NONDEDUCTIBLE EXPENSES

- Adoption expenses.
- Broker's commissions.
- Burial or funeral expenses, including the cost of a cemetery lot.
- Campaign expenses.
- Capital expenses.
- Check-writing fees.
- Club dues.
- Commuting expenses.
- Fees and licenses, such as car licenses, marriage licenses, and dog tags.
- Fines or penalties.
- Health spa expenses.
- Hobby losses, but see *Hobby Expenses*, earlier.
- Home repairs, insurance, and rent.

- Home security system.
- Illegal bribes and kickbacks.
- Investment-related seminars.
- Life insurance premiums paid by the insured.
- Lobbying expenses.
- Losses from the sale of your home, furniture, personal car, etc.
- Lost or misplaced cash or property.
- Lunches with co-workers.
- Meals while working late.
- Medical expenses as business expenses other than medical examinations required by your employer.
- Personal disability insurance premiums.
- Personal legal expenses.
- Personal, living, or family expenses.
- Political contributions.
- Professional accreditation fees.
- Professional reputation improvement expense.
- Relief fund contributions.
- Residential telephone line.
- Stockholders' meeting attendance expenses.
- Tax-exempt income earning/collecting expenses.
- The value of wages never received or lost vacation time.
- Travel expenses for another individual.
- Voluntary unemployment benefit fund contributions.
- Wristwatches.

Adoption Expenses

You cannot deduct the expenses of adopting a child, but you may be able to take a credit for those expenses. See chapter 37.

Campaign Expenses

You cannot deduct campaign expenses of a candidate for any office, even if the candidate is running for reelection to the office. These include qualification and registration fees for primary elections.

Legal fees. You cannot deduct legal fees paid to defend charges that arise from participation in a political campaign.

Check-Writing Fees on Personal Account

If you have a personal checking account, you cannot deduct fees charged by the bank for the privilege of writing checks, even if the account pays interest.

Club Dues

Generally, you cannot deduct the cost of membership in any club organized for business, pleasure, recreation, or other social purpose. This includes business, social, athletic, luncheon, sporting, airline, hotel, golf, and country clubs.

You cannot deduct dues paid to an organization if one of its main purposes is to:

- Conduct entertainment activities for members or their guests, or
- Provide members or their guests with access to entertainment facilities.

Dues paid to airline, hotel, and luncheon clubs are not deductible.

Commuting Expenses

You cannot deduct commuting expenses (the cost of transportation between your home and your main or regular place of work). If you haul tools, instruments, or other items in your car to and from work, you can deduct only the additional cost of hauling the items such as the rent on a trailer to carry the items.

Fines and Penalties

Generally, no deduction is allowed for fines and penalties paid to a government or specified nongovernmental entity for the violation of any law except in the following situations.

- Amounts that constitute restitution.
- Amounts paid to come into compliance with the law.
- Amounts paid or incurred as the result of certain court orders in which no government or specified nongovernmental agency is a party.
- Amounts paid or incurred for taxes due.

Nondeductible amounts include an amount paid in settlement of your actual or potential liability for a fine or penalty (civil or criminal). Fines or penalties include amounts paid such as parking tickets, tax penalties, and penalties deducted from teachers' paychecks after an illegal strike.

No deduction is allowed for the restitution amount or amount paid to come into compliance with the law unless the amounts are specifically identified in the settlement agreement or court order. Also, any amount paid or incurred as reimbursement to the government for the costs of any investigation or litigation are not eligible for the exceptions and are nondeductible.

Health Spa Expenses

You cannot deduct health spa expenses, even if there is a job requirement to stay in excellent physical condition, such as might be required of a law enforcement officer.

Home Security System

You cannot deduct the cost of a home security system as a miscellaneous deduction. However, you may be able to claim a deduction for a home security system as a business expense if you have a home office.

Investment-Related Seminars

You cannot deduct any expenses for attending a convention, seminar, or similar meeting for investment purposes.

Life Insurance Premiums

You cannot deduct premiums you pay on your life insurance. You may be able to deduct, as alimony, premiums you pay on life insurance policies assigned to your former spouse. See chapter 18 for information on alimony.

Lobbying Expenses

You generally cannot deduct amounts paid or in-curred for lobbying expenses. These include expenses to:

- Influence legislation;
- Participate or intervene in any political campaign for, or against, any candidate for public office;
- Attempt to influence the general public, or segments of the public, about elections, legislative matters, or referendums; or
- Communicate directly with covered executive branch officials in any attempt to influence the official actions or positions of those officials.

Lobbying expenses also include any amounts paid or incurred for research, preparation, planning, or coordination of any of these activities.

Dues used for lobbying. If a tax-exempt organization notifies you that part of the dues or other amounts you pay to the organization are used to pay nondeductible lobbying expenses, you cannot deduct that part.

Lost or Mislaid Cash or Property

You cannot deduct a loss based on the mere disappearance of money or property. However, an accidental loss or disappearance of property can qualify as a casualty if it results from an identifiable event that is sudden, unexpected, or unusual. See chapter 26.

Lunches With Co-workers

You cannot deduct the expenses of lunches with co-workers, except while traveling away from home on business. See chapter 20 for information on deductible expenses while traveling away from home.

Meals While Working Late

You cannot deduct the cost of meals while working late. However, you may be able to claim a deduction if the cost of meals is a deductible entertainment expense, or if you're traveling away from home. See chapter 20 for information on deductible entertainment expenses and expenses while traveling away from home.

Personal Legal Expenses

You cannot deduct personal legal expenses such as those for the following.

- Custody of children.
- Breach of promise to marry suit.
- Civil or criminal charges resulting from a personal relationship.
- Damages for personal injury, except for certain unlawful discrimination and whistle-blower claims.
- Preparation of a title (or defense or perfection of a title).
- Preparation of a will.
- Property claims or property settlement in a divorce.

You cannot deduct these expenses even if a result of the legal proceeding is the loss of income-producing property.

Political Contributions

You cannot deduct contributions made to a political candidate, a campaign committee, or a newsletter fund. Advertisements in convention bulletins and admissions to dinners or programs that benefit a political party or political candidate aren't deductible.

Professional Accreditation Fees

You cannot deduct professional accreditation fees such as the following.

- Accounting certificate fees paid for the initial right to practice accounting.
- Bar exam fees and incidental expenses in securing initial admission to the bar.
- Medical and dental license fees paid to get initial licensing.

Professional Reputation

You cannot deduct expenses of radio and TV appearances to increase your personal prestige or establish your professional reputation.

Relief Fund Contributions

You cannot deduct contributions paid to a private plan that pays benefits to any covered employee who cannot work because of any injury or illness not related to the job.

Residential Telephone Service

You cannot deduct any charge (including taxes) for basic local telephone service for the first telephone line to your residence, even if it is used in a trade or business.

Stockholders' Meetings

You cannot deduct transportation and other expenses you pay to attend stockholders' meetings of companies in which you own stock but have no other interest. You cannot deduct these expenses even if you are attending the meeting to get information that would be useful in making further investments.

Tax-Exempt Income Expenses

You cannot deduct expenses to produce tax-exempt income. You cannot deduct interest on a debt incurred or continued to buy or carry tax-exempt securities.

If you have expenses to produce both taxable and tax-exempt income, but you cannot identify the expenses that produce each type of income, you must divide the expenses based on the amount of each type of income to determine the amount that you can deduct.

Travel Expenses for Another Individual

You generally cannot deduct travel expenses you pay or incur for a spouse, dependent, or other individual who accompanies you (or your employee) on business or personal travel unless the spouse, dependent, or other individual is an employee of the taxpayer, the travel is for a bona fide business purpose, and such expenses would otherwise be deductible by the spouse, dependent, or other individual. See chapter 20 for more information on deductible travel expenses.

Voluntary Unemployment Benefit Fund Contributions

You cannot deduct voluntary unemployment benefit fund contributions you make to a union fund or a private fund. However, you can deduct contributions as taxes if state law requires you to make them to a state unemployment fund that covers you for the loss of wages from unemployment caused by business conditions.

Wristwatches

You cannot deduct the cost of a wristwatch, even if there is a job requirement that you know the correct time to properly perform your duties.

V. EXPENSES YOU CAN DEDUCT

You can deduct the items listed below as itemized deductions. Report these items on Schedule A (Form 1040), line 16, or Schedule A (Form 1040-NR), line 7.

LIST OF DEDUCTIONS

Each of the following items is discussed in detail after the list (except where indicated).

- Amortizable premium on taxable bonds.
- Casualty and theft losses from income-producing property.
- Excess deductions of an estate or trust.
- Federal estate tax on income in respect of a decedent.
- Gambling losses up to the amount of gambling winnings.
- Impairment-related work expenses of persons with disabilities.
- Losses from Ponzi-type investment schemes. See *Losses from Ponzi-type investment schemes* under *Theft* in chapter 26.
- Repayments of more than $3,000 under a claim of right.
- Unlawful discrimination claims.
- Unrecovered investment in an annuity.

Amortizable Premium on Taxable Bonds

In general, if the amount you pay for a bond is greater than its stated principal amount, the excess is bond premium. You can elect to amortize the premium on taxable bonds. The amortization of the premium is generally an offset to interest income on the bond rather than a separate deduction item.

Part of the premium on some bonds may be an itemized deduction on Schedule A (Form 1040).

Casualty and Theft Losses of Income-Producing Property

You can deduct a casualty or theft loss as an itemized deduction on Schedule A (Form 1040), line 16, if the damaged or stolen property was income-producing property (property held for investment, such as stocks, notes, bonds, gold, silver, vacant lots, and works of art). First, report the loss in Form 4684, Section B. You may also have to include the loss on Form 4797, if you are otherwise required to file that form. To figure your deduction, add all casualty or theft losses from this type of property included on Form 4684, lines 32 and 38b, or Form 4797, line 18a. For more information on casualty and theft losses, see chapter 26.

Excess Deductions of an Estate or Trust

Generally, if an estate or trust has an excess deduction resulting from total deductions being greater than its gross income, in the estate's or trust's last tax year, a beneficiary can deduct the excess deductions, depending on its character. The excess deductions retain their character as an adjustment to arrive at adjusted gross income on Schedule 1 (Form 1040), as a non-miscellaneous itemized deduction, or as a miscellaneous itemized deduction. For more information on excess deductions of an estate or trust, see the Instructions for Schedule K-1 (Form 1041) for a Beneficiary Filing Form 1040.

Federal Estate Tax on Income in Respect of a Decedent

You can deduct the federal estate tax attributable to income in respect of a decedent that you as a beneficiary include in your gross income. Income in respect of the decedent is gross income that the decedent would have received had death not occurred and that was not properly includible in the decedent's final income tax return.

Gambling Losses up to the Amount of Gambling Winnings

You must report the full amount of your gambling winnings for the year on Schedule 1 (Form 1040), line 8b. You deduct your gambling losses for the year on Schedule A (Form 1040), line 16. You cannot deduct gambling losses that are more than your winnings.

Caution!

You cannot reduce your gambling winnings by your gambling losses and report the difference. You must report the full amount of your winnings as income and claim your losses (up to the amount of winnings) as an itemized deduction. Therefore, your records should show your winnings separately from your losses.

Tip

Diary of winnings and losses. You must keep an accurate diary or similar record of your losses and winnings.

Your diary should contain at least the following information.

- The date and type of your specific wager or wagering activity.
- The name and address or location of the gambling establishment.
- The names of other persons present with you at the gambling establishment.
- The amount(s) you won or lost.

Impairment-Related Work Expenses

If you have a physical or mental disability that limits your being employed, or substantially limits one or more of your major life activities, such as performing manual tasks, walking, speaking, breathing, learning, and working, you can deduct your impairment-related work expenses.

Impairment-related work expenses are ordinary and necessary business expenses for attendant care services at your place of work and for other expenses in connection with your place of work that are necessary for you to be able to work.

Self-employed. If you are self-employed, enter your impairment-related work expenses on the appropriate form (Schedule C, E, or F) used to report your business income and expenses.

Repayments Under Claim of Right

If you had to repay more than $3,000 that you included in your income in an earlier year because at the time you thought you had an unrestricted right to it, you may be able to deduct the amount you repaid or take a credit against your tax. See Repayments in chapter 12 for more information.

Unlawful Discrimination Claims

You may be able to deduct, as an adjustment to income on Schedule 1 (Form 1040), line 24h, attorney fees and court costs for actions settled or decided after October 22, 2004, involving a claim of unlawful discrimination, a claim against the U.S. Government, or a claim made under section 1862(b)(3)(A) of the Social Security Act. However, the amount you can deduct on Schedule 1 (Form 1040), line 24h, is limited to the amount of the judgment or settlement you are including in income for the tax year.

Unrecovered Investment in Annuity

A retiree who contributed to the cost of an annuity can exclude from income a part of each payment received as a tax-free return of the retiree's investment. If the retiree dies before the entire investment is recovered tax free, any unrecovered investment can be deducted on the retiree's final income tax return. See chapter 10 for more information about the tax treatment of pensions and annuities.

CHAPTER 27: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1.	**All of the following categories of employment can continue to claim a deduction for unreimbursed employee expenses post the passage of the TCJA except:** **A.** Armed Forces reservists **B.** qualified performing artists **C.** nonprofit organization employees **D.** fee-basis state or local government officials
2.	**In order for employees in certain categories of employment to deduct unreimbursed employee expenses, the expenses must be which of the following:** **A.** ordinary **B.** necessary **C.** lavish **D.** both A and B above

CHAPTER 27: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. You are a member of a reserve component of the Armed Forces if you are in the Army, Navy, Marine Corps, Air Force, or Coast Guard Reserve; the Army National Guard; or the Reserve Corps of the Public Health Service. **B.** Incorrect. You are a qualified performing artist if you performed services in the performing arts as an employee for at least two employers during the tax year, received at least two of the employer's wages of $200 or more per employer, had allowable business expenses attributable to the performing arts of more than 10% of gross income from the performing arts, and had adjusted gross income of $16,000 or less before deducting expenses as a performing artist. **C.** **CORRECT**. Nonprofit organization employees are not among the categories listed by the IRS. **D.** Incorrect. You are a qualifying fee-basis official if you are employed by a state or political subdivision of a state and are compensated, in whole or in part, on a fee basis. *(See page 408 of the course material.)*
2.	**A.** Incorrect. An expense is ordinary if it is common and accepted in your trade, business, or profession. However, this is not the best response. **B.** Incorrect. An expense is necessary if it is appropriate and helpful to your business. However, this is not the best response. **C.** Incorrect. Lavish expenses are not considered deductible. **D.** **CORRECT**. Unreimbursed employee expenses can only be deducted if they are paid or incurred during the taxpayer's tax year, for carrying on the taxpayer's trade or business of being an employee, and ordinary and necessary. *(See page 409 of the course material.)*

CHAPTER 28: SECTION 199A PASS-THROUGH INCOME DEDUCTION

Chapter Objective

After completing this chapter, you should be able to:

- Identify the rules in the TCJA related to claiming a deduction for "qualified business income."

Note: This chapter has been updated with the Final Regulations and Other IRS Guidance issued by the IRS in January 2019 and inflation adjusted numbers for 2024.

I. ¶4.01 QUALIFIED BUSINESS INCOME

Probably the most complex and far-reaching rule contained in the TCJA is the ability to claim a deduction for "qualified business income." This rule, contained in Code Section 199A, permits proprietors, partners and S corporation shareholders to claim a deduction for up to 20% of the taxable income from their enterprises. This new deduction is termed the "Section 199A deduction" or the "QBI deduction."

The American Jobs Creation Act of 2004 had added a deduction for Income Attributable to Domestic Production Activities. [Code Sec. 199] This rule allowed a deduction for certain income of various domestic production activities − up to 9% of taxable income. To allay some concerns about exportation of jobs, this deduction was limited to 50% of the W-2 wages paid in a taxable year. Thus, outsourcing of jobs could mean the loss of part of the base for the deduction. The Tax Cuts and Jobs Act repealed this deduction, but retained the 50% of W-2 wage rule for the QBI deduction. To accommodate real estate enterprises, which do not always have significant W-2 wage payments, Section 199A provides an alternate test using the basis of depreciable property.

As of 2018, two tax savings mechanisms replaced the former Section 199, Domestic Production Activities Deduction:

1. Reduction of the C corporation rate to 21%; and
2. A special deduction for noncorporate taxpayers for qualified business income (QBI).

However, the Further Consolidated Appropriations Act, 2018 [P.L. 115-141] restored the rules of former Section 199 for cooperatives. [P.L. 115-141, Sec. 101(b)(2)(A), Div. T]

DEDUCTION FOR QUALIFIED BUSINESS INCOME (QBI)

Code Section 199A permits a deduction for 20% of certain income from partnerships, proprietorships and S corporations. It also applies to dividends from real estate investment trusts (REITs), income from publicly-traded partnerships (PTPs) and certain payments from cooperatives (COOPs) to their patrons.

The deduction is 20% of the qualifying income, but is limited to 20% of the individual's taxable income, reduced for items taxed as net capital gains (long-term capital gains and qualified dividends). [Code Sec. 199A(a)(1)(B)] The deduction is taken below AGI, although it is available in full for taxpayers who itemize or those who use the standard deduction. [Code Sec. 63(b)(3)]

The rules for income from Real Estate Investment Trusts (REITs) and Publicly Traded Partnerships (PTPs) are straightforward. Commercial businesses, professional service businesses and farms are subject to the most complex rules described below.

- The rules require separate computations for each separate trade or business;
- The income and other items must be effectively connected with a U.S. trade or business;
- There are special rules based on the taxpayer's taxable income (before the § 199A deduction);
- Wage, salary and retirement income are not components of QBI;
- Dividends, including qualified dividends, are not components of QBI;
- Capital gains and losses do not directly enter into the computation of QBI, but these items may affect the ultimate deduction.

Comment

The QBI deduction was written hastily, and was amended several times between its initial exposure in the Senate draft bill and the product that ultimately became law. The various drafters omitted detailed rules which may be necessary to apply the law in its intended manner. Some of these might take the form of technical corrections or other statutory changes down the road. However, the IRS has specific and broad regulatory authority to interpret Section 199A. [Code Sec. 199A(f)(4)] Therefore, its interpretations will have substantial weight of authority and will not be easy to challenge successfully. The Consolidated Appropriations Act, 2018 has already amended rules concerning cooperatives and their patrons.

INCOME FROM REITs AND PTPs

A REIT is a domestic corporation, or association treated as a corporation for federal tax purposes, which qualifies and elects to be treated as a REIT. [Code Sec. 856] Substantially all of its income and assets must be connected with real estate. It must have 100 or more owners and cannot be controlled by a small group. It must distribute at least 90% of its taxable income.

A REIT is taxable as a corporation, except that it deducts the dividends paid to its owners. The owners include the dividends from the REIT as gross income. Some of the dividends may be treated as capital gains and others as ordinary income. [Code Sec. 857]

Comment

REITs are subject to several complex rules as to permissible income, assets and activities. These rules are beyond the scope of this Guide, and are found in Code Sections 856–860.

A PTP exists when interests in the partnership are traded on an established securities market or secondary market. [Code Sec. 7704(b)] A PTP is treated as a corporation unless 90% or more of its gross income is from "passive-type" sources. [Code Sec. 7704(c)] These sources are interest, dividends, real property rents, gains from the disposition of real property, income from oil, gas, mineral and other natural resources, and gains from disposition of any assets used in these income-producing activities. [Code Sec. 7704(d)] There are special rules relating to commodities.

A distribution from a REIT to an individual is not QBI, per se. [Code Sec. 199A(c)(1)] However, a distribution from a REIT qualifies for the 20% deduction if it is not treated as a capital gain or qualified dividend. [Code Sec. 199A(b)(1)(B), 199A(e)(3)] Similarly, an individual's share of income from a PTP is not QBI, although it qualifies for the 20% deduction.

The shareholder deduction for QBI from a REIT or PTP does not depend on the W-2 wages or qualified property of the entity. However, a PTP must have qualifying income from a U.S. trade or business. A PTP may have items of income and gain that do not qualify for the QBI deduction. As a reporting entity, a PTP must inform its partners about the income items that do qualify for this deduction.

Gains from dispositions of interests in REITs and PTPs are generally capital gains. However, if a PTP has unrealized receivables or substantially appreciated inventory items, some or all of the gain on the disposition of an interest in a partnership may be ordinary income. [Code Sec. 751(a)] Ordinary income resulting from the disposition of a PTP qualifies for the QBI deduction.

Comment

Given the requirements for the income and assets of a qualifying PTP, it is unlikely that unrealized receivables and substantially appreciated inventory items would be a significant portion of the partnership's assets. Therefore, it is unlikely that many gains from the disposition of interests in these entities will be treated as ordinary income.

The deduction for income from a REIT or PTP is the easiest to compute. There is no reference to W-2 wages, qualified property or the taxpayer's taxable income, except for the overall limit. The deduction is the lesser of 20% of the REIT or PTP income or 20% of the individual's taxable income (excluding gains and dividends taxed at capital gain rates).

Example 1

Jeannie, a single individual, has the following income in 2024:

Salary	$100,000
Dividends from REITs (ordinary income)	50,000
Income from PTPs	40,000
AGI	$190,000

Her itemized deductions are $31,000. Thus, her taxable income is $159,000, before any QBI deduction. She calculates her base for the QBI deduction as the lesser of:

Income from REITs and PTPs	$90,000	
Tentative deduction	20%	18,000
Taxable income:		
AGI	190,000	
Less itemized deductions	(31,000)	
Taxable income pre QBI	159,000	
Tentative deduction	20%	31,800
Lesser amount		18,000
199A Deduction		$18,000

When some of the taxable income is taxed as a net capital gain there is another limitation. Since capital gain tax rates already provide an advantage over ordinary income, this amount of taxable income reduces the base for the QBI deduction. [Code Sec. 199A(2)(B)]

Example 2

Merle, a single individual, has the following income in 2024:

Qualified dividends	$100,000
Dividends from REITs	50,000
Income from PTPs	40,000
AGI	$190,000

His itemized deductions are $31,000. Thus, his taxable income before the QBI deduction is $159,000, the same amount reported by Jeannie in Example 1. He calculates his base for the QBI deduction as the lesser of:

Example 2 (continued)

Income from REITs and PTPs	$90,000	
Tentative deduction	20%	18,000
Taxable income:		
AGI	190,000	
Less itemized deductions	(31,000)	
Taxable income pre QBI	159,000	
Less net capital gain	(100,000)	
Taxable income limitation	59,000	
Tentative deduction	20%	11,800
Lesser amount		11,800
199A Deduction		$11,800

INCOME FROM SOURCES OTHER THAN REITs AND PTPs

For business income other than from REITs and PTPs, there are several requirements, some of which depend upon the taxpayer's level of income. Rules that do not fluctuate with the taxpayer's income level include:

- The income must be effectively connected with a U.S. trade or business; [Code Sec. 199A(c)(3)(A)(i)]
- Certain income is not QBI, even if it is effectively connected with a U.S. trade or business; [Code Sec. 199A(c)(3)(B)]
- Each taxpayer must compute a separate deduction for each trade or business. [Code Sec. 199A(b)(2)]

Provisions that vary with the taxpayer's income are:

- The deduction is generally limited to 20% of the taxable income if taxable income is less than the taxpayer's QBI. [Code Sec. 199A(a)(1)(B)(i)]
- Income from a specified service business may or may not be part of the base for the QBI deduction, depending on the amount of taxable income and the taxpayer's filing status. [Code Sec. 199A(d)(1)(A), 199A(d)(3)]
- For a business other than specified service activity, the deduction may or may not depend on W-2 wages paid by the taxpayer or qualified property held by the taxpayer, depending on the amount of taxable income and the taxpayer's filing status. [Code Sec. 199A(b)(2)]

EFFECTIVELY CONNECTED WITH TRADE OR BUSINESS WITHIN U.S.

To be QBI, the income must be effectively connected with a U.S. trade or business. [Code Sec. 199A(c)(3)(A)(i)] This rule borrows from Code Section 864(c), in Subchapter N, *Tax Based on Income from Sources Within or Without the United States*.

The U.S. place of business is also a material factor if it is used for management of U.S. sales, rents or royalties. [Reg. § 1.864-6(b)(2)] Thus, rentals and royalties from U.S. property are clearly within this requirement. Any business conducted in Puerto Rico is treated as a U.S. trade or business for this purpose. [Code Sec. 199A(f)(1)(C)(i)]

Section 864(c) contains several rules applicable to foreign persons and entities and most of its language is concerned with what is not U.S. source income. The principal test is based on having an office or other fixed place of business within the U.S., if the place is a material factor in the realization of the income, gain, or loss, and if the income, gain, or loss is realized in the ordinary course of the trade or business carried on through that office or other fixed place of business. [Reg. § 1.864-6(b)(1)]

INCOME NOT TREATED AS QUALIFIED BUSINESS INCOME

Certain income is not QBI, even if it is effectively connected with a U.S. trade or business. [Code Sec. 199A(c)(3)(B)]

These items include:

- Long-term and short-term capital gains and losses;
- Dividends and equivalents (other than patronage dividends from cooperatives);
- Interest (other than that properly allocable to a trade or business); and
- Annuities (unless properly allocable to a trade or business).

In addition, wage or salary income received from the activity does not constitute QBI for an S corporation shareholder-employee. [Code Sec. 199A(c)(4)(A)] Similarly, guaranteed payments received by a partner, as well as any amounts received by a partner in a nonpartner capacity do not count as QBI. [Code Sec. 199A(c)(4)(B), (C)]

Example 3

Sandy and Paul are the sole and equal shareholders of Sapco, an S corporation. Sandy is the president and active manager of the corporation's business. Paul, her brother, lives in another state and is a passive investor. All of the business income in 2023 is QBI. The net income, after payment of Sandy's $200,000 salary, is $600,000. There are no other employees of Sapco. Sandy and Paul would each treat $300,000 as qualified business income and would each treat their portions of Sandy's salary as qualifying W-2 wages (see discussion below). Therefore, assuming that both shareholders had taxable income in excess of the threshold and phaseout limits, they could claim a QBI deduction of $50,000, the lesser of 20% of QBI or 50% of their allocable W-2 wages. Sandy cannot claim any of her salary as QBI.

Example 4

Assume the same facts in Example 3 except that Sapco is a limited liability company, treated as a partnership for federal income tax purposes. Sandy's compensation is a guaranteed payment for services. Since guaranteed payments are not reported on Form W-2, Sapco has no qualifying W-2 wages. If the partners are above the threshold and phaseout ranges, they cannot claim any QBI deduction.

These rules do not restrict QBI to ordinary income, *per se*. As a matter of fact, due to the incorporation of the Section 864 rules, gains from sales of property used in a U.S. trade or business are not excluded from QBI.

Example 5

Salty, an S corporation realized $85,000 of ordinary income in 2024. It also sold some business assets, resulting in a $25,000 depreciation recapture and $45,000 of Section 1231 gain from the sale of depreciated real estate. Salty also reported interest and dividend income of $10,000 from portfolio investments. Salty has no sources of income from outside the U.S.

The ordinary income and the depreciation recapture are taxable at ordinary income rates. Thus, if any shareholder is at the highest income bracket, and has sufficient taxable income to deduct the entire 20% from Salty, the effective tax rate on this income is 29.6% (80% x 37%). Assuming that the Section 1231 gain is not converted to ordinary income by the five-year lookback rule, it is not treated as part of QBI.

Example 5 (continued)

Sally, the sole shareholder of Salty, has no Section 1231 losses in the current or past five years. Her Section 1231 gain is not QBI. She computes her QBI from Salty as:

Ordinary income	$85,000
Depreciation recapture	25,000
QBI	$110,000

TAXABLE INCOME THRESHOLD RULES

Some of the most important tax planning needs to focus on increasing or decreasing taxable income to get certain results for the QBI deduction. Important limits apply to individual taxpayers, based on their level of taxable income.

- If taxable income is below a certain threshold, income from specified services constitutes qualified business income. If the income is above the threshold, this income does not qualify for the QBI deduction.
- If income is below the threshold, the deduction for income from a trade or business other than a specified service activity is not dependent upon the W-2 wages paid by the business or the qualified property held by the business. If the taxpayer's income exceeds the threshold, the deduction for QBI is limited by one or both of these factors.

When income exceeds the threshold, there is a phaseout range. When taxable income exceeds the threshold, but is within the phaseout range, the limits apply in part. When taxable income exceeds the threshold plus the phaseout range, the limits apply in full. The threshold rules depend on the taxpayer's filing status. [Code Sec. 199A(e)(2)]. The thresholds, but not the phaseout ranges, are indexed after 2018.

TABLE 28-1. THRESHOLDS FOR PHASE-IN OF LIMITATIONS (2024)

Filing Status	All Except Married Filing Joint	Married Filing Joint
Threshold	$191,950	$383,900
Phaseout for wage and property limit [Code Sec. 199A(b)(3)(B)] and service income [Code Sec. 199A(d)(3)]	50,000	100,000
End of phaseout	$241,950	$483,900

SEPARATE COMPUTATION FOR EACH TRADE OR BUSINESS

Code Section 199A requires a separate computation of the income and other limits for each qualified trade or business. [Code Sec. 199A(b)(1)(A), Code Sec. 199A(c)(1)] Accordingly, a taxpayer with more than one trade or business may not mix the income of one activity with the W-2 wages or qualified property of another.

Determination of what constitutes a separate trade or business will be problematic for planning and compliance with the new deduction. In some cases, taxpayers may want to separate certain activities, especially when one activity is a specified service business, and another is not.

In other cases, taxpayers will want to combine business ventures so that the income from one enterprise can draw upon the W-2 wages or qualified property of another.

Aggregation of Multiple Trades or Businesses

The Code does not specify rules for aggregation and separation. According to the regulations, each business activity must be treated as a separate trade or business unless aggregation is permitted. [Reg. §1.199A-4(a)] The regulations contain some specific aggregation rules. A pass-through entity that conducts more than one business may aggregate, if the businesses meet the ownership and business relationship rules and if none of the businesses to be aggregated are specified service trades or businesses (SSTBs). If a pass-through entity elects to aggregate businesses, each partner or shareholder is bound by the aggregation of those particular businesses.

