STUDY UNIT ONE

FILING REQUIREMENTS

To determine the proper tax liability, the taxpayer must claim the appropriate filing status, elect the available deductions, and comply with the necessary filing requirements.

1.1 PRELIMINARY WORK TO PREPARE TAX RETURNS

Prior-Year Return

1. Use of the prior year's returns for comparison helps prevent gross mathematical errors and identify significant changes.
   a. If the comparison shows that there were no significant changes, the current-year return should result in similar amounts and tax liability or refund.
   b. Comparison of the prior year's returns helps to identify applicable items that are not common to all individuals (retirement pay, sale of principal residence, itemized deductions, applicable taxes, etc.).

EXAMPLE 1-1 Prior-Year Return

The taxpayer's prior-year Form 1040 shows repayment of the Premium Tax Credit.

The preparer should ask questions such as

1. What was the total amount of the original credit received?
2. How much of the credit has already been repaid?
3. What estimate was used for family income?
4. Did the taxpayer receive Premium Tax Credits for the current year?

2. The accuracy of the prior year's return affects the accuracy of the current year's return in areas in which the prior year is relied upon (state taxes paid or refunded). It also increases efficiency in completing the current return.

Previous IRS Correspondence

3. A taxpayer's previous correspondence (e.g., letters, notices) with the IRS is likely to provide insight to issues still affecting a current return. It should be reviewed to ensure, among other things, compliance with prior audits, adjustments, or judgments.

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Personal Information

4. Taxpayer personal information (e.g., date of birth, age, marital status, dependents, etc.) is used to verify the identity of the taxpayer and related dependents.
   a. The age of an individual determines if (s)he qualifies for additional deductions (65 and over), retirement distributions, dependency, etc.
   b. Married filing jointly status often increases beneficial dollar limits for deductions and credits.
   c. A state-issued photo ID from the taxpayer is a good source for obtaining personal information.

Nationality

5. Immigration status and/or citizenship (e.g., citizen, resident alien, or nonresident alien).
   a. If a taxpayer is an alien (not a U.S. citizen), (s)he is considered a nonresident alien unless either the green card test or the substantial presence test for the calendar year is met.
   b. Even if a taxpayer does not meet either of these tests, (s)he may be able to choose to be treated as a U.S. resident for part of the year (dual-status aliens). This usually occurs in the year of arrival in or departure from the United States.
   c. A non-U.S. citizen typically is denied a Social Security number (SSN). Any individual required to have a U.S. taxpayer identification number but not eligible for a SSN obtains an Individual Taxpayer Identification Number (ITIN) from the IRS. The ITIN is used to comply with U.S. tax laws and to process and account for tax returns and payments. ITINs are issued regardless of immigration status (e.g., for both resident and nonresident aliens).
6. The following table lists the key forms to file and the applicable due dates:

IF you are liable for . . .	THEN use . . .	DUE by . . .
Income tax	Form 1040 and Schedule C	15th day of 4th month after end of tax year
Self-employment tax	Schedule SE	File with Form 1040
Estimated tax	Form 1040-ES	15th day of 4th, 6th, and 9th months of tax year, and 15th day of 1st month after the end of tax year
Social Security and Medicare taxes and income tax withholding	Form 941 or 944	April 30, July 31, October 31, and January 31 See Publication 15
Providing information on Social Security and Medicare taxes and income tax withholding	Form W-2 (to employee) Forms W-2 and W-3 (to the Social Security Administration)	January 31 January 31
Federal unemployment (FUTA) tax	Form 940	January 31 April 30, July 31, October 31, and January 31, but only if the liability for unpaid tax is more than $500

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Information Returns

7. The following information returns provide potential sources of taxpayer gross income:

   W-2 – Wage and Tax Statement
   W-2G – Certain Gambling Winnings
   Form 1099-B – Proceeds from Broker and Barter Exchange Transactions
   Form 1099-C – Cancellation of Debt
   Form 1099-DIV – Dividends and Distributions
   Form 1099-G – Certain Government Payments
   Form 1099-INT – Interest Income
   Form 1099-K – Payment Card and Third Party Network Transactions
   Form 1099-MISC – Miscellaneous Income
   Form 1099-NEC – Nonemployee Compensation
   Form 1099-OID – Original Issue Discount
   Form 1099-PATR – Taxable Distributions Received From Cooperatives
   Form 1099-Q – Payments From Qualified Education Programs (Under Sections 529 and 530)
   Form 1099-R – Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
   Form 1099-S – Proceeds From Real Estate Transactions
   Form 1099-SA – Distributions From an HSA, Archer MSA, or Medicare Advantage MSA
   Schedule K-1 (Form 1065) – Partner's Share of Income, Deductions, Credits, etc.
   Schedule K-1 (Form 1120-S) – Shareholder's Share of Income, Deductions, Credits, etc.

Individual or Business

8. Determine if an individual and/or a business entity is involved.

   a. A personal, living, or family expense is not deductible unless the Code specifically provides otherwise. Nondeductible expenses include

      1) Rent and insurance premiums paid for the taxpayer's own dwelling;
      2) Life insurance premiums paid by the insured;
      3) Upkeep of a personal automobile;
      4) Personal interest; and
      5) Payments for food, clothing, or domestic help.

Items Affecting Future Returns

9. Certain items from the prior-year return may be needed to complete the current-year return (state income tax refund, AMT for credit, gain or loss carryover, charitable gift carryover, Schedule D, Form 8801, etc.).

All Required Taxes Filed

10. A determination should be made as to which taxes apply to the taxpayer, e.g., income tax, withholding (estimated tax), FICA (self-employment tax) and FUTA, AMT, estate tax, gift tax, GST tax.

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Special Filing Requirements

11. Foreign income. For purposes of determining whether a taxpayer must file a return, gross income includes any income that can be excluded as foreign-earned income or as a foreign housing amount.
12. If a taxpayer is a U.S. citizen or resident alien, the rules for filing income, estate, and gift tax returns and for paying estimated tax are generally the same whether the taxpayer is in the United States or abroad.
    a. A taxpayer's income, filing status, and age generally determine whether a taxpayer's income tax return must be filed.
    b. In general, U.S. citizens and resident aliens are taxed on their worldwide income. Generally, nonresident aliens are only taxed on U.S. source income. An exception to this general rule is if a nonresident elects to be treated as a U.S. resident, e.g., in order to file a joint return with the spouse who is a citizen or resident alien.

Reporting Foreign Financial Accounts and Specified Foreign Assets

13. Generally, any U.S. citizen, resident, or person doing business in the United States who has an ownership interest in, or signatory authority or other authority over, a financial account (or several accounts) in a foreign country with an aggregate value in excess of $10,000 at any time during the calendar year must file a Form FinCEN Report 114, *Report of Foreign Bank and Financial Accounts* (commonly referred to as an FBAR), reporting certain information with respect to that account by April 15 of the subsequent year or the extension due date of October 15. Failure to file an FBAR is subject to both civil and criminal penalties.

EXAMPLE 1-2 Required FBAR Filing

On January 1, a U.S. taxpayer deposits $5,000 in an account in foreign country X. On July 1, the taxpayer deposits $5,001 in an account in foreign country Y. On July 2, the taxpayer withdraws the $5,000 from X to make a purchase. Because the taxpayer had a total of more than $10,000 (in this case $10,001) in foreign accounts (in this case a combined total of two separate countries/accounts) at any time during the year (i.e., July 1), the taxpayer must file an FBAR for the year.

    a. Individuals living in the U.S. must use Form 8938 to report specified foreign financial assets with an aggregate value greater than $50,000 at the last day of the year or more than $75,000 at any time during the tax year (these thresholds double for married individuals filing jointly).
        1) For single individuals and married individuals filing separately who are living outside the U.S., the thresholds are $200,000 at the last day of the year or more than $300,000 at any time during the tax year (like those living in the U.S., these thresholds double for married individuals filing jointly who are living outside the U.S.).
        2) Form 8938 is required to be filed with an individual's annual income tax return. Individuals not required to file an annual income tax return are not required to file Form 8938.

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b. The purposes of Form 8938 and the FBAR are similar, and there is significant overlap. Yet filing Form 8938 does not relieve an individual of the requirement to file the FBAR. Many individuals will be required to file both Form 8938 and the FBAR to report substantially the same information.

1) Despite the similarities, there are some differences between the FBAR and Form 8938.

a) The FBAR is not filed with an individual's federal income tax return and must be filed online with the Financial Crimes Enforcement Network by April 15 each year.

b) In contrast, Form 8938 is filed with any annual return, whether it is an income tax return or an information return, listed as follows: Form 1040, Form 1040-NR, Form 1040-SR, Form 1041, Form 1041-N, Form 1065, Form 1120, and Form 1120-S.

c) In addition, the filing thresholds for Form 8938 and the FBAR are different, and the foreign financial assets that must be reported on Form 8938 are not limited to bank and financial accounts.

c. Form 5471 is used by certain U.S. citizens and residents who are officers, directors, or shareholders in certain foreign corporations. The forms and schedules are used to satisfy the reporting requirements of Secs. 6038, 6046, and 965 (transition tax) and the related regulations. This form is filed with the tax return.

Transactions with Foreign Trusts

14. U.S. persons and executors of estates of U.S. decedents file Form 3520 to report certain transactions with foreign trusts, ownership of foreign trusts under the rules of Secs. 671 through 679, and receipts of certain large gifts or bequests from certain foreign persons.

Interest in Foreign Partnerships

15. U.S. persons qualifying, based on interest in a foreign partnership, under one or more of the following four categories of filers must complete and file Form 8865 with the tax return.

a. Category 1: 50% or greater ownership

b. Category 2: 10% or greater ownership of U.S.-controlled partnership

c. Category 3: Contributed property (1) resulting in at least a 10% interest or (2) with a value of more than $100,000

d. Category 4: Had a reportable event (acquisition, disposition, or change in proportional interest)

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16. The following table is a basic listing of changes to be discussed as part of the preliminary work to prepare a tax return:

Personal and Financial Changes

Factor	Examples
Lifestyle change	Marriage Divorce Birth or adoption of child Loss of right to claim a dependent Purchase of a new home Retirement Filing Chapter 11 bankruptcy
Wage income	Either spouse starts or stops working or starts or stops a second job
Change in the amount of taxable income not subject to withholding	Interest income Dividends Capital gains Self-employment income IRA (including certain Roth IRA) distributions
Change in the amount of adjustments to income	IRA deduction Student loan interest deduction Alimony expense (pre-2019 divorces)
Change in the amount of itemized deductions or tax credits	Medical expenses Taxes Interest expense Gifts to charity Dependent care expenses Education credit Child Tax Credit Earned Income Credit

17. The return is due the 15th day of the 4th month after the end of the tax year (this includes when filed with respect to a decedent or filed by the estate).

    a. A taxpayer is allowed an automatic 2-month extension to file if, on the regular due date of the return, (s)he is living outside of the U.S. and Puerto Rico due to (1) his or her main place of business or post of duty or (2) on-duty military service.

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18. A publicly traded partnership (PTP) is any partnership an interest in which is regularly traded on an established securities market regardless of the number of its partners.
    a. A PTP that has effectively connected income, gain, or loss must pay withholding tax on any distributions of that income made to its foreign partners.
        1) In this situation, a PTP must use Form 1042, *Annual Withholding Tax Return for U.S. Source Income of Foreign Persons*, and Form 1042-S, *Foreign Person's U.S. Source Income Subject to Withholding*, to report withholding from distributions.
    b. A taxpayer's net income from a PTP may not be used to offset net losses from other PTPs or net losses from other passive activities. A disallowed loss from a PTP is carried forward and allowed as a deduction in a tax year when the PTP has net income or when the taxpayer disposes his or her entire interest in the PTP.

1.2 FILING STATUS

The standard deduction amount and applicable tax rates vary with filing status.

Married Filing a Joint Return

1. Taxpayers can choose married filing jointly as their filing status if they are considered married and both spouses agree to file a joint return. On a joint return, both spouses report combined income and deduct combined allowable expenses. Taxpayers can file a joint return even if one of the spouses had no income or deductions.
    a. Two individuals are treated as legally married for the entire tax year if, on the last day of the tax year, they are
        1) Legally married and cohabiting as spouses
        2) Legally married and living apart but not separated pursuant to a valid divorce decree or separate maintenance agreement
        3) Separated under a valid divorce decree that is not yet final

        NOTE: If a spouse dies, status for each spouse is determined when the spouse dies, unless the surviving spouse remarries before the end of the tax year (in which case the decedent files married filing separate).
    b. A joint return is not allowed if one spouse was a nonresident alien (NRA) at any time during the tax year, unless the U.S. citizen and the NRA spouse so elect and agree to be taxed on their worldwide income.
    c. Generally, if one spouse files separately, so must the other. An exception to this is if the other spouse qualifies for head of household while married. Then one spouse may file separately and the other may file as head of household.
    d. Once a joint return has been filed for the year and the time for filing the return of either spouse has expired, the spouses may not amend the return to file separate returns.

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e. Married individuals who file separate returns may later file a joint (amended) return. Payment of the entire joint tax liability is not required at the time the amended return is filed.

f. If an individual obtains a marriage annulment (no valid marriage ever existed), the individuals must file amended returns claiming a filing status of single or head of household, whichever applies.

   1) All prior tax years not closed by the statute of limitations must be amended.

g. A joint return is signed by both spouses. Generally, the spouses are jointly and severally liable for the tax due and any interest and penalties.

   1) One spouse may be relieved of joint and several liability under the “innocent spouse” provisions in very limited circumstances.

h. Married individuals who file a joint return account for their items of income, deduction, and credit in the aggregate.

   1) A joint return is allowed when spouses use different accounting methods.
   2) Spouses with different tax years may not file a joint return.

i. **Same-Sex Spouses**

   1) Same-sex couples qualify for married filing status. This only applies to married individuals, not to those in domestic partnerships or civil unions.

j. **Injured Spouse**

   1) When a joint return is filed and only one spouse owes a past-due amount, the other spouse can be considered an injured spouse.

      a) An injured spouse can get a refund for his or her share of the joint overpayment that would otherwise be used to pay the past-due amount.

   2) To be considered an injured spouse, the taxpayer must

      a) File a joint return,
      b) Have reported income (such as wages, interest, etc.),
      c) Have made and reported tax payments (such as federal income tax withheld from wages or estimated tax payments) or claimed the Earned Income Credit or other refundable credit,
      d) Not be required to pay a past-due amount, and
      e) File Form 8379.

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k. **Innocent Spouse Relief**

1) Generally, both spouses are responsible for paying the full amount of tax, interest, and penalties due on a joint return. However, if qualified for innocent spouse relief, a taxpayer may be relieved of part or all of the joint liability.

2) Qualifying events include

a) An understatement of tax because the spouse omitted income or claimed false deductions or credits, and the innocent taxpayer was not aware of the understatement;

b) An understatement of tax, and the innocent taxpayer is divorced or otherwise no longer living with the spouse; or

c) Given all the facts and circumstances, it is not fair to hold the innocent taxpayer liable for the tax.

3) Related types of relief include separation of liability relief, equitable relief, and relief from liability arising from community property law.

Married Filing Separate Returns

2. Each spouse accounts separately for items of income, deduction, and credit. A spouse who uses his or her own funds to pay expenses of jointly owned property is entitled to any deduction attributable to the payments.

Qualifying Surviving Spouse

3. This status is available for 2 years following the year of death of a spouse and may be elected if

a. The surviving spouse did not remarry during the tax year.

b. The surviving spouse qualified (with the deceased spouse) for married filing joint return status for the tax year of the death of the spouse.

c. The surviving spouse maintained a household for the taxable year. Household maintenance means the spouse furnishes more than 50% of the costs to maintain the household for the tax year.

1) The household must be the principal place of abode of a qualifying dependent of the surviving spouse.

2) The dependent must be a son or daughter, a stepson or stepdaughter, or an adopted child. This does not include a foster child. (This is an exception to the general dependent rules covered in Subunit 1.4.)

NOTE: An adopted child is always treated as the taxpayer's own child; i.e., the term "child" includes "adopted child."

d. The surviving spouse can file a joint return in the tax year of the death of the spouse.

1) The surviving spouse must not have remarried prior to the end of the year.

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Head of Household

4. An individual qualifies for head of household status if (s)he satisfies conditions with respect to filing status, marital status, and household maintenance.
   a. Filing status. The individual may not file as a surviving spouse.
   b. Marital status. Generally, the taxpayer must be unmarried on the last day of the year. A married person may qualify for head of household status if the conditions in item d. on the next page are satisfied, i.e., considered unmarried. An individual is not treated as married for head of household status if the spouse is a nonresident alien at any time during the tax year.

Household Maintenance

   c. An individual must maintain a household that is the principal place of abode for a qualifying individual.
      1) To maintain a household for federal filing status purposes, an individual must furnish more than 50% of the costs, of mutual benefit, of maintaining the household during the tax year.

Qualifying Expenditures	Nonqualifying Costs
Property tax	Clothing
Mortgage interest	Education
Rent	Medical treatment
Utilities	Life insurance
Upkeep	Transportation
Repair	Vacations
Property insurance	Services by the taxpayer
Food consumed in-home	Services by the dependent

Qualifying Person and Time

      2) The taxpayer must maintain a household that constitutes the principal place of abode for more than half of the taxable year for at least one qualified individual who is
         a) A qualifying child or
         b) A qualifying relative. (Both of these are defined in Subunit 1.4.)
      3) Note that there are two special rules concerning a qualifying person:
         a) First, the taxpayer with a dependent parent qualifies even if the parent does not live with the taxpayer.
         b) Second, if a qualifying child lives with the taxpayer, the qualifying child need not be the taxpayer's dependent. For example, if all regular requirements are met but the custodial parent releases claim to the child as his or her dependent to the noncustodial parent per Form 8332.

         Otherwise, the IRS maintains that the qualifying individual must occupy the same household (except for temporary absences).

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4) The following table is an additional guide for qualifying children and relatives:

IF the person is a . . .	AND . . .	THEN that person is . . .
qualifying child (such as a son, daughter, or grandchild who lived with the taxpayer more than half the year and meets certain other tests)	(s)he is single	a qualifying person, whether or not the taxpayer can claim the person as a dependent.
	(s)he is married **and** the taxpayer can claim him or her as a dependent	a qualifying person.
	(s)he is married **and** the taxpayer cannot claim him or her as a dependent	not a qualifying person.
qualifying relative who is the taxpayer's father or mother	the taxpayer can claim him or her as a dependent	a qualifying person.
	the taxpayer cannot claim him or her as a dependent	not a qualifying person.
qualifying relative other than the taxpayer's father or mother (such as a grandparent, brother, or sister who meets certain tests)	(s)he lived with the taxpayer more than half the year, **and** (s)he is related to the taxpayer in one of the ways listed under immediate relationships in Subunit 1.4, **and** the taxpayer can claim him or her as a dependent	a qualifying person.
	(s)he did not live with the taxpayer more than half the year	not a qualifying person.
	(s)he is not related to the taxpayer in one of the ways listed under immediate relationships in Subunit 1.4 **and** is the taxpayer's qualifying relative only because (s)he lived with the taxpayer all year as a member of the taxpayer's household	not a qualifying person.
	the taxpayer cannot claim him or her as a dependent	not a qualifying person.

d. A married individual who lives with a dependent apart from the spouse will be considered unmarried and qualify for head of household status if, for the tax year,

1) The individual files separately;
2) The individual pays more than 50% toward maintaining the household;
3) The spouse is not a member of the household for the last 6 months;
4) The household is the principal home of the individual's child, stepchild, or qualified foster child for more than half the year; and
5) The individual can claim the child as a dependent.

EXAMPLE 1-3 Head of Household Filing Status

Hector and Maria are married with one child. Hector moves out of the residence in May. They are not divorced by the end of the year. Maria maintains the household for the remainder of the year and claims the child on her individual tax return. Maria may claim head of household status. Hector would then be required to file as married filing separately.

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Single

5. An individual must file as an unmarried individual if (s)he neither is married nor qualifies for surviving spouse or head of household status.

EXAMPLE 1-4 Filing Status -- Year of Separation
George and Rebecca married 5 years ago. At the end of the current year, they were legally separated under a final decree of separate maintenance. They are considered unmarried for the year and, if neither has a qualified dependent, they will each file as single individuals.

The Standard Deduction

6. Taxable income (TI) is adjusted gross income (AGI) minus the greater of itemized deductions or the standard deduction.

Taxable income = Adjusted gross income − Greater of allowable itemized deductions on Schedule A or the standard deduction

a. The taxpayer itemizes deductions if the total allowable itemized deductions is greater than the standard deduction. Otherwise, the taxpayer claims the standard deduction. A person must elect to itemize, or no itemized deductions will be allowed.
   1) Election is made by filing Schedule A of Form 1040.
   2) Election in any other taxable year is not relevant.
   3) Election may be changed by filing an amended return (Form 1040-X).

Ineligible

b. The following persons are not allowed the standard deduction:
   1) Persons who itemize deductions
   2) Nonresident alien individuals
   3) Individuals who file a "short period" return
   4) A married individual who files a separate return and whose spouse itemizes
   5) Partnerships, estates, and trusts
   6) Corporations

c. The standard deduction is the sum of the basic standard deduction and additional standard deductions.

EXAMPLE 1-5 Ineligible Standard Deduction
Gary and Sara Beers are married but file separately. Gary has AGI of $40,000 and $8,200 of itemized deductions. Sara has $30,000 of AGI and $17,000 of itemized deductions. Gary and Sara can elect to take the standard deduction of $12,950 each. If they elect to itemize, Gary will have itemized deductions of $8,200 and Sara will have itemized deductions of $17,000. If either Gary or Sara choose to itemize, the other is required to itemize.

Basic Standard Deduction

d. The basic standard deduction amount depends on filing status and dependency status on another's return. The table on the next page lists the amount per filing status.
   1) The basic standard deduction amount of a child under age 19 or a student under age 24 who can be claimed as a dependent on another individual's income tax return is limited to the greater of either
      a) $1,150 or
      b) Earned income for the year plus $400 up to $12,950 (i.e., the applicable single standard deduction).
   2) Earned income does not include dividends or capital gains from the sale of stock.

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Additional Standard Deduction

e. Additional standard deduction amounts, indexed for inflation, appear in the table below.

1) An individual who has attained the age of 65 or is blind is entitled to the amount.

a) "Blind" in this context means no better than 20/200 vision in the better eye even with corrective lenses.

2) The individual is entitled to the amount if (s)he attains age 65 before the end of the tax year

a) Even if (s)he dies before the end of the year

b) But not if (s)he dies before attaining age 65, even if (s)he would have otherwise reached age 65 before year's end.

3) A person who becomes blind on or before the last day of the taxable year is entitled to the amount.

4) Once qualified, the standard deduction is allowed in full.

a) It is not prorated if a person dies during a tax year.

5) An individual who has both reached age 65 and is blind is entitled to twice the amount.

2022 Standard Deduction Amounts

Filing Status	Basic	Additional
Married Filing Jointly	$25,900	$1,400
Qualifying Surviving Spouse	25,900	1,400
Head of Household	19,400	1,750
Single (other than above)	12,950	1,750
Married Filing Separately	12,950	1,400

EXAMPLE 1-6 Standard Deduction -- Head of Household

Toni Mills, 52, qualifies as head of household. Her basic standard deduction is $19,400. She does not qualify for an additional standard deduction.

EXAMPLE 1-7 Additional Standard Deduction -- Head of Household

Mike Forth is 68, legally blind, and qualifies as head of household. His basic standard deduction is $19,400. He also qualifies for two additional standard deductions of $3,500 ($1,750 for being 65 or older + $1,750 for being blind). His total standard deduction is $22,900.

EXAMPLE 1-8 Additional Standard Deduction -- Married Filing Jointly

Adam and Betty Washington are both over 65 and legally blind. They are married and file a joint return. They qualify for four additional standard deductions (one each for being over 65 and one each for being blind). Their total standard deduction for the year is $31,500 [$25,900 basic standard deduction + ($1,400 × 4 additional standard deductions)].

EXAMPLE 1-9 Standard Deduction -- Head of Household

Joni Woodson is unmarried and fully supports her 72-year-old mother. Joni qualifies as head of household. Joni's basic standard deduction is $19,400. Joni may not claim the additional standard deduction for her dependent mother.

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1.3 FILING REQUIREMENTS

An individual must file a federal income tax return if gross income is above a threshold, net earnings from self-employment is $400 or more, or (s)he is a dependent (i.e., listed on another person's tax return) with more gross income than the standard deduction or with unearned income over $1,150.

Gross Income Filing Threshold

1. Until 2026, the gross income filing threshold amount generally is the standard deduction (excluding any amount for being blind).
   a. The first exception to the general rule is the $5 filing threshold for married filing separately taxpayers.
   b. The second exception is that, except for married filing separately, the filing requirement limitations are increased for taxpayers by the additional standard deductions for being over 65, but not for being blind.

   NOTE: Gross income does not include any Social Security benefits unless (1) the taxpayer(s) is (are) married filing a separate return and lived with the spouse at any time during the year or (2) one-half of the Social Security benefits plus other gross income and any tax-exempt interest is more than $25,000 ($32,000 if married filing jointly).

   c. Married individuals filing separately are not allowed to include the standard deduction in the threshold computation because if one taxpayer itemizes his or her deductions, the other is required to itemize.
   d. Each individual who is over age 65 is entitled to an additional standard deduction when calculating the gross income threshold.

Additional Standard Deduction	
Married Filing Jointly Qualifying Surviving Spouse Married Filing Separately	$1,400
Head of Household Single	$1,750

   e. Any personal residence disposition gain that was excluded and any foreign-earned income that was excluded must be added back to gross income for purposes of this filing requirement.

EXAMPLE 1-10 Gross Income Filing Requirements

Josie is retired and receives only $2,500 in interest income for the year. She sold her residence, which she has lived in for over 10 years, for $180,000 with a gain of $40,000. Even though any gain on the sale of the residence is excluded from income, Josie is required to file an income tax return because the gain is added to gross income for filing purposes.

   f. Special conditions may also require filing, e.g., liability for a special tax, such as AMT or receipt of wages from a church.
   g. Even if not required, an individual should file to obtain a refund and possibly to establish a record and trigger running of statutes of limitation.

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Signature Requirement

2. The taxpayer, the taxpayer's spouse, and the paid return preparer all must sign the completed return, declaring under penalty of perjury that they have examined the return and the accompanying schedules and statements and, to the best of their knowledge and belief, the return and schedules are true, correct, and complete.
   a. The penalty of perjury means if the taxpayer willfully makes and subscribes any return, statement, or other document that the taxpayer does not believe to be true and correct as to every material matter, the taxpayer has committed a felony and could be penalized up to $250,000 (for an individual).

Due Date

3. Generally, the income tax return must be filed (postmarked) not later than the 15th day of the 4th month following the close of the tax year. This is April 15 for calendar-year taxpayers. If the 15th day is a Saturday, a Sunday, or a legal holiday, the due date is the next day that is not a Saturday, a Sunday, or a legal holiday.
   a. An **automatic extension** of 6 months is provided for an individual who files Form 4868 or uses a credit card to make the required tax payment on or before the initial due date.
   b. A U.S. citizen or resident who is on **military or naval duty outside the U.S.** (or Puerto Rico) on April 15 is given an automatic 2-month extension without the necessity of filing Form 4868.
      1) Filing of Form 4868 during the 2 months will allow another 4-month extension.
   c. The due date for a decedent's final return is the date on which the return would have been due if death had not occurred.
   d. A Form 1040-NR **nonresident alien's** tax return (when not subject to wage withholding) must be filed by the 15th day of the 6th month after the close of the tax year (unless extended).
      1) A nonresident alien must file his or her tax return on the 15th day of the 4th month after the close of the tax year (unless extended) if his or her wages are subject to withholding.

Liability Payment

4. Tax liability must be paid when the return must be filed. Automatic extension for filing the return does not extend time for payment.
   a. Interest will be charged from the original due date.
   b. A penalty of 5% per month up to 25% of unpaid liability is assessed for failure to file a return.
   c. In general, a failure to pay penalty is imposed from the due date for taxes (other than the estimated taxes) shown on the return.
      1) The penalty is 0.5% per month of the tax not paid, up to 25%.
      2) A failure to pay penalty may offset a failure to file penalty.
      3) When an extension to file is timely requested, a failure to pay penalty may be avoided by paying an estimate of unpaid tax in conjunction with the extension request.
         a) The payment may not be less than 90% of the actual tax liability due, and the balance must be paid when the return is filed.
         b) Exceptions and adjustments to these rules do apply in unique situations.

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Recordkeeping

5. Books of account or records sufficient to establish the amount of gross income, deductions, credit, or other matters required to be shown in any tax or information return must be kept.
   a. Records must be maintained as long as the contents may be material in administration of any internal revenue law.
   b. Employers are required to keep records on employment taxes until at least 4 years after the due date of the return or payment of the tax.
6. If an individual is required to report employment taxes or give tax statements to employees, (s)he must have an employer identification number (EIN).
   a. The EIN is a 9-digit number the IRS issues to identify the tax accounts of employers.
7. Penalties are applied when an employer fails to make a required deposit of taxes on time.
   a. The penalties do not apply if any failure to make a proper and timely deposit was due to reasonable cause and not to willful neglect.
   b. For amounts not properly or timely deposited, the penalty rates are
      1) 2% for deposits made 1 to 5 days late
      2) 5% for deposits made 6 to 15 days late
      3) 10% for deposits made 16 or more days late

Author's Note

The exception for a 15% rate is beyond the scope of the exam and therefore not covered in detail.

Identity Protection Personal Identification Number (IP PIN)

8. The IRS IP PIN is a 6-digit number assigned to eligible taxpayers to help prevent the misuse of their Social Security numbers on fraudulent federal income tax returns. The IP PIN helps the IRS verify a taxpayer's identity and accept their electronic or paper tax return.
   a. If a return is e-filed with the taxpayer's SSN and an incorrect or missing IP PIN, the IRS system will reject it until the return is submitted with the correct IP PIN or filed on paper. If the same conditions occur on a paper-filed return, the IRS will delay its processing and any refund that may be due for taxpayer protection while the IRS determines if the return is the taxpayer's.

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1.4 DEPENDENTS

Overview

1. Until 2018, taxpayers were allowed personal exemptions reducing their adjusted gross income for themselves and any of their qualified dependents. From 2018 through 2025, the exemption amount is $0; in essence, the personal exemption is eliminated for these years. For that reason, this review course has removed all coverage of personal exemptions.
   a. However, the rules pertaining to qualified dependents still apply because dependency status affects more than just the exemption. For example, as discussed in Subunit 1.2, having dependents is required for qualifying for Head of Household. It is also required to qualify for the Child Tax Credit and certain Earned Income Credit amounts. Therefore, it is important to learn the rules qualifying someone as a dependent of the taxpayer.

Dependent Status

2. To qualify as a dependent, the individual must be a qualifying child or a qualifying relative. A spouse is never considered a dependent.

Qualifying Child

   a. To be a qualifying child, four tests must be met:
      1) Relationship – The child must be the taxpayer's son, daughter, stepson, stepdaughter, brother, sister, stepbrother, stepsister, or any descendant of any such relative. Adopted individuals and eligible foster children meet the relationship test.

      NOTE: An adopted child is always treated as the taxpayer's own child; i.e., the term "child" includes "adopted child."

      2) Age – The child must, at the end of the year, be (a) under the age of 19, (b) a full-time student under the age of 24, or (c) any age if permanently and totally disabled. Full-time student status requires 5 months of enrollment or registration at a school or in an on-farm training course.
      3) Principal Residence – The child must have the same principal place of abode as the taxpayer for more than half of the year.
      4) Not Self-Supporting – The child must not have provided over half of his or her own support.

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Qualifying Relative

b. To be a qualifying relative, the following tests [1)-4)] must be met:

1) Relationship or residence. An individual must satisfy either a relationship or a residence requirement to qualify as a dependent.

a) Residence. The residence requirement is satisfied for any individual who merely resides with a potential claimant (of the dependent) for the entire tax year.

b) Relationship. The relationship requirement is satisfied by existence of an extended (by blood) or immediate (by blood, adoption, or marriage) relationship. The relationship need be present to only one of the two married persons who file a joint return. Any relationship established by marriage is not treated as ended by divorce or by death.

i) Extended relationships: grandparents and ancestors; grandchildren and descendants; uncles or aunts; nephews or nieces

ii) Immediate relationships

- Parent: natural, adoptive, stepparent; father or mother-in-law
- Child: natural, adoptive, stepchild; son or daughter-in-law; foster child
- Sibling: full or half brother or sister; adoptive brother or sister; stepbrother or sister; brother or sister-in-law

NOTE: A cousin can only be claimed as a dependent if (s)he lived with the taxpayer all year.

2) Gross income of the individual (to be claimed as a dependent) must be less than $4,400 for 2022.

a) Gross income for the gross income dependency test is all income that is received but not exempt from tax.

i) Any expenses from rental property do not reduce rental income.

ii) Gross income from a business is the total net sales minus the cost of goods sold, plus any miscellaneous income from the business.

iii) Gross income includes all unemployment compensation.

iv) Social Security benefits are generally excluded from gross income unless additional income is received.

v) Municipal bond interest is exempt from tax.

EXAMPLE 1-11	**Qualifying Relative**
Allan Cripes, 22, earned $5,000 working part time while attending school full time. Allan lives with Doris, his cousin, the entire year. Doris pays more than one-half of Allan's support. Allan will not be a dependent of Doris since Allan exceeds $4,400 of gross income.	

3) Support. The person who may claim an individual as a dependent must provide more than 50% of the (economic) support of the individual for the year.

a) Support includes welfare benefits, Social Security benefits, and any support provided by the dependency exemption claimant, the dependent, and any other person.

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b) Only amounts provided during the calendar year qualify as support. Amounts paid in arrears (i.e., payment for child support for a previous year) are not considered as support for the current year.

c) Support includes money and items, or amounts spent on items, such as

i) Food, clothing, shelter, utilities
ii) Medical and dental care and insurance
iii) Education
iv) Child care, vacations, etc.

d) Excluded. Certain items (or amounts spent on them) have not been treated as support, e.g., scholarship received by a dependent, taxes, medical insurance benefits, and life insurance premiums.

i) The purchase of capital items (e.g., furniture, appliances, and cars) cannot be included in total support if they are purchased for personal and family reasons and benefit the entire household.

e) The amount of an item of support provided in a form other than cash is usually its cost, if purchased, or FMV, if otherwise obtained.

f) Support received as a single amount is prorated among more than one possible dependent, e.g., three children.

g) A divorced or separated individual need not meet the support test if (s)he and the (ex-)spouse meet (or have met) the following conditions:

i) Provided more than 50% of the support
ii) Had (between them) custody for more than 50% of the year
iii) Lived apart for the last half of the year
iv) Did not have a multiple support agreement in effect

NOTE: The parent having custody for more than 50% of the year is entitled to the dependency exemption, but the dependency exemption may be allocated to the noncustodial parent if there is an agreement signed by the custodial parent and attached to the noncustodial parent's return.

h) Multiple support agreement (Form 2120). One person of a group that together provides more than 50% of the support of an individual may, pursuant to agreement, be allowed the dependency exemption.

i) The person must be otherwise eligible to claim the dependency exemption and must provide more than 10% of the support.

ii) No other person may provide more than 50% of the support.

iii) Each other person in the group who provided more than 10% of the support must sign a written consent filed with the return of the taxpayer who claims the dependency exemption.

4) The individual must not be a qualifying child of the taxpayer or any other taxpayer.

a) A child being adopted is eligible to be claimed as a dependent by the adopting parents if an identifying number for the child is obtained. Initially, an adoption taxpayer identification number (ATIN) is assigned.

b) Both a dependent who dies before the end of the calendar year and a child born during the year may be claimed as dependents.

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Qualifying as a Dependent

c. There are special rules that apply to individuals qualifying as a dependent:

1) Dependent taxpayer test. If an individual meets the requirements to be classified as a dependent on another person's tax return, the individual (dependent) will be treated as having no dependents for the tax year.

2) Filing status (occasionally referred to as the joint return test). An individual does not qualify as a dependent on another's return if the individual is married and files a joint return.

a) However, such an individual can qualify as a dependent if (s)he files a joint return solely to claim a refund of withheld tax without regard to the citizenship test.

EXAMPLE 1-12	**Filing by Dependents to Obtain a Refund**
Mr. and Mrs. Kind provided more than half the support for their married daughter and son-in-law who lived with the Kinds all year. Neither the daughter nor the son-in-law is required to file a 2022 tax return. They do so only to get a refund of withheld taxes. The Kinds may claim the daughter and the son-in-law as dependents on their 2022 joint return.	

3) Citizenship or resident. To qualify as a dependent, an individual must be, for any part of the year, a U.S. citizen, resident, or national, or a Canadian or Mexican resident.

EXAMPLE 1-13	**Citizenship of Dependents**
Resident aliens living in the U.S. provide all the support for their four minor children even though they all live with various relatives in other countries. One is in Mexico, two others are in Canada, and the fourth is in Chile. All family members are citizens of Chile. The resident aliens may claim dependent exemptions for only the three children residing in Mexico and Canada.	

4) Taxpayer identification number. The taxpayer must provide the correct taxpayer identification number (TIN) of a dependent on the income tax return.

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Overview of the Rules for Claiming a Dependent

d. This table is only an overview of the rules.

- A taxpayer cannot claim any dependents if the taxpayer, or the spouse if filing jointly, could be claimed as a dependent by another taxpayer.
- A taxpayer cannot claim a married person who files a joint return as a dependent unless that joint return is only a claim for refund and there would be no tax liability for either spouse on separate returns.
- A taxpayer 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.
- A taxpayer cannot claim a person as a dependent unless that person is the taxpayer's **qualifying child** or **qualifying relative**.

Tests To Be a Qualifying Child	Tests To Be a Qualifying Relative
1. The child must be a son, daughter, stepchild, foster child, brother, sister, half brother, half sister, stepbrother, stepsister, or a descendant of any of them. Adopted individuals qualify. 2. The child must be (a) under age 19 at the end of the year and younger than the taxpayer (or the spouse if filing jointly); (b) under age 24 at the end of the year, a student, and younger than the taxpayer (or the spouse if filing jointly); or (c) any age if permanently and totally disabled. 3. The child must have lived with the taxpayer for more than half of the year. 4. The child must not have provided more than half of his or her own support for the year. 5. The child is not filing a joint return for the year (unless that joint return is filed only as a claim for refund of withheld income tax 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. The person cannot be the taxpayer's qualifying child or the qualifying child of anyone else. 2. The person either (a) must be related to the taxpayer in one of the ways listed previously under Immediate relationships or (b) must live with the taxpayer all year as a member of the taxpayer's household (and the taxpayer's relationship must not violate local law). 3. The person's gross income for the year must be less than $4,400. 4. The taxpayer must provide more than half of the person's total support for the year.

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1.5 DEPENDENT'S UNEARNED INCOME

1. The standard deduction for a dependent with unearned income is limited to the greater of $1,150 or the amount of earned income plus $400.

EXAMPLE 1-14	**Standard Deduction of Dependent**

If a dependent has $750 or less of earned income, the standard deduction is $1,150. If a dependent has more than $750 and less than $12,550 of earned income, the standard deduction is earned income plus $400. If a dependent has $12,550 or more of earned income, the standard deduction is $12,950.

Kiddie Tax

2. For 2022, net unearned income (NUI) of a dependent under 19 (under 24 for full-time students) at the close of the tax year is taxed to the dependent at the parent's marginal rate. This is referred to as the "kiddie" tax.
   a. Net unearned income is unearned income minus the sum of
      1) $1,150 (first $1,150 clause) and
      2) The greater of (a) $1,150 of the standard deduction or $1,150 of itemized deductions or (b) the amount of allowable deductions that are directly connected with the production of unearned income.

EXAMPLE 1-15	**Taxable Income of a Dependent Child**

Chris, dependent child age 5, has $4,700 of unearned income and no earned income. How much of his income may be taxed at the parent's marginal rate?

Unearned income	$4,700
First $1,150 clause	(1,150)
Standard deduction	(1,150)
Net unearned income	$2,400

EXAMPLE 1-16	**Kiddie Tax**

Melvin, an unmarried individual age 15, is claimed as a dependent by his parents. He received income of $6,450 from earnings and had taxable interest of $2,400 on a savings account. Melvin's taxable income is $2,000 [$8,850 gross income ($6,450 + $2,400) – $6,850 standard deduction ($6,450 + $400)]. The amount taxed at the parents' marginal rate is $100 ($2,400 unearned income – $1,150 – $1,150). The amount taxed at Melvin's tax rate is $1,900 ($2,000 taxable income – $100 taxed at his parents' marginal tax rate).

   b. A dependent is allowed at least a $2,300 ($1,150 + $1,150) reduction in unearned income.
   c. **Unearned** income is all taxable income other than earned income. Earned income is payment received for performance of personal services and is usually reported on Form W-2.

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Examples of Child Income

Earned	Unearned
Salaries	Interest
Wages	Dividends
Tips	Capital gains
	Trusts distributions
	Debt cancellation
	Pension/Annuities
	Social Security
	Royalties
	Taxable scholarships

3. The tax on a dependent is the greater of

TI -- dependent	$X,XXX
Times: Rate	.XX
Total tax	$X,XXX

OR

TI -- dependent	$X,XXX
Less: NUI	(XX)
Total	$X,XXX
Times: Rate (child)	.XX
Total (1)	$X,XXX
TI -- parent	$X,XXX
Plus: NUI	XX
Total	$X,XXX
Times: Rate (parent)	.XX
Total (2)	$X,XXX
Total (1)	$X,XXX
Plus: Total (2)	X,XXX
Total	$X,XXX
Less: Tax on parent's TI	(X,XXX)
Total tax	$X,XXX

4. If more than one child has NUI, the parents' total NUI must be proportioned among the children to determine the amount taxed to each child.

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1.6 NONRESIDENT AND DUAL-STATUS ALIENS

1. A taxpayer is considered a dual-status alien if the taxpayer was both a nonresident and resident alien during the year.
2. Generally, a taxpayer is considered a resident alien if either the green card test or the substantial presence test is met. Even if the taxpayer does not meet either of these tests, (s)he may be able to choose to be treated as a U.S. resident for part of the year.

Green Card Test

3. A taxpayer is a resident for tax purposes if (s)he was a lawful permanent resident (immigrant) of the United States at any time during the year.

Nonresident Alien

4. A nonresident alien may file a joint return if (s)he is married to a U.S. citizen or resident at the end of the year.
   a. If the couple files a joint return, both spouses are treated as U.S. residents for the entire tax year.
5. If a taxpayer chooses to be treated as a U.S. resident, both spouses are taxed on worldwide income.
6. A taxpayer is considered unmarried for head of household purposes if the taxpayer's spouse was a nonresident alien at any time during the year and the taxpayer does not choose to treat his or her nonresident spouse as a resident alien.
   a. A taxpayer's spouse is not a qualifying person for head of household purposes.
   b. A taxpayer must have another person qualifying as a dependent and meet the other tests to be eligible to file as a head of household.
7. Even if a taxpayer is considered unmarried for head of household purposes because the taxpayer is married to a nonresident alien, the taxpayer is still considered married for purposes of the Earned Income Credit.
   a. A taxpayer is not entitled to the Earned Income Credit unless a joint return is filed and other qualifications are met.
8. Nonresident aliens can deduct certain itemized deductions if income is received that is effectively connected with a U.S. trade or business.
   a. These deductions include state and local income taxes, charitable contributions to U.S. organizations, casualty and theft losses, and other itemized deductions.
9. If a taxpayer is a nonresident alien who is married to a U.S. citizen or resident at the end of the year and chooses to be treated as a U.S. resident, (s)he can take the standard deduction.
10. A nonresident alien is not eligible for the credit for the elderly and the education credits unless (s)he elects to be treated as a U.S. resident.
11. Nonresident aliens are required to file a return if they earn any wages effectively connected with a U.S. trade or business.
12. Most types of U.S. source income received by a foreign taxpayer are subject to a tax rate of 30%.
13. A scholarship, fellowship, grant, etc., received by a nonresident alien for activities conducted outside the U.S. is treated as foreign source income and therefore is not subject to U.S. taxation.

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Substantial Presence Test

14. A taxpayer is considered a U.S. resident if (s)he was physically present in the United States for at least

    a. 31 days during 2022 and

    b. 183 days during 2022, 2021, and 2020, counting all days of physical presence in 2022 but only 1/3 the number of days of presence in 2021 and only 1/6 the number of days in 2020.

Ending Resident Status

15. Either spouse may choose to revoke resident status of the nonresident alien spouse. Other means by which the status is ended include death, divorce or legal separation, and inadequate records. The following table breaks down the details of each:

Revocation	**Either spouse can revoke the choice for any tax year.** ● The revocation must be made by the due date for filing the tax return for that tax year. ● The spouse who revokes the choice must attach a signed statement declaring that the choice is being revoked. The statement revoking the choice must include the following: ■ The name, address, and Social Security number (or taxpayer identification number) of each spouse ■ The name and address of any person who is revoking the choice for a deceased spouse ■ A list of any states, foreign countries, and possessions that have community property laws in which either spouse is domiciled or where real property is located from which either spouse receives income ● If the spouse revoking the choice does not have to file a return and does not file a claim for refund, send the statement to the Internal Revenue Service Center where the last joint return was filed.
Death	**The death of either spouse ends the choice, beginning with the first tax year following the year in which the spouse died.** ● If the surviving spouse is a U.S. citizen or resident alien and is entitled to the joint tax rates as a surviving spouse, the choice will not end until the close of the last year for which these joint rates may be used. ● If both spouses die in the same tax year, the choice ends on the first day after the close of the tax year in which the spouses died.
Divorce or legal separation	**A divorce or legal separation ends the choice as of the beginning of the tax year in which the legal separation occurs.**
Inadequate records	**The Internal Revenue Service can end the choice for any tax year that either spouse has failed to keep adequate books, records, and other information necessary to determine the correct income tax liability, or to provide adequate access to those records.**

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STUDY UNIT TWO

GROSS INCOME I

This study unit is the first of two that presents items that are included in gross income, income items that are excluded from gross income, and income items for which the Internal Revenue Code provides a partial exclusion from gross income. The following formula is an overview of the steps to compute federal income tax liability for individual taxpayers.

Individual Income Tax
FORMULA

	GROSS INCOME
–	Section 62 Adjustments/Deductions (above the line)
=	**ADJUSTED GROSS INCOME**
–	Greater of Itemized Deductions or Standard Deduction
–	Qualified Business Income Deduction
=	**TAXABLE INCOME**
×	Tax Rate
=	**GROSS TAX Liability**
–	Credits
=	**NET TAX Liability or Refund Receivable**

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2.1 GROSS INCOME

The IRC (Internal Revenue Code) defines gross income as all income from whatever source derived except as otherwise provided.

1. Section 61(a) enumerates types of income that constitute gross income. The list is not exhaustive.
   a. Compensation for services, including fees, commissions, and fringe benefits
   b. Gross income derived from business
   c. Gains derived from dealings in property
   d. Interest
   e. Rents
   f. Royalties
   g. Dividends
   h. Annuities
   i. Income from life insurance and endowment contracts (This is a broader application than the general exclusion for proceeds due to death.)
   j. Pensions
   k. Income from discharge of indebtedness
   l. Distributive share of partnership gross income
   m. Income in respect of a decedent (income earned but not received before death)
   n. Income from an interest in an estate or trust

Author's Note

A 2017 tax law change removed alimony and separate maintenance payments from the above list as divorces executed after 2018 no longer include these items in gross income. However, payments under a divorce executed before 2019 are still included in gross income and may be tested as such on the exam.

2. Other types of income also constitute gross income unless a statute specifically excludes them.
   a. This specifically includes income derived from all sources regardless of whether the taxpayer receives a Form W-2 or Form 1099.
   b. Form 1099-MISC is used for reporting a variety of types of income not reported on a W-2 or other specific Form 1099s. Any errors on this form should be reported to the payor. If the payor will not correct and reissue the new form, the taxpayer must attach an explanation and report the correct amount.

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Domestic vs. Foreign Source Income

3. There are several factors that determine the source (domestic or foreign) of a specific type of income. The following table explains the general rules:

Item of Income	Factor Determining Source
Salaries, wages, other compensation	Where services performed
Business income: Personal services Sale of inventory—purchased Sale of inventory—produced	 Where services performed Where sold Allocation
Interest	Residence of payor
Dividends	Whether a U.S. or foreign corporation
Rents	Location of property
Royalties: Natural resources Patents, copyrights, etc.	 Location of property Where property is used
Sale of real property	Location of property
Sale of personal property	Seller’s tax home
Pension distributions attributable to contributions	When services were performed that earned the pension
Investment earnings on pension contributions	Location of pension trust
Sale of natural resources	Allocation based on fair market value of product at export terminal

4. Items are included in income based on the method of accounting used by the taxpayer.
   a. The cash method of accounting includes income when constructively received.
   b. The accrual method of accounting reports income when
      1) All events have occurred fixing the right to receive the income.
      2) The amount can be determined with reasonable accuracy.
   c. The accrual method of accounting is required when there are inventories.
   d. The hybrid method allows a business to use the cash method for the portion of the business that is not required to be on the accrual method.
   e. Income is reported when it can be estimated with reasonable accuracy. Adjustments are made in a later year for any differences between the actual amount and the previously reported amounts.

EXAMPLE 2-1 Cash vs. Accrual-Method Income

Lucy is a calendar-year accrual-method taxpayer. She provided services on December 21, Year 1. She billed the customer in the first week of January Year 2 but did not receive payment until February Year 2. She must include the amount received for the services in her Year 1 income. If she were on the cash basis, she would report the income in Year 2.

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Constructive Receipt

5. Income, although not actually in a taxpayer's possession, is constructively received in the taxable year during which it is credited to his or her account, set apart for him or her, or otherwise made available so that (s)he may draw upon it at any time, or so that (s)he could have drawn upon it during the taxable year if notice of intention to withdraw had been given.
   a. A check received in the mail is considered to be income on the date received, whether or not it is cashed.
   b. To determine receipt of income from securities trades, the trade date, rather than the settlement date, should be used.
   c. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.
   d. Constructive receipt applies to the cash method of accounting. Under the accrual method, income is reported in the year earned.

Claim-of-Right Doctrine

6. A taxpayer receiving payments under a claim of right and without restrictions on its use or disposition includes the payment in income in the year received even though the right to retain the payment is not yet fixed or the taxpayer may later be required to return it.
   a. If payment is not received, then the payment is not included in income.

Compensation for Services

7. All compensation for personal services is gross income. The form of payment is irrelevant.
   a. If services are paid for in property, its fair market value at the time of receipt is gross income.
   b. The amount included in income becomes the basis in the property.
   c. If services were performed for a price agreed on beforehand, the price will be accepted as the FMV of the property only if there is no evidence to the contrary.
   d. Gross income of an employee includes any amount paid by an employer for a liability (including taxes) or expense of the employee.
   e. Income from self-employment is included in gross income. The director of a corporation is considered self-employed, and all fees are included in gross income.
   f. Reported and unreported compensation (e.g., tips) is gross income.
      1) Food service employers required to allocate tip income use 8% of food and drink sales to determine the allocable amount.

(Food/drink sales × 8%) – All employee's reported tips = Amount to be allocated

Business Income from Electronic Payments

8. Taxpayers who receive payments in either of the following forms will receive a Form 1099-K, *Payments Card and Third Party Network Transactions*, from the payment settlement entity:
   a. From payment cards (e.g., credit/debit/stored-valued cards), or
   b. Through a third-party network when the total transactions exceed both $20,000 in value and 200 in volume for the year.

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Virtual Currency

9. In some environments, virtual currency, e.g., Bitcoin, operates like “real” currency (i.e., the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance), but it does not have legal tender status in any jurisdiction.
   a. Virtual currency is treated as property for U.S. federal tax purposes. General tax principles that apply to property transactions apply to transactions using virtual currency. Among other things, this means that
      1) Wages paid to employees using virtual currency are taxable to the employee, must be reported by an employer on a Form W-2, and are subject to federal income tax withholding and payroll taxes.
      2) Payments using virtual currency made to independent contractors and other service providers are taxable and self-employment tax rules generally apply. Normally, payors must issue Form 1099.
      3) The character of gain or loss from the sale or exchange of virtual currency depends on whether the virtual currency is a capital asset in the hands of the taxpayer.
      4) A payment made using virtual currency is subject to information reporting to the same extent as any other payment made in property.
   b. A taxpayer who receives virtual currency as payment for goods or services must, in computing gross income, include the fair market value of the virtual currency, measured in U.S. dollars, as of the date the virtual currency was received.

Prepaid Income

10. Generally, prepaid income is taxable in the year received whether the taxpayer is on the cash or accrual method of accounting.
    a. Prepayments for merchandise inventory are not income until the merchandise is shipped.

Bartering

11. Bartered services or goods are included in gross income at the fair market value of the item(s) received in exchange for the services.

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Assignment of Income

12. Gross income includes income attributable to a person even though the income is received by other persons. This doctrine imposes the tax on income on those who earn it, produce the right to receive it, enjoy the benefit of it when paid, or control property that is its source.

EXAMPLE 2-2	Assignment of Income
Swift, a life insurance salesperson, directs his employer to pay his commissions to his daughter. The commissions paid to Swift's daughter are gross income to Swift.	

a. The doctrine applies to income earned by personal services or derived from property.

EXAMPLE 2-3	Assignment of Income Derived from Property
Taxpayer makes a gift of interest earned on securities to her 20-year-old daughter who attends college. The interest is gross income to Taxpayer.	

b. Assignment of an income-producing asset is effective to shift the gross income to the assignee.

EXAMPLE 2-4	Assignment of Income-Producing Asset
Taxpayer gives the underlying securities to her 20-year-old daughter. Interest earned after the transfer is gross income to the daughter.	

c. Effective assignment requires that the transfer of property be complete and bona fide, with no control retained over either the property or the income it produces, and that the transfer take place before the income is actually earned.

Royalties

13. Royalties are payments to an owner from people who use a right belonging to that owner. Royalties constitute ordinary gross income and are not a return of capital.

Personal Rental Income

14. Cash or the FMV of property or services received for the use of personal property is taxable as rental income.

    a. Schedule C (not Schedule E, which is for rental of real estate) is used if the taxpayer is in the business of renting personal property. A taxpayer is in the business of renting personal property if the primary purpose for renting the property is income or profit and the taxpayer is involved in the rental activity with continuity and regularity. If rental of personal property is not a business, any income and deductions from the rental of personal property for profit must be reported on Form 1040 (Schedule 1).

Not-for-Profit Rental Income

15. If property is not rented to make a profit, under hobby loss rules, taxpayers cannot deduct their expenses.

    a. Not-for-profit rental income is reported on Form 1040 or 1040-NR. Taxpayers can include their casualty losses on the appropriate lines of Schedule A if they itemize their deductions.

    b. If rental income is more than rental expenses for at least 3 years out of a period of 5 consecutive years, taxpayers are presumed to be renting property to make a profit.

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c. If taxpayers are starting a rental activity and do not have 3 years showing a profit, they can elect to have the presumption made after they have the 5 years of experience required by the test. They may choose to postpone the decision of whether the rental is for profit by filing Form 5213.

   1) Form 5213 must be filed within 3 years after the due date of the return (determined without extensions) for the year in which the taxpayer first carried on the activity or, if earlier, within 60 days after receiving written notice from the Internal Revenue Service proposing to disallow deductions attributable to the activity.

Alimony

16. Alimony and separate maintenance payments are included in the gross income of the recipient (payee) and are deducted from the gross income of the payor for divorce decrees executed (i.e., established) prior to 2019. Alimony is not deductible by the payor and is not included in the gross income of the recipient if (a) the divorce is finalized after 2018 or (b) a pre-2019 divorce is modified after 2018 and that modification expressly provides for exclusion from income.

   a. A payment is considered to be alimony (even if paid to a third party, e.g., home mortgage) when it is

      1) Paid in cash
      2) Paid pursuant to a written divorce or separation instrument
      3) Not designated as other than alimony
      4) Terminated at death of recipient
      5) Not paid to a member of the same household
      6) Not paid to a spouse with whom the taxpayer is filing a joint return

Child Support

   b. Child support payments are an exclusion from the gross income of the recipient and are not deductible by the payor. These payments are not alimony.

      1) If the divorce or separation instrument specifies payments of both alimony and child support, and only partial payments are made, then the partial payments are considered to be child support until this obligation is fully paid, and any excess is then treated as alimony.

      2) If the payment amount is to be reduced based on a contingency relating to a child (e.g., attaining a certain age, marrying), the amount of the reduction will be treated as child support.

Property Settlement

   c. Property settlements, which are simply a division of property, are not treated as alimony.

      1) Property transferred to a spouse or former spouse incident to a divorce is treated as a transfer by gift, which is specifically excluded from gross income.

         a) “Incident to a divorce” means a transfer of property within 1 year after the date the marriage ceases or a transfer of property related to the cessation of the marriage.

         b) This exclusion does not apply if the spouse or former spouse is a nonresident alien.

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Annuity Contracts

17. The portion of amounts received under an annuity contract for which a statute does not provide an exclusion is gross income. Taxpayers are permitted to recover the cost of the annuity (the price paid) tax-free.

EXAMPLE 2-5	**Annuity Contracts**
Donna paid $1,200 for an annuity that pays $200 per month for an entire year, for a total of $2,400 ($200 × 12 months). The percentage of each payment that can be excluded is 50% ($1,200 price of annuity ÷ $2,400 total payments). Therefore, Donna may exclude $100 ($200 × 50%) of each payment from income for a total of $1,200 ($100 × 12 months).	

401(k) Plans

18. Employer contributions generally are not included in the income of the participant.

Income from Life Insurance and Endowment Contracts

19. Proceeds received due to the death of the insured are generally excluded from gross income.
    a. Interest paid on the proceeds of a policy that is paid out over time is gross income to the beneficiary.
    b. The amount excluded from gross income of an applicable policy holder with respect to an employer-owned life insurance contract is not to exceed the premiums and other amounts paid by the policyholder for the life insurance policy.
        1) The income inclusion rule does not apply to a member of the insured's family, to any individual who is the designated beneficiary of the insured under the contract (other than an applicable policy holder), to a trust established for the benefit of the insured's family or a designated beneficiary, or to the estate of the insured.
    c. If the owner of a policy transfers the policy to another person for consideration, the proceeds are taxable. However, amounts paid to acquire the policy and subsequent premium payments are treated as return of investment capital.

Debt Discharge

20. Discharge of indebtedness can result in gross income.
    a. Gross income includes the cancellation of indebtedness when a debt is canceled in whole or in part for consideration.
        1) If a creditor cancels a debt (Form 1099-C) in consideration for services performed by the debtor, the debtor must recognize income in the amount of the debt as compensation for his or her services.
        2) Income from discharge of indebtedness is reported on the same form as for any other income (i.e., Schedule C for a sole proprietor).
    b. Generally, a corporation has gross income from discharge of indebtedness when it satisfies a debt by transferring its own corporate stock to the creditor.
        1) The amount of gross income is the amount by which the principal of the debt exceeds the value of the transferred stock, plus the value of any other property transferred.
    c. If a creditor gratuitously cancels a debt, the amount forgiven is treated as a gift (the IRC generally provides for exclusion of gifts from gross income).
    d. Exceptions. Gross income does not include discharges that
        1) Occur in bankruptcy, except the stock for debt transfer as described in item 20.b. above.

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2) Occur when the debtor is insolvent but not in bankruptcy.
   a) The amount excluded is the smaller of the debt canceled or the amount of insolvency, based on the excess of liabilities over the FMV of assets on the date of debt cancellation.
3) Are related to qualified farm indebtedness.
4) Are a discharge of qualified real property business indebtedness.
5) Are related to principal residence indebtedness. (Item i. below has more information on this exception.)

e. When a taxpayer excludes discharge of indebtedness under d.1), 2), or 3) on the previous page and above, the taxpayer must reduce his or her tax attributes in the following order:
   1) NOLs and NOL carryovers
   2) General business credit
   3) Minimum tax credit
   4) Capital loss carryovers
   5) Basis of the taxpayer's property
   6) Passive activity loss and passive activity credit carryovers
   7) Foreign tax credit carryovers

   NOTE: The taxpayer may first elect to decrease the basis of depreciable property.

f. When there is a debt discharge involving real property, there are typically two separate transactions:
   1) The property is sold to the lender when the property is acquired by the lender for the debt. Form 1099-A may be issued. A gain or loss may be required to be reported on the transaction.
   2) The lender cancels the debt. Form 1099-C may be issued. Income may have to be reported as discussed above.

g. The sale of the property and the cancellation of the debt do not have to occur in the same year. If they occur in the same year, the lender will issue only a Form 1099-C.

h. When a canceled debt is a nonbusiness debt (e.g., discount for early payment of a mortgage loan), it is to be reported as cancellation of debt under Other Income on Form 1040 (Schedule 1).

EXAMPLE 2-6 Debt Cancellation

The amount of debt cancellation as a reward for early payoff of a home mortgage is cancellation of debt reported as Other Income on Schedule 1, Form 1040.

i. The Mortgage Forgiveness Debt Relief Act excludes discharges of up to $750,000 ($375,000 if married filing separately) of indebtedness, which is secured by a principal residence and which is incurred in the acquisition, construction, or substantial improvement of the principal residence.
   1) This exclusion applies to discharge of debt occurring after December 31, 2020, and before January 1, 2026.
   2) The amount excluded from gross income reduces the basis of the residence, but not below zero, and only when the taxpayer retains the residence.
   3) Principal residence has the same meaning as when used in Sec. 121.
   4) The exclusion does not apply if the discharge is due to any reason not directly related to a decline in the home's value or the taxpayer's financial condition.

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Student Loan Cancellation

j. Federal, state, and/or local government student loan indebtedness may be discharged and excluded from income until 2026 unless the loan is a private education loan or made by a tax-exempt organization. If the debt is discharged and the former student engages in certain employment (e.g., in a specified location, for a specified period, for a specified employer), the discharge is actually compensation for work provided directly to a lender. Discharge due to the death or total and permanent disability of the student may also be excluded from income.

Social Security Benefits

21. Social Security benefits are generally not taxable unless additional income is received. The gross income inclusion is dependent upon the relation of provisional income (PI) to the base amount (BA) and the adjusted base amount (ABA).
    a. PI = Adjusted gross income (AGI) + Tax-exempt interest + Excluded foreign income + Several other exclusions and deductions + 50% of Social Security benefits.
    b. BA means $32,000 if married filing jointly (MFJ), $0 if married filing separately and having lived with the spouse at any time during the tax year (MFSLT), or $25,000 for all others.
    c. ABA is the BA plus $12,000 if MFJ, $0 if MFSLT, or $9,000 for all others.

If . . .	PI ≤ BA	BA < PI ≤ ABA	PI > ABA
Then SS benefit inclusion equals . . .	0%	50%	85%

EXAMPLE 2-7 Taxable Social Security Benefits

Mr. and Mrs. Slom, both over 65 and filing jointly, received $20,000 in Social Security benefits. Additionally, they reported $30,000 of taxable interest, $15,000 of tax-exempt interest, $18,000 in dividends, and a taxable pension of $16,000. Therefore, their AGI excluding Social Security benefits is $64,000 ($30,000 taxable interest + $18,000 dividends + $16,000 taxable pension payments).

- PI is $89,000 [$64,000 AGI + $15,000 tax-exempt interest + 50% of Social Security benefits ($10,000)].
- The adjusted base amount is $44,000.
- Gross income will include $17,000 (85% of Social Security benefits) since this amount is less than 85% of the excess of PI over the ABA plus the lesser of 50% of the incremental BA ($6,000) or 50% of Social Security benefits.
- Calculation of included Social Security benefits:

1)	AGI, excluding Social Security benefits		$64,000
2)	+ Tax-exempt interest/excluded foreign income	+	15,000
3)	= Modified AGI	=	$79,000
4)	+ 50% of Social Security benefits	+	10,000
5)	= PI	=	$89,000
6)	– BA ($32,000, $25,000, or $0)	–	32,000
7)	= Excess PI (If < $0, then $0 inclusion)	=	$57,000
8)	– Incremental base amount ($12,000, $9,000, or $0)	–	12,000
9)	= Excess PI	=	$45,000
10)	Smaller of amount in line 7 or 8		$12,000
11)	50% of line 10		6,000
12)	Smaller of amount in line 4 or 11		6,000
13)	Multiply line 9 by 85%		38,250
14)	Add lines 12 and 13		44,250
15)	Social Security benefits × 85%		17,000
16)	Taxable benefits = Smaller of amount in line 14 or 15		17,000

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Railroad Retirement

22. The Railroad Retirement Board allows for participants to receive retirement annuities at age 60 with 30 or more years of service. Social Security beneficiaries are not eligible until age 62, regardless of how long they have been paying into the system.
    a. The Social Security Benefits Worksheet is used to determine whether any of the benefits are taxable.

Illegal Activities

23. Income from illegal activities is gross income.

Scholarships

24. Amounts received by an individual as scholarships or fellowships are excluded from gross income to the extent that the individual is a candidate for a degree from a qualified educational institution and the amounts are used for required tuition or fees, books, supplies, or equipment (not personal expenses, such as room and board).
    a. Gross income includes any amount received, e.g., as tuition reduction, in exchange for the performance of services, such as teaching or research.
    b. Generally, a reduction in undergraduate tuition for an employee of a qualified educational organization does not constitute gross income.
    c. Subsistence payments administered by Veteran Affairs are excluded from gross income.

EXAMPLE 2-8 Scholarships

Laura received a scholarship of $2,500, and as a condition for receiving the scholarship, Laura must serve as a part-time teaching assistant. Of the $2,500 scholarship, $1,000 represents payment for teaching. Assuming Laura only uses her scholarship for qualified education expenses, Laura will be able to exclude $1,500 from income. The $1,000 she received for teaching is taxable and must be included in income.

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Prizes and Awards

25. If the prize or award is in a form other than money, the amount of gross income is the FMV of the property. The honoree may avoid inclusion by rejecting the prize or award. Some prizes and awards are excludable.
    a. An award recipient may exclude the FMV of the prize or award from his or her gross income if
        1) The amount received is in recognition of religious, scientific, charitable, or similar meritorious achievement;
        2) The recipient is selected without action on his or her part;
        3) The receipt of the award is not conditioned on substantial future services; and
        4) The amount is paid by the organization making the award to a tax-exempt organization (including a governmental unit) designated by the recipient.
    b. A prize or award may qualify for exclusion as a scholarship.
    c. Certain employee achievement awards may qualify for exclusion from the employee's gross income as a de minimis fringe benefit.
        1) Employee achievement awards may qualify for exclusion from the recipient employee's gross income if they are awarded as part of a meaningful presentation for safety achievement or length of service and
            a) The awards do not exceed $400 (cost to employer) for all nonqualified plan awards,
            b) The awards do not exceed $1,600 (cost to employer) for all qualified plan awards, and
            c) The awards are tangible personal property. Cash and cash equivalents, including gift cards, are not tangible personal property.
        2) Awards in excess of limitations
            a) If the employer exceeds the cost limitations for the award, the employee's exclusion from income is only preserved up to the limitation. In this case, the employee must include in his or her gross income, as compensation, the amount by which the cost exceeds the limitation.

EXAMPLE 2-9 Award in Excess of Limitations

Assume that an award cost the employer $450 and its fair market value is $475. In this case, the employer's deduction is limited to $400, and the amount includible by the employee in his or her income is the difference between the item's cost and the deduction limitation ($50).

        3) A qualified plan award is an employee achievement award provided under an established written program that does not discriminate in favor of highly compensated employees.

Unemployment Benefits

26. Unemployment benefits received under a federal or state program, as well as company-financed supplemental plans, are gross income.
    a. Strike benefits received from a union are also included in income.

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Compensation for Injury or Sickness

27. Gross income does not include benefits specified that might be received in the form of disability pay, health or accident insurance proceeds, workers' compensation awards, or other "damages" for personal physical injury or physical sickness.
    a. Specifically excluded from gross income are amounts received
        1) Under workers' compensation acts as compensation for personal injuries or sickness
        2) Under an accident and health insurance policy purchased by the taxpayer even if the benefits are a substitute for lost income
        3) By employees as reimbursement for medical care and payments for permanent injury or loss of bodily function under an employer-financed accident or health plan
        4) As a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country
    b. The following are excluded from gross income regardless of whether the damages are received by lawsuits or agreements or as lump sums or periodic payments:
        1) Damages received for personal physical injury or physical sickness
        2) Payments received for emotional distress if an injury has its origin in a physical injury or physical sickness
    c. Compensation for slander of personal, professional, or business reputation is included in gross income.
    d. An in- or out-of-court settlement for lost profits in a business or court-awarded damages is included in gross income.
    e. Punitive damages received are included in gross income, even if in connection with a physical injury or physical sickness.
        1) An amount for both actual and punitive damages must be allocated.
    f. Wrongful death damages can be excluded to the extent they were received on account of a personal injury or sickness.
    g. Damages received solely for emotional distress are included in gross income. These damages include amounts received for claims, such as employment or age discrimination.
    h. Interest earned on an award for personal injuries is included in gross income.

Recovery of Medical Deductions

    i. If the taxpayer incurred medical expenses in Year 1, deducted these expenses on his or her Year 1 tax return, and received reimbursement for the same medical expenses in Year 2, the reimbursement is included in gross income on the Year 2 return to the extent of the previous deduction that was allowed on the return.

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Accident and Health Plans

28. Benefits received by an employee under an accident and health plan under which the employer paid the premiums or contributed to an independent fund are excluded from gross income of the employee.
    a. The benefits must be either
        1) Payments made due to permanent injury or loss of bodily functions or
        2) Reimbursement paid to the employee for medical expenses of the employee, spouse, or dependents.
            a) Any reimbursement in excess of medical expenses is included in income.
    b. The plan must not discriminate in favor of highly compensated executives, shareholders, or officers.
    c. Any excess reimbursement over the actual cost of medical expenses may be excluded only to the extent the taxpayer contributed to the plan.

Disability Policies

29. Proceeds from disability insurance policies are tax-free if paid for by the employee.
    a. If the employer contributed to the coverage (employer contributions are excluded from the employee's income), then the amount received must be prorated into taxable and nontaxable amounts.
    b. Payments made from a qualified trust on behalf of a self-employed person are considered employer contributions.
    c. For example, if the employer pays 75% of the insurance premiums of a disability policy, 75% of the proceeds are includible in income.

Employer-Provided Dependent Care

30. Up to $5,000 of dependent care provided by an employer is excluded from income. This includes
    a. Amounts paid directly to the taxpayer or the taxpayer's care provider for the care of the dependent
    b. FMV of employer-provided daycare facility
    c. Pre-tax contributions under a flexible spending plan

Employer-Provided Life Insurance

31. Proceeds of a life insurance policy for which the employer paid the premiums are excluded from the employee's gross income. Certain premiums paid by the employer are, however, included in the employee's gross income.
    a. The cost of group term life insurance up to a coverage amount of $50,000 is excluded from the employee's gross income.
        1) The amount included is the premiums representing excess coverage (over $50,000) less any amounts paid by the employee on the insurance policy.

Long-Term Care Coverage

32. Contributions by an employer to an employee's long-term care coverage are nontaxable employee benefits.

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Pensions

33. Pensions are most often paid in the form of an annuity. Therefore, the rules for pensions are similar to the rules for annuities. Employees are able to recover their cost tax-free.
    a. The investment in the contract is the amount contributed by the employee in after-tax dollars.
    b. Amounts withdrawn early are treated as a recovery of the employee's contributions (excluded from gross income) and of the employer's contributions (included in gross income).
        1) After all of the employee's contributions are recovered, additional withdrawals are included in gross income.
    c. Persons retired on disability before they reach minimum retirement age must report their taxable disability payments as wages.
    d. A foreign pension or annuity distribution is a payment from a pension plan or retirement annuity received from a source outside the United States. They are received from a
        1) Foreign employer,
        2) Trust established by a foreign employer,
        3) Foreign government or one of its agencies (including a foreign social security pension),
        4) Foreign insurance company, or
        5) Foreign trust or other foreign entity designated to pay the annuity.

        As with domestic pensions or annuities, the taxable amount generally is the gross distribution minus the cost (investment in the contract). Income received from foreign pensions or annuities may be fully or partly taxable, even if the taxpayer did not receive a Form 1099 or the foreign equivalent reporting the amount of the income.

Death Benefits

34. All death benefits received by the beneficiaries or the estate of an employee from, or on behalf of, an employer are included in gross income.
    a. This is for employer-paid death benefits, not to be confused with the death benefits of a life insurance plan provided by an employer.

Rental Value of Parsonage

35. Ministers may exclude from gross income the rental value of a home or a rental allowance to the extent the allowance is used to provide a home, even if deductions are taken for home expenses paid with the allowance. The exclusion is the smaller of
    a. The actual expenditures of the minister for the home,
    b. The amount designated with the employer as a rental allowance, or
    c. The fair rental value of the housing, plus the cost of utilities.

    The parsonage allowance is subject to self-employment taxes. A minister should include any offerings given directly to him or her for church-related functions (e.g., marriages).

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Combat Zone Compensation

36. Military officers may exclude compensation up to an amount equal to the highest rate of basic pay at the highest pay grade that enlisted personnel may receive (plus any hostile fire/imminent danger pay).
    a. The exclusion applies only to compensation received while serving in a combat zone or while hospitalized as a result of wounds, disease, or injury incurred in a combat zone.
    b. Military personnel below officer level (i.e., enlisted) are allowed the same exclusion without the cap.

Gifts or Inheritance

37. The IRC provides for exclusion from the gross income of the recipient the value of property acquired by gift or inheritance. A gift is a transfer for less than full or adequate consideration that results from the detached and disinterested generosity of the transferor.
    a. Gift transfers include inter vivos (between the living) gifts and gifts by bequest (of personal property by a will), devise (of real property by a will), and inheritance (under state intestacy law).
    b. Voluntary transfers from employer to employee are presumed to be compensation, not gifts.

Treasure Trove

38. Treasure trove is gross income for the tax year in which it is undisputedly in the taxpayer's possession.

EXAMPLE 2-10	Reporting of a Treasure Trove
Rich purchased an old piano for $500 15 years ago. In the current year, Rich finds $10,000 hidden in the piano. Rich must report the $10,000 as gross income in the current year.	

Gambling

39. All gambling winnings are gross income and may require reporting by the payor on Form W-2G.
    a. Gambling losses, e.g., nonwinning lottery tickets, are deductible only to the extent of winnings as an other itemized deduction.
    b. Gambling losses over winnings for the taxable year cannot be used as a carryover or carryback to reduce gambling income from other years.

Recovery of Tax Benefit Item

40. The tax benefit rule includes, in gross income, items received for which the taxpayer received a tax benefit in a prior year.

EXAMPLE 2-11	Recovery of Tax Benefit -- Bad Debt
Taxpayer writes off bad debt 5 years ago. In the current year, the debtor pays Taxpayer the principal of the debt written off, which must be included in gross income since the deduction 5 years ago reduced the tax liability.	

    a. Section 111 provides for exclusion of amounts recovered during the tax year that were deducted in a prior year to the extent the amount did not reduce income tax.

EXAMPLE 2-12	Recovery Not Providing a Tax Benefit
Taxpayer pays $2,000 state income tax and itemizes deductions. Subsequent refunds must be included. However, if Taxpayer used the standard deduction, the refund would not be included because no tax benefit from payment of state income tax was realized.	

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Reimbursements for Moving Expenses

41. Qualified reimbursements incurred by members of the military on active duty are excluded from gross income. If the reimbursement is not for qualified moving expenses, or if the taxpayer is not a member of the military, it is included in gross income.

Adoption Assistance Programs

42. Qualified adoption expenses paid to a third party or reimbursed to an employee by an employer under a written adoption assistance program are excludable from the employee's gross income.
    a. An adoption assistance program is a written plan that
        1) Benefits employees who qualify under rules set up by the employer that do not favor highly compensated employees or their dependents,
        2) Does not pay more than 5% of its payments each year to shareholders or owners of more than 5% of the stock,
        3) Provides for adequate notice to employees of their eligibility, and
        4) Requires employees to provide reasonable substantiation of qualified expenses that are to be paid or reimbursed.

Adoption Exclusion

    b. The maximum exclusion for 2022 is $14,890.
        1) The phase-out range for upper-income taxpayers is $223,410 to $263,410 for 2022.
        2) Adoption expenses must be reduced by an amount used in determining the adoption credit.
    c. For a child who is a U.S. citizen or resident, the exclusion is taken in the year the payments were made whether or not the adoption became final.
        1) For the adoption of a foreign child, the exclusion cannot be taken until the adoption becomes final.
    d. The excluded amount is not subject to income tax withholding. However, the payments are subject to Social Security, Medicare, and federal unemployment taxes.
    e. An eligible child must be under 18 years of age or must be physically or mentally incapable of self care.
    f. Qualified adoption expenses are reasonable and necessary adoption expenses, including adoption fees, court costs, attorney fees, and other directly related expenses.
        1) Expenses that are not eligible for the adoption exclusion include
            a) Costs associated with a surrogate parenting arrangement,
            b) Expenses incurred in violation of state or federal law, and
            c) Expenses incurred in connection with the adoption of a child of the taxpayer's spouse.

Reimbursement for Living Expenses

43. Insurance payments received by a taxpayer whose residence is damaged or destroyed and who must temporarily occupy another residence are excluded. This includes taxpayers with an undamaged residence who are required not to occupy the home due to a disaster.
    a. The exclusion is limited to the excess of actual living expenses over normal living expenses.

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Reimbursed Employee Expenses

44. If reimbursements equal expenses and the employee makes an accounting of expenses to the employer, the reimbursements are excluded from the employee's gross income, and the employee may not deduct the expenses (accountable plan).

    a. This rule also applies if reimbursements exceeding expenses are returned to the employer and the employee substantiates the expenses.

    b. If excess reimbursements are not returned or if the employee does not substantiate them, the reimbursements are included in the employee's gross income.

Employee Housing at an Educational Institution

45. Employee housing at an educational institution (including an academic health center) is excluded from income if the rent paid by the employee exceeds 5% of the fair market value of the housing.

Fringe Benefits

46. An employee's gross income does not include the cost of any fringe benefit supplied or paid for by the employer that qualifies as a(n)

    - No-additional-cost service
    - Qualified employee discount
    - Working condition fringe
    - De minimis fringe
    - Qualified transportation fringe
    - Qualified moving expense reimbursement (active military only)
    - Employer-provided educational assistance

No-Additional-Cost Service

a. The value of a no-additional-cost fringe benefit provided to employees, their spouses, or their dependent children by employers is excluded from gross income.

    1) A no-additional-cost fringe is a service or product that the employer offers for sale to customers in the ordinary course of business in which the employee performs substantial services.

        a) The employer must not incur any substantial additional costs in providing the service to the employee.

        b) An example is free telephone service to a phone company employee.

    2) The fringe benefits must be available to employees on a nondiscriminatory basis; e.g., benefits available only to executives are included in their gross income.

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Employee Discount

b. Certain employee discounts on the selling price of qualified property or services of their employer are excluded from gross income. “Qualified property or services” are offered in the ordinary course of business in which the employee is performing services and are purchased by the employee for his or her own use.

1) The employee discount may not exceed

a) The gross profit percentage in normal offers by the employer to customers or
b) 20% of the price offered to customers in the case of qualified services.

2) The discounts must be available to employees on a nondiscriminatory basis.

Working Condition Fringe

c. The FMV of property or services provided to an employee by an employer as a working condition fringe benefit is excludable by the employee to the extent the employer can deduct the costs as an ordinary and necessary business expense.

1) Property or services provided to an employee qualify as a working condition fringe benefit only if

a) The employee’s use of the property or services relates to the employer’s trade or business,

b) The employee would have been entitled to a business expense deduction if the property or services that were provided by the employer had been purchased by the employee, and

c) The employee maintains the required records, if any, with respect to the business use of the property or services provided by the employer.

2) The maximum value of employer-provided vehicles first made available to employees for personal use in 2022 for which the cents-per-mile valuation may be used is $56,100.

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De Minimis Fringe

d. The value of property or services provided to an employee is excludable as a de minimis fringe benefit if the value is so minimal that accounting for it would be unreasonable or impracticable.

1) The following are examples of de minimis fringes:

a) Occasional use of company copy machines
b) Occasional company parties or picnics
c) Tickets to entertainment events, if only distributed occasionally
d) Occasional taxi fare or meal money due to overtime work
e) Coffee and snacks
f) Traditional noncash holiday gifts with a small FMV
g) Tokens, vouchers, and reimbursements to cover the costs of commuting by public transit as long as the amount of reimbursement provided by the employer does not exceed $280 a month for any month (2022).

NOTE: Any cash benefit or its equivalent (e.g., use of a credit card or gift certificate) cannot be excluded as a de minimis fringe benefit under any circumstances. Season tickets to sporting events, commuting use of an employer-provided car more than once a month, or membership to a private country club or athletic facility are never excludable as de minimis fringe benefits.

2) An eating facility for employees is treated as a de minimis fringe benefit if

a) It is located on or near the business premises of the employer and
b) The revenue derived from the facility normally equals or exceeds its direct operating costs.

EXAMPLE 2-13 **De Minimis Fringe Benefit**
An employer provides meals at its own eating facility, and the direct operating costs of the facility exceed the annual revenue from the facility. Because the costs exceed revenue, the benefit is taxable to employees.

NOTE: The excess value of the meals over the fees charged to employees is excluded from employees' income.

3) The value of an on-premises athletic facility provided by an employer is generally excluded from gross income of employees.

Transportation Fringe

e. Qualified transportation fringe benefits of up to $280 per month (2022) may be excluded for the value of employer-provided parking (except residential), transit passes, and transportation in an employer-provided "commuter highway vehicle" (must seat six adults with 80% of mileage used for employee commuting when the vehicle is at least 1/2 full) between the employee's residence and place of employment.

1) Employers may offer the cash equivalent of the benefit without the loss of the $280 employee exclusion for the benefit.

2) If an employee chooses the cash option, cash amounts received are included in gross income.

3) Employees may use any combination of these exclusions (i.e., qualified parking at a subway terminal).

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Employer-Provided Educational Assistance

f. Up to $5,250 may be excluded by the employee for employer-provided educational assistance.

1) This rule does not apply to graduate teaching or research assistants who receive tuition reduction under Sec. 117(d).

2) Excludable assistance payments may not include tools or supplies that the employee retains after the course or the cost of meals, lodging, or transportation.

g. Under the CARES Act, payments made by an employer to an employee or lender (up to $5,250 per employee) between March 27, 2020, and January 1, 2026, on any qualified educational loan incurred by the employee for his or her education may be excluded by the employer from the employee's taxable wages.

Foreign-Earned Income Exclusion

47. U.S. citizens and qualifying resident aliens may exclude up to $112,000 of foreign-earned income and a statutory housing cost allowance from gross income.

a. To qualify for exclusion, the taxpayer must have foreign-earned income, a tax home in a foreign country, and be one of the following:

1) A U.S. citizen who is a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire tax year,

2) A U.S. resident alien who is a citizen or national of a country with which the United States has an income tax treaty in effect and who is a bona fide resident of a foreign country or countries for an uninterrupted period that includes an entire tax year, or

3) A U.S. citizen or a U.S. resident alien who is physically present in a foreign country or countries for at least 330 full days during any period of 12 consecutive months.

b. The $112,000 limitation must be prorated if the taxpayer is not present in (or a resident of) the foreign country for the entire year (Form 2555).

c. This exclusion is in lieu of the foreign tax credit.

d. Deductions attributed to the foreign-earned income (which is excluded) are disallowed.

e. The following table clarifies the types of income for the purposes of the foreign-earned income exclusion:

Earned Income	Unearned Income	Variable Income
Salaries and wages Commissions Bonuses Professional fees Tips	Dividends Interest Capital gains Gambling winnings Alimony Social Security benefits Pensions Annuities	Business profits Royalties Rents Scholarships and fellowships

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Foreign Housing Allowance

48. The inflation-adjusted standard cost-allowance for 2022 is $33,600 ($112,000 × 30%) for those locations not on the IRS's list of high-cost locations.

    a. Foreign housing allowances are broken into three categories:

        1) The first $17,920 ($112,000 × 16%) of any foreign housing reimbursement is includible in income,

        2) The next portion of any reimbursement up to the greater of $33,600 or the amount listed for the city on the IRS's list of high-cost locations is excludable from income (for a maximum exclusion of $15,680 in 2022), and

        3) Any reimbursement exceeding the amount in item 2) above is includible in income.

    b. The chart below can help you determine whether a taxpayer can claim either the foreign-earned income exclusion or the foreign housing exclusion.

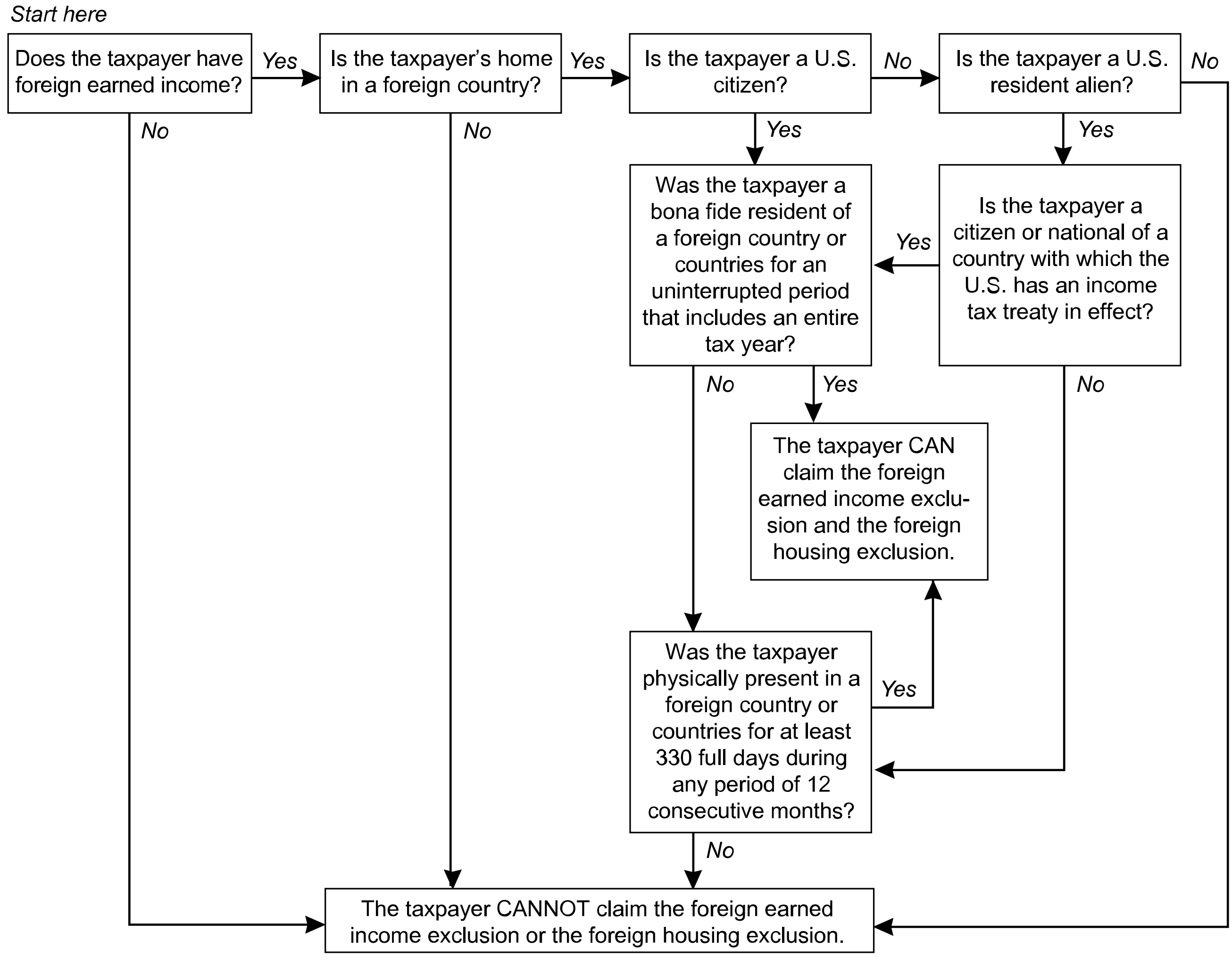

Figure 2-1

Rebate

49. A rebate to the purchaser is treated as a reduction of the purchase price. It is not included in gross income.

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Community Property Income

50. The question of tax liability for married persons filing separate returns arises frequently during discussions concerning to whom income is taxable. Several states have community property laws. These states require significantly different treatment of tax liability than in states without such laws.

    a. In the nine community property states of Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin, all property acquired by spouses **after** marriage is considered as owned by them in community, and as such, is referred to as community property.

        1) Any income from these properties is automatically considered joint or community income, and if taxpayers are filing separate tax returns, the income would be shared equally between them on their separate returns.

        2) Wisconsin has implemented a marital property act; therefore, for federal income tax purposes, it is considered a community property state.

        3) Alaska adopted an optional system whereby a couple can choose to opt in to the community property system.

    b. Property acquired **before** marriage or inherited by one spouse during marriage is considered to be that spouse's separate property.

        1) In California, Arizona, Nevada, New Mexico, and Washington, any income from these separate properties is considered separate income; thus, if the spouses are filing separately, the income would not be shared and would be reported on that spouse's separate return.

        2) Conversely, in Texas, Idaho, Louisiana, and Wisconsin, income from these separate properties is considered community income; thus, if the spouses are filing separately, the income would be shared between them on their separate returns.

    c. Section 66 of the IRC sets forth a specific rule for treatment of community income when the spouses live apart. The need for this section arose because, in community property states, each spouse is liable for one-half of the tax on income. Generally, when spouses are living apart, the spouse that earns the income will keep it.

    d. If two individuals are married to each other at some time during a calendar year but live apart for the **entire** tax year, do not file a joint return, and one or both have earned income, none of which is transferred between them, the following rules cover the reporting of income on their separate tax returns:

        1) Earned income (other than trade or business income and partnership income) is treated as income of the spouse who rendered the personal services.

        2) Trade or business income shall be treated as the gross income and deductions of the spouse carrying on such trade or business or, if such trade or business is jointly operated, treated as the gross income and deductions of each spouse on the basis of their respective distributive share of the gross income and deductions.

        3) Community income derived from the separate property of one spouse is treated as the income of such spouse.

        4) All other community income is taxed in accordance with the applicable community property law.

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Statutory Employees

51. Business taxpayers must determine the correct classification for each worker.

    a. A statutory employee is a worker who straddles the divide between being self-employed and being considered a regular employee.

        1) A statutory employee is a person who is in business for himself or herself, but who works primarily or wholly for a specific company.

    b. If workers are independent contractors under the common law rules, such workers may nevertheless be treated as employees by statute (statutory employees) for certain employment tax purposes if they fall within any one of the following four categories and meet the three conditions described under Social Security and Medicare taxes (listed in item d. below):

        1) A driver who distributes beverages (other than milk) or meat, vegetable, fruit, or bakery products, or who picks up and delivers laundry or dry cleaning, if the driver is the business agent or is paid on commission.

        2) A full-time life insurance sales agent whose principal business activity is selling life insurance or annuity contracts, or both, primarily for one life insurance company.

        3) An individual who works at home on materials or goods that the taxpayer/employer supplies and that must be returned to the taxpayer or to a person the taxpayer names if the taxpayer also furnishes specifications for the work to be done.

        4) A full-time traveling or city salesperson who works on the taxpayer's/employer's behalf and turns in orders to the taxpayer from wholesalers; retailers; contractors; or operators of hotels, restaurants, or other similar establishments. The goods sold must be merchandise for resale or supplies for use in the buyer's business operation. The work performed for the taxpayer must be the salesperson's principal business activity.

    c. Officers of exempt organizations are considered statutory employees.

    d. The employer withholds Social Security and Medicare taxes from the wages of statutory employees if all three of the following conditions apply:

        1) The service contract states or implies that substantially all the services are to be performed by them.

        2) They do not have a substantial investment in the equipment and property used to perform the services (other than an investment in transportation facilities).

        3) The services are performed on a continuing basis for the same payer.

    e. Companies report their payments to statutory employees on Form W-2, but they must check Box 13 on the W-2 for "Statutory employee."

        1) Federal income tax is not withheld from the wages of statutory employees.

        2) Federal unemployment (FUTA) taxes are paid by employers on the first and fourth categories [b.1) and b.4) above] of statutory employees but not on categories b.2) and b.3).

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f. Statutory employee earnings are reported on line 1 of Schedule C, *Profit or Loss From Business*.

   1) Employees check the box on line 1 of Schedule C.

      a) The employee does not have to fill out a Schedule SE.

   2) The employee is permitted to deduct work-related expenses on Schedule C.

   3) The employee does not combine statutory employee income and other income from a business on a single Schedule C.

      a) Two Schedule Cs must be filed, and only the income from the non-statutory-employee business will flow through to Schedule SE.

g. Statutory employees are not eligible to participate in retirement plans sponsored by the company that employs them.

   1) Statutory employees are regarded as “self-employed individuals” under Sec. 401(c)(1) and allowed to set up their own retirement plans.

   2) Full-time life insurance salespersons are deemed to be employed by the insurance company whose policies the salespersons sell for the purposes of retirement and health plans and can be covered under the insurance company retirement plan.

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STUDY UNIT THREE

GROSS INCOME II: INTEREST, SECURITIES, AND DECEDENT

This study unit is the second of two that presents items that are included in gross income, income items that are excluded from gross income, and income items for which the Internal Revenue Code provides a partial exclusion from gross income.

3.1 INTEREST INCOME

1. Interest is value received or accrued for the use of money.
   a. Interest is reported under the doctrine of “constructive receipt” when the taxpayer’s account is credited with the interest.
   b. Accrued interest on a deposit that may not be withdrawn at the close of an individual’s tax year because of an institution’s actual or threatened bankruptcy or insolvency is not includible until the year in which such interest is withdrawable.
   c. All interest is gross income for tax purposes unless an exclusion applies.
   d. Examples of taxable interest include
      1) A merchandise premium, e.g., a toaster given to a depositor for opening an interest-bearing account
         a) A noncash de minimis gift is tax-free if it does not have a value of more than $10 for a deposit of less than $5,000 or $20 for a deposit of $5,000 or more.
      2) Imputed interest on a below-market term loan

Imputed Interest

2. Loans at below-market interest rates may be the economic equivalent of a receipt of income in the amount of forgone interest. Thus, interest is imputed on below-market loans.

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Below-Market Loan

3. Below-market loans (BMLs) are categorized as demand loans or term loans.
   a. Demand loans are payable in full on demand or have indefinite maturity dates. A term loan is any loan other than a demand loan.
   b. A below-market demand loan is a loan on which interest is payable at a rate lower than the applicable federal rate. The excess of the interest that would have been payable in that year under the applicable federal rate over the actual interest payable is treated as imputed interest.
      1) The imputed interest is deemed transferred by the borrower to the lender on the last day of each year. It may be deductible by the borrower. The imputed interest is then deemed to be retransferred to the borrower by the lender. It could be either a gift, compensation (employment relationship), or a dividend (corporation/shareholder relationship) to the borrower.
   c. A below-market term loan is a loan in which the amount lent exceeds the present value of all payments due under the loan.
      1) Gift term loans. The lender is treated as transferring the excess of the amount of the loan over the present value of all principal and interest payments due under the loan, at one time, when the loan is first made. The retransfer, however, is computed at the end of each year.
      2) Non-gift term loans are treated as original issue discount. Thus, the lender has interest income over the course of the loan, and the borrower has interest expense.
   d. The imputed interest rules apply to any below-market loan that is a
      1) Gift loan
      2) Loan between a corporation and a shareholder
      3) Compensation-related loan between an employer and an employee or between an independent contractor and a person for whom the independent contractor provides services
      4) Loan that has tax avoidance as one of its principal purposes

BML Exceptions

   e. No interest is imputed for any day on which the total loans between borrower and lender are below certain amounts.
      1) If the BML (gift loan) between individuals is $10,000 or less, then there is no interest imputation unless the loan was made to acquire income-producing assets.
         a) In the case of gift loans between individuals, if the total debt is less than $100,000, the amount deemed as transferred is limited to the borrower's net investment income, and such net investment income is treated as $0 unless it exceeds $1,000.
            i) This exception allows family gift loans without penalizing the lender.
      2) If the BML between a corporation and its shareholder is $10,000 or less, there is no interest imputation unless the loan's principal purpose was tax avoidance.
      3) Certain loans without a significant tax effect are excluded from the BML rules.

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Original Issue Discount (OID)

4. OID is the excess, if any, of the stated redemption price at maturity over the issue price and is included in income based on the effective interest rate method of amortization.
   a. If there is OID of at least $10 for the calendar year and the term of the obligation exceeds 1 year, the interest income must be reported on Form 1099-OID.

EXAMPLE 3-1 Original Issue Discount

Cathy purchases a 20-year 7% bond at original issue for $10,000. The stated redemption price is $12,400, and interest is paid annually. The ratable monthly portion of OID is $10. Assume that the effective rate of interest is 10%. During the first year held, interest income is $1,000 ($10,000 × 10%) and interest received is $868 ($12,400 × 7%). The difference of $132 ($1,000 – $868) is included in income under the effective interest rate method. This amount increases the investor's book value from $10,000 to $10,132. The second year's interest is $1,013.20, and the discount amortization is $145.20.

Redemption of U.S. Savings Bonds to Pay Educational Expenses

5. If a taxpayer pays qualified higher education expenses during the year, all or a part of the interest received on redemption of a Series EE, or I, U.S. Savings Bond may be excluded.
   a. To qualify,
      1) The taxpayer, the taxpayer's spouse, or a dependent incurs tuition and fees to attend an eligible educational institution.
      2) The taxpayer's modified adjusted gross income must not exceed a certain limit. The exclusion is phased out when certain levels of modified adjusted gross income are reached.
         a) The phaseout is inflation-adjusted each year.
         b) The exclusion is reduced when AGI exceeds a threshold of $85,800 ($128,650 if a joint return) for tax years beginning in 2022. The amount at which the benefit is completely phased out is $100,800 ($158,650 if a joint return) for tax years beginning in 2022.
      3) The purchaser of the bonds must be the sole owner of the bonds (or joint owner with his or her spouse).
      4) The issue date of the bonds must follow the 24th birthday(s) of the owner(s).
      5) Married taxpayers must file a joint return.
   b. If the qualified expenses are less than the total amount of principal and interest redeemed, the interest is multiplied by the exclusion rate to determine the amount excludable. The exclusion rate is qualified expenses divided by the total of principal and interest.

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Interest on State and Local Government Obligations

6. Payments to a holder of a debt obligation incurred by a state or local governmental entity (e.g., municipal or "muni" bonds) are generally exempt from federal income tax.
   a. Exclusion of interest received is allowable even if the obligation is not evidenced by a bond, is in the form of an installment purchase agreement, or is an ordinary commercial debt.
   b. These obligations must be in registered form.
   c. The exclusion applies to obligations of states, the District of Columbia, U.S. possessions, and political subdivisions of each of them.
   d. The interest on private activity bonds, which are not qualified bonds, and arbitrage bonds is not excluded from gross income.
      1) Private activity bonds are bonds of which more than 10% of the proceeds are to be used in a private business and more than 10% of the principal or interest is secured or will be paid by private business property, or more than 5% or $5,000,000 of the proceeds are to be used for private loans, whichever is lesser.
      2) Interest on qualified private activity bonds can still be excluded if the bond is for residential rental housing developments or public facilities (such as airports or waste removal), or for a qualified mortgage or VA bond, qualified small issue bond, qualified student loan bond, qualified redevelopment bond, or qualified tax-exempt organization bond.
   e. Interest on state, local, and federal tax refunds is includible in income.
   f. Tax-exempt interest is still reported on the taxpayer's federal income tax return.
7. Recall that Form 1099-INT is the standard form used for reporting interest income. A nominee distribution is a special distribution that generally occurs when several taxpayers are entitled to interest while only one taxpayer has his or her name on the account. When interest on a single form is intended to be awarded to more than one taxpayer in this manner, the taxpayer receiving the Form 1099-INT has additional reporting responsibilities.
   a. The taxpayer must first report all interest listed on the 1099-INT, regardless of its rightful owner, on his or her Schedule B.
   b. Next, the taxpayer may subtract the interest belonging to other owners from the amount above to arrive at the total interest allocable to the taxpayer.
   c. Finally, for each other recipient of interest, the taxpayer must file two copies of Form 1099-INT: one to be furnished to the IRS, and the other to be furnished to the recipient. The taxpayer must also send a Form 1096 to the IRS with the 1099-INT indicating that the taxpayer is the "filer."

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3.2 INCOME FROM SECURITIES

Dividends

1. Amounts received as dividends are ordinary gross income.
   a. **Qualified dividends** are dividends from domestic corporations or a qualified foreign corporation and are taxed at a 0%, 15%, or 20% rate depending on filing status and taxable income. Thresholds for capital gains rates are discussed in Study Unit 9, Subunit 8. The dividends must be held for more than 60 days (90 days for preferred stock).
   b. A dividend for purposes of taxable income is, generally, any distribution of money or other property made by a corporation to its shareholders, with respect to their stock, out of earnings and profits.
   c. Any distribution in excess of earnings and profits (both current and accumulated) is considered a recovery of capital and therefore is not taxable but does reduce basis.
   d. Once basis is reduced to zero, any additional distributions are capital gain and are taxed as such.
   e. Dividends paid or credited by a credit union or savings and loan are not qualified dividends.

Mutual Funds

2. Mutual fund distributions depend upon the character of the income source.
   a. Distributions or dividends from a fund investing in tax-exempt securities will be tax-exempt interest.
   b. Capital gain distributions are treated as long term regardless of the actual period the mutual fund investment is held.
   c. If the capital gain remains undistributed, the taxpayer still must report the amount as gross income (i.e., as if the capital gain were actually received).
   d. The tax rates for long-term capital gains are 0%, 15%, 20%, 25%, and 28%.
   e. Mutual funds and REITs may retain their long-term capital gains and pay tax on them instead of distributing them.
      1) A taxpayer must treat his or her portion of these long-term capital gains as a distribution even though the taxpayer did not actually receive a distribution.

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Dividend Reinvestment Plans

3. A dividend reinvestment plan allows a taxpayer to use his or her dividends to buy more shares of stock in the corporation instead of receiving the dividends in cash.
   a. The basis of stock received as a result of a dividend reinvestment plan is fair market value, even if purchased at a discounted price.
   b. A member of a dividend reinvestment plan that lets the member buy more stock at a price equal to its fair market value must report the dividends as income.
   c. A member of a dividend reinvestment plan that lets the member buy more stock at a price of less than fair market value must report as income the fair market value of the additional stock on the dividend payment date.
   d. If the dividend reinvestment plan allows members to invest more cash to buy shares of stock at a price of less than fair market value, the member must report as income the difference between the cash the member invests and the fair market value of the stock purchased. Fair market value of the stock is determined on the dividend payment date.
   e. Any service charge subtracted from the cash dividends before the dividends are used to buy additional stock is considered dividend income.

EXAMPLE 3-2 Dividend Reinvestment Plan

A taxpayer at a company with a dividend reinvestment plan has 100 shares of stock and opts to use the cash dividend to purchase 10 more shares at a total price of $1 when the total FMV of 10 shares is $20. The transaction cost $0.50, which is deducted from the cash dividends prior to the purchase of the stock. The taxpayer's dividend income is $20.50 [(10 shares × $2 per share) + $0.50 charge].

   f. Reinvested dividends are taxable in the year paid.
   g. Reinvested dividends are added to the basis of the stock or mutual fund.
   h. Reinvested dividends are treated as ordinary dividends.

Stock Dividends

4. Generally, a shareholder does not include in gross income the value of a stock dividend (or right to acquire stock) declared on its own shares unless one of five exceptions applies:
   a. If any shareholder can elect to receive cash or other property, none of the stock dividends are excluded (shareholders may, however, receive cash for fractional shares, which is included in gross income).
   b. Some shareholders receive cash or other property, and other shareholders receive stock, which increases their proportionate interest in earnings.
   c. Some common stock shareholders receive preferred stock, while other common stock shareholders receive common stock.
   d. The distribution is on preferred stock (but a distribution on preferred stock merely to adjust conversion ratios as a result of a stock split or dividend is excluded).
   e. If a shareholder receives common stock and cash for a fractional portion of stock, only the cash received for the fractional portion is included in gross income.

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Constructive Dividends

5. Payments of personal expenses by a corporation may be considered taxable constructive dividends.

Nonstatutory Stock Option Plans

6. The term “nonstatutory stock options” refers to those options that do not qualify for the favorable tax treatment accorded options that are covered by a specific Code provision, as are qualified stock options, incentive stock options, employee stock purchase plans, and restricted stock options.
   a. Nonstatutory stock options usually are taxed at ordinary income rates at the time they are granted, the options being considered compensation for services rendered by the employee. Generally, if an option is acquired under a nonstatutory program, the employee may be taxed when
      1) The option is granted,
      2) The option is exercised,
      3) The option is sold, or
      4) The restrictions on the disposition of the option-acquired stock lapse.
   b. If an option has a readily ascertainable fair market value at the time it is granted in connection with the performance of services, the person who performed the services realizes compensation either (1) when the rights of the option become transferable or (2) when the right in the option is not subject to a substantial risk of forfeiture.
      1) If the option does not have an ascertainable fair market value at the time when it is granted, taxation occurs when the right to receive the stock is unconditional.
      2) The difference between the option cost and the fair market value of the stock at the time the optionee has a right to receive it is taxed as compensation.

EXAMPLE 3-3 Nonstatutory Stock Options

Mary Martin is granted a nonstatutory option to buy 5,000 shares of her employer’s stock at $50 per share for 5 years at the time the stock is selling for $45 per share. Three years later, Mary exercises the option when the stock is selling for $55 per share. Mary has no income, and her employer receives no deduction at the time the option is granted. Upon exercise of the option, Mary has ordinary compensation of $25,000, the bargain element, and her employer receives a corresponding deduction. Mary’s basis in the stock is $275,000. Upon a later sale, Mary generates a short- or long-term capital gain or loss with the holding period starting at the time the option is exercised.

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Incentive Stock Options

7. An employee may not recognize income when an incentive stock option is granted or exercised depending upon certain restrictions.
   a. The employee recognizes long-term capital gain if the stock is sold 2 years or more after the option was granted and 1 year or more after the option was exercised.
      1) The employer is not allowed a deduction.
   b. Otherwise, the excess of the stock's FMV on the date of exercise over the option price is ordinary income to the employee when the stock is sold.
      1) The employer may deduct this amount.
      2) The gain realized is short-term or long-term capital gain.
   c. Nonqualified stock option
      1) An employee stock option is not qualified if it does not meet numerous technical requirements to be an incentive stock option.
      2) If the option's FMV is ascertainable on the grant date,
         a) The employee has gross income equal to the FMV of the option,
         b) The employer is allowed a deduction,
         c) There are no tax consequences when the option is exercised, and
         d) Capital gain or loss is reported when the stock is sold.
      3) If the option's FMV is not ascertainable on the grant date,
         a) The excess of FMV over the option price is gross income to the employee when the option is exercised.
         b) The employer is allowed a corresponding compensation deduction.
         c) The employee's basis in the stock is the exercise price plus the amount taken into ordinary income.

EXAMPLE 3-4 Incentive Stock Option

On July 1, Year 1, Mighty, Inc., granted Henry an incentive stock option to purchase 2,000 shares of its stock for $40 a share (its FMV) for the next 5 years. On September 18, Year 2, Henry exercised the option and paid $80,000 when the stock's FMV was $53 a share. On November 23, Year 3, Henry sold the stock for $124,000. Mighty, Inc., receives no deduction upon grant, exercise, or sale. Henry reports a long-term capital gain of $44,000.

If Henry had sold the stock for $124,000 on April 15, Year 3, the special 2-year holding period would not have been met. As a result, Henry would have had $26,000 of ordinary income and $18,000 of long-term capital gain in Year 3, and Mighty, Inc., would have had compensation expense of $26,000.

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Employee Stock Purchase Plans

8. An employee stock option plan is, generally, one permitting employees to buy stock in the employer corporation at a discount. Options issued under an employee stock purchase plan qualify for special tax treatment. No income is recognized under such a plan at the time the option is granted; the recognition is deferred until stock acquired under the plan is disposed of.
   a. If stock acquired under such a plan is disposed of after being held for the required period, the employee will realize ordinary income to the extent of the excess of the fair market value of the stock at the time that option was granted over the option price. Any further gain is a capital gain.
      1) If the stock is disposed of when its value is less than its value at the time the option was granted, the amount of ordinary income will be limited to the excess of current value over the option price.
   b. An employee stock purchase plan must provide that only employees may be granted options and must be approved by the stockholders of the granting corporation within 12 months before or after the date the plan is adopted. Other conditions that must be met either by the plan or in the stock offering are
      1) The option price may not be less than the smaller of
         a) 85% of the fair market value of the stock when the option is granted or
         b) 85% of the fair market value at exercise.
      2) The option must be exercisable within 5 years from the date of grant, where the option price is not less than 85% of the fair market value of the stock at exercise.
         a) If the option price is stated in any other terms, the option must not be exercisable after 27 months from the date of the grant.
      3) No options may be granted to owners of 5% or more of the value or voting power of all classes of stock of the employer or its parent or subsidiary.
      4) No employee may be able to purchase more than $25,000 of stock in any 1 calendar year.
      5) The option may not be transferable (other than by will or laws of inheritance) and may be exercisable only by the employee to whom it is granted.
      6) If the exercise price was less than the value of the stock upon grant and the option was exercised, the employee may have compensation income (with an offsetting deduction by the employer) upon disposition, including a transfer at death.
         a) The compensation equals the lesser of fair market value at grant or at exercise, less the exercise price, and is added to the stock basis.
         b) There is no offsetting deduction by the employer.

EXAMPLE 3-5 **Employee Stock Purchase Plans -- Calculation**
Alice Nichel was given an option to buy 200 shares of Delta, Inc., stock for $55 a share when it was selling for $62. She exercised the option 2 years later when the stock was selling for $68 and sold the stock after another 3 years for $81 a share. The lesser of $68 or $62, less $55 a share, which is $7 a share, is compensation in the year of sale, i.e., $1,400. Alice's basis is increased by $7 a share to $62. Thus, her long-term capital gain is $19 per share ($81 – $62), or $3,800.

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3.3 INCOME IN RESPECT OF A DECEDENT (IRD)

The filer of a decedent's income tax and estate tax returns is required to make the appropriate allocation of income related to the decedent during the year of death. IRD is all amounts to which a decedent was entitled as gross income but that were not includible in computing taxable income on the final return. The person had a right to receive it prior to death, e.g., salary was earned or sale contract was entered into.

1. Not includible on the final income tax return of a cash-method (CM) taxpayer are amounts not received. Not includible on the final income tax return of an accrual-method (AM) taxpayer are amounts not properly accrued.

Items of Income in Respect of a Decedent

IRD	Not IRD
Salary earned prior to, but not received before, death of a CM taxpayer	**Salary** earned and accrued by AM taxpayer
Collection after death of A/R of CM taxpayer	**Collection** of A/R by AM taxpayer
Gain on sale of property by CM taxpayer received not before death	**Gain** on sale of property received before death
Rent accrued but not received before death by CM taxpayer	**Rent** received before death
Interest on installment debt accrued before death by CM taxpayer	**Interest** on installment debt accrued after death by AM taxpayer
Installment income recognized after death on contract entered into before death	**Installment** contract income recognized before death

2. IRD is reported by the person receiving the income as if the recipient were the decedent.
   a. The cash method applies to income once designated IRD.
   b. IRD received by a trust or estate is fiduciary income.
3. A right to receive IRD has a transferred basis. The basis is not stepped-up to FMV on the date of death, as is generally the case for property acquired from a decedent.

EXAMPLE 3-6 Right to Receive IRD -- Transferred Basis

Mrs. Hart had earned 2 weeks' salary of $2,000 that had not been paid when she died. As a cash-method taxpayer, her basis in the right to receive the $2,000 was $0. When her estate received the income, it had $2,000 of ordinary income because its basis in the right to receive it was also $0. Note that the $2,000 is not reported on Mrs. Hart's final return.