Each partner or shareholder may also be allowed to aggregate activities. This aggregation could include businesses conducted by one or more S corporations or partnerships, even if the entities did not elect to aggregate. However, in order to aggregate, all of the owners' aggregate activities must meet the ownership and business relationship tests as discussed below.

The Ownership Tests

There are three basic rules governing the ownership tests.

1. In order to aggregate, a person, entity, or group must own at least 50% of each trade or business. [Reg. §1.199A-4(b)(1)(i)] The ownership must be outright ownership of the entire activity, stock (in S corporations) and capital or profits interest (in partnerships).
2. There must be common ownership for a majority of the taxable year in question. [Reg. §1.199A-4(b)(1)(ii)]
3. All of the businesses must use the same taxable year, not including short years. [Reg. §1.199A-4(b)(1)(iii)]

A taxpayer uses the rules of Code Sections 267(b) and 707(b) to determine constructive ownership for purposes of the aggregation rules. [Reg. §1.199A-4(b)(1)(i)]

The Business Relationship Tests

Each of the eligible businesses must share at least two of these attributes with the others:

1. The products or services must be the same or complementary;
2. The businesses must share the same facilities or business functions such as accounting, and payroll, advertising, etc.; and
3. There must be interdependence between (or among) the businesses. [Reg. §1.199A-4(b)(1)(v)]

Aggregation Election by Pass-Through Entity

The primary burdens on the pass-through entity in this situation are reporting income, deductions, gains, losses, etc., to shareholders and accounting for separate and combined lines of business. The burdens of disallowance, and the benefits of deducting suspended losses, fall entirely on the owners.

Once a pass-through entity makes a grouping election, the owners must group those activities with each other, with activities conducted directly by the taxpayer, or with activities conducted through other S corporations or partnerships, in accordance with the same criteria. [Reg. §1.199A-4(b)(2)(ii)]

Example 6

Green, LLC has several partners. Green owns and operates a highway center. The center has a gas and diesel station, a convenience store and a fast food franchise. Each of these businesses has separate books and records. If Green treats these enterprises as separate activities, each of the owners may group the income or loss from each enterprise with income or loss from other enterprises of a similar nature, assuming that the other activities meet all tests for aggregation with Green's businesses. If Green aggregates the three as a single business, no shareholder will be able to disaggregate the grouping.

Aggregation by Shareholder or Partner

A shareholder or partner may not treat activities owned by a pass-through entity as separate activities if the entity has grouped them together. However, the owners may group certain activities together. This could be useful when combining attributes of separate activities could match income with one venture with W-2 wages paid by another activity or with the qualified property owned by an enterprise under common control. See discussion of these limits below.

Example 7

Sally and Vic are married and file a joint return. Vic is the sole shareholder of Vic's Market, an S corporation that operates a grocery store. Sally is the sole shareholder of J Co., which owns a building and rents it to Vic's Market. This arrangement has been in effect for the entire taxable year. Under Code Section 267(b), Sally and Vic are each treated as the owner of each other's property. Therefore, the rental and grocery meet the ownership test required for aggregation. The store and the building are also interdependent. They are also at the same location. Therefore, Vic and Sally can aggregate the rental and the grocery operation.

The net income from the market and the net income from the rent would be treated as QBI from one business. Sally and Vic would also be able to use the qualified property limit from the rental as one of the factors determining the deduction for the income of the combined entity.

SPECIFIED SERVICE TRADE OR BUSINESS RULES

Any taxpayer whose taxable income exceeds the threshold plus phaseout is not able to claim a deduction for income from a *"specified service trade or business."* This rule begins by borrowing a definition from Code Section 1202(e)(3)(A), but then makes some modifications. Section 1202(e)(3)(A) lists the following activities as being service businesses:

- Health
- Law
- Engineering (but see below for Section 199A)
- Architecture (but see below for Section 199A)
- Accounting
- Actuarial Science
- Performing Arts
- Consulting
- Athletics
- Financial Services
- Brokerage Services, or
- Any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees.

The regulations treat the reputation of owners or employees as the principal asset of an SSTB only under the following limited circumstances: [Reg. §1.199A-5(b)(2)(xiv)]

- Fees, compensation, or other income is received for endorsing products or services;
- Licenses or fees, compensation, or other income for the use of an individual's image, likeness, name, signature, voice, trademark, or any other symbols associated with the individual's identity is received;
- Fees, compensation, or other income for appearing at an event or on radio, television, or another media format is received.

Example 8

Ed's Eatery, Inc., an S corporation, owns a gourmet restaurant in an out of the way location. Since Ed's Eatery hired Esther Epicurean, a widely-renowned chef, it is booked every night of the week, and customers need to reserve tables several days in advance. Ed's Eatery is not treated as an SSTB.

Section 199A adds investing and investment management, trading, or dealing in securities, partnership interests, or commodities to the list of specified services. [Code Sec. 199A(d)(2)(B)]

However, Section 199A specifically excludes engineering and architecture. Thus, these professions are governed by the commercial business rules.

TAXABLE INCOME DOES NOT EXCEED THRESHOLD

Taxpayers whose taxable income does not exceed the threshold described in Table 1 treat income from a specified service business as QBI. Thus, if a taxpayer's AGI less the standard deduction or itemized deductions does not exceed $191,950 ($383,900 for married filing joint returns), all of the specified service business income is QBI. [Code Sec. 199A(d)(3)(A)(i)]

Example 9

Dino, a single individual, has the following income in 2024:

Qualified dividends	$10,000
Income from law practice, sole practitioner	120,000
Other ordinary income, not from trade or business, rent or royalty	15,000
Self-employment tax deduction	(8,478)
AGI	$145,000

Dino does not itemize deductions. Subtracting the standard deduction of $14,600 from his AGI, his taxable income is $130,400. He must determine whether or not his taxable income (before the Section 199A deduction) is under the threshold of $191,950.

Example 9 (continued)

[*See Table 1, above*] Since his income is less than the threshold, he treats all of his law practice income as QBI. He calculates his base for the QBI deduction as the lesser of:

Income from law practice, net of self-employment tax deduction	$111,522	
Tentative deduction	20%	$22,304
Taxable income:		
AGI	145,000	
Less standard deduction	(14,600)	
Taxable income pre QBI	121,922	
Less net capital gain	(10,000)	
Taxable income limitation	111,922	
Tentative deduction	20%	22,384
Lesser amount		22,304
Deduction		$22,304

Dino's taxable income is:

Adjusted gross income	$136,522
Standard deduction	(14,600)
QBI deduction	(22,304)
Taxable income	$99,618

TAXABLE INCOME EXCEEDS THRESHOLD PLUS PHASEOUT

When a person's taxable income exceeds the threshold limit of $191,950 ($383,900 for married filing joint return) plus the phaseout range of $50,000 ($100,000 for married filing joint return), none of the income from a specified service business is QBI.

Example 10

Assume the same facts in Example 9, except that Dino's income from his law practice is $250,000. He has the following income in 2024:

Qualified dividends	$10,000
Income from law practice, sole practitioner	250,000
Other ordinary income, not from trade or business, rent or royalty	15,000
Self-employment tax deduction	12,056
AGI	$262,944

Example 10 (continued)

Dino does not itemize deductions. Subtracting the standard deduction of $14,600 from his AGI, his taxable income is $248,344. He must determine whether or not his taxable income (before the Section 199A deduction) is under the threshold of $191,950 plus the $50,000 phaseout, or $241,950. [*See* Table 1] Since his income exceeds the threshold plus the phaseout range, none of his law practice income is QBI. Dino's taxable income is:

Adjusted gross income	$262,944
Standard deduction	(14,600)
QBI deduction	0
Income	$248,344

In this case, the increase of $130,000 of gross income, when comparing Example 10 and Example 9, created $148,726 of additional taxable income ($248,344 - 99,618) resulting from the loss of the QBI deduction.

TAXABLE INCOME EXCEEDS THRESHOLD BUT IS WITHIN PHASEOUT RANGE

When a person's taxable income exceeds the threshold limit of $191,950 ($383,900 for married filing joint return,or $191,950 for married filing separate return)) but is within the phaseout range of $50,000 ($100,000 for married filing joint return), a portion of the income from a specified service business is QBI. To determine the percentage allowed as QBI, the taxpayer must back in from the amount disallowed. The amount disallowed is [Code Sec. 199A(d)(3)(B]:

$$\frac{\text{(Taxable income less threshold)}}{\text{(phaseout range)}}$$

Example 11

Assume the same facts in Example 9 except that Dino's income from his law practice is $220,000. He has the following income in 2024:

Dividends	$10,000
Income from law practice, sole practitioner	220,000
Other ordinary income, not from trade or business, rent or royalty	15,000
Self-employment tax deduction	(11,520)
AGI	$233,480

Example 11 (continued)

He does not itemize deductions. Thus, his taxable income is $218,880 ($233,480 – 14,600), before any allowable Section 199A deduction. His income from his law practice is subject to the specified service rules. Since his income exceeds the threshold but not the phaseout range he may treat a portion of his law practice income as QBI.

Taxable income before Section 199A deduction	$218,880
Threshold	(191,950)
Excess	26,930
Phaseout range	50,000
Excess as % of phaseout range ($26,930/50,000)	53.9%
Percent of deduction allowed	46.1%
Service before limit ($220,000 - 11,520)	208,480
QBI	96,109
QBI deduction (20% of permitted specified service business income)	19,222
20% of taxable income before Section 199A deduction (20% of $218,880)	43,776
Lesser of two: QBI deduction	$19,222

Thus, his taxable income is:

Adjusted gross income	$233,480
Standard deduction	(14,600)
QBI deduction	(19,222)
Income	$199,658

INAPPLICABILITY OF W-2 WAGE OR QUALIFIED PROPERTY LIMITS

Qualifying trade or business income, other than that from specified service businesses, is subject to deduction limits based on W-2 wages, and basis of qualified property. These limits are subject to the same threshold and phaseout limits and the same partial allowances that apply to specified service business income. Therefore, these limits only apply when the taxable income is above the threshold but below the full phase-out.

OTHER TRADE OR BUSINESS RULES

U.S. source business income other than specified service business income, is subject to the QBI deduction even for taxpayers whose incomes exceed the threshold. However, there are some special limitations that affect this deduction, which are dependent upon the relationship of the taxpayer's taxable income to the thresholds and phaseouts.

W-2 WAGE LIMITATION

A holdover rule from the now-repealed Domestic Production Activities Deduction is a limitation based on the W-2 wages paid by the business during the taxable year. In general, a taxpayer's QBI deduction is limited to 50% of W-2 wages paid. [Code Sec. 199A(b)(2)(i)]

However, there are some exceptions to this rule. First, the limit does not apply to any taxpayer whose taxable income (before the Section 199A deduction) is less than the threshold amount. [Code Sec. 199A(b)(3)(A)] The threshold and phase-ins are the same as those discussed above under specified service business income.

Moreover, a taxpayer with substantial depreciable property may qualify for the combined W-2 wage and property limitation. W-2 wages include any payment subject to either FICA or withholding. [Code Secs. 199A(b)(4)(A), 6051(a), 3401(a)] Thus, items included on Form W-2, such as health insurance for employees, including S corporation shareholder-employees, constitute part of the W-2 base. Wages paid in Puerto Rico also qualify as part of this base. [Code Sec. 199A(f)(1)(C)(ii)]

However, guaranteed payments to partners are not reported on Form W-2, but, rather, are reported on Form 1065, Schedule K-1. These payments are not part of the W-2 base. The W-2 wages are only those applicable to a qualified trade or business. [Code Sec. 199A(b)(4)(B)] Any wages allocable to foreign source income or to investment income that does not constitute trade or business income, would not be taken into account for this limit.

Moreover, the W-2 wages must be reported on a payroll tax return. This return, if not filed timely, must be filed no later than 60 days following the due date of the return. [Code Sec. 199A(b)(4)(C)]

LIMIT PER TRADE OR BUSINESS

This limitation applies to each separate trade or business. The grouping limitations discussed above may be important in this regard.

Example 12

Surpersoft, Inc, an S corporation, sells and installs specialized computer software. Surpersoft has a substantial payroll. Softmagic, LLC, is owned by the shareholders of Surpersoft, in equal proportions. Softmagic owns the intellectual property rights to the software sold by Surpersoft and receives royalties from Surpersoft on every copy of software it sells. Softmagic has no employees. All of the owners have taxable income in excess of the thresholds and phaseout ranges.

Since the two entities are functionally independent, in similar business lines and have identical ownership, the owners should be able to group income from both entities together and treat them as a unified business for purposes of the Section 199A deduction. Otherwise the income from Softmagic would not qualify for the deduction since it pays no W-2 wages.

TAXABLE INCOME EXCEEDS THRESHOLD PLUS PHASEOUT

When a person's taxable income exceeds the threshold limit of $191,950 ($383,900 for married filing joint return) plus the phaseout range of $50,000 ($100,000 for married filing joint return), the W-2 wage limit applies in full.

Example 13

Bryce and Josephine file a joint return in 2024. Their combined income items are:

Ordinary income	$50,000
Capital gains & qualified dividends	60,000
Qualified business income	750,000
AGI	860,000
Itemized deductions	(70,000)
Taxable income before 199A deduction	$790,000

Bryce's business reported $350,000 net income and paid $90,000 W-2 wages this year. Josephine's net income was $400,000 and her business paid $1,300,000 in W-2 wages. They compute each QBI deduction separately and then combine the two.

	Bryce	**Josephine**	**Total**
Net income	$350,000	$400,000	
20% QBI	70,000	80,000	
W-2 wages	90,000	1,300,000	
W-2 limit (50%)	45,000	650,000	
Lesser amount, 2 or 4	**$45,000**	**$80,000**	$125,000
Taxable income limitation (less capital gain)	730,000	20%	146,000
Section 199A deduction			$125,000

Their itemized deductions are $70,000. They compute their taxable income as follows:

AGI	$860,000
Itemized deductions	70,000
Taxable income before 199A deduction	790,000
199A deduction	125,000
Taxable income	$665,000

WAGE AND PROPERTY LIMITATION

As an alternative to the wage limitation, a taxpayer may claim a limit based on W-2 wages plus a percentage of basis of certain property. [Code Sec. 199A(b)(2)(ii)] The first component is 25 percent of the W-2 wage base. The second component is based on the unadjusted basis of certain *qualified property* held at the end of the year. [Code Sec. 199A(b)(6)] Qualified property has several requirements as described below:

- Only tangible and depreciable property qualifies (thus land and intangibles do not qualify); [Code Sec. 199A(b)(6)(A)]
- The property must be held and available for use at the end of the year; [Code Sec. 199A(b)(6)(A)(i)]
- The property must have been used for production of QBI during the year; [Code Sec. 199A(b)(6)(A)(ii)]
- The "depreciable period" of the property must not have ended at the close of the year; [Code Sec. 199A(b)(6)(A)(iii)]
- There are some special rules relating to the depreciable period, of property, as the term applies to Section 199A:
    - If the property's MACRS life exceeds 10 years, the depreciable period is the last full year MACRS life;
    - For other property, the depreciable period is 10 years.

The MACRS life is determined without regard to any required or elected alternative depreciation system period. The period ends with the last year in which the holder may claim an entire year of depreciation. For nonresidential property, that year would be 39 years, since the mid-month convention applies to real estate. For nonresidential property with a 27½ year, it would be the 27th or 28th year of ownership, depending upon the time of year the property was originally placed in service. For qualified improvement property, subject to the half-year convention or mid-quarter convention, the depreciable period ends with the 15th year.

Example 14

Assume the same facts in Example 13 except that Bryce's business holds $1,500,000 of qualified property at the end of the year and Josephine's business owns $1,000,000 of qualified property (unadjusted basis in both cases). They would compute the QBI deductions as:

Example 14 (continued)

	Bryce	Josephine	Total
Net income	$350,000	$400,000	
Wages paid	90,000	1,300,000	
W-2 limit (50%)	**45,000**	**650,000**	
W-2 + property limit			
Qualified property	1,500,000	1,000,000	
2.5%	37,500	25,000	
25% W-2 wages	22,500	325,000	
W-2 + property limit	**60,000**	350,000	
Limit, > of W-2 or W-2 + qualified property	60,000	650,000	
20% QBI	70,000	**80,000**	
20% of taxable income (less capital gain) before §199A, from Example 13			146,000
QBI deduction	60,000	80,000	$140,000

Again, their itemized deductions are $70,000. They compute their taxable income as follows:

AGI	$860,000
Itemized deductions	70,000
Taxable income before 199A deduction	790,000
199A deduction	140,000
Taxable income	$650,000

PHASE-IN OF W-2 AND QUALIFIED PROPERTY LIMITS

The limits concerning W-2 wages and qualified property do not apply to taxpayers whose taxable income does not exceed the threshold amount, described in Table 1. [Code Sec. 199A(b)(3)(B)] When taxable income exceeds the threshold, but is still within the phaseout range, the limits apply proportionately. [Code Sec. 199A(b)(3)(B)(i)]

Example 15

Assume the same facts in Example 14, except that Bryce and Josephine also incur a loss from an interest in a Mexican resort in which they materially participate. The loss is $400,000, which reduces their ordinary income from $50,000 to a loss of $350,000. Since this business is not located in the U.S., it has no effect on QBI, *per se*.

Their joint taxable income, before the Section 199A deduction is:

Ordinary income	($350,000)
Capital gains & qualified dividends	60,000
Qualified business income	750,000
AGI	460,000
Itemized deductions	(70,000)
Taxable income before 199A deduction	390,000

Since they file a joint return, their threshold is $383,900 and their phaseout range is $100,000. Their income is between the threshold and the end of the phaseout range, so they may claim deductions for a portion of QBI in excess of the W-2 or W-2 and qualified property limits.

Their taxable income before the Section 199A deduction of $390,000 exceeds their threshold amount of $383,900 by $6,100. This is 6.1% of the phaseout range. Accordingly, they can claim a Section 199A deduction for 93.9% (1-.061) of the amount by which the QBI exceeds the W-2 and property limits, in addition to the amount allowed by those limits. Their allowable Section 199A deduction, before considering the taxable income limitation, is:

Example 15 (continued)

	Bryce	Josephine	Total
Net income	$350,000	$400,000	
Wages paid	90,000	1,300,000	
W-2 limit (50%)	**45,000**	**650,000**	
W-2 + property limit			
Qualified property	1,500,000	1,000,000	
2.5%	37,500	25,000	
25% W-2 wages	22,500	325,000	
W-2 + property limit	**60,000**	**350,000**	
Limit, > of W-2 or W-2 + QP	**60,000**	650,000	
20% QBI	70,000	**80,000**	
Excess	10,000	0	
Excess amount/$100,000	6.1%	6.1%	
Excess disallowed	610	0	
Excess allowed	9,390	0	
Section 199A deduction	$69,390	$80,000	$149,390

However, in this situation, their taxable income, less capital gain, is only $330,000. Thus, their Section 199A deduction is limited to $66,000. Their taxable income is:

Taxable income before 199A deduction	$390,000
199A deduction	66,000
Taxable income	324,000

EFFECT OF QUALIFIED BUSINESS LOSS

The effect of a loss from a qualified business is to offset income from other qualified businesses. If the overall QBI is still positive, it reduces the QBI from each other business proportionately. [Reg. §1.199A-1(d)(2)(iii)(A)] If the overall QBI is negative, the result is a carryforward, which offsets QBI deductions in future years. [Reg. §1.199A-1(d)(2)(iii)(B)]

Example 16

Assume the same facts in Example 15 except that the resort was in Puerto Rico, rather than Mexico. This loss is an item of negative QBI since any business in Puerto Rico is a U.S. business for purposes of QBI. Their joint taxable income, before the Section 199A deduction is unchanged in total, but the composition is different.

Ordinary income	$50,000
Capital gains & qualified dividends	60,000
Qualified business income	350,000
AGI	460,000
Itemized deductions	(70,000)
Taxable income before 199A deduction	$390,000

The loss from the Puerto Rico activity reduces their Section 199A deduction.

	Bryce	Josephine	Resort	Total
Net income	$350,000	$400,000	($400,000)	
Offset proportionately	(186,667)	(213,333)	400,000	
Net after loss	163,333	186,667		
Wages paid	90,000	1,300,000	0	
W-2 limit (50%)	45,000	650,000	0	
W-2 + property limit				
Qualified property	1,500,000	1,000,000	0	
2.5%	37,500	25,000	0	
25% W-2 wages	22,500	325,000	0	
W-2 + property limit	60,000	350,000	0	
Limit, > of W-2 or W-2 + QP	60,000	650,000	0	
20% QBI	32,667	37,333		
199A deduction	32,667	37,333		$70,000

However, the taxable income before the QBI deduction, net of capital gains and qualified dividends, is $330,000 Their Section 199A deduction is limited to $66,000.

Taxable income before 199A deduction	$390,000
199A deduction	(66,000)
Taxable income	$324,000

OVERALL LOSS FROM QUALIFIED BUSINESS ACTIVITIES

When the overall result of the QBI rules is negative, the negative amount carries forward and offsets future QBI deductions. [Code Sec. 199A(c)(2)]

Example 17

Assume the same facts in Example 16, except that the loss from the Puerto Rico activity was $780,000. Their income is:

Ordinary income	$50,000
Capital gains & qualified dividends	60,000
Qualified business income	(30,000)
AGI	$80,000
Itemized deductions	(70,000)
Taxable income before 199A deduction	$10,000

Their Section 199A deduction is:

	Bryce	Josephine	Resort	Total
Net income	350,000	400,000	(780,000)	
Offset proportionately	(364,000)	(416,000)	780,000	
Net after loss	(14,000)	(16,000)		(30,000)

The $30,000 negative item is carried forward as a separate item of QBI in 2025. Their taxable income is:

Taxable income before 199A deduction	$10,000
199A deduction	0
Taxable income	$10,000

The qualified business loss carryforward becomes an offset to QBI deductions in the next taxable year. [Code Sec. 199A(c)(2)]

Example 18

Assume in 2025 Bryce and Josephine had the same losses on Bryce's business and Josephine's business, and their taxable income did not allow them any relief from the W-2 and W-2 plus qualified property limits. Now assume that the Puerto Rico resort produced a breakeven in 2025. Their 199A deduction would be computed in the same manner as in Example 17, except that they would need to include their carryforward from 2024. Their computation would be:

	Bryce's business, 2025	**Josephine's business, 2025**	**Carryforward from 2024**	**Total**
Net income	$350,000	$400,000		
Offset proportionately	(14,000)	(16,000)	(30,000)	
Net after loss	336,000	384,000		
Wages paid	90,000	1,300,000		
W-2 limit (50%)	45,000	650,000		
Qualified property	1,500,000	1,000,000		
2.5%	37,500	25,000		
25% W-2 wages	22,500	325,000		
W-2 + QP limit	60,000	350,000		
Limit, > of W-2 or W-2 + QP	60,000	650,000		
20% QBI	67,200	76,800		
199A combined	60,000	76,800		136,800
20% of taxable income (less capital gain) before §199A				146,000
199A deduction				136,800

RULES FOR S CORPORATIONS AND PARTNERSHIPS

When the entity that actually conducts the business is not an individual, there are some special rules that apply. If the entity is a C corporation, there is no Section 199A deduction. If the entity is a partnership or S corporation, the deduction is claimed by the owners. [Code Sec. 199A(f)(1)(A)(i)]

In order for the partners or shareholders to calculate their QBI deductions, the partnership or S corporation must report the appropriate income and other items to each owner. The information needed is each partner or shareholder's portion of the necessary variables: [Code Sec. 199A(f)(1)(A)(ii)]

- Qualifying income and loss items from the qualifying business;
- W-2 wages paid by the qualifying business; and
- Qualified property owned by the business at the end of the taxable year.

PARTNERSHIPS

If the entity is a partnership, each partner receives a share of W-2 wages according to his or her share of partnership wage expense. [Code Sec. 199A(f)(1)(A)] If the partnership makes no special allocations of wage expense, this percentage will be the same as the partner's share of partnership income.

The partnership must allocate UBIA in accordance with its allocation of depreciation to the partners on the last day of the partnership's taxable year. [Reg. §1.199A-2(a)(3)(ii)] There is no allocation of UBIA to any person who has completely disposed of his or her partnership interest before the end of the partnership's taxable year.

Example 19

The Definer Partnership has four partners, David, Ellen, Floyd and Irene. David, the general partner, has an interest in 25% of the profits other than depreciation. David has a 10% share of partnership depreciation. The other three members each have a 25% interest in partnership income, except for depreciation and 30% of the depreciation deductions. In 2024, the partnership reports the following:

Interest income	$60,000
Rent income	250,000
W-2 wages to employees	(30,000)
Net rent before depreciation	220,000
Depreciation	(120,000)
Net rental income	100,000
Net income overall	$160,000

The partnership owns depreciable property with an unadjusted basis of $2,400,000 at year end. None of this property's depreciable period has expired.

The interest income is reported separately as portfolio income and does not become part of qualified business income. Each of the four partners receives $15,000 of interest income on Schedule K-1. The rent income is a bit more complicated.

The partners will be allocated the following:

Example 19 (continued)

	Total	David	Each other partner
Interest income	$60,000	$15,000	$15,000
Rent income	250,000	62,500	62,500
W-2 wages to employees	30,000	7,500	7,500
Net rent before depreciation	220,000	55,000	55,000
Depreciation	120,000	12,000	36,000
Net rental income	$100,000	$43,000	$19,000

Each partner determines his or her share of the income, W-2 and W-2 plus qualified property limits as follows:

	David	Each other partner
20% Net rent	$8,600	$3,800
50% W-2	3,750	3,750
25% W-2	1,875	1,875
2.5% QP	6,000	18,000
25% W-2 + 2.5% QP	7,875	19,875
199A deduction	$7,875	$3,800

S CORPORATIONS

When the entity is an S corporation, there will be no special allocations of any line item, such as depreciation. Therefore, if there are no changes in shareholdings during a taxable year, the qualifying income, W-2 wages, and qualified property limits will all be allocated per-share per day. However, if there is a complete termination of a shareholder's interest in the corporation, a substantial disposition of stock or a substantial issuance of new stock, there may be a split year. In this case, the corporation must allocate the income and W-2 wage information to each shareholder based on the income in each part of the year.

The S corporation must allocate UBIA in proportion to the outstanding shares on the last day of the corporation's taxable year. [Reg. §1.199A-2(a)(3)(iii)] There is no allocation of UBIA to any person who has disposed of all of his or her stock before the end of the corporation's taxable year.

Example 20

Hamlet, Inc., an S corporation, sold a building in June 2024. It purchased another in that same month, and some equipment in December. At the beginning of the year, Ken and Linda each held half of the stock of Hamlet, Inc. On May 26, 2024, Ken sold all of his stock to Mel.

Hamlet's income and deduction items, according to each portion of the year, were:

	Total	**Jan. 1 - May 26**	**May 27 - Dec. 31**
Income before wages and depreciation	$817,750	$293,500	$524,250
Depreciation	(77,750)	(21,500)	(56,250)
Wages	(240,000)	(72,000)	(168,000)
Net ordinary income	500,000	200,000	300,000
Section 1231 Gain	185,000		185,000
Qualifying income	$685,000	$200,000	$485,000

As of December 31, Hamlet has $2,420,000 unadjusted basis of qualified property. All of it had been used for production of qualified business income and none of this property was older than its depreciable period.

Hamlet's default allocation among the three shareholders is the weighted average per share per day method. [Code Sec. 1377(a)(1)] These pro-rata allocations will be:

	Linda 50%	**Ken 20%**	**Mel 30%**
Net ordinary income	$250,000	$100,000	$150,000
Section 1231 gain	92,500	37,000	55,500
QBI	342,500	137,000	205,500
UBIA 50% to Linda, 50% to Mel	1,210,000	0	1,210,000

Based on these allocations, each shareholder computes the appropriate Section 199A deduction, assuming that each is above the applicable taxable income threshold, and each has sufficient taxable income to support the deduction. For all of the items except UBIA, the corporation must allocate among the three shareholders on a per-share per-day formula. However, the corporation must allocate UBIA among the shareholders in proportion to the shares held on the last day of the year. In this case, Linda holds 50% and Mel holds 50%. The shareholders would each compute their Section 199A deductions as follows:

Example 20 (continued)

	Linda	Ken	Mel
20% Income	68,500	27,400	41,100
50% W-2 wages	60,000	24,000	36,000
2.5% Qualified property, 50% to Linda and 50% to Mel	30,250	0	30,250
25% W-2 wages	30,000	12,000	18,000
Combined W-2 & QP	60,250	12,000	48,250
Section 199A	60,250	24,000	41,100

Using the interim closing method to allocate income between Ken and Mel produces some different results.

Interim closing	**Linda 50% entire year**	**Ken 50% 1/1-5/26**	**Mel 50% 5/27-12/31**
Net ordinary income	$250,000	$100,000	$150,000
Section 1231 gain	92,500	0	92,500
QBI	342,500	100,000	242,500
W-2 wages	120,000	36,000	84,000
UBIA 50% to Linda, 50% to Mel	1,210,000		1,210,000

Each of the shareholders would then compute the QBI deduction.

	Linda	Ken	Mel
20% Income	68,500	20,000	48,500
50% W-2 wages	60,000	18,000	42,000
2.5% Qualified property, 50% to Linda and 50% to Mel	30,250		30,250
25% W-2 wages	30,000	9,000	21,000
Combined W-2 & QP	60,250	9,000	51,250
Section 199A	60,250	18,000	48,500

Since Linda did not exchange any shares during the year, her allocation using the interim closing method is the same as the pro-rata, and her Section 199A deduction is the combined W-2 wage and qualified property limit. However, Ken, who is allocated no UBIA for the year, uses the 50% of W-2 wage limit for his deduction. Mel, like Linda, has a slight advantage from the combined W-2 wage and qualified property limit.