4. IRD has the same character and tax status it would have had in the hands of the decedent.

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5. IRD is taxable as income to the recipient and is includible in the gross estate. Double tax is mitigated by deductions.
   a. Deductions in respect of a decedent.
      1) Expenses accrued before death, but not deductible on the final return because the decedent used the cash method, are deductible when paid if otherwise deductible.
         a) They are deductible on the return of the taxpayer reporting the IRD (Form 1041).
         b) They are also deductible on the estate tax return (Form 706).
   b. Deduction for estate tax. Estate taxes attributable to IRD included in the gross estate are deductible on the recipient's income tax return.
      1) Administrative expenses and debts of a decedent are deductible on the estate tax return [Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*]. Some of them may also be deductible on the estate's income tax return (Form 1041, *U.S. Income Tax Return for Estates and Trusts*).
         a) Double deductions are disallowed.
         b) The right to deduct the expenses on Form 706 must be waived in order to claim them on Form 1041.
      2) Deduction (on Form 1041) is allowed for any excess of the federal estate tax over the amount of the federal estate tax if the IRD had been excluded from the gross estate.
   c. The tax returns that would report IRD include, but are not limited to, the following:
      1) The decedent's estate, Form 1041, if the decedent's estate receives right to the income.
      2) The beneficiary's Form 1040, if the right to income arising out of the decedent's death is passed directly to the beneficiary and is never acquired by the decedent's estate.
      3) The Form 1040 of any person to whom the decedent's estate properly distributes the income.

      NOTE: The decedent's final Form 1040 would not include IRD.

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EXAMPLE 3-7 IRD -- Return Presentation

Frank Johnson owned and operated an apple orchard. He used the cash method of accounting. He sold and delivered 1,000 bushels of apples to a canning factory for $2,000, but did not receive payment before his death. The proceeds from the sale are income in respect of a decedent. When the estate was settled, payment had not been made and the estate transferred the right to the payment to his widow. When Frank's widow collects the $2,000, she must include that amount in her return. The amount is not reported on the final return of the decedent or on the return of the estate.

EXAMPLE 3-8 IRD -- Recognized Income

Assume the same facts as in Example 3-7, except that Frank used the accrual method of accounting. The amount accrued from the sale of the apples would be included on his final return. Neither the estate nor the widow would realize income in respect of a decedent when the money is later paid.

EXAMPLE 3-9 IRD -- Recognized Gain

On February 1, George High, a cash-method taxpayer, sold his tractor for $3,000, payable March 1 of the same year. His adjusted basis in the tractor was $2,000. George died on February 15, before receiving payment. The gain to be reported as income in respect of a decedent is the $1,000 difference between the decedent's basis in the property and the sale proceeds. In other words, the income in respect of a decedent is the gain the decedent would have realized had he lived.

EXAMPLE 3-10 IRD -- Recognized Income Assignment

Cathy O'Neil was entitled to a large salary payment at the date of her death. The amount was to be paid in five annual installments. The estate, after collecting two installments, distributed the right to the remaining installments to the beneficiary. The payments are income in respect of a decedent. None of the payments were includible on Cathy's final return. The estate must include in its income the two installments it received, and the beneficiary must include in income each of the three installments as the installments are received.

EXAMPLE 3-11 IRD -- Recognized Income Assignment

Paige inherited the right to receive renewal commissions on life insurance sold by her father before his death. Paige inherited the right from her mother, who acquired it by bequest from Paige's father. Paige's mother died before she received all the commissions she had the right to receive, so Paige received the rest. The commissions are income in respect of a decedent. None of these commissions were includible on Paige's father's final return. The commissions received by Paige's mother were included in her income. The commissions Paige received are not includible in Paige's mother's income, even on her final return. Paige must include them in her income.

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STUDY UNIT FOUR

BUSINESS DEDUCTIONS

Gross income is reduced by deductions to compute taxable income. No amount can be deducted from gross income unless allowed by the Internal Revenue Code (IRC). **Above-the-line deductions** are deducted from gross income to arrive at adjusted gross income (AGI). Several deductions and credits are limited by reference to AGI. **Below-the-line deductions** are deducted from AGI to arrive at taxable income.

Business expenses for self-employed taxpayers (i.e., those filing Schedule C) are generally deductible. However, the unreimbursed business expenses of employees are nondeductible for tax years 2018 through 2025. For the reimbursed expenses of an employee, if reimbursements equal expenses and the employee makes an accounting of expenses to the employer, the reimbursements are excluded from the employee's gross income and the employer may deduct the expenses (accountable plan).

1) This rule also applies if reimbursements exceeding expenses are returned to the employer and the employee substantiates the expenses.
2) If excess reimbursements are not returned or if the employee does not substantiate them, the reimbursements are included in the employee's gross income and none of the expenses are deductible by the employee (nonaccountable plan).
    a) The employee's old 2%-of-AGI miscellaneous itemized deduction allowance is repealed for tax years 2018 through 2025.
    b) An exception to the disallowed employee deductions for business expenses remains. The exception is the above-the-line adjustment to income for certain business expenses of reservists, performing artists, and fee-basis government officials.
        i) The qualified employee (e.g., reservist, performing artist) reports these expenses on Form 2106, *Employee Business Expenses*.
    c) An employer (e.g., sole proprietor) reports the reimbursed expenses on Schedule C.
3) Reimbursements for **transportation** not exceeding $0.585/mile for January-June and $0.625/mile for July-December 2022 are considered adequately substantiated by a record of time, place, and business purpose.
4) The employer decides which plan to use, and this determines the employee's tax consequences.

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4.1 BUSINESS EXPENSES

1. A deduction from gross income is allowed for all ordinary and necessary expenses paid or incurred during a tax year in carrying on a trade or business.
   a. A sole proprietor claims these deductions on Schedule C.
2. The reporting of many of these expenses is done on Form 1099-MISC, *Miscellaneous Income*, for each payee. The following box provides some general requirements for reporting payments on Form 1099-MISC:

Reason for Payment	Minimum Amount Paid	Form Box Reported In/On
Rents	$600 (includes payments for parts and materials)	1
Prizes & Awards		3
Other Income Pmt.		3
Medical & Health*		6
Crop Insurance		9
Notional Contract		3
Attorney*		10
Fishing Boat*		5

* Typically, payments to a corporation are not reported on a Form 1099-MISC. However, these payments to corporations generally must be reported on the form.

Trade/Business and Expenses Defined

3. A trade or business is a regular and continuous activity that is entered into with the expectation of making a profit.
   a. "Regular" means the taxpayer devotes a substantial amount of business time to the activity.
4. An activity that is not engaged in for a profit is a hobby (personal).
   a. An activity that results in a profit in any 3 of 5 consecutive tax years (2 out of 7 for the breeding and racing of horses) is presumed not to be a hobby.
   b. Expenses related to a hobby are not deductible during tax years 2018 through 2025, but any income is included in gross income.
5. An expense must be **both** ordinary and necessary to be deductible.
   a. "Ordinary" implies that the expense normally occurs or is likely to occur in connection with businesses similar to the one operated by the taxpayer claiming the deduction.
      1) The expenditures need not occur frequently. In fact, an expense occurring only once in a business's lifetime may be ordinary (e.g., major litigation).
   b. "Necessary" implies that an expenditure must be appropriate and helpful in developing or maintaining the trade or business.

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c. Implicit in the "ordinary and necessary" requirement is the requirement that the expenditures be reasonable. For example, if the compensation paid to a shareholder exceeds that ordinarily paid for similar services (reasonable compensation), the excessive payment may constitute a nondeductible dividend.

1) Whether an expense is reasonable depends on each taxpayer's individual facts and circumstances. Thus, an expense may be reasonable to one taxpayer and unreasonable to another.

EXAMPLE 4-1 Ordinary and Necessary

For truck drivers, the cost of satellite radio is deductible because it provides access to weather and traffic across the country and is a standard expense in the industry.

EXAMPLE 4-2 Ordinary and Necessary

The cost for an accountant to prepare a business's financial statements is always considered an ordinary and necessary business expense.

Expense Treatment

6. **Allocation**

   a. Only the portion of an expenditure that is attributable to business activity is deductible.
   b. A reasonable method of allocation may be used. It must clearly reflect income.

7. **Compensation**

   a. Cash and the FMV of property paid to an employee are deductible by the employer.
   b. Accrual-basis taxpayers may deduct unpaid sick time, vacation time, paid time off, and bonuses that have vested by calendar year end if the employee receives payment within 2 1/2 months of year end. Payments made after the 2 1/2 month period are treated as deferred compensation.

EXAMPLE 4-3 Employee Compensation -- Property

A company distributes game consoles as compensation to each employee. Each console costs $450 and has a FMV of $600. The company takes a compensation deduction of $600 and reports income of $150 for each console given as compensation.

EXAMPLE 4-4 Employee Compensation -- Cash and PTO

In Year 1, Charlotte, an accrual-basis taxpayer, paid her employees $150,000 in cash. As of December 31, Year 1, her employees accrued $10,000 in bonuses and $20,000 in paid time off. Charlotte paid the bonuses on January 25, Year 2, and $12,000 of the accrued paid time off was used in February and paid on March 3, Year 2. None of the employees are related to Charlotte. On her Year 1 tax return, Charlotte may deduct $172,000 in compensation paid ($150,000 + $10,000 + $12,000). The $8,000 of deferred compensation is deductible when paid.

EXAMPLE 4-5 Employee Compensation -- Wages, Bonus, and Property

Allaboard Train Company paid its conductor $1,400 in cash and a scooter with a fair market value of $300 for services performed in the previous 2 weeks. Allaboard has a $150 basis in the scooter. The conductor also received a $500 bonus for his record of on-time arrivals. Allaboard may claim a deduction for $2,200 in wages ($1,400 + $300 + $500), and the employee will recognize the same amount as wage income. Notably, Allaboard will also recognize a $150 gain on the transfer of the scooter.

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c. Compensation expenses for nonemployees, e.g., payments to independent contractors, are reported to each payee on Form 1099-NEC, *Nonemployee Compensation*. As with Form 1099-MISC, there is a $600 minimum amount required to be paid before a Form 1099-NEC must be provided.

8. **Rent**

   a. Advance rental payments may be deducted by the lessee only during the tax periods to which the payments apply.

   b. Generally, even a cash-method taxpayer must amortize prepaid rent expense over the period to which it applies. The exception to this rule is if the rental contract is for 12 months or less and the payments do not extend beyond the end of the next taxable year (i.e., the 12-month rule).

EXAMPLE 4-6 **Cash-Method Prepaid Rent**
A cash-method calendar-year taxpayer leases a building at a monthly rental rate of $1,000 beginning July 1, 2022. On June 30, 2022, the taxpayer pays advance rent of $12,000 for the last 6 months of 2022 and the first 6 months of 2023. The taxpayer may deduct the entire $12,000 payment for 2022. The payment applies to the right to use the property that does not extend beyond 12 months after the date the taxpayer received this right. If the taxpayer deducts the $12,000 in 2022, there is no deduction left for 2023.

<u>**Travel**</u>

9. While away from home **overnight** on business, travel expenses are deductible. Travel expenses include transportation, lodging, and meal expenses in an employment-related context.

   a. No deduction is allowed for

      1) Travel that is primarily personal in nature except for

         a) Directly related business expenses while at the destination.

      2) The travel expenses of the taxpayer's spouse unless

         a) There is a bona fide business purpose for the spouse's presence,
         b) The spouse is an employee, and
         c) The expenses would be otherwise deductible.

      3) Attending investment meetings

      4) Travel as a form of education

      5) Commuting between home and work

EXAMPLE 4-7 **Deductible Travel Expenses**
John Jones takes a trip that includes 4 business days and 2 personal days. The entire $400 airfare expense is deductible. However, if the trip included 5 personal days and 1 business day, no portion of the airfare expense would be deductible. Any hotel expenses for the working days are deductible.

   b. **Substantiation**

      1) A taxpayer must substantiate the amount, time, place, and business purpose of expenses paid or incurred while traveling away from home.

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Transportation while Traveling

c. Actual expenses for automobile use are deductible (e.g., services, repairs, gasoline, depreciation, insurance, and licenses).

1) Alternatively, the taxpayer may deduct the standard mileage rate ($0.585/mile for January-June and $0.625/mile for July-December 2022), plus parking fees, tolls, etc.

2) If a taxpayer switches from using the standard mileage rate to actual expenses, the depreciation deduction must be computed using the straight-line method.

d. To determine a taxpayer's principal place of business for purposes of travel expenses, the location of an individual's tax home must be determined. When a taxpayer has multiple places of business, the IRS determines the principal place of business using a three-pronged test:

1) The total time spent at each place of business
2) The degree of business activity at each place of business
3) The relative income earned at each place of business

e. Taxpayers without any regular or main place of business or living location are considered itinerants (i.e., transients), and their tax home is wherever they work. Because they are never away from home, they are not allowed any travel expense deductions.

Foreign Travel

f. Traveling expenses of a taxpayer who travels outside of the United States away from home must be allocated between time spent on the trip for business and time spent for pleasure.

EXAMPLE 4-8 Deductible Foreign Travel Expenses

Scott's foreign trip is for more than a week, and he spends 35% of his time as a personal vacation. However, he spends the other 65% providing business-related services.

Only 65% of the expenses related to the time providing business services, including transportation, lodging, local travel, etc., may be deducted.

1) No allocation is required for costs of getting to and from the destination when

a) The trip is for no more than 1 week,

b) The taxpayer can establish that a personal vacation is not the major consideration, or

c) The personal time spent on the trip is less than 25% of the total time away from home.

2) A deduction for travel expenses will be denied to the extent that they are not allocable to the taxpayer's business when the trip is longer than 1 week.

Conventions

g. Convention Travel Expenses

1) Deductible

a) Travel expenses for attending a convention related to the taxpayer's business, even when the taxpayer is an employee

i) The fact that an employee uses vacation or leave time or that attendance at the convention is voluntary will not necessarily negate the deduction.

2) Not deductible

a) Expenses for a convention or meeting in connection with investments, financial planning, or other income-producing property

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3) Limited deduction

a) Expenses for conventions on U.S. cruise ships.

b) The deduction is limited to $2,000 with respect to all cruises beginning in any calendar year.

c) It applies only if

i) All ports of such cruise ship are located in the U.S. or in U.S. possessions,

ii) The taxpayer establishes that the convention is directly related to the active conduct of his or her trade or business, and

iii) The taxpayer includes certain specified information in the return on which the deduction is claimed.

h. The following chart summarizes expenses that can be deducted when traveling away from home for business purposes:

IF there are expenses for . . .	THEN the taxpayer can deduct the cost of . . .
transportation	travel by airplane, train, bus, or car between the home and the business destination. If the taxpayer was provided with a free ticket or the taxpayer was riding free as a result of a frequent traveler or similar program, the cost is zero. Travel by ship (e.g., cruise ships) for conventions has additional rules and limits.
taxi, commuter bus, and airport limousine	fares for these and other types of transportation that take the taxpayer between • The airport or station and the hotel, and • The hotel and the work location of the customers or clients, the business meeting place, or the temporary work location.
baggage and shipping	sending baggage and sample or display material between the regular and temporary work locations.
car	operating and maintaining the car when traveling away from home on business. The taxpayer can deduct the actual expenses or the standard mileage rate, as well as business-related tolls and parking. If the taxpayer rents a car while away from home on business, (s)he can deduct only the business-use portion of the expenses.
lodging and meals	lodging and meals if the business trip is overnight or long enough to require a stop for sleep or rest to properly perform duties. Meals include amounts spent for food, beverages, taxes, and related tips and have additional rules and limits.
cleaning	dry cleaning and laundry.
telephone	business calls while on the business trip. This includes business communication by fax machine or other communication devices.
tips	tips paid for any expenses in this chart.
other	other similar ordinary and necessary expenses related to the 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.

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Transportation Expenses

10. Transportation expenses for employees include taxi fares, automobile expenses, tolls and parking fees, and airfare.

    a. These expenses are treated as **travel expenses if the taxpayer is away from home overnight**. Otherwise, they are transportation expenses.

    b. The following illustration summarizes the rules for transportation expense deductions:

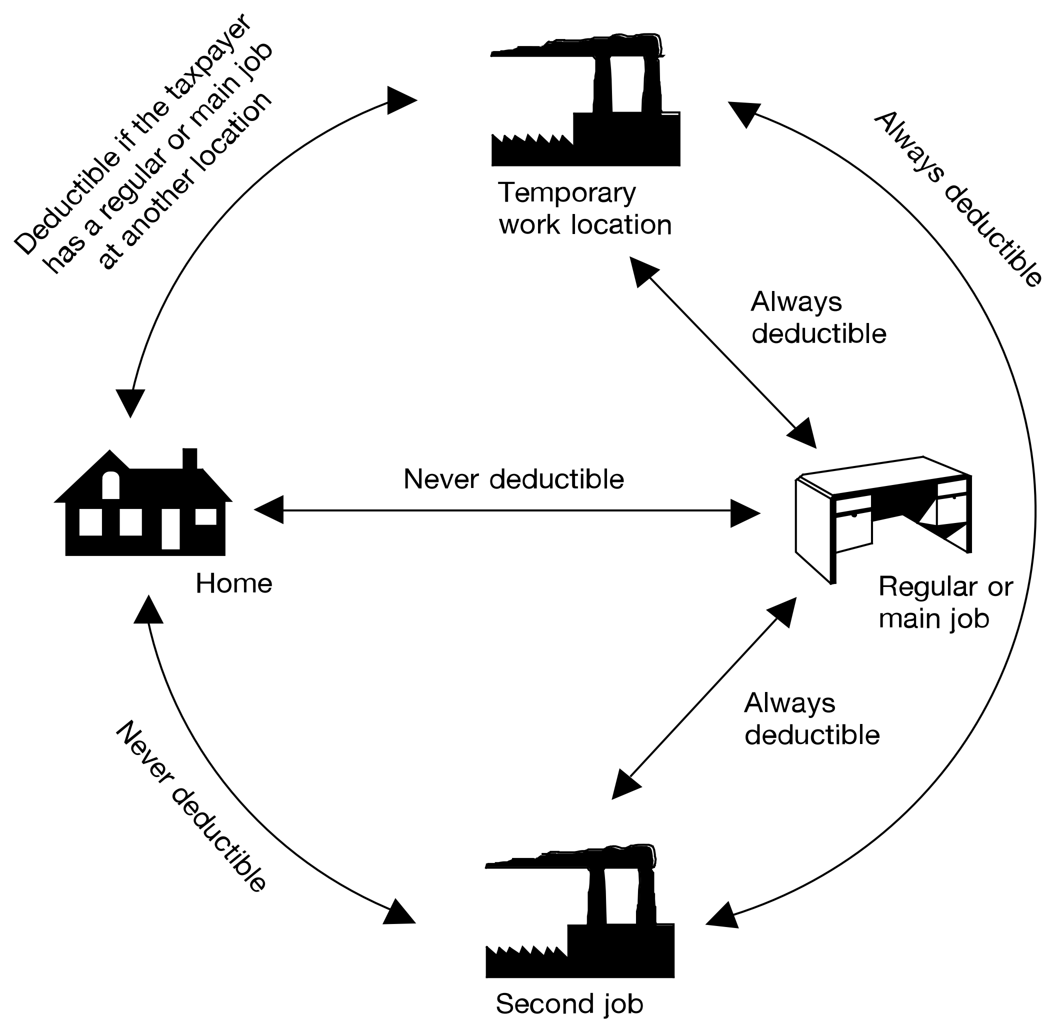

Figure 4-1

Home: The place where the taxpayer resides. Transportation expenses between the home and the main or regular place of work are personal commuting expenses.

Regular or main job: The taxpayer's principal place of business. If the taxpayer has more than one job, the taxpayer must determine which one is the regular or main job. Consider the time spent at each, the activity performed at each, and the income earned at each.

Temporary work location: A place where the work assignment is realistically expected to last (and does in fact last) 1 year or less. Unless the taxpayer has a regular place of business, the taxpayer can only deduct transportation expenses to a temporary work location **outside** of the metropolitan area.

Second job: If the taxpayer regularly works at two or more places in one day, whether or not for the same employer, the taxpayer cannot deduct the transportation costs between the home and a second job on a day off from the main job.

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c. Commuting costs are nondeductible.

1) A self-employed individual who uses an automobile to transport tools to work will be allowed a deduction for transportation expenses only if additional costs are incurred, such as renting a trailer. A deduction is allowed only for the additional costs incurred to transport the tools to work.

2) There are four exceptions to the commuting expense deduction disallowance.

a) The costs of going between one business location and another business location are generally deductible.

b) The costs of going between the taxpayer's residence and a temporary work location outside the metropolitan area where the taxpayer lives and normally works are generally deductible.

i) A work location is considered temporary if it is expected to last less than 1 year even if it ultimately lasts more than 1 year.

ii) A work location is considered indefinite if it is expected to last more than 1 year even if it ultimately lasts less than 1 year.

iii) A work location that is expected to be temporary but that becomes indefinite is considered to be indefinite from the point at which the employment time becomes indefinite.

c) If the taxpayer has one or more regular work locations away from his or her residence, (s)he may deduct commuting expenses incurred in going between the residence and a temporary work location in the same trade or business, regardless of the distance.

d) If a taxpayer's residence is the taxpayer's principal place of business within the meaning of a home office, the taxpayer may deduct commuting expenses incurred in going between the residence and another work location in the same trade or business, regardless of whether the work location is regular or temporary and regardless of the distance.

d. Actual automobile expenses may be used for the deduction, or the taxpayer may use the standard mileage rate.

1) The standard mileage rate is $0.585/mile for January-June and $0.625/mile for July-December 2022, plus parking fees and tolls. This rate applies to vehicles that are owned or leased.

EXAMPLE 4-9 Standard Mileage Rate

A self-employed taxpayer traveled 10,000 business miles in his car, paid $100 in parking fees, and $100 in tolls during the months of July through December. No business miles were driven January through June. Using the standard mileage rate, the taxpayer may deduct $6,450 [(10,000 mi. × $0.625) + $100 parking + $100 tolls].

a) This standard mileage rate cannot be used when the taxpayer owns or leases five or more cars (i.e., a fleet) that are used for business at the same time.

b) This rate also can be used for cars used for hire (e.g., taxicabs).

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2) Actual expenses must be allocated between business use and personal use of the automobile. A deduction is allowed only for the business use.

   a) Actual automobile expenses include the following: gas and oil, lubrication and washing, repairs, garage and parking fees, insurance, tires and supplies, tolls, interest expense, leasing fees, licenses, and depreciation. Remember, depreciation is only taken on the business portion of the automobile; therefore, all depreciation is deductible.

3) Recall that the unreimbursed expenses of an employee are nondeductible.

EXAMPLE 4-10 Mixed Use Automobile Expenses

Carlos uses a large truck that has been fully depreciated for his business and for personal use. In 2022, he drove 20,000 miles, of which 18,000 were for business use (90%). All business miles were driven July through December. His actual expenses were $15,000 for gas, oil, and maintenance. Carlos can deduct $13,500 ($15,000 × 90%) for business driving expenses, which exceeds the standard mileage amount of $11,250 (18,000 miles × $0.625 per mile).

11. The following factors are used to determine a taxpayer's tax home:

    a. The taxpayer performs part of his or her business in the area surrounding his or her main home and uses that home for lodging while doing business in the area.
    b. The taxpayer has living expenses at his or her main home that are duplicated because his or her business requires him or her to be away from that home.
    c. The taxpayer has not abandoned the area in which both his or her traditional place of lodging and his or her main home are located, members of his or her family live at his or her main home, or (s)he often uses that home for lodging.

EXAMPLE 4-11 Tax Home

An unmarried self-employed taxpayer lives in a rented apartment in City A and has done so for several years. The taxpayer is enrolled in a 12-month executive training program, and, after completing the course, the taxpayer will not return to City A to work. All training is away from City A. The taxpayer uses the apartment in City A frequently for personal business and socializing with friends. After completion of the course, the taxpayer moves to City B. The taxpayer does not satisfy item 11.a. above but does satisfy items 11.b. and 11.c. Therefore, for the year, the taxpayer's tax home is City A.

Insurance Expense

12. Trade or business insurance expense paid or incurred during the tax year is deductible.

    a. A cash-method taxpayer may not deduct a premium before it is paid.
    b. Prepaid insurance must be apportioned over the period of coverage.
    c. Self-employed persons may deduct from gross income 100% of amounts paid for health insurance premiums.

EXAMPLE 4-12 Life Insurance Expenses

Harry provides his employees with group-term life insurance equal to their salaries. In Year 1, Daniel, an employee, has a salary of $80,000. Daniel is 40 years old, so the monthly cost per $1,000 of protection is $0.10. Daniel includes in his income premiums for $30,000 ($80,000 – $50,000 excluded) of the group-term life insurance, which equal $36 ($30,000 ÷ $1,000 × $0.10 × 12 months) for the year.

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Bad Debts

13. A bad-debt deduction is allowed only for a bona fide debt arising from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money.
14. Worthless debt is deductible only to the extent of adjusted basis in the debt.
    a. A cash-basis taxpayer has no basis in accounts receivable and generally has no deduction for bad debts.
15. A **business bad debt** is one incurred or acquired in connection with the taxpayer's trade or business.
    a. Partially worthless business debts may be deducted to the extent they are worthless and specifically written off.
    b. A business bad debt is treated as an ordinary loss.

EXAMPLE 4-13 Business Bad Debt

Peter is a cash-basis taxpayer in the lawn care business and charges clients monthly. One of his clients stopped paying and built up a $500 bill before moving out of state. Peter is not able to deduct the bad debt because he is a cash-basis taxpayer. The unpaid bill is never included in revenue, but Peter may deduct any expenses for providing the service and attempting to collect the debt. If he was an accrual-basis taxpayer, the only difference would be that gross income and bad debt would both include the unpaid $500 bill that was written off.

16. A **nonbusiness bad debt** is a debt other than one incurred or acquired in connection with the taxpayer's trade or business.
    a. Investments are not treated as a trade or business.
    b. A partially worthless nonbusiness bad debt is not deductible.
    c. A wholly worthless nonbusiness bad debt is treated as a short-term capital loss; i.e., deductible up to any capital gains plus $3,000 of ordinary income. Any excess losses can be carried forward to future tax years.

EXAMPLE 4-14 Business vs. Nonbusiness Bad Debt

Tye is a sole proprietor who designs custom skateboards. Last year, Tye discovered that he will only be able to collect $100 of a $500 loan he gave to a supplier for business reasons due to the supplier's insolvency. This is considered a business bad debt; thus, Tye may deduct the worthless portion of the debt, or $400. However, if Tye made the same loan to a friend for personal reasons, he would not be allowed a deduction. A partially worthless nonbusiness bad debt is not deductible.

17. The **specific write-off method** generally must be used for tax purposes. The reserve method usually is used only for financial accounting purposes.

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Worthless Securities

18. Worthless corporate securities are not considered bad debts. They are generally treated as a capital loss.
19. The **loss on deposits** can occur when a bank, credit union, or other financial institution becomes bankrupt or insolvent.
    a. The individual may treat the nonbusiness account loss as a personal casualty loss, which is nondeductible.
    b. Alternatively, the individual can elect to treat the loss as a nonbusiness ordinary loss arising from a transaction entered into for profit.
    c. If no election is made, the default classification for the nonbusiness bad debt is a short-term capital loss subject to a $3,000 annual limit.

Business Gifts

20. Expenditures for business gifts are deductible. They must be ordinary and necessary.
    a. Deduction for business gift expenditure is disallowed unless the taxpayer substantiates, by adequate records, the following:
        1) Amount (cost) of the gift,
        2) Date of the gift,
        3) Description of the gift,
        4) Business purpose of the gift, and
        5) Business relation of the recipient to the taxpayer.
    b. Deduction is limited to $25 per recipient per year for excludable items.
        1) The $25 limit does not apply to incidental (e.g., advertising) items costing (the giver) not more than $4 each, and other promotional materials including signs and displays.
        2) Spouses are treated as one taxpayer, even if they file separate returns and have independent business relationships with the recipient.

Employee Achievement Awards

21. Up to $400 of the cost of employee achievement awards is deductible by an employer for all nonqualified plan awards.
    a. An employee achievement award is tangible personal property awarded as part of a meaningful presentation for safety achievement or length of service.
        1) Tangible personal property does not include cash, cash equivalents, gift cards/ coupons/certificates, vacations, meals, lodging, event tickets (e.g., theater, sporting), stocks, bonds, and other securities.
22. Deduction of qualified plan awards is limited to $1,600 per year.
    a. A qualified plan award is an employee achievement award provided under an established written program that does not discriminate in favor of highly compensated employees.
        1) If the average cost of all employee achievement awards is greater than $400, it is not a qualified plan award.

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Depreciation

23. Deduction is permitted for obsolescence or wear and tear of property used in a trade or business. Depreciation is discussed in Study Unit 9, Subunit 6.

Start-Up Costs

24. Taxpayers can deduct up to $5,000 of start-up costs and $5,000 of organizational expenditures in the taxable year in which the business begins.
    a. Examples of start-up costs include the costs of investigating the creation or acquisition of an active trade or business, to prepare to enter into the trade or business, to secure suppliers and customers, and to obtain certain supplies and equipment (noncapital).
    b. Any start-up costs or organizational expenditures in excess of the $5,000 limit are capitalized and amortized proportionally over a 15-year period beginning with the month in which the active trade or business begins. The total start-up or organizational costs deducted for the first year equal the sum total of the $5,000 limit and the amortized amount allocated to the first year.
        1) These amounts are reduced, but not below zero, by the cumulative cost of the start-up costs or organizational expenditures that exceed $50,000.

       NOTE: This phaseout is computed separately for start-up costs and organizational costs.
    c. A taxpayer is deemed to have made the election; therefore, a taxpayer is not required to attach a separate statement to the return.

Reforestation Cost

25. Amounts paid or incurred for reforestation may be expensed in the current year up to $10,000. Any remaining balance is to be amortized over a period of 7 years.

Vacant Land

26. Interest and taxes on vacant land are deductible.

Demolition

27. If a structure is demolished, demolition costs, undepreciated (remaining) basis, and losses sustained are not deductible. They are allocated to the land.

Abandoned Assets

28. A loss is deductible in the year the assets are actually abandoned with no claim for reimbursement.
    a. The loss equals the adjusted basis in the abandoned property.

COGS

29. Cost of goods sold (COGS) is deducted before arriving at gross income.

Sales – COGS = Gross income

Medical Reimbursement Plans

30. The cost of such a plan for employees is deductible by the employer.

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Political Contributions

31. Contributions to a political party or candidate and, generally, lobbying expenses are not deductible.

EXAMPLE 4-15	**Nondeductible Political Contributions**
Craft Store pays for advertising in the program for a political party's convention. Proceeds are used for the party's activities. The expense is a political contribution, which is not deductible.	

a. Lobbying activity equates to appearances before and communications with any council or similar governing body with respect to legislation of direct interest to the taxpayer.

b. Up to $2,000 of direct cost of lobbying activity at the state or federal level is deductible.

   1) If total direct costs exceed $2,000, this de minimis exception is entirely unavailable.

Debt of Another

32. Payment of a debt of another party is generally not ordinary for a trade or business and thus is not deductible.

   a. A legal obligation or definite business requirement renders the payment deductible, e.g., if required by suppliers to stay in business.

Intangibles

33. The cost of intangibles must generally be capitalized.

   a. Amortization is allowed if the intangible has a determinable useful life, e.g., a covenant not to compete or if a code section specifically so provides.

Tax-Exempt Income

34. An expenditure related to producing tax-exempt income is not deductible, e.g., interest on a loan used to purchase tax-exempt bonds.

Public Policy

35. A trade or business expenditure that is ordinary, necessary, and reasonable may be nondeductible if allowing the deduction would frustrate public policy.

   a. Examples are

      1) Fines and penalties paid to the government for violation of the law
      2) Illegal bribes and kickbacks
      3) Two-thirds of damages for violation of federal antitrust law
      4) Expenses of dealers in illegal drugs

         a) However, adjustment to gross receipts is permitted for the cost of merchandise.

EXAMPLE 4-16	**Tax Deductible Fines**
Percy signed a contract to sell Penny 100 widgets for $2,500 to be delivered on April 1. Percy must pay a $10 fine per unit for each week the shipment is late. In March, Percy received and accepted a $5,000 order from Marc for the 100 widgets that were set aside for Penny. Because Percy decided to sell the 100 widgets to Marc, he was only able to deliver 50 widgets to Penny on April 1 and delivered the remaining 50 widgets on April 5. Percy paid Penny a $500 late shipment fine. The $500 fine is tax deductible because it was a business decision and not paid to a government for violating a law.	

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Impairment-Related Expenses

36. Expenses of a handicapped individual for attendant care services at his or her place of employment and/or other expenses connected to his or her place of employment necessary for the individual to work are deductible expenses. The expenses are claimed under other itemized deductions for the individual's return.

Miscellaneous Expenses

37. Miscellaneous ordinary and necessary business expenses are deductible.
    a. Examples include costs of office supplies, advertising, professional fees, and bank fees.

Withdrawal Penalties

38. Penalties on the early withdrawal of interest income are deductible as above-the-line deductions.

Business Use of Home

39. Employers (who reimburse) and the self-employed may deduct expenses incurred for the use of a person's home for business purposes but only if strict requirements are met.
    a. The portion of the home must be used exclusively and regularly as
        1) The principal place of business for any trade or business of the taxpayer;
        2) A place of business that is used by patients, clients, or customers in the normal course of the taxpayer's trade or business;
        3) A separate structure that is not attached to the dwelling unit that is used in the taxpayer's trade or business;
        4) Administrative or management activities;
        5) Storage of inventory or product samples used in a trade or business of selling products at retail or wholesale;
        6) Rental use; or
        7) A day care facility.
    b. The exclusive-use test is strictly applied. Any personal use of the business portion of the home by anyone results in complete disallowance of the deductions. There are two exceptions to the exclusive-use test:
        1) Retail/wholesale. A retailer or wholesaler whose **sole** location of his or her business is his or her home need not meet the exclusive-use test.
            a) The ordinary and necessary business expenses allocable to an identifiable space used regularly for inventory or product sample storage by a taxpayer in the active pursuit of his or her trade or business are deductible.
        2) Day care. If the business portion of a home is used to offer qualifying day care, the exclusive-use test need not be met. The home office deduction may be taken for the portion of the home that is used to provide day care on a regular basis for children, the elderly over 65 years of age, and/or those who are physically or mentally unable to care for themselves, even if the space is used for nonbusiness purposes.

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EXAMPLE 4-17	**Trade or Business Requirement**
A taxpayer uses part of their home exclusively and regularly to read financial periodicals and reports, clip bond coupons, and carry out similar activities related to the taxpayer's own investments. The taxpayer does not make investments as a broker or dealer. These activities do not qualify as part of a trade or business, and disqualify the home space for a deduction.	

c. If the taxpayer has more than one business location, the primary factor in determining whether a home office is a taxpayer's principal place of business is the relative importance of the activities performed at each business location.

1) If the primary location cannot be determined by the relative importance test, then the amount of time spent at each location will be used.

d. A home office qualifies as a "principal place of business" if used by the taxpayer to conduct administrative or management activities of the taxpayer's trade or business and there is no other fixed location where the taxpayer conducts such activities. Activities that qualify as administrative or management are billing customers, clients, or patients; keeping books and records; ordering supplies; setting up appointments; and forwarding orders or writing reports.

EXAMPLE 4-18	**Principal Place of Business**
Brian owns Fisher Company, which does not have a physical office and has five sales people. Once a month, Brian meets with the sales team in a spare bedroom in his house that is used as a conference room. The only activities that occur in the conference room are the monthly meetings and administrative functions for Fisher Company. The conference room is treated as a home office.	

e. Deduction for business use is limited to

1) Gross income derived from the trade or business for which the home office is used, minus

2) Deductions allocable to the home, allowed regardless of business or personal use, e.g., interest or taxes, minus

3) Deductions allocable to the trade or business for which the home office is used that are not home office expenses, e.g., employee compensation.

EXAMPLE 4-19	**Home Office Deductions Allocable to the Home**
Toni has $10,000 of net income from a business activity conducted in a home office. The home office makes up 30% of the square footage of the home. Toni has mortgage interest and property taxes on the home of $20,000. Toni has $5,000 in insurance and utilities on the home. The maximum amount of depreciation deduction on the home office is $2,500 {$10,000 – [30% × ($20,000 + $5,000)]}.	

NOTE: Keep in mind, the Schedule C deduction is still only the portion allocated to the business use of the home. The remaining expense, if otherwise deductible (e.g., mortgage interest), is an itemized deduction on Schedule A.

EXAMPLE 4-20	**Home Office Deductions for Non-Home Office Expenses**
Tammy has $32,000 of gross income from a business activity conducted in a home office. She may deduct $10,000 of mortgage interest and property taxes allocable to the home office as personal expenses. Tammy has $6,000 of home office expenses other than depreciation, $3,500 in depreciation, and $15,000 of business deductions that are not home office expenses. Only $1,000 [$32,000 – ($10,000 + $15,000 + $6,000)] of the depreciation is deductible as home office expenses.	

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f. Any currently disallowed amount is deductible in succeeding years, subject to the same limitations.

g. A simplified option allows taxpayers to claim $5 per square foot of home office space up to 300 ft^2, for a maximum deduction of $1,500. Individuals using this simplified method can claim all of their allowable mortgage interest and real estate taxes on Schedule A, even for the portion attributable to business use.

h. The deduction is not available to employees because of the repeal of the 2%-of-AGI miscellaneous itemized deductions for tax years 2018 through 2025.

EXAMPLE 4-21 Not a Qualified Home Office

Kathleen is employed as a teacher. She is required to teach and meet with students at the school and to grade papers and tests. The school provides her with a small office where she can work on her lesson plans, grade papers and tests, and meet with parents and students. The school does not require her to work at home. Kathleen prefers to use the office she has set up in her home and does not use the one provided by the school. She uses this home office exclusively and regularly for the administrative duties of her teaching job. Kathleen cannot claim a deduction for the business use of her home because (1) the home office is not for the convenience of the employer and (2) the home office deduction is not available to employees.

4.2 BUSINESS MEALS

Limit on Meals

1. The amount deductible for business meal expenses, provided to a current or potential business customer, client, consultant, or similar business contact, is 100% of the actual expense for food or beverages provided by a restaurant between December 31, 2020, and January 1, 2023.

   a. The limit also applies to the taxpayer's own meals.

   b. Related expenses, such as taxes, tips, and parking fees, but not transportation to and from a business meal, are also fully deductible.

   c. There is a 50% limit to deductible amounts for other allowable meal expenses (i.e., meals not provided by a restaurant) and related expenses.

   d. A taxpayer that properly applies the rules of Rev. Proc. 2019-48 may treat the meal portion of a per diem rate or allowance paid or incurred after December 31, 2020, and before January 1, 2023, as being attributable to food or beverages provided by a restaurant.

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e. The IRS has denied deductions for any meal expense over $75 for which the claimant did not provide substantiating evidence: documented dates, amounts, location, purpose, and business relationship.

EXAMPLE 4-22	Substantiation of a Business Meal
Lucy, an event planner, took her client Genie to dinner to discuss an upcoming art event and paid $100, including the tip. To provide sufficient documentation, Lucy saved her receipt showing the tip amount and wrote on the back of the receipt that she had dinner with Genie to discuss the art event. Later, she added the information to her business calendar and filed the receipt.	

f. For employees subject to Department of Transportation hours-of-service rules (e.g., over-the-road truck drivers), the deductible meals percentage is 80%.

g. Additionally, the meal must not be lavish or extravagant; i.e., it must be reasonable based on facts and circumstances.

2. Meal expenses are not deductible if neither the taxpayer nor an employee of the taxpayer is present at the meal.

3. Restaurants. The term “restaurant” means a business that prepares and sells food or beverages to retail customers for immediate consumption, regardless of whether the food or beverages are consumed on the business’s premises. However, a restaurant does not include a business that primarily sells prepackaged food or beverages not for immediate consumption, such as a grocery store; specialty food store; beer, wine, or liquor store; drug store; convenience store; newsstand; or vending machine or kiosk.

Entertainment

4. Most entertainment expenses are **nondeductible**.

   a. However, entertainment expenses for recreational, social, or similar activities primarily for the benefit of employees are 100% deductible. For example, the expenses for an annual company holiday party would be 100% deductible.

   b. If otherwise deductible meals occur at a nondeductible entertainment event, the meal expense must be separately stated in order to be deductible.

Ownership of Facility

5. Expenses in connection with the use of an entertainment facility that the taxpayer owns are not deductible as a business expense.

   a. Any property that a taxpayer rents, owns, or uses for entertainment purposes is considered to be an entertainment facility.

   b. Swimming pools, cars, hotel suites, and yachts are all examples of entertainment facilities.

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6. Now that most of the business deductions have been explained in Subunits 4.1 and 4.2, the following two tables provide guidance on how to document the deductions:

IF there are expenses for . . .	**THEN records must be kept that show details of the following elements . . .**			
	Amount	**Time**	**Place or Description**	**Business Purpose 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, tips, etc.	Dates taxpayer left and returned for each trip and number of days spent on business.	Destination or area of 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 business use began, 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.	The business destination.	Purpose: Business purpose for the expense. Relationship: N/A

			Odometer Readings			**Expenses**	
Date	**Destination** (City, Town, or Area)	**Business Purpose**	**Start**	**Stop**	**Miles this trip**	**Type** (Gas, oil, tolls, etc.)	**Amount**
	Weekly Total						
Total Year-to-Date							

7. The following is a summary of the rules explained on the previous pages:

General rule	A taxpayer can deduct ordinary and necessary expenses to provide a meal to a client, customer, or employee.
Definitions	• An **ordinary** expense is one that is common and accepted in the taxpayer's field of business, trade, or profession. • A **necessary** expense is one that is helpful and appropriate, although not necessarily required, for the business.
Other rules	• The taxpayer cannot deduct meal expenses that are lavish or extravagant under the circumstances. • **Entertainment** expenses are nondeductible. ▪ Entertainment includes any activity generally considered to provide entertainment, amusement, or recreation and includes meals provided to a customer or client that are not separately stated.

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STUDY UNIT FIVE

ABOVE-THE-LINE DEDUCTIONS AND LOSSES

Deductions to compute taxable income are heavily tested on the EA exam. The business expense deductions explained in this study unit are also tested in the corporate context. You should focus on classifying each deduction as an above-the-line or itemized deduction and be able to apply each deduction limit without hesitation.

Gross income is reduced by deductions to compute taxable income. No amount can be deducted from gross income unless allowed by the Internal Revenue Code (IRC). Above-the-line deductions are deducted from gross income to arrive at adjusted gross income (AGI).

Several deductions and credits are limited by reference to AGI. Below-the-line deductions are deducted from AGI to arrive at taxable income. Above-the-line deductions are also referred to as deductions to arrive at AGI and as deductions for AGI.

5.1 EDUCATOR EXPENSES

1. Primary and secondary school educators may claim an above-the-line deduction for up to $300 in 2022 for unreimbursed expenses paid or incurred for books and supplies used in the classroom. Qualified expenses also include amounts paid or incurred after March 12, 2020, for personal protective equipment, disinfectant, and other supplies used for the prevention of the spread of coronavirus. Each taxpayer (educator) on a joint return may deduct up to $300.
   a. Books, supplies, computer equipment (including related software and services) and other equipment, and supplementary materials used in the classroom qualify for the deduction.
   b. An eligible educator is an individual who, for at least 900 hours during a school year, is a kindergarten through grade 12 teacher, instructor, counselor, principal, or aide.
   c. The term “school” is defined as one that provides elementary or secondary education, as determined under state law.

EXAMPLE 5-1 Reimbursable Educator Expenses

Tommy and Lily Jones, a married couple, are both teachers in their local school system. They each spend more than $300 in unreimbursed expenses for books and supplies used in the classroom. They are allowed an above-the-line deduction of $600 on their tax return. The deduction is taken in Part II of Schedule 1, Form 1040.

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5.2 HEALTH SAVINGS ACCOUNT

1. A Health Savings Account is a tax-exempt trust or custodial account set up with a U.S. financial institution in which money can be saved exclusively for future medical expenses. This account must be used in conjunction with a high-deductible health plan.
   a. The amount that may be contributed to a taxpayer's Health Savings Account depends on the nature of his or her coverage and his or her age.
      1) For self-only coverage, the taxpayer or his or her employer can contribute up to $3,650 ($4,650 for taxpayers aged 55-64).
      2) For family coverage, the taxpayer or his or her employer can contribute up to $7,300 ($8,300 for taxpayers aged 55-64).
      3) Contributions are not allowed for taxpayers aged 65 and over or for taxpayers enrolled in Medicare.
   b. The taxpayer is not required to have the insurance for the whole year to contribute the full amount.
   c. A taxpayer can contribute up to the annual healthcare deductible but no more than the maximum.
   d. Contributions to a Health Savings Account for 2022 include contributions made until April 15, 2023.
   e. The taxpayer cannot be claimed as a dependent on another taxpayer's return.

5.3 SELF-EMPLOYMENT DEDUCTIONS

1. **Self-Employment Tax**
   a. A self-employed person is allowed a deduction for the employer's portion of the FICA taxes paid to arrive at his or her AGI. The deduction for the employer's share is equal to 50% of the self-employment tax or
      1) 6.2% of the first $147,000 of net self-employment income (per b. below) plus
      2) 1.45% of net self-employment income (no cap).
   b. Net self-employment income is total net self-employed profits multiplied by 92.35%.
   c. The 0.9% additional Medicare tax is on the employee's portion of FICA taxes. Therefore, the 0.9% tax is not deductible.

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2. **Self-Employed SEP, SIMPLE, and Qualified Plans**
   a. A self-employed individual can deduct specified amounts paid on his or her behalf to a qualified retirement or profit-sharing plan, such as a SEP or SIMPLE plan.
   b. The most common self-employed retirement plan used is a SEP (Keogh) plan.
      1) The maximum annual contribution is limited to the lesser of 25% of the self-employed earnings or $61,000 (indexed for inflation).
      2) Self-employed earnings are reduced by the deductible part of self-employment taxes.
      3) Contributions to the plan are subtracted from net earnings to calculate self-employed earnings, creating a circular computation. For convenience, a standard rate of 20% is used to calculate the allowed deduction.

EXAMPLE 5-2 Self-Employed SEP Qualified Plan Deduction

Alice has business income of net self-employed earnings of $125,000 before the deductible part of self-employment taxes of $9,563. The maximum annual deduction is calculated as follows:

($125,000 – $9,563) × 20% = $23,087

   c. Another option for a self-employed taxpayer is a Savings Incentive Match Plan for Employees (SIMPLE).
      1) Self-employed taxpayers may make both employer contributions and elective employee contributions.
      2) Employee contributions are considered deferred compensation and are limited to $14,000 in 2022.
      3) An employer match of up to 3% of self-employed earnings may be deducted as an above-the-line deduction.
3. **Self-Employed Health Insurance Deduction**
   a. Self-employed individuals can deduct 100% of payments made for health insurance coverage for the individual, his or her spouse, and dependents.
   b. The deduction is limited to the taxpayer’s earned income derived from the business for which the insurance plan was established.
   c. No deduction is allowed when the taxpayer is eligible for an employer-sponsored plan by his or her employer or an employer of a spouse or dependent.

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5.4 ALIMONY

For divorces executed before 2019, alimony and separate maintenance payments are gross income to the recipient and deductible by the payor. For divorces executed after 2018, alimony is nondeductible to the payor and not included in the gross income of the recipient. Therefore, the rules explained in the rest of this subunit apply to pre-2019 divorces only.

Qualified Payments

1. Requirements for Qualified Alimony Payments
   a. Payment is made in cash or equivalent.
   b. Payment is received by or on behalf of a spouse under a divorce or separation agreement.
      1) Payments made to a third party on behalf of a spouse at the written request of the payee spouse will qualify as alimony.
         a) Common examples of payments made on behalf of the payee spouse include mortgage payments, rent, medical costs, and education.
      2) Payments may not be for upkeep of property owned by the payor, such as when the payor has retained ownership of the house and pays the mortgage.
   c. The payee spouse and payor spouse must not be members of the same household at the time of payments.
   d. The payor spouse is not liable for any payments after the death of the payee spouse.
   e. The spouses must not file joint returns with each other.

Jointly Owned Home

2. If the divorce or separation instrument states that the taxpayer must pay expenses for a home owned by the taxpayer and his or her spouse or former spouse, some of the payments may be alimony.

Mortgage Payments

   a. If required to pay all the mortgage payments (principal and interest) on a jointly owned home, and the payments otherwise qualify as alimony, a taxpayer can deduct one-half of the total payments as alimony.
      1) If deductions are itemized and the home is a qualified home, a taxpayer can claim half of the interest in figuring deductible interest.
   b. The spouse must report one-half of the payments as alimony received.
      1) If the spouse itemizes deductions and the home is a qualified home, (s)he can claim one-half of the interest on the mortgage in figuring deductible interest.

Taxes and Insurance

   c. If required to pay all the real estate taxes or insurance on a home held as tenants in common, a taxpayer can deduct one-half of these payments as alimony.
      1) The spouse must report one-half of these payments as alimony received.
      2) If a taxpayer and his or her spouse itemize deductions, each can claim one-half of the real estate taxes and none of the home insurance.
   d. If the home is held as tenants by the entirety or joint tenants, none of the payments for taxes or insurance are alimony.
      1) If a taxpayer itemizes deductions, (s)he can claim all of the real estate taxes and none of the home insurance.

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e. The following table reiterates the information on the previous page for jointly owned homes:

Expenses for a Jointly Owned Home

IF the taxpayer must pay all of the . . .	AND the taxpayer's home is . . .	THEN the taxpayer can deduct and the spouse (or former spouse) must include as alimony . . .	AND the taxpayer can claim as an itemized deduction . . .
mortgage payments (principal and interest)	jointly owned	half of the total payments	half of the interest as interest expense (if the home is a qualified home).
real estate taxes and home insurance	held as tenants in common	half of the total payments	half of the real estate taxes and none of the home insurance.
	held as tenants by the entirety or in joint tenancy	none of the payments	all of the real estate taxes and none of the home insurance.

<u>Child Support</u>

3. Child support payments and any part of an alimony payment designated as child support are not deductible.
   a. If any amount of an alimony payment is to be reduced based on a contingency relating to a child, such as the attainment of a certain age or graduation, the amount of the specified reduction is treated as child support.
   b. If the divorce or separation instrument specifies payments of both alimony and child support, and only partial payments are made, then the partial payments are considered to be child support until this obligation is fully paid.
      1) Any excess is treated as alimony.

EXAMPLE 5-3 **Child Support and Alimony**
Stephen and Chelsea were divorced in 2018 and agreed that Chelsea would pay Stephen $4,500 as part of the divorce agreement. These payments are to be made in cash and discontinued upon Stephen's death. Because the two no longer live together and do not file a joint return, these amounts would typically be treated as alimony. However, an additional provision states that $1,000 of the payment will stop upon their son Daniel reaching age 18. Accordingly, this amount is presumed to be child support and only $3,500 of the payment is deductible as alimony. Additionally, for divorces after 2018, alimony payments are not deductible by the payor or includible in income of the payee. If these two taxpayers wanted to switch to the newer treatment, the modification of the pre-2019 divorce must expressly provide for non-taxability in order to be excluded from the payee's income and nondeductible by the payor.

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5.5 RETIREMENT SAVINGS (IRA) CONTRIBUTIONS

Subject to certain qualifying rules and limitations, an individual who is not an active participant in an employer-maintained retirement plan may make contributions to an IRA that are fully deductible, up to the lesser of $6,000 ($7,000 for taxpayers age 50 or older) or 100% of his or her includible compensation. Contributions must be made by the due date of the return, without regard to extensions, to qualify for return year.

1. Compensation includes earned income but not pensions, annuities, or other deferred compensation distributions.

EXAMPLE 5-4 IRA Contribution Limit

Susan occasionally performs duties as an employee of ABC Corporation but does not participate in the employer-sponsored retirement plan. Because Susan only made $4,750 in the previous year, she may not contribute more than her earnings to her IRA. In the following year, if Susan earns over $6,000, she will only be permitted to contribute $6,000.

2. An additional $6,000 may be contributed to the IRA for the taxpayer's nonworking spouse if a joint return is filed.
   a. The combined IRA contributions by both spouses may not exceed their combined compensation for the year.

<u>Phaseout</u>

3. If the taxpayer is an active participant in an employer-sponsored retirement plan and has modified AGI of over $109,000 in 2022 ($68,000 in 2022 for single/head of household taxpayers and $0 for taxpayers married filing separately), the IRA maximum ($6,000) deduction is proportionately reduced over a phaseout range (fully phased out at $129,000).
   a. An individual is not labeled an active plan participant due to the status of that individual's spouse.
   b. If an individual's spouse is an active plan participant, that individual's deductible contribution will be phased out when modified AGI is between $204,000 and $214,000.
   c. The amount deducted is the lesser of contribution made or the phased-out (i.e., limited) maximum deduction.
   d. The following table is a summary of the effect of modified AGI on deduction if covered by a retirement plan at work:

<table>
<tr><th>IF the taxpayer's filing status is . . .</th><th>AND the taxpayer's modified AGI is . . .</th><th>THEN the taxpayer can take . . .</th></tr>
<tr><td rowspan="3">single or
head of household</td><td>$68,000 or less</td><td>a full deduction.</td></tr>
<tr><td>more than $68,000
but less than $78,000</td><td>a partial deduction.</td></tr>
<tr><td>$78,000 or more</td><td>no deduction.</td></tr>
<tr><td rowspan="3">married filing jointly or
qualifying widow(er)</td><td>$109,000 or less</td><td>a full deduction.</td></tr>
<tr><td>more than $109,000
but less than $129,000</td><td>a partial deduction.</td></tr>
<tr><td>$129,000 or more</td><td>no deduction.</td></tr>
<tr><td rowspan="2">married filing separately</td><td>less than $10,000</td><td>a partial deduction.</td></tr>
<tr><td>$10,000 or more</td><td>no deduction.</td></tr>
</table>

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e. The following table is a summary of the effect of modified AGI on deduction if **not** covered by a retirement plan at work:

IF the taxpayer's filing status is . . .	**AND** the taxpayer's modified AGI is . . .	**THEN** the taxpayer 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	$204,000 or less	a full deduction.
	more than $204,000 but less than $214,000	a partial deduction.
	$214,000 or more	no deduction.
married filing separately with a spouse who ***is*** covered by a plan at work	less than $10,000	a partial deduction.
	$10,000 or more	no deduction.

4. If an individual has reached age 50 before the close of the tax year, the regular contribution limit is increased by $1,000 for tax year 2022.
5. Excessive contributions (over the $6,000/contribution limit amount) may be subject to a 6% excise tax. The distribution of excess contribution is reported on Form 1099-R in box 2a and coded in box 7.
6. The owner of an IRA must begin receiving distributions by April 1 of the calendar year following the calendar year in which the employee attains age 72 (or the calendar year in which the employee retires, if later, for active participants in an employer-sponsored plan).

10% Penalty

7. IRA distributions made before age 59 1/2 for a reason other than death or disability are subject to taxation as well as a **10% penalty** tax. Some other exceptions to the penalty include distributions for
   a. Payment of medical expenses in excess of 7.5% of AGI
   b. Qualified first-time homebuyer expenses up to $10,000

EXAMPLE 5-5 Homebuyer Exception

Sonja, a 35-year-old CPA, recently withdrew $5,000 from her IRA established in 2013 in order to cover expenses related to purchasing her first home. Because this distribution qualifies as an exception to the general rules on early withdrawal, Sonja will not owe the 10% penalty tax.

   c. "Qualified higher education expenses" for the individual or his or her lineal relatives

EXAMPLE 5-6 Early Withdrawal Penalty

Jeremy withdrew $100,000 from his IRA upon reaching age 50 in order to take a vacation to Jamaica. Because this is not a special exception to the premature distribution rules, Jeremy will be subject to the 10% penalty tax of $10,000 in addition to the regular tax on the distribution.

   d. Qualified first-year birth or adoption of a child expenses up to $5,000

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Roth IRAs

8. Contributions to a Roth IRA are nondeductible, but income can be accumulated tax free. The contribution amount for a Roth IRA is the same amount as for a deductible (traditional) IRA, and the total contribution to both deductible and nondeductible IRAs in any given tax year cannot exceed $6,000 per taxpayer ($7,000 if age 50 or older). Roth IRA contributions are subject to income limits and phaseout rules.

5.6 HIGHER EDUCATION DEDUCTIONS

Student Loan Interest Deduction

1. Taxpayers may deduct $2,500 of interest paid on qualified educational loans in 2022.
   a. The deduction is subject to income limits.

	MAGI Phaseout Range
MFJ	$145,000 to $175,000
Single, HH, QW	$70,000 to $85,000

   b. The amount of reduction in the deduction for a single filer can be calculated as follows:

$$\$2{,}500 \times \frac{\text{(MAGI – \$70,000)}}{\text{\$15,000 phaseout range}}$$

EXAMPLE 5-7	Deduction Limitation
Shane, a single taxpayer, paid $4,500 in student loan interest in 2022 and made $145,000 from his job as a web designer. As a result of his high income, despite paying more than the ordinarily deductible $2,500, Shane is unable to take any deduction for the student loan interest paid due to the phaseout.	

   c. Qualified expenses include
      1) Room and board
      2) Tuition and fees
      3) Books, supplies, and equipment
      4) Other necessary expenses (e.g., transportation)

      NOTE: This list of qualified expenses is specific for educational interest expense deduction. Other educational deductions (credits) are not as liberal (i.e., do not allow for inclusion of room and board).

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5.7 OTHER ABOVE-THE-LINE DEDUCTIONS

1. Performing artists qualify to deduct employee business expenses as an adjustment to gross income if all of the following requirements are met:
   a. Performing-arts services were performed as an employee for at least two employers,
   b. At least $200 was received from each of any two of these employers,
   c. Related performing-arts business expenses are more than 10% of total gross income from the services, and
   d. AGI is not more than $16,000 before deducting these expenses.

   NOTE: Married persons not living apart at all times during the year must file a joint return and figure the requirements of a., b., and c. above separately.
2. Until 2026, the deduction for job-related relocation (i.e., moving expenses) has been removed except for military service persons on active duty who move pursuant to a military order and due to a permanent change of station.
3. **Penalty on Early Withdrawal of Savings**
   a. Deduction is allowable for an early withdrawal of funds from certificates of deposit or other time savings accounts.
   b. The deduction is taken in the year the penalty is incurred.
4. **Archer MSAs** (previously called Medical Savings Accounts) allow individuals who are self-employed or employed by a small employer and who are covered by a high-deductible health insurance plan to make tax-deductible contributions to an Archer MSA and use those funds accumulated to pay medical expenses. The deduction for an Archer MSA is not included with other medical expenses and is not subject to the 7.5% limitation.
   a. Earnings generated by the plan and distributions from an Archer MSA used to pay medical expenses are nontaxable.
   b. Distributions not used for medical expenses are taxable and subject to a 20% penalty tax, unless made after age 65 or upon death or disability.
   c. Contributions to an Archer MSA are subject to an annual limitation, which is a percentage of the deductible of the required high-deductible health plan.
   d. The Archer MSA program is limited to 750,000 people.
   e. An Archer MSA can be rolled into a Health Savings Account tax-free.
5. Jury duty pay returned to an employer is deductible by the employee from gross income.
6. Expenses from the nonbusiness rental of personal property are not deductible.

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5.8 LOSS LIMITATIONS

1. A taxpayer's deductible loss is limited to the smallest amount of the following limitations.
   a. The loss is limited
      1) To the amount of the taxpayer's basis in the activity,
      2) By the at-risk rules, and
      3) By the passive activity rules.

EXAMPLE 5-8	Business Activity Loss
A taxpayer who owns both a lumber business and a boat for personal use incurred two losses during the tax year upon selling both the boat and the lumberyard to a colleague. Though the combined loss totaled $10,000, only the portion attributable to the business is potentially deductible. Losses on sales of property held for personal use are not deductible.	

At-Risk Rules

2. The amount of a loss allowable as a deduction is limited to the amount a person has at risk in the activity from which the loss arose.
   a. A loss is any excess of deductions over gross income attributable to the same activity.
   b. The rules apply to individuals, partners in partnerships, members in limited liability companies, shareholders of S corporations, trusts, estates, and closely held C corporations.
      1) Personal holding companies, foreign personal holding companies, and personal service corporations are not subject to at-risk rules.
   c. The at-risk rules are applied separately to each trade or business or income-producing activity.
   d. A person's amount at risk in an activity is determined at the close of the tax year.
      1) A person's initial at-risk amount includes money contributed, the adjusted basis (AB) of property contributed, and borrowed amounts.
      2) Recourse debt requirements include the following:
         a) A person's at-risk amount includes amounts borrowed only to the extent that, for the debt, the person has either personal liability or property pledged as security (no more than the FMV when pledged minus prior or superior claims is included).
         b) The at-risk amount does not include debt if one of the following applies:
            i) Property pledged as security is used in the activity.
            ii) Insurance, guarantees, stop-loss agreements, or similar arrangements provide protection from personal liability.
            iii) A person with an interest in the activity or one related to him or her extended the credit.

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3) Nonrecourse debt is generally excluded from the amount at risk.
   a) The amount at risk in the activity of holding real property includes qualified nonrecourse financing (QNRF).
   b) In qualified nonrecourse financing, the taxpayer is not personally liable, but the financing is
      i) Used in an activity of holding real estate;
      ii) Secured by the real property;
      iii) Not convertible to an ownership interest; and
      iv) Either obtained from an unrelated third party, obtained from a related party but on commercially reasonable terms, or guaranteed by a governmental entity.

EXAMPLE 5-9 Nonrecourse Debt

Kathy purchased a small apartment building for $200,000 using $25,000 of her own money and $25,000 borrowed from her father to make the down payment. She signed a note to pay the remainder of the purchase price to the seller. The debt to the seller was nonrecourse, secured only by the apartment building. Kathy is not at-risk for the loan from the seller because the seller is a person from whom the taxpayer acquired the property.

EXAMPLE 5-10 At-Risk Rules

Mooch purchased rental real estate with some money borrowed from his mother at commercially reasonable terms and the rest of the money borrowed from the seller. Both loans were nonrecourse and only secured by the property. Mooch is at risk for the loan from his mother because of the commercially reasonable terms and the nonrecourse loan is for real property. Regardless of the terms, Mooch is not at risk for the seller's loan.

4) Adjustments to an at-risk amount are made for events that vary the investors' economic risk of loss.
   a) Add contributions of money and property (its AB), recourse debt increases, QNRF increases, and income from the activity.
   b) Subtract distributions (e.g., from a partnership), liability reductions (recourse or QNRF), and tax deductions allowable (at year end).
5) Disallowed losses are carried forward.
6) If the amount at risk decreases below zero, previously allowed losses must be recaptured as income.
7) If a deduction would reduce basis in property and part or all of the deduction is disallowed by the at-risk rules, the basis is reduced anyway.

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Passive Activity Loss (PAL) Limitation Rules

3. The amount of a loss attributable to a person's passive activities is allowable as a deduction or credit only against, and to the extent of, gross income or tax attributable to those passive activities (in the aggregate).
   a. The excess is deductible or creditable in a future year, subject to the same limits.

EXAMPLE 5-11 PAL Limitation

A wealthy taxpayer invested in an architecture partnership as a passive investor. Because the taxpayer does not engage in the business outside of occasional business consulting, any income or loss derived from the business is passive in nature. Therefore, any losses derived from the partnership may only offset passive activity gains.

4. The passive activity rules apply to individuals, estates, trusts, personal service corporations, and closely held corporations.
   a. Although passive activity rules do not apply to grantor trusts, partnerships, and S corporations directly, they do apply to the owners of these entities.
5. A passive activity is either rental activity or a trade or business in which the person does not materially participate.
   a. A taxpayer materially participates in an activity during a tax year if (s)he satisfies one of the following tests:
      1) Participates more than 500 hours
      2) Participation constitutes substantially all of the participation in the activity
      3) Participates for more than 100 hours and exceeds the participation of any other individual
      4) The activity is a significant participation activity in which the taxpayer participates more than 100 hours and the taxpayer's participation in all significant participation activities exceeds 500 hours
      5) Materially participated in the activity for any 5 years of the 10 years preceding the year in question
      6) Materially participated in a personal service activity for any 3 years preceding the year in question
      7) Satisfies a facts and circumstances test proving that the taxpayer participated on a "regular, continuous, and substantial" basis
         a) A taxpayer will not be considered to have materially participated in an activity under this test if (s)he participated in the activity for 100 hours or less during the year.

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EXAMPLE 5-12	**Business Passive Activity Loss**

For 2022, Sally realized a $10,000 net loss (sales of $95,000 less expenses of $105,000) from operating a sole proprietorship, without regard to dispositions of property other than inventory. The income tax return also showed gross income of $5,000 ($2,500 of wages, $500 interest on personal savings, and a $2,000 long-term capital gain on business property). The excess of deductions over income was $18,950 ($5,000 gross income – $10,000 loss from business operations – $1,000 nonbusiness short-term capital loss on the sale of stock – $12,950 standard deduction).

Because she does not engage in the business outside of occasional business consulting, any income or loss derived from the business is passive in nature. Therefore, any losses derived from the partnership may only offset passive activity gains.

6. Passive activity rules do not apply to
   a. Active income, loss, or credit
   b. Portfolio income, loss, or credit
   c. Casualty and theft losses, vacation home rental, qualified home mortgage interest, business use of home, or a working interest in an oil or gas well held through an entity that does not limit the person's liability
7. Rental Real Estate
   a. All rental activity is passive.
   b. A person who actively participates in rental real estate activity is entitled to deduct up to $25,000 of a tax year loss from rental real estate activities in excess of passive activity gross income against portfolio or active income.

EXAMPLE 5-13	**PAL Limitation -- Rental Real Estate Activities**

A taxpayer has wages of $30,000, $5,000 gain from a passive partnership interest, and $35,000 loss from active rental real estate activity. The taxpayer may first offset the passive gain (i.e., $5,000) with $5,000 of the passive loss. With the remaining $30,000 passive loss, $25,000 of the nonpassive gain (i.e., wages) may be offset.

      1) The $25,000 limit is reduced by 50% of the person's MAGI [i.e., AGI without regard to PALs, Social Security benefits, and qualified retirement contributions (e.g., IRAs)] over $100,000.
      2) Excess rental real estate PALs are suspended. They are treated as other PALs carried over.
   c. This exception to the general PAL limitation rule applies to a person who
      1) Actively participates in the activity,
      2) Owns 10% or more of the activity (by value) for the entire year, and
      3) Has MAGI of less than $150,000 [phaseout begins at $100,000; as discussed in b.1) above].
   d. Active participation is a less stringent requirement than material participation.
      1) It is met with participation in management decisions or arranging for others to provide services (such as repairs).
      2) There will not be active participation if at any time during the period there is ownership of less than 10% of the interest in the property (including the spouse's interest).

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e. Real property trades or businesses rules include the following:

   1) The passive activity loss rules do not apply to certain taxpayers who are involved in real property trades or businesses.

   2) An individual may avoid passive activity loss limitation treatment on a rental real estate activity if two requirements are met:

      a) More than 50% of the individual's personal services performed during the year are performed in the real property trades or businesses in which the individual materially participates.

      b) The individual performs more than 750 hours of service in the real property trades or businesses in which the individual materially participates.

   3) This provision also applies to a closely held C corporation if 50% of gross receipts for the tax year are from real property trades or businesses in which the corporation materially participated.

   4) Any deduction allowed under this rule is not taken into consideration in determining the taxpayer's AGI for purposes of the phaseout of the $25,000 deduction.

   5) If 50% or less of the personal services performed are in real property trades or businesses, the individual will be subject to the passive activity limitation rules.

EXAMPLE 5-14 PAL Limitation -- Active Participation

Lynne, a single taxpayer, has $70,000 in wages, $15,000 income from a limited partnership, and a $26,000 loss from rental real estate activities in which she actively participated and is not subject to the modified adjusted gross income phase-out rule. She can use $15,000 of her $26,000 loss to offset her $15,000 passive income from the partnership. She actively participated in her rental real estate activities, so she can use the remaining $11,000 rental real estate loss to offset $11,000 of her nonpassive income (wages).

f. Suspension of loss is allowed.

   1) A PAL not allowable in the current tax year is carried forward indefinitely and treated as a deduction in subsequent tax years.

g. PALs continue to be treated as PALs even after the activity ceases to be passive in a subsequent tax year, except that it may also be deducted against income from that activity.

h. Disposition of a passive activity is subject to the following rules:

   1) Suspended (and current-year) losses from a passive activity become deductible in full in the year the taxpayer completely disposes of all interest in the passive activity.

   2) The loss is deductible first against net income or gain from the taxpayer's other passive activities. The remainder of the loss, if any, is then treated as nonpassive.

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Wash Sales

8. Losses from wash sales are not deductible.

   a. A wash sale occurs when a taxpayer sells or trades an asset at a loss and, within 30 days before or after the sale, the taxpayer does one of the following:

      1) Purchases a substantially identical asset,
      2) Acquires a substantially identical asset in a fully taxable trade, or
      3) Acquires a contract or option to buy a substantially identical asset.

   b. The unrecognized loss is added to the basis of the asset that caused the wash sale.

   c. The holding periods of the original asset and the substantially identical asset are added together.

EXAMPLE 5-15	**Wash Sales**
On February 16, Year 1, Fred Samson purchased 100 shares of Oscar Corporation stock at $40 per share. On July 28, Year 5, he sold the 100 shares at $25 per share. On August 10, Year 5, Fred's wife, Laura, purchased 50 shares of Oscar Corporation at $30 per share. Consequently, 50 of the shares Fred sold are not eligible for the capital loss deduction because this is considered a wash sale (spouses are treated as the same taxpayer for this purpose). A capital loss deduction is available for the other 50 shares. The sale of 50 shares resulted in a $750 loss.	

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STUDY UNIT SIX

ITEMIZED DEDUCTIONS

Below-the-line deductions are all the deductions that may be subtracted from AGI to arrive at taxable income. Each below-the-line deduction is either an itemized, standard, or qualified business income deduction.

	Adjusted gross income
–	Greater of allowable itemized deductions on Schedule A or the standard deduction
–	Qualified business income deduction (Study Unit 7, Subunit 1)
=	Taxable income

Generally, the taxpayer itemizes deductions if the total amount of allowable itemized deductions is greater than the amount of the standard deduction. Otherwise, the taxpayer claims the standard deduction. A taxpayer must elect to itemize, or no itemized deductions will be allowed.

- Election is made by filing Schedule A of Form 1040 or Form 1040-SR.
- Election made in any other taxable year is not relevant.
- Election may be changed by filing an amended return (Form 1040-X).

EXAMPLE 6-1 Standard vs. Itemized Deduction

David is single and has itemized deductions of $11,250. Because this amount is less than the $12,950 standard deduction, he would instead use the standard deduction and would not submit Schedule A to the IRS as part of his Form 1040 (most tax software automatically prevents the taxpayer from filing Schedule A in such a case).

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6.1 MEDICAL EXPENSES

7.5% of Adjusted Gross Income (AGI)

Amounts paid for qualified medical expenses that exceed 7.5% of AGI may be deducted.

1. To qualify for a deduction, an expense must be paid during the taxable year for the taxpayer, the taxpayer's spouse, or a dependent and must not be compensated for by insurance or otherwise during the taxable year, although the service could have been rendered in a prior year. The expenses must be primarily to alleviate or prevent a physical or mental disability or illness.
   a. The deduction is allowed for a person who was either a spouse or a dependent at the time medical services were rendered or at the time the expenses were actually paid.
      1) Medical expenses charged on a credit card are deductible in the year the medical expenses were incurred, not when the credit card bill is paid.
      2) To qualify as a dependent, the person (dependent)
         a) Must have over half of his or her support for the year paid for by the taxpayer;
         b) Must fall within a family relationship (including adopted children or any other person who lived with the taxpayer all year as a member of the taxpayer's household); and
         c) Must be a citizen, national, or resident of the U.S., Canada, or Mexico during a portion of the tax year.
   b. However, the individual need not satisfy the gross income test or the joint return test, and a child of divorced parents is treated as a dependent of both parents.
2. Deductible medical expenses are amounts paid for
   a. Diagnosis, cure, mitigation, treatment, or prevention of disease or for the purpose of affecting any structure or function of the body (i.e., to alleviate or prevent a physical or mental disability or illness)
   b. Medical insurance
   c. Qualified long-term care premiums and services
   d. Smoking cessation programs and prescribed drugs designed to alleviate nicotine withdrawal
   e. Transportation primarily for and essential to medical care

EXAMPLE 6-2 Deductible Medical Expenses

If a taxpayer undergoes facial reconstructive surgery as a result of severe burns, it is considered a deductible medical expense. However, if a taxpayer has elective facial surgery for cosmetic reasons (not related to a deformity), it is not deductible.

Professional Services

3. Deductible medical expenses include amounts paid to physicians, surgeons, dentists, chiropractors, osteopaths, chiropodists, podiatrists, psychiatrists, psychologists, etc., solely in their professional capacity.

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Activity or Treatment

4. A medical expense deduction is not allowed for amounts paid for any activity or treatment designed merely to improve an individual's general health or sense of wellness, even if recommended by a physician.
    a. Examples include participation in a health club or a weight-loss institute.
        1) Such expenses may be deductible if the services are prescribed by a physician who provides a written statement that they are necessary to alleviate a physical or mental defect or illness.

Institutional Care

5. The cost of in-patient hospital care (including meals and lodging) is deductible as a medical expense.
    a. If the principal reason an individual is in an institution other than a hospital (a special school for those with disabilities, a rest home, etc.) is the need for and availability of the medical care furnished by the institution, the full costs of meals, lodging, and other services necessary for furnishing the medical care are all deductible.

EXAMPLE 6-3 **Inpatient Hospital Care Expenses**
A parent takes a child to see a medical specialist out of state. The parent and child spend 2 nights at a hotel in the city of the specialist. They are able to deduct $200 for lodging ($50 per night × 2 nights × 2 individuals). However, if the child stays overnight under medical supervision, the full cost of inpatient care is deductible.

Prescription

6. Aside from insulin, only **medicines and drugs** that require a prescription are qualified medical expenses.

Capital Expenditures

7. The following are considered deductible medical expenses:
    a. Eyeglasses or contact lenses
    b. A guide dog
    c. Wheelchairs, crutches, or artificial limbs
    d. Special beds
    e. Air conditioning
    f. Dehumidifying equipment

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8. Expenditures for new building construction or for permanent improvements to existing structures primarily for medical care may be deductible in part as a medical expense.
   a. The excess of the cost of a permanent improvement over the increase in value of the property is a deductible medical expense.
      1) Although the cost of the capital asset is not deductible, the cost of operating and maintaining the asset may be deductible when the asset is operated primarily for medical care.
   b. Construction of entrance or exit ramps for those with disabilities, installation of elevators, widening of doorways, or lowering of kitchen cabinets or equipment may each qualify.

EXAMPLE 6-4 Medical Expenses -- Capital Expenditures

Billy had bypass heart surgery in February 2022. At the advice of his doctor, he had an elevator installed in his home so that he would not have to climb stairs. The costs associated with this capital improvement are as follows:

Cost of elevator installed June 30, 2022	$5,000
Increase in value of home due to elevator	2,500
Maintenance and repair of elevator, September 30, 2022	500

The taxpayer may deduct the cost of the elevator installed (less any increase in FMV) plus any maintenance, repair, and operating expenses. Thus, the total allowable deduction is

Cost of Elevator Installed	$5,000
Less: Increase in FMV	(2,500)
Deductible Capital Expenditure	$2,500
Plus: Maintenance and Repair	500
Total Allowable Medical Expenses	$3,000

The maintenance and repair expenses might have qualified as medical expenses regardless of whether the elevator expenditure was deductible.

Travel

9. Amounts paid for transportation essential to (and primarily for) medical care are deductible.
   a. This includes the transportation cost of traveling to a warm climate on a doctor's order to alleviate a specific chronic ailment.
10. The taxpayer may choose between actual expenditures (e.g., taxis, airfare) or $0.18 per mile for January-June and $0.22 per mile for July-December 2022 (plus the cost of tolls and parking).
11. Expenditures for lodging are deductible up to $50 per night per individual.
12. The cost of meals is not deductible.

Insurance

13. Premiums paid for medical insurance that provides for reimbursement of medical care expenses are deductible.
    a. Premiums paid on a policy that merely pays the insured a specified amount per week, etc., are not deductible.
    b. Premiums paid for membership in an association that gives cooperative (free choice) medical service are deductible.

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Medicare

14. The basic cost of Medicare insurance (Medicare Part A) is not deductible unless voluntarily paid by the taxpayer for coverage.
    a. The extra cost of Medicare (Medicare Part B) is deductible.

Payment after Death

15. If a decedent's own medical expenses are paid by his or her estate within 1 year beginning on the day after the decedent's death, the expenses may be deducted on the decedent's tax return for the year incurred.
    a. Alternatively, the estate can deduct medical expenses as a claim against the estate for federal estate tax purposes.

EXAMPLE 6-5 Payments after Death

George died on February 2, 2022, and his estate paid his final medical expenses on November 15, 2022. These expenses can be deducted on either George's final (2022) tax return (Form 1040) or the estate's income tax return (Form 1041), but not both.

Adopted Child

16. The amount paid by an adopting parent for medical expenses rendered directly to a child before his or her placement in the adopting parent's home constitutes a medical expense, provided that
    a. The child qualifies as a dependent of the adopting parent at the time that the medical services are rendered or at the time the fees therefore are paid,
    b. The adopting parent can clearly substantiate that any deduction claimed is directly attributable to the medical care of the child, and
    c. The medical expenses are paid by the adopting parent or his or her agent for the medical care of the particular child.
        1) Reimbursement for expenses incurred and paid by someone other than the taxpayer prior to adoption negotiations are not considered deductible medical expenses.

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6.2 TAXES

A taxpayer who itemizes deductions is permitted to deduct the full amount of certain taxes that are paid and incurred during the taxable year, subject to the $10,000 ($5,000 MFS) limit on total state and local taxes.

Real Property

1. State and local real property taxes are deductible by the person upon whom they are imposed (i.e., the owner) in the year in which they were paid.
   a. If real property is bought or sold during the year, the real property tax is apportioned between the buyer and the seller on the basis of the number of days each one held the property during the real property tax year.
      1) The purchaser is presumed to own the property on the date of sale.
      2) Any taxes paid by an owner (e.g., purchaser) for a period in which someone else owned (e.g., seller) the property are not deductible but are added to the basis (e.g., cost) of the property.
   b. Taxes paid to a financial institution and held in escrow are deductible when the financial institution pays the funds over to the taxing body.
   c. Service charges for police and fire protection may be deductible if the funds are paid into a general revenue fund.
   d. Special assessments for local improvements increase the basis of the property and are not deductible.

EXAMPLE 6-6 Nondeductible Property Taxes
In April of Year 2, property taxes are assessed for Year 1. The taxes are paid by the due date in Year 2. The taxes are deductible on the Year 2 return. If the owner in Year 2 did not own the property in Year 1, then payment for Year 1 taxes are not deductible but are added to the basis of the property.

   e. Foreign real property taxes paid do not qualify for deduction.

Ad Valorem and Personal Property

2. State and local ad valorem and personal property taxes are deductible only if the tax is
   a. Actually imposed,
   b. Imposed on an annual basis, and
   c. Substantially in proportion to the value of the property.

EXAMPLE 6-7 Deductions from Value-Based Taxes
Registration or licensing of vehicles is deductible if the tax is based on the value of the vehicle.

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Income Taxes

3. State and local income taxes are deductible.
4. Foreign income taxes paid are deductible, unless the Foreign Tax Credit is claimed.
5. Individual taxpayers may claim an itemized deduction for general state and local sales taxes in lieu of state income tax.
    a. Taxpayers can deduct either actual sales tax amounts or a predetermined amount from an IRS table.

Nondeductible Taxes

6. The following taxes are not deductible:
    a. Federal taxes on income, estates, gifts, inheritances, legacies, and successions.
        1) A deduction may be available on the estate tax return for income taxes paid on account of a decedent.
    b. State taxes on cigarettes and tobacco, alcoholic beverages, gasoline, licensing/registration, estates, gifts, inheritances, legacies, and successions.
    c. Licensing/registration fees of highway motor vehicles (if based on the weight instead of the value of the vehicle).
    d. Sales tax on business property. It is added (i.e., capitalized) to the basis of the acquired property.

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6.3 INTEREST EXPENSE

Personal Interest

1. The general rule is that no personal interest may be deducted.
2. Personal interest includes interest on credit card debt, revolving charge accounts and lines of credit, car loans, medical fees and premiums, home acquisition debt greater than the allowed deduction limit, etc. Personal interest also includes any interest on underpaid tax liabilities.

EXAMPLE 6-8	Personal Interest
Mr. Griffin paid the following in interest in the current year: $3,000 on his credit card, $1,200 on his car loan, and $500 to the IRS for failing to meet the required tax withholding. All of these interest payments are considered personal interest, so Mr. Griffin is unable to deduct any of the $4,700.	

EXAMPLE 6-9	Personal Interest from Medical Expenses
Carl Wynn paid $8,000 in medical expenses related to his 5-year-old son's broken leg. In order to pay these expenses, Carl took out a loan, which incurred interest of $500. Carl may deduct medical expenses in excess of 7.5% of his AGI. However, he may not deduct the $500 of interest because it is considered personal interest.	

3. Personal interest does not include
   a. Interest on trade or business debt
   b. Investment interest
   c. Passive activity interest
   d. Qualified residence interest
   e. Interest on the unpaid portion of certain estate taxes
   f. Student loan interest

Investment Interest

4. The IRC allows the deduction of a limited amount of investment interest as an itemized deduction.
5. Investment interest is interest paid or incurred (on debt) to purchase or carry property held for investment.
   a. Generally, investment interest includes the following:
      1) Interest allocable to portfolio income under the PAL rules
         a) Passive activity interest is includible with passive activities and deductible within the passive loss rules.
      2) Any interest derived from an activity involving a trade or business in which the taxpayer does not materially participate and which is not treated as a passive activity under the PAL rules
      3) Any deductible amount in connection with personal property used in a short sale
   b. Investment interest does **not** include qualified residence interest, interest for generating tax-exempt income, or passive activity interest.

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c. Limit.

1) Investment interest may be deducted only to the extent of net investment income.

a) Net investment income is any excess of investment income over investment expense(s) (other than interest expense).

2) Investment income is

a) Nontrade or nonbusiness income from

i) Interest

ii) Dividends (not subject to the capital gains tax)

iii) Rents, royalties, and other gross income from property held for investment

b) Net gain on the disposition of property held for investment

i) A taxpayer may elect to treat all or a portion of long-term capital gains and qualified dividends as investment income.

c) Income treated as gross portfolio income under the PAL rules

d) Income from interests in activities that involve a trade or business in which the taxpayer does not materially participate if the activity is not treated as passive activity under the PAL rules

3) Investment income does not include income from a rental real estate activity in which the taxpayer materially participates.

d. Disallowed investment interest is carried forward indefinitely. It is deductible to the extent of investment income in subsequent tax years.

EXAMPLE 6-10 Disallowed Investment Interest Carryforward

Kayla borrowed money to invest. In Year 3, due to a bad market downturn, her net investment income was $4,500 before considering $15,000 of investment interest expense. In Year 3, she may deduct $4,500 of investment interest expense, and the remaining $10,500 is carried over to Year 4 to be applied against net investment income.

Residence Interest

6. Qualified residence interest (as discussed in Publication 530) is deductible on no more than $750,000 of the sum of acquisition and home equity indebtedness ($375,000 if married filing separately). For qualifying debt taken out on or before December 15, 2017, taxpayers can only deduct home mortgage interest of up to $1 million ($500,000 if married filing separately) of that debt.

a. Qualified residence interest is interest paid or accrued during the tax year on acquisition or home equity indebtedness that is secured by a qualified residence (Form 1098).

1) Ministers and military personnel can deduct mortgage interest on their homes even when they receive a parsonage or military allowance that is excludable from gross income.

b. A qualified residence is the principal residence of the taxpayer and any one other residence owned by the taxpayer and used for personal purposes for the greater of 14 days or 10% of the number of days during the year in which it is rented.

c. A taxpayer who has more than two residences may select, each year, the residences used to determine the amount of qualified residence interest.

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d. Acquisition indebtedness is debt incurred in acquiring, constructing, or substantially improving a qualified residence. The debt must be secured by such residence.

   1) Any debt that is refinanced is treated as acquisition debt to the extent that it does not exceed the principal amount of acquisition debt immediately before refinancing.

e. Home equity indebtedness is all debt other than acquisition debt that is secured by the qualified residence. For tax years 2018-2025, the home equity debt must be used to buy, build, or substantially improve the qualified residence. This means the prior allowance to use the funds for other personal expenses, such as college tuition, is suspended until 2026.

EXAMPLE 6-11 Nondeductible Home Equity Interest

After 3 years of home ownership, a taxpayer's home has increased in value by $150,000. In 2022, the taxpayer took out a $100,000 home equity loan to pay for her children's college education. However, interest on a home equity loan that is not used to buy, build, or substantially improve a qualified residence is not deductible.

   1) Home equity indebtedness cannot exceed the fair market value of the residence (reduced by any acquisition debt).

Maximum home equity indebtedness = Property FMV – Acquisition indebtedness

EXAMPLE 6-12 Itemized Deductions -- Interest

A taxpayer with AGI of $100,000 made the following transactions in Year 1:

Paid $3,000 interest on a bank loan

Using the loan, purchased interest-bearing bonds with interest income of $10,000 in Year 1

No other investment income was earned in Year 1.

Paid personal credit card interest of $650

Paid interest in the amount of $12,000 on home mortgage for Year 1

The $15,000 total interest expense in calculating itemized deductions for Year 1 is calculated as follows:

Net investment income	$10,000	
Deductible investment expense		$ 3,000
Home mortgage interest		12,000
Total interest expense		$15,000

NOTE: Deductible investment interest is limited to net investment income. In this example, net investment income is greater than investment expense; therefore, the total expense of $3,000 is deductible. Credit card interest is a personal interest expense in this example and is not deductible.

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<u>Points Paid</u>

f. Points paid by the borrower with respect to a home mortgage are prepaid interest, which is typically deductible over the term of the loan.

1) Amounts paid as points may be deducted in the year paid if

a) The loan is used to buy or improve a taxpayer's principal home and is secured by that home,

b) The settlement statement clearly designates the points or loan origination fees,

c) The points are computed as a percentage of the principal loan amount,

d) Payment of points is an established business practice in the area where the loan is made, and

e) The points paid do not exceed points generally charged in the area.

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

g. Points paid by the seller are selling expenses that reduce the amount realized on the sale.

1) The purchaser can elect to deduct points on the acquisition indebtedness of a principal residence by reducing the basis by the amount of the points.

7. To compute interest deductions, individuals must allocate interest expenditures as investment interest, personal interest, trade or business interest, portfolio interest, or interest connected to passive activities.

a. Interest is allocated by tracing the disbursement of the proceeds of the debt to which it relates to the expenditure for which the proceeds are used.

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6.4 CHARITABLE CONTRIBUTIONS

1. Charitable contributions are deductible only if they are made to qualified organizations.
2. Donations can be made in the form of cash or noncash property.
3. All rights and interest to the donation must be transferred to the qualified organization.
4. Generally, a deduction is allowed in the year the contribution is paid, including amounts charged to a bank credit card.
5. The value of any property donated is equal to (a) FMV or (b) the lower of FMV or AB, depending on the type of property and elections.
6. The deduction is generally limited to 50% (60% for cash contributions) of the taxpayer's AGI; however, sometimes the limit is 30% or 20%.

Qualified Organizations

7. Qualified organizations can be either public charities or private foundations.
   a. Generally, a public charity is one that derives more than one-third of its support from its members and the general public.
   b. Qualified organizations include
      1) Corporations, trusts, community chests, funds, or foundations, created or organized in the U.S. and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals.
      2) Posts or organizations of war veterans.
      3) Domestic fraternal societies, orders, or associations only if the contribution is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals.

Receipt

8. Donations must meet the following requirements:
   a. Clothing and household items donated must be in good or better condition.
      1) The exception to this rule is that a single item donation in less than good condition with a more than $500 value is deductible with a qualified appraisal. This lower $500 rule for clothing and household items is an exception to the higher $5,000 rule on the next page.
   b. Cash or cash equivalent donations require a bank record, or receipt, letter, etc., from the donee organization regardless of the amount. The receipt, etc., must
      1) Be written;
      2) State the name of the organization;
      3) Include the date and amount of the donation;
      4) State whether the qualified organization gave the donor any goods or services as a result of the contribution; and
      5) Be obtained on or before the earlier of
         a) The date the tax return is filed for the year of contribution or
         b) The date, including extensions, for filing the return.
   c. Donations of $250 or more require substantiation by a contemporaneous written receipt from the organization (the bank record alone is insufficient).

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EXAMPLE 6-13	**Donation of Goods**
The local chamber of commerce hosts an annual food drive for needy children (a charitable cause). While dues and other donations to the chamber of commerce are not charitable contributions (though they may be business expenses), donations of food, cash, and other property to the food drive are considered charitable donations because the donations are exclusively for a charitable purpose. These are deductible by the taxpayer as charitable contributions.	

Property

9. If a donation is in the form of property, the amount of the donation depends upon the type of property and the type of organization that receives the property.
   a. Capital gain property is property on which a long-term (i.e., held more than a year) capital gain would be recognized if it were sold on the date of the contribution.
   b. Ordinary income property is property on which ordinary income or short-term (i.e., held a year or less) capital gain would be recognized if it were sold on the date of the contribution.
   c. The chart on page 15 has donation amounts.
   d. If the donee organization disposes of the donated property (valued at $500 or more) within 3 years of acquisition, the donee organization must file Form 8282 within 125 days and provide a copy to the donor.
      1) Similarly, if an organization sells a qualified donated vehicle, the donee organization must send a Form 1098-C to the donor within 30 days of sale in order for the deduction to exceed $500.
   e. A qualified appraisal for non-cash or traded security property donations is required to be attached to the tax return for property valued over $5,000.
   f. Any deductions on noncash contributions in excess of $500 must be reported on Form 8283.

Limitations

10. There are basically two types of charitable organizations: those classified as 50% limit organizations and all others that are classified as **non**-50% limit organizations.

50% Limit Organizations

   a. The 50% limit organizations, which encompass the majority of qualified charitable organizations, are generally public organizations (although some private foundations are acceptable) such as the following:
      1) Churches
      2) Educational organizations
      3) Hospitals and certain medical research organizations
      4) Organizations that are operated only to receive, hold, invest, and administer property and to make expenditures to or for the benefit of state and municipal colleges and universities
      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 a Native American tribal government
      6) Private operating foundations
      7) Private nonoperating foundations that make qualifying distributions of 100% of contributions within 2 1/2 months following the year they receive the contribution

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Non-50% Limit Organizations

b. Non-50% limit organizations encompass all other qualified charities that are not designated as 50% limit organizations.

1) They are primarily composed of other private organizations.
2) Charitable contribution deductions are subject to limitations.

a) The overall limitation on charitable deductions is 50% (60% for cash contributions) of AGI (applicable to the total of all charitable contributions during the year), but certain contributions may be individually limited to 30% or 20% of AGI, depending on the type of contribution given (discussed below and on page 16).

b) Any donations that exceed this limitation can be carried forward and deducted in the next 5 tax years.

EXAMPLE 6-14 Charitable Contributions -- Calculation

Celina has an AGI of $100,000. She donates $40,000 cash to her church. She also donates stock with a basis of $35,000 and held short-term to the Red Cross. She first takes a $35,000 deduction for the stock in the 50% category. She then takes $25,000 ($100,000 × 60% – $35,000) of the cash donation as a deduction in the 60% category. This leaves her with a $15,000 carryover in the 60% category to be used within the following 5 tax years.

c. Further limitations

Regular 30% Limitation

1) This 30% limit applies to gifts to all qualified charitable organizations other than 50% limit organizations. (However, if capital gain property is donated, it may be subject to the 20% limitations discussed on page 16.) The chart on the next page summarizes all the rules.

Special 30% Limitation for Capital Gain Property

2) A special 30% limitation applies to gifts of capital gain property given to 50% limit organizations, but is only applicable if the donor elects **not** to reduce the fair market value of the donated property by the amount that would have been long-term capital gain if he had sold the property. If the reduction is elected, then only the 50% (60% for cash contributions) limitation applies. The chart on the next page summarizes all the rules.

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50% Limit Organizations		
(Mainly Public)		
Form of Property	**Amount of Donation**	**Limitation**
Cash	Cash amount	60% AGI
Capital Gain Property	FMV (elect not to reduce FMV by potential long-term capital gain)	30% AGI (special limit)
• Tangible personal property unrelated to donee's purpose	Lower of FMV or AB	50% AGI
• Election to reduce property to adjusted basis	Lower of FMV or AB	50% AGI
Ordinary Income Property	Lower of FMV or AB	50% AGI
Services	Unreimbursed expenses	50% AGI
Non-50% Limit Organizations		
(Mainly Private)		
Cash	Cash amount	30% AGI (regular limit)
Capital Gain Property	Lower of FMV or AB	Lesser of 20% AGI or excess of 30% AGI over contributions to public charities
Ordinary Income Property	Lower of FMV or AB	30% AGI (regular limit)
Services	Unreimbursed expenses	30% AGI (regular limit)

EXAMPLE 6-15 Charitable Contribution Deduction

A single taxpayer had AGI of $80,000 in Year 6. On June 5, Year 6, the taxpayer donated land and stock to a church. The taxpayer purchased the land as an investment in Year 1 for $5,000 and purchased the stock on January 14, Year 6, for $1,500. On the day of donation, the land's fair market value was $9,000 and the stock's fair market value was $1,860.

The charitable contribution deduction for Year 6, in the amount of $10,500, is calculated as follows:

Property	Form of Property	Nature of Deduction	Deductible Amount
Land held for investment greater than 1 year	Capital gain property	FMV	$ 9,000
Stock held for investment less than 1 year	Ordinary income property	Lower of FMV or adjusted basis	1,500
Total deductible contribution			**$10,500**

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20% Limitation

3) This limitation applies to capital gain property donated to non-50% limit charities. The limit is actually the lesser of 20% of AGI or 30% of AGI minus capital gain contributions to public charities.
4) In accounting for the different limitations, the order in which each is considered is as follows:
   a) 50% (60% for cash contributions), then
   b) 30%, and finally,
   c) 20%.
5) In carrying over excess contributions to subsequent tax years, the excess must be carried over to the appropriate limitation categories.
   a) If a contribution in the 30% category is in excess of the limit, the excess is carried over and subject to the 30% limitation in the next year.

EXAMPLE 6-16 Charitable Contributions -- Calculation

Rich has an AGI of $100,000. He donates $70,000 cash to his former university (60% limitation) and $5,000 to his private foundation (30% limitation). In the current year, he can deduct $60,000 ($100,000 × 60%) and will carry forward the remaining $10,000 of deductions subject to the 60% limitation and all of the $5,000 of deductions subject to the 30% limitation.

If Rich instead donated $5,000 cash to the university and $70,000 to the private foundation, the charitable contribution that could be deducted would be calculated as follows: The $5,000 would be fully deductible as a 60% deduction. The $70,000 contribution to the private foundation would be deductible to the lesser of 30% of AGI ($30,000) or 60% of AGI minus contributions to 60%-limit organizations ($55,000 remaining). In the current year, Rich would be able to deduct $35,000 ($5,000 + $30,000) and carry forward $40,000 ($70,000 – $30,000) subject to the 30% charitable contribution limitation.

Services

11. The value of services provided to a charitable organization is not deductible.
    a. However, out-of-pocket, unreimbursed expenses (e.g., uniforms or equipment) incurred in rendering the service are deductible.
    b. Travel expenses incurred while performing the services away from home for the charitable organization are deductible if no significant element of personal pleasure, recreation, or vacation exists.
       1) Individuals who qualify for the charitable deduction for the use of an automobile may use the statutory standard mileage rate of $0.14 per mile (plus parking fees and tolls) or actual expenses incurred.
          a) Depreciation and insurance are not deductible expenses.

Tickets

12. The value of a ticket to a charitable event is a deductible contribution to the extent the purchase price exceeds the FMV of the admission or privilege associated with the event.

Carryover

13. Generally, individuals may carry forward excess donations for 5 years.

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6.5 PERSONAL CASUALTY LOSSES

Historically, taxpayers who itemize may deduct a limited amount for casualty losses to nonbusiness property that arise from theft, fire, storm, shipwreck, or other casualty. However, for tax years 2018 through 2025, this personal deduction has only been allowed for federally declared disasters.

Limitation

1. Only the amount of each loss over $100 is deductible. Only the aggregate amount of all losses over $100 each in excess of 10% of AGI is deductible.
   a. If the loss was covered by insurance, timely filing of an insurance claim is prerequisite to deduction.
      1) The portion of the loss usually not covered by insurance (i.e., a deductible) is not subject to this rule.
   b. The amount of a loss is the lesser of the decrease in FMV of the property due to the casualty or the property's adjusted basis, minus any insurance reimbursements.
   c. Regardless of the 10% AGI floor, casualty losses are deductible against casualty gains.
   d. A taxpayer may claim personal casualty losses to the extent of personal **casualty gain** even if the personal casualty losses are not attributable to federally declared disasters.

EXAMPLE 6-17 Personal Casualty Losses
In 2022, Marsha incurred damages to her home from a fire that was not a federally declared disaster. After insurance reimbursement, she had damage to her home in the amount of $10,000 and a $3,000 gain on an antique that was destroyed. Marsha is able to offset the $3,000 gain with the $10,000 loss. The remaining loss is not deductible.

2. If the net amount of all personal casualty gains and losses after applying the $100 limit (but before the 10%-of-AGI threshold) is positive, each gain or loss is treated as a capital gain or loss.
   a. If the net amount is negative, the excess over 10% of AGI is deductible as either an itemized deduction or an addition to the standard deduction.
3. The cost of appraising a casualty loss is treated as a cost to determine tax liability, for which there is no deduction.
4. The cost of insuring a personal asset is a nondeductible personal expense.

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5. Additional rules for a loss in a federally declared disaster area include the following:
   a. Disaster loss treatment is available when a personal residence is rendered unsafe due to the disaster in the area and is ordered to be relocated or demolished by the state or local government.
   b. The taxpayer has the option of deducting the loss on
      1) The return for the year in which the loss actually occurred or
      2) The preceding year's return (by filing an amended return).
         a) Revocation of the election may be made before expiration of time for filing the return for the year of loss.
6. The loss is calculated on Form 4684, *Casualties and Thefts*, and carried over to Schedule A, *Itemized Deductions*.
7. Although net operating losses (NOLs) are typically associated with businesses and not individuals, items such as personal casualty losses may create an individual NOL.

6.6 OTHER ITEMIZED DEDUCTIONS

Other Itemized Deductions

1. The following expenses are deductible as other itemized deductions and are reported on line 16 of Schedule A (Form 1040):
   a. Amortizable premium on taxable bonds
   b. Casualty and theft losses from income-producing property
   c. Federal estate tax on income in respect of a decedent
   d. Gambling losses up to the amount of gambling winnings
   e. Impairment-related work expenses of persons with disabilities
   f. Repayments of more than $3,000 under a claim of right
   g. Unrecovered investment in a pension

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STUDY UNIT SEVEN

QUALIFIED BUSINESS INCOME DEDUCTION, AMT, AND OTHER TAXES

The first subunit explains the last of the below-the-line deductions, the qualified business income deduction (QBID). The last two subunits discuss the alternative minimum tax and other taxes a taxpayer may be subject to, including self-employment taxes.

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7.1 QUALIFIED BUSINESS INCOME DEDUCTION (QBID)

1. Calculation

   a. **Qualified Business Income Deduction (QBID) (Section 199A)**

      1) When Congress passed the Tax Cuts and Jobs Act (TCJA), it reduced the C corporation tax rate to 21%.

      2) Congress did not want to disadvantage owners of pass-through entities (sole proprietorships, S corporations, and partnerships) by leaving them with a substantially higher tax liability (potentially 37%) than C corporations (21%). Congress reduced this burden by creating the QBID.

      3) The QBID is the last deduction before determining a taxpayer's taxable income. It is based on determining qualified business income (QBI).

      4) For the QBID, Congress divided pass-through entities into two categories: (a) specified service trades or businesses and (b) qualified trades or businesses. The reason for the two categories is that above certain thresholds of taxable income, each QBID is subject to varying limitations.

         a) The specifics of the limitations are complex and beyond the scope of the exam. Therefore, the coverage in this subunit is the general information needed to have a basic understanding of the QBID for the exam.

   b. **Specified Service Trades or Businesses**

      1) In general, a specified service trade or business (SSTB) is any trade or business in which the principal asset is the reputation or skill of one or more of its employees.

      2) Specifically, SSTBs include the following types of trades and businesses:

         a) Health (e.g., physicians, nurses, dentists, and other similar healthcare professionals)

            i) Health does not include services not directly related to a medical field, such as medical device sales, coding, billing, and payment processing.

         b) Law

         c) Accounting

         d) Actuarial science

         e) Performing arts

         f) Consulting

         g) Athletics

         h) Financial services (e.g., financial advisors, wealth planners, retirement advisors, investment bankers, and other professionals performing similar services)

            i) This includes any professional service consisting of investing, investment management, trading or dealing in securities, partnership interests, or commodities.

         i) Brokerage services

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3) Also, an SSTB is any trade or business wherein a principal earns income (e.g., fees, licenses, or compensation) for any of the following activities:
   a) Endorsing products or services
   b) Use of the principal's likeness, image, name, etc.
   c) Appearance fees for an event or media performance (e.g., radio, TV, etc.)

EXAMPLE 7-1 Reputation and Skill

Bill owns Bill's Plumbing, a sole proprietorship. Bill's Plumbing's motto is "Bill is a very skilled plumber with a great reputation." According to the regulations, because Bill's Plumbing does not involve endorsements, compensation for use of one's likeness, or appearance fees, Bill's Plumbing's principal asset is not the reputation or skill of one or more of its employees or owners. Thus, Bill's Plumbing is not considered a specified service business.

4) Trades and businesses that are specifically **not** considered SSTBs include
   a) Architects
   b) Engineers
   c) Real estate agents and brokers
   d) Insurance agents and brokers

EXAMPLE 7-2 SSTB

Danny is a partner at XYZ, LLP, a public accounting firm. Danny is single with taxable income of $500,000. Because Danny's taxable income is above the upper taxable income threshold, the specified service business limitation applies. Thus, because XYZ is a specified service business (and Danny's taxable income is above the upper threshold), XYZ's business income is not QBI and thus is not eligible for the QBID. However, if Danny's taxable income had instead been $100,000, XYZ's business income would have been eligible for the QBID because the specified service business limitation would not have applied.

c. **Qualified Trades or Businesses**

1) In general, a qualified trade or business is any pass-through entity not considered an SSTB.
2) Specifically, a pass-through entity can be identified as a qualified trade or business if it has QBI.

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d. The QBID on line 13 of Form 1040 is generally 20% of QBI, but it is limited due to an **overall limitation**.

   1) The overall limitation is the **lesser of**

      a) 20% × Qualified business income or
      b) 20% × (Taxable income – Net capital gains).

   2) Therefore, if a taxpayer has net capital gains, the taxpayer's net capital gains decrease his or her QBID. (For this deduction, net capital gains are long-term gains and qualified dividends, minus short-term losses.)

   3) Before a taxpayer can apply the overall limitation, (s)he has to determine the combined QBID before the taxable income limitation. Determining the combined QBID is a three-step process. After the three steps have been used to determine the combined QBID, the taxpayer must apply the overall limitation, which becomes Step 4.

e. To **calculate the combined QBID and ultimately the QBID, the following must be completed**:

   1) **Step 1** – Every pass-through entity must first determine its QBI.

      a) This information will be reported on a Schedule K-1 (or a Schedule C if the entity is a sole proprietorship).

      b) The details of this process are described in Figure 7-1 on the next page.

   2) **Step 2** – The sum of each pass-through entity's QBI must then be tested against the taxpayer's taxable income.

      a) If the taxpayer is in the phase-in range or upper threshold, the QBID for each respective pass-through entity is reduced or limited by the IRS. This reduction is the allowed amount of QBID for each respective pass-through entity.

         i) Single taxpayers reach the phase-in range once taxable income exceeds $170,050 and enter the upper threshold at $220,050.

         ii) Married filing jointly taxpayers reach the phase-in threshold when taxable income exceeds $340,100 and enter the upper threshold at $440,100.

      b) The details of this process are complex and beyond the scope of the exam.

      c) General rules that should be understood:

         i) Below the phase-in ranges, the QBID is the full 20% overall limitation.

         ii) Above the phase-in ranges, the QBID is subject to additional limitations.

         iii) For SSTBs, the QBID is completely disallowed above the upper threshold.

   3) **Step 3** – A taxpayer determines the applicable combined QBID by adding together the allowed QBID amount for each respective entity to arrive at a total (or combined) QBID.

   4) **Step 4** – The final step is for the taxpayer to apply the overall limitation to total (or combined) QBID to determine the correct amount to deduct. This amount is then reported on line 13 of Form 1040.

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Step 1 – Determine What Constitutes QBI[1]

Step 1 Ensure the entity is a relevant pass-through entity (i.e., sole proprietor, S corporation, partnership, estate, or trust).

Step 2 Determine whether the entity is directly owned by the taxpayer (e.g., a K-1 is sent directly to the taxpayer as a direct owner of the pass-through entity or business income is reported on Schedule C).

Step 3 Calculate the net amount of income, gain, deduction, and loss with respect to any trade or business. This includes the sale, exchange, or distribution of unrealized receivables or inventory. Also, post-2017 adjustments from changes to accounting methods or previously disallowed losses or deductions currently allowed are treated as items attributable to the trade or business for computing QBI in the current year.

Limited to Amounts

Effectively connected with the conduct of a trade or business within the United States or Puerto Rico AND Included or allowed in determining taxable income for the taxable year

Step 4[2] Remove the following from the calculation of net income[3]

1) Capital gains and losses
2) Dividends
3) Nonoperating interest income
4) Interest income attributable to working capital
5) Gains or losses relating to transactions in commodities
6) Foreign currency gains[4]
7) Any less-than-reasonable salary payments to owners[5]
8) Any deduction or loss properly allocated to the items above

[1] This is the same methodology for determining income from an SSTB.

[2] Conceptually, Congress is allowing small business owners the ability to deduct income that results from the core operations of a small business because the entrepreneurial spirit of small business can drive domestic employment. Because the overarching goal is to spur growth and, ultimately, employment, Congress hopes to incentivize small business owners to grow their core business rather than speculate on side-ventures unrelated to their main business objectives. Therefore, qualified business income is the ordinary, noninvestment income of a business.

[3] There are more reductions in total, but these are the big-picture items that are most likely to affect most taxpayers.

[4] The IRS lists “excess foreign currency gains.” For most taxpayers, this effectively means any foreign currency gains.

[5] If the taxpayer paid himself or herself a salary (or guaranteed payment) less than a reasonable amount to receive a higher QBI deduction, the taxpayer must reduce QBI by the amount of the less-than-reasonable salary payment.

Figure 7-1

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7.2 ALTERNATIVE MINIMUM TAX (AMT)

Corporations

1. The TCJA repealed the old corporate AMT for tax years beginning after December 31, 2017. A new corporate AMT will be in effect for tax year 2023; however, there is still no corporate AMT for tax year 2022.

Individuals (Including Sole Proprietors, Partners, and S Corporation Shareholders)

2. The AMT is an income tax in addition to the regular income tax (Form 6251).
   a. The **formula** for computing AMT is below.

	AMT FORMULA		
	Taxable income		
+	Tax preferences		
+	Standard deduction if taxpayer does not itemize		
+/–	Certain other adjustments		
	Alternative minimum taxable income (AMTI)		
–	Exemption amount	2022	25% phaseout for excess over
	Single	$ 75,900	$ 539,900
	Married filing jointly	$118,100	$1,079,800
	Married filing separately	$ 59,050	$ 539,900
	Alternative minimum tax base		
×	Rate	2022	
	AMT base (married filing jointly)		
	First $206,100 ($103,050 MFS)	26%	
	Excess	28%	
	Tentative minimum tax		
–	Regular income tax		
	Alternative minimum tax		

1) AMT income (AMTI) is based on taxable income (TI).
   a) AMTI is TI after amounts are added or subtracted for tax preferences, adjustments, and loss limitations.
   b) The AMT base is AMTI reduced by an exemption amount and any AMT NOL carryover.
2) Tentative AMT is determined by multiplying a rate times the AMT base after a reduction for the AMT Foreign Tax Credit.
   a) For individuals, a two-tiered graduated rate schedule applies.
      i) A 26% rate applies to the first $206,100 ($103,050 if married filing separately) of AMTI (net of the exemption amount).
      ii) A 28% rate applies to any excess.

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3) AMT is the excess tentative AMT over regular income tax.

4) AMT must be reported and paid at the same time as regular tax liability. Estimated payments of AMT are required.

5) A credit is allowed for the amount AMT exceeds the regular tax for a tax year. The credit carries forward indefinitely.

b. **Tax preference items.** These items generate tax savings by reducing the taxpayer's taxable income. Therefore, they must be added back to taxable income when computing AMTI.

1) **Section 1202 stock.** When computing taxable income, noncorporate taxpayers may exclude up to 100% of gain realized on the sale or exchange of qualified small business stock acquired after September 27, 2010, and held more than 5 years.

a) The exclusion percentage drops to 75% for stock acquired after February 17, 2009, and before September 28, 2010; and to 50% for stock acquired before February 18, 2009. Generally, 7% of the exclusion is a tax preference item for AMT.

b) However, stock purchased after September 27, 2010, is excluded from tax preference treatment.

2) **Private activity bonds.** Add any tax-exempt interest minus expenses (including interest) attributable to earning it. Bonds issued in 2009 and 2010 are excluded from tax preference treatment.

3) **Percentage depletion.** Add any excess of deduction claimed over adjusted basis.

4) **Intangible drilling costs (IDC).** Add any excess of IDC amortized over 10 years over 65% of net income from oil, gas, and geothermal properties.

c. Usually, **adjustments** eliminate "time value" tax savings from accelerated deductions or deferral of income. An adjustment is an increase or a decrease to TI in computing AMTI and includes the following:

1) **Installment sales.** The installment method is not allowed for a disposition of stock in trade in the ordinary course of business (e.g., inventory). Add any balance (+ or –) of current-year gain recognized disregarding the installment method, minus gain recognized under the installment method.

2) **Long-term contracts.** The percentage-of-completion method must be used to determine AMTI. Add any balance (+ or –) if the completed-contract or cash-basis method is normally used.

a) The same percentage of completion must be used for AMT and regular tax.

b) Small construction contracts require a simplified method of allocating costs in applying the percentage-of-completion method. The contract's estimated duration must be less than 2 years.

c) No AMT adjustment is made for home construction contracts.

3) **Pollution control facilities (certified).** For property placed in service after 1986, the 5-year amortization method for depreciation must be replaced by the alternate depreciation system [Sec. 168(g)]. Add any balance (+ or –).

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4) **Mining exploration and development.** If these expenditures were expensed for regular tax purposes, the expenditures must be capitalized and amortized over a 10-year period for AMT. Add any balance (+ or –) for the difference.
   a) Tax loss. If a worthless mine is abandoned, expenditures capitalized but unamortized can be deducted from AMTI.
5) **Net operating loss (NOL) adjustments.** To determine the NOL amount for AMT,
   a) Subtract all amounts added to TI as tax preference amounts to the extent they increased the regular tax NOL.
   b) Tax adjustments made for the AMTI calculation (+ or –) must be made for the NOL calculation.
6) **Distributions from a trust or estate.**
7) **Research and experimental expenditures.** Add any balance (+ or –) of regular tax deduction claimed for the year (normally expensed), minus expenditures capitalized and amortized over 10 years (beginning in year made).
8) **Standard deduction.** The standard deduction cannot be claimed for AMTI purposes.
9) **Certain itemized deductions.** Some itemized deductions that were claimed for regular tax purposes may not be claimed for AMTI purposes. Disallowed deductions include
   a) State, local, or foreign payments. Likewise, any refunds of these taxes can be excluded from AMTI.
   b) Tax-exempt interest on private activity bonds, which is included in investment income.
   c) **Home equity refinancing.** The TCJA suspended the deduction for interest on home equity indebtedness for the tax years 2018 through 2025 unless the indebtedness is used to buy, build, or substantially improve the taxpayer's home that secures the loan.
10) **Circulation expenditures.** Add any balance (+ or –) of regular tax deduction for the year (normally expensed), minus the expenditures capitalized and amortized over 3 years (beginning in year made).
11) **Incentive stock option (ISO).** Add any balance (+ or –) of the FMV of the stock when exercised, minus the amount paid for stock.

d. **AMT NOL.** The alternative minimum tax net operating loss (AMT NOL) is technically an adjustment to taxable income (TI).
   1) After tax preferences have been computed and added to TI and all other adjustments have been computed and made, one of the two AMT NOL adjustment steps is performed.
   2) **NOL year.** Compute the AMT NOL. It is carried back or forward to another tax year.
      a) The AMT NOL is modified for each of the tax preferences and other adjustments for the current tax year.
   3) **Profit year.** An AMT NOL is a final adjustment to TI in computing AMTI in a tax year in which (before reduction by part or all of unused AMT NOLs) there is AMTI.
      a) Limit: 90% of AMTI. Alternative NOL may not offset more than 90% of the AMT base (computed without the alternative NOL deduction).