APPLICATION TO COOPERATIVES AND PATRONS

Code Section 199A, after amendment by the Further Consolidated Appropriations Act, 2018, provides a special deduction for agricultural and horticultural cooperatives. In general, the deduction follows the rules for the Domestic Production Activities Deduction, prior to its repeal by the TCJA. The cooperative is allowed a deduction for 9% of its qualified production activities income of the year, or taxable income, whichever is less. [Code Sec. 199A(g)(1)(A)] The deduction is limited to 50% of the W-2 wages paid in connection with domestic production activities gross receipts. [Code Sec. 199A(g)(1)(B)]

Taxable dividends from cooperatives also qualify for the deduction by the patrons. However, the patron may be required to reduce the 20% deduction. As with the former DPAD, cooperatives may pass through a portion of this Code Section 199A(g) deduction to their patrons. Whether or not the cooperative passes through this deduction, a patron must reduce the QBI deduction attributable to patronage income by the lesser of 9% of the patron's income attributable to patronage income or 50% of wages paid by the patron in connection with the business that earned the income from the cooperative. [Code Sec. 199A(b)(7)]

EFFECT ON PARTNER OR SHAREHOLDER BASIS

The qualified business income passes through from the partnership or S corporation to the owner. Under the general basis rules, this income increases the owner's basis, thus making it available for tax-free distributions of cash, or deduction of future losses, or losses of a different character in the same year. However, the QBI deduction, computed at the owner level, does not affect basis in the partner's interest in the partnership or the shareholder's stock or debt basis.

Example 21

James and Meaghan are the two equal and only members in JAM, LLC. In 2024, JAM reports $200,000 of QBI, and $18,000 of cash charitable contributions. JAM distributes $50,000 to each member. James itemizes his deductions and Meaghan uses the standard deduction. Both are able to claim the Section 199A deduction in full.

The effects on each member's basis and taxable income are:

	James	**Meaghan**	**Total**
Ordinary income	$100,000	$100,000	$200,000
Distribution	(50,000)	(50,000)	(100,000)
Charitable contribution	(9,000)	(9,000)	(18,000)
Effect on basis	$41,000	$41,000	$82,000

	James	**Meaghan**
Ordinary income	$100,000	$100,000
Section 199A deduction	(20,000)	(20,000)
Charitable contribution	(9,000)	
Effect on taxable income	$71,000	$80,000

Comment

Although the statutory language on the effect of losses on the Section 199A deduction is scant, it seems almost certain that a loss would actually need to be allowable, and not blocked by the basis at-risk or passive activity limitations to result in a negative QBI amount.

Example 22

Evelyn is a shareholder in Evico, an S corporation. In 2024, her share of Evico's ordinary loss is $60,000. Evico's business qualifies for the Section 199A deduction. She has no other sources of QBI in 2024. Her basis in Evico stock is $40,000 and she has no debt basis in Evico. The amount she can potentially deduct on her 2024 income tax return is $40,000, and she must carry $20,000 of the loss forward to 2025. [Code Sec. 1366(d)(2)]

She must carry $40,000 forward to offset QBI in 2025 and future years, whether or not she is ever allowed to deduct the $20,000 loss in excess of basis. The $20,000 loss in excess of her basis has no effects on QBI until she can claim it on a return.

However, a loss carried forward from a year that began before 2018 does not affect QBI. The loss disallowance can be from basis, amount at risk, the passive activity loss limits, or a net operating loss. [Reg. §1.199A-3(b)(1)(iv)]

ACCURACY-RELATED PENALTIES ON UNDERPAYMENTS

Among the penalties of underpayment, or late payment of tax, is the Section 6662 penalty imposed in cases of negligence, disregard of rules, or "substantial understatement" of income tax. [Code Sec. 6662(b)] The penalty is 20 percent of the offending amount of understatement. [Code Sec. 6662(a)]

In general, a substantial understatement exists when the understatement exceeds the greater of $5,000 or 10 percent of the correct tax for the year. [Code Sec. 6662(d)(1)(A)] However, for any taxpayer claiming the Section 199A deduction, the 10 percent threshold is reduced to 5 percent. [Code Sec. 6662(d)(1)(C)]

Comment

The reduction of the underpayment threshold applies to any taxpayer claiming the Section 199A deduction. The understatement need not be caused by the deduction, but could be related to any overstated deduction or understated income.

EFFECT OF QBI DEDUCTION ON OTHER TAXES

In addition to the income tax, partners and shareholders may be subject to other taxes as a result of income from the pass-through entity. The most important federal taxes, in addition to the income tax, are:

- The alternative minimum tax;
- The self-employment tax; and
- The net investment income tax.

Section 199A specifically states that the deduction is limited to "this chapter." To understand the scope, Section 199A is contained in:

CHAPTER 1: NORMAL TAXES AND SURTAXES [Secs. 1—1400Z-2]

Thus, it only applies to taxes imposed on noncorporate taxpayers within these sections. The most important of these are the regular income tax (Section 1) and the alternative minimum tax (Section 55). Although the alternative minimum tax requires recalculation of several items of income and deductions, there is no second calculation of the QBI deduction for purposes of the alternative minimum tax. [Code Sec. 199A(f)(2)]

The self-employment tax rules appear in Chapter 2:

TAX ON SELF-EMPLOYMENT INCOME.

The net investment income tax rules are in Chapter 3:

UNEARNED INCOME MEDICARE CONTRIBUTION.

Therefore, the QBI deduction cannot reduce either of these taxes.

II. ¶4.02 ALTERNATIVE MINIMUM TAX

Although the House version of the TCJA would have repealed the alternative minimum tax, the final version did not go this far. The Act repealed the corporate alternative minimum tax, with a provision allowing the taxpayer to claim the alternative minimum tax credit between 2018 and 2021. [Code Sec. 53(c)]

The final version of the Tax Cuts and Jobs Act of 2017 did not repeal the alternative minimum tax for individuals. However, it substantially raised the exemption and phaseout. The 2024 exemptions and phaseouts are:

	2024
Exemption, married joint	$133,300
Exemption, single or head of household	85,700
Exemption, married filing separate	66,650
Exemption, estate or trust	29,900
Exemption phaseout begins, married joint	1,218,700
Exemption phaseout begins, single or head of household	609,350
Exemption phaseout begins, married filing separate	609,350
Exemption phaseout begins, estate or trust	99,700

** Rev. Proc. 2018-57, 2018-49 IRB 827 §3.12*

Pass-through entities must continue to report tax preferences and adjustments to their partners and shareholders. C corporations will need to determine their tentative alternative minimum tax for purposes of the alternative minimum tax credit. Individuals, estates and trusts will still need to determine tentative alternative minimum tax, although the imposition of the alternative minimum tax will undoubtedly apply in greatly reduced numbers.

III. ¶4.03 REPATRIATION OF FOREIGN EARNINGS

The United States has historically taxed its citizens and domestic corporations on their worldwide incomes. To alleviate the problems of multiple taxes on one income stream, the United States has offered a foreign tax credit.

Beginning in 2018, the U.S. approach shifted toward a territorial system, whereby domestic corporations are allowed to claim a deduction for dividends received attributable to foreign source income. [Code Sec. 245A] This deduction applies only to C corporations.

As part of the transition to the territorial system, there is a deemed repatriation of deferred foreign income for certain U.S. shareholders of foreign corporations. [Code Sec. 965] Under this rule, the U.S. shareholder must include in its income its share of undistributed foreign income from corporations in which it owns at least 10 percent of the stock. In some cases, a U.S. shareholder can be a partnership or S corporation. Since partnerships and S corporations are pass-through entities, the repatriation tax applies at the partner or shareholder level. There are certain reduced tax rates, depending upon the U.S. shareholder's portion of the cash, cash equivalents and noncash assets held abroad.

IV. ¶4.04 CHARITABLE CONTRIBUTIONS AND FOREIGN TAXES

One of the areas where there was a divergence between partnerships and S corporations was the relationship of charitable contributions and foreign taxes to shareholder basis. Since 1983, the Code has treated charitable contributions and foreign income taxes as items that are limited by shareholder basis [Code Sec. 1366(a)(1), flush language]

Example 23

Sharon and Barbara each own 50% of the stock in Sharbar, Inc., an S corporation. For 2017, the corporation sustained an ordinary loss of $80,000 and made qualifying cash contributions of $20,000. Neither shareholder received any distribution.

Sharon had basis of $60,000 at the beginning of 2017. She claims a deduction for $40,000 of ordinary loss and $10,000 of charitable contributions. She must reduce her basis by $50,000.

Barbara had no basis at the beginning of 2017. She would not be allowed any deduction for either the ordinary loss or the charitable contributions. Her basis would remain at zero.

In contrast, charitable contributions made by the partnership and foreign income taxes paid by the partnership had not been subject to the partner basis limit for deductibility. [Code Secs. 702(a)(4), 702(a)(6), 703(a)(2)(B), 703(a) (2)(C), Reg. § 1.704-1(d)(2); Ltr. Rul. 8405084]

Example 24

If Sharbar, from Example 23 had been a partnership, Sharon's deductible amounts would have been the same. However, Barbara, who had no basis in her partnership interest, would be able to claim her $10,000 charitable contribution. She would not have been allowed to deduct her share of ordinary loss and would have carried that amount forward. However, the charitable contribution would not reduce her basis in her partnership interest in 2017 or in any future year.

The TCJA removed this distinction. For taxable years beginning after 2017, both charitable contributions and foreign income tax of partnerships are now subject to the same limits as other losses. [Code Sec. 704(d)(3)(A)]

Example 25

Assume the same facts in Example 24 except that in the year 2024 Barbara would not be able to deduct any of the charitable contribution. She would need to carry it forward along with the ordinary loss from the year. Her total carryforward to 2025 would be:

Ordinary loss	$40,000
Charitable contributions	10,000
Total	$50,000

Assume that her share of income in 2025 was $30,000. She would be allowed to claim 60% ($30,000/$50,000) of each of the carryforwards on her 2025 tax return.

This rule does not apply to the excess of fair market value over the partnership's adjusted basis of capital gain property contributed to a qualifying organization. [Code Sec. 704(d)(3)(B), Conference Report to Accompany H.R. 1, December 15, 2017, p. 515] This also conforms to the treatment of S corporations and shareholders.

Example 26

Assume the same facts in Example 25, except that the contribution had been capital gain property with a FMV of $60,000 and adjusted basis of $20,000. Sharon and Barbara would each be allocated $30,000 of fair market value and $10,000 of basis in the contributed property. In 2024, Sharon would be able to claim a $30,000 charitable deduction and would only reduce her basis in her partnership interest by her allocated $10,000 of partnership basis of contributed property. Barbara would not be able to claim a $20,000 deduction in 2024 for her allocated basis in the contributed property but would be able to claim a 2024 deduction for her share of the contributed property's unrealized appreciation.

V. ¶4.05 TAXES PAID ON INCOME FROM PASS-THROUGH ENTITIES

Before 2018, individuals were allowed to claim itemized deductions for state, local and foreign income taxes assessed on their taxable income, including income from partnerships and S corporations. [Code Sec. 164(a)(3)] This deduction was subject to an add-back adjustment for purposes of the alternative minimum tax. [Code Sec. 56(b)(1)(A)(ii)]

At least one attempt to treat state income tax imposed on S corporation income as a trade or business, "above the line" deduction was unsuccessful. [Cutler v. Comm'r, TC Memo 2015-73] Therefore the proper treatment of state, local and foreign income tax imposed on an individual is that of an itemized deduction.

The Tax Cuts and Jobs Act of 2017 limits the deduction for all taxes allowed as itemized deductions to $10,000 per year. [Code Sec. 164(b)(6)] The legislative history indicates that the only exception is a business tax that is treated as an above the line deduction on Schedule C, Schedule E or Schedule F. [Conference Report to Accompany H.R. 1, December 15, 2017, p. 260]

CHAPTER 28: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1.	**Which of the following would be treated as qualified business income (QBI) for an S corporation shareholder-employee:** **A.** wage or salary income **B.** dividends (other than patronage dividends from cooperatives) **C.** long-term and short-term capital gains and losses **D.** none of the above
2.	**Which of the following deduction limits are unnecessary to compute when an activity's income is derived from a specified service business:** **A.** those based on W-2 wages **B.** those based on the basis of qualified property **C.** both A and B above **D.** none of the above
3.	**The information needed for partners or shareholders of an S corporation to calculate their QBI deductions include all of the following except:** **A.** qualifying income and loss items from the qualifying business **B.** W-2 wages paid by the qualifying business **C.** qualified property owned by the business at the end of the taxable year **D.** qualified property owned by the business at the beginning of the taxable year

4.	**For taxable years after 2017, the TCJA made which of the following subject to the same limits as other losses for partnerships:** **A.** charitable contributions made by the partnership **B.** foreign income taxes paid by the partnership **C.** both A and B above **D.** none of the above

CHAPTER 28: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. Wage or salary income received from the activity does not constitute QBI for an S corporation shareholder-employee. **B.** Incorrect. Dividends and equivalents are not treated as QBI, even if effectively connected with a U.S. trade or business. **C.** Incorrect. Long-term and short-term capital gains and losses are not treated as QBI. **D.** **CORRECT**. None of the responses are items that are treated as QBI. *(See page 430 of the course material.)*
2.	**A.** Incorrect. These limits only apply when the taxable income is above the threshold but below the full phase-out. **B.** Incorrect. These limits only apply when the taxable income is above the threshold but below the full phase-out. **C.** **CORRECT**. These limits only apply when the taxable income is above the threshold but below the full phase-out. **D.** Incorrect. At least one of the responses is correct. *(See page 439 of the course material.)*
3.	**A.** Incorrect. These income and loss items are among the necessary variables for each partner or shareholder's portion. **B.** Incorrect. W-2 wages paid for each partner or shareholder's portion is needed. **C.** Incorrect. Qualified property at the end of the taxable year is a variable needed. **D.** **CORRECT**. Qualified property owned by the business at the end of the taxable year is necessary, but not at the beginning of the taxable year. *(See pages 448 to 449 of the course material.)*

4.	**A.** Incorrect. Due to changes made by the TCJA, charitable contributions are subject to the same limits as other losses, but this is not the best answer. **B.** Incorrect. Due to changes made by the TCJA, foreign income taxes paid by the partnership are subject to the same limits as other losses, but this is not the best answer. **C.** **CORRECT**. The TCJA removed the distinction between partnerships and S corporations related to charitable contributions and foreign income taxes. **D.** Incorrect. At least one of the responses is correct. *(See pages 457 to 458 of the course material.)*

PART SIX: FIGURING YOUR TAXES AND CREDITS

The nine chapters in this part explain how to figure your tax and how to figure the tax of certain children who have unearned income. They also discuss tax credits that, unlike deductions, are subtracted directly from your tax and reduce your tax, dollar for dollar. Chapter 35 discusses the earned income credit. Chapter 37 discusses a wide variety of other credits, such as the adoption credit.

CHAPTER 29: HOW TO FIGURE YOUR TAX

Chapter Objective

After completing this chapter, you should be able to:

- Recognize various alternative minimum tax adjustments and preference items.

I. INTRODUCTION

After you have figured your income and deductions as explained in *Parts One* through *Five*, your next step is to figure your tax. This chapter discusses:

- The general steps you take to figure your tax, and
- An additional tax you may have to pay called the alternative minimum tax (AMT).

II. FIGURING YOUR TAX

Your income tax is based on your taxable income. After you figure your income tax and any alternative minimum tax, subtract your tax credits and add any other taxes you may owe. The result is your total tax. Compare your total tax with your total payments to determine whether you are entitled to a refund or must make a payment.

This section provides a general outline of how to figure your tax.

Tax. Most taxpayers use either the Tax Table or the Tax Computation Worksheet to figure their income tax. However, there are special methods if your income includes any of the following items.

- A net capital gain (see chapter 16).
- Qualified dividends taxed at the same rates as a net capital gain (see chapters 8 and 16).
- Lump-sum distributions (see chapter 10).
- Farming and fishing income (see Schedule J (Form 1040).
- Tax for certain children who have unearned income (see chapter 30).
- Parents' election to report child's interest and dividends (see chapter 30).
- Foreign earned income exclusion or the housing exclusion.

Credits. After you figure your income tax and any alternative minimum tax (discussed later), determine if you are eligible for any tax credits. Eligibility information for these tax credits is discussed in chapters 31 through 37 and your form instructions.

III. ALTERNATIVE MINIMUM TAX

This section briefly discusses an additional tax you may have to pay.

The tax law gives special treatment to some kinds of income and allows special deductions and credits for some kinds of expenses. Taxpayers who benefit from the law in these ways may have to pay at least a minimum amount of tax through an additional tax. This additional tax is called the alternative minimum tax (AMT).

In 2024, you may have to pay the alternative minimum tax if your taxable income for regular tax purposes, combined with certain adjustments and tax preference items, is more than:

- $133,300 if your filing status is married filing joint (or qualifying surviving spouse),
- $85,700 if your filing status is single or head of household, or
- $66,650 if your filing status is married filing separate.

These amounts will be indexed annually for inflation.

Adjustments and tax preference items. The more common adjustments and tax preference items include:

- Addition of *standard deduction* (if claimed),
- Addition of *itemized deductions* claimed for state and local taxes and certain interest,
- Subtraction of any *refund of state and local taxes* included in gross income,
- Changes to accelerated *depreciation* of certain property,
- Difference between *gain or loss* on the sale of property reported for regular tax purposes and AMT purposes,
- Addition of certain income from *incentive stock options*,
- Change in certain *passive activity loss* deductions,
- Addition of certain *depletion* that is more than the adjusted basis of the property,
- Addition of part of the deduction for certain *intangible drilling costs*, and
- Addition of *tax-exempt interest* on certain private activity bonds.

CHAPTER 29: TEST YOUR KNOWLEDGE

The following question is designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). It is included as an additional tool to enhance your learning experience and does not need to be submitted in order to receive CPE credit.

We recommend that you answer the question and then compare your response to the suggested solution on the following page before answering the final exam question(s) related to this chapter (assignment).

1.	**You may have to calculate and pay the alternative minimum tax (AMT) if your taxable income for regular tax purposes, combined with certain adjustments and tax preference items, exceeds a specified amount. Which of the following is <u>not</u> a tax preference item or an adjustment:** **A.** changes to accelerated depreciation of certain property **B.** deductions for intangible drilling costs **C.** tax-exempt interest on certain private activity bonds **D.** interest income from savings accounts

CHAPTER 29: SOLUTION AND SUGGESTED RESPONSES

Below is the solution and suggested responses for the question on the previous page. If you choose an incorrect answer, you should review the page(s) as indicated for the question to ensure comprehension of the material.

1.	**A.** Incorrect. Changes to accelerated depreciation of certain property is an example of an adjustment or tax preference item. **B.** Incorrect. Deductions for intangible drilling costs is an example of an adjustment or tax preference item. **C.** Incorrect. Tax-exempt interest on certain private activity bonds is an example of an adjustment or tax preference item. **D.** **CORRECT**. Interest income on a standard savings account would be reported on Schedule B and not as a tax preference item. *(See page 466 of the course material.)*

CHAPTER 30: TAX ON UNEARNED INCOME OF CERTAIN CHILDREN

Chapter Objective

After completing this chapter, you should be able to:

- Recall the rules related to the tax on unearned income of certain children.

I. INTRODUCTION

This chapter discusses the following two rules that may affect the tax on unearned income of certain children.

1. If the child's interest and dividend income (including capital gain distributions) total less than $13,000, the child's parent may be able to choose to include that income on the parent's return rather than file a return for the child.

2. If the child's interest, dividends, and other unearned income total more than $2,600, the child's income is taxed at special tax rates.

For these rules, the term "child" includes a legally adopted child and a stepchild. These rules apply whether or not the child is a dependent. These rules do not apply if neither of the child's parents were living at the end of the year.

II. PARENT'S ELECTION TO REPORT CHILD'S INTEREST AND DIVIDENDS

You may be able to elect to include your child's interest and dividend income (including capital gain distributions) on your tax return. If you do, your child will not have to file a return.

You can make this election only if all the following conditions are met.

- Your child was under age 19 (or under age 24 if a full-time student) at the end of the year.
- Your child had income only from interest and dividends (including capital gain distributions and Alaska Permanent Fund dividends).
- The child's gross income was less than $13,000.
- The child is required to file a return unless you make this election.
- The child does not file a joint return for the year.

- No estimated tax payment was made for the year, and no overpayment from the previous year (or from any amended return) was applied to this year under your child's name and SSN.

- No federal income tax was taken out of your child's income under the backup withholding rules.

- You are the parent whose return must be used when applying the special tax rules for children.

How to make the election. Make the election by attaching Form 8814 to your Form 1040, 1040-SR, or 1040-NR. Attach a separate Form 8814 for each child for whom you make the election. You can make the election for one or more children and not for others.

EFFECT OF MAKING THE ELECTION

The federal income tax on your child's income may be more if you make the Form 8814 election.

Rate may be higher. If your child received qualified dividends or capital gain distributions, you may pay up to $130 more tax if you make this election instead of filing a separate tax return for the child. This is because the tax rate on the child's income between $1,300 and $2,600 is 10% if you make this election. However, if you file a separate return for the child, the tax rate may be as low as 0% because of the preferential tax rates for qualified dividends and capital gain distributions.

Deductions you cannot take. By making the Form 8814 election, you cannot take any of the following deductions that the child would be entitled to on his or her return.

- The additional standard deduction if the child is blind.

- The deduction for a penalty on an early withdrawal of your child's savings.

- Itemized deductions (such as your child's investment interest expenses or charitable contributions).

Alternative minimum tax (AMT). If your child received tax-exempt interest (or exempt-interest dividends paid by a regulated investment company) from certain private activity bonds, you must determine if that interest is a tax preference item for AMT purposes. If it is, you must include it with your own tax preference items when figuring your AMT.

Net Investment Income Tax (NIIT). When figuring any NIIT on Form 8960, the amount on line 12 of Form 8814 (other than Alaska Permanent Fund dividends) will increase the amount of your net investment income reported on Form 8960.

Reduced deductions or credits. If you use Form 8814, your increased adjusted gross income may reduce certain deductions or credits on your return including the following.

- Deduction for contributions to a traditional individual retirement arrangement (IRA).

- Deduction for student loan interest.

- Itemized deductions for medical expenses and casualty and theft losses.
- Credit for child and dependent care expenses.
- Child tax credit.
- Education tax credits.
- Earned income credit.

Penalty for underpayment of estimated tax. If you make this election for 2024 and did not have enough tax withheld or pay enough estimated tax to cover the tax you owe, you may be subject to a penalty. If you plan to make this election for 2025, you may need to increase your federal income tax withholding or your estimated tax payments to avoid the penalty.

III. TAX FOR CERTAIN CHILDREN WHO HAVE UNEARNED INCOME

Special tax rates apply to certain dependent children with unearned income of $2,600 or more. If the child's income is $2,600, you may be able to file Form 8615 to figure the tax. If the parent does not or cannot choose to include the child's income on the parent's return, use Form 8615 to figure the child's tax. Attach the completed form to the child's Form 1040 or 1040-NR.

WHEN FORM 8615 MUST BE FILED

Form 8615 must be filed for a child if all of the following statements are true:

1. The child's unearned income was more than $2,600.
2. The child is required to file a return for 2024.
3. The child either:
   a) Was under age 18 at the end of the year,
   b) Was age 18 at the end of the year and did not have earned income that was more than half of his or her support, or
   c) Was a full-time student at least age 19 and under age 24 at the end of 2024 and did not have earned income that was more than half of his or her support.
4. At least one of the child's parents was alive at the end of 2024.
5. The child does not file a joint return for 2024.

EARNED INCOME

Earned income includes salaries, wages, tips, professional fees, and other compensation received for personal services performed. It also includes any amount received as a scholarship that you must include in income.

Unearned Income Defined. Unearned income is generally all income other than salaries, wages, and other amounts received as pay for work actually done. It includes taxable interest, dividends, capital gains, unemployment compensation, taxable scholarship and fellowship grants not reported on Form W-2, the taxable part of social security and pension payments, and certain distributions from trusts. Unearned income includes amounts produced by assets the child obtained with earned income (such as interest on a savings account into which the child deposited wages).

Nontaxable income. For this purpose, unearned income includes only amounts the child must include in total income. Nontaxable unearned income, such as tax-exempt interest and the nontaxable part of social security and pension payments, is not included.

Income from property received as a gift. A child's unearned income includes all income produced by property belonging to the child. This is true even if the property was transferred to the child, regardless of when the property was transferred or purchased or who transferred it.

A child's unearned income includes income produced by property given as a gift to the child. This includes gifts to the child from grandparents or any other person and gifts made under the Uniform Gift to Minors Act.

Trust Income. If a child is the beneficiary of a trust, distributions of taxable interest, dividends, capital gains, and other unearned income from the trust are unearned income to the child.

However, for purposes of completing Form 8615, a taxable distribution from a qualified disability trust is considered earned income, not unearned income.

SUPPORT

Your child's support includes all amounts spent to provide the child with food, lodging, clothing, education, medical and dental care, recreation, transportation, and similar necessities. To figure your child's support, count support provided by you, your child, and others. However, a scholarship received by your child is not considered support if your child is a full-time student.

ALTERNATIVE MINIMUM TAX

A child may be subject to alternative minimum tax (AMT) if he or she has certain items given preferential treatment under the tax law.

NET INVESTMENT INCOME TAX

A child whose tax is figured on Form 8615 may be subject to the Net Investment Income Tax (NIIT). NIIT is a 3.8% tax on the lesser of the net investment income or the excess of the child's modified adjusted gross income (MAGI) over the threshold amount.

CHAPTER 30: TEST YOUR KNOWLEDGE

The following question is designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). It is included as an additional tool to enhance your learning experience and does not need to be submitted in order to receive CPE credit.

We recommend that you answer the question and then compare your response to the suggested solution on the following page before answering the final exam question(s) related to this chapter (assignment).

1.	**Which of the following is correct regarding tax on unearned income of certain children:** **A.** it cannot be subject to the alternative minimum tax (AMT) **B.** it cannot be subject to the net investment income tax (NIIT) **C.** tax-exempt interest is not included in the child's total income **D.** all of the above

CHAPTER 30: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. A child may be subject to AMT if he or she has certain items given preferential treatment under the tax law. **B.** Incorrect. A child whose tax is figured on Form 8615 may be subject to the NIIT. **C.** **CORRECT**. Nontaxable unearned interest, such as tax-exempt interest and the nontaxable part of social security and pension payments, is not included. **D.** Incorrect. Only one of the responses is correct. *(See pages 471 to 472 of the course material.)*

CHAPTER 31: CHILD AND DEPENDENT CARE CREDIT

Chapter Objective

After completing this chapter, you should be able to:

- Recall how to figure the child and dependent care credit.

I. INTRODUCTION

This chapter discusses the credit for child and dependent care expenses and covers the following topics.

- Tests you must meet to claim the credit.
- How to figure the credit.
- How to claim the credit.
- Employment taxes you may have to pay as a household employer.

You may be able to claim the credit if you pay someone to care for your dependent who is under age 13 or for your spouse or dependent who is not able to care for himself or herself. The credit can be up to 35% of your expenses. To qualify, you must pay these expenses so you can work or look for work.

Dependent care benefits. If you received any dependent care benefits from your employer during the year, you may be able to exclude from your income all or part of them. You must complete Part III of Form 2441 before you can figure the amount of your credit.

II. TESTS TO CLAIM THE CREDIT

To be able to claim the credit for child and dependent care expenses, you must file Form 1040, 1040-SR, or 1040-NR, and meet all the following tests.

1. The care must be for one or more qualifying persons who are identified on Form 2441. (See *Qualifying Person Test*.)
2. You (and your spouse if filing jointly) must have earned income during the year. (However, see *Rule for student-spouse or spouse not able to care for self* under *Earned Income Test*, later.)
3. You must pay child and dependent care expenses so you (and your spouse if filing jointly) can work or look for work. (See *Work-Related Expense Test*, later.)

4. You must make payments for child and dependent care to someone you (or your spouse) cannot claim as a dependent. If you make payments to your child, he or she cannot be your dependent and must be age 19 or older by the end of the year. You cannot make payments to:

    a) Your spouse, or

    b) The parent of your qualifying person if your qualifying person is your child and under age 13.

    (See *Payments to Relatives or Dependents* under *Work-Related Expense Test*, later.)