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e. **AMT exemption.** An exemption is allowed that reduces AMTI to produce the AMT base. The basic exemption is phased out at $.25 for each dollar of AMTI above a threshold. All members of a controlled group must share the exemption amount.

AMT EXEMPTION AMOUNT (Tax Year 2022)			
Entity/Filing Status	Basic Amount	Threshold	Cap
Married filing jointly	$118,100	$1,079,800	$1,552,200
Surviving spouse	118,100	1,079,800	1,552,200
Head of household	75,900	539,900	843,500
Unmarried and not the previous two	75,900	539,900	843,500
Married filing separately	59,050	539,900	776,100

f. **AMT FTC.** Only one credit is allowed in computing AMT: the AMT Foreign Tax Credit (FTC). The AMT FTC is the lower of the FTC or 90% of gross tentative AMT computed before any AMT NOL deduction and FTC.

g. **Minimum Tax Credit (MTC).** A credit is allowed for AMT paid in a tax year against regular tax liability in one or more subsequent tax years.

1) **Individuals.** The MTC amount is the AMT that would have been computed if the only adjustments made to TI in computing AMTI were those for (tax-favored) items that result in deferral, as opposed to exclusion, of income.

a) To compute the MTC amount, recompute the most recent year's AMT without adjustment for the following (exclusion) items, and add carryover MTC:

i) Standard deduction.

ii) Miscellaneous itemized deductions.

iii) Tax-exempt interest on private activity bonds.

iv) Home equity refinancing. The TCJA suspended the deduction for interest on home equity indebtedness for the tax years 2018 through 2025 unless the indebtedness is used to buy, build, or substantially improve the taxpayer's home that secures the loan.

v) Depletion.

vi) Taxes.

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7.3 OTHER TAXES

Employment Taxes and Withholding

1. **Federal Insurance Contributions Act (FICA) tax.** Employers are required to pay tax based on their employee's pay. An employee's wages include all remuneration for employment, including the cash value of all wages paid in a medium other than cash.
   a. The employer must
      1) Pay 6.20% of the first $147,000 (2022) of wages paid for old-age, survivors, and disability insurance (OASDI), also known as Social Security tax, plus
      2) Pay 1.45% of all wages for the hospital insurance (Medicare) portion. This tax has no cap.
   b. For 2022, the employer must withhold 6.20% for OASDI and 1.45% for Medicare from the employee's wages.
      1) The employee's contribution (tax) must be withheld upon each payment of wages computed at the same rate up to the same maximum base.
      2) Any overwithholding is taken as a credit against the income tax if the overwithholding resulted from multiple-employer withholding.
   c. Contributions made by the employee are not tax deductible by the employee, while those made by the employer are deductible by the employer.
   d. An employer must pay FICA taxes for all household employees, e.g., babysitters and maids, who are paid more than $2,400 during the year.
      1) Household employees are exempt from withholdings on noncash payments (e.g., goods, lodging, food, or services) made in exchange for household work.
      2) Schedule H is a simplified form that may be used by employers of household workers in private homes. The form is filed, and the employment taxes can be paid with the employer's annual Form 1040.
2. **Additional Medicare Tax**

NOTE: Throughout our EA Review, "PPACA," instead of "ACA," is used to identify significant topics from the Patient Protection and Affordable Care Act in order to avoid confusion with the Applicable Credit Amount for gift and estate taxes.

   a. PPACA created an additional Medicare tax of 0.9% that applies to wages (cash and noncash), compensation (taxable fringe benefits, bonuses, tips, commissions, etc.), and self-employment income above the specified threshold amount, i.e., the amount of income found in box 5 of the taxpayer's Form W-2 plus net self-employment income on Schedule SE.

Filing Status	Threshold Amount
Married filing jointly	$250,000
Surviving spouse	$200,000
Head of household (with qualifying person)	$200,000
Single	$200,000
Married filing separately	$125,000

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1) Withholding by the employer at the additional rate begins at $200,000 regardless of the employee's filing status on Form W-4. If both spouses work for the same employer, the withholding threshold is still applied on an individual basis and not on the combined compensation of both employees.

EXAMPLE 7-3 No Additional Medicare Tax -- Wages

One spouse received $220,000 of wages, while the other spouse earned $25,000 of either W-2 wages or net self-employment income. The employer of the first spouse is required to withhold an additional 0.9% additional Medicare tax on the last $20,000 of taxable wages (i.e., $180) even though the couple will not owe the 0.9% additional Medicare tax when they file their 2022 Form 1040 ($220,000 + $25,000 = $245,000, which is less than the $250,000 MFJ threshold). The excess withholding will apply toward any other tax they owe.

2) The 0.9% is added to the employer's overall withholding of earned income, as opposed to treating it as a separate item. It is up to the employee to reconcile the total additional Medicare tax at the end of the year when the employee's Form 1040 is filed.

3) Failure by the employer to withhold the additional 0.9% results in the employee being personally responsible for the tax. However, this does not relieve the employer of any penalties associated with failure to withhold the proper amount.

EXAMPLE 7-4 Additional Medicare Tax -- Wages

MFJ taxpayers each have box 5 Medicare wages of $170,000 listed on their respective W-2s. The combined $340,000 of earned income will be shown on the form/schedule for calculating the 0.9% additional Medicare tax. The couple will owe a 0.9% additional Medicare tax of $810 [($340,000 – $250,000 threshold) × 0.9%], which will be included as "Other Taxes" on Schedule 2 of Form 1040.

EXAMPLE 7-5 Additional Medicare Tax -- Self-Employment

Spouse A has $170,000 of box 5 Medicare wages listed on A's W-2. Spouse B has a K-1 from B's law firm listing box 14 self-employment income of $182,426 ($170,000 net self-employment income). The couple will owe $810 [($170,000 wages + $170,000 net SE – $250,000 MFJ threshold) × 0.9%] of additional Medicare tax on their collective earned income.

EXAMPLE 7-6 No Additional Medicare Tax -- Self-Employment

Spouse X has $170,000 of box 5 Medicare wages listed on X's W-2. Spouse Y has a K-1 from Y's law firm with net self-employment income of $170,000. Y also has a $90,000 loss from the start-up of a new Schedule C business. Since Y's self-employment income is now only $80,000, when it is added to X's $170,000 in W-2 wages, the couple is not above the applicable threshold of $250,000 for married filing jointly taxpayers. Therefore, no additional Medicare tax on their collective earned income is due.

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4) The employee portion includes an additional 0.9% for high-income earnings, i.e., earnings in excess of $200,000 ($250,000 MFJ, $125,000 MFS).

a) Individuals with wages and self-employment income calculate their liabilities in three steps:

i) Calculate the tax on any wages in excess of the applicable threshold without regard to any withholding;

ii) Reduce the applicable threshold by the total amount of Medicare wages received, but not below zero; and

iii) Calculate the tax on any self-employment income in excess of the reduced threshold.

b) Remember that this tax only applies to the employee's share of Medicare taxes. Therefore, self-employed individuals are not allowed an additional deduction for one-half of the 0.9%, as the deduction is only for the employer's payment of Medicare taxes. Also, a loss from self-employment can only offset self-employment income, i.e., not W-2 income.

EXAMPLE 7-7 Additional Medicare Tax -- Wages and Self-Employment

C, a single filer, has $130,000 in wages and $145,000 in self-employment income. C's wages are not in excess of the $200,000 threshold for single filers, so C is not liable for the surtax on these wages. Before calculating the tax on self-employment income, the $200,000 threshold for single filers is reduced by C's $130,000 in wages, resulting in a reduced self-employment threshold of $70,000. C is liable to pay tax on $75,000 of self-employment income ($145,000 – $70,000).

3. **Net investment income tax.** Under PPACA, all investment income in excess of deductions allowable for such income and income from passive activities are subject to a 3.8% tax. This tax essentially applies FICA taxes to income that previously was not subject to the taxes.

a. The tax is imposed on the lesser of an individual's net investment income or any excess of modified adjusted gross income (MAGI) for the tax year over a specified threshold.

Filing Status	Threshold Amount
Married filing jointly, surviving spouse	$250,000
Single, head of household	$200,000
Married filing separately	$125,000

b. MAGI is the sum of AGI and excludable foreign earned income/housing costs after any deductions, exclusions, or credits applicable to the foreign earned income.

c. Net investment income tax does not apply to non-resident aliens.

4. **Self-employment tax.** The FICA tax liability is imposed on net earnings from self-employment at twice the rate that applies to an employer, that is, at the rate of 15.3% [2 × (6.20% + 1.45%)].

a. In order to figure self-employment tax liability, a self-employed person is entitled to deduct an amount equal to the employer's portion of the tax. This reduced amount of self-employment net income is net earnings from self-employment and is multiplied by the self-employment tax rate to arrive at the amount of self-employment tax.

$$\text{Net earnings from self-employment} = \text{NI from self-employment} - (.0765 \times \text{NI from self-employment})$$

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b. Instead of reducing net income from self-employment by 7.65%, the reduced amount (i.e., net earnings from SE) may be computed by multiplying net income from self-employment by 92.35%.

c. Self-employment income is equal to the net earnings an individual derives from self-employment during any tax year.

d. Net income from self-employment does not include rents, gain (or loss) from disposition of business property, capital gain (or loss), nonbusiness interest, or dividends.

e. An individual who has less than $400 in net earnings from self-employment during the year has no self-employment income.

f. For 2022, the self-employed person is allowed a deduction for the employer portion of the FICA tax paid to arrive at his or her AGI. The deduction is 50% of the FICA tax paid (ignoring any portion subject to the Additional Medicare Tax).

g. The income inclusion for self-employment taxes differs from gross income inclusion in the case of ministers and/or clergymen.

   1) A minister may exclude the rental value of his or her home or parsonage if it is connected with the performance of religious duties.

   2) The rental value is not excluded from the income used to compute self-employment taxes.

   3) Any wages received by ministers and/or clergymen on a W-2 is not subject to Social Security but is included in self-employment income, unless one of the following applies:

      a) The minister and/or clergyman is a member of a religious order who has taken a vow of poverty.

      b) The minister and/or clergyman asks the Internal Revenue Service (IRS) for an exemption from SE tax for his or her services and the IRS approves his or her request.

      c) The minister and/or clergyman is subject only to the Social Security laws of a foreign country under the provisions of a Social Security agreement between the United States and that country.

5. **Unemployment (FUTA) tax.** This tax is imposed on employers. The tax is 6.0% of the first $7,000 of wages paid to each employee. The employee does not pay any portion of FUTA.

   a. Employers are required to pay unemployment taxes for 2022 if they pay wages of $1,500 or more for any quarter in 2021 or 2022.

   b. Up to 5.4% of the 6.0% is allowable as a credit based on state unemployment taxes paid.

6. **Household employee taxes.** An employer is subject to these taxes if (s)he

   a. Paid one household employee cash wages of $2,400 or more during the year (FICA taxes),

   b. Withheld federal income tax at the request of the employee (income tax), or

   c. Paid total cash wages of $1,000 or more in any calendar quarter to household employees (FUTA tax).

7. With regard to income tax withholding and Social Security, Medicare, and federal unemployment, no differences are recognized among full-time employees, part-time employees, and temporary employees.

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8. If an individual is required to report employment taxes or give tax statements to employees, (s)he must have an employer identification number (EIN).
    a. The EIN is a nine-digit number the IRS issues to identify the tax accounts of employers.

Homebuyer Credit Repayment

9. Between April 8, 2008, and May 1, 2010, a credit for qualifying first-time homebuyers was available. Taxpayers who claimed the credit after 2008 did not have to repay the credit once they lived in the home for 3 years. Taxpayers who claimed it in 2008 continue to repay it over 15 years.
    a. The repayment amount each year is 6.67% of the original credit amount. If, at any time during the repayment period, the taxpayer converts the property to nonqualified use (e.g., no longer primary residence), all remaining balance of the credit is due that year.
    b. The repayment is generally reported on Schedule 2 (Form 1040) line 10; however, some taxpayers may be required to file Form 5405.

FBAR

10. For taxpayers having a financial interest in or signature authority over a foreign financial account (including a bank account, brokerage account, mutual fund, trust, or other type of foreign financial account) exceeding certain thresholds, the Bank Secrecy Act may require them to report the account yearly to the Department of Treasury by electronically filing a Financial Crimes Enforcement Network (FinCEN) 114, *Report of Foreign Bank and Financial Accounts* (FBAR).
    a. Those required to file an FBAR who fail to properly file a complete and correct FBAR may be subject to a civil penalty not to exceed $14,489 per violation for nonwillful violations that are not due to reasonable cause. For willful violations, the penalty may be the greater of $144,886 or 50% of the balance in the account at the time of the violation for each violation.

Specified Foreign Financial Assets

11. Taxpayers with specified foreign financial assets that exceed certain thresholds must report those assets to the IRS on Form 8938, *Statement of Specified Foreign Financial Assets*, which is filed with the taxpayer’s tax return. This form is in addition to the FBAR filing requirement, despite the chance of duplication of reported items.
    a. There is a $10,000 penalty for failure to file the form on time. After 90 days of being notified of the failure, an additional $10,000 penalty will be assessed every 30 days, but it is not to exceed $50,000. There is also a 40% penalty on the understated tax for failure to disclose assets.

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STUDY UNIT EIGHT

TAX CREDITS AND PAYMENTS

The first subunit discusses tax credits, which are used to achieve policy objectives such as encouraging energy conservation or providing tax relief to low-income taxpayers. A $1 credit reduces gross tax liability by $1. Various nonrefundable and refundable tax credits are available. Most credits are nonrefundable, meaning that once the tax liability reaches zero, no more credits can be taken to produce refunds. Nonrefundable personal credits include the

- Foreign Tax Credit
- Lifetime Learning Credit
- Child and Dependent Care Credit
- Child Tax Credit
- Credit for Other Dependents
- Retirement Savings Contribution Credit
- Credit for the Elderly or Disabled
- Adoption Credit
- Residential Mortgage Interest Credit
- Minimum Tax Credit
- Residential Energy Credit

Refundable credits are treated as payments and can result in refunds for the taxpayer. Refundable credits include the

- American Opportunity Tax Credit
- Additional Child Tax Credit
- Earned Income Credit
- Health Insurance Premium Tax Credit

In the last subunit, we discuss payment requirements, claims for refunds, and the statute of limitations.

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8.1 TAX CREDITS

Foreign Tax Credit (FTC)

1. A taxpayer may elect either a credit or a deduction for taxes paid to other countries or U.S. possessions.
   a. Generally, the FTC is applied against gross tax liability after nonrefundable personal credits and before all other credits.
   b. The FTC, as modified, may offset AMT liability.
      1) The FTC is not creditable against the accumulated earnings tax (AET) or the personal holding company (PHC) tax.
   c. **Pass-through entities** apportion the foreign taxes among the partners, shareholders (of an S corporation), or beneficiaries (of an estate).
      1) The taxpayers then elect and compute a credit or deduction on their personal returns.
   d. For a **non-U.S. person**, the FTC is allowed only for foreign taxes paid on income effectively connected with conduct of a trade or business in the U.S. and against U.S. tax on the effectively connected income.
      1) Nonresident aliens and foreign corporations are included under this provision.
   e. **Qualified foreign taxes (QFTs)** include foreign taxes on income, war profits, and excess profits.
      1) QFTs must be analogous to the U.S. income tax.
         a) They must be based on a form of net annual income, including gains.
         b) Concepts such as realization should be incorporated into the tax structure.
      2) Foreign taxes paid on foreign earned income or housing costs excluded as excessive may neither be credited nor deducted.
      3) Deemed QFT. A domestic corporation that owns at least 10% (voting) of a foreign corporation is deemed to have paid the foreign taxes paid by the foreign corporation on income that it distributed to the domestic corporation as a dividend.

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f. **FTC limit.** The maximum amount of tax that may be credited is computed using the following formula:

$$\text{FTC} = \begin{array}{c}\text{U.S. income}\\ \text{tax before FTC}\end{array} \times \frac{\text{Foreign earned taxable income}}{\text{Worldwide taxable income}}$$

1) The limit must be applied separately to nonbusiness interest income and all other income.
2) The amount used for TI in the numerator and denominator is regular TI with adjustments.
3) The credit is limited by foreign taxes paid or accrued during the tax year.

g. The FTC is claimed on Form 1116, *Foreign Tax Credit*, unless the taxpayer meets all of the following conditions and elects to claim the credit on Schedule 3 (Form 1040), line 1:

1) The taxpayer is an individual,
2) The only foreign source income for the year is passive income that is reported on a qualified payee statement (e.g., Form 1099-DIV, Form 1099-INT, Schedule K-1, or Schedule K-3), and
3) The QFTs for the year do not exceed $300 ($600 for a joint return).

h. **Carryover.** Foreign tax paid in excess of the FTC limit may be carried back 1 year and forward 10, in chronological order. The carryover is treated as foreign tax paid subject to the FTC limit.

1) The carryover may not be applied in any year when a deduction for foreign taxes is taken (in lieu of the FTC).

i. A credit (or deduction) cannot be taken for foreign income taxes paid on income that is excluded from U.S. tax under the foreign earned income exclusion.

j. A choice must be made to take either a credit or a deduction for all qualified foreign taxes.

EXAMPLE 8-1 Foreign Tax Credit

Maria had an AGI of $100,000 in 2022, of which $80,000 was wages earned in the United States and $20,000 was unqualified foreign dividend income. She paid $4,000 of foreign taxes on the dividend income. Maria's 2022 tax liability before the FTC is $15,000. The portion of U.S. tax liability assigned to foreign income is $3,000 ($15,000 × $20,000 ÷ $100,000). Maria is able to claim a $3,000 Foreign Tax Credit on Form 1116 and has $1,000 ($4,000 taxes paid – $3,000 allowed credit) of unused Foreign Tax Credit that can be carried back to 2021 or forward through 2032.

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Education Credits

2. Two tax credits may be elected by low- and middle-income individuals for education expenses incurred by students pursuing higher education or vocational training.
    a. The American Opportunity Tax Credit is partially refundable, and the Lifetime Learning Credit is nonrefundable. In addition, neither credit is allowed by married taxpayers who file separately; i.e., they must file a joint return.
    b. **American Opportunity Tax Credit (AOTC).** The AOTC provides a maximum credit of $2,500 per student for each of the first 4 years of post-secondary education.
        1) The $2,500 per year is the sum of 100% of the first $2,000 of qualified expenses and 25% of the next $2,000 of qualified expenses.
        2) The credit applies to the first 4 years of higher education received by the taxpayer, the taxpayer's spouse, and/or the taxpayer's dependents.
        3) The credit applies to tuition and tuition-related fees, books, and other required course materials.
            a) The credit is not allowed for room and board, insurance, student health fees, transportation costs, activity fees, or any other fees or expenses not related to the student's academic course of instruction.
        4) Qualified education expenses paid in 2022 for an academic period that begins in the first 3 months of 2023 can be used in figuring an education credit for 2022.
        5) The credit cannot be claimed if
            a) An exclusion for an education IRA or a state tuition program is claimed for the same expenses
            b) The student has been convicted of a federal or state felony offense consisting of the possession or distribution of a controlled substance
            c) The student is not taking at least one-half of the normal full-time workload for at least one academic period that begins during the calendar year in which the credit is claimed
        6) The credit phases out for MAGI between $80,000 and $90,000 for single taxpayers and between $160,000 and $180,000 on a joint return.
        7) Up to 40% of the credit is refundable.
            a) When the original tax equals or exceeds $2,500, the entire $2,500 is used to lower the tax bill. Thus, no credit will be refunded.
            b) When the original tax is less than $2,500 and the tax is lowered to zero, the remaining credit is partially (40%) refundable. For example, the original tax is $1,500. After $1,500 of the credit is used to lower the tax to zero, 40% (i.e., $400) of the remaining $1,000 credit is refundable.
            c) No refund of the credit is allowed if the student is a child subject to the "kiddie tax" (covered in Study Unit 1, Subunit 5).

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c. **Calculating the American Opportunity Tax Credit**

1) Step 1: Calculate the maximum AOTC for each student based on 100% of the first $2,000 of qualified expenses and 25% of the next $2,000 of qualified expenses. If there is at least $4,000 of qualified expenses, the maximum per-student AOTC is $2,500.

2) Step 2: Add the maximum AOTCs for each qualified student to find the maximum AOTC for all students.

3) Step 3: If MAGI is $160,000 or less for married taxpayers filing jointly or $80,000 or less for all others, the maximum AOTC for all students is the result of Step 2. MAGI is below the phaseout amount.

   a) If MAGI is $180,000 or more for married taxpayers filing jointly or $90,000 or more for all others, the maximum AOTC is zero. MAGI is above the upper threshold and the AOTC is phased out.

   b) If MAGI is between $160,000 and $180,000 for married taxpayers filing jointly or between $80,000 and $90,000 for all others, the AOTC is computed as follows:

$$\text{Maximum AOTC for all students (Step 2)} \times \frac{\$180{,}000 \text{ (if joint return) or } \$90{,}000 \text{ (all others)} - \text{MAGI}}{\$20{,}000 \text{ (if joint return) or } \$10{,}000 \text{ (all others)}}$$

4) Step 4: Compare the results from Step 3 to the federal income tax liability.

   a) If the federal income tax liability is greater than the results of Step 3, Step 3 is a nonrefundable AOTC.

   b) If the results of Step 3 are greater than the federal income tax liability, the amount of the federal income tax liability becomes a nonrefundable AOTC. The refundable portion of the AOTC is 40% of the excess of Step 3 over the federal income tax liability.

EXAMPLE 8-2 American Opportunity Tax Credit

Jack and Jill Smith, married taxpayers who file a joint return, have a combined modified AGI of $172,000. They paid $3,000 in tuition expenses for their dependent daughter, who is in her second year of college, and $8,000 in tuition expenses for their dependent son, who is in graduate school. The tuition expenses the Smiths paid for their son do not qualify for the AOTC because he is not in his first 4 years of post-secondary education.

The $3,000 of tuition expenses paid for their daughter's education qualifies for the credit. The tentative credit allowed is $2,250 [($2,000 × 100%) + ($1,000 × 25%)]. However, the Smiths' AGI is within the phase-out range and their credit must be reduced accordingly. The Smiths' allowable credit is calculated as follows:

$2,250 × [($180,000 – $172,000) ÷ $20,000] = $900

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d. **Lifetime Learning Credit.** The Lifetime Learning Credit provides a credit of 20% of qualified tuition expenses paid by the taxpayer for any year the AOTC is not claimed for the same student.

1) The maximum credit allowed per year is $2,000.
2) This is based on 20% of up to $10,000 of qualified tuition and fees paid for the taxpayer, the taxpayer's spouse, and/or the taxpayer's dependents.
3) The credit is figured on a per-taxpayer basis, whereas the AOTC is allowed per student.
4) The credit is available for an unlimited number of years and can be used for both graduate- and undergraduate-level courses.
5) Eligible expenses for this credit include tuition and fees required for enrollment.
6) The Lifetime Learning Credit phases out for AGI between $80,000 and $90,000 for single filers and between $160,000 and $180,000 for those filing a joint return.

e. The credits may not be used for room and board, activity fees, athletic fees, insurance expense, or transportation.

f. The tuition statement (1098-T) provided to the taxpayer/student is required to include the name, address, and TIN of the taxpayer/student.

EXAMPLE 8-3 Lifetime Learning Credit

Barney is a single taxpayer with a modified AGI of $52,000. Barney has two dependent daughters in graduate school. He pays $6,000 in tuition expenses for each of his daughters, for a total of $12,000. The first $10,000 of these expenses qualifies for the Lifetime Learning Credit. Thus, Barney may claim a credit of $2,000 ($10,000 × 20%). There is no phaseout of the Lifetime Learning Credit for Barney because the credit phaseout for single taxpayers commences when modified AGI is $80,000 and ends at $90,000.

EXAMPLE 8-4 Lifetime Learning Credit

Weasley and Brandy Kat, who file a joint tax return, have an adjusted gross income (AGI) of $158,000 for 2022. Their daughter Honey began her first year of graduate school on July 21, 2021. Weasley and Brandy incurred tuition expenses of $12,000 in 2022.

A Lifetime Learning Credit is limited to 20% of the first $10,000 of tuition paid. The Lifetime Learning Credit is available in years the American Opportunity Tax Credit is not claimed. The Kats' credit for 2022 will be $2,000 ($10,000 × 20%). There is no phaseout of the Lifetime Learning Credit for the Kats because the credit phaseout for married taxpayers filing jointly commences when modified AGI is $160,000 and ends at $180,000.

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Credits for Children and Dependents

3. There are four credits available for children and/or dependents.
   a. Child and Dependent Care Credit
   b. Child Tax Credit
   c. Additional Child Tax Credit
   d. Credit for Other Dependents
4. The **Child and Dependent Care Credit** is available for offsetting child and dependent care expenses and is reported on Form 2441. The Child and Dependent Care Credit is nonrefundable.
   a. A taxpayer is eligible for this credit only if items b. and c. below are satisfied.
   b. **Employment.** Child and dependent care expenses are incurred to enable the taxpayer to be gainfully employed.
      1) The expenses may be incurred when the claimant is employed or actively seeking employment.
   c. **Household cost.** The taxpayer provides more than half the cost of maintaining a household for a dependent under age 13 or a physically or mentally incapacitated spouse or dependent.
      1) To be a qualifying person, the person must have lived with the taxpayer for more than half of 2022.
      2) **Special rule for children of divorced or separated parents.** Even if the taxpayer cannot claim his or her child as a dependent, the child is treated as the taxpayer's qualifying person if
         a) The child was under age 13 or was not physically or mentally able to care for himself or herself and
         b) The taxpayer was the child's custodial parent.
            i) The custodial parent is the parent with whom the child lived for the greater number of nights in 2022. If the child was with the parent for an equal number of nights, the custodial parent is the parent with the higher adjusted gross income.

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3) Qualifying Employment Related Expenses
   a) Household services, such as babysitting, housekeeping, and nursery.
   b) Outside services, such as day care, must be in qualified facilities.
      i) Outside expenses for the care of an incapacitated spouse or dependent qualify only if the individual spends more than 8 hours a day in the taxpayer's home.
   c) The cost of sending a child to school if the child is in a grade below kindergarten.
   d) Payments to a relative for the care of a qualifying individual.
      i) These payments do not qualify for the credit if the taxpayer claims a dependent exemption for the relative or if the relative is the taxpayer's child and is under age 19.
4) The cost of transporting a qualifying person from the home to the care location and back is a nonqualified expense.
5) Total child and dependent care expenses cannot exceed the taxpayer's earned income. For married taxpayers, the income for this limitation is the smaller income of the two.
   a) If one of the spouses is a full-time student at an educational institution or is unable to care for himself or herself, (s)he is considered to have earned $250 per month if there is one qualifying individual and $500 per month if there are two or more qualifying individuals.
6) For 2022, child and dependent care expenses are limited to $3,000 for one qualifying individual and $6,000 for two or more individuals, less excludable employer dependent-care assistance program payments.
7) The credit is equal to 35% of the child and dependent care expenses paid during the year.
   a) This rate is reduced by 1% (but not below 20%) for each $2,000 (or part thereof) by which AGI exceeds $15,000.
   b) A taxpayer with AGI over $43,000 will have a credit of 20%.

EXAMPLE 8-5 Child and Dependent Care Credit

Kimberly is a head of household taxpayer with twin 2-year-old daughters. Kimberly has an AGI of $80,000. Kimberly is eligible for a 20% credit on the first $6,000 of dependent care expenses. Kimberly spent $7,000 on childcare, allowing her to claim a $1,200 Dependent Care Credit ($6,000 × 20%).

d. Taxpayers must provide each dependent's **taxpayer identification number** in order to claim the credit, as well as the identifying number of the service provider.

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e. The figure below is a general guide for determining if the taxpayer qualifies for the credit:

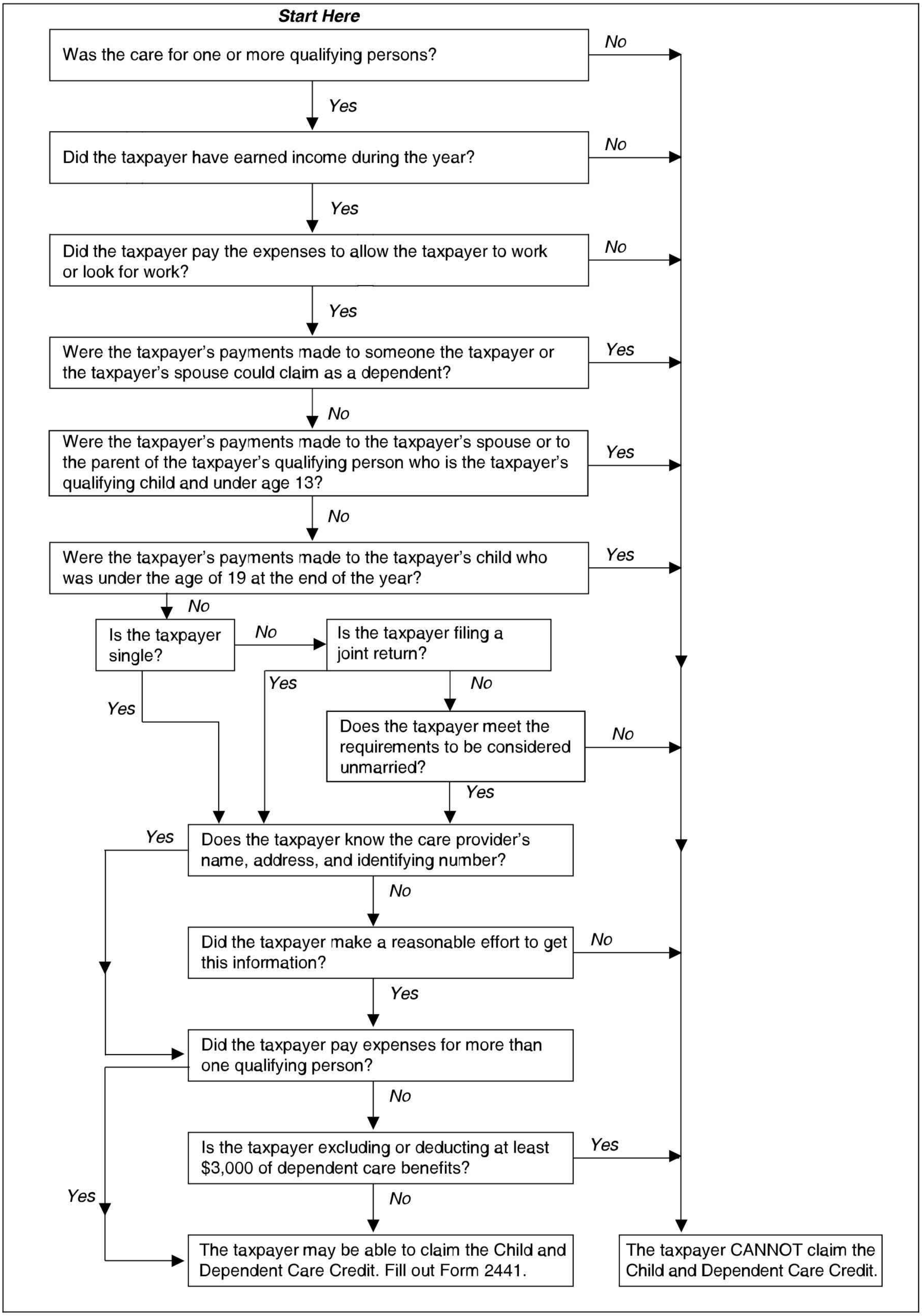

Figure 8-1

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Child Tax Credit, Additional Child Tax Credit, and Credit for Other Dependents

5. The **Child Tax Credit (CTC)** is for taxpayers who have a qualifying child. It is in addition to the Child and Dependent Care Credit and the Earned Income Credit.
   a. For 2022, the maximum credit is $2,000.
   b. The CTC is not refundable.
6. The **Additional Child Tax Credit (ACTC)** is for certain individuals who get less than the full amount of the CTC. This credit is refundable up to the lesser of 15% of earned income in excess of $2,500 or the unclaimed portion of the nonrefundable credit. The refund is capped at $1,500 per child.
7. The **Credit for Other Dependents** is a $500 nonrefundable credit for dependents other than a qualifying child or for a qualifying child without the required SSN.
8. A qualifying child for purposes of the CTC is a child who
   a. Is the taxpayer's son, daughter, stepchild, foster child, brother, sister, stepbrother, stepsister, half brother, half sister, or a descendant of any of them (for example, the taxpayer's grandchild, niece, or nephew);
   b. Was under age 17 at the end of 2022;
   c. Did not provide over half of his or her own support for 2022;
   d. Lived with the taxpayer for more than half of 2022;
      1) A child is considered to have lived with the taxpayer for more than half of 2022
         a) If the child was born or died in 2022 and the taxpayer's home was the child's home for more than half the time (s)he was alive during the year.
         b) Temporary absences by the taxpayer or the child for special circumstances, such as school, vacation, business, medical care, military service, or detention in a juvenile facility, count as time the child lived with the taxpayer.
         c) Exceptions exist for kidnapped children and children of divorced or separated parents.
   e. Is claimed as a dependent on the taxpayer's return;
   f. 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);
   g. Was a U.S. citizen, a U.S. national, or a U.S. resident alien; and
   h. Has a Social Security number (SSN) issued before the due date of the return.

   NOTE: An adopted child is always treated as the taxpayer's own child. An adopted child includes a child lawfully placed with the taxpayer for legal adoption.

EXAMPLE 8-6 CTC Age Test

The taxpayer's son turned 17 on December 30, 2022. He is a citizen of the United States, and the taxpayer claimed him as a dependent on the taxpayer's return. He is not a qualifying child for the CTC because he was not under age 17 at the end of 2022.

EXAMPLE 8-7 CTC Citizenship Test

Your 10-year-old nephew lives in Mexico and qualifies as your dependent. Because he is not a U.S. citizen, U.S. national, or U.S. resident alien, he is not a qualifying child for the CTC.

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9. For 2022, the credit is phased out when AGI reaches $400,000 for married filing jointly and $200,000 for all other taxpayers.
   a. The credit is reduced by $50 for each $1,000 by which the taxpayer's AGI exceeds the threshold.
10. The credit is allowed only for tax years consisting of 12 months.
11. The credits are reported on Schedule 8812 reproduced below and on the next page.

SCHEDULE 8812 (Form 1040)

Department of the Treasury
Internal Revenue Service

Credits for Qualifying Children and Other Dependents

Attach to Form 1040, 1040-SR, or 1040-NR.

Go to *www.irs.gov/Schedule8812* for instructions and the latest information.

OMB No. 1545-0074

2022

Attachment Sequence No. **47**

Name(s) shown on return | **Your social security number**

Part I Child Tax Credit and Credit for Other Dependents

1	Enter the amount from line 11 of your Form 1040, 1040-SR, or 1040-NR			**1**	
2a	Enter income from Puerto Rico that you excluded	**2a**			
b	Enter the amounts from lines 45 and 50 of your Form 2555	**2b**			
c	Enter the amount from line 15 of your Form 4563	**2c**			
d	Add lines 2a through 2c			**2d**	
3	Add lines 1 and 2d			**3**	
4	Number of qualifying children under age 17 with the required social security number	**4**			
5	Multiply line 4 by $2,000			**5**	
6	Number of other dependents, including any qualifying children who are not under age 17 or who do not have the required social security number	**6**			
	Caution: Do not include yourself, your spouse, or anyone who is not a U.S. citizen, U.S. national, or U.S. resident alien. Also, do not include anyone you included on line 4.				
7	Multiply line 6 by $500			**7**	
8	Add lines 5 and 7			**8**	
9	Enter the amount shown below for your filing status. • Married filing jointly—$400,000 • All other filing statuses—$200,000			**9**	
10	Subtract line 9 from line 3. • If zero or less, enter -0-. • If more than zero and not a multiple of $1,000, enter the next multiple of $1,000. For example, if the result is $425, enter $1,000; if the result is $1,025, enter $2,000, etc.			**10**	
11	Multiply line 10 by 5% (0.05)			**11**	
12	Is the amount on line 8 more than the amount on line 11?			**12**	
	☐ **No. STOP.** You cannot take the child tax credit, credit for other dependents, or additional child tax credit. Skip Parts II-A and II-B. Enter -0- on lines 14 and 27. ☐ **Yes.** Subtract line 11 from line 8. Enter the result.				
13	Enter the amount from the **Credit Limit Worksheet A**			**13**	
14	Enter the smaller of line 12 or 13. **This is your child tax credit and credit for other dependents** **Enter this amount on Form 1040, 1040-SR, or 1040-NR, line 19.**			**14**	

If the amount on line 12 is more than the amount on line 14, you may be able to take the **additional child tax credit** on Form 1040, 1040-SR, or 1040-NR, line 28. Complete your Form 1040, 1040-SR, or 1040-NR through line 27 (also complete Schedule 3, line 11) before completing Part II-A.

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 59761M **Schedule 8812 (Form 1040) 2022**

Figure 8-2

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Schedule 8812 (Form 1040) 2022 Page **2**

Part II-A Additional Child Tax Credit for All Filers

Caution: If you file Form 2555, you cannot claim the additional child tax credit.

15 Check this box if you **do not** want to claim the additional child tax credit. Skip Parts II-A and II-B. Enter -0- on line 27 . . . . . . ☐

16a Subtract line 14 from line 12. If zero, **stop here**; you cannot take the additional child tax credit. Skip Parts II-A and II-B. Enter -0- on line 27 . . . **16a** ______

b Number of qualifying children under 17 with the required social security number: ______ x $1,500. Enter the result. If zero, **stop here**; you cannot claim the additional child tax credit. Skip Parts II-A and II-B. Enter -0- on line 27 . . . **16b** ______

TIP: The number of children you use for this line is the same as the number of children you used for line 4.

17 Enter the **smaller** of line 16a or line 16b . . . **17** ______

18a Earned income (see instructions) . . . **18a** ______

b Nontaxable combat pay (see instructions) . . . **18b** ______

19 Is the amount on line 18a more than $2,500?

☐ **No.** Leave line 19 blank and enter -0- on line 20.

☐ **Yes.** Subtract $2,500 from the amount on line 18a. Enter the result . . . **19** ______

20 Multiply the amount on line 19 by 15% (0.15) and enter the result . . . **20** ______

Next. On line 16b, is the amount $4,500 or more?

☐ **No.** If you are a bona fide resident of Puerto Rico, go to line 21. Otherwise, skip Part II-B and enter the **smaller** of line 17 or line 20 on line 27.

☐ **Yes.** If line 20 is equal to or more than line 17, skip Part II-B and enter the amount from line 17 on line 27. Otherwise, go to line 21.

Part II-B Certain Filers Who Have Three or More Qualifying Children and Bona Fide Residents of Puerto Rico

21 Withheld social security, Medicare, and Additional Medicare taxes from Form(s) W-2, boxes 4 and 6. If married filing jointly, include your spouse's amounts with yours. If your employer withheld or you paid Additional Medicare Tax or tier 1 RRTA taxes, see instructions . . . **21** ______

22 Enter the total of the amounts from Schedule 1 (Form 1040), line 15; Schedule 2 (Form 1040), line 5; Schedule 2 (Form 1040), line 6; and Schedule 2 (Form 1040), line 13 . **22** ______

23 Add lines 21 and 22 . . . **23** ______

24 **1040 and 1040-SR filers:** Enter the total of the amounts from Form 1040 or 1040-SR, line 27, and Schedule 3 (Form 1040), line 11.
1040-NR filers: Enter the amount from Schedule 3 (Form 1040), line 11. **24** ______

25 Subtract line 24 from line 23. If zero or less, enter -0- . . . **25** ______

26 Enter the **larger** of line 20 or line 25 . . . **26** ______

Next, enter the **smaller** of line 17 or line 26 on line 27.

Part II-C Additional Child Tax Credit

27 **This is your additional child tax credit. Enter this amount on Form 1040, 1040-SR, or 1040-NR, line 28** . . **27** ______

Schedule 8812 (Form 1040) 2022

Figure 8-2 (continued)

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Retirement Savings Contributions Credit (Saver's Credit)

12. The Saver's Credit can be taken for the taxpayer's contributions to a traditional or Roth IRA, 401(k), SIMPLE IRA, SARSEP, 403(b), 501(c)(18), or governmental 457(b) plan and for voluntary after-tax employee contributions to qualified retirement and 403(b) plans.
13. Rollover contributions (money that the taxpayer moved from another retirement plan or IRA) are not eligible for the Saver's Credit. Additionally, eligible contributions may be reduced by any recent distributions the taxpayer received from a retirement plan or IRA.
14. The taxpayer is eligible for the credit if the taxpayer is (a) age 18 or older, (b) not claimed as a dependent on another person's return, and (c) not a full-time student.
    a. A taxpayer is a student if, during any part of 5 calendar months of 2022, the taxpayer was
        1) Enrolled as a full-time student at a school
            a) A school includes technical, trade, and mechanical schools. It does not include on-the-job training courses, correspondence schools, or schools offering courses only through the Internet.
        2) Took a full-time, on-farm training course given by a school or a state, county, or local government agency
15. The amount of the credit is 50%, 20%, or 10% of a maximum contribution amount of $2,000 ($4,000 if married filing jointly) to the taxpayer's retirement plan or IRA, based on the adjusted gross income.
    a. The chart below has the Saver's Credit AGI limits for 2022.

2022 Saver's Credit

Credit Rate	Married Filing Jointly	Head of Household	All Other Filers
50% of contribution	AGI ≤ $41,000	AGI ≤ $30,750	AGI ≤ $20,500
20% of contribution	$41,001-$44,000	$30,751-$33,000	$20,501-$22,000
10% of contribution	$44,001-$68,000	$33,001-$51,000	$22,001-$34,000
0% of contribution	more than $68,000	more than $51,000	more than $34,000

EXAMPLE 8-8 Retirement Savings Contribution Credit

Stephanie, who works at a retail store, is married and earned $39,000 in 2022. Stephanie's husband was unemployed in 2022 and did not have any earnings. Stephanie contributed $1,000 to her IRA in 2022. After deducting her IRA contribution, Stephanie's adjusted gross income on her joint return is $38,000. Stephanie may claim a 50% credit, $500, for her $1,000 IRA contribution.

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Credit for the Elderly or Disabled

16. The Credit for the Elderly or Disabled is nonrefundable.

    a. An individual may be eligible for this credit if (s)he was age 65 before the close of the tax year or retired before the close of the tax year due to a total and permanent disability.

Qualified Individual for the Credit for the Elderly or Disabled

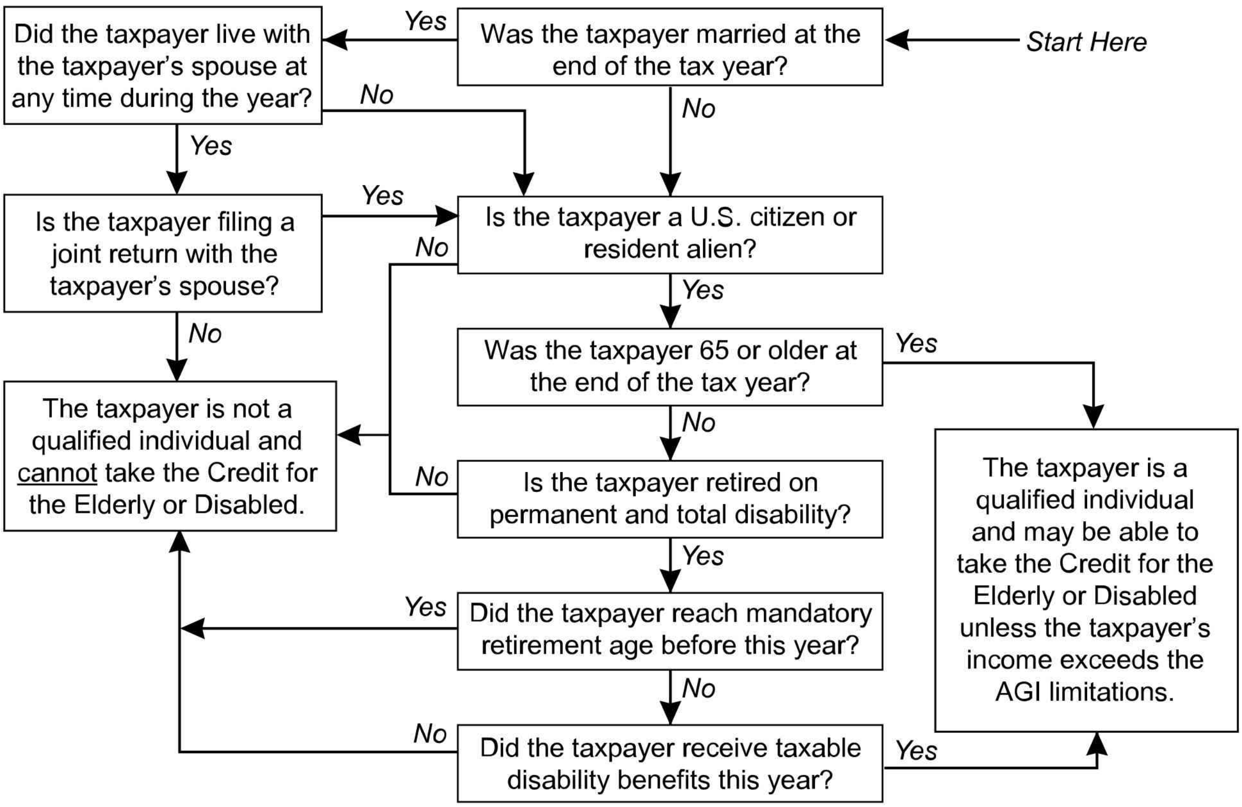

Figure 8-3

    b. The credit is equal to 15% times an initial base amount, which is $5,000 ($7,500 for married filing joint return with both spouses age 65 or older, $3,750 MFS), and limited to disability income if under age 65. This initial base amount is reduced by the following:

        1) Tax-exempt Social Security benefits,
        2) Pension or annuity benefits excluded from gross income,
        3) Disability income if under 65, and
        4) One-half the excess of AGI over $7,500 ($10,000 for married filing jointly, $5,000 MFS).

EXAMPLE 8-9	**Elderly Credit**
Virginia is 66 and unmarried, claims the standard deduction, and has not started to receive any retirement income. In 2022, Virginia's AGI is $15,500 and her taxable income is $800 ($15,500 AGI – $12,950 standard deduction – $1,750 additional standard deduction), creating a $80 ($800 × 10%) tax liability. Virginia's remaining base amount for the elderly credit is $1,000 {$5,000 – [($15,500 – $7,500) × 50%]}, creating a $150 credit ($1,000 × 15%). Virginia's $80 tax liability is less than the $150 credit, so she can only claim $80 of the credit.	

    c. A married person filing separately who lives with the spouse at any time during the year may not claim the credit.

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d. The credit is claimed/reported on Schedule R. The following table provides the initial credit amounts:

Initial Amounts

IF the taxpayer's filing status is . . .	**THEN entered on line 10 of Schedule R is . . .**
single, **head of household**, or **qualifying widow(er)** with dependent child and, by the end of 2022, the taxpayer was	
• 65 or older	$5,000
• under 65 and retired on permanent and total disability	$5,000
married filing a joint return and by the end of 2022	
• both spouses were 65 or older	$7,500
• both spouses were under 65 and one spouse retired on permanent and total disability	$5,000
• both spouses were under 65 and both spouses retired on permanent and total disability	$7,500
• one spouse was 65 or older, and the other was under 65 and retired on permanent and total disability	$7,500
• one spouse was 65 or older, and the other was under 65 and **not** retired on permanent and total disability	$5,000
married filing a separate return and the taxpayer did not live with the taxpayer's spouse at any time during the year and, by the end of 2022, the taxpayer was	
• 65 or older	$3,750
• under 65 and retired on permanent and total disability	$3,750

IF the taxpayer's filing status is . . .	**THEN, even if the taxpayer qualifies, the taxpayer CANNOT take credit if . . .**	
	The taxpayer's adjusted gross income (AGI) is equal to or more than . . .	OR the total of the taxpayer's nontaxable Social Security and other nontaxable pension(s), annuities, or disability income is equal to or more than . . .
single, head of household, or qualifying widow(er) with dependent child	$17,500	$5,000
married filing jointly **and** only one spouse qualifies	$20,000	$5,000
married filing jointly **and** both spouses qualify	$25,000	$7,500
married filing separately and the taxpayer lived apart from the taxpayer's spouse for all of 2022	$12,500	$3,750

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Adoption Credit

17. A nonrefundable Adoption Credit is allowed for qualified adoption expenses.
    a. An eligible child must be under 18 years of age or must be physically or mentally incapable of self-care.
    b. Qualified adoption expenses are reasonable and necessary adoption expenses, including adoption fees, court costs, attorney fees, and other directly related expenses.
        1) Expenses that are not eligible for the Adoption Credit include
            a) Costs associated with a surrogate parenting arrangement,
            b) Expenses incurred in violation of state or federal law,
            c) Expenses incurred in connection with the adoption of a child of the taxpayer's spouse, and
            d) Infant care supplies.

EXAMPLE 8-10	**Adoption Credit**
A taxpayer with modified AGI of $80,000 pays $15,000 of qualified adoption expenses to adopt a 10-year-old girl. As part of the taxpayer's employee benefit program, the employer reimburses the taxpayer for $5,000. This amount reduces the taxpayer's qualified adoption expenses to $10,000. Thus, the taxpayer can only claim a $10,000 credit for qualified adoption expenses.	

    c. The maximum credit is $14,890 per qualified child, including a special-needs domestic adoption.
        1) The maximum credit amount is allowed for the adoption of a child with special needs regardless of the actual expenses paid or incurred in the year the adoption becomes final.
        2) The amount of the credit allowable for any tax year is phased out for taxpayers with modified adjusted gross income (MAGI) in excess of $223,410 and is fully eliminated when MAGI reaches $263,410.

$$\text{Adoption Credit} = \$14{,}890 \times \left[1 - \left(\frac{\text{MAGI} - \$223{,}410}{\$40{,}000}\right)\right]$$

        3) The credit is also reduced if the taxpayer receives excludable adoption assistance from an employer.
    d. Unused credit may be carried forward for up to 5 years and is not subject to the AGI phaseout.

Residential Mortgage Interest Credit

18. The Residential Mortgage Interest Credit is nonrefundable.
    a. State and local governments can elect to issue qualified mortgage bonds (QMBs) in lieu of certain tax-exempt bonds.
        1) The QMBs finance mortgage credit certificates (MCCs) issued to qualified individuals who use the MCCs when privately financing their first purchase of a principal residence.
        2) The interest on the home mortgage is the base.
        3) The MCC rate is between 10% and 50% (assumption is 25%).
        4) If the rate exceeds 20%, the credit is limited to $2,000 per year.
        5) MCC credit disallowed by the overall limit may be carried forward 3 years.

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EXAMPLE 8-11	**Residential Mortgage Interest Credit**
David and Lydia paid $4,800 of interest in 2022 on the mortgage given upon acquiring their first home. They received a mortgage credit certificate that specifies a 20% credit rate. They are entitled to a credit of $960 ($4,800 × 20%). The amount of mortgage interest they may use as an itemized deduction is reduced by the amount of the credit to $3,840 ($4,800 – $960).	

Minimum Tax Credit (MTC)

19. The Minimum Tax Credit is nonrefundable.
    a. A credit is allowed for alternative minimum tax (AMT) paid in a tax year against regular tax liability in one or more subsequent tax years (Form 8801).
    b. **Individuals.** The MTC amount is the AMT that would have been computed if the only adjustments made to taxable income in computing AMTI were those for (tax-favored) items that result in deferral, as opposed to exclusion, of income.
        1) To compute the MTC amount, recompute the most recent year's AMT without adjustment for the following (exclusion) items, and add carryover MTC:
            a) Standard deduction,
            b) Tax-exempt interest on private activity bonds (except ones issued in 2009 or 2010),
            c) Interest expense (e.g., investment interest),
            d) Depletion, and
            e) Taxes.
    c. **Limits.** The MTC allowable is limited to current-year gross regular tax (reduced by certain credits) minus current-year tentative minimum tax.

	Gross regular tax
–	Credits
–	Tentative minimum tax (for current year)
=	MTC maximum allowable

        1) The current-year gross regular tax amount is reduced by the amount currently allowable for each of the following:
            a) Refundable credits
            b) Nonrefundable personal credits
            c) Foreign tax, drug testing, nonconventional source fuel credits
            d) General Business Credit
    d. **Carryover.** Any MTC amount beyond the current limit may be carried forward indefinitely.

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Earned Income Credit (EIC)

20. The Earned Income Credit is refundable.

    a. Under Sec. 32(a), the EIC is available to individuals who have earned income and gross income below certain thresholds.

        1) An individual is not eligible for the EIC if (s)he does not include his or her correct SSN on the return claiming the credit.

        2) Individual taxpayer identification numbers (ITINs) disqualify the taxpayer and/or the otherwise qualifying child (QC) from the credit.

        3) Married individuals who file separately are not eligible for the EIC.

        4) The EIC increases for individuals having at least one QC. Schedule EIC must be attached to the return; it lists relevant information about each QC.

        5) The credit is not available for taxpayers who fraudulently claim the EIC.

        6) The IRS may request birth certificates, medical records, school records, etc., to verify eligibility for the credit.

    b. An individual without a QC must have his or her principal residence in the U.S. for more than half of the tax year, be at least 25 but under age 65 at the end of the tax year, and not be a dependent of another.

    c. **QC tests.** In order for a child to be a QC, three tests must be met:

        1) **Relationship.** The child must be related by birth or adoption or be an eligible foster child or stepchild.

        2) **Residency.** The child must have lived with the taxpayer in the United States for more than half of the year.

        3) **Age.** The child must be under age 19 at the close of the tax year, be permanently disabled, or be a student under the age of 24.

    d. **Child claimed by both parents.** In the event that two or more taxpayers claim the same child in the same calendar year, the child will be the qualifying child for the parents first and then for the taxpayer with the highest AGI.

        1) If both of a qualifying child's parents seek to claim the credit, but do not file jointly, then the parent with whom the child resides the longest period of time during the year may claim the child.

        2) The parent with the highest AGI will be able to claim the child as a qualifying child in the event the child spends an equal amount of time with each parent during the year (Publication 504).

    e. **QC of another person.** A taxpayer (or spouse if filing a joint return) who is a qualifying child of another person cannot claim the EIC.

        1) This applies even if the person for whom the taxpayer is the qualifying child does not claim the EIC or meet the criteria in order to claim the EIC.

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Tests for Qualifying Child

Relationship

A qualifying child who is the taxpayer's . . .

Son, daughter, stepchild, foster child, or a descendant of any of them (for example, the taxpayer's grandchild)

OR

Brother, sister, half brother, half sister, stepbrother, stepsister, or a descendant of any of them (for example, the taxpayer's niece or nephew)

AND

Age

was . . .

Under age 19 at the end of the tax year and younger than the taxpayer (or taxpayer's spouse, if filing jointly)

OR

Under age 24 at the end of the tax year, a student, and younger than the taxpayer (or the taxpayer's spouse, if filing jointly)

OR

Permanently and totally disabled at any time during the year, regardless of age

AND

Residency

Who lived with the taxpayer in the United States for more than half of the tax year

Figure 8-4

f. **Earned income** includes wages, salaries, tips, and net earnings from self-employment.

1) It does not include nontaxable compensation (e.g., military allowances), welfare benefits (e.g., AFDC), veteran's benefits, pensions, annuities, unemployment compensation, and scholarships.
2) Disqualified income includes interest, dividends, capital gain net income, positive passive income, nonbusiness rents, or royalties.
3) For 2022, the amount of disqualified income that causes a taxpayer to become ineligible for the EIC is $10,300.