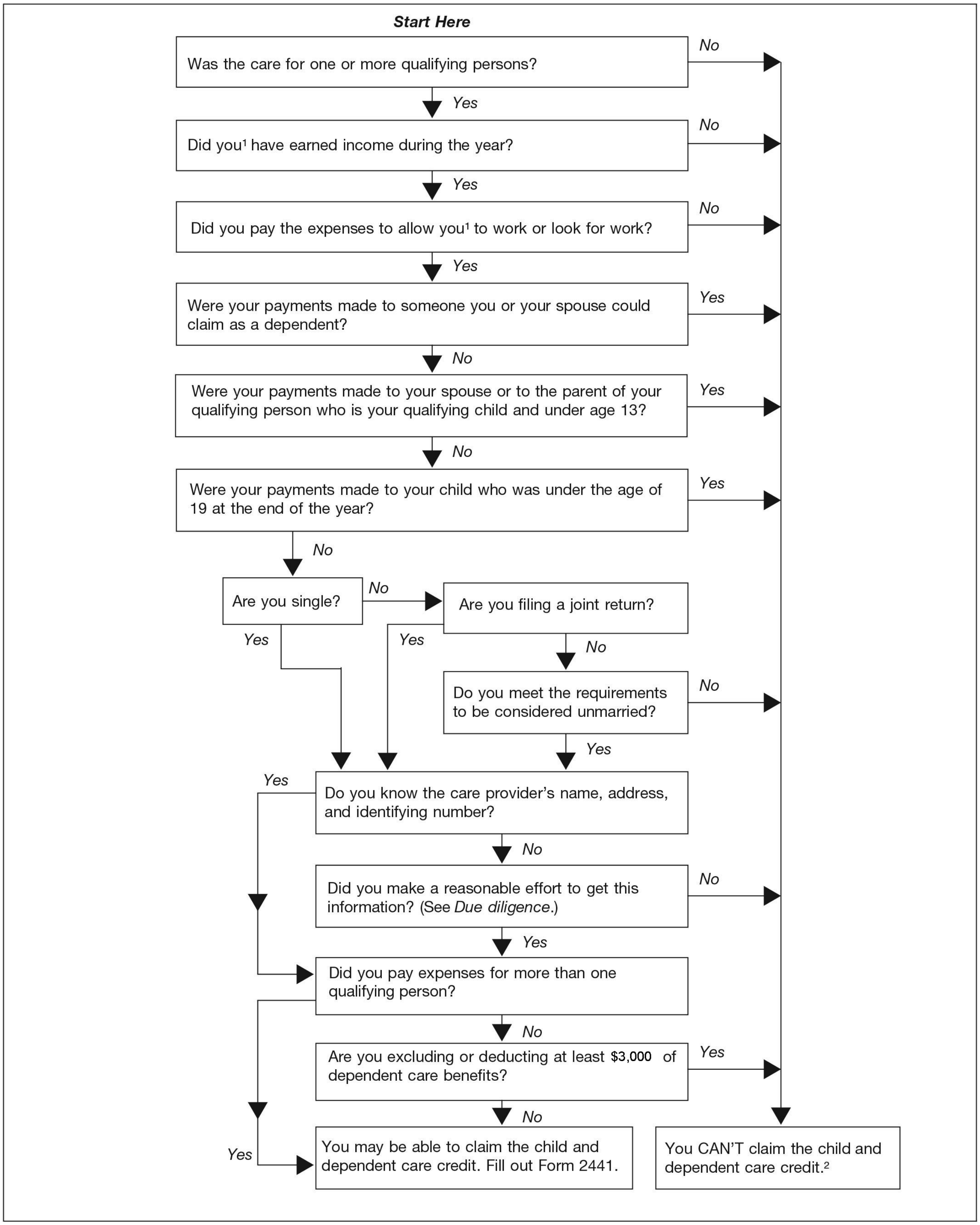
5. Your filing status must be single, head of household, or qualifying widow(er) with dependent child. You must file a joint return if you are married, unless an exception applies to you. (See *Joint Return Test*, later.)

6. You must identify the care provider on your tax return. (See *Care Provider Identification Test*, later.)

7. If you exclude or deduct dependent care benefits provided by a dependent care benefits plan, the total amount you exclude or deduct must be less than the dollar limit for qualifying expenses (generally, $3,000 if one qualifying person was cared for or $6,000 if two or more qualifying persons were cared for).

These tests are presented in *Figure 31-A* and are also explained in detail in this chapter.

FIGURE 31-A. CAN YOU CLAIM THE CREDIT?



1. This also applies to your spouse, unless your spouse was disabled or a full-time student.
2. If you had expenses that met the requirements for 2023, except that you did not pay them until 2024, you may be able to claim those expenses in 2024. See Expenses not paid until the following year under How to Figure the Credit.

QUALIFYING PERSON TEST

Your child and dependent care expenses must be for the care of one or more qualifying persons.

A qualifying person is:

1. Your qualifying child who is your dependent and who was under age 13 when the care was provided,
2. Your spouse who was physically or mentally not able to care for himself or herself and lived with you more than half the year, or
3. A person who was physically or mentally not able to care for himself or herself, lived with you for more than half the year, and either:
   a) Was your dependent, or
   b) Would have been your dependent except that (i) he or she received gross income greater than the threshold, (ii) he or she filed a joint return, or (iii) you, or your spouse if filing jointly, could be claimed as a dependent on someone else's 2024 return.

If you are divorced or separated, see *Child of Divorced or Separated Parents*, later, to determine which parent may treat the child as a qualifying person.

Person qualifying for part of year. You determine a person's qualifying status each day. For example, if the person for whom you pay child and dependent care expenses no longer qualifies on September 16, count only those expenses through September 15. Also see *Dollar Limit* under *How To Figure the Credit,* later.

Taxpayer identification number. You must include on your return the name and taxpayer identification number (generally the social security number) of the qualifying person(s). If the correct information is not shown, the credit may be reduced or disallowed.

Individual taxpayer identification number (ITIN) for aliens. If your qualifying person is a nonresident or resident alien who does not have and cannot get a social security number (SSN), use that person's ITIN. To apply for an ITIN, file Form W-7 with the IRS. The ITIN is entered wherever an SSN is requested on a tax return.

An ITIN is for tax use only. It does not entitle the holder to social security benefits or change the holder's employment or immigration status under U.S. law.

Adoption taxpayer identification number (ATIN). If your qualifying person is a child who was placed in your home for adoption and for whom you do not have an SSN, you must get an ATIN for the child. File Form W-7A, *Application for Taxpayer Identification Number for Pending U.S. Adoptions*.

Child of Divorced or Separated Parents. Even if you cannot claim your child as a dependent, he or she is treated as your qualifying person if:

- The child was under age 13 or was not physically or mentally able to care for himself or herself,
- The child received over half of his or her support during the calendar year from one or both parents who are divorced or legally separated under a decree of divorce or separate maintenance, are separated under a written separation agreement, or lived apart at all times during the last six months of the calendar year,
- The child was in the custody of one or both parents for more than half the year, and
- You were the child's custodial parent.

The custodial parent is the parent with whom the child lived for the greater number of nights in 2023. If the child was with each parent for an equal number of nights, the custodial parent is the parent with the higher adjusted gross income.

The noncustodial parent cannot treat the child as a qualifying person even if that parent is entitled to claim the child as a dependent under the special rule for a child of divorced or separated parents.

EARNED INCOME TEST

To claim the credit, you (and your spouse if filing jointly) must have earned income during the year.

Earned income. Earned income includes wages, salaries, tips, other taxable employee compensation, and net earnings from self-employment. A net loss from self-employment reduces earned income. Earned income also includes strike benefits and any disability pay you report as wages.

Generally, only taxable compensation is included. However, you can elect to include nontaxable combat pay in earned income. If you are filing a joint return and both you and your spouse received nontaxable combat pay, you can each make your own election. (In other words, if one of you makes the election, the other one can also make it but does not have to.) You should figure your credit both ways and make the election if it gives you a greater tax benefit.

Members of certain religious faiths opposed to social security. Certain income earned by persons who are members of certain religious faiths that are opposed to participation in Social Security Act programs and have an IRS-approved form that exempts certain income from social security and Medicare taxes may not be considered earned income for this purpose.

Not earned income. Earned income does not include:

- Pensions and annuities,
- Amounts reported on Form 1040 or 1040-SR, line 1 excluded as foreign earned income on Form 2555, line 43,
- Social security and railroad retirement benefits,
- Workers' compensation,

- Interest and dividends,
- Unemployment compensation,
- Scholarship or fellowship grants, except for those reported on a Form W-2 and paid to you for teaching or other services,
- Nontaxable workfare payments,
- Child support payments received,
- Income of nonresident aliens that is not effectively connected with a U.S. trade or business, or
- Any amount received for work while an inmate in a penal institution.

Rule for student-spouse or spouse not able to care for self. Your spouse is treated as having earned income for any month that he or she is:

1. A full-time student, or
2. Physically or mentally not able to care for himself or herself. (Your spouse also must live with you for more than half the year.)

If you are filing a joint return, this rule also applies to you. You can be treated as having earned income for any month you are a full-time student or not able to care for yourself.

Figure the earned income of the nonworking spouse described under (1) or (2) above as explained under *Earned Income Limit*, later.

This rule applies to only one spouse for any one month. If, in the same month, both you and your spouse do not work and are either full-time students or physically or mentally not able to care for yourselves, only one of you can be treated as having earned income in that month.

Full-time student. You are a full-time student if you are enrolled at and attend a school for the number of hours or classes that the school considers full time. You must have been a student for some part of each of 5 calendar months during the year. (The months need not be consecutive.)

School. The term "school" includes high schools, colleges, universities, and technical, trade, and mechanical schools. It does not include on-the-job training courses, correspondence schools, or school offering courses only through the Internet.

WORK-RELATED EXPENSE TEST

Child and dependent care expenses must be work-related to qualify for the credit. Expenses are considered work related only if both of the following are true.

- They allow you (and your spouse if you are married) to work or look for work.
- They are for a qualifying person's care.

Working or Looking for Work

To be work-related, your expenses must allow you to work or look for work. If you are married, generally both you and your spouse must work or look for work. Your spouse is treated as working during any month he or she is a full-time student or is physically or mentally not able to care for himself or herself.

Your work can be for others or in your own business or partnership. It can be either full time or part time.

Work also includes actively looking for work. However, if you do not find a job and have no earned income for the year, you cannot take this credit. See *Earned Income Test*, earlier.

An expense is not considered work-related merely because you had it while you were working. The purpose of the expense must be to enable you to work. Whether your expenses allow you to work or look for work depends on the facts.

Volunteer work. For this purpose, you are not considered to be working if you do unpaid volunteer work or volunteer work for a nominal salary.

Work for part of year. If you work or actively look for work during only part of the period covered by the expenses, then you must figure your expenses for each day. For example, if you work all year and pay care expenses of $250 a month ($3,000 for the year), all the expenses are work-related. However, if you work or look for work for only 2 months and 15 days during the year and pay expenses of $250 a month, your work-related expenses are limited to $625 (2½ months x $250).

Temporary absence from work. You do not have to figure your expenses for each day during a short, temporary absence from work, such as for vacation or a minor illness, if you have to pay for care anyway. Instead, you can figure your credit including the expenses you paid for the period of absence.

An absence of 2 weeks or less is a short, temporary absence. An absence of more than 2 weeks may be considered a short, temporary absence, depending on the circumstances.

Example

You pay a nanny to care for your 2-year-old son and 4-year-old daughter so you can work. You become ill and miss 4 months of work but receive sick pay. You continue to pay the nanny to care for the children while you are ill. Your absence is not a short, temporary absence, and your expenses are not considered work-related.

Part-time work. If you work part-time, you generally must figure your expenses for each day. However, if you have to pay for care weekly, monthly, or in another way that includes both days worked and days not worked, you can figure your credit including the expenses you paid for days you did not work. Any day when you work at least 1 hour is a day of work.

Example 1

You work 3 days a week. While you work, your 6-year-old child attends a dependent care center, which complies with all state and local regulations. You can pay the center $150 for any 3 days a week or $250 for 5 days a week. Your child attends the center 5 days a week. Your work-related expenses are limited to $150 a week.

Example 2

The facts are the same as in *Example 1* except the center does not offer a 3-day option. The entire $250 weekly fee may be a work-related expense.

Care of a Qualifying Person

To be work related, your expenses must be to provide care for a qualifying person. You do not have to choose the least expensive way of providing the care. The cost of a paid care provider may be an expense for the care of a qualifying person even if another care provider is available at no cost.

Expenses are for the care of a qualifying person only if their main purpose is the person's well-being and protection.

Expenses for household services qualify if part of the services is for the care of qualifying persons. See *Household services*, later.

Expenses not for care. Expenses for care do not include amounts you pay for food, clothing, education, and entertainment. However, you can include small amounts paid for these items if they are incidental to and cannot be separated from the cost of caring for the qualifying person.

Child support payments are not for care and do not qualify for the credit.

Education. Expenses for a child in nursery school, pre-school, or similar programs for children below the level of kindergarten are expenses for care. Expenses to attend kindergarten or a higher grade are not expenses for care. Do not use these expenses to figure your credit.

However, expenses for before- or after-school care of a child in kindergarten or a higher grade may be expenses for care.

Summer school and tutoring programs are not for care.

Example 1

You take your 3-year-old child to a nursery school that provides lunch and educational activities as a part of its preschool childcare service. The lunch and educational activities are incidental to the childcare, and their cost cannot be separated from the cost of care. You can count the total cost when you figure the credit.

Example 2

You are a member of the Armed Forces, and you are ordered to a combat zone. To be able to comply with the order, you place your 10-year-old child in a boarding school. Only the part of the boarding school expense that is for the care of your child is a work-related expense. You can count that part of the expense in figuring your credit if it can be separated from the cost of education. You cannot count any part of the amount you pay the school for your child's education.

Care outside your home. You can count the cost of care provided outside your home if the care is for your dependent under age 13 or any other qualifying person who regularly spends at least 8 hours each day in your home.

Dependent care center. You can count care provided outside your home by a dependent care center only if the center complies with all state and local regulations that apply to these centers.

A dependent care center is a place that provides care for more than six persons (other than persons who live there) and receives a fee, payment, or grant for providing services for any of those persons, even if the center is not run for profit.

Camp. The cost of sending your child to an overnight camp is not considered a work-related expense. The cost of sending your child to a day camp may be a work-related expense, even if the camp specializes in a particular activity, such as computers or soccer.

Transportation. If a care provider takes a qualifying person to or from a place where care is provided, that transportation is for the care of the qualifying person. This includes transportation by bus, subway, taxi, or private car. However, transportation not provided by a care provider is not for the care of a qualifying person. Also, if you pay the transportation cost for the care provider to come to your home, that expense is not for care of a qualifying person.

Fees and deposits. Fees you paid to an agency to get the services of a care provider, deposits you paid to an agency or pre-school, application fees, and other indirect expenses are work-related expenses if you have to pay them to get care, even though they are not directly for care. However, a forfeited deposit is not for the care of a qualifying person if care is not provided.

Example 1

You paid a fee to an agency to get the services of the nanny who cares for your 2-year-old daughter while you work. The fee you paid is a work-related expense.

Example 2

You placed a deposit with a pre-school to reserve a place for your 3-year-old child. You later sent your child to a different pre-school and forfeited the deposit. The forfeited deposit is not for care and so is not a work-related expense.

Household services. Expenses you pay for household services meet the work-related expense test if they are at least partly for the well-being and protection of a qualifying person.

Household services are ordinary and usual services done in and around your home that are necessary to run your home. They include the services of a housekeeper, maid, or cook. However, they do not include the services of a chauffeur, bartender, or gardener.

In this chapter, the term housekeeper refers to any household employee whose services include the care of a qualifying person.

Taxes paid on wages. The taxes you pay on wages for qualifying child and dependent care services are work-related expenses. See *Employment Taxes for Household Employers*, later.

Payments to Relatives or Dependents

You can count work-related payments you make to relatives who are not your dependents, even if they live in your home. However, do not count any amounts you pay to:

1. A person for whom you (or your spouse if filing jointly) can claim as a dependent,
2. Your child who was under age 19 at the end of the year, even if he or she is not your dependent,
3. A person who was your spouse any time during the year, or
4. The parent of your qualifying child who is your qualifying person and is under age 13.

JOINT RETURN TEST

Generally, married couples must file a joint return to take the credit. However, if you are legally separated or living apart from your spouse, you may be able to file a separate return and still take the credit.

Legally separated. You are not considered married if you are legally separated from your spouse under a decree of divorce or separate maintenance. You may be eligible to take the credit on your return using Head of Household filing status.

Married and living apart. You are not considered married and are eligible to take the credit if ***all*** the following apply.

1. You file a return apart from your spouse.
2. Your home is the home of a qualifying person for more than half the year.
3. You pay more than half the cost of keeping up your home for the year.
4. Your spouse does not live in your home for the last 6 months of the year.

Death of spouse. If your spouse died during the year and you do not remarry before the end of the year, you generally must file a joint return to take the credit. If you do remarry before the end of the year, the credit can be claimed on your deceased spouse's return.

CARE PROVIDER IDENTIFICATION TEST

You must identify all persons or organizations that provide care for your child or dependent. Use Part I of Form 2441 to show the information.

Information needed. To identify the care provider, you must give the provider's:

1. Name,
2. Address, and
3. Taxpayer identification number.

If the care provider is an individual, the taxpayer identification number is his or her social security number or individual taxpayer identification number. If the care provider is an organization, then it is the employer identification number (EIN).

You do not have to show the taxpayer identification number if the care provider is one of certain tax-exempt organizations (such as a church or school). In this case, write "Tax-Exempt" in the space where Form 2441 asks for the number.

If you cannot provide all of the information or if the information you provide is incorrect you must be able to show that you used due diligence (discussed later) in trying to furnish the necessary information.

Getting the information. You can use Form W-10 to request the required information from the care provider. If you do not use Form W-10, you can get the information from one of the other sources listed in the instructions for Form W-10 including:

1. A copy of the provider's social security card,
2. A copy of the provider's completed Form W-4 if he or she is your household employee,
3. A copy of the statement furnished by your employer if the provider is your employer's dependent care plan, or
4. A recently printed letterhead or invoice that shows the provider's name, address, and taxpayer identification number.

Due diligence. If the care provider information you give is incorrect or incomplete, your credit may not be allowed. However, if you can show that you used due diligence in trying to supply the information, you can still claim the credit.

You can show due diligence by getting and keeping the provider's completed Form W-10 or one of the other sources of information listed earlier. Care providers can be penalized if they do not provide this information to you or if they provide incorrect information.

Provider refusal. If the provider refuses to give you their identifying information, you should report on Form 2441 whatever information you have (such as the name and address) on the form you use to claim the credit. Enter "See Attached Statement" in the columns calling for the information you do not have. Then, attach a statement explaining that you requested the information from the care provider, but the provider did not give you the information. Be sure to write your name and social security number on this statement. The statement will show that you used due diligence in trying to furnish the necessary information.

III. HOW TO FIGURE THE CREDIT

Your credit is a percentage of your work-related expenses. Your expenses are subject to the earned income limit and the dollar limit. The percentage is based on your adjusted gross income.

FIGURING TOTAL WORK-RELATED EXPENSES

To figure the credit for 2024 work-related expenses, count only those you paid by December 31, 2024.

Expenses prepaid in an earlier year. If you pay for services before they are provided, you can count the prepaid expenses only in the year the care is received. Claim the expenses for the later year as if they were actually paid in that later year.

Expenses not paid until the following year. Do ***not*** count 2023 expenses that you paid in 2024 as work-related expenses for 2024. You may be able to claim an additional credit for them on your 2024 return, but you must figure it separately.

Expenses reimbursed. If a state social services agency pays you a nontaxable amount to reimburse you for some of your child and dependent care expenses, you cannot count the expenses that are reimbursed as work-related expenses.

Example

You paid work-related expenses of $3,000. You are reimbursed $2,000 by a state social services agency. You can use only $1,000 to figure your credit.

Medical expenses. Some expenses for the care of qualifying persons who are not able to care for themselves may qualify as work-related expenses and also as medical expenses. You can use them either way, but you cannot use the same expenses to claim both a credit and a medical expense deduction.

If you use these expenses to figure the credit and they are more than the earned income limit or the dollar limit, discussed later, you can add the excess to your medical expenses. However, if you use your total expenses to figure your medical expense deduction, you cannot use any part of them to figure your credit.

Dependent Care Benefits

Dependent care benefits include:

1. Amounts your employer pays directly to either you or your care provider for the care of your qualifying person while you work,
2. The fair market value of care in a daycare facility provided or sponsored by your employer, and
3. Pre-tax contributions you made under a dependent care flexible spending arrangement.

Your salary may have been reduced to pay for these benefits. If you received benefits, they should be shown on your W-2 form. See *Statement for employee*, later.

Exclusion or deduction. If your employer provides dependent care benefits under a qualified plan, you may be able to exclude these benefits from your income. Your employer can tell you whether your benefit plan qualifies. To claim the exclusion, you must complete Part III of Form 2441.

If you are self-employed and receive benefits from a qualified dependent care benefit plan, you are treated as both employer and employee. Therefore, you would not get an exclusion from wages. Instead, you would get a deduction on Form 1040 or 1040-SR, Schedule C, Schedule E, or Schedule F. To claim the deduction, you must use Form 2441.

The amount you can exclude or deduct is limited to the smallest of:

1. The total amount of dependent care benefits you received during the year,
2. The total amount of qualified expenses you incurred during the year,
3. Your earned income,
4. Your spouse's earned income, or
5. The maximum amount allowed under your dependent care plan. For 2024, the maximum amount that can be excluded from an employee's income is $5,000 ($2,500 if married filing separately).

The definition of earned income for the exclusion or deduction is the same as the definition used when figuring the credit except that earned income for the exclusion or deduction does not include any dependent care benefits you receive. See *Earned Income Limit*, later.

Statement for employee. Your employer must give you a **Form W-2** (or similar statement), showing in box 10 the total amount of dependent care benefits provided to you during the year under a qualified plan. Your employer will also include any dependent care benefits over $5,000 ($2,500 if married filiing separately) in your wages shown on your Form W-2 in box 1.

Effect of exclusion. If you exclude dependent care benefits from your income, the amount of the excluded benefits:

1. Is not included in your work-related expenses, and
2. Reduces the dollar limit, discussed later.

EARNED INCOME LIMIT

The amount of work-related expenses you use to figure your credit cannot be more than:

1. Your earned income for the year if you are single at the end of the year, or
2. The smaller of your or your spouse's earned income for the year if you are married at the end of the year.

Earned income is defined under *Earned Income Test*, earlier.

Tip

For purposes of item (2), use your spouse's earned income for the entire year, even if you were married for only part of the year.

Separated spouse. If you are legally separated or married and living apart from your spouse (as described under *Joint Return Test*, earlier), you are not considered married for purposes of the earned income limit. Use only your income in figuring the earned income limit.

Surviving spouse. If your spouse died during the year and you file a joint return as a surviving spouse, you may, but are not required to, take into account the earned income of your spouse who died during the year.

Community property laws. You should disregard community property laws when you figure earned income for this credit.

Student-spouse or spouse not able to care for self. Your spouse who is either a full-time student or not able to care for himself or herself is treated as having earned income. His or her earned income for each month is considered to be at least $250 if there is one qualifying person in your home, or at least $500 if there are two or more.

Spouse works. If your spouse works during that month, use the higher of $250 (or $500) or his or her actual earned income for that month.

Spouse qualifies for part of month. If your spouse is a full-time student or not able to care for himself or herself for only part of a month, the full $250 (or $500) still applies for that month.

You are a student or not able to care for yourself. These rules also apply if you are a student or not able to care for yourself and you are filing a joint return. For each month or part of a month you are a student or not able to care for yourself, your earned income is considered to be at least $250 (or $500). If you also work during that month, use the higher of $250 (or $500) or your actual earned income for that month.

Both spouses qualify. If, in the same month, both you and your spouse are either full-time students or not able to care for yourselves, only one spouse can be considered to have this earned income of $250 (or $500) for that month.

DOLLAR LIMIT

There is a dollar limit on the amount of your work-related expenses you can use to figure the credit. For 2024, this limit is $3,000 for one qualifying person, or $6,000 for two or more qualifying persons.

Yearly limit. The dollar limit is a yearly limit. The amount of the dollar limit remains the same no matter how long, during the year, you have a qualifying person in your household. Use the $3,000 limit if you paid work-related expenses for the care of one qualifying person at any time during the year. Use $6,000 if you paid work-related expenses for the care of more than one qualifying person at any time during the year.

Reduced Dollar Limit

If you received dependent care benefits from your employer that you exclude from your income, you must subtract that amount from the dollar limit that applies to you. Your reduced dollar limit is figured in Part III of Form 2441. See *Dependent Care Benefits*, earlier, for information on excluding or deducting these benefits.

Example

George is a widower with one child and earns $24,000 a year. He pays work-related expenses of $2,900 for the care of his 4-year-old child and qualifies to claim the credit for child and dependent care expenses. His employer pays an additional $1,000 under a dependent care benefit plan. This $1,000 is excluded from George's income.

Although the dollar limit for his work-related expenses is $3,000 (one qualifying person), George figures his credit on only $2,000 of the $2,900 work-related expenses he paid. This is because his dollar limit is reduced as shown next.

George's Reduced Dollar Limit

1) Maximum allowable expenses for one qualifying person	$3,000
2) Minus: Dependent care benefits George excludes from income	1,000
3) Reduced dollar limit on expenses George can use for the credit	$2,000

AMOUNT OF CREDIT

To determine the amount of your credit, multiply your work-related expenses (after applying the earned income and dollar limits) by a percentage. This percentage depends on your adjusted gross income shown on Form 1040 or 1040-SR, line 11. The maximum percentage of your work-related expenses allowed as a credit for 2024 is 35 percent.

The following chart illustrates the percentage to be used based on adjusted gross income:

IF your adjusted gross income is over...	BUT not over...	THEN the percentage is...
$0	$15,000	35%
15,000	17,000	34%
17,000	19,000	33%
19,000	21,000	32%
21,000	23,000	31%
23,000	25,000	30%
25,000	27,000	29%
27,000	29,000	28%
29,000	31,000	27%
31,000	33,000	26%
33,000	35,000	25%
35,000	37,000	24%
37,000	39,000	23%
39,000	41,000	22%
41,000	43,000	21%
43,000	No limit	20%

IV. HOW TO CLAIM THE CREDIT

To claim the credit, you must file Form 1040 or 1040-SR.

Form 1040 or 1040-SR. You must complete Form 2441 and attach it to your Form 1040 or 1040-SR. Enter the credit on Schedule 3 (Form 1040), line 2.

Limit on credit. The amount of credit you can claim is limited to the amount of your tax.

Tax credit not refundable. For 2024, you cannot get a refund for any part of the credit that is more than this limit.

V. EMPLOYMENT TAXES FOR HOUSEHOLD EMPLOYERS

If you pay someone to come to your home and care for your dependent or spouse, you may be a household employer. If you are a household employer, you will need an employer identification number (EIN) and you may have to pay employment taxes. If the individuals who work in your home are self-employed, you are not liable for any of the taxes discussed in this section. Self-employed persons who are in business for themselves are not household employees. Usually, you are not a household employer if the person who cares for your dependent or spouse does so at his or her home or place of business.

If you use a placement agency that exercises control over what work is done and how it will be done by a babysitter or companion who works in your home, that person is not your employee. This control could include providing rules of conduct and appearance and requiring regular reports. In this case, you do not have to pay employment taxes. But, if an agency merely gives you a list of sitters and you hire one from that list, the sitter may be your employee.

If you have a household employee you may be subject to:

1. Social security and Medicare taxes,
2. Federal unemployment tax, and
3. Federal income tax withholding.

Social security and Medicare taxes are generally withheld from the employee's pay and matched by the employer. Federal unemployment (FUTA) tax is paid by the employer only and provides for payments of unemployment compensation to workers who have lost their jobs. Federal income tax is withheld from the employee's total pay if the employee asks you to do so and you agree.

State employment tax. You may also have to pay state unemployment tax for your household employee. Contact your state unemployment tax office for information. You should also find out whether you need to pay or collect other state employment taxes or carry workers' compensation insurance.

CHAPTER 31: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1.	**For 2024, the credit for child and dependent care expenses can be up to what percent of your expenses:** **A.** 10% **B.** 25% **C.** 35% **D.** 50%
2.	**In regards to the child and dependent care credit, work-related expenses for care of a child include amounts or expenses you pay for which of the following:** **A.** food **B.** clothing **C.** nursery school **D.** tutoring programs
3.	**For 2024, what is the dollar limit on the amount of your work-related expenses that you can use to figure the child and dependent care credit for two qualifying persons:** **A.** $1,000 **B.** $3,000 **C.** $5,000 **D.** $6,000

CHAPTER 31: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. You can claim a credit of greater than 10%. **B.** Incorrect. The maximum percentage of child and dependent care expenses that can be claimed is not 25%. **C.** **CORRECT**. The credit is limited to 35% of the expenses for your dependent who is under 13, your spouse, or another dependent not able to care for him or herself. The expenses must have been paid so you can work or look for work. **D.** Incorrect. The credit is limited to less than 50% of your expenses. *(See page 475 of the course material.)*
2.	**A.** Incorrect. Work-related expenses for care do not include amounts paid for food. **B.** Incorrect. Work-related expenses for care do not include amounts paid for clothing. **C.** **CORRECT**. Work-related expenses for a child in nursery school, pre-school, or similar programs for children below the level of kindergarten are expenses for care. **D.** Incorrect. Summer school and tutoring programs are not considered a work-related expense for care. *(See page 482 of the course material.)*
3.	**A.** Incorrect. The limit is higher than $1,000. **B.** Incorrect. Three thousand dollars applies to one qualifying person, not two persons. **C.** Incorrect. Five thousand dollars is the maximum amount excludable from income if your employer provides dependent care benefits under a qualified plan, but is not the correct answer to this question. **D.** **CORRECT**. The limit for two or more qualifying persons is six thousand dollars. The percentage of the expenses that can be claimed as a credit varies from 20% to 35%, depending on the amount of your reported adjusted gross income. *(See page 489 of the course material.)*

CHAPTER 32: CREDIT FOR THE ELDERLY OR THE DISABLED

Chapter Objective
After completing this chapter, you should be able to: • Identify who qualifies to take the credit for the elderly or disabled.

I. INTRODUCTION

If you qualify, you may be able to reduce the tax you owe by taking the credit for the elderly or the disabled on Schedule R (Form 1040).

This chapter explains:

- Who qualifies for the credit for the elderly or the disabled, and
- How to figure the credit.

You may be able to take the credit for the elderly or disabled if:

- You are age 65 or older at the end of 2024, or
- You retired on permanent and total disability and have taxable disability income.

II. CAN YOU TAKE THE CREDIT?

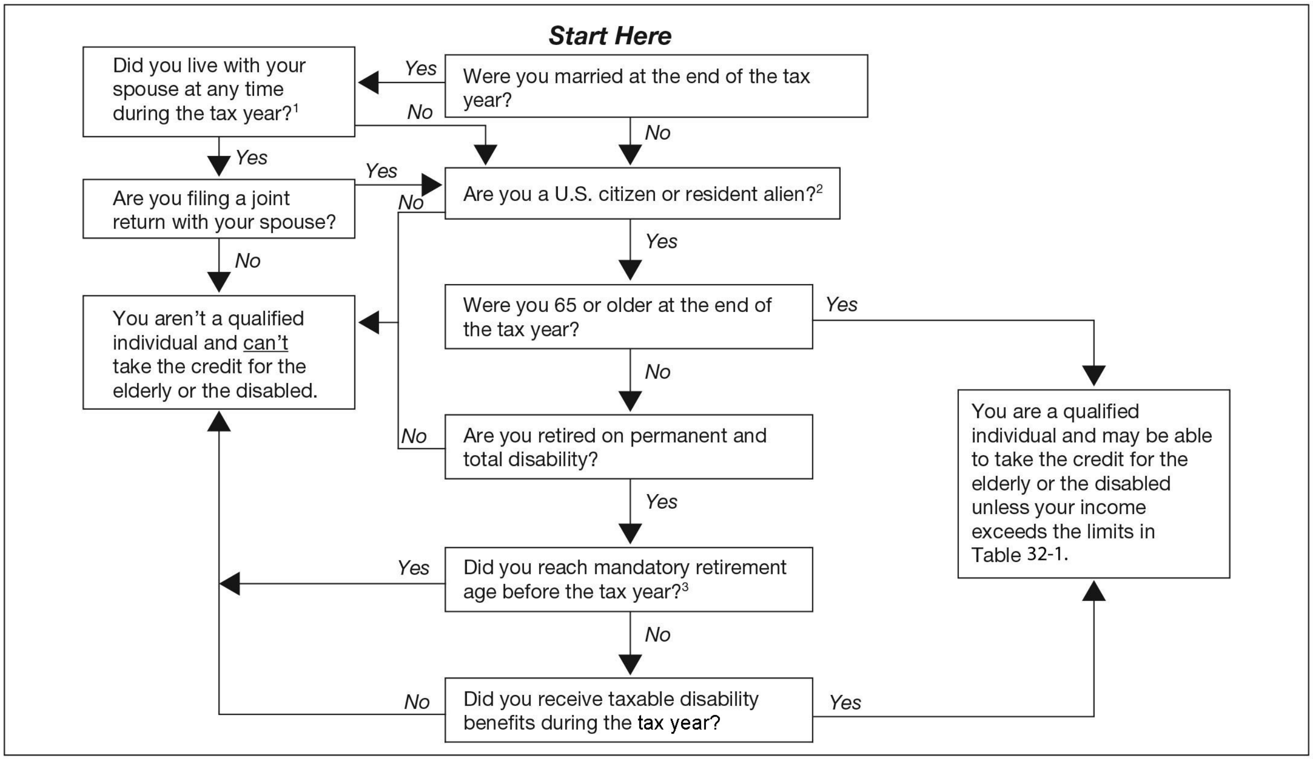
You can take the credit for the elderly or the disabled if you meet both of the following requirements.

1. You are a qualified individual.
2. Your income is not more than certain limits.

You can use *Figure 32-A* and *Table 32-1* as guides to see if you are eligible for the credit.

Use *Figure 32-A* first to see if you are a qualified individual. If you are, go to *Table 32-1* to make sure your income is not too high to take the credit.

FIGURE 32-A. ARE YOU A QUALIFIED INDIVIDUAL?



1. However, you may be able to claim this credit even if you lived with your spouse during the first 6 months of the tax year, as long as you qualify to file as head of household. You qualify to file as head of household if you are considered unmarried and meet certain other conditions. See chapter 2 for more information.

2. If you were a nonresident alien at any time during the tax year and were married to a U.S. citizen or resident at the end of the tax year, see U.S. Citizen or Resident under Qualified Individual. If you and your spouse choose to treat you as a U.S. resident, answer "yes" to this question.

3. Mandatory retirement age is the age set by your employer at which you would have been required to retire, had you not become disabled.

TABLE 32-1. INCOME LIMITS

If your filing status is...	THEN even if you qualify (see Figure 32-A), you CANNOT take the credit if... Your adjusted gross income (AGI)* is equal to or more than...	OR the total of your nontaxable social security and other nontaxable pension(s) is equal to or more than...
single, head of household, or qualifying surviving spouse	$17,500	$5,000
married filing a joint return **and** both spouses qualify in *Figure 32-A*	$25,000	$7,500
married filing a joint return **and** only one spouse qualifies in *Figure 32-A*	$20,000	$5,000
married filing a separate return **and** you did not live with your spouse for all of 2024	$12,500	$3,750

**AGI is the amount on Form 1040 or 1040-SR, line 11.*

QUALIFIED INDIVIDUAL

You are a qualified individual for this credit if you are a U.S. citizen or resident and either of the following applies.

1. You were age 65 or older at the end of 2024
2. You were under age 65 at the end of 2024 and all three of the following statements are true.
   a) You retired on permanent and total disability (explained later).
   b) You received taxable disability income for 2024.
   c) On January 1, 2024, you had not reached mandatory retirement age (defined later under *Disability income*).

Age 65. You are considered to be age 65 on the day before your 65th birthday. Therefore, if you were born on January 1, 1960, you are considered to be age 65 at the end of 2024.

U.S. Citizen or Resident Alien

You must be a U.S. citizen or resident alien (or be treated as a resident alien) to take the credit. Generally, you cannot take the credit if you were a nonresident alien at any time during the tax year.

Exceptions

You may be able to take the credit if you are a nonresident alien who is married to a U.S. citizen or resident alien at the end of the tax year and you and your spouse choose to treat you as a U.S. resident alien. If you make that choice, both you and your spouse are taxed on your worldwide incomes.

If you were a nonresident alien at the beginning of the year and a resident alien at the end of the year, and you were married to a U.S. citizen or resident alien at the end of the year, you may be able to choose to be treated as a U.S. resident alien for the entire year. In that case, you may be allowed to take the credit.

Married Persons

Generally, if you are married at the end of the tax year, you and your spouse must file a joint return to take the credit. However, if you and your spouse did not live in the same household at any time during the tax year, you can file either joint or separate returns and still take the credit.

Head of household. You can file as head of household and qualify to take the credit, even if your spouse lived with you during the first 6 months of the year, if you meet certain tests.

Under Age 65

If you are under age 65 at the end of 2024, you can qualify for the credit only if you are retired on permanent and total disability and have taxable disability income.

You are retired on permanent and total disability if:

- You were permanently and totally disabled when you retired, and
- You retired on disability before the close of the tax year.

Even if you do not retire formally, you are considered retired on disability when you have stopped working because of your disability.

Permanent and total disability. You are permanently and totally disabled if you cannot engage in any substantial gainful activity because of your physical or mental condition. A qualified physician must certify that the condition has lasted or can be expected to last continuously for 12 months or more, or that the condition can be expected to result in death. See *Physician's statement*, later.

Substantial gainful activity. Substantial gainful activity is the performance of significant duties over a reasonable period of time while working for pay or profit, or in work generally done for pay or profit. Full-time work (or part-time work done at your employer's convenience) in a competitive work situation for at least the minimum wage conclusively shows that you are able to engage in substantial gainful activity.

Substantial gainful activity is not work you do to take care of yourself or your home. It is not unpaid work on hobbies, institutional therapy or training, school attendance, clubs, social programs, and similar activities. However, the nature of the work you perform may show that you are able to engage in substantial gainful activity.

The fact that you have not worked or have been unemployed for some time is not, of itself, conclusive evidence that you cannot engage in substantial gainful activity.

Sheltered employment. Certain work offered at qualified locations to physically or mentally impaired persons is considered sheltered employment. These qualified locations include work centers that are certified by the Department of Labor, hospitals and similar institutions, homebound programs, and Department of Veterans Affairs (VA) sponsored homes.

Compared to commercial employment, pay is lower for sheltered employment. Therefore, one usually does not look for sheltered employment if he or she can get other employment. The fact that one has accepted sheltered employment is not proof of that person’s ability to engage in substantial gainful activity.

Physician’s statement. If you are under age 65, you must have your physician complete a statement certifying that you were permanently and totally disabled on the date you retired. You can use the statement in the Instructions for Schedule R.

You do not have to file this statement with your tax return, but you must keep it for your records.

Veterans. If the Department of Veterans Affairs (VA) certifies that you are permanently and totally disabled, you can substitute VA Form 21-0172, *Certification of Permanent and Total Disability*, for the physician’s statement you are required to keep. VA Form 21-0172 must be signed by a person authorized by the VA to do so. You can get this form from your local VA regional office.

Physician’s statement obtained in earlier year. If you got a physician’s statement in an earlier year and, due to your continued disabled condition, you were unable to engage in any substantial gainful activity during 2024, you may not need to get another physician’s statement for 2024. For a detailed explanation of the conditions you must meet, see the instructions for Part II of Schedule R. If you meet the required conditions, check the box on line 2 of Part II of Schedule R.

If you checked box 4, 5, or 6 in Part I of Schedule R, enter in the space above the box on line 2 in Part II, the first name(s) of the spouse(s) for whom the box is checked.

Disability income. If you are under age 65, you can qualify for the credit only if you have taxable disability income. Disability income must meet both of the following requirements.

1. It must be paid under your employer’s accident or health plan or pension plan.
2. It must be included in your income as wages (or payments instead of wages) for the time you are absent from work because of permanent and total disability.

Payments that are not disability income. Any payment you receive from a plan that does not provide for disability retirement is not disability income. Any lump-sum payment for accrued annual leave that you receive when you retire on disability is a salary payment and is not disability income.

For purposes of the credit for the elderly or the disabled, disability income does not include amounts you receive after you reach mandatory retirement age. Mandatory retirement age is the age set by your employer at which you would have had to retire, had you not become disabled.

INCOME LIMITS

To determine if you can claim the credit, you must consider two income limits. The first limit is the amount of your adjusted gross income (AGI). The second limit is the amount of nontaxable social security and other nontaxable pensions, annuities, or disability income you received. The limits are shown in Table 32-1, earlier.

If your AGI and nontaxable pensions, annuities, or disability income are less than the income limits, you may be able to claim the credit. See *Figuring the Credit*, next.

Caution!

If your AGI or your nontaxable pensions, annuities, or disability income are equal to or more than the income limits, you cannot take the credit.

III. FIGURING THE CREDIT

You can figure the credit yourself or the IRS will figure it for you.

CREDIT FIGURED BY YOU

To figure the credit yourself, first check the box in Part I of Schedule R that applies to you. Only check one box in Part I. If you check box 2, 4, 5, 6, or 9 in Part I, also complete Part II of Schedule R.

Next, figure the amount of your credit using Part III of Schedule R.

Finally, report the amount from line 22 of Schedule R on your tax return. Then, check box c on Schedule 3 (Form 1040), line 6d, and enter “Sch R” on the line next to that box. Attach Schedule R to your return.

Limit on credit. The amount of the credit you can claim is generally limited to the amount of your tax. Use the Credit Limit Worksheet in the Instructions for Schedule R to determine if your credit is limited.

CHAPTER 32: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1.	**You may be able to take the credit for the elderly or the disabled if you meet which of the following conditions:** **A.** you are a qualified individual **B.** your income is not more than certain limits **C.** both A and B above **D.** you are over age 59½ and are retired
2.	**If your filing status is married filing a joint return and only one spouse qualifies for the credit for the elderly or disabled, you cannot take the credit if your AGI is equal to or more than what amount:** **A.** $12,500 **B.** $17,500 **C.** $20,000 **D.** $25,000

CHAPTER 32: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. Being a qualified individual is only one of the necessary conditions to claim the credit. **B.** Incorrect. Income restricted to certain limits is only one of the necessary conditions to claim the credit. **C.** **CORRECT**. You must meet both an income limit test and an age/residency test. **D.** Incorrect. You are a qualified individual for this credit if you are a U.S. citizen or a resident, meet certain income limits, and either: (1) you were age 65 or older at the end of the year, or (2) you were under age 65 and you were retired on permanent and total disability, you received taxable disability income, and you had not reached the mandatory retirement age. *(See page 495 of the course material.)*
2.	**A.** Incorrect. If your filing status is married filing a joint return and you did not live with your spouse at any time during the year, then even if you qualify for the credit for the elderly or disabled, you cannot take the credit if your AGI is equal to or more than $12,500. **B.** Incorrect. If your filing status is single, head of household, or qualifying widow(er) with dependent child, then even if you qualify for the credit for the elderly or disabled, you cannot take the credit if your AGI is equal to or more than $17,500. **C.** **CORRECT**. If your filing status is married filing a joint return and only one spouse qualifies for the credit for the elderly or disabled, you also cannot take the credit if the total of your nontaxable social security and other nontaxable pension(s) is equal to or more than $5,000. **D.** Incorrect. If your filing status is married filing a joint return and both spouses qualify for the credit for the elderly or disabled, you cannot take the credit if your AGI is equal to or more than $25,000. *(See page 497 of the course material.)*

CHAPTER 33: CHILD TAX CREDIT/CREDIT FOR OTHER DEPENDENTS

Chapter Objective

After completing this chapter, you should be able to:

- Recall the limits of the child tax credit.

I. INTRODUCTION

The child tax credit (CTC) is a credit that may reduce your tax by as much as $2,000 for each of your qualifying children in 2024.

The additional child tax credit (ACTC) is a credit you may be able to take if you are not able to claim the full amount of the child tax credit.

The other dependents credit (ODC) is a credit that may reduce your tax by as much as $500 for each eligible dependent.

Caution!

The CTC and the ACTC should not be confused with the child and dependent care credit discussed in Chapter 31.

II. QUALIFYING CHILD FOR THE CTC

A qualifying child for purposes of the child tax credit is a child who meets all of the following conditions:

1. The child is your son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, half brother, half sister, or a descendant of any of them;
2. The child was under age 17 at the end of 2024;
3. The child did not provide over half his or her own support for 2024;
4. The child lived with you for more than half of 2024;
5. The child is claimed as a dependent on your return;

6. The child does not file a joint return for the year (or files it only to claim a refund of withheld income tax or estimated tax paid); and

7. The child was a U.S. citizen, a U.S. national, or a U.S. resident alien. If the child was adopted, see *Adopted child*, later.

Example

Your son turned 17 on December 30, 2024. He is a citizen of the United States and you claimed him as a dependent on your return. You cannot use him to claim the CTC because he was not under age 17 at the end of 2024.

Adopted child. An adopted child is always treated as your own child. An adopted child includes a child lawfully placed with you for legal adoption.

If you are a U.S. citizen or U.S. national and your adopted child lived with you as a member of your household in 2024, that child meets condition (7) above to be a qualifying child for the child tax credit.

III. CREDIT FOR OTHER DEPENDENTS (ODC)

This credit is for individuals with a dependent who meets additional conditions (described later).

Note

This credit is different from and in addition to the credit for child and dependent care expenses that you also may be eligible to claim.

The maximum amount you can claim for this credit is $500 for each qualifying dependent. See *Limits on the CTC and ODC*, later.

QUALIFYING PERSON FOR THE ODC

A person qualifies you for the ODC if the person meets all of the following conditions.

1. The person is claimed as a dependent on your return.

2. The person cannot be used by you to claim the CTC or ACTC. See *Child Tax Credit (CTC)*, earlier.

3. The person is a U.S. citizen, U.S. national, or U.S. resident alien.

Example

Your 10-year-old nephew lives in Mexico and qualifies as your dependent. He is not a U.S. citizen, U.S. national, or U.S. resident alien. You cannot use him to claim the ODC.

Caution!

You cannot use the same child to claim both the CTC (or ACTC) and the ODC.

In addition to being a qualifying person for the ODC (defined earlier), your qualifying person must have an SSN, ITIN, or ATIN issued to him or her on or before the due date of your 2024 return (including extensions). If your qualifying person has not been issued an SSN, ITIN, or ATIN by that date, you cannot use the individual to claim the ODC.

IV. LIMITS ON THE CTC AND ODC

The maximum credit amount of your CTC or ODC may be reduced if:

- Your modified adjusted gross income (AGI) is above the amount shown below for your filing status.
    a) Married filing jointly - $400,000.
    b) All other filing statuses - $200,000.

Modified AGI. For purposes of the child tax credit, your modified AGI is your AGI plus the following amounts that may apply to you.

- Any amount excluded from income because of the exclusion of income from Puerto Rico.
    - On the dotted line next to Form 1040 or 1040-SR, line 11, enter the amount excluded and identify it as “EPRI”
    - Also attach a copy of any Form(s) 499R-2/W-2PR to your return
- Any amount on line 45 or line 50 of Form 2555, *Foreign Earned Income*.
- Any amount on line 15 of Form 4563, *Exclusion of Income for Bona Fide Residents of American Samoa*.

If you do not have any of the above, your modified AGI is the same as your AGI.

AGI. Your AGI is the amount on Form 1040, 1040-SR, or 1040-NR, line 11.

V. CLAIMING THE CTC AND ODC

To claim the CTC or ODC, make sure you meet the following requirements.

- You must file Form 1040, 1040-SR, or 1040-NR and include the name and TIN of each dependent for whom you are claiming the CTC or ODC.
- You must file Schedule 8812 (Form 1040).
- You must file Form 8862, if applicable.
- You must have a timely issued TIN on your tax return for you and your spouse (if filing jointly).
- For each qualifying child under 17 for whom you are claiming the CTC, you must enter the required SSN for the child in column (2) of the *Dependents* section of your tax return and check the Child tax credit box in column (4).
- For each dependent for whom you are claiming the ODC, you must enter the timely issued TIN for the dependent in column (2) of the *Dependents* section of your tax return and check the Credit for other dependents box in column (4).

Caution!

Do not check both the Child tax credit box and the Credit for other dependents box for the same person.

VI. ADDITIONAL CHILD TAX CREDIT (ACTC)

This credit is for certain individuals who get less than the full amount of the child tax credit. The additional child tax credit may give you a refund even if you do not owe any tax.

Caution!

The ODC cannot be used to figure the ACTC. Only your CTC can be used to figure your ACTC. If you are claiming the ODC but not the CTC, you cannot claim the ACTC.

Foreign earned income. If you file Form 2555 (relating to foreign earned income), you cannot claim the ACTC.

How to claim the additional child tax credit. To claim the additional child tax credit, see Schedule 8812 (Form 1040) and its Instructions.

CHAPTER 33: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1.	**For 2024, the child tax credit may reduce your tax by as much as what amount for a qualifying child:** **A.** $1,000 **B.** $2,000 **C.** $3,000 **D.** $4,000
2.	**The additional child tax credit (ACTC) is for individuals who exceed the modified adjusted gross income limit for the regular child tax credit.** **A.** true **B.** false

CHAPTER 33: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. The child tax credit is greater than this suggested amount per child of any age. **B.** CORRECT. The child tax credit may reduce your tax by as much as $2,000 for each qualifying child. **C.** Incorrect. The maximum child tax credit is less than this amount, but multiple qualifying children will increase the total amount of the credit to the taxpayer. **D.** Incorrect. The maximum child tax credit is less than this amount per child. *(See page 503 of the course material.)*
2.	**A.** Incorrect. This credit is for individuals who get less than the full amount of the child tax credit. **B.** CORRECT. This credit is for individuals who get less than the full amount of the child tax credit, not for those that exceeded the modified adjusted gross income limit for the regular child tax credit. *(See page 506 of the course material.)*

CHAPTER 34: EDUCATION CREDITS

Chapter Objective

After completing this chapter, you should be able to:

- Identify the requirements for and benefits of the American opportunity credit and the lifetime learning credit.

I. INTRODUCTION

For 2024, there are two tax credits available to persons who pay expenses for higher (postsecondary) education. They are:

- The American opportunity credit, and
- The lifetime learning credit.

The chapter will present an overview of these education credits.

Can you claim more than one education credit this year? For 2024, you can claim one education credit for each eligible student. For example, if you elect to claim the American opportunity credit for a child on your 2024 tax return, you cannot, for that same child, also claim the lifetime learning credit for 2024.

If you are eligible to claim the American opportunity credit and you are also eligible to claim the lifetime learning credit for the same student in the same year, you can choose to claim either credit, but not both.

If you pay qualified education expenses for more than one student in the same year, you can choose to take the American opportunity and the lifetime learning credits on a per-student, per-year basis. This means that, for example, you can claim the American opportunity credit for one student and the lifetime learning credit for another student in the same year.

Differences between the American opportunity and lifetime learning credits. There are several differences between these two credits. These differences are summarized in *Table 34-1*, next.

TABLE 34-1. COMPARISON OF EDUCATION CREDITS

Caution! You can claim both the American opportunity credit and the lifetime learning credit on the same return – but not for the same student.

	American Opportunity Credit	Lifetime Learning Credit
Maximum credit	Up to $2,500 per **eligible student**	Up to $2,000 credit per **return**
Limit on modified adjusted gross income (MAGI)	$180,000 if married filing jointly; $90,000 if single, head of household, or qualifying widow(er)	$180,000 if married filing jointly; $90,000 if single, head of household, or qualifying widow(er)
Refundable or nonrefundable	40% of credit may be refundable	Nonrefundable - Credit limited to the amount of tax you must pay on your taxable income
Number of years of postsecondary education	Available **ONLY** if the student had not completed the first 4 years of postsecondary education before 2024	Available for all years of postsecondary education and for courses to acquire or improve job skills
Number of tax years credit available	Available **ONLY** for 4 tax years per eligible student	Available for an unlimited number of years
Type of program required	Student must be pursuing a program leading to a degree or other recognized education credential	Student does not need to be pursuing a program leading to a degree or other recognized education credential
Number of courses	Student must be enrolled at least half time for at least one academic period beginning during 2024 (or the first 3 months of 2025 if the qualified expenses were paid in 2024)	Available for one or more courses
Felony drug conviction	At the end of 2024, the student had not been convicted of a felony for possessing or distributing a controlled substance	Felony drug convictions do not make the student ineligible

	American Opportunity Credit	Lifetime Learning Credit
Qualified expenses	Tuition, required enrollment fees, and course materials that the student needs for a course of study, whether or not the materials are bought at the educational institution as a condition of enrollment or attendance	Tuition and required enrollment fees (including amounts required to be paid to the institution for course-related books, supplies, and equipment)
Payments for academic periods	Payments made in 2024 for academic periods beginning in 2024 and in the first 3 months of 2025	
TIN needed by filing due date	Filers and students must have a TIN by the due date of their 2024 return (including extensions)	
Educational institution's EIN	You must provide the educational institution's employer identification number (EIN) on your Form 8863	

II. WHO CAN CLAIM AN EDUCATION CREDIT

You may be able to claim an education credit if you, your spouse, or a dependent you claim on your tax return was a student enrolled at or attending an eligible educational institution. For 2024, the credits are based on the amount of qualified education expenses paid for the student in 2024 for academic periods beginning in 2024 and in the first 3 months of 2025.

For example, if you paid $1,500 in December 2024 for qualified tuition for the spring 2025 semester beginning in January 2025, you may be able to use that $1,500 in figuring your 2024 education credit(s).

Academic period. An academic period includes a semester, trimester, quarter, or other period of study (such as a summer school session) as reasonably determined by an educational institution. In the case of an educational institution that uses credit hours or clock hours and does not have academic terms, each payment period can be treated as an academic period.

Eligible educational institution. An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the U.S. Department of Education. It includes virtually all accredited public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions.

Who can claim a dependent's expenses. If a dependent is claimed on a tax return, all qualified education expenses of the student are treated as having been paid by the person claiming the dependent. Therefore, only the person claiming the dependent on a tax return can claim an education credit for the student. If a student is not claimed as a dependent on another person's tax return, only the student can claim a credit.

Expenses paid by a third party. Qualified education expenses paid on behalf of the student by someone other than the student (such as a relative) are treated as paid by the student. However, qualified education expenses paid (or treated as paid) by a student who is claimed as a dependent on your tax return are treated as paid by you. Therefore, you are treated as having paid expenses that were paid by the third party.

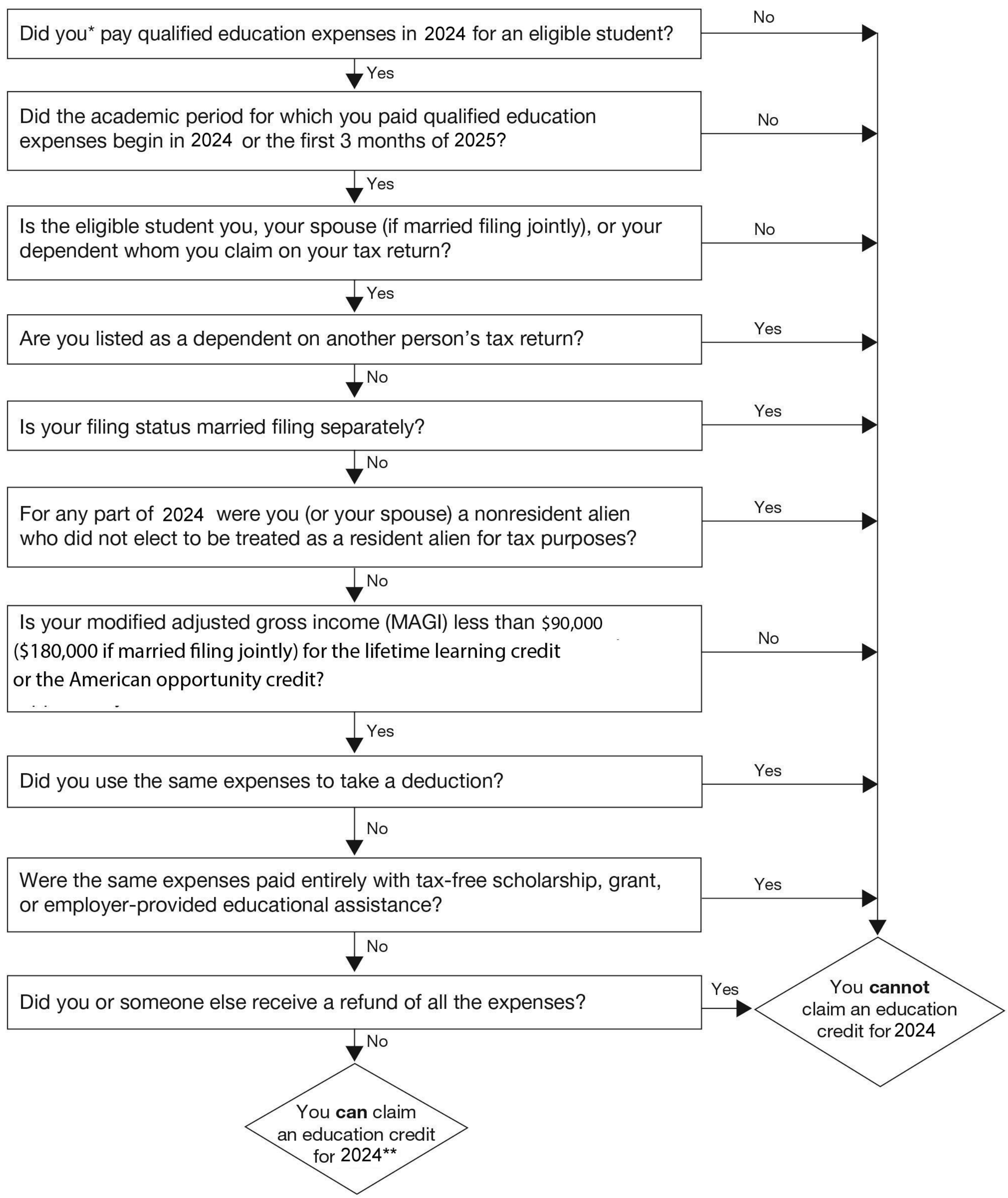
Who cannot claim a credit. You cannot claim an education credit if any of the following apply.

1. Your filing status is married filing separately.
2. You are claimed as a dependent on another person's tax return, such as your parent's return.
3. You (or your spouse) were a nonresident alien for any part of 2024 and did not elect to be treated as a resident alien for tax purposes.
4. You did not have a social security number (SSN) (or individual taxpayer identification number (ITIN)) by the due date of your 2024 return (including extensions); you cannot claim the American opportunity credit on either your original or an amended 2024 return, even if you later get an SSN (or ITIN). Also, you cannot claim this credit on your original or amended 2024 return for a student who did not have an SSN, adoption taxpayer identification number (ATIN), or ITIN by the due date of your return (including extensions), even if the student later gets one of those numbers.
5. Your MAGI is one of the following.
    a) American opportunity credit: $180,000 or more if married filing jointly, or $90,000 or more if single, head of household, or qualifying surviving spouse.
    b) Lifetime learning credit: $180,000 or more if married filing jointly, or $90,000 or more if single, head of household, or qualifying surviving spouse.

Generally, your MAGI is the amount on your Form 1040 or 1040-SR, line 11. However, if you are filing Form 2555 or Form 4563, or are excluding income from Puerto Rico, add to the amount on your Form 1040 or 1040-SR, line 11, the amount of income you excluded.

Figure 34-A may be helpful in determining if you can claim an education credit on your tax return.

FIGURE 34-A. CAN YOU CLAIM AN EDUCATION CREDIT FOR 2024?



* Qualified education expenses paid by a dependent whom you claim on your tax return, or by a third party for that dependent, are considered paid by you.

** Your education credits may be limited to your tax liability minus certain credits. See Form 8863 for more details.

III. QUALIFIED EDUCATION EXPENSES

Generally, qualified education expenses are amounts paid in 2024 for tuition and fees required for the student's enrollment or attendance at an eligible educational institution. It does not matter whether the expenses were paid in cash, by check, by credit or debit card, or with borrowed funds.

Only certain expenses for course-related books, supplies, and equipment qualify.

- American opportunity credit: Qualified education expenses include amounts spent on books, supplies, and equipment needed for a course of study, whether or not the materials are purchased from the educational institution as a condition of enrollment or attendance.
- Lifetime learning credit: Qualified education expenses include only amounts for books, supplies, and equipment only if required to be paid to the institution as a condition of enrollment or attendance.

Qualified education expenses include nonacademic fees, such as student activity fees, athletic fees, or other expenses unrelated to the academic course of instruction, **only if** the fee must be paid to the institution as a condition of enrollment or attendance. However, fees for personal expenses (described below) are never qualified education expenses.