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g. **Calculation of EIC.** Multiply the individual's earned income by the applicable percentage.

EIC: Maximum Amounts, 2022			
Type of Taxpayer	Applicable Percentage	Earned Income Amount	Maximum EIC
0 QC	7.65%	$ 7,320	$ 560
1 QC	34.00%	10,980	3,733
2 QC	40.00%	15,410	6,164
3 or more QC	45.00%	15,410	6,935

h. **Phaseout of EIC.** Decrease the maximum EIC by any phaseout, which is determined by multiplying the applicable phaseout percentage by the excess of the amount of the individual's AGI (or earned income, if greater) over the beginning amount.

1) No EIC is available when AGI or earned income exceeds the completed phaseout amount.

EIC: Phaseout Amounts, 2022					
Type of Taxpayer	Applicable Phaseout Percentage	Beginning Phaseout Amount	Beginning Phaseout Amount for Joint Filers	Completed Phaseout Amount	Completed Phaseout Amount for Joint Filers
0 QC	7.65%	$ 9,160	$15,290	$16,480	$22,610
1 QC	15.98%	20,130	26,260	43,492	49,622
2 QC	21.06%	20,130	26,260	49,399	55,529
3 or more QC	21.06%	20,130	26,260	53,057	59,187

EXAMPLE 8-12 Earned Income Credit

Joe is a 50-year-old single taxpayer with wages of $12,300 and $8,000 of AGI. Joe does not have any qualifying children and is eligible for the EIC. With no qualifying children, Joe's applicable percentage for the EIC is 7.65%. Joe's earned income of $12,300 is greater than the amount required for the maximum credit of $7,320. The higher of his earned income or AGI is $12,300, which is greater than the beginning phaseout amount of $9,160. Therefore, Joe's earned income credit is $320 {$560 – [($12,300 – $9,160) × 7.65%]}.

Due Diligence Requirement

i. **Penalty.** Section 6695(g) imposes a $560 penalty with respect to any return or claim for refund for each failure to comply with the four due diligence requirements imposed by regulations with respect to determining a taxpayer's eligibility for the EIC or the amount of any allowable EIC.

1) New expanded regulations clarify these requirements and set a performance standard for the "knowledge" requirement (i.e., what a reasonable and well-informed tax return preparer, knowledgeable in the law, would do). The four due diligence requirements are discussed on the next page.

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Completion of Form 8867

a) Complete Form 8867, *Paid Preparer's Due Diligence Checklist*, truthfully and accurately and any actions described on Form 8867 for applicable credit(s) claimed.

i) Determine that this taxpayer is eligible to claim the EIC for the number of children for whom the EIC is being claimed or to claim the EIC if the taxpayer has no qualifying children.

ii) Determine that the child lived with the taxpayer for over half of the year.

iii) Explain the tiebreaker rules as described in item d. on page 18.

Computation of the Credit

b) Complete the applicable EIC worksheet associated with Form 1040, 1040-SS, 1040-PR, or 1040-NR or an equivalent and all related forms and schedules.

Knowledge

c) Interview the taxpayer, ask questions, and document the taxpayer's responses and review the information to determine that the taxpayer is eligible to claim the credit.

i) Do not ignore the implications of information furnished or known.

ii) Make reasonable inquiries in such a manner that another well-informed tax preparer would conclude that the information furnished appears to be correct, consistent, and complete.

iii) Document any additional inquiries made and the client's responses.

Record Retention

d) Satisfy the document retention requirement by retaining the following five records:

i) Form 8867;

ii) The EIC worksheet(s) or the preparer's own worksheet(s);

iii) Copies of any taxpayer documents relied on to determine eligibility for or amount of EIC;

iv) A record of how, when, and from whom the information used to prepare the form and worksheet(s) was obtained; and

v) A record of any additional questions the preparer asked and the client's answers.

e) These records must be kept for 3 years from the latest of the following due dates:

i) The due date of the tax return (not including extensions)

ii) The date the return was filed (if a signing tax return preparer electronically filed the return)

iii) The date the return was presented to the taxpayer for signature (if the signing tax preparer is not electronically filing the return)

iv) The date a preparer submitted the part of the return for which they were responsible to the signing tax return preparer (if that preparer is a nonsigning tax return preparer)

f) The retention of a copy of the Social Security cards of the taxpayer and each qualifying child is not required.

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Residential Energy Credits

21. There are two credits available for individuals to improve the energy consumption of their residence. The first is for installing alternative energy property, and the second is for installing energy-efficient improvement property.

    a. The residential clean energy credit (previously the residential energy efficient property credit) for property placed in service in 2022 through 2032 is 30% of the cost of qualified property, which includes the following:

        1) Solar electric property
        2) Solar water heating property
        3) Small wind energy property
        4) Geothermal heat pump property
        5) Fuel cell property
        6) Biomass fuel property

    b. The energy efficient home improvement credit (previously the nonbusiness energy property credit) is the sum of (1) 10% of the amount paid or incurred for qualified energy efficiency improvements installed during the tax year and (2) the amount of residential energy property expenditures.

    c. The total maximum credit is $500 over the lifetime of the taxpayer. The maximum lifetime credit is $200 for exterior windows and skylights.

10% Property	Fixed Limit Property	
Insulation	Energy-efficient building property	$300
Exterior doors	Natural gas, propane, oil furnace,	
Metal and asphalt roof	hot water boiler	$150
Exterior windows and skylights	Advanced main air circulating fan	$50

Premium Tax Credit (PTC)

22. Taxpayers who obtain health insurance coverage through the Health Insurance Marketplace may be eligible for the Health Insurance Premium Tax Credit. The Premium Tax Credit is a refundable credit.

    a. Historically, the credit is available to households with income no greater than 400% of the federal poverty line. However, for 2021 through 2025, this ceiling is removed.

23. The amount of the credit is generally equal to the premium for the second lowest cost silver plan available through the marketplace minus a certain percentage of household income.

24. The cost of insurance is capped at 9.61% of household income. The percentage decreases as income decreases.

25. Taxpayers may be eligible for the credit if they meet all of the following requirements:

    a. Buy health insurance through the Marketplace;
    b. Are ineligible for coverage through an employer or government plan;
    c. Do not file a separate return, if married[1]; and
    d. Cannot be claimed as a dependent by another person.

[1]There is an exception for MFS if the taxpayer is a victim of domestic violence.

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26. Eligible taxpayers may either receive advance payments toward their health insurance premiums or receive a regular credit at the end of the year.
27. Taxpayers who claim the Advanced Premium Tax Credit must file a tax return regardless of whether the taxpayer's income is below the filing threshold.
    a. The return must include Form 8962, *Premium Tax Credit (PTC)*, to compare the amount the taxpayer received for the Advanced Premium Tax Credit to the amount the taxpayer is actually eligible for based on the taxpayer's actual income.
        1) If the taxpayer earns more income than was used for determining the Advanced Premium Tax Credit, the taxpayer may be required to repay some or all of the excess credit received.
        2) A taxpayer who does not complete the reconciliation will not be eligible for the Advanced Premium Tax Credit in future years.
28. A refund is available for eligible taxpayers who did not receive any advance payments. All taxpayers who received advanced payments must deduct the total of any advanced payments received during the year from the amount of the premium tax credit calculated on the return. This may affect the tax refund or balance due.
29. Taxpayers must claim the credit by filing a federal income tax return regardless of which method is used to receive the tax credit.
30. Taxpayers with insurance coverage will receive one of three tax forms showing their insurance coverage status. All Forms 1095 show information about the coverage, who is included in the coverage, and for what months the coverage was applied.
    a. Form 1095-A, *Health Insurance Marketplace Statement*, is received by individuals who purchased health insurance through a state or federal health insurance marketplace.
    b. Form 1095-B, *Health Coverage*, is received by individuals from their health insurance provider (e.g., a health insurance company).
    c. Form 1095-C, *Employer-Provided Health Insurance Offer and Coverage*, is received by certain employees with information about what coverage the employer offered.
    d. Only taxpayers who receive health insurance through a state or federal health insurance marketplace are required to wait to file until they receive Form 1095-A, as this impacts the calculation of the premium tax credits.
    e. Taxpayers who expect to receive Form 1095-B or 1095-C may file their federal income tax return before their form is received by confirming how many months they were covered by qualifying health insurance.
    f. Taxpayers should store these forms like any other tax document for recordkeeping purposes.
    g. Taxpayers can receive multiple Forms 1095 if their health insurance coverage changed during the year.

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8.2 PAYMENTS

Estimated Tax Payments

1. The IRC is structured to obtain at least 90% of the final income tax through withholding and estimated tax payments. Individuals who earn income not subject to withholding must pay estimated tax on that income in quarterly installments.
   a. **Calendar-year due dates.** For a calendar-year taxpayer, the installments are due by
      1) April 15 (January-March),
      2) June 15 (April-May),
      3) September 15 (June-August), and
      4) January 15 (September-December) of the following year.

      NOTE: Dates are adjusted for weekends and holidays.
   b. Underpayment of the fourth installment does not result in penalty if, on or before January 31 of the following tax year, an individual both files a return and pays the amount computed payable on that return.
      1) Any underpayment penalties from the first three quarterly installments will not increase any further.
   c. Each of the following is treated as payment of estimated tax:
      1) The election to apply an overpayment of tax in a prior tax year, which has not been refunded, to the following year's tax return
         a) It is applied to the first required installment due.
      2) Amount of federal income tax (FIT) withheld (by an employer) from wages
         a) The aggregate amount is treated as if an equal part was paid on each due date, unless the individual establishes the actual payment dates.
      3) Direct payment by the individual (or another on his or her behalf)
         a) It is applied to the first estimated tax payment due.
      4) Excess FICA withheld when an employee has two or more employers during a tax year who withheld (in the aggregate) more than the ceiling on FICA taxes
      5) Refundable tax credits
   d. **Installment percentage.** Each installment must be 25% of the lowest of the following amounts:
      1) 100% of the prior year's tax (if a return was filed)
      2) 90% of the current year's tax
      3) 90% of the annualized current year's tax (applies when income is uneven)

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e. **Safe harbor rule.** Taxpayers whose 2021 tax returns showed AGI in excess of $150,000 ($75,000 for married filing separately) must apply the safe harbor rule. This rule requires the taxpayer to make estimated payments of the lesser of 110% of the 2021 tax liability or 90% of the 2022 tax liability.

f. A taxpayer is not required to make a payment until the first period in which there is income.

EXAMPLE 8-13 Estimated Tax Payments

John's tax liability for 2021 was $10,000 and his AGI was $100,000. John projects his tax liability for 2022 to be $12,000. In order to avoid an underpayment of estimated tax penalty, John must pay through withholdings and estimated payments throughout the year, i.e., the lesser of $10,000 (100% of prior year tax, the 110% is not applied because John's prior year AGI is less than $150,000) or $10,800 (90% of the current year tax).

g. Tax refers to the sum of the regular tax, AMT, self-employment tax, and household employee tax.

h. **Penalty.** A penalty is imposed if, by the quarterly payment date, the total of estimated tax payments and income tax withheld is less than 25% of the required minimum payment for the year.

   1) The penalty is determined each quarter.
   2) The penalty is the federal short-term rate plus 3% times the underpayment.
   3) The penalty is not allowed as an interest deduction.

i. The penalty will not be imposed if any of the following apply:

   1) Actual tax liability shown on the return for the tax year (after reduction for amounts withheld by employers) is less than $1,000.

EXAMPLE 8-14 Underpayment Penalty

Taxpayer has a tax liability of $11,000 for 2022. Taxpayer's employer withheld $7,000 for 2022. Taxpayer's 2021 liability was $7,000 and AGI was $160,000.

Even though only $700 [($7,000 prior year liability × 110%) – $7,000 current year withholding] is subject to the penalty, the $1,000 minimum exception does not apply due to the fact that the exception is based on the current year. The total tax liability shown on the tax return of $11,000 minus the amount paid through withholding of $7,000 is greater than $1,000. Hence, the taxpayer will be subject to an underpayment penalty.

   2) No tax liability was incurred in the prior tax year.
   3) The IRS waives it for reasonable cause shown.

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j. **Farmers or fishermen** who expect to receive at least two-thirds of their gross income from farming or fishing activities (or did in the prior tax year) may pay estimated tax in one installment.

1) For 2022, the installment can be made as late as January 17, 2023, without penalty. The installment must be for the entire amount of estimated tax.

2) Alternatively, the farmer or fisherman does not need to make an installment payment if (s)he files his or her tax return for 2022 and pays the entire amount due by March 1, 2023.

3) Wages received as a farm employee are not farm income.

4) S corporation distributions from farming are farm income to the shareholder.

k. To avoid underpayment penalties, taxpayers may review their withholding and estimated tax payment situation throughout the year. A mid-year review allows the taxpayer to look back at the recently filed prior-year return and know if too much or too little was withheld last year.

1) Any need for correction can be accomplished by having an employer adjust the amount being withheld for the rest of the year or by the taxpayer calculating any deficiency and making appropriate estimated quarterly payments. Items taxpayers should consider include life events (e.g., marriages and births) and financial changes (e.g., a raise or bonus, change in employment, or a significant capital gain from the sale of property).

l. The following chart explains in general who is and is not subject to estimated payments:

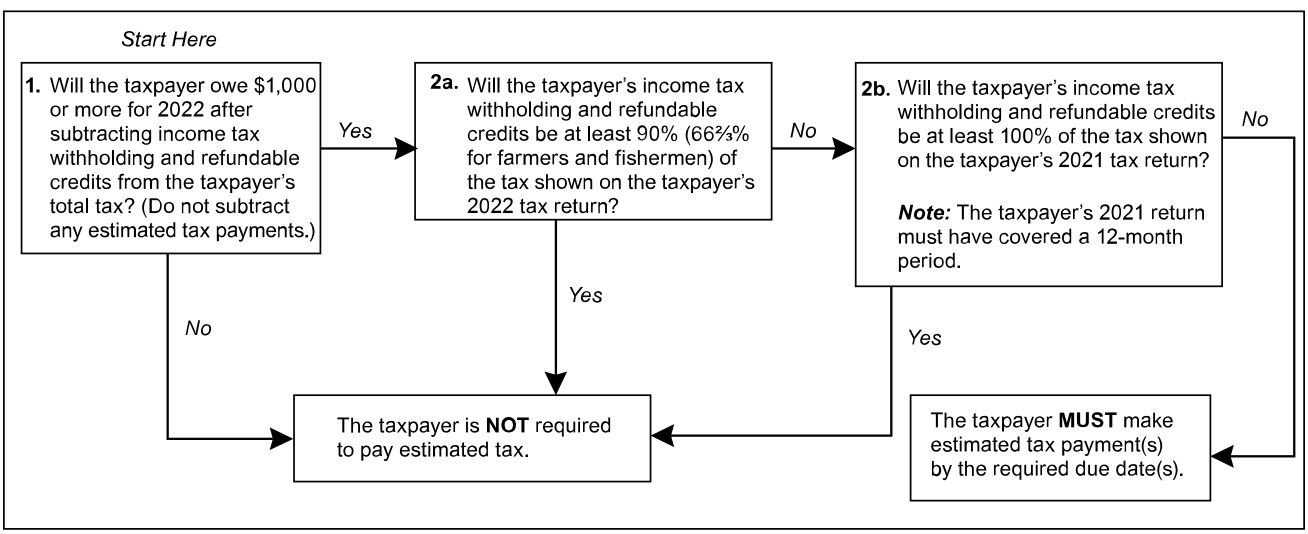

Figure 8-5

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Exemption from Withholding on Form W-4

2. Some taxpayers are exempt from withholding requirements. The following chart explains the exemptions:

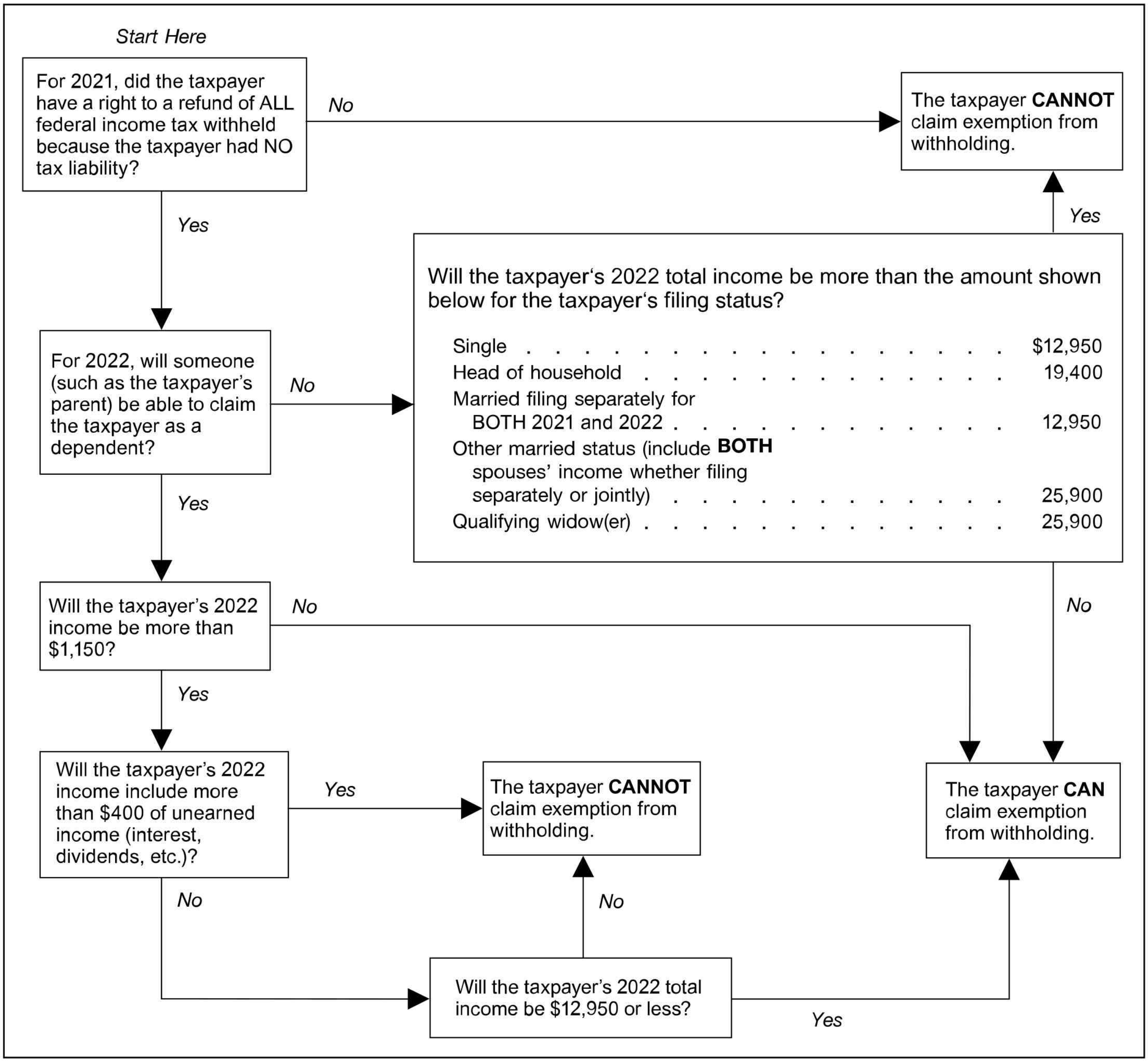

Figure 8-6

NOTE: This chart does not apply if the taxpayers are 65 or older or blind or if the taxpayers will itemize deductions or claim tax credits.

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Excess Social Security Credit

3. An employer must deduct and withhold Social Security tax on an employee’s first $147,000 of wages. For 2022, the withholding rate is 6.2%.
   a. When the maximum withholding is exceeded due to the correct withholding of two or more employers, a special refund of the excess amount may be obtained only by claiming a credit for the amount.
      1) The credit must be claimed in the same manner as if such special refund were an amount deducted and withheld as income tax at the source.
      2) The credit is computed separately for each spouse on a joint return.
   b. When an employer incorrectly withholds Social Security taxes on more than the maximum amount, a credit may not be claimed for the excess.
      1) The employer should refund the overcollection to the employee.

Claims for Refund

4. Taxpayers have a limited amount of time in which to file a claim for a credit or refund. Taxpayers encountering trouble obtaining a refund or other tax issues may request assistance from the Taxpayer Advocate Service by submitting Form 911.
   a. **Form 1040-X.** Taxpayers file a claim for refund on Form 1040-X with the Internal Revenue Service Center where the original return was filed.
      1) A separate form for each year or period involved is filed.
      2) An explanation of each item of income, deduction, or credit on which the refund claim is based is included.
   b. **Statute of limitations.** Generally, taxpayers must file a claim for credit or refund within 3 years from the date the return was filed or 2 years from the date the tax was paid, whichever is later.
      1) The Tax Court can consider taxes paid during the 3-year period preceding the date of a notice of deficiency for determining any refund due to a nonfiler.
      2) If a claim is made within 3 years after the filing of the return, the credit or refund cannot be more than the part of the tax paid within the 3 years (plus the length of any extension of time granted for filing the return) before the claim was filed.
         a) If a claim is filed after the 3-year period but within the 2 years from the time a tax was paid, the credit or refund cannot be more than the tax paid within the 2 years immediately before the filed claim.
      3) The period of limitations on credits and refunds can be suspended for individuals during periods in which they are unable to manage their financial affairs because of physical or mental impairment that is medically determinable and either
         a) Has lasted or can be expected to last continuously for at least 12 months or
         b) Can be expected to result in death.

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STUDY UNIT NINE

PROPERTY TRANSACTIONS: BASIS AND DISPOSITIONS

The concept of basis is important in federal income taxation. Generally, basis is the measurement of a taxpayer's investment in property, which the taxpayer is entitled to have returned without tax consequences. The property basis is generally used in determining the gain or loss associated with the property.

The basis of an asset is generally its cost, but it may be adjusted over the course of time due to various events. The basis of property must be increased by capital expenditures and decreased by capital returns.

- Increases in basis have the effect of reducing the amount of gain realized or increasing the amount of realized loss.
- Decreases in basis have the effect of increasing the amount of realized gain or decreasing the amount of loss.

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9.1 COST BASIS

When a taxpayer acquires property, his or her basis in the property is initially cost, substituted, transferred, exchanged, or converted basis.

1. **Cost basis** is the sum of capitalized acquisition costs.
2. **Substituted basis** is computed by reference to basis in other property.
3. **Transferred basis** is computed by reference to basis in the same property in the hands of another.
4. **Exchanged basis** is computed by reference to basis in other property previously held by the person.
5. **Converted basis** is when personal-use property is converted to business use; the basis of the property is the lower of its basis or the FMV on the date of conversion.

Capitalized Acquisition Costs

6. Initial basis in purchased property is the cost of acquiring it. Only capital costs are included, i.e., those for acquisition, title acquisition, and major improvements.

Common Capitalized Costs (for Sec. 1012)

Purchase Price (Stated)	Miscellaneous Costs
Includes liability to which property is subject NOTE: Not unstated interest	Appraisal fees Freight Installation Testing
Closing Costs	**Major Improvements**
Brokerage commissions Pre-purchase taxes Sales tax on purchase Excise taxes Title transfer taxes Title insurance Recording fees Attorney fees Document review, preparation	New roof New gutters Extending water line to property Demolition costs and losses New electrical wiring

Expenses Not Properly Chargeable to a Capital Account

a. Costs of maintaining and operating property are not added to basis, e.g., interest on credit related to the property, insurance (e.g., casualty), and ordinary maintenance or repairs (e.g., painting).

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Basis in a Rental House – How to Calculate and Treat Improvements that Happen Later

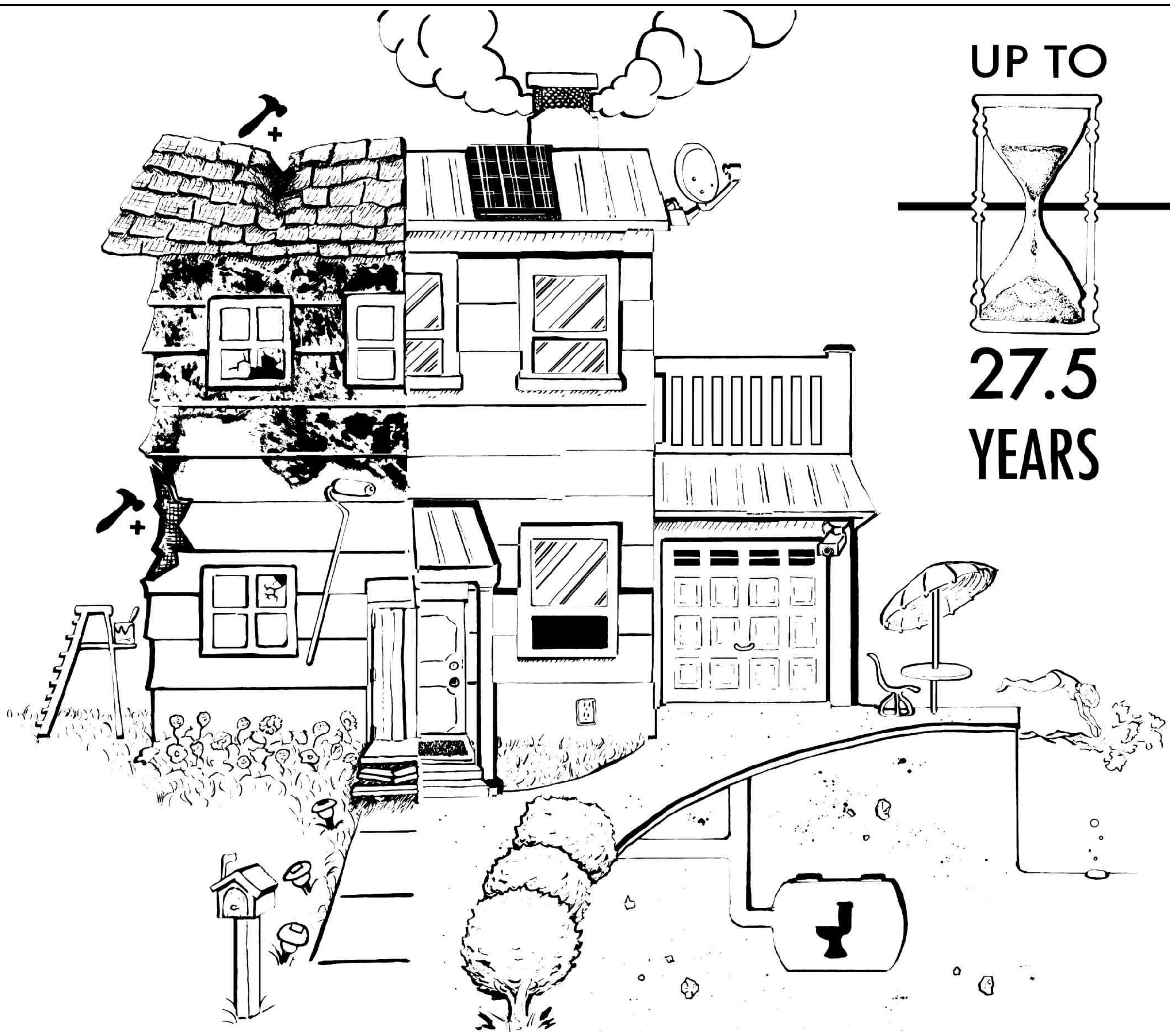

Figure 9-1

Visual Memory Aid: For candidates who are visual learners, the figure above and the description below can aid in recalling how to capitalize certain capital acquisition costs.

Basis in a rental house includes purchase price plus closing costs. Add to the basis and capitalize long-term improvements.

In Figure 9-1 above, the right side of the house shows capitalized improvements that must be depreciated over periods of up to 27 1/2 years. These include improvements to land (e.g., sidewalks, landscaping, sprinkler systems), swimming pools, new roofs, extensions of or additions to the structure, air conditioning units, central vacuum systems, security systems, and septic tanks. Improvements that are added later in the life of the rental unit must be separately capitalized and depreciated.

The left side of the house shows short-term repairs. Short-term repairs are expensed in the year in which they are made. Short-term repairs include repairing broken windows, faucets, and air conditioning units; patching leaking roofs; painting; etc.

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Uniform Capitalization Rules

7. Costs for construction of real or tangible personal property to be used in trade or business and costs of producing or acquiring property for sale to customers (retail) are capitalized.
   a. All costs necessary to prepare the property for its intended use are capitalized, including both direct and most allocable indirect costs, e.g., for permits, materials, equipment rent, compensation for services (minus any work opportunity credit), and architect fees.
   b. Construction-period interest and taxes must be capitalized as part of building costs.
8. Cost basis includes the FMV of property given up. If it is not determinable with reasonable certainty, use FMV of property received.
   a. Capital acquisition expenditures may be made by cash, by cash equivalent, in property, with liability, or by services.
   b. A rebate to the purchaser is treated as a reduction of the purchase price. It is not included in basis or in gross income.
9. Uniform capitalization rules do not apply if property is acquired for resale and the company's annual gross receipts (for the past 3 years) do not exceed $27 million.

Liabilities

10. Acquisition basis is
    a. Increased for notes to the seller (minus unstated interest)
    b. Increased for liabilities to which the acquired property is subject

EXAMPLE 9-1 **Tax Basis -- Building with a Mortgage**
If an individual buys a building for $30,000 cash and assumes a mortgage on it of $190,000, the individual's basis is $220,000.

11. The FMV of property received in exchange for services is income (compensation) to the provider when it is not subject to a substantial risk of forfeiture and not restricted as to transfer. The property acquired has a tax cost basis equal to the FMV of the property.
    a. Sale of stock to an employee is treated as gross income (bonus compensation) to the extent any price paid is less than the stock's FMV.
       1) The basis of restricted stock is the price paid other than by services.
       2) Upon lapse of the restriction, the recipient has ordinary gross income of the spread between FMV on that date and any amounts otherwise paid.
       3) Basis is increased by that same amount.
       4) The transferee may elect to include the FMV minus the cost spread in gross income when the stock is purchased.
          a) Basis includes tax cost, but no subsequent deduction (recovery of tax cost) is allowed if the stock is forfeited by operation of the restriction.

Lump Sum Purchase

12. When more than one asset is purchased for a lump sum, the basis of each is computed by apportioning the total cost based on the relative FMV of each asset.

$$\text{Allocable cost (basis)} = \frac{\text{FMV of asset}}{\text{FMV of all assets purchased}} \times \text{Lump sum purchase price}$$

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a. Alternatively, the transferor and transferee may agree in writing as to the allocation of consideration or the FMV of any assets.

1) The agreement is binding on the parties unless the IRS deems it improper.

a) If improper, the residual method must be used for any transfers of a group of assets that constitutes a trade or business and for which the buyer's basis is determined only by the amount paid for the assets.

b. The residual method, particularly relevant to goodwill and going-concern value when a transferor-transferee agreement is not applicable, allocates purchase price for both transferor and transferee to asset categories up to FMV in the following order:

1) Cash and cash equivalents

2) Near-cash items, such as CDs, U.S. government securities, foreign currency, and other marketable securities

3) Accounts receivable and other debt instruments, as well as other assets marked to market at least annually

NOTE: Regulation 1.338-6(b)(2)(iii) created exceptions applicable to certain specific debt instruments.

4) Property held primarily for sale to customers in the ordinary course of a trade or business or stocks that are part of dealer inventory

5) All other assets, excluding Sec. 197 intangibles

6) Section 197 intangibles, such as patents and covenants not to compete except goodwill and going-concern value

7) Goodwill and going-concern value

NOTE: When the purchase price is lower than the aggregate FMV of the assets other than goodwill and going-concern value, the price is allocated first to the face amount of cash and then to assets listed in 2) through 6) above according to relative FMVs.

EXAMPLE 9-2 Lump-Sum Assets -- Price < FMV

Bennett Industries just purchased Beard Nation, Inc., for $450,000. All of the liabilities were paid off at the date of purchase. The assets of Beard Nation are as follows:

Cash	$ 50,000
Marketable securities	150,000
Accounts receivable	125,000
Inventory	100,000
Equipment	75,000
Land	50,000
FMV of all assets	$550,000

The basis of cash is the face value of $50,000, which reduces the outstanding basis to $400,000. Next, the fair market value is assigned to Class 2 assets, so the basis for marketable securities is $150,000, which reduces the remaining basis to $250,000. Accounts receivable are Class 3 assets and are assigned the fair market value of $125,000, reducing the remaining basis to $125,000. Inventory is a Class 4 asset and receives the fair market value of $100,000, reducing the remaining allocable basis to $25,000. The land and equipment are both Class 5 assets, but the fair market value of these assets is less than the remaining basis. The basis needs to be allocated between these two assets based upon the relative fair market values. The equipment receives a basis of $15,000 ($25,000 × $75,000 ÷ $125,000), and the land receives a $10,000 basis ($25,000 × $50,000 ÷ $125,000).

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Sale of Stock

13. To compute gain realized on the sale of stock, specific identification of the stock sold is used if possible. Otherwise, FIFO is assumed.

Demolition

14. Costs and losses associated with demolishing a structure are allocated to the land. The costs include the remaining basis (not FMV) of the structure and demolition costs.

9.2 PROPERTY RECEIVED BY GIFT

The donee's basis in property acquired by gift is the donor's basis, increased for any gift tax paid attributable to appreciation. The donor's basis is increased by

$$\text{Gift tax paid} \times \left[\frac{\text{FMV (at time of gift)} - \text{Donor's basis}}{\text{FMV (at time of gift)} - \text{Annual exclusion}}\right]$$

NOTE: The 2022 annual exclusion for gift tax is $16,000 per person.

1. If the FMV on the date of the gift is less than the donor's basis, the donee has a dual basis for the property, which minimizes the gain (loss) recognized on a subsequent transfer.
   a. **Loss basis.** The FMV at the date of the gift is used if the property is later transferred at a loss.
   b. **Gain basis.** The donor's basis is used if the property is later transferred at a gain.
   c. If the property is later transferred for more than FMV at the date of the gift but for less than the donor's basis at the date of the gift, no gain (loss) is recognized.

Depreciable Basis

2. Depreciable basis is transferred basis adjusted for gift taxes paid.
3. If gift property is immediately used as business property, the basis for depreciation is the donor's AB.
4. If gift property is later converted from personal to business use, the depreciable basis is the lower of the transferor's AB or the FMV on the date of conversion.

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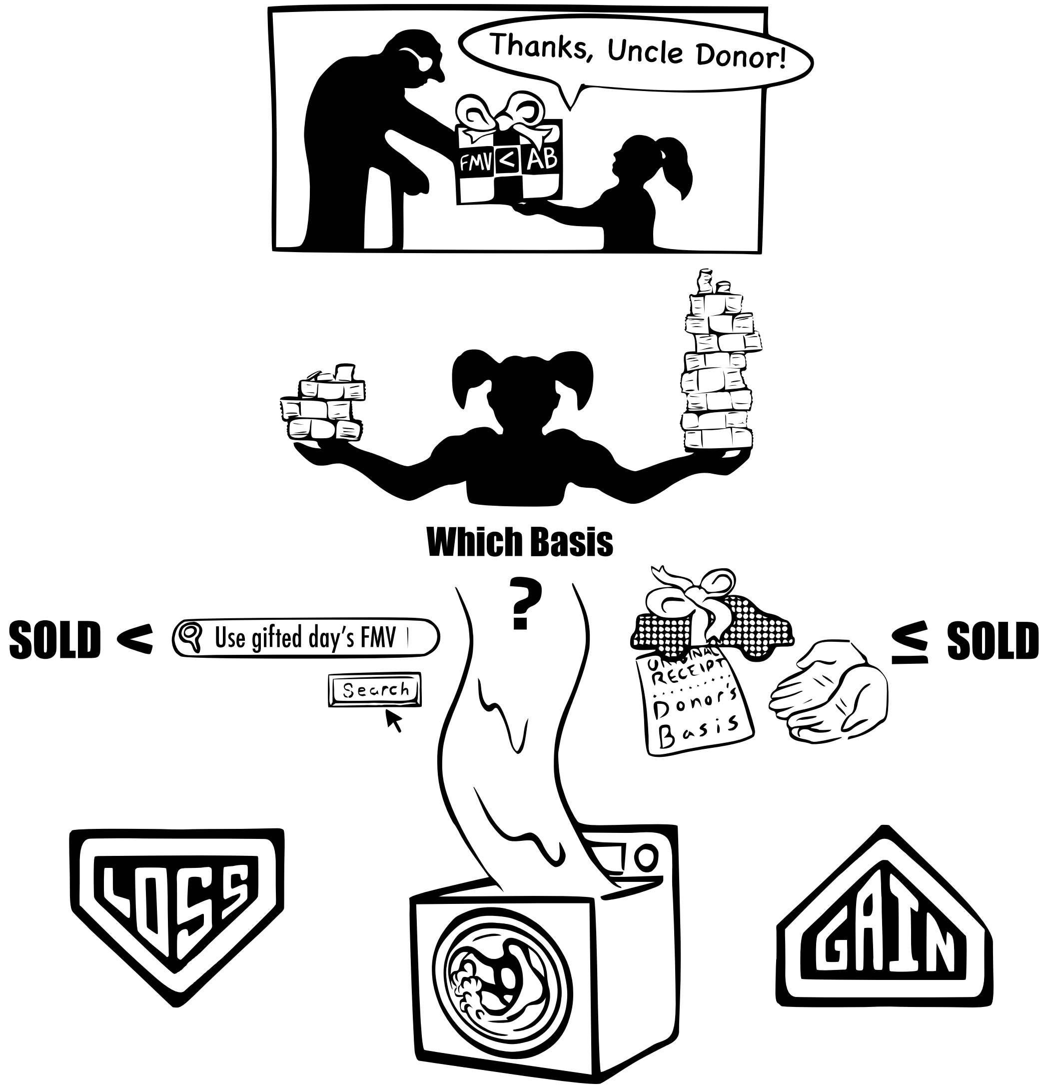

Figure 9-2

Visual Memory Aid: For candidates who are visual learners, the figure above and the description below can aid in recalling how to calculate gains and losses of gifts with a FMV less than AB.

In the illustration above, Uncle Donor gifts his niece a vehicle. The big question: What basis should she use if she decides to sell the vehicle and how can she determine a gain or loss on her tax return?

Imagine on the day of the gift the FMV is only $10,000 (according to Internet research), but the uncle paid $40,000 (his AB) for it years ago. If the niece is only able to sell it for $9,500, she can claim a loss of $500. Note in her hand the small stack of bills. It may help to remember that if she sells it for "pennies" her **basis is the *Fair* Market Value, because it was a *Fair* Loss**.

Now, imagine the same FMV ($10,000) and AB ($40,000), but the niece was able to sell it for $41,000 and claim a gain of only $1,000. Notice the large stack of bills in her other hand. Her basis for determining a gain is the donor's adjusted basis. The memory device is ***GAIN* a *DONOR***.

Alternatively, imagine the same FMV ($10,000) and AB ($40,000), but the sale price falls between the FMV and the AB, leaving the niece with neither a gain nor a loss. Without a net gain or loss, the sale is a ***WASH***, represented in the illustration by a washing machine.

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9.3 PROPERTY RECEIVED FOR SERVICES

All compensation for personal services is gross income. The form of payment is irrelevant. If property is received for services, gross income is the fair market value of the property received minus any cash or other property given.

1. Basis in property received is the amount included in income plus any cash or other property given.
2. Gross income of an employee includes any amount paid by an employer for a liability (including taxes) or an expense of the employee.

9.4 INHERITED PROPERTY

Basis is the FMV on the date of death.

1. If the executor elects the alternate valuation date, the basis of the assets is the FMV 6 months after the decedent's death.
   a. If the assets are sold or distributed within the first 6 months after death, basis equals FMV on the sale or distribution date.
2. The FMV basis rule also applies to the following property:
   a. One-half of community property interests
   b. Property acquired by form of ownership, e.g., right of survivorship, except if consideration was paid to acquire the property from a nonspouse
   c. Property received prior to death without full and adequate consideration (if a life estate was retained in it) or subject to a right of revocation
      1) Reduce basis by depreciation deductions allowed the donee.

   NOTE: The FMV rule does not apply to (1) income in respect of a decedent or (2) appreciated property given to the decedent within 1 year of death (use adjusted basis in the property immediately prior to death).

   A shareholder must report his or her ratable share of any income that is income in respect to a decedent as if (s)he had received it directly from the decedent.

EXAMPLE 9-3 **Tax Basis -- Inherited S Corporation Stock**
The shareholder's basis in the inherited S corporation stock is its FMV on the date of death minus the ratable share of any S corporation income attributable to those shares.

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EXAMPLE 9-4	**Basis of Inherited Property**
A purchased 10 shares of ABC, Inc., in 1980 for $200. When A dies in the current year, she leaves the stock to her grandson, B, in her will. At the date of A's death, the stock has a FMV of $1,000. The estate has not elected an alternative valuation date. B's basis in the stock is $1,000.	

EXAMPLE 9-5	**Alternate Valuation Date**
A purchased 10 shares of XYC, Inc., in 1980 for $200. When A dies on February 1 of the current year, she leaves the stock to her grandson, B, in her will. At the date of A's death, the stock has a FMV of $1,000. The FMV of the stock remains unchanged until October 1 of the current year, when the FMV of the stock declined to $980. The estate has elected the alternate valuation date. B's basis in the stock is $1,000 (the FMV of the stock on August 1, 6 months after A's death).	

3. If no federal estate tax return is required to be filed, the value as appraised for state inheritance tax purposes is used.

9.5 STOCK DIVIDENDS

A corporation recognizes no gain or loss on transactions involving its own stock.

1. A proportionate distribution of stock issued by the corporation is generally not gross income to the shareholders.
   a. A shareholder allocates the aggregate adjusted basis (AB) in the old stock to the old and new stock in proportion to the FMV of the old and new stock.
      1) Basis is apportioned by relative FMV to different classes of stock if applicable.
   b. The holding period of the distributed stock includes that of the old stock.
   c. Earnings and profits (E&P) are not altered for a tax-free stock dividend.

Stock Rights

2. A distribution of stock rights is treated as a distribution of the stock.
   a. Basis is allocated based on the FMV of the rights.
      1) Basis in the stock rights is zero if their aggregate FMV is less than 15% of the FMV of the stock on which they were distributed, unless the shareholder elects to allocate.
   b. Basis in the stock, if the right is exercised, is any basis allocated to the right plus the exercise price.
   c. Holding period of the stock begins on the exercise date.
   d. No deduction is allowed for basis allocated to stock rights that lapse.
      1) Basis otherwise allocated remains in the underlying stock.

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Taxable Stock Distribution

3. Distributions of stock are subject to tax. The amount of a distribution subject to tax is the FMV of distributed stock or stock rights.
    a. Taxable distributions of stock include the following:
        1) If a shareholder has an option to choose between a distribution of stock or a distribution of other property, the amount of the distribution is the greater of the FMV of stock or the cash or FMV of other property.
            a) For example, some shareholders receive property, and other shareholders receive stock; or some common shareholders receive common stock, and others receive preferred.
        2) Distribution of preferred stock is made with respect to preferred stock.
            a) Limited change in conversion ratios, by itself, does not trigger taxability.
        3) Convertible preferred stock is distributed, and the effect is to change the shareholder's proportionate stock ownership.
        4) Constructive stock distributions change proportionate interests, resulting from a transaction such as a change in conversion ratio or redemption price.
        5) Some shareholders receive property, and other shareholders receive an increase in their proportionate interests.
    b. E&P are reduced by the FMV of stock and stock rights distributed.
    c. Basis in the underlying stock does not change. Basis in the new stock or stock rights is their FMV.
    d. Holding period for the new stock begins on the day after the distribution date.
    e. If a distribution of a stock dividend or stock right is taxable when received, the basis is the FMV on the date of acquisition.
        1) The holding period begins the day following the acquisition date.

Stock Split

4. A stock split is not a taxable distribution.
    a. The basis of the old stock is divided by the number of new shares.
    b. Holding period of the new stock includes that of the old stock.

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9.6 ADJUSTMENTS TO ASSET BASIS

Initial basis is adjusted consistent with tax-relevant events. Adjustments include the following.

Subsequent to Acquisition

1. Certain expenditures subsequent to acquisition are property costs, and they increase basis, e.g., legal fees to defend title or title insurance premiums.

Prolong Life

2. Basis must be increased for expenditures that substantially prolong the life of the property by at least 1 year or materially increase its value. Assessments/improvements that increase the value of property should be capitalized.
    a. Examples include major improvements (e.g., new roof, addition to building) and zoning changes.
    b. Generally, maintenance, repair, and operating costs are considered a current-period deduction and are not capitalized.
3. An increase to basis may result from a liability to the extent it is secured by real property and applied to extend its life.

Depreciation

4. Depreciation taken on business property will decrease the basis.
    a. The base for MACRS depreciation is the cost.
    b. All assets depreciated under the General Depreciation System (GDS) under MACRS must be included in a class of depreciation, such as 5-, 7-, or 20-year property.
    c. A few of the depreciation classes follow:
        1) Five-year property includes automobiles; computers and peripheral equipment; office machinery (such as typewriters, calculators, and copiers); any property used in research and experimentation; and appliances, carpets, furniture, etc., used in a residential real estate activity.
        2) Seven-year property includes office furniture and fixtures (such as desks, files, and safes), agricultural machinery and equipment, and any property that does not have a class life and has not been designated by law as being in any other class.
        3) Residential real property is any property from which 80% or more of its gross rental income comes from dwelling units. This property has a recovery period of 27 1/2 years.
        4) Nonresidential real property is Sec. 1250 property.
            a) It includes office buildings, stores, or warehouses that are not classified as residential real property and are not otherwise specified to have a life less than 27 1/2 years.
            b) The recovery period of this property is 39 years.

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5. Basis must be reduced by the larger of the amount of depreciation allowed or allowable (even if not claimed). Unimproved land is not depreciated.
   a. Section 179 expense is treated as a depreciation deduction. (The Sec. 179 amount is $1,080,000 for 2022.)

Contributed Property

6. A shareholder does not recognize gain on the voluntary contribution of capital to a corporation.
   a. The shareholder's stock basis is increased by the basis in the contributed property.
   b. The corporation has a transferred basis in the property.

Dividends

7. Distributions out of earnings and profits (E&P) are taxable as dividends.
   a. Dividends are taxable and therefore do not reduce basis.

Return of Capital

8. When a corporation makes a distribution that is not out of E&P, it is a nontaxable return of capital (until basis is reduced to zero).
   a. Distributions in excess of basis are treated as capital gain.
   b. When a shareholder has purchased several stocks, the distribution is applied on a specific identification method, if applicable.
      1) The FIFO method is used when specific identification is impossible.
      2) If a shareholder purchases stock in different lots and at different times and it is impossible to definitely identify the shares subject to a return of capital, the basis of the earliest shares purchased is reduced first [Reg. 1.1012-1(c)].

Stock Rights

9. The basis of stock acquired in a nontaxable distribution (e.g., stock rights) is allocated a portion of the basis of the stock upon which the distribution was made.
   a. If the new shares and old shares are not identical, the basis is allocated in proportion to the FMV of the original stock and the distribution as of the date of distribution.
   b. If the new shares and old shares are identical (e.g., stock splits), the old basis is simply divided among the new total shares.
   c. If the FMV of the stock rights is less than 15% of the FMV of the stock upon which it was issued, the rights have a zero basis (unless an election is made to allocate basis).

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Tax Benefits

10. Basis adjustment is required for certain specific items that represent a tax benefit. Three examples follow:

Casualty Losses

   a. Basis is reduced by the amount of the casualty loss allowed as a deduction and by any amounts recovered by insurance. Generally, the itemized deduction for personal casualty and theft losses for tax years 2018 through 2025 has been limited. The limitations include

      1) Loss attributed to a federally declared disaster and
      2) Non-federally declared disaster losses limited to casualty gains.

Debt Discharge

   b. Specific exclusion from gross income is allowed to certain insolvent persons for debt discharged. Reduction in basis is required for certain amounts excluded.

Credit on Asset Purchases

   c. Credits are allowed on certain asset purchases, such as building rehabilitation, energy equipment, and low-income housing.

      1) A partial or full amount of the credit must be deducted from the basis.

Partial Disposition of Property

11. The basis of the whole property must be equitably apportioned among the parts; relative FMV is generally used.

Personal Use Converted to Business Use

12. Basis for depreciation is the lesser of the FMV of the property at the conversion date or the adjusted basis at conversion.

Leasehold Improvements

13. Generally, lessors do not report income when a lessee makes leasehold improvements or when the leasehold improvements revert to the lessor at the termination of the lease.

   a. Thus, the lessor has a zero basis in the leasehold improvements.

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9.7 HOLDING PERIOD (HP)

1. The holding period of an asset is measured in calendar months, beginning on the date after acquisition and including the disposal date.
   a. The holding period may include that of the transferor.
   b. If the property is held for 1 year or less, it is considered short-term.
   c. If it is held for more than 1 year, it is long-term (LT).

Acquisition by or of	Holding Period - Starts or by reference to
Sale or exchange	Acquisition*
Gift: for gain	Donor’s acquisition
for loss	Acquisition
Inheritance	Automatic LT
Nontaxable exchanges	
Like-kind (Sec. 1031)	Include HP of exchanged asset**
Corporate stock (Sec. 351)	Include HP of contributed asset**
Property in entity	Include transferor’s HP
Stock dividend (307)	Include HP of “old stock”
Partnership interest (Sec. 721)	Include HP of contributed asset**
Property in entity	Include transferor’s HP**
Ordinary income property	Exchange
Involuntary conversion (Sec. 1033)	Include HP of converted asset
Residence	Acquisition
Use conversion (trade/business & personal)	Include period of prior use
Optioned property	Exclude option period
Securities	Trading date
Short sales (Ss)	Earlier of Ss closing or property sale date
Commodity futures	LT after 6-month HP
Capital gain dividend	Automatic LT

* Always start computation using day after date of applicable acquisition.
** If capital asset or Sec. 1231 property; otherwise, the holding period starts the day after date of exchange

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9.8 CAPITAL GAINS AND LOSSES

A capital gain or loss is realized on the sale or exchange of a capital asset.

Capital Assets

1. All property is characterized as a capital asset, unless expressly excluded.
   a. The following types of property are not capital assets:
      1) Inventory (or stock-in-trade): property held primarily for sale to customers in the ordinary course of a trade or business
      2) Real or depreciable property used in a trade or business
      3) Accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or for item 1) or item 2) above
      4) Copyrights and artistic compositions held by the person who composed them, including letters
      5) Certain U.S. government publications acquired at reduced cost
   b. Property held either for personal use or for the production of income is a capital asset, but dealer property is not.
   c. Examples of capital assets are
      1) Personal homes,
      2) Furnishings,
      3) Automobiles,
      4) Stocks,
      5) Bonds,
      6) Commodities,
      7) Partnership interests,
      8) Land,
      9) Internally generated goodwill,
      10) Contract rights,
      11) Patents,
      12) Trade secrets, and
      13) Collectibles.
   d. Examples of collectibles are
      1) Works of art,
      2) Rugs,
      3) Antiques,
      4) Metals,
      5) Gems,
      6) Stamps,
      7) Coins, and
      8) Alcoholic beverages.

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Goodwill

e. Goodwill is a capital asset when generated within the business.

1) Goodwill acquired with the purchase of a trade or business is an amortizable intangible asset under Sec. 197.

a) This ability to amortize characterizes acquired goodwill as a Sec. 1231 asset rather than as a capital asset.

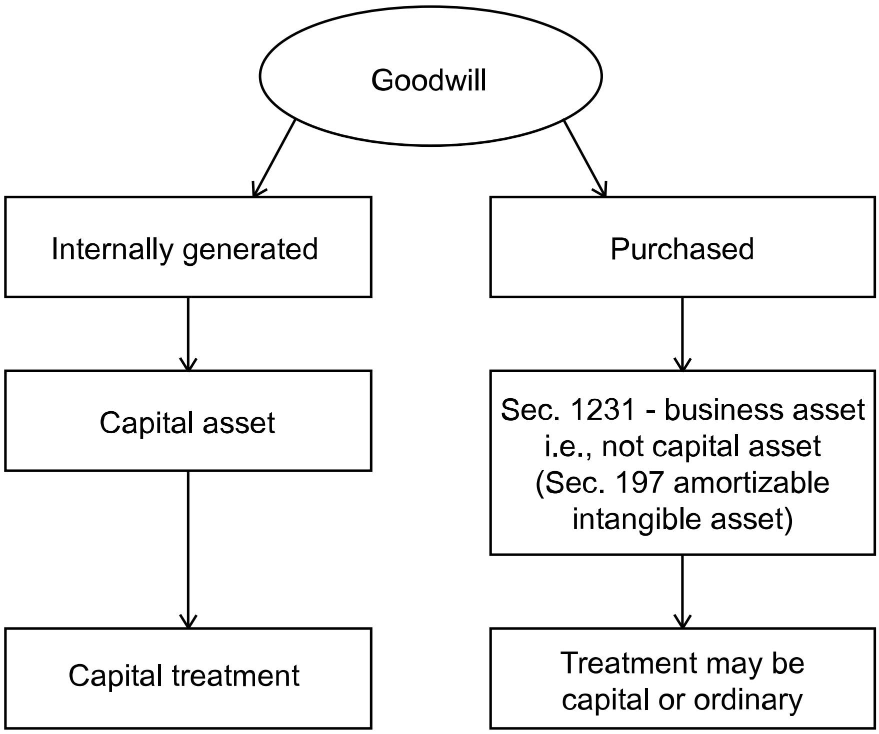

Figure 9-3

Option

f. An option is treated the same as the underlying property.

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Stocks, Bonds, Commodities

g. Stocks, bonds, commodities, and the like are capital assets for investors and traders but not dealers.

1) A dealer holds an asset primarily for sale to customers in the ordinary course of his or her trade or business.

2) A dealer may identify particular assets as held for investment by the close of the business day of acquisition.

a) Such assets are capital.

b) A trader buys and sells assets for his or her own account. They are capital assets in that they are not considered held for sale to customers.

c) To be engaged in business as a trader in securities, all of the following conditions must be met:

i) The taxpayer must seek to profit from daily market movements in the prices of securities and not from dividends, interest, or capital appreciation;

ii) The activity must be substantial; and

iii) The taxpayer must carry on the activity with continuity and regularity.

d) If the nature of the trading activities does not qualify as a business, the taxpayer is considered an investor and not a trader.

e) Investors typically buy and sell securities and expect income from dividends, interest, or capital appreciation. They buy and sell these securities and hold them for personal investment; they are not conducting a trade or business. Most investors are individuals and hold these securities for a substantial period of time.

Land Investment

h. Land held primarily for investment (capital asset) that is then subdivided may be treated as converted to property held for sale in a trade or business.

1) Mere subdivision for sale of land held by other than a C corporation does not establish that it is held for sale in a trade or business.

2) The subdivided land is treated as a capital asset if particular conditions are satisfied, e.g., if no substantial improvements have been made to the land while held by the person.

Sale or Exchange

2. Generally, under Sec. 1001, all gains (losses) are realized on the “sale or other disposition of property.” This includes sales or exchanges that are required in characterizing a realized gain or loss as capital.

a. A sale is a transfer of property in exchange for money or a promise to pay money, while an exchange is a transfer of property in return for other properties or services.

b. For real property, a sale or exchange occurs on the earlier of the date of conveyance or the date that the burdens of ownership pass to the buyer.

c. Also, liquidating distributions and losses on worthless securities are treated as sales or exchanges.

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Gain (Loss) Recognized

3. All realized gains must be recognized unless the IRC expressly provides otherwise. Conversely, no deduction is allowed for a realized loss unless the IRC expressly provides for it. The following formula shows computation of gain or loss realized:

How to Figure a Gain or Loss	
IF the taxpayer's . . .	THEN the taxpayer has a . . .
Adjusted basis is more than the amount realized	Loss
Amount realized is more than the adjusted basis	Gain

	Money received (or to be received)
+	FMV of other property received[1]
+	Liability relief[2]
–	Money or other property given up
–	Selling expenses[3]
–	Liabilities assumed[2]
=	**Amount realized**

	Amount realized
–	Adjusted basis
=	**Gain (loss) realized**

1 If the FMV of other property received is not determinable with reasonable certainty, FMV of the property given up is used.
2 Whether recourse or nonrecourse.
3 Selling expenses are subtracted from gross receivables to yield the amount realized.

EXAMPLE 9-6 Realized Gain

The purchase price of a building was $400,000 ($100,000 cash + $300,000 mortgage). Two years later, improvements of $80,000 were made to the building. The building sold for $700,000 ($600,000 cash + $100,000 mortgage balance). A total of $180,000 depreciation had been taken as of the date sold. The adjusted basis is $300,000 ($400,000 original basis + $80,000 improvements – $180,000 depreciation taken). The realized gain is $400,000 ($700,000 cash and liability relief – $300,000 adjusted basis).

a. Long-term capital gain or loss (LTCG or LTCL) is realized from a capital asset held for more than 1 year. Short-term capital gain or loss (STCG or STCL) is realized if the asset was held 1 year or less.

Short-Term or Long-Term Gain or Loss	
IF property is held . . .	THEN it is a . . .
1 year or less	Short-term capital gain or loss
More than 1 year	Long-term capital gain or loss

b. For individuals, net capital gain (NCG) is the excess of net LTCG over net STCL. Net STCG is not included in NCG. Do not confuse it with capital gain net income.

c. Net STCG is treated as ordinary income for individuals. NCG rates do not apply to net STCG.

   1) Net STCG = STCG – STCL
   2) But net STCG may be offset by net LTCL.

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Capital Gains Rates

d. For individuals, net short-term capital gain is taxed as ordinary income.

e. For individuals, capital transactions involving **long-term holding periods** (assets held for over 12 months) are grouped by tax rates. The maximum capital gains rates are 0%, 15%, 20%, 25%, or 28%.

1) The thresholds for the application of the capital gains rates are adjusted for inflation. The 2022 thresholds are listed below.

Filing Status	0% Breakpoint	15% Breakpoint	20% Breakpoint
Married Filing Jointly	Under $83,350	$83,350	$517,200
Head of Household	Under 55,800	55,800	488,500
Single	Under 41,675	41,675	459,750
Married Filing Separately	Under 41,675	41,675	258,600
Estates and Trusts	Under 2,800	2,800	13,700

2) The capital gains rate is **25%** on unrecaptured Sec. 1250 gains (discussed further in Study Unit 10, Subunit 2).

3) The capital gains rate is **28%** on gains and losses from the sale of collectibles and taxable portions of gains from qualified Sec. 1202 stock (certain small business stock).

NOTE: The 0%, 15%, 20%, 25%, and 28% capital gains rate outline content above will be referenced as "baskets" in the following outline content for simplicity.

f. After gains and losses are classified in the appropriate baskets, losses for each long-term basket are first used to offset any gains within that basket.

g. If a long-term basket has a net loss, the loss will be used first to offset net gain for the highest long-term rate basket, then to offset the next highest rate basket, and so on.

EXAMPLE 9-7 Capital Gains (Losses) and Grouping by Tax Rates

A taxpayer realizes a $10,000 net loss in the 15% basket, a $5,000 net gain in the 25% basket, and an $8,000 net gain in the 28% basket. The taxpayer will first apply the net loss against the gain in the 28% basket, reducing the gain in this basket to zero. Then, the remaining $2,000 loss is applied against the gain in the 25% basket, leaving a $3,000 net capital gain in the 25% basket.

Carryover of NLTCL

h. A carryover of a net long-term capital loss from a prior year is used first to offset any net gain in the 28% basket and continues down in order of highest percentage to offset gain until it reaches the 0% basket. Likewise, net STCL is also used first to offset net gain for the highest long-term basket and so on.

EXAMPLE 9-8 Long-Term Capital Loss Carryover and Net STCL

A taxpayer has a $1,000 long-term capital loss carryover, a net short-term capital loss of $3,000, a $1,000 net gain in the 28% basket, a $2,000 net gain in the 25% basket, and a $5,000 net gain in the 15% basket. Both losses are first applied to offset the 28% rate gain, using the $1,000 loss carryover first until completely exhausted. Since no gain exists in the 28% basket after applying the carryover, the net STCL is then applied against the next highest gain in the 25% basket. Since no gain exists in the 25% basket after applying $2,000 of the net STCL, the remaining $1,000 net STCL is applied to the 15% basket. As a result, only a $4,000 net capital gain remains in the 15% basket.

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Corporations

i. For corporations, all capital gains (ST or LT) are taxed at the corporation's regular tax rate.

Loss Limits

j. An individual may offset a net capital gain with a net capital loss. If the individual does not have net capital gains, (s)he recognizes a net capital loss in the current year up to the lesser of $3,000 ($1,500 for married filing separately) or ordinary income. An individual may carry forward any excess CLs indefinitely.

   1) The carryforward is treated as a CL incurred in the subsequent year.

   2) Net STCL is treated as having been deductible in the preceding year before net LTCL.

   3) There can be no carryover from a decedent to his or her estate.

k. A corporation may use CLs only to offset CGs each year. A corporation must carry the excess CL back 3 years and forward 5 years and characterize all carryovers as STCLs (regardless of character).

Schedule D

l. Schedule D (Form 1040) is used to compute and summarize total capital gains and/or losses on the sale or disposition of capital assets listed on Form 8949, and the summary combines the long-term gains (losses) with the short-term gains (losses).

   1) When these capital gains and losses all net to a gain, it is called "capital gain net income" [Sec. 1222(a)].

   2) If a taxpayer has capital gain distributions and no other capital gains or losses, the capital gains distributions may be reported directly on line 7 of Form 1040 (without using Schedule D), provided that the following conditions are met:

      a) (S)he only has capital gains from box 2a from Form 1099-DIV to report.

      b) No amounts appear in box 2b (unrecaptured Sec. 1250 gain), box 2c (Sec.1202 gain), or box 2d [collectibles (28%) gain].

      c) Form 4952, *Investment Interest Expense Deduction*, is not being filed, or, if the amount on line 4g of that form includes any qualified dividends, it also includes all net capital gains from the disposition of property held for investment.

m. Liabilities discharged in bankruptcy are treated as a short-term capital loss on Schedule D to a creditor who is an individual.

   1) The loss is short-term capital loss regardless of how long the debt was in the hands of the creditor.

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9.9 CAPITAL GAINS ON SALES OF STOCK

Gains and Losses

1. Gains and losses from the disposition of securities are generally determined and taxed like gains and losses from the disposition of other property.
    a. Securities held by investors are capital assets.

Return of Capital

2. A return of capital distribution reduces basis and becomes a capital gain when the shareholder's basis in the stock reaches zero.

Undistributed Gains

3. Undistributed capital gains earned in a mutual fund are taxed as capital gains in the current period.
    a. A credit is allowed for any tax paid by the mutual fund on behalf of the taxpayer.

60/40 Rule

4. Generally, positions in regulated futures contracts, foreign currency contracts, nonequity options, and dealer equity options in an exchange using the mark-to-market system are treated as if they were sold on the last day of the year.
    a. Any capital gains or losses arising under this rule are treated as if they were 60% long-term and 40% short-term without regard to the holding period.

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9.10 SECTIONS 1202 AND 1244 STOCK

50% Exclusion

1. Taxpayers may exclude 50% of the gain from the sale or exchange of qualified small business stock (QSB stock).
   a. The stock must have been issued after August 10, 1993, and held for more than 5 years.
   b. For Sec. 1202 stock acquired after February 17, 2009, and before September 28, 2010, the exclusion increases to 75%.
   c. For Sec. 1202 stock acquired after September 27, 2010, the exclusion increases to 100%.

Asset Limits

2. Qualified small business stock must be that of a domestic C corporation with aggregate gross assets not exceeding $50 million.
3. The corporation must have at least 80%, by value, of its assets used in the active conduct of a qualified business.
   a. A qualified business is any business other than
      1) The performance of personal services (e.g., banking, financing, and leasing),
      2) Any farming business,
      3) Any extractive industry, and
      4) Hospitality businesses (e.g., hotels and restaurants).

Annual Gain Limit

4. The aggregate annual gain for which a taxpayer may qualify under Sec. 1202 is limited to the greater of $10 million or 10 times the adjusted tax basis of qualified stock disposed of by the taxpayer during the year.

Rate

5. Section 1202 stock qualifying for the 50% or 75% exclusions are taxed at the 28% rate.

AMT Preference

6. An alternative minimum tax (AMT) preference is equal to 7% of the excluded gain. Since this is an exclusion preference, there is no minimum tax credit allowed.
   a. For stock acquired after September 27, 2010, there is no AMT preference.

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Gain Rollover

7. Individuals are allowed to roll over capital gains from the sale of Sec. 1202 stock if other small business stock is purchased within 60 days after the date of sale.
   a. The small business stock being sold must have been held for more than 6 months.
   b. The normal rules of nontaxable exchange apply to the gain being deferred, the basis of the small business stock acquired, and the holding period for the acquired stock.
   c. Qualified small business (QSB) stock held through pass-through entities qualifies for the rollover rules.
      1) A pass-through entity may make the election if the entity sells QSB stock held more than 6 months and purchases replacement QSB stock during the 60-day period beginning on the date of sale.
         a) The benefit of deferral will flow through to the taxpayers (other than C corporations) that held interests in the entity during the entire period in which the entity held the QSB stock.
      2) If a pass-through entity sells QSB stock held for more than 6 months, an individual who has held an interest in the entity and who purchases replacement QSB stock may make the rollover election with respect to the individual's share of any gain on the sale that the entity does not defer under Sec. 1045.
         a) The individual's interest in the entity must be held during the entire period in which the entity held the QSB stock.
         b) The purchase of replacement QSB stock must take place during the 60-day period beginning on the date of the sale of the QSB stock.
   d. If a person has more than one sale of QSB stock in a tax year that qualifies for the rollover election, the person may make the rollover election for any one or more of those sales.

Section 1244

8. An individual may deduct, as an ordinary loss, a loss from the sale or exchange or from worthlessness of "small business stock" (Sec. 1244 stock) issued by a qualifying small business corporation.
   a. A corporation qualifies if the amount of money and other property it receives as a contribution to capital does not exceed $1 million.
      1) This determination is to be made at the time the stock is issued.
   b. The shareholder must be the original owner of the stock.
   c. The maximum amount deductible as an ordinary loss in any one year is $50,000 ($100,000 on a joint return).
   d. If a taxpayer makes capital investments in the corporation without receiving stock, the loss must be allocated between the investments where stock was received and investments where stock was not received.
      1) Losses from investments without receiving stock are not eligible for Sec. 1244.
   e. The loss is shown on Form 4797.

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STUDY UNIT TEN

RELATED PARTIES, BUSINESS PROPERTY, AND INSTALLMENT SALES

This study unit involves a discussion of related party sales, the sale of business property, and installment sales. Special rules prevent taxpayers from receiving unwarranted tax benefits. Losses on sales to related parties are disallowed, except for sales in corporate liquidation rules. Depreciation is recaptured on the sale of business property in order to prevent taxpayers from taking ordinary depreciation deductions and then receiving capital gain treatment at the time of sale of the property. When payments from the sale of property are received after the year of sale, gain recognition is deferred for each payment until the payment's corresponding tax year.

10.1 RELATED PARTY SALES

These rules limit tax avoidance between related parties.

1. Gain recognized on sale of an asset is ordinary income when an asset is transferred to a related person in whose hands the asset is depreciable.
   a. For this unique situation, "related" means
      1) A person and the person's controlled entity(ies),
      2) A taxpayer and any trust in which the taxpayer (or spouse) is a beneficiary,
      3) An executor and a beneficiary of an estate, and
      4) An employer and a welfare benefit fund controlled directly or indirectly by the employer (or related person).

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Loss Nonrecognition

2. Loss realized on sale or exchange of property to a related person is not recognized.
   a. The transferee takes a cost basis.
   b. There is no adding of holding periods.
   c. Gain realized on a subsequent sale to an unrelated party is recognized only to the extent it exceeds the previously disallowed loss.

EXAMPLE 10-1	**Disallowed Loss on Sale to Related Person**

Taxpayer A sells stock with a basis of $100,000 to a related person, Taxpayer B, for $80,000, creating a $20,000 disallowed loss for Taxpayer A. If Taxpayer B in turn sells the stock to an unrelated party for $130,000, creating a realized gain of $50,000 ($130,000 sales price – $80,000 basis), Taxpayer B only has to recognize $30,000 of gain ($50,000 realized gain – $20,000 disallowed loss from original transaction between A and B). In addition, if the unrelated sale had been for only $90,000, resulting in $10,000 gain ($90,000 sale price – $80,000 basis), Taxpayer B would not recognize any gain as the $10,000 gain is offset by $10,000 of the prior $20,000 disallowed loss. Finally, if the unrelated sale had been for only $65,000, creating an additional $15,000 loss, Taxpayer B could only recognize the $15,000 loss and not a $35,000 loss ($20,000 disallowed loss + $15,000 unrelated sale loss).

   d. Loss realized on a subsequent sale to a third party is recognized, but the previously disallowed loss is not added to it.
3. For property purchased on or after January 1, 2016, a new rule precludes the previously discussed recognition of the disallowed loss when later sold to an unrelated party, if the original transferor (e.g., Taxpayer A in the prior example) is a tax-indifferent party.
   a. Tax-indifferent parties are those not subject to federal income tax or to whom an item would have no substantial impact on its income tax. Examples of tax-indifferent parties include non-U.S. persons, tax-exempt organizations, and government entities.

EXAMPLE 10-2	**Disallowed Loss -- Tax-Indifferent Party**

Returning to Example 10-1, if Taxpayer A is changed to a tax-indifferent party, the disallowed loss is still $20,000 when the stock is sold for $80,000 to Taxpayer B; however, on the sale from Taxpayer B to an unrelated party for $130,000, the realized and recognized gain is $50,000 ($130,000 – $80,000). The $50,000 gain is not offset by the disallowed loss.

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Related Parties

4. Related parties under Sec. 267(b) and (c) for purposes of these provisions include
   a. Ancestors, lineal descendants, spouses, and siblings (nephews and nieces are not descendants)
   b. Trusts and beneficiaries of trusts
   c. Controlled entities (greater than 50% ownership)

   NOTE: Constructive ownership rules between family members apply.
5. Loss on sale or exchange of property between a partnership and a person owning more than 50% of the capital or profit interests in the partnership is not recognized (deductible).

Employer-Employee Transactions

6. An employee is not a related party to the employer for purposes of the related-party sale rules.
   a. When an employer sells assets to an employee at less than FMV, the difference between FMV and the sales price is considered compensation to the employee.
      1) Since the employee pays tax on the compensation, his or her basis in the new property will be FMV.

Interspousal Transfer

7. No gain or loss is recognized on the transfer of property between spouses or, incident to a divorce, on transfers of property to a former spouse.
   a. The transferee takes a carryover basis in the property.
   b. These rules apply whether the transfer is a gift, a sale, or an exchange.

10.2 BUSINESS PROPERTY

Sections 1231, 1245, and 1250 recharacterize gain or loss. Sections 1245 and 1250 also accelerate recognition of certain installment gain that would otherwise be deferred.

Because the concepts in this subunit are challenging, we have included Examples 10-8 and 10-9 on page 11, to provide additional context.

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Overview of Business Property Recharacterization

(i.e., depreciation recapture)

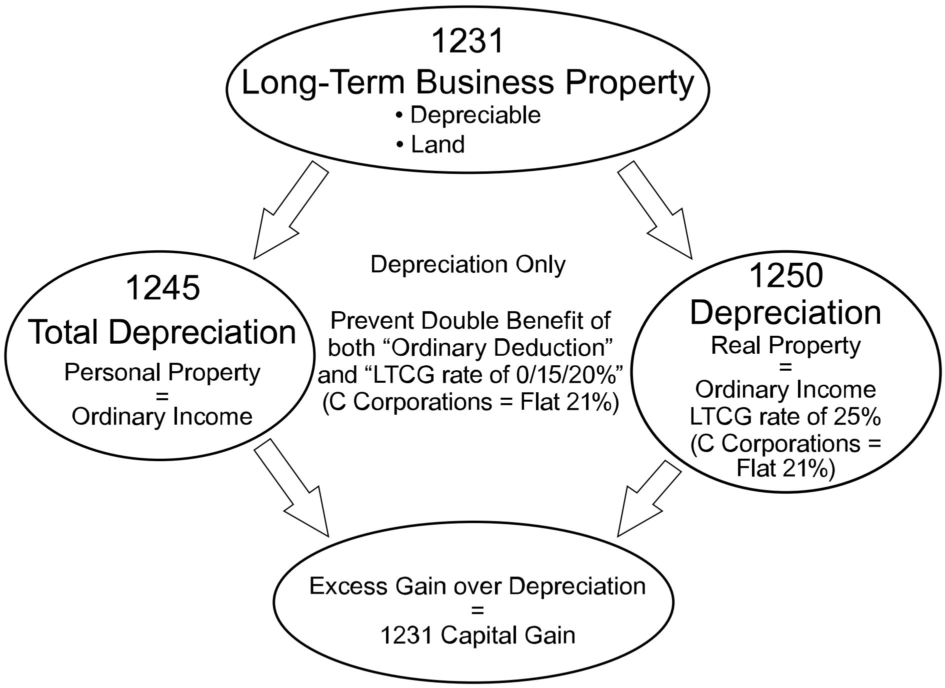

Figure 10-1

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Section 1245 Property

Figure 10-2

Visual Memory Aid: For candidates who are visual learners, the figure above and the description below can aid in recalling that depreciation taken on Sec. 1245 property is treated as ordinary income when sold at a gain.

This figure shows Sec. 1245 depreciation as being recaptured and treated as ordinary income. (Think "ordinary getting recaptured.") The Sec. 1245 property is depicted as an animal trapped in a cage. The man declares that the animal (45) has been recaptured, while the animal (45) moans that they feel "so ordinary" while captured in the cage.

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1. A recognized gain on the disposition of Sec. 1245 property is ordinary income to the extent of all depreciation or amortization taken or gain realized.
   a. Amounts expensed under Sec. 179 are considered depreciation deductions. Depreciation deductions may be taken for the taxable year the business property is placed in service.
   b. Property is considered placed in service when it is ready and available for a specific use.
   c. The downward basis adjustment for a general business credit is considered a deduction allowed for depreciation and is subject to recapture.
   d. The recognized gain in excess of the depreciation taken may be treated as a gain from the sale or exchange of Sec. 1231 property.

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2. Section 1245 property generally is depreciable personal property used in a trade or business for over 12 months.
   a. It is tangible (intangible), depreciable (amortizable) personal property (e.g., equipment, patent); recovery property, including specified real property; and tax benefit property (e.g., qualified Sec. 179 expense property).
   b. Other tangible property (excluding a building or its structural components) includes property used as an integral part of a trade or business, e.g., manufacturing or production equipment.
   c. Intangible, amortizable (Sec. 197) personal Sec. 1245 property examples include
      1) Leaseholds of Sec. 1245 property
      2) Professional athletic contracts, e.g., major league baseball
      3) Patents
      4) Livestock
      5) Goodwill acquired in connection with the acquisition of a trade or business
      6) Covenants not to compete
   d. Particular types of property are treated as Sec. 1245 property due to an attributable tax benefit. An example is amortized pollution control facilities.

EXAMPLE 10-3 Section 1245 Ordinary Income and Section 1231 Gain

Paige owns a patent with a cost of $300,000 and an adjusted basis of $260,000. On January 2 of this year, Paige sold the patent for $345,000.

Total amortization taken previously equals $40,000 ($300,000 – $260,000). Paige's realized gain is $85,000 ($345,000 sales price – $260,000 adjusted basis). Section 1245 requires the gain to be recognized as ordinary income to the extent of the amortization taken. Therefore, $40,000 of the $85,000 gain is Sec. 1245 gain and the remaining $45,000 is Sec. 1231 gain.

Section 1250 Ordinary Income

3. Section 1250 property is all depreciable real property, held for more than 1 year, such as a building or its structural components.
   a. Section 1250 property is subject to its own recapture rules. For the three items listed below, the aggregate gain recognized on the sale or disposition of Sec. 1250 property is ordinary income (OI).
      1) The excess of accelerated depreciation taken over S-L depreciation is OI to the extent of gain recognized.
         a) However, because most Sec. 1250 property (for example, 39-year nonresidential real property and 27.5 year residential real property) has been depreciated using straight-line since 1987, it is relatively uncommon to encounter Sec. 1250 recapture.
      2) For corporations, the gain must be computed under both Secs. 1245 and 1250. If Sec. 1245 gain is larger than Sec. 1250 gain, 20% of the difference is characterized as OI.
      3) For property held 1 year or less, any depreciation is recaptured as OI.

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b. Examples of Sec. 1250 property include shopping malls, an apartment or office building, low-income housing, rented portions of residences, and escalators or elevators.

c. Income received or accrued for more than one asset is allocated to each asset by agreement, by FMV, or by the residual method.

1) To compute Sec. 1245 and Sec. 1250 OI, an amount realized allocable to an asset must be further allocated to each use of a mixed-use asset for each tax year.

2) Apportionment is on the basis of relative time or amount of asset usage, e.g., 5% of automobile usage for business or one-half of a house used as rental property.

Unrecaptured Section 1250 Depreciation

4. Only applies to individual taxpayers and only if there is a gain on the sale of the asset. In the case of multiple Sec. 1231 assets, this rule applies only if there is a net Sec. 1231 gain on the sale of all the assets bundled together. If multiple Sec. 1231 sales net to a loss, then the loss is simply ordinary.

a. The lesser of the following is taxed at a maximum capital gains rate of 25%:

1) Gain on the sale of the asset less any depreciation recognized as OI.

2) Accumulated depreciation on the asset less any depreciation recognized as OI (straight-line depreciation taken).

b. Any excess gain is allocated to net Sec. 1231 gain to be taxed at a 0%, 15%, or 20% rate.

EXAMPLE 10-4 Section 1250 Unrecaptured Gain Taxed as Sec. 1231 Gain

Annie sold a building used in her trade or business for $110,000. This is her only Sec. 1231 property sale for the year. Annie purchased the building several years ago for $100,000. At the time of the sale, the building has accumulated depreciation of $20,000. The building was depreciated using the straight-line method; Sec. 1250 recapture does not apply, and Annie has a Sec. 1231 gain of $30,000 ($110,000 amount realized – $80,000 adjusted basis). Of the $30,000 gain, $20,000 is attributable to straight-line depreciation and is classified as Sec. 1250 unrecaptured gain, which is subject to a maximum rate of 25%. The remaining $10,000 gain is taxed at a maximum rate of 0/15/20%.

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Section 1231 Property

Figure 10-3

Visual Memory Aid: For candidates who are visual learners, the figure above and the description below can aid in recalling the dual benefits of Sec. 1231 property.

Section 1231 business assets are truly "the Best of Both Worlds" because they treat losses as ordinary losses (able to offset ordinary income) and tax gains at the preferable capital gains tax rate. This memory aid uses the "31" as a "B" for "Best of Both Worlds" and an "L" for "Losses." This will remind you of the benefits of this class of assets.

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5. Unlike the recapture provisions in Secs. 1245 and 1250, Sec. 1231 is beneficial to the taxpayer.
   a. When Sec. 1231 property gains exceed losses (a net Sec. 1231 gain), each gain or loss is treated as being from the sale of a long-term capital asset.
   b. If Sec. 1231 property losses exceed gains (a net Sec. 1231 loss), each gain or loss is considered ordinary.
   c. Section 1231 property is property held for more than 1 year and includes
      1) All real or depreciable property used in a trade or business or
      2) Involuntarily converted capital assets held in connection with a trade or business or in a transaction entered into for a profit.
   d. Examples of Sec. 1231 property include land, apartment buildings, parking lots, manufacturing equipment, and involuntarily converted investment artwork.
      1) Land is not depreciable. Thus, it does not fall within Sec. 1245 or Sec. 1250. Land is referred to as pure Sec. 1231 property if used for a trade or business and held for more than 1 year.

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e. Examples that are not Sec. 1231 property include personal-use property and inventory.

f. Section 1231 has a two-step test.

1) Step 1: Determine net gain or loss from all casualties or thefts of Sec. 1231 property for the tax year. Gain or loss from involuntary conversions by other than casualty or theft is included in Step 2 but not Step 1.

a) If the result is a net loss, each gain or loss is treated as ordinary income or loss.

b) If the result is a net gain, each gain or loss is included in Step 2.

2) Step 2: Determine net gain or loss from all dispositions of Sec. 1231 property for the year, including the property included in Step 1 only if Step 1 resulted in a net gain.

a) If the result is a net loss, each gain or loss is treated as ordinary income or loss.

b) If the result is a net gain, each gain or loss is treated as a long-term capital gain or loss, subject to the recapture rules under i. below.

EXAMPLE 10-5 Section 1231 Loss on Sale

A business taxpayer sold for scrap outdated equipment purchased years ago. The equipment had an adjusted basis of $5,000 and a sale price of $2,000. Business equipment held longer than a year is Sec. 1231 property, and, when sold at a loss, the loss is ordinary loss, not capital loss. If this business had $10,000 taxable income from operations and no other transactions, its taxable income for the year would be $7,000 ($10,000 taxable income – $3,000 loss).

Allocation

g. Allocation is required when Sec. 1245 or Sec. 1250 property is also Sec. 1231 property and only a portion of gain recognized is Sec. 1245 or Sec. 1250 OI.

h. The installment method can apply to Sec. 1231 property.

i. Recapture. Net gain on Sec. 1231 property is treated as OI to the extent of unrecaptured net Sec. 1231 losses from preceding tax years.

1) Unrecaptured net Sec. 1231 losses are the total of net Sec. 1231 losses for the last 5 tax years, reduced by net Sec. 1231 gains characterized as OI under Sec. 1231(c).

EXAMPLE 10-6 Section 1231 Recapture

Eric has unrecaptured Sec. 1231 losses of $4,500 from 2 years ago. This year, he has a net Sec. 1231 gain of $7,600. Of this gain, $4,500 will be recharacterized as ordinary, and the remaining $3,100 will be classified as long-term capital gain.

2) Sections 1245 and 1250 recapture is computed before Sec. 1231 recapture, but Sec. 1231 recapture is computed before Steps 1 and 2 above.

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3) Section 1231 merely characterizes gain or loss. Any Sec. 1231 gain that is recharacterized as capital gain will first consist of 25% gain, then 0/15/20% gain.

a) When sales price is above the cost of the asset and no losses exist (current year and preceding tax years), the Sec. 1231 gain is characterized as follows:

i) Ordinary income as depreciation is recaptured up to the cost of the asset and then as

ii) Capital gain for sales price amount in excess of cost.

EXAMPLE 10-7 Section 1231 Gain

ZP Enterprises purchased a delivery truck for $100,000 more than 1 year ago and fully depreciated the truck. ZP Enterprises sold the truck for $120,000 this year resulting in a $120,000 Sec. 1231 gain. The character of the $120,000 gain is as follows:

$100,000	Ordinary income
20,000	Section 1231 long-term capital gain
$120,000	Total gain

Installment Sales

6. All gain realized from a disposal of recapture property in an installment sale is characterized as OI by Sec. 1245 or Sec. 1250 and must be recognized in the period of sale. Excess gain over Sec. 1245 or Sec. 1250 OI is accounted for by the installment method.

Gift Property

7. Neither Sec. 1245 nor Sec. 1250 applies to a gift disposition. Any gain realized by the donee upon a subsequent taxable disposition is subject to Sec. 1245 and Sec. 1250 characterization up to the sum of any potential Sec. 1245 and Sec. 1250 OI at the time of the gift and any Sec. 1245 and Sec. 1250 OI potential arising between gift and subsequent disposition.

Inherited Property

8. Neither Sec. 1245 nor Sec. 1250 applies to a disposition by bequest, devise, or intestate succession. Exceptions include the following:

a. Section 1245 and Sec. 1250 OI is recognized for a transfer at death to the extent of any income in respect of a decedent (IRD).

b. Section 1245 OI potential also results from depreciation allowed to a decedent because the depreciation does not carry over to the transferee.

Section 351 Exchange for Stock

9. Generally, no gain is recognized upon an exchange of property for all the stock of a newly formed corporation. Section 1245 and Sec. 1250 OI is limited to any amount of gain recognized in a Sec. 351 transaction.

10. Section 1245 applies to the amount of gain recognized plus the FMV of non-Sec. 1245 property received (e.g., boot) that is not already taken into account in calculating the recognized gain.

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EXAMPLE 10-8 Section 1245 Recapture

On January 17, Year 1, Relief Corp. purchased and placed into service 7-year MACRS tangible property costing $100,000. On December 21, Year 4, Relief Corp. sold the property for $105,000 after taking $60,000 in MACRS depreciation deductions.

The adjusted basis of the property is $40,000 ($100,000 historical cost – $60,000 depreciation); therefore, Relief will recognize a gain of $65,000 ($105,000 selling price – $40,000 adjusted basis). Since this property qualifies for Sec. 1245 recapture, the gain is recaptured as ordinary income to the extent of the lesser of all depreciation taken or gain realized. Thus, Relief will have $60,000 of Sec. 1245 (ordinary) gain. The remaining $5,000 of gain is Sec. 1231 (capital) gain.

EXAMPLE 10-9 Section 1245 Recapture

The facts from Example 10-8 apply, except Relief sold the property for $95,000.

Relief recognizes a gain of $55,000 ($95,000 selling price – $40,000 adjusted basis). Since this property qualifies for Sec. 1245 recapture, the gain is recaptured as ordinary income to the extent of the lesser of all depreciation taken or gain realized. Thus, Relief has $55,000 of Sec. 1245 (ordinary) gain.

Sec. 1245 Depreciation Recapture: Examples 10-8 and 10-9

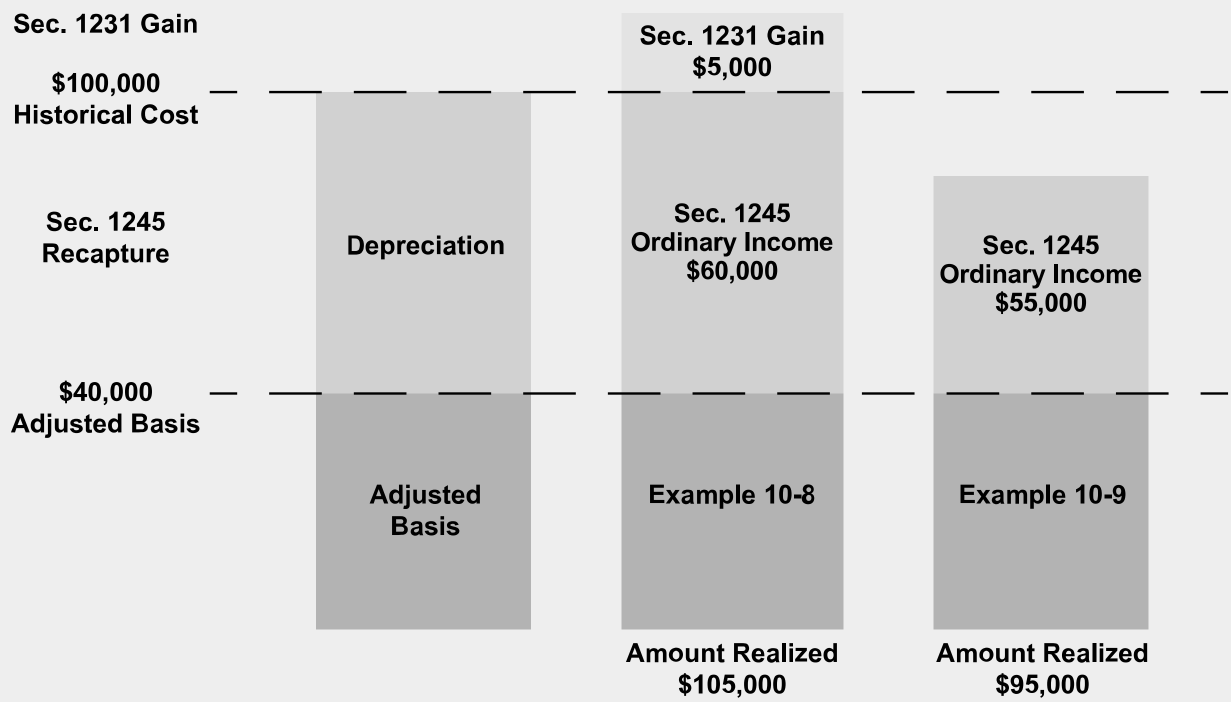

Figure 10-4

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Sale of Business-Use Assets Held **One Year or Less**

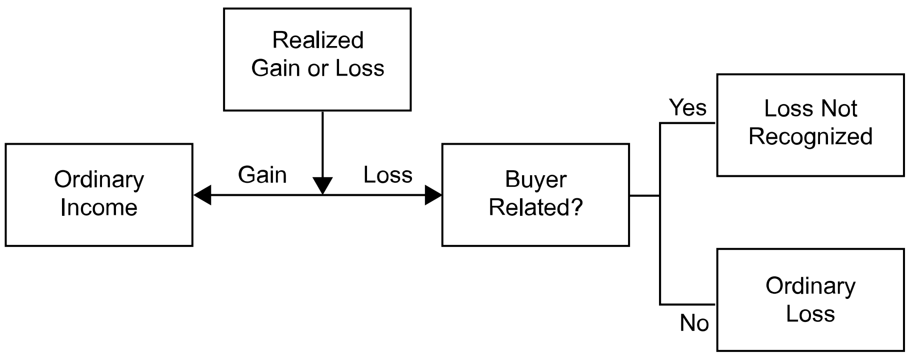

Figure 10-5

Sale of Business-Use Assets Held **More than One Year**

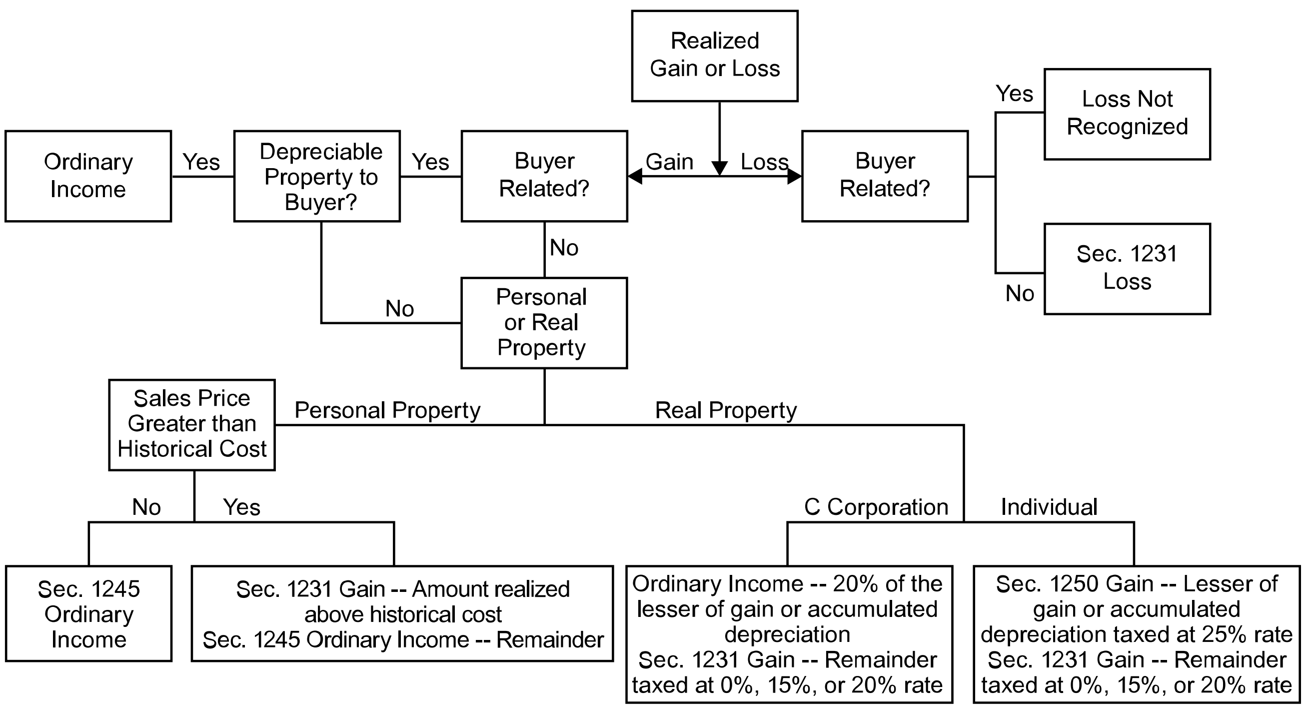

Figure 10-6

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10.3 INSTALLMENT SALES

The installment method must be used to report installment sales unless election is made not to apply the method. An installment sale is a disposition of property in which at least one payment is to be received after the close of the tax year in which the disposition occurs.

1. Installment sales do not apply to the following dispositions:
   a. Inventory personal property sales
   b. Revolving credit personal property sales
   c. Dealer dispositions, including dispositions of
      1) Personal property of a type regularly sold by the person on the installment plan
      2) Real property held for sale to customers in the ordinary course of trade or business
   d. Securities, generally, if publicly traded
   e. Sales on agreement to establish an irrevocable escrow account
2. Not excluded from installment sale deferral are
   a. Certain sales of residential lots or timeshares subject to interest on the deferred tax
   b. Property used or produced in a farming business

Recognized Gain

3. The amount of realized gain to be recognized in a tax year is equal to the gross profit multiplied by the ratio of payments received in the current year divided by the total contract price.
   a. Recognize, as income, payments received multiplied by the gross profit percentage.

      Recognized gain = Gross profit percentage × Payments received

      1) Excess of liability assumed over adjusted basis (AB) and selling expenses is treated as part of the down payment.
      2) A payment is considered paid in full if the balance is placed into an irrevocable escrow account (i.e., amounts that cannot revert to the purchaser) at a later date.
   b. The gross profit percentage is the ratio of the gross profit to the total contract price.

$$\textbf{Gross profit percentage} = \frac{\textbf{Gross profit}}{\textbf{Contract price}} = \frac{\textbf{Selling price – Selling expenses – Adjusted basis}}{\textbf{Amount to be collected}}$$

      1) The gross profit is the sales price reduced by any selling expenses (including debt cancellation) and adjusted basis.
         a) When the selling price is reduced in a future year, the gross profit on the sale will also be reduced.
            i) The gross profit percentage must be recalculated for the remaining periods by using the reduced sales price and subtracting the gross profit already recognized.

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EXAMPLE 10-10 Gain Recognition on Installment Sale

In Year 1, Harry sold land with an adjusted basis to him of $120,000 to Joe for $200,000. Joe made a down payment of $80,000 in Year 1, and agreed to pay $30,000 per year plus interest for the next 4 years beginning January Year 2. After Joe made the payment in Year 2, Harry and Joe agreed to reduce the overall sales price to $185,000 and the yearly payments to $25,000. Since the selling price is reduced at a later date, the gross profit on the sale will also change. The gross profit percentage must be recalculated for the remaining periods by using the reduced sales price and subtracting the gross profit already recognized. The amount includible in Year 3 is determined as follows:

Gross profit ($185,000 sales price – $120,000 basis)	$65,000
Less: Gain recognized to date [$110,000 payments × ($80,000 original gross profit ÷ $200,000 original sales price)]	(44,000)
Remaining gain	$21,000
Adjusted gross profit ratio ($21,000 remaining gain ÷ $75,000 remaining payments)	28%
Multiplied by: Payment received in Year 3	25,000
Gain recognized in Year 3	$ 7,000

b) Gross profit includes the unrecognized gain on sale of a personal residence.

2) The sales price is the sum of any cash received, liability relief, and installment notes from the buyer. It does not include imputed interest.

3) The total contract price is the sales price minus liabilities assumed by the buyer (that do not exceed the shareholder's basis in the property).

EXAMPLE 10-11 Installment Sale with Mortgage Assumption

John owns a piece of land with a basis of $100,000 and a mortgage attached of $50,000. He sells the land for $300,000 plus interest, with the buyer taking over the mortgage, paying $20,000, and issuing a promissory note for $230,000. The sales price is $300,000 ($250,000 + $50,000). The contract price is $250,000 ($300,000 amount realized – $50,000 mortgage assumed). John incurs selling expenses of $10,000.

a) The contract price and the amount received in the span of sale includes the excess of liability assumed over AB and selling expenses.

EXAMPLE 10-12 Installment Sale with Mortgage Assumption

If the mortgage attached in Example 10-11 were $140,000, the selling price would be $390,000 ($250,000 + 140,000). The contract price would be $280,000 ($390,000 – 140,000 + 30,000) excess of mortgage assumed over the basis plus selling expenses.

i) When the liability exceeds the AB and selling expenses, the gross profit percentage is 100%.

4) The adjusted basis for installment sale purposes is the total of the following three items:

a) Adjusted basis
b) Selling expenses
c) Depreciation recapture

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Character of Gain

4. Character of gain recognized depends on the nature of the property in the transferor's hands.
5. The full amount of Sec. 1245 and Sec. 1250 ordinary gain ("depreciation recapture") must be recognized in the year of sale, even if it exceeds payments received.
   a. If a taxpayer sells property for which a depreciation deduction was claimed, any depreciation recapture income in the year of sale must be reported, whether or not an installment payment was received that year.
   b. The gain is added to basis before further applying the installment method.

Anti-Avoidance Rule

6. An anti-avoidance rule applies to an installment sale of property to a related party. On a second disposition (by the related party transferee in the first sale), payments received must be treated as a payment received by the person who made the first (installment) sale to a related party.
   a. A second disposition by gift is included. The FMV is treated as the payment.
   b. Death of the first disposition seller or buyer does not accelerate recognition.

Repossession

7. The seller of personal property recognizes as gain or loss any difference between the FMV of repossessed property and the AB of an installment sale obligation satisfied by the repossession. If real property, recognize the lesser of
   a. Cash and other property (FMV) received in excess of gain already recognized or
   b. Gross profit in remaining installments less repossession costs.

Example Calculations for Gain (Loss) on Repossession (Per Publication 537)		
Basis of Repossessed Real Property		
1) The unpaid balance of the installment obligation	$160,000	
2) Gross profit percentage for the installment sale	20%	
3) Unrealized profit (multiply line 1 by line 2)	$32,000	
4) Basis of the obligation (subtract line 3 from line 1)		$128,000
5) Taxable gain on the repossession		27,000
6) Cost of repossessing the property		5,000
7) Add lines 4, 5, and 6. This is the basis in the repossessed real property.		160,000
Taxable Gain on Repossession of Real Property		
1) Total payments received before repossession		$90,000
2) Gain already reported as income		18,000
3) Gain on Repossession (subtract line 2 from line 1)		72,000
4) Gross profit on the original sale		50,000
5) Repossession costs		5,000
6) Add line 2 and line 5		23,000
7) Subtract line 6 from line 4		27,000
8) Taxable gain on the Repossession (lesser of line 3 or line 7)		27,000

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Interest

8. Interest is imposed on deferred tax on obligations from nondealer installment sales (of more than $150,000) outstanding at the close of the tax year.
   a. This interest is applied if the taxpayer has nondealer installment receivables of over $5 million at the close of the tax year from installment sales of over $150,000 that occurred during the year.
   b. This interest is not applied to
      1) Personal-use property,
      2) Residential lots and time shares, and
      3) Property produced or used in the farming business.

Disposition of Installment Obligations

9. Excess of the FMV over the AB of an installment obligation is generally recognized as income if it is transferred.
   a. FMV is generally the amount realized.
   b. If a gift, use the face value of the obligation.
   c. The adjusted basis is generally determined by the following formula:

Face value × (100% – Gross profit percentage)

EXAMPLE 10-13 Disposition of Installment Obligation
In Year 1, Bob sold land to Ann for $80,000. He reported the sale using the installment method. At the time of the sale, the land had an adjusted basis of $20,000. Ann made a down payment of $25,000 in Year 1 and agreed to pay $11,000 per year plus interest for the next 5 years. Before the Year 3 payment was made, Bob sold the installment obligation for $30,000. The face amount of the obligation is $44,000 ($11,000 annual payments × 4 years). The basis of the obligation is $11,000 [$44,000 face amount × (100% – 75% gross profit percentage)]. The gain is $19,000 ($30,000 amount realized – $11,000 basis).

   d. Characterize as if the property for which the installment obligation was received was sold.
   e. A disposition of the installment obligation is deemed to occur when the obligation is transferred by gift, is forgiven, or becomes unenforceable.
   f. Exceptions. Disposition of obligations by the following events can result in the transferee treating payments as the transferor would have:
      1) Transfers to a controlled corporation
      2) Corporate reorganizations and liquidations
      3) Contributions to capital of, or distributions from, partnerships
      4) Transfer between spouses incident to divorce
      5) Transfer upon death of the obligee

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STUDY UNIT ELEVEN

NONRECOGNITION PROPERTY TRANSACTIONS

Generally, a taxpayer recognizes a gain when the fair market value of the property received is greater than the adjusted basis of the property given up. This study unit deals with situations in which there may be nonrecognition of the gain or loss. This nonrecognition can be temporary, as in the deferral of gain on a like-kind exchange of real property, or it can be permanent, as in the exclusion of the gain on a sale of a principal residence.

11.1 SALE OF A PRINCIPAL RESIDENCE

Section 121 provides an exclusion upon the sale of a principal residence. No loss may be recognized on the sale of a personal residence.

Ownership and Occupancy

1. The exclusion is available if the individual owned and occupied the residence for an aggregate of at least 2 of the 5 years before the sale.
2. Nonqualified use after 2008 requires the gain to be reduced for the period of nonqualified use.
3. The exclusion may be used only once every 2 years.

Exclusion Amount

4. A taxpayer may exclude up to $250,000 ($500,000 for married taxpayers filing jointly) of realized gain on the sale of a principal residence.
   a. The exclusion is increased to $500,000 for married individuals filing jointly if
      1) Either spouse meets the ownership test,
      2) Both spouses meet the use test, and
      3) Neither spouse is ineligible for the exclusion by virtue of a sale or an exchange of a residence within the last 2 years.
   b. A surviving spouse can qualify for the $500,000 exclusion if the residence is sold within 2 years of the other spouse’s death.
5. The exclusion is determined on an individual basis. Therefore, for married couples who do not share a principal residence but file joint returns, a $250,000 exclusion is available for a qualifying sale or exchange of each spouse’s principal residence.
6. If a single individual eligible for the exclusion marries a person who used the exclusion within 2 years before marriage, the individual is entitled to a $250,000 exclusion. Even though the individual’s spouse used the exclusion within the past 2 years, an individual may not be prevented from claiming the $250,000 exclusion.

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Divorce Transfer

7. If a residence is transferred to a taxpayer incident to a divorce, the time during which the taxpayer's spouse or former spouse owned the residence is added to the taxpayer's period of ownership.
   a. A taxpayer who owns a residence is deemed to use it as a principal residence while the taxpayer's spouse or former spouse is given use of the residence under the terms of a divorce or separation.

Widowed Taxpayer

8. A widowed taxpayer's period of ownership of residence includes the period during which the taxpayer's deceased spouse owned the residence.

Physically or Mentally Incapable Individuals

9. If an individual becomes physically or mentally incapable of self-care, the individual is deemed to use a residence as a principal residence during the time in which the individual owns the residence and resides in a licensed care facility.
   a. The individual must have owned and used the residence as a principal residence for an aggregate period of at least 1 year during the 5 years preceding the sale or exchange.

Prorating the Exclusion

10. The exclusion amount may be prorated if the use, ownership, or prior sale tests are not met.
    a. The exclusion is based on the ratio of months used to 24 months and is a proportion of the total exclusion.
    b. The pro rata exclusion is allowed only if the sale is due to a change in place of employment, health, or unforeseen circumstances.

EXAMPLE 11-1	**Prorating the Section 121 Exclusion**
A taxpayer purchased and moved into a house. Then, 18 months later, he sold the residence because of a change of job location. He must prorate any gain exclusion by 18/24, the number of months used as a principal residence to 24 months.	

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Nonqualified Use

11. The gain on the sale of the residence must be prorated between qualified and nonqualified use.
    a. Nonqualified use includes periods that the residence was not used as the principal residence of the taxpayer, prior to the last day the homeowner lived in the house.

EXAMPLE 11-2	**Nonqualified Use Reduction of the Section 121 Exclusion**
During the 5 years prior to the sale of the house, the taxpayer lived in the house for Years 1, 2, and 4. The absence during the third year is nonqualified use, causing a reduction (prorated based on 1 year of nonqualified use) in the allowed exclusion. The absence during the fifth year does not affect the allowed exclusion since the taxpayer did not return to live in the house prior to the sale. Therefore, only 4/5 of any gain is eligible for exclusion, up to the $250,000 limit.	

    b. Nonqualified use does not include use before 2009.
    c. Periods when the residence was not used as a principal residence occurring after the last date the property was used as a principal residence are not counted as nonqualified use.
        1) This rule is designed to prevent a landlord from moving into rental property for 2 years and then making the gain on the sale of that property eligible for the principal residence exclusion. Conversely, by not counting periods after the last use as a principal residence as nonqualified, the provision does not penalize a taxpayer who moves out of the principal residence and then rents it short-term prior to selling.

EXAMPLE 11-3	**Sale of Principal Residence Exclusion**
Sharon purchased a rental house on January 1, 2017. She used the house as her personal residence for 3 years and then rented the house for 2 years before selling it on January 1, 2022. The time the residence was not used as a principal residence is not considered nonqualified use because it occurred after the last date the property was used as a principal residence. Thus, the full amount of Sharon's gain is eligible for exclusion up to the $250,000 limit.	

EXAMPLE 11-4	**Sale of Principal Residence Exclusion**
Mary purchased a rental house on January 1, 2017. She rented the house for 3 years and then made it her principal residence for 2 years before selling it on January 1, 2022. The time the residence was not used as a principal residence before the last date the property was used as a principal residence is nonqualified use and reduces the amount of gain eligible for exclusion. Thus, only 40% (2 years ÷ 5 years) of the gain is eligible for the exclusion. The eligible gain excluded is then limited to the $250,000 limit.	

    d. Members of the military are allowed up to a 10-year suspension of the 5-year test period for extended duty away from home. Together this gives a 15-year test period.

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Principal Residence Requirement

12. Section 121 excludes realized gain on the sale of a principal residence only. Therefore, gain may need to be recognized on the portion of the property that is not considered a personal residence (e.g., use of a guest facility as rental property).
    a. The portion of the principal residence that is business-use property (e.g., a home office for the taxpayer's business and not as an employee) may not qualify for gain exclusion.
        1) If the business-use property is within the taxpayer's home, such as a room used as a home office for a business, the part of any gain equal to any depreciation allowed or allowable after May 6, 1997, is included in income.
        2) If the business-use property is a separate part of the property (e.g., a rental suite not attached to the principal residence, a working farm on which the house was located, etc.), the basis of the property and the amount realized upon its sale must be allocated between the business rental part and the part used as a home. Any gain associated with the business-use property is not eligible for the principal residence exclusion and must be reported on Form 4797.
    b. Realized gain may qualify for exclusion even though the entire property is used as rental property or business-use property at the time of sale.
        1) For example, the entire property is subject to gain exclusion as long as the individual owned and occupied the entire residence (as a principal residence) for an aggregate of at least 2 of the 5 years before the sale (as noted in item 1. on page 1). The full exclusion amount would be reduced by the nonqualified use.
    c. Deductions (other than depreciation) that relate solely to the rental or business-use portion of the property do not reduce the basis of the principal residence portion.
    d. Any selling expenses incurred in selling the personal residence reduce the amount realized by the seller.
    e. Any gain equal to depreciation allowed or allowable may not be excluded.
    f. Any capital improvements made to the personal residence are added to the adjusted basis of the house.
    g. Any amount of gain not excludable is reported on Schedule D, *Capital Gains*.

Basis

13. Basis in a new home is its cost.

Like-Kind Exchange

14. If the residence was acquired in a Sec. 1031 like-kind exchange in which any gain was not recognized in the prior 5 years, then the Sec. 121 exclusion for gain on sale or exchange of a principal residence does not apply.

Reporting

15. If the amount of the realized gain is less than the maximum exclusion amount, the gain need not be reported on the individual's income tax return.

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11.2 LIKE-KIND EXCHANGES

Section 1031 defers recognizing gain or loss to the extent that **real** property productively used in a trade or business or held for the production of income (investment) is exchanged (commonly referred to as relinquished) for property of like-kind. This means neither personal-use property nor inventory qualify for the deferral. Realized gain (loss) is the gain (loss) from the sale or exchange. Recognized gain (loss) is the amount reported on the tax return.

Like-Kind Property

1. Only real property qualifies for like-kind treatment for transfers after 2017. Like-kind real property is alike in nature or character but not necessarily in grade or quality.
   a. Properties are of like kind if each is within a class of like nature or character, without regard to differences in use (e.g., business or investment), improvements (e.g., bare land or house), location (e.g., city or rural), or proximity.
      1) A real estate lease that runs 30 years or more is treated as real property, and the exchange of it for other real estate qualifies under Sec. 1031 as long as the parties to the exchange are not dealers in real estate.
   b. Real property located within the United States is like-kind with all other real property in the U.S. Foreign real estate is like-kind with other foreign real estate. But, U.S. real estate and foreign real estate are not like-kind.

Boot

2. Boot is all nonqualified property transferred in an exchange transaction.
   a. Gain is recognized equal to the lesser of gain realized or boot received.
   b. Boot received includes cash, net liability relief, and other nonqualified property (its FMV).

EXAMPLE 11-5 Like-Kind Exchange with Boot

Scott owned a parcel of real estate that he was holding for investment. It had an adjusted basis of $50,000. Scott exchanged the real estate for a piece of land with a fair market value of $60,000, a boat for personal use that had a fair market value of $3,000, and $2,000 cash. Scott's basis in the land received is equal to the adjusted basis of the real estate transferred ($50,000), less the boot received of the boat ($3,000) and the cash ($2,000), plus the gain recognized on the transaction. Gain is recognized to the extent of boot received. Here, the boat and the cash are boot; therefore, a gain of $5,000 must be recognized. This recognized gain increases basis of the land to $50,000.

EXAMPLE 11-6 Like-Kind Exchange

Real property with an adjusted basis of $50,000 is exchanged for $20,000 cash and like-kind property with a FMV of $40,000. The recognized gain is $10,000 ($40,000 + $20,000 – $50,000), the lesser of the gain realized ($10,000) and the boot received ($20,000).

EXAMPLE 11-7 Like-Kind Qualified Property

Alan exchanged real property with a basis of $60,000 plus $5,000 cash for like-kind property with a FMV of $63,000. Alan's $2,000 loss [$63,000 – ($60,000 + $5,000)] is not deductible.

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Liabilities

3. Liabilities are treated as money paid or received.
   a. If each party assumes a liability of the other, only the net liability given or received is treated as boot.
   b. Liabilities include mortgages on property.

Basis

4. Qualified property received in a like-kind exchange has an exchanged basis adjusted for boot and gain recognized.

	AB of property given
+	Gain recognized
+	Boot given (cash, liability incurred, other property)
–	Boot received (cash, liability relief, other property) + Exchange fees incurred
–	Loss recognized (boot given)
=	Basis in acquired property

NOTE: The IRS has ruled that exchange expenses can be deducted to compute gain or loss realized, offset against cash payments received in determining recognized gain, or included in the basis of the property received.

Realized Gain

5. Under Sec. 1031, realized gain is usually recognized only to the extent of boot received (Cash + FMV of other property + Net liability relief).
   a. Basis in property acquired is increased for gain recognized.

Loss

6. If some qualified property is exchanged, loss realized with respect to qualified property is not recognized, but loss on boot given may be recognized.

Qualified Exchange Accommodation Arrangement or Agreement

7. With a qualified exchange accommodation agreement, the property given up or the replacement property is transferred to a qualified intermediary (QI), also referred to as exchange accommodation titleholder (EAT) or facilitator. The QI is considered the beneficial owner of the property.
   a. This arrangement allows a transfer in which a taxpayer acquires replacement property before transferring relinquished property to qualify as a tax-free exchange.
   b. The following requirements must be met:
      1) Time limits for identifying and transferring the property are satisfied.
      2) A written agreement exists.
      3) The exchange accommodation titleholder has the qualified indications of ownership of the property.

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Deadlines

c. An exchange of like-kind real properties must be completed within the earlier of
   1) 180 days after the transfer of the exchanged property or
   2) The due date (including extensions) for the transferor's tax return for the taxable year in which the exchange took place.

d. The taxpayer has 45 days from the date of the transfer to identify the like-kind real property received in the exchange.
   1) The replacement property must be clearly described in a signed, written document. The document then must be delivered to the other person involved in the exchange.
      a) The identification of multiple replacement real properties is permitted.
         i) The replacement property must be received within 180 days from the date of transfer.