Qualified education expenses **do not** include amounts paid for:

- Personal expenses. This means room and board, insurance, medical expenses (including student health fees), transportation, or other similar personal, living, or family expenses.
- Any course or other education involving sports, games, or hobbies, or any noncredit course, unless such course or other education is part of the student's degree program or (for the lifetime learning credit only) helps the student acquire or improve job skills.

Paid with borrowed funds. You can claim an education credit for qualified education expenses paid with the proceeds of a loan. Use the expenses to figure the credit for the year in which the expenses are paid, not the year in which the loan is repaid. Treat loan payments sent directly to the educational institution as paid on the date the institution credits the student's account.

Student withdraws from class(es). You can claim an education credit for qualified education expenses not refunded when a student withdraws.

NO DOUBLE BENEFIT ALLOWED

You cannot do any of the following.

- Deduct higher education expenses on your income tax return (as, for example, a business expense) and also claim an education credit based on those same expenses.
- Claim more than 1 education credit based on the same qualified education expenses.

- Claim an education credit based on the same expenses used to figure the tax-free portion of a distribution from a Coverdell education savings account (ESA) or qualified tuition program (QTP).
- Claim an education credit based on qualified education expenses paid with educational assistance, such as a tax-free scholarship, grant, or employer-provided educational assistance. See *Adjustments to Qualified Education Expenses*, next.

ADJUSTMENTS TO QUALIFIED EDUCATION EXPENSES

For each student, reduce the qualified education expenses paid in 2024 by or on behalf of that student under the following rules. The result is the amount of adjusted qualified education expenses for each student.

Tax-free educational assistance. For tax-free educational assistance received in 2024, reduce the qualified educational expenses for each academic period by the amount of tax-free educational assistance allocable to that academic period. See *Academic period*, earlier.

Tax-free educational assistance includes:

- Tax-free parts of scholarships and fellowships (including Pell grants),
- The tax-free part of employer-provided educational assistance,
- Veterans' educational assistance, and
- Any other nontaxable (tax-free) payments (other than gifts or inheritances) received as educational assistance.

Refunds. A refund of qualified education expenses may reduce qualified education expenses for the tax year or may require you to repay (recapture) the credit that you claimed in an earlier year. Some tax-free educational assistance received after 2024 may be treated as a refund. See *Tax-free educational assistance*, earlier.

Amounts that do not reduce qualified education expenses. Do not reduce qualified education expenses by amounts paid with funds the student receives as:

- Payment for services, such as wages,
- A loan,
- A gift,
- An inheritance, or
- A withdrawal from the student's personal savings.

Do not reduce the qualified education expenses by any scholarship or fellowship reported as income on the student's tax return in the following situations.

- The use of the money is restricted, by the terms of the grant, to costs of attendance (such as room and board) other than qualified education expenses.
- The use of the money is not restricted.

CHAPTER 34: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1.	**For 2024, what is the maximum American opportunity credit:** **A.** $1,500 per eligible student **B.** $2,000 per eligible student **C.** $2,500 per eligible student **D.** $3,000 per eligible student
2.	**The lifetime learning credit may be claimed for qualified educational expenses paid to postsecondary institutions, but is restricted to which of the following:** **A.** the first 2 years of study **B.** the first 3 years **C.** a total of 4 years **D.** none of the above; there is no limit on the years of study

CHAPTER 34: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. The maximum credit available is more than $1,500 per eligible student. **B.** Incorrect. The maximum credit available is more than $2,000 per eligible student. The lifetime learning credit, however, is $2,000 per return. **C.** **CORRECT**. The maximum credit available per eligible student is $2,500. **D.** Incorrect. The maximum credit available per eligible student is lower than $3,000. *(See page 512 of the course material.)*
2.	**A.** Incorrect. Neither of the education credits are restricted to claiming a tax credit to two years. **B.** Incorrect. Neither of the education credits are restricted to claiming a tax credit to three years. **C.** Incorrect. The American opportunity credit is limited to four years postsecondary education. **D.** **CORRECT**. There is no limit on the number of years for which the lifetime learning credit can be claimed for qualifying students. The lifetime learning credit can be up to $2,000 per year for all students. *(See page 512 of the course material.)*

CHAPTER 35: EARNED INCOME CREDIT (EIC)

Chapter Objective
After completing this chapter, you should be able to: • Recall the limit of investment income to qualify for the earned income credit.

I. INTRODUCTION

The earned income credit (EIC) is a tax credit for certain people who work and have a limited earned income. A tax credit usually means more money in your pocket. It reduces the amount of tax you owe. The EIC may also give you a refund.

Earned income amount is more. The maximum amount of income you can earn and still get the credit has increased. You may be able to take the credit if:

- You have three or more qualifying children and you earned less than $59,899 ($66,819 if married filing jointly),
- You have two qualifying children and you earned less than $55,768 ($62,688 if married filing jointly),
- You have one qualifying child and you earned less than $49,084 ($56,004 if married filing jointly), or
- You do not have a qualifying child and you earned less than $18,591 ($25,511 if married filing jointly).

Your adjusted gross income also must be less than the amount in the above list that applies to you.

Investment income amount is more. The maximum amount of investment income you can have and still get the credit is $11,600.

How do you get the earned income credit? To claim the EIC, you must:

1. Qualify by meeting certain rules, and
2. File a tax return, even if you:
    a) Do not owe any tax,
    b) Did not earn enough money to file a return, or
    c) Did not have income taxes withheld from your pay.

When you complete your return, you can figure your EIC by using a worksheet in the instructions for Form 1040 or 1040-SR. Or, if you prefer, you can let the IRS figure the credit for you.

II. DO YOU QUALIFY FOR THE CREDIT?

To qualify to claim the EIC, you must first meet all of the rules explained in Part A, *Rules for Everyone.* Then, you must meet the rules in Part B, *Rules If You Have a Qualifying Child*, or Part C, *Rules If You Do Not Have a Qualifying Child*. There is one final rule you must meet in Part D, *Figuring and Claiming the EIC*. You qualify for the credit if you meet all the rules in each part that applies to you.

- If you have a qualifying child, the rules in *Parts A, B,* and *D* apply to you.
- If you do not have a qualifying child, the rules in *Parts A, C,* and *D* apply to you.

IF IMPROPER CLAIM MADE IN PRIOR YEAR

If your EIC for any year after 1996 was denied or reduced for any reason other than a math or clerical error, you must attach a completed Form 8862 to your next tax return if you wish to claim the EIC. You must also qualify to claim the EIC by meeting the rules.

If your EIC was denied or reduced as a result of a math or clerical error, do not attach Form 8862 to your next tax return. For example, if your arithmetic is incorrect, the IRS can correct it. If you do not provide a correct social security number, the IRS can deny the EIC. These kinds of errors are called math or clerical errors.

If your EIC for any year after 1996 was denied and it was determined that your error was due to reckless or intentional disregard of the EIC rules, then you cannot claim the EIC for the next 2 years. If your error was due to fraud, then you cannot claim the EIC for the next 10 years.

TABLE 35-1. EARNED INCOME CREDIT IN A NUTSHELL

First, you must meet all the rules in this column.		Second, you must meet all the rules in one of these columns, whichever applies.		Third, you must meet the rule in this column.
Part A. Rules for Everyone		**Part B. Rules If You Have a Qualifying Child**	**Part C. Rules If You Do Not Have a Qualifying Child**	**Part D. Figuring and Claiming the EIC**
1. Your adjusted gross income (AGI) must be less than: • $59,899 ($66,819 for married filing jointly) if you have three or more qualifying children. • $55,768 ($62,688 for married filing jointly) if you have two qualifying children. • $49,084 ($56,004 for married filing jointly) if you have one qualifying child, or • $18,591 ($25,511 for married filing jointly) if you do not have a qualifying child.	**2.** You must have a valid social security number by the due date of your 2024, return (including extensions). **3.** Your filing status cannot be "married filing separately." **4.** You must be a U.S. citizen or resident alien all year. **5.** You cannot file Form 2555 (relating to foreign earned income). **6.** Your investment income must be $11,600 or less. **7.** You must have earned income.	**8.** Your child must meet the relationship, age, residency, and joint return tests. **9.** Your qualifying child cannot be used by more than one person to claim the EIC. **10.** You cannot be a qualifying child of another person.	**11.** You must be at least age 25 but under age 65. **12.** You cannot be the dependent of another person. **13.** You cannot be a qualifying child of another person. **14.** You must have lived in the United States more than half of the year.	**15.** Your earned income must be less than: • $59,899 ($66,819 for married filing jointly) if you have three or more qualifying children. • $55,768 ($62,688 for married filing jointly) if you have two qualifying children. • $49,084 ($56,004 for married filing jointly) if you have one qualifying child, or • $18,591 ($25,511 for married filing jointly) if you do not have a qualifying child.

Example 1

You, your 5-year-old son, and your son's father lived together all year. You and your son's father are not married. Your son is a qualifying child of both you and his father because he meets the relationship, age, residency, and joint return tests for both you and his father. Your earned income and AGI are $12,000, and your son's father's earned income and AGI are $14,000. Neither of you had any other income. Your son's father agrees to let you treat the child as a qualifying child. This means, if your son's father does not claim your son as a qualifying child for the EIC or any of the other tax benefits listed earlier, you can claim him as a qualifying child for the EIC and any other tax benefits listed for which you qualify.

Example 2

You and your 7-year-old niece, your sister's child, lived with your mother all year. You are 25 years old, and your AGI is $9,300. Your only income was from a part-time job. Your mother's AGI is $15,000. Her only income was from her job. Your niece's parents file jointly, have an AGI of less than $9,000, and do not live with you or their child. Your niece is a qualifying child of both you and your mother because she meets the relationship, age, residency, and joint return tests for both you and your mother. However, only your mother can treat her as a qualifying child. This is because your mother's AGI, $15,000, is more than your AGI, $9,300.

CHAPTER 35: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1.	**The earned income credit not only may reduce the tax you owe, but also give you a refund.** **A.** true **B.** false
2.	**What is the maximum amount of income you can earn and still receive the earned income credit if you have three or more qualifying children and are filing single:** **A.** $18,591 **B.** $49,084 **C.** $59,899 **D.** $66,819

CHAPTER 35: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** CORRECT. The earned income credit is different than most credits because not only does it reduce the amount of tax you may owe, but it also may give you a refund. **B.** Incorrect. To get your earned income credit, you must qualify by meeting certain rules, and file a tax return even if you did not owe any tax, did not earn enough money to file a return, or did not have income taxes withheld from your pay. *(See page 521 of the course material.)*
2.	**A.** Incorrect. $18,591 is the maximum that an individual can earn and receive the earned income credit if he or she is filing single and has no qualifying children. **B.** Incorrect. $49,084 is the maximum that an individual can earn and receive the earned income credit if he or she is filing single and has one qualifying child. **C.** CORRECT. The adjusted gross income must also be less than $59,899. **D.** Incorrect. $66,819 is the maximum that an individual can earn and receive the earned income credit if he or she is married filing jointly and has three or more qualifying children. *(See page 521 of the course material.)*

CHAPTER 36: PREMIUM TAX CREDIT (PTC)

Chapter Objective

After completing this chapter, you should be able to:

- Recognize who is eligible to claim the premium tax credit.

I. INTRODUCTION

You may be able to take the PTC only for health insurance coverage in a qualified health plan purchased through a Health Insurance Marketplace (also known as an Exchange). This includes a qualified health plan purchased on healthcare.gov or through a state Marketplace.

This chapter provides an overview of the following.

- What is the PTC.
- Who can take the PTC.
- How to claim the credit.

II. WHAT IS THE PREMIUM TAX CREDIT (PTC)?

Premium tax credit (PTC). The PTC is a tax credit for certain people who enroll, or whose family member enrolls, in a qualified health plan. The credit provides financial assistance to pay the premiums for the qualified health plan offered through a Marketplace by reducing the amount of tax you owe, giving you a refund, or increasing your refund amount. You must file Form 8962 to compute and take the PTC on your tax return.

Advance payments of the premium tax credit (APTC). APTC is a payment made to your insurance provider that pays for part or all of the premiums for a qualified health plan covering you or an individual in your tax family. Your APTC eligibility is based on the Marketplace's estimate of the PTC you will be able to take on your tax return. If APTC was paid for you or an individual in your tax family, you must complete Form 8962 to reconcile (compare) the APTC with your PTC. If the APTC is more than your PTC, you have excess APTC. If the APTC is *less* than the PTC, you can get a credit for the difference, which reduces your tax payment or increases your refund.

Changes in circumstances. The Marketplace determined your eligibility for and the amount of your 2024 APTC using projections of your income and the number of individuals you certified to the Marketplace would be in your tax family (yourself, spouse, and dependents) when you enrolled in a qualified health plan. If this information changed during 2024 and you did not promptly report it to the Marketplace, the amount of APTC paid may be substantially different from the amount of PTC you can take on your tax return.

III. WHO CAN TAKE THE PTC?

You can take the PTC for 2024 if you meet all the conditions under (1), (2), and (3) below.

1. For at least one month of the year, all of the following were true.

   a) An individual in your tax family was enrolled in a qualified health plan offered through the Marketplace on the first day of the month;

   b) The individual was not eligible for minimum essential coverage, other than coverage in the individual market; and

   c) The portion of the enrollment premiums for the month for which you are responsible was paid by the due date of your tax return (not including extensions).

2. No one can claim you as a dependent for the year.

3. You are an applicable taxpayer for 2024. To be an applicable taxpayer, you must meet all of the following requirements.

   a) For 2024, your household income is at least 100% of the Federal poverty line for your family size (provided in Tables 1-1, 1-2, and 1-3, in the Instructions for Form 8962). See the Instructions for Form 8962 for exceptions when household income is below 100% of the Federal poverty line.

   b) If you were married at the end of 2024, generally you must file a joint return. However, filing a separate return from your spouse will not disqualify you from being an applicable taxpayer if you meet certain requirements described under *Married taxpayers* in the Instructions for Form 8962.

You are not entitled to the PTC for health coverage for an individual for any period during which the individual is not lawfully present in the United States.

IV. HOW TO TAKE THE PTC?

You must file Form 8962 with your income tax return if any of the following apply to you.

- You are taking the PTC.
- APTC was paid for you or another individual in your tax family.
- APTC was paid for an individual for whom you told the Marketplace would be in your tax family and neither you nor anyone else included that individual in a tax family. See *Individual enrolled who is not included in a tax family under Lines 12 Through 23 - Monthly Calculation* in the Instructions for Form 8962.

If any of the circumstances above apply to you, you must file an income tax return and attach Form 8962 even if you are not otherwise required to file. You must file Form 1040, 1040-SR, or 1040-NR.

Form 1095-A. You will need Form 1095-A to complete Form 8962. The Marketplace uses Form 1095-A to report certain information to the IRS about individuals who enrolled in a qualified health plan through the Marketplace. The Marketplace sends copies to individuals to allow them to accurately file a tax return taking the PTC and reconciling APTC. For coverage in 2024, the Marketplace is required to provide or send Form 1095-A to the individual(s) identified in the Marketplace enrollment application by January 31, 2025.

Under certain circumstances (for example, where two spouses enroll in a qualified health plan and divorce during the year), the Marketplace will provide Form 1095-A to one taxpayer, but another taxpayer will also need the information from that form to complete Form 8962. The recipient of Form 1095-A should provide a copy to other taxpayers as needed.

Allocating policy amounts. You need to allocate policy amounts (enrollment premiums, LCSP premiums, and/or APTC) on a Form 1095-A between your tax family and another tax family if:

- The policy covered at least one individual in your tax family and at least one individual in another tax family, and
- You received a Form 1095-A for the policy that does not accurately reflect the members of your tax family who were enrolled in the policy (meaning that it either lists someone who is not in your tax family or does not list a member of your tax family who was enrolled in the policy) or the other tax family received a Form 1095-A for the policy that includes a member of your tax family.

If these conditions apply to you, check the "Yes" box on line 9 of Form 8962. For each policy to which the two conditions above apply, follow the instructions in *Table 3. Shared Policy Allocation—Line 9*, in the Form 8962 instructions, to determine which allocation rule applies for that qualified health plan.

A qualified health plan may have covered at least one individual in your tax family and one individual not in your tax family if:

- You got divorced during the year,
- You are married but filing a separate return from your spouse,
- You or an individual in your tax family was enrolled in a qualified health plan by someone who is not part of your tax family (for example, your ex-spouse enrolled a child whom you are claiming as a dependent), or
- You or an individual in your tax family enrolled someone not part of your tax family in a qualified health plan (for example, you enrolled a child whom your ex-spouse is claiming as a dependent).

CHAPTER 36: TEST YOUR KNOWLEDGE

The following question is designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). It is included as an additional tool to enhance your learning experience and does not need to be submitted in order to receive CPE credit.

We recommend that you answer the question and then compare your response to the suggested solution on the following page before answering the final exam question(s) related to this chapter (assignment).

1.	**To be an applicable taxpayer for purposes of taking the premium tax credit (PTC), which of the following must be true:** **A.** no one can claim you as a dependent on their tax return for 2024 **B.** if you were married at the end of 2024, generally you must file a separate return **C.** your household income cannot be above the Federal poverty line for your family size **D.** you must have reached retirement age

CHAPTER 36: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** CORRECT. Not being able to be claimed as a dependent on another's tax return is one of the three requirements that must be met in order to be an applicable taxpayer to take the PTC. **B.** Incorrect. If you were married at the end of 2024, generally you must file a joint return; however, filing a separate return from your spouse will not automatically disqualify you from being an applicable taxpayer if you meet certain requirements. **C.** Incorrect. Your household income must be at least 100% but not more than 400% of the Federal poverty line for your family size in order to be an applicable taxpayer to take the credit. **D.** Incorrect. There is no age restriction for those taking the PTC. *(See page 528 of the course material.)*

CHAPTER 37: OTHER CREDITS

Chapter Objective

After completing this chapter, you should be able to:

- Identify various nonrefundable and refundable credits available for income tax purposes.

I. IMPORTANT

Adoption credit. The maximum adoption credit has been increased to $16,810 for 2024.

II. INTRODUCTION

This chapter discusses the following nonrefundable credits.

- Adoption credit.
- Credit to holders of tax credit bonds.
- Foreign tax credit.
- Mortgage interest credit.
- Nonrefundable credit for prior year minimum tax.
- Residential energy credit.
- Retirement savings contributions credit.

This chapter also discusses the following refundable credits.

- Credit for tax on undistributed capital gain.
- Credit for Excess Social Security Tax or Railroad Retirement Tax Withheld.

Nonrefundable credits. The first part of this chapter, *Nonrefundable Credits*, covers seven credits that you subtract directly from your tax. These credits may reduce your tax to zero. If these credits are more than your tax, the excess is not refunded to you.

Refundable credits. The second part of this chapter, *Refundable Credits*, covers three credits that are treated as payments and are refundable to you. These credits are added to the federal income tax withheld and any estimated tax payments you made. If this total is more than your total tax, the excess will be refunded to you.

III. NONREFUNDABLE CREDITS

ADOPTION CREDIT

You may be able to take a tax credit of up to $16,810 for qualifying expenses paid to adopt an eligible child. The credit may be allowed for the adoption of a child with special needs even if you do not have any qualified expenses.

If your modified adjusted gross income (AGI) is more than $252,150, your credit is reduced. If your modified AGI is $292,150 or more, you cannot claim the credit.

Qualified adoption expenses. Qualified adoption expenses are reasonable and necessary adoption fees, court costs, attorney fees, traveling expenses (including amounts spent for meals and lodging) while away from home, and other expenses directly related to, and whose principal purpose is for, the legal adoption of an eligible child. These expenses include:

- Adoption fees,
- Court costs,
- Attorney fees,
- Travel expenses (including amounts spent for meals and lodging) while away from home, and
- Re-adoption expenses to adopt a foreign child.

Nonqualified expenses. Qualified adoption expenses do not include expenses:

- That violate state or federal law,
- For carrying out any surrogate parenting arrangement,
- For the adoption of your spouse's child,
- For which you received funds under any federal, state, or local program,
- Allowed as a credit or deduction under any other federal income tax rule, or
- Paid or reimbursed by your employer or any other person or organization.

Eligible child. The term "eligible child" means any individual:

1. Under 18 years old, or
2. Physically or mentally incapable of caring for himself or herself.

Child with special needs. An eligible child is a child with special needs if all three of the following apply:

1. The child was a citizen or resident of the United States (including U.S. possessions) at the time the adoption process began.

2. A state (including the District of Columbia) determines that the child cannot or should not be returned to his or her parents' home.

3. The state has determined that the child will not be adopted unless assistance is provided to the adoptive parents. Factors used by states to make this determination include:

    - The child's ethnic background,
    - The child's age,
    - Whether the child is a member of a minority or sibling group, or
    - Whether the child has a medical condition or physical, mental, or emotional handicap.

When to take the credit. Generally, until the adoption becomes final, you take the credit in the year after your qualified expenses are paid or incurred. If the adoption becomes final, you take the credit in the year your expenses were paid or incurred.

Foreign child. If the child is not a U.S. citizen or resident, you cannot take the credit unless the adoption becomes final. You treat all adoption expenses paid or incurred in years before the adoption becomes final as paid or incurred in the year it becomes final.

How to take the credit. Figure your 2024 nonrefundable credit and any carryforward to 2025 on Form 8839 and attach it to your Form 1040 or 1040-SR. Include the credit in your total for Schedule 3 (Form 1040), line 6c.

CREDIT TO HOLDERS OF TAX CREDIT BONDS

Tax credit bonds are bonds in which the holder receives a tax credit in lieu of some or all of the interest on the bond.

You may be able to take a credit if you are a holder of one of the following bonds.

- Clean renewable energy bonds (issued before 2010).
- New clean renewable energy bonds.
- Qualified energy conservation bonds.
- Qualified school construction bonds.
- Qualified zone academy bonds.
- Build America bonds.

In some instances, an issuer may elect to receive a credit for interest paid on the bond. If the issuer makes this election, you cannot also claim a credit.

Interest income. The amount of any tax credit allowed (figured before applying tax liability limits) must be included as interest income on your tax return.

How to take the credit. Complete Form 8912 and attach it to your Form 1040 or 1040-SR. Include the credit in your total for Schedule 3 (Form 1040), line 6k.

FOREIGN TAX CREDIT

You generally can choose to claim income taxes you paid or accrued during the year to a foreign country or U.S. possession as a credit against your U.S. income tax. Or, you can deduct them as an itemized deduction (see chapter 23).

You cannot take a credit (or deduction) for foreign income taxes paid on income that you exclude from U.S. tax under the foreign earned income exclusion, the foreign housing exclusion, income from Puerto Rico exempt from U.S. tax, or the possession exclusion.

Limit on the credit. Unless you can elect not to file Form 1116, your foreign tax credit cannot be more than your U.S. tax liability (the total of Form 1040 or 1040-SR, line 16, and Schedule 2 (Form 1040), line 2) multiplied by a fraction. The numerator of the fraction is your taxable income from sources outside the United States. The denominator is your total taxable income from U.S. and foreign sources.

How to take the credit. Complete Form 1116 and attach it to your Form 1040 or 1040-SR. Enter the credit on Schedule 3 (Form 1040), line 1.

Exception

You do not have to complete Form 1116 to take the credit if all of the following apply.

1. All of your foreign source gross income was "passive category income" (which includes most interest and dividends) and all of that income and the foreign tax paid on it were reported to you on qualified payee statements, such as Form 1099-INT and Form 1099-DIV (or substitute statements).

2. The total of your foreign taxes was not more than $300 (not more than $600 if married filing jointly).

For more details on these requirements, see the instructions for Form 1116.

MORTGAGE INTEREST CREDIT

The mortgage interest credit is intended to help lower-income individuals own a home. If you qualify, you can take a credit each year for part of the home mortgage interest you pay.

Who qualifies. You may be eligible for the credit if you were issued a mortgage credit certificate (MCC) from your state or local government. Generally, an MCC is issued only in connection with a new mortgage for the purchase of your main home.

Amount of credit. Figure your credit on Form 8396. If your mortgage is equal to (or smaller than) the certified indebtedness amount (loan) shown on your MCC, enter on Form 8396, line 1, all the interest you paid on your mortgage during the year.

If your mortgage loan amount is larger than the certified indebtedness amount shown on your MCC, you can figure the credit on only part of the interest you paid. To find the amount to enter on line 1, multiply the total interest you paid during the year on your mortgage by the following fraction.

$$\frac{\text{Certified indebtedness amount on your MCC}}{\text{Original amount of your mortgage}}$$

Limit based on credit rate. If the certificate credit rate is more than 20%, the credit you are allowed cannot be more than $2,000. If two or more persons (other than a married couple filing a joint return) hold an interest in the home to which the MCC relates, this $2,000 limit must be divided based on the interest held by each person.

Carryforward. Your credit (after applying the limit based on the credit rate) is also subject to a limit based on your tax that is figured using Form 8396. If your allowable credit is reduced because of this tax liability limit, you can carry forward the unused portion of the credit to the next 3 years or until used, whichever comes first.

If you are subject to the $2,000 limit because your certificate credit rate is more than 20%, you cannot carry forward any amount more than $2,000 (or your share of the $2,000 if you must divide the credit).

How to take the credit. Figure your 2024 credit and any carryforward to 2025 on Form 8396, and attach it to your Form 1040 or 1040-SR. Be sure to carry any credit carryforward from 2021, 2022, and 2023.

Include the credit on Schedule 3 (Form 1040), line 6g.

Reduced home mortgage interest deduction. If you claim the credit and itemize your deductions on Schedule A (Form 1040), you must reduce your home mortgage interest deduction by the amount of the mortgage interest credit shown on Form 8396, line 3. You must do this even if part of that amount is to be carried forward to 2025.

Recapture of federal mortgage subsidy. If you received an MCC with your mortgage loan, you may have to recapture (pay back) all or part of the benefit you received from that program. The recapture may be required if you sell or dispose of your home at a gain during the first 9 years after the date you closed your mortgage loan.

NONREFUNDABLE CREDIT FOR PRIOR YEAR MINIMUM TAX

The tax laws give special treatment to some kinds of income and allow special deductions and credits for some kinds of expenses. If you benefit from these laws, you may have to pay at least a minimum amount of tax in addition to any other tax on these items. This is called the alternative minimum tax.

The special treatment of some items of income and expenses only allows you to postpone paying tax until a later year. If in prior years you paid alternative minimum tax because of these tax postponement items, you may be able to claim a credit for prior year minimum tax against your current year's regular tax.

You may be able to take a credit against your regular tax if for 2023 you:

1. Had an alternative minimum tax liability and adjustments or preferences other than exclusion items,
2. Had a minimum tax credit that you are carrying forward to 2024, or
3. Had an unallowed qualified electric vehicle credit.

How to take the credit. Figure your 2024 nonrefundable credit (if any) and any carryforward to 2024 on Form 8801, and attach it to your Form 1040 or 1040-SR. Include the credit on Schedule 3 (Form 1040), line 6b. You can carry forward any unused credit for prior year minimum tax to later years until it is completely used.

For additional information about the credit, see the instructions for Form 8801.

RESIDENTIAL CLEAN ENERGY CREDIT

You may be able to claim the residential clean energy credit if you made energy saving improvements to your home located in the United States in 2024.

Note

If you are a member of a condominium management association for a condominium you own or a tenant-stockholder in a cooperative housing corporation, you are treated as having paid your proportionate share of any costs of the association or corporation.

Residential clean energy credit. You may be able to take a credit of 30% of your costs of qualified solar electric property, qualified solar water heating property, small wind energy property, geothermal heat pump property, and fuel cell property. Include any labor costs properly allocable to the onsite preparation, assembly, or original installation of the residential energy efficient property and for piping or wiring to interconnect such property to the home.

Basis reduction. You must reduce the basis of your home by the amount of any credit allowed.

How to take the credit. Complete Form 5695 and attach it to your Form 1040 or 1040-SR. Enter the credit on Schedule 3 (Form 1040), line 5a.

RETIREMENT SAVINGS CONTRIBUTIONS CREDIT (SAVER'S CREDIT)

You may be able to take this credit if you, or your spouse if filing jointly, made:

- Contributions (other than rollover contributions) to a traditional or Roth IRA,
- Elective deferrals to a 401(k), 403(b), SEP, SIMPLE plan, or to the federal Thrift Savings Plan,
- Voluntary after-tax employee contributions to a qualified retirement plan (including the federal Thrift Savings Plan) or 403(b) plan,
- Contributions to a 501(c)(18)(D) plan, or
- Contributions to an ABLE account by the designated beneficiary.

However, you cannot take the credit for 2024 if either of the following applies.

1. The amount on Form 1040 or 1040-SR, line 12, is more than $38,250 ($57,375 if head of household; $76,500 if married filing jointly).
2. The person(s) who made the qualified contribution or elective deferral (a) was born after January 1, 2006, (b) is claimed as a dependent on someone else's 2024 tax return, or (c) was a student (defined next).

Student. You were a student if during any part of 5 calendar months of 2024 you:

- Were 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.

School. 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.

How to take the credit. Figure the credit on Form 8880. Enter the credit on your Schedule 3 (Form 1040), line 4, and attach Form 8880 to your return.

IV. REFUNDABLE CREDITS

CREDIT FOR TAX ON UNDISTRIBUTED CAPITAL GAIN

You must include in your income any amounts that regulated investment companies (commonly called mutual funds) or real estate investment trusts (REITs) allocated to you as capital gain distributions, even if you did not actually receive them. If the mutual fund or REIT paid a tax on the capital gain, you are allowed a credit for the tax since it is considered paid by you. The mutual fund or REIT will send you Form 2439, *Notice to Shareholder of Undistributed Long-Term Capital Gains*, showing the undistributed capital gains and the tax paid, if any.

How to take the credit. To take the credit, attach Copy B of Form 2439 to your Form 1040 or 1040-SR. Include the amount from box 2 of your Form 2439 in the total for Schedule 3 (Form 1040), line 13a.

CREDIT FOR EXCESS SOCIAL SECURITY TAX OR RAILROAD RETIREMENT TAX WITHHELD

Most employers must withhold social security tax from your wages. If you work for a railroad employer, that employer must withhold tier 1 railroad retirement (RRTA) tax and tier 2 RRTA tax.

If you worked for two or more employers in 2024, you may have had too much social security tax withheld from your pay. If one or more of those employers was a railroad employer, too much tier 1 RRTA tax may also have been withheld at the 6.2% rate. You can claim the excess social security or tier 1 RRTA tax as a credit against your income tax when you file your return. For the tier 1 RRTA tax, only use the portion of the tier 1 RRTA tax that was taxed at the 6.2% rate when figuring if excess tier 1 RRTA tax was withheld; do not include any portion of the tier 1 RRTA tax that was withheld at the Medicare tax rate (1.45%) or the Additional Medicare Tax rate (0.9%). The following table shows the maximum amount of wages subject to tax and the maximum amount of tax that should have been withheld for 2024.

Type of tax	Maximum wages subject to tax	Maximum tax that should have been withheld
Social security or RRTA tier 1	$168,600	$10,453.20
RRTA tier 2	$125,100	$6,129.90

Caution!

All wages are subject to Medicare tax withholding.

Tip

Use Form 843, *Claim for Refund and Request for Abatement,* to claim a refund of excess tier 2 RRTA tax. Be sure to attach a copy of all of your W-2 forms.

Employer's error. If any one employer withheld too much social security or tier 1 RRTA tax, you cannot take the excess as a credit against your income tax. The employer should adjust the tax for you. If the employer does not adjust the overcollection, you can file a claim for refund using Form 843.

Joint return. If you are filing a joint return, you cannot add the social security or tier 1 RRTA tax withheld from your spouse's wages to the amount withheld from your wages. Figure the withholding separately for you and your spouse to determine if either of you has excess withholding.

How to figure the credit if you did not work for a railroad. If you did not work for a railroad during 2024, figure the credit as follows:

1.	Add all social security tax withheld (but not more than $10,453.20 for each employer). Enter the total here	________
2.	Enter any uncollected social security tax on tips or group-term life insurance included in the total on Schedule 2 (Form 1040), line 13, identified by "UT"	________
3.	Add lines 1 and 2. If $10,453.20 or less, stop here. You cannot take the credit	________
4.	Social security tax limit	$10,453.20
5.	Credit. Subtract line 4 from line 3. Enter the result here and on Schedule 3 (Form 1040), line 11	________

CHAPTER 37: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1.	**Which of the following is a refundable credit:** **A.** the adoption credit **B.** the foreign tax credit **C.** the mortgage interest credit **D.** the credit for tax on undistributed capital gain
2.	**You may be able to take a 30% credit of your costs of qualified solar electric property incurred in 2024.** **A.** true **B.** false

CHAPTER 37: SOLUTION AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. You may be able to take a credit of up to $16,810 (2024) for qualifying expenses paid to adopt an eligible child. This credit, however, is nonrefundable. **B.** Incorrect. You generally can choose to claim income taxes you paid or accrued during the year to a foreign country or U.S. possession as a credit against your U.S. income tax. This credit, however, is nonrefundable. You can otherwise choose to deduct them as an itemized deduction if within the SALT limitation. **C.** Incorrect. The mortgage interest credit is intended to help lower-income individuals own a home. If you qualify, you can take a credit each year for part of the home mortgage interest you pay. This credit, however, is nonrefundable. **D.** **CORRECT**. You must include in your income any amounts that regulated investment companies or real estate investment trusts allocated to you as capital gain distributions, even if you did not actually receive them. To take the credit, attach Copy B of Form 2439 to your Form 1040 or 1040-SR. *(See page 533 of the course material.)*
2.	**A.** **CORRECT**. You must reduce the basis of your home by the amount of any credit allowed. **B.** Incorrect. To take the credit, you must complete Form 5695 and attach it to your Form 1040 or 1040-SR. *(See page 538 of the course material.)*

GLOSSARY

401(k) plan. A deferred compensation plan, authorized by Section 401(k) of the Internal Revenue Code, under which a percentage of an employee's salary is withheld and placed in a savings account or the company's profit-sharing plan. Income accumulates on the deferred amount until withdrawn by the employee at age 59½ or when the employee retires or leaves the company.

Accelerated cost recovery system (ACRS). A statutory method of depreciation allowing accelerated rates for most types of property used in business and income-producing activities during the years 1981 through 1986. It has been superseded by the modified accelerated cost recovery system (MACRS) for assets placed in service after 1986.

Accelerated death benefit. Certain payments received under a life insurance contract on the life of a terminally or chronically ill individual before the individual's death.

Accelerated depreciation. A method of depreciation that allows a person to deduct the cost of property more rapidly than *straight-line depreciation*. Accelerated depreciation rates are included in ACRS rates and most Modified Accelerated Cost Recovery System *(MACRS)* rates if a person wants to use them.

Accountable plan. An employer's plan for reimbursing employees for business – related expenses, under which the employees are required to substantiate each business expense to the employer and return any reimbursement in excess of the substantiated expenses. Reimbursements received under an accountable plan are generally excluded from wages and are not subject to employment taxes.

Accrual method. A business method of accounting requiring income to be reported when earned and expenses to be deducted when incurred. However, deductions generally may not be claimed until economic performance has occurred.

Acquisition debt. Debt used to buy, build, or construct a principal residence or second home and that generally qualifies for a full interest expense deduction.

Active participation. The level of activity necessary to claim rental losses up to $25,000 from real estate rental activities.

Adjusted basis. A statutory term describing the cost used to determine your profit or loss from a sale or exchange of property. It is generally your original cost, increased by capital improvements, and decreased by depreciation, depletion, and other capital write-offs.

Adjusted gross income (AGI). Important tax term representing gross income less allowable adjustments, such as IRA, alimony, and Keogh deductions. AGI determines whether various tax benefits are phased out, such as, itemized deductions and the rental loss allowance. Also see modified adjusted gross income (MAGI).

Administrator. Person who is usually appointed by the court if no will exists, if no executor was named in the will, or if the named executor cannot or will not serve. The administrator will have to administer the estate (property or debts left by the decedent) and distribute properties as the decedent has directed.

Alimony. Payments made to a separated or divorced spouse as required by a decree or agreement.

Alternate payee. The recipient of qualified retirement benefits under a court order, judgment, decree, or approved property settlement constituting a qualified domestic relations order.

Alternative Depreciation System (ADS). A way of depreciating assets using the straight-line depreciation method and longer recovery period than are available under *MACRS*. Mandatory for such items as foreign assets, luxury automobiles, and tax-exempt use property.

Alternative Minimum Tax (AMT). A tax that may apply in lieu of income tax when a taxpayer has *tax preference items* or certain deductions allowed in determining regular taxable income.

Amended return. Filed on Form 1040X within a three-year period to correct a mistake made on an original or previously amended return.

American Opportunity credit. The maximum credit is generally $2,500 per student, and it is allowed for the first four years of post-secondary education. The phaseout of the credit applies if modified adjusted gross income is between $80,000 and $90,000, or between $160,000 and $180,000 on a joint return.

Amortization. A deductible expense allowed as a means of recovering the investment in an intangible asset. Compare with *depreciation*.

Amount realized. The *fair market value* of property, including money (at face value), received in a sale or an exchange.

Amount recognized. The amount of gain reportable and subject to tax. On certain tax-free exchanges of property, gain is not recognized in the year it is realized.

Annual gift tax exclusion. An exclusion that applies to gifts of present interests on a per donee basis.

Annualized rate. A rate for a period of less than a year computed as though for a full year.

Annuity. A sum of money paid periodically that includes the return of the invested capital plus income generated by it. An annuity is frequently purchased by an individual for investment purposes and is used by retirement plans to pay *pensions*.

Applicable federal rate. Interest rate fixed by the Treasury for determining imputed interest on transactions providing for below-market interest.

Archer Medical Savings Account (MSA). A type of medical plan combining high deductible medical insurance protection with an IRA-type savings account fund to pay unreimbursed medical expenses.

Assessment. The IRS action of fixing tax liability that sets in motion collection procedures, such as charging interest, imposing penalties, and, if necessary, seizing property.

At-risk limitations. Generally, partnership losses are deductible up to the amount you have a risk in the activity. The amount at risk is your basis in the activity and any amounts borrowed for use in the activity for which you are personally liable.

At-risk rules. Rules limiting loss deductions to cash investments and personal liability notes. An exception for real estate treats certain nonrecourse commercial loans as amounts "at risk."

Audit. An IRS examination of your tax return, generally limited to a three-year period after you file.

Average cost method. A method of figuring the basis of shares in mutual funds for purposes of determining gain or loss on the sale of less than one's entire holdings in a fund.

Bad debt. An amount owed you representing a cash outlay or an item already included in income that you are unable to collect.

Basis. Generally, the amount paid for property or the cost of an asset. Needed to figure gain or loss on a sale.

Below market loans. Demand loans on which interest is payable at a rate below the applicable federal rate or term loans where the amount loaned exceeds the present value of all payments due under the loan (using a discount rate equal to the applicable federal rate).

Cafeteria plan. A plan that allows employees to choose between cash and certain qualified benefits.

Calendar year. A year that begins on January 1st and ends on December 31st . Most individual taxpayers are required to file their returns on the basis of such a year. Compare to *fiscal year*.

Cancellation of debt. Release of a debt without consideration by a creditor. Cancellations of debts are generally taxable.

Capital asset. In general, property held for personal purposes or investment, rather than for business purposes. Property subject to capital gain or loss treatment. Almost all assets you own are considered capital assets except for certain business assets or works you created.

Capital expenses. Costs that are not currently deductible and that are added to the basis of property. A capital expense generally increases the value of property. When added to depreciable property, the cost is deductible over the life of the asset.

Capital gain dividend (capital gain distribution). A distribution to shareholders in a *mutual fund* of a *capital gain* realized by the fund on the sale of a part of its investment portfolio.

Capital gain or loss. A gain or loss arising from the sale or exchange of capital assets. Computed by comparing the amount realized on the sale or exchange of an asset with the adjusted basis of the asset.

Capital loss carryover. The excess of *capital losses* over *capital gains* that cannot be deducted in a particular year and must be carried over to the succeeding year.

Capitalization. Adding a cost or expense to the basis of the property.

Carryback. A tax technique for receiving a refund of back taxes by applying a deduction or credit from a current tax year to a prior tax year.

Carryforward. A tax technique of applying a loss or credit from a current year to a later year. For example, a business net operating loss may be carried forward indefinitely.

Cash method. Reporting income when actually or *constructively received* and deducting expenses when paid. Certain businesses may not use the cash method.

Casualty loss. Loss from an unforeseen and sudden event that is deductible, subject to a 10% income floor and $100 reduction for losses attributable to a federally declared disaster.

Charitable contributions. An itemized deduction is allowed for donations to qualifying charities. For property donations, the deductible amount depends on the type of property and donee organization, the holding period, and in some cases how the property is used.

Child and dependent care credit. A credit of up to 35% based on certain care expenses incurred that allow the taxpayer to work.

Child support. Payments to support a minor child generally to a custodial parent under a divorce or separation decree or agreement. The payments cannot be deducted from *gross income* and are not taxable to the recipient parent. Starting in 1985, the parent with custody of the child is generally entitled to claim the dependent unless such a right is expressly waived.

Child tax credit. For tax years beginning after 1997, a tax credit is allowed against income with respect to each qualifying child for taxpayers with modified adjusted gross income below certain thresholds.

Community income. Income earned by persons domiciled in community property states and treated as belonging equally to husband and wife.

Community property. Property that belongs equally to husband and wife. This concept of property ownership is currently used in Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin.

Condemnation. The seizure of property by a public authority for a public purpose. Tax on gain realized on many conversions may be deferred.

Constructive receipt. Income you are taxed on because it was made available to you to draw on, even if it has not yet been physically transferred to you.

Coverdell Education Savings Account. A special account set up to fund education expenses of a student.

Credit. A tax credit directly reduces tax liability, as opposed to a deduction that reduces income subject to tax.

Declining balance depreciation. A method of *accelerated depreciation* by which each year's *depreciation* is a percentage of the reduced *basis* of the *asset*.

Deductions. Items directly reducing income. Personal deductions such as for mortgage interest, state and local taxes, and charitable contributions are allowed only if deductions are itemized on Schedule A, but deductions such as for certain alimony, capital losses, business losses, student loan interest, and IRA and Keogh deductions are deducted from gross income even if itemized deductions are not claimed.

Deferred compensation. A portion of earnings withheld by an employer or put into a retirement plan for distribution to the employee at a later date. If certain legal requirements are met, the deferred amount is not taxable until actually paid, for example, after retirement.

Deferred gain. A gain realized but not recognized as taxable income *until a later time*.

Deficiency. The excess of the tax assessed by the IRS over the amount reported on your return.

Defined benefit plan. A retirement plan that pays fixed benefits based on actuarial projections.

Defined contribution plan. A retirement plan that pays benefits based on contributions to individual accounts, plus accumulated earnings. Contributions are generally based on a percentage of salary or earned income.

Dependent. A person supported by another person.

Depletion. A deductible expense that reflects the decrease of a depletable natural resource, such as oil and gas, as it is extracted.

Depreciable property. A business or income-production asset with a useful life exceeding one year.

Depreciation. Writing off the cost of depreciable property over a period of years, usually its class life or recovery period specified in the tax law.

Depreciation recapture. An amount of gain on the sale of certain depreciable property that is treated as ordinary income in the case of personal property. Recapture is computed on Form 4797.

Designated beneficiary. A person, trust, tax-exempt organization or estate named to receive qualified plan benefits or IRAs after a taxpayer's death. In some cases, the designated beneficiary enables a taxpayer to figure required minimum distributions over joint lives (or joint life expectancy).

Direct rollover. An eligible rollover distribution that is paid directly to an eligible retirement plan for the benefit of the distributee.

Disaster losses. Casualty losses, such as from a storm, in areas declared by the President to warrant federal assistance. An election may be made to deduct the loss in the year before the loss or the year of the loss.

Dividend. A distribution made by a corporation to its shareholders generally of company earnings or surplus. Most dividends are taxable but exceptions do exist.

Domicile. The place that an individual intends to be his or her permanent residence.

Dual-status alien. An individual who is a *nonresident alien* for part of the year and a *resident alien* or U.S. citizen for the rest of the year.

Earned income. Compensation for performing personal services. You must have earned income for a deductible IRA, or to claim the earned income credit. Earned income does not include amounts received from an annuity or a *pension*.

Earned income credit. A credit allowed to taxpayers with earned income or adjusted gross income (AGI) below certain thresholds.

Education credits. There are two education credits: the American opportunity credit and the lifetime learning credit.

Education savings account. A trust or custodial account created for the purpose of paying the qualified higher education expenses of the designated beneficiary of the account.

Electronic Federal Tax Payment System (EFTPS). A tax deposit method using electronic transfers of funds from bank accounts that must be used by certain businesses with substantial employment tax liability.

Eligible retirement plan. A qualified retirement plan, an individual retirement account, or an individual retirement annuity.

Estate tax. A tax imposed on the value of a decedent's taxable estate, after deductions and credits.

Estimated tax. Advance payment of current tax liability based either on wage withholdings or installment payments of your estimated tax liability. To avoid penalties, you generally must pay to the IRS either 90% of your final tax liability, or either 100% or 110% of the prior year's tax liability, depending on your adjusted gross income.

Exclusion. An amount that is excluded from *gross income*.

Executor. Person named in the decedent's will to administer the estate (property or debts left by the decedent) and distribute properties as the decedent has directed.

Fair market value (FMV). What a willing buyer would pay to a willing seller when neither is under any compulsion to buy or sell.

Fiduciary. A personal or corporation such as a trustee, executor, or guardian who manages property for another person.

Flexible spending arrangements (FSAs). A salary reduction plan that allows employees to pay for enhanced medical coverage or dependent care expenses on a tax-free basis.

Foreign earned income exclusion. Foreign earned income exempt from tax if a foreign residence or physical presence test is met.

Foreign tax credit. A credit allowed for income taxes paid to a foreign tax jurisdiction (e.g., a foreign country) to mitigate double taxation.

Gift tax. Gifts in excess of a $18,000 per donee annual exclusion are subject to gift tax, but the tax may be offset by a unified gift and estate tax credit.

Gross income. The total amount of income received from all sources before exclusions and deductions.

Gross receipts. Total business receipts reported on Schedule C before deducting adjustments for returns and allowances and costs of goods sold.

Group-term life insurance. Employees are not taxed on up to $50,000 of group-term coverage.

Head of household. A taxpayer who is unmarried and pays more than 50% of the cost of maintaining a residence for the entire year for a qualifying individual. If you are a head of household, you qualify for special tax rates.

Holding period. The length of time an asset is held. The holding period of a capital asset determines whether a sale or an exchange results in a *long-term* or a *short-term capital gain* or *loss*.

Home equity debt. Debt secured by a principal residence or second home to the extent of the excess of fair market value over acquisition debt.

Home sale exclusion. The tax-free amount of gain on the sale of a principal residence where certain ownership and use tests are satisfied.

Imputed interest. Interest deemed to have been earned or charged on a debt if the stated interest rate is below the rate set by law.

Incentive stock option. A type of stock option that can be received and exercised without recognition of income until the option stock is sold, if certain statutory requirements are met.

Income in respect of a decedent. Income earned by a person before death but taxable to an estate or heir who receives it.

Income shifting. A strategy to direct income to a taxpayer in a lower tax bracket to produce an overall tax savings for both parties involved in the shift.

Independent contractor. One who controls his or her own work and reports as a self-employed person.

Individual retirement account (IRA). A retirement account to which a specific amount may be contributed annually, but deductions for the contribution are restricted if you are covered by a company retirement plan. Earnings accumulate tax free.

Innocent spouse relief. Reduction or forgiveness of joint and several liability for the tax on a joint return for the requesting spouse who meets certain requirements.

Installment sale. A sale of property that allows for tax deferment if at least one payment is received after the end of the tax year in which the sale occurs. The installment method does not apply to year-end sales of publicly traded securities. Dealers may not use the installment method. Investors with very large installment balances could face a special tax.

Intangible assets. Intangible assets that come within Section 197, such as goodwill, are amortizable over a 15-year period.

Internal Revenue Service. The division of the U.S. Treasury Department that is responsible for the enforcement of the tax laws.

Investment interest. Interest on debt used to carry investments, but not including interest expenses from a passive activity. Deductions are limited to net investment income.

Involuntary conversion. Forced disposition of property due to condemnation, theft, or casualty. Upon conversion, you usually receive cash through insurance proceeds or condemnation awards. Tax on gain from involuntary conversion may be deferred if replacement property is purchased.

Itemized deductions. Items, such as interest, state and local taxes, charitable contributions, and medical deductions, claimed on Schedule A for Form 1040. Itemized deductions are subtracted from *adjusted gross income* to arrive at taxable income.

Joint return. A return filed by a married couple reporting their combined income and deductions. Joint return status provides tax savings to many couples.

Joint tenants. Ownership of property by two persons. When one dies, the decedent's interest passes to the survivor.

Keogh plan. Retirement plan set up by a self-employed person that provides tax-deductible contributions, tax-free income accumulations until withdrawal, and favorable averaging for qualifying lump-sum distributions.

Kiddie tax. The tax on the investment income in excess of $2,600 (2024) of a dependent child, based on the parent's marginal tax rate and computed on Form 8615.

Legally separated. A husband and wife who are required to live apart from each other by the terms of a decree of separate maintenance. Payments under the decree are deductible by the payor and taxable to the payee as alimony.

Lifetime learning credit. 20% credit for up to $10,000 of qualified tuition and related expenses for undergraduate or graduate level courses.

Like-kind exchange. An exchange of similar assets used in a business or held for investment on which gain may be deferred.

Long-term capital gain or loss. Gain or loss on the sale or exchange of a *capital asset* that has been held for a legislatively mandated *holding period*.

Long-term care. A type of medical care for chronically ill individuals which generally is not covered by Medicare.

Long-term care insurance contract. Insurance contract that only provides coverage for qualified long-term care services.

Lump-sum distribution. Payments within one tax year of the entire amount due to a participant in a qualified retirement plan. Qualifying lump-sums may be directly rolled over tax fee, or, in some cases, are eligible for current tax under a favorable averaging method.

Marginal tax rate. The tax rate at which each additional dollar of income over a specified ceiling is taxed.

Marital deduction. An estate tax and gift tax deduction for assets passing to a spouse. It allows estate and gift transfers completely free of tax.

Market discount. The difference between face value of bond and lower market price, attributable to rising interest rates. On a sale, gain on the bond is generally taxed as ordinary income to the extent of the discount.

Material participation. The level of participation required to deduct losses from trade or business activities otherwise subject to the passive activity loss limitations.

Miscellaneous itemized deductions. A class of itemized deductions (e.g., investment expenses, fee for tax advise, union dues) that previously were deductible to the extent that the total exceeded 2% of adjusted gross income.

Modified ACRS (MACRS). Depreciation methods applied to assets placed in service after 1986.

Modified adjusted gross income (MAGI). This is generally adjusted gross income increased by certain items such as tax-free foreign earned income. MAGI usually is used to determine phaseouts of certain deductions and credits.

Mortgage interest. Fully deductible interest on up to two residences if acquisition debt secured by a home up to certain limits of indebtedness.

Mutual fund. A company that is in the business of investing its shareholder's funds, usually in stocks or bonds; sometimes known as a *regulated investment company*.

Net operating loss. A loss taken in a period where a company's allowable tax deductions are greater than its taxable income. When more expenses than revenues are incurred during the period, the net operating loss for the company can generally be used to recover past tax payments.

Nonperiodic distributions. A 20% withholding rule apples to nonperiodic distributions, such as lump-sum distributions, paid directly to employees from an employer plan.

Nonqualified stock option. A type of stock option that when exercised creates *ordinary income* for the taxpayer.

Nonrecourse financing. Debt on which a person is not personally liable. In case of non-payment, the creditor must foreclose on property securing the debt. At-risk rules generally bar losses where there is nonrecourse financing, but an exception applies to certain nonrecourse financing for real estate.

Nonresident alien. A person who is not a United States citizen or a permanent resident. Tax is generally limited to income from U.S.

Nontaxable exchange. An exchange of property in which no gain or loss is recognized for tax purposes.

Offers in compromise. Arrangements in which the IRS agrees to accept less than full payment of taxes because it realizes that full payment may never be made.

Ordinary gain or loss. A gain or loss other than a *capital gain or loss*.

Ordinary income. Income that does not arise from the sale or exchange of a *capital asset* or a *Section 1231* asset and is not subject to any preferential tax treatment.

Ordinary loss. A loss other than a capital loss.

Original issue discount (OID). The difference between the face value of a bond and its original issue price. OID is reported on an annual basis as interest income.

Owner-employee. An *employee* who is the *proprietor* of a business. Also, a partner who owns more than 10% of either the capital or the profit interest in a partnership.

Partnership. An unincorporated business or income-producing entity organized by two or more persons. A partnership is not subject to tax but passes through to the partners all income, deductions, and credits, according to the terms of the partnership agreement.

Passive activity loss. A loss from a trade or a business in which the taxpayer is not a *material participant*. Passive activity losses are subject to deduction limitations. Passive activities include rental activities and investments in limited partnerships.

Pension. Payments to employees from an employer-funded retirement plan for past services.

Percentage depletion. A method of calculating *depletion* that applies a fixed percentage to the gross income generated by the mineral property.

Personal interest. Tax term for interest on personal loans and consumer purchases. Such interest is not deductible.

Personal-use property. Property that is not held for investment or use in a trade or a business.

Placed in service. The time when a depreciable asset is ready to be used. The date fixes the beginning of the depreciation period.

Points. Certain charges paid by a borrower, calculated as a percentage of the loan proceeds; each point is 1%. They are also called loan origination fees, maximum loan charges, or premium charges. Depending on the type of loan, points may be currently deductible or amortized over the life of the loan.

Premature distributions. Withdrawals before age 59½ from qualified retirement plans are subject to penalties unless specific exceptions are met.

Profit-sharing plan. A defined contribution plan under which the amount contributed to the employee's accounts is based on a percentage of the employer's profits.

Proprietor. An individual who is the sole owner of his or her trade or business.

Qualified business income deduction. For taxable years beginning after December 31, 2017, taxpayers other than corporations may be entitled to a deduction of up to 20 percent of their qualified business income from a qualified trade or business under the Tax Cuts and Jobs Act. This deduction can be taken in addition to the standard or itemized deductions. The deduction is subject to multiple limitations based on the type of trade or business, the taxpayer's taxable income, the amount of W-2 wages paid with respect to the qualified trade or business, and the unadjusted basis of qualified property held by the trade or business. Notwithstanding these limitations, however, taxpayers with qualified business income (which does not include income from performing services as an employee) and with taxable income under $191,950 (2024) or $383,900 (2024) for joint returns, will generally be eligible for the deduction.

Qualified charitable organization. A nonprofit philanthropic organization specifically approved by the U.S. Treasury as a recipient of charitable contributions that are deductible for tax purposes.

Qualified domestic relations order (QDRO). A court order, judgment, decree or approved property agreement which specifies the amount of qualified plan benefits to be paid to an alternate payee and which are not taxable to the plan participant.

Qualified improvement property. As of the TCJA, a combination of previously identified qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property.

Qualified plan. An *employee* benefit plan established by an employer that meets certain requirements and therefore qualifies for certain tax benefits.

Qualified tuition programs. State-sponsored plans to allow for higher education savings on a tax-advantaged basis. While there is no federal tax deduction for contributions to these programs, states may provide a deduction from state income tax.

Qualifying surviving spouse. A filing status entitling the taxpayer with dependents to use joint tax rates for up to two tax years after the death of a spouse.

Real estate professionals. Taxpayers who are exempt from the passive activity loss limitations because of their level of involvement with real estate activities.

Real property (real estate). Physical property that is permanent and nonmovable in nature. Two examples are land and buildings.

Realized gain or loss. The difference between the amount you are entitled to receive on a sale or exchange of property and the *adjusted basis* of the property.

Recognized gain or loss. The amount of gain or loss to be reported on a tax return. Gain may not be recognized on certain exchanges of property.

Refundable tax credit. A credit that entitles you to a refund even if you owe no tax for the year.

Regulated investment company. An investment company subject to Security and Exchange Commission regulations. If the investment company distributes its income to its shareholders, it does not pay any taxes.

Remainder interest. An interest in property or a *trust* that is left after the income beneficiaries have received their income interest.

Required minimum distributions. Distributions from qualified plans and IRAs that generally must commence at age 73 to avoid a 25% penalty (as of 2023).

Resident alien. An individual who is not a citizen of the United States but is a permanent resident of the United States.

Residential rental property. Real property in which 80% or more of the gross income is from dwelling units. Under MACRS, depreciation is claimed over 27.5 years under the straight-line methods.

Return of capital. A distribution of your investment that is not subject to tax unless the distribution exceeds your investment.

Rollover. A distribution from a qualified plan that is reinvested tax-free in another qualified plan or IRA within 60 days of the date of receipt.

Roth IRA. Contributions to a Roth IRA are nondeductible, and, if certain specified conditions are met, distributions are tax free. The contribution may be limited by certain threshold amounts.

Royalty income. Income received for the use of certain kinds of property (e.g., mineral and literary properties, patents).

Salvage value. The estimated value of an asset at the end of its *useful life*. Salvage value is ignored by ACRS and MACRS rules.

Scholarships. Grants to degree candidates receive tax-free treatment if awarded after August 16, 1986 and used for tuition and course-related expenses, but not room and board.

Section 1231 assets. Generally, *depreciable assets* used in a trade or a business and held for the required long-term holding period. Net gains from the sale or exchange of Section 1231 assets (after recapture of *depreciation*), are treated as *capital gains*; net losses are treated as *ordinary losses*.

Section 179 expensing. Allows a taxpayer to elect to deduct the cost of certain types of property on their income taxes as an expense, rather than requiring the cost of the property to be capitalized and depreciated.

Section 457 plan. Deferred compensation plan set up by a state or local government, or tax-exempt organization, which allows tax-free deferrals of salary.

Section 529 plans. Qualified tuition plans set up by states or private institutions as either prepaid tuition plans or savings-type plans. While contributions are not deductible for federal income tax purposes, distributions used to pay qualified higher education costs are tax free.

Self-employed person. An individual who operates a business or profession as a proprietor or independent contractor and reports self-employment income on Schedule C.

Self-employment tax. Tax paid by self-employed persons to finance Social Security coverage.

Separate maintenance payments. Payments made from one spouse to another when they are living apart. The payments are made in accordance with a court order or an agreement between the parties.

Separate return. Return filed by a married person who does not file a joint return. Filing separately may save taxes where each spouse has separate deductions, but certain tax benefits require a joint return.

Short-term capital gain or loss. A gain or loss on the sale or exchange of a *capital asset* that has been held for less than the legislatively mandated *holding period*.

SIMPLE plans. Qualified retirement plans restricted to small employers that can be either SIMPLE IRAs or SIMPLE 401(k) plans. These plans have easy nondiscrimination rules and no heavy reporting requirements.

Simplified Employee Pension (SEP). IRA-type plan set up by an employer, rather than the employee.

Single. The filing status of an individual who is not married on December 31 of the year for which a return is filed.

Standard deduction. A *deduction* used to reduce income by taxpayers who do not itemize their deductions. The amount of the deduction depends on ones filing status, whether they are 65 or older or blind, and whether they can be claimed as a *dependent* on another taxpayer's return. Adjusted annually for inflation since 1989.

Standard mileage rate. An IRS-approved optional amount used to claim a *deduction* for business transportation expenses in lieu of deducting actual expenses (not including parking, tolls, interest, and taxes).

Statute of limitations. The time period within which the IRS can assess and collect taxes and taxpayers can file for refunds.

Statutory employees. Certain employees, such as full-time life insurance salesperson, who may report income and deductions on Schedule C.

Stock dividend. A distribution of additional shares of a corporation's stock to its shareholders.

Stock option. A right to buy stock at a fixed price.

Straight-line depreciation. A method of *depreciation* in which the cost or other basis of the asset is deducted in equal amounts over the property's *useful life*.

Sum of the years' digits depreciation. A method of *accelerated depreciation* that is based on a formula developed from the expected *useful life* of the property.

Support. Payments made for the care and maintenance of a *dependent*. Expenditures for support include payments for food, lodging, medical expenses and so on.

Tax attributes. When debts are canceled in bankruptcy cases, the canceled amount is excluded from gross income. Tax attributes are certain losses, credits, and property basis that must be reduced to the extent of the exclusion.

Tax credit carryforward (or carryover). Tax credit that you were unable to use to reduce previous year's tax and that can be applied to offset future tax.

Tax deferral. Shifting income to a later year, such as where you defer taxable interest to the following year by purchasing a T-bill or savings certificate maturing after the end of the current year. Investments in qualified retirement plans provide tax deferral.

Tax preference items. Items that may subject a taxpayer to the alternative minimum tax (AMT). Two examples are *accelerated depreciation of real property and percentage depletion*.

Tax year. A period (generally 12 months) for reporting income and expenses.

Taxable income. Net income after claiming all deductions from *gross income* and *adjusted gross income*, such as IRA *deductions*, itemized *deductions*, or the standard deduction.

Taxpayer identification number. For an individual, his or her social security number; for businesses, fiduciaries, and other non-individual taxpayers, the employer identification number.

Tax-exempt income. Income that is not subject to federal income tax. An example is income for state and municipal bonds.

Tax-sheltered annuity. A type of retirement annuity offered to employees of charitable organizations and educational systems, generally funded by employee salary-reduction contributions.

Trade date. The date on which a purchase or sale of securities occurs. The trade date is used in determining the *holding period* of a security.

Trust. An arrangement under which one person transfers legal ownership of assets to another person or corporation (the trustee) for the benefit of one or more third persons (beneficiaries).

Undistributed capital gains. Capital gains that investors in mutual funds must report but for which they can claim a tax credit for their share of tax paid by the fund.

Useful life. For property not depreciated under ACRS and MACRS, the estimate of time in which a depreciable asset will be used.

Wash sales. Sales on which losses are disallowed because you recover your market position within a 61-day period.

Withholding. An amount taken from income as pre-payment of an individual's tax liability for the year. In the case of wages, the employer withholds part of every wage payment. Backup withholding from dividend or interest income is required if you do not provide the payer with a correct taxpayer identification number. Withholding on pensions and IRAs is automatic unless you elect to waive withholding.

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INCOME TAX FOR INDIVIDUALS (COURSE #3105M) – FINAL EXAM COPY

The following exam will not be graded. It is attached only for your convenience while you read the course text. To access the exam to be submitted for grading, go to your account and select Take Exam.

1. **What is the standard deduction for a 65 year old individual who files as single in 2024:**
   - **A.** $14,600
   - **B.** $16,150
   - **C.** $16,550
   - **D.** $31,150

2. **For homeowners who take out a new mortgage for a first or second home, the mortgage interest deduction is available for up to a maximum of how much of mortgage debt:**
   - **A.** $250,000
   - **B.** $500,000
   - **C.** $750,000
   - **D.** $1,000,000

3. **Which of the following is correct regarding the medical expense deduction for 2024:**
   - **A.** it is limited to expenses up to 7.5% of adjusted gross income
   - **B.** it is limited to expenses greater than 7.5% of adjusted gross income
   - **C.** it is limited to expenses up to 10% of adjusted gross income
   - **D.** it is limited to expenses greater than 10% of adjusted gross income

4. **For 2024, what is the maximum estate and gift tax exemption for an individual taxpayer:**
   - **A.** $5.0 million
   - **B.** $10.0 million
   - **C.** $13.61 million
   - **D.** $27.22 million

5. **In December 2024, what is the standard mileage rate for eligible business use of a vehicle:**
   - **A.** 18.0 cents per mile
   - **B.** 65.5 cents per mile
   - **C.** 67.0 cents per mile
   - **D.** 70.0 cents per mile

6. **All of the following are goals of the SECURE Act 2.0 <u>except</u>:**
   - **A.** to increase individual retirement savings
   - **B.** to simplify and clarify the retirement plan rules
   - **C.** to lower the employer cost of setting up a retirement plan
   - **D.** to improve tax credits for energy efficient home improvements

7. **Filing Form 4868, *Application for Automatic Extension of Time to File U.S. Individual Income Tax Return*, provides an automatic extension to file of how long:**
   - **A.** 3 months
   - **B.** 6 months
   - **C.** 9 months
   - **D.** 1 year

8. **If your filing status is single and you are under 65 years old at the end of 2024, you need to file a return if your gross income was at least how much:**
   - **A.** $5
   - **B.** $14,600
   - **C.** $16,550
   - **D.** $21,900

9. Generally, when is a taxpayer's filing status as either married or unmarried determined:

A. on the date the taxpayer files his or her return

B. on the first day of the tax year

C. on the last day of the tax year

D. on April 15th of the tax year

10. Which of the following is a requirement for filing as head of household:

A. the taxpayer must be considered unmarried on the first day of the tax year

B. the taxpayer must have paid more than half of the cost of keeping up the home for the year

C. a qualifying person must have lived with you for at least 9 months of the year (except for temporary absences)

D. all of the above

11. If you are a surviving spouse and you have not remarried, you may be eligible to use the qualifying surviving spouse as your filing status for a maximum of how long:

A. the current tax year

B. 1 year following the year of death of your spouse

C. 2 years following the year of death of your spouse

D. 3 years following the year of death of your spouse

12. In order to be a qualifying relative, the person's gross income for the year 2024 generally must be <u>less than</u>:

A. $1,500

B. $4,550

C. $5,050

D. $5,500

13. What is the method used to pay tax on income that is <u>not</u> subject to withholding called:

A. excise tax

B. estimated tax

C. direct tax

D. capital gains tax

14. For 2024, the social security tax on employees is what percentage of wages up to the $168,600 threshold:

A. 6.2%

B. 7.65%

C. 12.4%

D. 15.3%

15. Which of the following is <u>not</u> a de minimis employee benefit that an employer would typically ignore when reporting employee fringe benefit compensation:

A. the pro-rata cost of a company picnic

B. a Christmas turkey given to each employee

C. food discounts at a company cafeteria

D. a $250 holiday gift certificate

16. Which of the following transportation fringe benefits can be excluded from income for 2024:

A. transit passes of unlimited amounts

B. qualified parking up to $315 per month

C. qualified bicycle commuting cash reimbursement up to $175 per month

D. all commuter highway vehicle expense reimbursements

17. Which of the following is correct regarding amounts received for personal injury through an accident or health plan:

- **A.** all amounts received must be reported as income, regardless of who paid for the plan
- **B.** in most cases, amounts received under a plan you paid for must be reported as income
- **C.** in most cases, amounts received under a plan paid for by your employer must be reported as income
- **D.** any amounts received under an accident or health plan are not reported as income

18. Which of the following is correct regarding tip income:

- **A.** tip income is not subject to federal income tax
- **B.** only cash tips received are considered income
- **C.** most noncash tips received are not considered income
- **D.** tips received under a tip-splitting arrangement are considered income

19. Generally, the amounts you receive from money market funds should be reported as which of the following:

- **A.** operating income
- **B.** capital gains
- **C.** interest
- **D.** dividends

20. Which of the following is correct regarding interest on U.S. savings bonds:

- **A.** interest on U.S. savings bonds is not taxable
- **B.** interest on U.S. savings bonds is taxable when received, regardless of the accounting method used by the taxpayer
- **C.** interest on U.S. savings bonds is taxable each year as it accrues, regardless of the accounting method used by the taxpayer
- **D.** interest on U.S. savings bonds is taxable each year as it accrues for an accrual method taxpayer but not for a cash method taxpayer

21. Unless a corporation informs you otherwise, you can assume that any dividend you receive on common or preferred stock is which of the following:

- **A.** an ordinary dividend
- **B.** a liquidating distribution
- **C.** a capital gains dividend
- **D.** a qualified dividend

22. What is the maximum tax rate on qualified dividends that apply to trusts and estates:

- **A.** 0%
- **B.** 15%
- **C.** 20%
- **D.** 28%

23. How should advance rent be recorded:

- **A.** in the period it covers if you use the accrual method
- **B.** in the period it covers if you use the cash method
- **C.** in the year it was received regardless of the period covered only if you use the cash method
- **D.** in the year it was received regardless of the period covered or the method used

24. Expenses you can deduct from your rental income include all of the following <u>except</u>:

- **A.** taxes
- **B.** charges for putting in streets
- **C.** utilities
- **D.** commissions for the collection of rent

25. When figuring the number of days of personal use for rental property, the owner must count each day that any of the following occur <u>except</u>:

A. when a family member uses the property

B. when the use of this unit is traded for the use of another property elsewhere

C. when working substantially full time repairing and maintaining the property

D. when the property is rented at less than the fair market price

26. Which of the following is correct regarding limits on rental losses:

A. all losses on rental real estate activity are deductible

B. rental activities (except for those by real estate professionals) are passive activities

C. a taxpayer can generally offset any income with losses from passive activities

D. passive activity losses and credits cannot be carried forward to the next tax year

27. What is the maximum amount a 52-year-old employee can contribute to a 401k in 2024:

A. $7,000

B. $8,000

C. $23,000

D. $30,500

28. Which of the following is correct regarding the taxation of periodic pension payments:

A. all periodic pension payments received are taxable

B. if you did not pay any part of the cost of your pension, the amounts you received each year are fully taxable

C. if you paid for any part of the cost of your pension, none of the amounts you received are taxable

D. both B and C are correct

29. For a rollover distribution of a qualified retirement plan to be considered eligible, it generally must be completed by the ______ day following the day on which you receive the distribution from your employer's plan.

A. 30th

B. 60th

C. 90th

D. 120th

30. For 2024, if actual distributions from a qualified retirement plan received in any year are less than the minimum required distribution for that year, a tax is assessed on the part of the required minimum distribution not distributed equal to what percentage if it is not timely corrected:

A. 6%

B. 10%

C. 25%

D. 50%

31. If you are married filing jointly, what is your social security benefits base amount:

A. $0

B. $25,000

C. $32,000

D. $42,000

32. What is the maximum percentage of your social security benefits that may be taxable:

A. 25%

B. 50%

C. 85%

D. 100%

33. Which of the following must be included as income on your federal income tax return in 2024:

A. the cancellation of debt that is intended as a gift

B. the cancellation of debt that is qualified principal residence indebtedness

C. the cancellation of debt that is in a bankruptcy case under title 11 of the U.S. Code

D. none of the above

34. Which of the following refunds or recoveries do <u>not</u> have to be included in your taxable income:

A. federal income tax refund

B. state income tax refund if deducted in an earlier year

C. interest income on recoveries

D. all of the above

35. Which of the following is considered income that <u>must</u> be included on your federal income tax return in 2024:

A. alimony resulting from an agreement executed prior to 2019

B. cash rebates

C. energy conservation subsidies

D. property received as a gift

36. Which of the following settlement fees and costs <u>cannot</u> be included in the basis of property:

A. fees and costs for getting a loan

B. charges for installing utility services

C. recording fees

D. owner's title insurance

37. If you receive property in a nontaxable exchange, generally what is its basis:

A. its cost

B. its fair market value at the time of the exchange

C. the same as the basis of the property you transferred

D. its adjusted basis

38. To figure the basis of property a taxpayer receives as a gift, the taxpayer must know each of the following <u>except</u>:

A. the property's adjusted basis to the donor just before it was gifted

B. the property's fair market value at the time it was given

C. any gift tax paid on the property

D. how long the donor owned the property before gifting it

39. When property is converted from personal use to business use, what is the basis for depreciation:

A. the fair market value of the property on the date of the change

B. your adjusted basis on the date of the change

C. the lesser of A or B above

D. the greater of A or B above

40. In order for a trade to be nontaxable, it must meet six conditions. Which of the following is <u>not</u> one of these conditions:

A. the property must be business or investment property

B. the property must be held primarily for sale

C. the property must be identified within 45 days after the date the property was given up in the trade

D. there must be a trade of like property

41. No gain or loss is recognized on the transfer of property from an individual to a spouse or former spouse (if incident to divorce), unless which of the following is true:

A. the spouse is a nonresident alien

B. the spouse is over age 72

C. the spouse earns over $100,000 in the taxable year

D. the spouse has been married to the transferor less than 3 years

42. Which of the following is true regarding the holding period of investment property that is sold or traded:

A. the holding period determines whether any capital gain or loss is taxable

B. the holding period determines whether any capital gain or loss was short-term or long-term

C. the holding period begins on the date the property was acquired

D. all of the above

43. To be deductible, which of the following <u>must</u> be true of a nonbusiness bad debt:

A. it must be totally worthless

B. it must be greater than $500

C. it must have had a basis of $0

D. it must have not been in your income

44. A wash sale occurs when a taxpayer sells or trades stock or securities at a loss and within how many days before or after that sale the taxpayer buys substantially identical stocks or securities:

A. 10 days

B. 15 days

C. 30 days

D. 45 days

45. If you have a gain from the sale of your main home, you may be able to exclude up to how much from your income if you file a joint return:

A. $125,000

B. $250,000

C. $500,000

D. $1,000,000

46. Which of the following is included in the adjusted basis of your home:

A. special assessments for local improvements

B. repainting the outside of the house

C. repainting the inside of the house

D. all of the above

47. The requirements for excluding the entire gain on the sale of your main home up to $250,000 include all of the following <u>except</u>:

A. you meet the ownership test

B. you meet the use test

C. your adjusted gross income is less than $250,000

D. during the 2-year period ending on the date of the sale, you did not exclude gain from the sale of another home

48. Married persons filing a joint return can exclude up to how much if one of them meets the ownership test, they both meet the use test, and during the 2-year period ending on the date of sale, neither spouse excluded gain from the sale of another home:

A. $0

B. $250,000

C. $500,000

D. $1,000,000

49. How long must a capital asset be held for a capital gain or loss to be considered long term:

A. 30 days
B. 180 days
C. more than 1 year
D. more than 2 years

50. What is the lowest possible capital gain tax rate for 2024:

A. 0%
B. 10%
C. 15%
D. 28%

51. What is the maximum amount that can be contributed to a traditional IRA for 2024 for an individual over age 50 who earned $50,000 and was not covered by an employer retirement plan:

A. $3,000
B. $4,000
C. $7,000
D. $8,000

52. If you are eligible to participate in your employer's defined benefit plan for the plan year that ends within your tax year, you are considered covered by the plan <u>unless</u>:

A. you declined to participate in the plan
B. you did not make a required contribution
C. you did not perform the minimum service required to accrue a benefit for the year
D. none of the above; you are considered covered by the plan even if you did any of the above

53. When must a tax-free IRA rollover contribution generally be made:

A. by the 30th day after you receive the distribution from your traditional IRA
B. by the 60th day after you receive the distribution from your traditional IRA
C. by the 90th day after you receive the distribution from your traditional IRA
D. by the end of the calendar year

54. Which of the following is correct regarding required minimum distributions from an IRA for 2024 if you are over age 73:

A. they generally must be taken by December 31, 2024
B. they must be taken by the due date of the 2024 return (including extensions)
C. they must be taken by the due date of the 2024 return (excluding extensions)
D. they were repealed for 2024

55. Generally, if you are under age 59½, you must pay an additional tax on the distribution of any assets from your traditional IRA of how much:

A. 6% of the early distribution
B. 10% of the early distribution
C. 25% of the early distribution
D. 50% of the early distribution

56. Which of the following is correct regarding contributions to a Roth IRA:

A. they are reported on your income tax return
B. they can only be made until you reach the age of 73
C. they are limited based on your modified AGI
D. they are deductible

57. In order to contribute to a Roth IRA for your spouse for 2024, all of the following must be satisfied <u>except</u>:

A. the contribution must satisfy the Kay Bailey Hutchison Spousal IRA limit

B. you must file a joint return

C. your modified adjusted gross income must be less than $240,000

D. your spouse must be under age 59½

58. A 59 year old taxpayer has taxable income of $50,000. What is the taxpayer's contribution limit to a Roth IRA for 2024:

A. $7,000

B. $8,000

C. $50,000

D. unlimited

59. How much is the excise tax that applies to any excess contribution to a Roth IRA:

A. 1%

B. 6%

C. 10%

D. 50%

60. Qualified distributions from a Roth IRA include all of the following distributions made after the 5-year period <u>except</u>:

A. it was made on or after the date you reach age 50

B. it was made because you are disabled

C. it is made to a beneficiary or to your estate after your death

D. it is made to pay up to $10,000 of certain qualified first-time homebuyer amounts

61. Which of the following is correct regarding the taxation of alimony for divorce or separation agreements executed after December 31, 2018:

A. alimony is generally deductible by the payer, regardless of the execution date of the divorce or separation agreement

B. alimony is generally taxable to the recipient spouse, regardless of the execution date of the divorce or separation agreement

C. both A and B above

D. none of the above

62. Which of the following qualifies as alimony:

A. transfers of services or property

B. execution of a debt instrument by the payer

C. cash payments, including checks and money orders

D. the use of the payer's property

63. The student loan interest deduction can reduce the amount of your income subject to tax in 2024 by up to how much:

A. $2,500

B. $5,000

C. $7,000

D. $8,000

64. Qualified education expenses for the student loan interest deduction include all of the following <u>except</u>:

A. tuition and fees

B. room and board

C. books, supplies, and equipment

D. clothing

65. For purposes of determining your travel away from home, what is considered your tax home:

A. where you maintain your family home

B. where you spend the most nights

C. the location that provides the greatest amount of deductible expense

D. the entire city or general area in which your business or work is located

66. You can deduct your travel expenses when you attend a convention that is for which of the following purposes:

A. advancing your trade or business
B. investment purposes
C. political purposes
D. social purposes

67. If you are self-employed, which of the following is correct regarding the deductibility of business-related meals:

A. you can deduct the full cost of all business-related meals
B. expenses for meals will be disallowed if they are more than a fixed dollar amount
C. generally you can deduct only 50% of the costs of your meals
D. you must use the standard meal allowance if lower than the actual cost of your meal

68. What is the maximum amount you can deduct for business gifts you give directly or indirectly to any one person during your tax year:

A. $25
B. $100
C. $250
D. $500

69. Which of the following are deductible transportation expenses:

A. commuting expenses
B. cost of using your car in a nonprofit car pool
C. parking fees when visiting a customer
D. advertising displays on your personal vehicle

70. Which of the following is correct when using the standard mileage rate for business use of a vehicle:

A. you must choose the standard mileage rate in the first year the car is available for use in your business
B. you cannot deduct parking fees in addition to the standard mileage rate
C. there is no limit to the number of vehicles you can use at the same time and use the standard mileage rate
D. you can use the standard mileage rate as well as claim the special depreciation allowance on the same vehicle

71. Documentary evidence is <u>not</u> required to support your travel expenses, other than lodging, if they are less than what amount:

A. $75
B. $100
C. $150
D. $200

72. To be an accountable plan, an employer's reimbursement or allowance arrangement must meet three rules. Each of the following is one of these rules <u>except</u>:

A. the expenses must have a business connection
B. the expenses must be less than or equal to the company's per diem allowance
C. the employee must adequately account to the employer for these expenses in a reasonable period of time
D. the employee must return any excess reimbursement or allowance within a reasonable period of time

73. If your employer has an accountable plan, how will excess reimbursements that you fail to return after a business trip be treated:

A. as paid under the accountable plan regardless of any excess funds retained
B. as additional unreported employee compensation for travel inconveniences
C. as paid under a nonaccountable plan
D. as an untaxed fringe benefit

74. What is the 2024 standard deduction for head of household under 65:

A. $14,600
B. $16,400
C. $21,900
D. $29,200

75. What does the standard deduction amount depend on:

A. your filing status
B. your age
C. your eyesight
D. all of the above

76. Taxpayers can generally deduct medical expenses that exceed what percentage of their income:

A. 5%
B. 7.5%
C. 10%
D. 12.5%

77. Generally, medical and dental expenses that can be included on Schedule A (Form 1040) include which of the following:

A. herbal supplements
B. funeral, burial, or cremation services
C. diagnostic devices
D. contributions to Archer MSAs

78. Which of the following <u>cannot</u> be included in your medical expenses on Schedule A (Form 1040):

A. medical insurance premiums for hospitalization
B. medical insurance premiums for long-term care
C. medical expenses reimbursed by a health reimbursement arrangement
D. medical expense premiums paid for Medicare Part D

79. Generally, which of the following fees and charges can you deduct:

A. charges for water bills
B. fines and penalties paid to the government
C. fees and charges that are for your trade or business
D. license fees for personal use

80. Which of the following types of real estate taxes and charges are <u>not</u> deductible:

A. state real estate taxes
B. local real estate taxes
C. tenant's share of real estate taxes paid by a cooperative housing corporation
D. homeowners' association charges

81. Whether you can deduct all of your home mortgage interest depends on all of the following <u>except</u>:

A. the interest rate on the mortgage
B. your use of its proceeds
C. the date you took out the mortgage
D. the amount of the mortgage

82. Generally, which of the following can be deducted as home mortgage interest:

A. rental payments made prior to final settlement on the purchase
B. late payment charge on mortgage payment
C. payments on nonredeemable ground rents
D. interest portion of mortgage assistance payments

83. Which of the following is true regarding points paid on loans secured by a second home:

A. they are not deductible
B. they are fully deductible in the year paid
C. they can only be deducted over the life of the loan
D. they are only 50% deductible in the year paid

84. Which of the following interest expenses are deductible:

- **A.** annual fees for credit cards
- **B.** loan fees
- **C.** personal interest
- **D.** investment interest

85. To be able to deduct out-of-pocket expenses you pay when providing services to a qualified charitable organization, those expenses must be which of the following:

- **A.** unreimbursed
- **B.** directly connected with the services
- **C.** not personal, living, or family expenses
- **D.** all of the above

86. Which of the following is <u>not</u> deductible as a charitable contribution:

- **A.** the value of services given to a qualified organization
- **B.** any unreimbursed out-of-pocket car expenses for gas and oil
- **C.** parking fees and tolls
- **D.** travel expenses necessarily incurred while away from home specifically performing services for a charitable organization

87. If you donate a qualified vehicle with a fair market value less than your cost or other basis to a qualified organization and you claim a deduction of more than $500, how much can you deduct:

- **A.** the gross proceeds from the sale of the vehicle by the organization
- **B.** the vehicle's fair market value on the date of the contribution
- **C.** the lesser of A or B above
- **D.** the greater of A or B above

88. Which of the following is correct regarding your charitable deduction if you contribute property with a fair market value that is less than your basis in it:

- **A.** it is limited to the property's fair market value
- **B.** it is equal to your basis in the property
- **C.** it is unlimited
- **D.** it is limited to the difference between the fair market value and the basis in the property

89. Excess charitable contributions that cannot be deducted in the current year because the amount exceeds the taxpayer's AGI limit can generally be deducted in each of the next ____ years until it is all used up.

- **A.** 5
- **B.** 4
- **C.** 3
- **D.** 2

90. When can you claim a deduction for a cash contribution of $250 or more:

- **A.** if you have a canceled check
- **B.** if you have the check notarized
- **C.** if you obtain a contemporaneous written acknowledgment from a qualified charitable organization or certain payroll deduction records
- **D.** if you have a copy of the qualified organization's bank statement showing deposit of the funds

91. Per the TCJA, personal casualty and theft losses of an individual are generally only deductible under which of the following conditions:

- **A.** if they are attributable to a federally declared disaster
- **B.** if they are greater than 2% of AGI
- **C.** if they are greater than $10,000
- **D.** if they are the result of a fire or flood

92. For a casualty loss to occur, the decrease in value of an asset must be the result of an event described as any of the following <u>except</u>:

A. sudden

B. avoidable

C. unexpected

D. unusual

93. Which of the following should be considered when attempting to establish the decrease in FMV of property for purposes of a casualty or theft loss:

A. cost of cleanup

B. cost of protection

C. sentimental value

D. all of the above

94. An eligible educator can deduct up to how much of qualified expenses he or she paid in 2024:

A. $0

B. $300

C. $600

D. $1,000

95. All of the following can be deducted in 2024 on Schedule A, line 16, <u>except</u>:

A. federal estate tax on income in respect of a decedent

B. gambling losses up to the amount of gambling winnings

C. fines and penalties

D. unlawful discrimination claims

96. A REIT must distribute what percentage of its taxable income to its owners:

A. 50%

B. 75%

C. 90%

D. 100%

97. What is the taxable income threshold for a taxpayer with a filing status of single for the income from specified services to constitute qualified business income for 2024:

A. $50,000

B. $191,950

C. $383,900

D. $483,900

98. Which of the following is correct regarding the aggregation of multiple trades or businesses:

A. the Code specifies rules for the aggregation of multiple trades or businesses

B. each partner or shareholder may be allowed to aggregate activities

C. in order to aggregate, at least half of the owners' aggregate activities must meet specific ownership and business relationship tests

D. in order to aggregate, a person, entity, or group must own at least 33% of each trade or business

99. Which of the following type of business was specifically excluded from the Section 199A definition of a specified service trade or business:

A. health

B. law

C. architecture

D. investment management

100. A taxpayer's QBI deduction is generally limited to what percentage of the W-2 wages paid:

A. 25%

B. 50%

C. 70%

D. 90%

101. Which of the following taxes can be reduced by the qualified business income (QBI) deduction:

- **A.** regular income tax
- **B.** self-employment tax
- **C.** net investment income tax
- **D.** all of the above

102. The Tax Cuts and Jobs Act (TCJA) limits the deduction for state and local taxes (SALT) allowed as itemized deductions to how much per year:

- **A.** $10,000
- **B.** $20,000
- **C.** $25,000
- **D.** none of the above; the deduction is unlimited

103. Which of the following is an additional tax a taxpayer may have to pay if they have benefited from the tax law that gives special treatment to some kinds of income and allows special deductions and credits for some kinds of expenses:

- **A.** the alternative minimum tax
- **B.** the estimated tax
- **C.** the capital gains tax
- **D.** the irregular tax

104. The alternative minimum tax adjustments and tax preference items include which of the following:

- **A.** interest income from savings accounts
- **B.** receipt of a gift or bequest
- **C.** disability payments received from social security
- **D.** difference between gain or loss on the sale of property reported for regular tax purposes and AMT purposes

105. Parents of a child may elect to include the child's interest and dividend income on their tax return if the child's gross income was less than how much in 2024:

- **A.** $130
- **B.** $1,300
- **C.** $3,000
- **D.** $13,000

106. For purposes of completing Form 8615, *Tax for Certain Children Who Have Unearned Income*, which of the following is considered earned income:

- **A.** a taxable distribution from a qualified disability trust
- **B.** the taxable part of social security payments
- **C.** unemployment compensation
- **D.** capital gains

107. Earned income required to claim the child and dependent care credit includes which of the following:

- **A.** tip income
- **B.** workers' compensation
- **C.** pensions
- **D.** social security benefits

108. In figuring the child and dependent care credit for 2024, which of the following can be included in figuring total work-related expenses:

- **A.** prepaid expenses only in the year the care is received
- **B.** 2023 expenses that you paid in 2024
- **C.** the nontaxable amount of reimbursed expenses received from state social services agencies
- **D.** the same medical expenses used to calculate your medical expense deduction

109. What is the dollar limit on the amount of your work-related expenses you can use to figure the child and dependent care credit for 3 qualifying persons:

A. $3,000
B. $6,000
C. $9,000
D. $12,000

110. If your AGI is $24,000, then your child and dependent care credit is calculated using what percentage of your work-related expenses (after applying earned income and dollar limits):

A. 20%
B. 26%
C. 30%
D. 35%

111. All of the following are correct regarding claiming the child and dependent care credit except:

A. the tax credit is refundable
B. you must complete Form 2441 and attach it to your return
C. you must file Form 1040 or 1040-SR
D. the amount of the credit is limited to the amount of your tax

112. In determining whether you are a qualified individual for the credit for the elderly or the disabled, when are you considered 65:

A. when you turn 65½
B. on January 1 during the year in which you turn 65
C. on the day before your 65th birthday
D. on the day of your 65th birthday

113. Which of the following credits is limited to $500 for each qualifying child in 2024:

A. the child tax credit (CTC)
B. the credit for other dependents (ODC)
C. the additional child tax credit (ACTC)
D. both A and B above

114. Which of the following is correct regarding the American opportunity credit:

A. it is limited to the amount of tax you must pay on your taxable income
B. it generally can be up to $2,500 per eligible student
C. it is available for an unlimited number of years
D. it is only available for those with a MAGI less than $40,000

115. To be eligible for the lifetime learning credit, a student must meet which of the following requirements:

A. have no felony convictions
B. be enrolled in one or more courses at an eligible educational institution
C. have incurred greater than $10,000 in qualified education expenses
D. have completed at least two years of postsecondary education

116. Qualified education expenses should not be reduced for which of the following:

A. loans
B. Pell grants
C. the tax-free part of employer-provided educational assistance
D. tax-free parts of scholarships

117. To qualify for the earned income credit, your investment income is limited to how much for 2024:

A. $100 or less
B. $1,600 or less
C. $11,600 or less
D. zero

118. Which of the following credits is for certain people who enroll, or whose family member enrolls, in a qualified health plan offered through a Marketplace:

A. Earned Income Tax Credit

B. Savers Credit

C. Premium Tax Credit (PTC)

D. Small Business Health Care Tax Credit

119. Qualifying adoption expenses for calculating the adoption credit include which of the following:

A. expenses for carrying out any surrogate parenting arrangement

B. traveling expenses while away from home

C. cost for the adoption of a spouse's child

D. costs for which funds were received under any federal, state, or local program

120. For purposes of the retirement savings contributions credit, a school does <u>not</u> include which of the following:

A. technical schools

B. trade schools

C. correspondence schools

D. mechanical schools