Exchange Expenses

8. Any exchange expenses are subtracted from the total of the following (but not below zero):
   a. Any cash paid to the taxpayer by the other party;
   b. The FMV of other (not like-kind) property received by the taxpayer, if any; and
   c. Net liabilities assumed by the other party–the excess, if any, of liabilities (including mortgages) assumed by the other party over the total of (1) any liabilities assumed, (2) cash paid by the taxpayer to the other party, and (3) the FMV of the other (not like-kind) property given up by the taxpayer. If the exchange expenses exceed (1), (2), and (3), the excess is added to the basis of the like-kind property.

Related Parties

9. Like-kind exchanges between related parties are subject to special restrictions.
   a. In a related-party exchange, the taxpayer cannot dispose of the property within 2 years after the date of the last transfer which was part of the exchange in order not to recognize any gain on the initial exchange.
   b. Related parties include members of a family, a grantor of a trust, a corporation in which the taxpayer has more than 50% ownership, or a partnership in which the taxpayer directly or indirectly owns more than 50% interest in the capital or profits.

Multiple Parties

c. There is no exception in Sec. 1031 that prohibits multiple-party transactions from qualifying as like-kind exchanges.

d. The trade of like-kind real property is reported on IRS Form 8824.

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Reporting

10. A taxpayer must substantiate the existence of a like-kind exchange.
11. Section 1031 like-kind exchanges are reported annually on Form 8824 and include the following:
    a. Description of property exchanged
    b. Dates of acquisition, transfer, property identification, and actual receipt
    c. Related party exchange information
    d. Realized gain (loss) and basis in property received

Holding Period

12. If property received in an exchange has the same basis in whole or in part as that of the property given and if the property given is a capital asset or a Sec. 1231 asset, the holding period of the property received includes the period for which the property given was held.

Like-Kind Exchange Process Flowchart

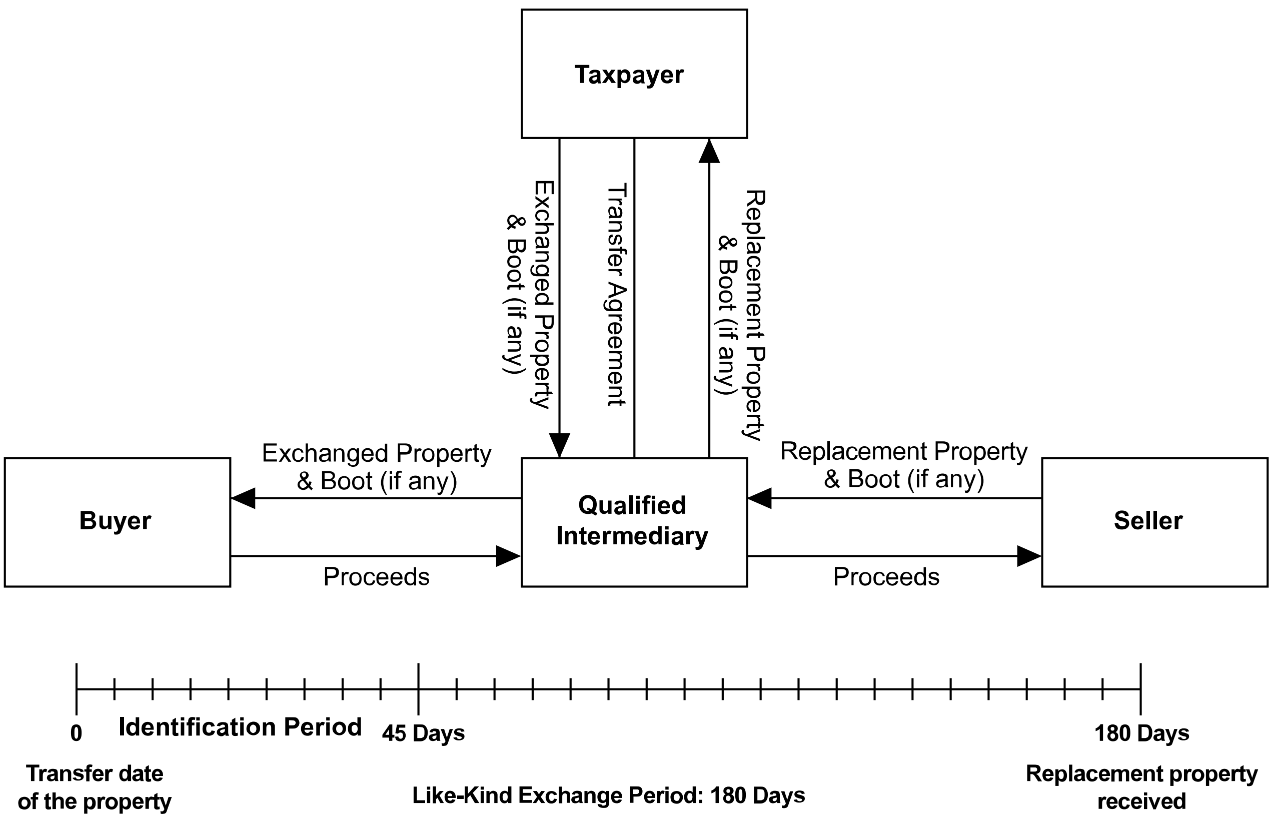

Figure 11-1

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Realized Gain or (Loss), Recognized Gain, and Basis of Like-Kind Property Received

	Not Like-Kind Property		
1.	Fair market value (FMV) of other property given up	$XXX,XXX	
2.	**Less:** Adjusted basis of other property given up	(XX,XXX)	
3.	**Gain or (loss) recognized on other property given up**		**$XX,XXX**
	Realized Gain or (Loss)		
4.	Boot Received: Cash received, FMV of other property received, plus net liabilities assumed by other party, reduced (but not below zero) by any exchange expenses	$ XX,XXX	
5.	**Plus:** FMV of acquired like-kind property	XX,XXX	
6.	**Less:** Adjusted basis of like-kind property given up, net amounts paid to other party, plus any exchange expenses not used above	(XX,XXX)	
7.	**Realized gain or (loss)**		**XX,XXX**
	Recognized Gain		
8.	Lesser of boot received or realized gain or (loss), but not less than zero	$ XX,XXX	
9.	**Recognized gain**		**XX,XXX**
	Deferred Gain or (Loss)		
10.	Subtract line 9 from line 7 (see related party restrictions on page 7)		**$XX,XXX**
	Basis of Acquired Like-Kind Property		
11.	Subtract line 4 from the sum of lines 6 and 9		**$XX,XXX**

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STUDY UNIT TWELVE

INDIVIDUAL RETIREMENT ACCOUNTS

An individual retirement account (IRA) is a personal savings plan that offers tax advantages to individuals who set aside money for retirement. Two advantages include

1) The deductibility of contributions and
2) The tax exemption of IRA earnings until they are distributed.

An IRA can be set up with most banks and similar savings institutions, mutual funds, stock brokerage firms, and insurance companies.

Included in this coverage are the rules applicable to employees for employer-established IRA plans. These plans include SEPs and SIMPLE plans.

12.1 IRAs DEFINED

Taxable Compensation

1. Any individual who receives taxable compensation during the year may set up an IRA.
   a. An individual may set up a spousal IRA for a spouse, provided a joint return is filed.

Compensation

2. Compensation is defined as earned income. It includes
   a. Wages and salaries
   b. Commissions
   c. Self-employment income
   d. Taxable alimony and separate maintenance payments (i.e., pre-2019 divorce decree)
3. Compensation does not include earnings and profits from property, such as rental income, interest income, dividend income or pension and annuity income, S corporation income, and deferred compensation distributions.

Types of IRAs

4. There are five kinds of individual retirement accounts (IRAs):
   a. Individual retirement account (traditional and Roth)
   b. Individual retirement annuity
   c. Employer and employee association trust accounts (e.g., ESOPs, pensions)
   d. Simplified employee pension (SEP)
   e. Savings Incentive Match Plans for Employees (SIMPLE)
5. Publications 590-A and 590-B also list individual retirement bonds, but not individual savings bonds, as permitted individual retirement accounts.

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Fully Vested

6. Under Secs. 219(d) and 408, an IRA must be fully vested at all times, the assets of the trust cannot be commingled with other property except in a common trust fund or common investment fund, and no part of the trust funds can be used to purchase life insurance contracts.

Shareholder Status

7. Generally, IRAs and Roth IRAs are not permitted as S corporation shareholders. However, if the IRA or Roth IRA held bank stock on or after October 22, 2004, the IRA or Roth IRA is permitted to hold this stock, and the owner of the plan is considered the shareholder.

12.2 CONTRIBUTIONS

1. Once an IRA is set up, a taxpayer may make contributions each year in which (s)he is qualified.
   a. To qualify to make contributions, a taxpayer must have received compensation.
   b. However, contributions are not required to be made each year.
   c. Contributions must be made by the due date of the return (not including extensions).

Contribution Limits

2. The maximum contribution that can be made during any year to a traditional IRA is the lesser of
   a. Compensation received or
   b. $6,000.
      1) Individuals age 50 and older at the end of the year can contribute an additional $1,000 (i.e., total contribution limit is $7,000).

   NOTE: For 401(k) plans, the limit is $20,500 ($27,000 if 50 or older). For 415(c) plans, the limit is $61,000 or 100% of includible compensation if less (an additional $6,500 is allowed for those 50 or older).

3. SIMPLE plans allow small employers to make matching contributions to employees' traditional IRAs.
   a. The maximum employee contribution to a SIMPLE plan is $14,000. For employees age 50 and over, an additional $3,000 may be contributed.
4. SEP plans allow employers to contribute to employees' traditional IRAs as well, though the employer contributions are not matching contributions like those of SIMPLE plans.
   a. The maximum contribution allowed is up to 25% of the employee's income, limited to an annual ceiling of $61,000 in 2022.

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Inherited IRAs

5. A person may deduct contributions made to an inherited IRA only if the IRA was inherited from a spouse. Contributions or rollovers cannot be made to an IRA inherited from someone who died after December 31, 1983, and who was not a spouse. An IRA is included in the estate of the decedent who owned it.
   a. When an IRA is inherited from a person other than a spouse, the IRA cannot be treated as though it was owned by the taxpayer who inherited the IRA.

Spousal IRA Limit

6. If a joint return is filed and a taxpayer makes less than his or her spouse, the taxpayer may still contribute the lesser of
   a. The sum of his or her compensation and the taxable compensation of the spouse, reduced by the amount of the spouse's IRA contribution and contributions to a Roth IRA, or
   b. $6,000 ($7,000 if over age 50).

   NOTE: Thus, the total combined contributions to an IRA and a spouse's IRA can be as much as $12,000 for the year (plus an additional $1,000 for each spouse age 50 or older).
7. If a taxpayer has more than one IRA, the limit applies to the total contributions made to the IRAs for the year.

Deductible Contributions

8. Generally, a deduction is allowed for contributions that are made to an IRA.
   a. If neither spouse was covered for any part of the year by an employer retirement plan, the entire contribution may be deducted.
   b. If a taxpayer is not covered by an employer plan but the taxpayer's spouse is, the taxpayer may still deduct the full amount of the contribution. However, the deduction is reduced if the adjusted gross income on the joint return is greater than $204,000 but less than $214,000. The deduction is eliminated if the income is greater than $214,000.
   c. If a taxpayer is covered by a retirement plan at work, the IRA deduction will be phased out or eliminated if the taxpayer's modified AGI is between
      1) $68,000 and $78,000 for a single individual
      2) $109,000 and $129,000 for a married couple filing a joint return
      3) $0 and $10,000 for a married individual filing a separate return
   d. If a taxpayer did not live with his or her spouse at any time during the year and the taxpayer's filing status is married filing separately, the taxpayer's filing status is considered single for the purpose of computing the phaseout.
   e. Deductible contributions to an IRA have to be made in cash and not any other property.
9. For an individual whose modified AGI falls within one of the phaseout ranges above, the amount that must be reduced from the IRA deduction is determined by the following equation:

$$\frac{\text{Modified AGI} - \text{Applicable minimum phaseout amount}}{\text{Maximum phaseout amount} - \text{Minimum phaseout amount}} \times \$6{,}000$$

   a. This amount is subtracted from the maximum allowable deduction to arrive at the allowable deductible amount.
   b. Round it up to the next multiple of $10 to find the allowable deduction.
      1) If a deduction is allowed, $200 or more is allowed.
      2) However, the deduction may not exceed the contributions made.

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10. Unlike contributions to traditional IRAs, contributions to SEP-IRAs are excluded from an employee’s income rather than deducted from it. Any excess employer contributions must be included in income without any offsetting deduction.

Rollovers

11. Generally, a rollover is a tax-free distribution of cash or other assets from one retirement plan to another retirement plan. There are two types of rollovers: direct and indirect.
    a. A **direct** rollover is a direct transfer of assets from one qualified plan to another qualified plan.
    b. An **indirect** rollover is a rollover in which the taxpayer takes physical possession of the assets (e.g., a check).
        1) The taxpayer must deposit the assets into another qualified plan within 60 days of the withdrawal to avoid taxes and penalties.
    c. A rollover cannot be deducted.
    d. Distributions that are not qualified distributions eligible for the rollover include the following:
        1) Required minimum distributions
        2) Hardship distributions
        3) Any series of substantially periodic distributions
        4) Corrective distributions due to excess contributions
        5) A loan treated as a distribution
        6) Dividends on employer securities
        7) The cost of life insurance coverage
    e. If a taxpayer withdraws assets from an IRA, rolls over part of it tax-free, and keeps the rest, ordinary income must be recognized, and (s)he may be subject to the 10% tax on premature distributions.
    f. The same property that was received from an old IRA may be rolled over into a new IRA.
    g. If an individual inherits a traditional IRA from anyone other than a deceased spouse (as previously discussed in item 5. on page 3), the person is not permitted to treat the inherited IRA as his or her own, making direct contributions.
        1) The inherited IRA will generally not have tax assessed on the IRA assets until distributions are received.
    h. The basis of a traditional IRA because of nondeductible contributions remains with the IRA.
    i. Generally, for distributions from an inherited IRA, either
        1) The distributions must begin by the end of the year following the death of the original IRA holder or
        2) The IRA must be completely distributed by the end of the 10th year following death.
    j. When transferring an IRA account to a spouse (or an ex-spouse pursuant to a domestic relations order), taxes and penalties may be avoided by
        1) Changing the name on the IRA account or
        2) Transferring the IRA assets into another qualified plan.
    k. Distributions from a SIMPLE IRA can be rolled over to another IRA 2 years after the first contribution is made.
    l. Rollovers to tax-sheltered annuities are not tax-free.

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Collectibles

12. Generally, an IRA is prohibited from investing in collectibles. However, an IRA may hold platinum coins as well as gold, silver, or platinum bullion.

Prohibited Transactions

13. A taxpayer may not engage in any of the transactions listed below with a traditional IRA. The tax consequence for engaging in any of these acts is that the account ceases to be an IRA and all assets are treated as if distributed that same year.
    a. Sell property to it
    b. Use it as security for a loan
    c. Buy property with it for the taxpayer's personal use
    d. Borrow money from it

Basis in a Traditional IRA (Form 8606)

14. A taxpayer will have a cost basis in a traditional IRA if any nondeductible contributions were made.
    a. Cost basis is the sum of the nondeductible contributions to the IRA minus any withdrawals or distributions of nondeductible contributions.
    b. The difference between the taxpayer's total permitted contributions and the taxpayer's IRA deduction, if any, is the nondeductible contribution.
        1) To designate contributions as nondeductible, Form 8606 must be filed.
        2) A taxpayer must file Form 8606 to report nondeductible contributions even if (s)he does not have to file a tax return for the year.
    c. For distributions from IRAs having a cost basis, only the part of the distribution that represents nondeductible contributions is tax-free. While basis exists, each distribution is partly taxable and partly nontaxable.
15. A taxpayer 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.
    a. A trustee-to-trustee transfer between the accounts must be made. The net income allocable to the contribution must also be included in the transfer.
    b. The transfer must be made by the due date for the tax return for the tax year during which the contribution was made.
    c. The contribution is treated as having been made to the second IRA on the date that it was actually made to the first IRA.

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Qualified Charitable Distributions (QCDs)

16. Up to $100,000 of distributions may be excluded from income if distributed directly by the trustees of the IRA to a qualified charitable organization (following the same rules as charitable itemized deductions). The only other requirements for this exclusion of income are that the taxpayer must
    a. Be at least age 70 1/2 and
    b. Retain the same acknowledgment of charitable contribution as for a charitable contribution deduction.
17. Only otherwise includible portions of the distribution are considered QCDs.
18. A QCD counts toward the taxpayer's required minimum distribution, as discussed in Subunit 12.3.

EXAMPLE 12-1	**Qualified Charitable Distributions**

On December 23, 2022, Jeff, age 75, directed the trustee of his IRA to make a distribution of $25,000 directly to a qualified 501(c)(3) organization (i.e., a charitable organization eligible to receive tax-deductible contributions). The total value of Jeff's IRA is $30,000 and consists of $20,000 of deductible contributions and earnings and $10,000 of nondeductible contributions (basis). Since Jeff is at least age 70 1/2 and the distribution is made directly by the trustee to a qualified organization, the part of the distribution that would otherwise be includible in Jeff's income ($20,000) is a QCD.

The remaining $5,000 of the $25,000 distribution to the charity may be deducted as an itemized charitable deduction on Jeff's Schedule A since that portion was taxed originally on contribution to the IRA, i.e., not double-dipping with both exclusion and deduction.

Retirement Savings Contributions Credit (Saver's Credit)

19. The Saver's Credit can be taken for the taxpayer's contributions to a traditional or Roth IRA, 401(k), SIMPLE IRA, SARSEP, 403(b), 501(c)(18), or governmental 457(b) plan and for voluntary after-tax employee contributions to qualified retirement and 403(b) plans.
20. Rollover contributions (money that the taxpayer moved from another retirement plan or IRA) are not eligible for the Saver's Credit. Additionally, eligible contributions may be reduced by any recent distributions the taxpayer received from a retirement plan or IRA.
21. The taxpayer is eligible for the credit if the taxpayer is (a) age 18 or older, (b) not claimed as a dependent on another person's return, and (c) not a full-time student.
    a. A taxpayer is a student if, during any part of 5 calendar months of 2022, the taxpayer was
        1) Enrolled as a full-time student at a school
            a) A school includes technical, trade, and mechanical schools. It does not include on-the-job training courses, correspondence schools, or schools offering courses only through the Internet.
        2) Took a full-time, on-farm training course given by a school or a state, county, or local government agency

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22. The credit amount is 50%, 20%, or 10% of the taxpayer's retirement plan or IRA contributions, up to $2,000 ($4,000 if married filing jointly), depending on the taxpayer's adjusted gross income.
    a. The chart below has the Saver's Credit AGI limits for 2022.

	2022 Saver's Credit		
Credit Rate	**Married Filing Jointly**	**Head of Household**	**All Other Filers**
50% of your contribution	AGI ≤ $41,000	AGI ≤ $30,750	AGI ≤ $20,500
20% of your contribution	$41,001-$44,000	$30,751-$33,000	$20,501-$22,000
10% of your contribution	$44,001-$68,000	$33,001-$51,000	$22,001-$34,000
0% of your contribution	more than $68,000	more than $51,000	more than $34,000

EXAMPLE 12-2 Retirement Savings Contribution Credit

Stephanie, who works at a retail store, is married and earned $39,000 in 2022. Stephanie's husband was unemployed in 2022 and did not have any earnings. Stephanie contributed $1,000 to her IRA in 2022. After deducting her IRA contribution, Stephanie's adjusted gross income on her joint return is $38,000. Stephanie may claim a 50% credit, $500, for her $1,000 IRA contribution.

Unrelated Business Income (UBI)

23. An IRA is subject to tax on UBI if it carries on an unrelated trade or business.
    a. An unrelated trade or business means any trade or business regularly carried on by the IRA, or by a partnership of which it is a member, that is not substantially related to performance of its exempt purpose or function.
        1) If the IRA has $1,000 or more of unrelated trade or business gross income, the IRA trustee is required to file a Form 990-T, *Exempt Organization Business Income Tax Return*.
            a) The Form 990-T must be filed by the 15th day of the 4th month after the end of the IRA's tax year.

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12.3 PENALTIES

Excess Contributions

1. Generally, an excess contribution is the amount contributed to an IRA that is more than the lesser of
   a. The taxpayer's compensation received or
   b. $6,000 ($7,000 for taxpayers age 50 and older).
      1) For SIMPLE plans, the limit is $14,000 ($17,000 for taxpayers age 50 and older).
      2) For SEP plans, the limit is the lesser of 25% of the employee's income or $61,000.
2. An excess contribution could be the result of a taxpayer's contribution, a spouse's contribution, an employer's contribution, or an improper rollover contribution.
3. A 6% excise tax (10% to employers contributing to SEP-IRAs) is imposed each year on excess contribution amounts that remain in an IRA at the end of each tax year. Distribution of excess contributions is reported on Form 1099-R in box 2a and coded in box 7.
4. The tax can be avoided if the excess contribution and the interest earned on it are withdrawn by the due date (including extensions) of the tax return.
   a. The interest earned on the excess contribution qualifies as a premature distribution and is subject to an additional tax of 10% on that distribution.
5. Under Sec. 219(f)(6), the taxpayer may treat the unused (excess) contributions from a previous year as having been made in the current year to the extent that the allowable contribution limit exceeds the actual contributions for the current year.

Premature Distributions

6. Premature distributions are amounts withdrawn from an IRA or annuity before a taxpayer reaches age 59 1/2.
   a. The additional tax on premature distributions is equal to 10% of the amount of the premature distribution that must be included in gross income. This tax is in addition to any regular income tax that is due.
   b. In certain circumstances, the additional tax does not apply to distributions from qualified retirement plans, even if they are made before a taxpayer reaches age 59 1/2 [Sec. 72(t)]. The exceptions are for when the distributions
      1) Are made to a beneficiary (or to the estate of the taxpayer) on or after the death of the taxpayer
      2) Result from the taxpayer having a qualifying disability

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3) Are part of a series of substantially equal periodic payments beginning after separation from service and made at least annually for the life or life expectancy of the taxpayer or the joint lives or life expectancies of the taxpayer and his or her designated beneficiary
4) Are made to a taxpayer after (s)he separated from service if the separation occurred during or after the calendar year in which the taxpayer reached age 55 (not applicable to SEP or traditional IRAs)
5) Are made to a taxpayer for medical care up to the amount allowable as a medical expense deduction (determined without regard to whether the taxpayer itemizes deductions)
6) Are made to an alternate payee under a qualified domestic relations order (QDRO)
7) Are made because of an IRS levy on the plan
8) Are made as a qualified U.S. reservist distribution (those called to active duty)
9) Are qualified hurricane or wildfire distributions
10) Are from federal retirement funds of a phased program
11) Are related to qualified birth of child or adoption (up to $5,000 per adoption or birth)
12) Are qualified higher education expenses, including those related to graduate-level courses (IRAs only)
    a) However, the amount of qualified higher education expenses is reduced by the amount of any qualified scholarship, educational assistance allowance, or payment (other than by gift, bequest, device, or inheritance) for an individual's educational enrollment, which is excludable from gross income.
13) Are used to pay medical insurance premiums of an unemployed individual (IRAs only)
14) Are used to pay (up to $10,000) first-time homebuyer expenses (IRAs only)
15) Are timely made to reduce excess contributions or excess deferrals (IRAs only)
16) Are used for medical expenses exceeding 7.5% of AGI
17) Are from a government plan to a qualified safety employee who is at least age 50

c. Permissible withdrawals include those made from an eligible automatic contribution arrangement (EACA) within 6 months after the close of the year.

d. If a taxpayer borrows money against an IRA, the fair market value of the IRA as of the first day of the tax year must be included in gross income. The taxpayer may also be subject to the 10% penalty tax. An individual may withdraw all or part of the assets of a traditional IRA and exclude the withdrawal from income if the individual transfers it to another traditional IRA or returns it to the same IRA within 60 days after the withdrawal.

e. A distribution from a SIMPLE IRA within 2 years after the first contribution is made is subject to a 25% tax.

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Excess Accumulations

7. Generally, a taxpayer must begin receiving distributions by April 1 of the year following the year in which (s)he reaches age 72.
   a. If distributions are less than the required minimum distribution (RMD) for the year, a 50% excise tax will be imposed on the amount not distributed.
   b. Required beginning dates
      1) Generally, for qualified plans [e.g., 401(k)], April 1 of the calendar year following the later of the employee attaining age 72 or retiring.
      2) For a traditional IRA, April 1 of the calendar year following the taxpayer attaining age 72.
      3) The required distribution date each year following the initial distribution date is December 31.

Borrowing from the Plan

8. The terms of a qualified plan [i.e., 401(k)] may permit the plan to lend money to participants without adverse income or excise tax results, if certain requirements are met.
   a. Section 72(p) basically treats loans as distributions.
      1) A loan will not be treated as a distribution to the extent loans to the employee do not exceed the lesser of
         a) $50,000 or
         b) The greater of one-half of the present value of the employee's vested accrued benefit under such plans or $10,000.
      2) The $50,000 maximum sum is reduced by the participant's highest outstanding loan balance during the preceding 12-month period.
   b. Plan loans generally have to be repaid within 5 years unless the funds are to acquire a principal residence for the participant.
   c. Plan loans must be amortized in level payments, made no less frequently than quarterly over the term of the loan.
   d. A pledge of the participant's interest under the plan or an agreement to pledge such interest as security for a loan by a third party, as well as a direct or indirect loan from the plan itself, is treated as a loan.
   e. Plan loan repayments due March 27-December 31, 2020, may be delayed 1 year.

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12.4 ROTH IRAs

Exempt Distributions

1. A tax-free IRA (referred to as a Roth IRA) has been available since the beginning of 1998.
   a. Contributions to a Roth IRA are nondeductible, but income can be accumulated tax-free.
   b. To be treated as a Roth IRA, the account must be designated as such when it is established.

Income Limits

   c. Roth IRAs are subject to income limits. The maximum yearly contribution that can be made to a Roth IRA is phased out for
      1) Single taxpayers with a modified AGI between $129,000 and $144,000,
      2) Joint filers with a modified AGI between $204,000 and $214,000, and
      3) A married taxpayer filing separately with a modified AGI between $0 and $10,000.
   d. Modified AGI is determined by subtracting any income resulting from a conversion of a traditional IRA to a Roth IRA and any minimum required distributions from a qualified retirement plan, including an IRA, from adjusted gross income. The following items are added to adjusted gross income:
      1) Traditional IRA deduction
      2) Student loan interest deduction
      3) Foreign earned income and/or housing exclusion
      4) Foreign housing deduction
      5) Exclusion of qualified savings bond interest
      6) Exclusion of employer-provided adoption benefits

Contribution Limit

2. The contribution amount is the same as the amount for a traditional IRA, and the total contribution to both deductible and nondeductible IRAs cannot exceed $6,000 per taxpayer ($7,000 for individuals who will be at least 50 years old by the end of the year).

No Age Limit

3. Like traditional IRAs, individuals are allowed to make contributions to the Roth IRA at any age.

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Qualified Distribution

4. Qualified distributions from a Roth IRA are not included in the taxpayer's gross income and are not subject to the additional 10% early withdrawal tax.
    a. Distributions are treated as made from contributions first; thus, no portion of a distribution is treated as attributable to earnings or includible in gross income until the total of all distributions from the Roth IRA exceeds the amount of contributions. Nonqualified distributions are included in income after recovery of contribution, and they may be subject to the 10% early withdrawal penalty.
        1) EXAMPLE: Jessica contributes $6,000 per year for each of three years. At the end of the three years the Roth IRA is worth $19,500. Jessica is able to withdraw up to $18,000 (her investment) from the Roth IRA without incurring any income tax or penalty.
    b. Taxpayers must meet two requirements for a qualified distribution.
        1) Satisfy a 5-year holding period
            a) To satisfy the 5-year holding period, the Roth IRA distribution may not be made before the end of the 5-tax-year period beginning with the first tax year for which the individual made a contribution to the Roth IRA.
                i) The 5-year holding period begins to run with the tax year to which the contribution relates, not the year in which the contribution is actually made; thus, a contribution made in April 2019, designated as a 2018 contribution, may be withdrawn tax free in 2023, if it is otherwise a qualified distribution.
        2) Made on or after the date on which the individual attains age 59 1/2
            a) Distributions made to a beneficiary (or the individual's estate) on or after the individual's death, attributed to the individual's being disabled, or for the use of a first-time purchase of a home ($10,000 limit) are exceptions to attaining age 59 1/2 requirement.
    c. EXAMPLE: Several years later when Jessica satisfies the 5-year holding period and is over 59 1/2, she withdraws the entire value of the Roth IRA. The distribution will be not be included in her income and will not be subject to a 10% penalty.
    d. EXAMPLE: If Jessica fails either of the two above tests, she will be subject to income tax on the distribution of the earnings of the Roth IRA. If the failed test is "age 59 1/2," then she will also be subject to a 10% of the income penalty.

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Rollover

5. Distributions from one Roth IRA can be rolled over or “converted” tax-free to another Roth IRA.
6. Amounts in a traditional IRA that was not inherited from a person other than a spouse can be rolled into a Roth IRA.
    a. If a taxpayer has both deductible and nondeductible IRAs and only a portion of the IRAs are converted into a Roth IRA, any amount rolled into a Roth IRA will be considered to have been drawn proportionately from both the deductible and nondeductible IRAs and will be taxed accordingly.
    b. Once a taxpayer has begun periodic distributions of a traditional IRA, (s)he is able to convert his or her traditional IRA into a Roth IRA and resume the periodic payments. In addition, the 10% penalty on early distributions will not apply to unqualified distributions.
    c. Hardship distributions are not directly convertible.
    d. Required minimum distributions are not permissible conversions.
    e. Once amounts from a traditional IRA have been rolled over or converted into a Roth IRA, the amounts may not be recharacterized back into a traditional IRA. However, recharacterization is still permitted with respect to other contributions. For example, an individual may make a contribution for a year to a Roth IRA and, before the due date for the individual’s income tax return for that year (including extensions), recharacterize it as a contribution to a traditional IRA.
7. Amounts carried in a SIMPLE IRA may be converted to a Roth IRA, assuming the required 2-year participation period has been met.

Required Distribution

8. Distributions from Roth IRAs are required only upon death.

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12.5 SECTION 529 QUALIFIED TUITION PROGRAMS

1. Under a Sec. 529 qualified tuition program (QTP) (also referred to as a Sec. 529 plan), a taxpayer can establish an account for the benefit of a designated beneficiary to provide for that beneficiary's qualified higher education expenses at an eligible educational institution. An eligible educational institution is generally any college, university, vocational school, or other postsecondary educational institution eligible to participate in a student aid program administered by the Department of Education.
2. No specific dollar limit is imposed on contributions to qualified tuition accounts. The QTP must have adequate safeguards to prevent contributions in excess of amounts necessary to provide for the beneficiary's qualified higher education expenses. Contributions to Sec. 529 plans are not deductible for federal income tax purposes. The earnings on the contributions are not taxable for federal tax purposes.
3. In determining the tax-free distribution, all eligible education costs must be reduced by any scholarships, grants, and other financial aid.
4. If more money than is needed is withdrawn from a Sec. 529 plan, taxes and penalties can be avoided if the money is recontributed within 60 days.
5. For purposes of receiving a tax-free distribution from a QTP, qualified higher education expenses include the following:
    a. Tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution.
    b. Special-needs services incurred in connection with the enrollment or attendance of a special-needs beneficiary.
    c. Room and board for students who are enrolled at least half-time. If a student lives off campus, you can use Sec. 529 funds to cover the cost of rent and utilities up to the college's housing allowance.
    d. Purchase of computer technology or equipment, or internet access or related services, if the technology or service is used primarily by the beneficiary during any of the years the beneficiary is enrolled at an eligible educational institution.
    e. Up to $10,000 in expenses for tuition incurred during the tax year for enrollment or attendance of the designated beneficiary in a public, private, or religious elementary or secondary school (kindergarten through grade 12). The limit applies on a per-student basis.
    f. Up to $10,000 (lifetime benefit) to pay principal and interest on student loans as well as the debt of beneficiaries' siblings.
    g. Amounts to pay for certain expenses associated with apprenticeship programs registered and certified by the Secretary of Labor under the National Apprenticeship Act. The apprenticeship provisions apply to repayments up to $10,000 per individual. This $10,000 is a lifetime amount, not an annual limit.
6. Generally, withdrawals from a Sec. 529 plan must be made during the same calendar year that the expenses are paid.

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STUDY UNIT THIRTEEN

GIFT TAX

The gift tax is a wealth transfer tax that applies if a property transfer occurs during a person's lifetime. The property transferred may be real, personal, tangible, or intangible. Both the gift tax and the estate tax are part of a unified transfer tax system under which gratuitous transfers of property between persons are subject to taxation.

13.1 GIFT TAX RETURN

A donor is required to file a gift tax return, Form 709, for any gift(s) made unless all gifts are excluded by the following:

1. The annual $16,000 exclusion,
2. The deduction for qualified charitable gifts, or
3. The deduction for qualified transfers to the donor's spouse.

These exclusions apply for gifts of present interests only. Any gift of a future interest requires the filing of Form 709. Gift splitting does not excuse the donor from the requirement to file.

Due Date

1. A gift tax return is due on the 15th of April following the calendar year in which a gift was made. But a gift tax return for a year of death is due no later than the estate tax return due date.
   a. A calendar-year taxpayer who receives an extension of time for filing his or her income tax return automatically receives an extension to that same extended due date for filing his or her gift tax return for that same year.

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Marital Exclusion

2. A taxpayer does not have to file a gift tax return to report gifts to his or her spouse. This rule does not apply if either
   a. The spouse is not a U.S. citizen and the total gifts exceed $164,000 or
   b. The taxpayer makes any gift of a terminable interest that does not meet the power of appointment exception.

Charitable Gifts

3. If the only gifts a taxpayer makes during the year are deductible as gifts to charities, the taxpayer is not required to file a return.
   a. The entire interest in the property must be transferred to the qualified charity.
   b. If only a partial interest was transferred, a return must be filed.
   c. If a taxpayer made both charitable and noncharitable gifts, all gifts must be included on the return.

Filing Requirement

4. If the total value of gifts of present interests to any donee is $16,000 or less, the taxpayer need not report on Form 709, Schedule A, any gifts (except gifts of future interests) that were made to that donee.
5. If the total value of the gifts of present interests to any donee is more than $16,000, the taxpayer must report all such gifts that were made during the year to or on behalf of that donee.
   a. This includes those gifts that will be excluded under the annual exclusion.

Exclusions

6. Publication 559 excludes the following from taxable gifts:
   a. The annual exclusion ($16,000 for 2022)
   b. Gifts to a spouse
   c. Charitable gifts
   d. Political contributions
   e. Qualified tuition payments
   f. Medical costs
7. Subunit 13.2 contains definitions of qualified tuition and medical costs.

Form 3520

8. On Form 3520, a U.S. donee must report information on gifts from foreign persons if the total of such gifts from all foreign persons exceeds $17,339 in 2022.

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13.2 GIFT TAX

Gift tax is a tax of the transfer, imposed on the donor. The table below presents the basic tax formula, modified for the gift tax.

	Gift Amount
	FMV on date of gift, for all gifts in the calendar year
–	Exclusions
	Annual exclusion
	\$16,000 per donee
	Gift splitting between spouses
	Paid on behalf of another for
	Medical care
	Education tuition
–	Deductions
	Marital
	Charitable
=	Taxable gifts for current year
+	Taxable gifts for prior years
=	Taxable gifts to date
×	Tax rate
=	Tentative gift tax
–	[Prior year's gifts × Current tax rates]
–	Applicable credit amount
=	Gift tax liability

Amount of Gift

1. Any excess of FMV of transferred property over the FMV of consideration for it is a gift.

	FMV of transferred property: Given
–	FMV of consideration (property, money, etc.): Received
=	Gift amount

   a. A gift is complete when the giver has given over dominion and control such that (s)he is without legal power to change its disposition.

EXAMPLE 13-1 Joint Bank Account -- Completion of Gift

R opens a joint bank account with A, I, and H, with R as the only depositor to the account. R, A, I, and H may each withdraw money. A gift is complete only when A, I, or H withdraws money.

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b. Gifts completed when the donor is alive **(inter vivos gifts)** are the only ones subject to gift tax. Transfers made in trust are included.

1) Property passing by will or inheritance is not included (although the estate tax may apply).

c. To the extent credit is extended with less than sufficient stated interest, the Code imputes that interest is charged. If the parties are related, the lender is treated as having made a gift of the imputed interest to the borrower each year the loan is outstanding.

1) Gift loans are excluded if the aggregate outstanding principal is not more than $10,000.

d. Basis in a gift is basis in the hands of the donor plus gift tax attributable to appreciation.

EXAMPLE 13-2 Basis of a Gift of Land

Thomas made a gift to his daughter of a piece of land with a FMV of $96,000. The land had a basis to Thomas of $61,000. He made a taxable gift of $80,000 ($96,000 FMV – $16,000 annual exclusion) and paid a gift tax of $32,000 ($80,000 × 40%). The basis of the land to the daughter is carryover basis of $60,000 plus the gift tax attributable to the appreciation.

$$\$61{,}000 + \left(\frac{\$35{,}000 \text{ increase in value}}{\$80{,}000 \text{ taxable gift}} \times \$32{,}000\right) = \$75{,}000$$

Annual Exclusion

2. The first $16,000 of gifts of present interest to each donee is excluded from taxable gift amounts. The annual exclusion is indexed to reflect inflation.

a. The $16,000 exclusion applies only to gifts of present interests.

b. A present interest in property includes an unrestricted right to the immediate possession or enjoyment of property or to the income from property (such as a life estate or a term for years). Gifts of future interest in property (such as remainders or reversions) do not qualify for the annual exclusion.

EXAMPLE 13-3 Gift of a Present Interest and a Future Interest

Edward sets up a trust with the income going to his daughter for her life and the remainder to his granddaughter. Edward has made a gift of a present interest to his daughter and a future interest to his granddaughter.

Medical or Tuition Costs

3. Excluded from taxable gifts are amounts paid on behalf of another individual as tuition to an educational organization or for medical care.

a. The payment must be made directly to the third party, i.e., the medical provider or the educational organization.

b. Amounts paid for room, board, and books are not excluded.

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Support

4. Transfers that represent support of a former spouse or a child are not gifts. Generally, child support payments end at age 18.

Political Contributions

5. Political contributions are not subject to gift tax and are not reported on the return.

Marital Deduction

6. The amount of a gift transfer to a spouse is deducted in computing taxable gifts. Donor and donee must be married at the time of the gift, and the donee must be a U.S. citizen. For noncitizen spouses, the deduction is limited to $164,000 in 2022.
   a. The deduction may not exceed the amount includible as taxable gifts. Otherwise, the amount of the deduction is not limited.
   b. Transfer of Qualified Terminable Interest Property (QTIP) is eligible for marital deduction.
      1) A spouse has a qualifying income interest for life if
         a) The decedent passes the property to the spouse,
         b) (S)he is entitled to all the income from the property that is paid at least annually, and
         c) No person has a power to appoint any portion of the property to anyone other than the surviving spouse unless the power cannot be exercised during the spouse's lifetime.

EXAMPLE 13-4 Marital Deduction

Sid Smith gave his wife, Mary, a diamond ring valued at $20,000 and cash gifts of $30,000 during 2022. Sid is entitled to a $16,000 exclusion with respect to the gifts to Mary. His marital deduction is $34,000 ($20,000 + $30,000 – $16,000).

Charitable Deduction

7. The FMV of property donated to a qualified charitable organization is deductible. Like the marital deduction, the amount of the deduction is the amount of the gift reduced by the $16,000 exclusion with respect to the donee.

Qualified Tuition Program

8. Payments to a qualified tuition program (QTP), also known as a 529 plan, are not to be confused with qualified tuition costs (explained on the previous page).
   a. A taxpayer may elect to treat up to $80,000 of a contribution to a QTP as if made ratably over a 5-year period.
   b. By making the election, the contribution will be excluded each year under the $16,000 annual limit.
   c. Any contribution in excess of the $80,000 limit is reported for the year of contribution (as opposed to being apportioned over the 5 years).
   d. Contributions to QTPs do not qualify for the education exclusion.

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Computing the Gift Tax

9. Tentative tax is the sum of taxable gifts to each person for the current year and for each preceding year times the gift tax rate. Taxable gifts to a person is the total of gift amounts (FMV) in excess of exclusions and the marital and charitable deductions for a calendar year.
   a. The unified transfer tax rates are used.
      1) Current-year applicable rates are applied to both current and preceding years' taxable gifts.
      2) The rate is 18% for taxable gifts up to $10,000.
      3) The rates increase in small steps (e.g., 2%, 3%) over numerous brackets.
      4) The maximum rate is 40% on cumulative gifts in excess of $1,000,000 in 2022.
   b. The tentative gift tax is reduced by the product of prior years' taxable gifts and the current-year rates.
   c. Applicable credit amount (ACA). Tentative tax may also be reduced by any ACA (formerly referred to as unified credit). The ACA is a base amount ($4,769,800) reduced by amounts allowable as credits for all preceding tax years. This excludes the first $12.06 million of taxable gifts.

	Tentative tax
–	(Prior-year gifts × Current rates)
–	ACA
=	Gift tax liability for a current year

13.3 GIFT SPLITTING

If both spouses consent, married couples may consider a gift made by one spouse to any person other than the other spouse as made one-half by each spouse.

1. A married couple is not allowed gift splitting if
   a. The couple is not married at the time of the gift;
   b. The couple divorces after the gift, and either spouse remarries before the end of the calendar year; or
   c. One of the spouses is a nonresident alien.
2. A joint gift tax return does not exist.
   a. Each spouse must file his or her own gift return.
   b. A spouse may simply give his or her consent to gift splitting by signing the donor spouse's return if all the requirements of one of the following exceptions are met:
      1) Only one spouse made any gifts, and the total value of these gifts did not exceed $32,000.
      2) One spouse made gifts of more than $16,000 but less than $32,000, and the only gifts made by the other spouse were gifts of not more than $16,000.
3. If taxpayers elect to split gifts, all gifts made by both spouses to third-party donees must be split. The only exception is if the taxpayer gives the spouse a general power of appointment over a gift the taxpayer made.
4. If spouses elect to split gifts, both spouses are jointly and severally liable.
5. Gift-splitting couples are not required to file a joint return.

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STUDY UNIT FOURTEEN

ESTATE TAX

Estate taxes are wealth transfer taxes that apply to dispositions of property that occur as a result of the transferor's death. The tax base for the federal estate tax is the total of the decedent's taxable estate and adjusted taxable gifts. The taxable estate is the gross estate minus allowable deductions. Current-year applicable rates are applied to both current and preceding years' taxable gifts. The rate is 18% for taxable gifts up to $10,000. The rates increase in small steps (e.g., 2%, 3%) over numerous brackets. The maximum rate is 40% on cumulative taxable gifts and estates in excess of $12.06 million in 2022.

14.1 THE GROSS ESTATE (GE)

A decedent's gross estate includes the FMV of all property, real or personal, tangible or intangible, wherever situated, to the extent the decedent owned a beneficial interest at the time of death.

1. Included in the GE are such items as cash, personal residence and effects, securities, other investments (e.g., real estate, collector items), and other personal assets such as notes and claims (e.g., dividends declared prior to death if the record date had passed), and business interests (e.g., interest in a sole proprietorship, partnership interest).
    a. Special tax-avoidance rules are established for U.S. citizens or residents who surrender their U.S. citizenship or long-term U.S. residency.

Decedent's Liabilities

2. Liabilities of the decedent generally do not affect the amount of the GE unless the estate actually pays them.

Dower/Curtesy

3. The GE includes the value of the surviving spouse's interest in property as dower or curtesy.
    a. Dower and curtesy are common-law rights recognized in some states, usually in modified form.
        1) **Dower** entitles a surviving wife to a portion of lands her husband owned and possessed during their marriage.
        2) **Curtesy** entitles a surviving husband to a life estate in all of his wife's land if they had children.

Joint Tenants with the Right of Survivorship

4. The GE includes the full value of property held as joint tenants with the right of survivorship, except to the extent of any part shown to have originally belonged to the other person and for which adequate and full consideration was not provided by the decedent (i.e., the other tenant provided consideration).
    a. The GE includes 50% of property held as joint tenants by spouses or as tenants by the entirety regardless of the amount of consideration provided by each spouse.

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Power of Appointment

5. The value of property interests over which the decedent had a general power of appointment (POA) is included in the GE. A POA is a power exercisable in favor of the decedent, his or her estate, his or her creditors, or the creditors of his or her estate.

Government Obligations

6. Bonds, notes, bills, and certificates of indebtedness of the federal, state, and local governments are included in the GE, even if interest on them is exempt from income tax.

Insurance Proceeds

7. The GE includes insurance proceeds on the decedent's life in certain situations.
   a. The insurance proceeds are payable to or for the estate (including if payable to the executor).
   b. The decedent had any incident of ownership in the policy at death, e.g.,
      1) Right to change beneficiaries
      2) Right to terminate the policy
   c. The proceeds of insurance policies given to others by the decedent within 3 years of death are included in the estate. This is an exception to the "gifts within 3 years of death rules."
   d. The proceeds included under c. above are allocated proportionately if the premiums are partially paid by the insured and partially paid by someone else.

EXAMPLE 14-1 GE and Life Insurance Proceeds

Twenty years before her death, Joanna bought a $200,000 term life insurance policy. One year before her death, she irrevocably transferred the policy and all incidents of ownership to a trust that paid the last year's premiums. Joanna's GE included $190,000 of proceeds since Joanna paid 95% of the premiums.

Annuities and Survivor Benefits

8. The GE includes the value of any annuity receivable by a beneficiary by reason of surviving the decedent if either of the following statements applies:
   a. The annuity was payable to the decedent
   b. The decedent had the right to receive the annuity or payment
      1) Either alone or in conjunction with another
      2) For his or her life or for any period not ascertainable without reference to his or her death, or for any period that does not end before his or her death

Medical Insurance

9. Medical insurance reimbursements due to the decedent at death are treated as property in which the decedent had an interest.

Gifts within 3 Years of Death

10. Gifts made within 3 years of death are not included in the GE of a decedent except for certain transfers, such as transfers of life insurance and property in which a life estate was retained.
    a. The GE does include gift taxes paid on gifts within 3 years before death.

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Inter Vivos Transfer

11. The GE includes assets transferred during life in which the decedent retained, at death, any of the following interests:
    a. A life estate, an income interest, possession or enjoyment of assets, or the right to designate who will enjoy the property
    b. A 5% or greater reversionary interest if possession was conditioned on surviving the decedent
    c. The power to alter, amend, revoke, or terminate the transfer
    d. An interest in a qualified terminable interest property (QTIP) trust

Valuing the Gross Estate

12. Value is the FMV of the property unless a special valuation rule is used.
    a. Real property is usually valued at its highest and best use.
    b. A transfer of interests in a corporation or partnership to a family member is subject to estate tax-freeze rules.
        1) Generally, the retained interest is valued at zero.
    c. Valuing property at FMV is referred to as stepped-up basis. Of course, if an asset declined in value, it would be a stepped-down basis.
13. The executor may elect to value the complete estate, not individual assets, at either the date of death or the alternate valuation date. An alternate valuation date election is irrevocable.
    a. The election can be made only if it results in a reduction in both the value of the gross estate and the sum of the federal estate tax and the generation-skipping transfer tax (reduced by allowable credits).
    b. The alternate valuation date is 6 months after the decedent's death.
        1) Assets sold or distributed before the alternate valuation date are valued on the date of sale or distribution.
        2) Assets, the value of which is affected by mere lapse of time, are valued as of the date of the decedent's death, but adjustments still may be made for valuation changes not related to the passage of time.
            a) Examples of such assets are patents, life estates, reversions, and remainders.
            b) The value of such assets is based on years.
            c) Changes due to time value of money are treated as from more than mere lapse of time.

EXAMPLE 14-2 Election of Alternate Valuation Date

Jenny died on January 1, Year 1. On the date of death, her estate was valued at $15,000,000, of which $10,000,000 was in her stock portfolio. On July 1, Year 1, the value of her portfolio decreased to $7,000,000, and the changes in value of the remaining assets were negligible. In order to minimize the estate's tax liability, the executor of Jenny's estate should elect to use the alternate valuation date of July 1, Year 1.

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14.2 DEDUCTIONS AND CREDITS

Deductions from the Gross Estate

1. Deductions from the GE in computing the taxable estate (TE) include ones with respect to expenses, claims, and taxes.

NOTE: A deductible amount is allowed against gross income on the decedent's final income tax return only if the right to deduct them from the GE is waived.

   a. Expenses for selling property of an estate are deductible if the sale is necessary to
      1) Pay the decedent's debts
      2) Pay expenses of administration
      3) Pay taxes
      4) Preserve the estate
      5) Effect distribution
   b. Funeral expenses are deductible.
   c. Attorney fees, accountant fees, and executor fees are all administrative expenses deducted on the estate tax return.
   d. Claims against the estate (including debts of the decedent) are deductible.
      1) Medical expenses paid within 1 year of death may be deducted on either the estate tax return or the income tax return for the year incurred (not both).
   e. Unpaid mortgages on property are deductible if the value of the decedent's interest is included in the GE.
   f. State inheritance taxes are deductible from the gross estate. Federal estate taxes and income tax paid on income earned and received after the decedent's death are not deductible.
   g. Casualty or theft losses (deemed deductible) incurred during the settlement of the estate are deductible if they were not deducted on the estate's income tax return.

Charitable Contributions

   h. Bequests to qualified charitable organizations are deductible.
      1) The entire interest of the decedent in the underlying property generally must be donated.
      2) Trust interests may enable deductible transfer of partial interests in underlying property.
      3) An inter vivos contribution (vs. a bequest) may result in exclusion from the GE and a current deduction for regular taxable income.

Marital Transfers

   i. Outright transfers to a surviving spouse are deductible from the GE as a marital deduction to the extent the interest is included in the gross estate.
      1) The surviving spouse generally must be a U.S. citizen when the estate tax return is filed.
      2) A marital deduction is allowed for transfers of QTIP. These transfers allow a marital deduction where the recipient spouse is not entitled to designate which parties will eventually receive the property.

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3) QTIP is defined as property that passes from the decedent in which the surviving spouse has a qualifying income interest for life and to which an election applies.

4) A spouse has a qualifying income interest for life if (s)he is entitled to all the income from the property that is paid at least annually, and no person has a power to appoint any portion of the property to anyone other than the surviving spouse unless the power cannot be exercised during the spouse's lifetime.

Credits

2. The estate tax is imposed on the sum of the taxable estate (TE), plus gifts subject to gift tax. Four credits are available to offset federal estate tax liability:

   a. Applicable credit amount (ACA). The ACA is a base amount ($4,769,800 in 2022) not reduced by amounts allowable as credits for gift tax for all preceding tax years.

      1) The ACA offsets the estate tax liability that would be imposed on a taxable estate of up to $12.06 million, per spouse, computed at current rates (2022).

      2) The ACA was formerly called the unified credit.

      3) Any unused amount by a deceased spouse may be used by the surviving spouse in addition to the surviving spouse's own exclusion amount. Under this portability election, the surviving spouse could potentially have an available exclusion amount of $24.12 million.

EXAMPLE 14-3	**Surviving Spouse's ACA**
The deceased spouse only used $6.06 million of the allowed exclusion in 2022. The surviving spouse, who died later in 2022, is allowed a $18.06 million exclusion ($12.06 million surviving spouse original amount + $6 million unused by the deceased spouse).	

   b. A credit is allowable for death taxes paid to foreign governments.

   c. A credit is allowable on gift tax paid on gifts made before 1977 and included in the gross estate.

   d. Prior transfers. A credit is allowed for taxes paid on transfers by or from a person who died within 10 years before, or 2 years after, the decedent's death.

      1) Amounts creditable are the lesser of the following:

         a) Estate tax paid by the (prior) transferor
         b) Amount by which the assets increase the estate tax

      2) Adjustment is made to the credit for transfers more than 2 years prior to the decedent's death.

Income in Respect of a Decedent

3. Beneficiaries may take a deduction for the estate tax paid on income earned before death but received after the decedent's death (income in respect of a decedent).

   a. The deduction is taken by individuals on Schedule A.

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14.3 ESTATE TAX PAYMENT AND RETURN

The executor is required to file Form 706, *United States Estate Tax Return*, if the gross estate at the decedent's death exceeds $12.06 million in 2022. Adjusted taxable gifts made by the decedent during his or her lifetime reduce the threshold.

Return Due Date

1. The estate tax return is due within 9 months after the date of the decedent's death. An extension of up to 6 months may be granted.

Payment Due Date

2. Time for payment may be extended for a period of 1 year past the due date. For reasonable cause, the time for payment may be extended for up to 10 years.

Assessment Period

3. The general period for assessment of estate tax is 3 years after the due date for a timely filed Form 706.
   a. The assessment period is extended an additional (fourth) year on transferees for transfers from an estate.

Tax Charged to Property

4. Estate tax is charged to estate property.
   a. If the tax on part of the estate distributed is paid out of other estate property, equitable contribution from the distributee beneficiary is recoverable.
   b. The executor is ultimately liable for payment of the taxes.

Closely Held Business

5. An estate that includes a substantial interest in a closely held business may be allowed to delay payment of part of the estate tax, if that interest exceeds 35% of the gross estate.
   a. A closely held business includes the following if carrying on a trade or business:
      1) A corporation, if it has 45 or fewer shareholders or if 20% or more in value of the voting stock is included in the gross estate
      2) A partnership, if it has 45 or fewer partners or if 20% or more of the capital interests in the partnership is included in the gross estate

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6. Consistent Basis Reporting for Estate Tax and Income Tax

   a. Those who file a Form 706, *United States Estate Tax Return*, after July 2015 are required to report the final estate tax value of property distributed from the estate.

      1) Form 8971, *Information Regarding Beneficiaries Acquiring Property From a Decedent*, along with a copy of every Schedule A (Form 8971), is used to report values to the IRS. Each beneficiary receiving the property is only provided their corresponding Schedule A.

      2) This filing requirement ties beneficiaries to the value the estate put on an asset for when the asset is later sold.

EXAMPLE 14-4	**Beneficiary's Basis**
Peter died in 2022 and left his son Victor a tract of land worth $6 million, which Peter had originally purchased for $1 million. The value of the land listed on Peter's estate tax return is $6 million, the stepped-up basis that Victor will have in the land. Victor cannot use a different appraisal amount to give himself a higher basis in the land.	

   b. If the decedent has no estate tax filing requirement (for example, if the gross estate is valued less than the basic exclusion amount, which is $12.06 million in 2022) but for whom a return is filed for the sole purpose of making an allocation or election respecting the generation-skipping transfer tax, a Form 8971 is not required.

   c. The Form 8971 due date is 30 days after the due date of the estate tax return.

   d. Form 8971 is subject to the accuracy related 20% of underpayment penalty. It applies to a beneficiary overstating his or her basis in an asset upon a subsequent sale. This prevents an individual from using both a low basis to avoid estate tax and a high basis to prevent a gain on the subsequent sale.

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14.4 GENERATION-SKIPPING TRANSFERS

1. The generation-skipping transfer tax (GSTT) is imposed separately and in addition to gift and estate taxes on transfers directly to or in trust for the sole benefit of a person at least two generations younger than the transferor.
   a. GSTT is generally imposed on each generation-skipping transfer (GST).

Transfer Types

   b. There are three types of GSTs:
      1) Direct skips
      2) Taxable distributions
      3) Taxable terminations

Direct Skip

2. A direct skip is a transfer of an interest in property, subject to estate tax or gift tax, to a skip person. The transferor is liable for the tax.
   a. A **skip person** is either a natural person assigned to a generation that is two or more generations below the transferor or a trust, all interests of which are held by skip persons.
   b. In the case of related persons, a skip person is identified by reference to the family tree.
      1) For example, a grandchild is two generations below the grandparent.
   c. In the case of nonrelated persons, a skip person is identified by reference to age differences.
      1) A person born 12 1/2 years or less after the transfer is assigned to the same generation as the transferor. There is a new generation for each additional 25 years thereafter from the transferor's birthdate.
      2) For example, an individual born between 37 1/2 years and 62 1/2 years after the transferor is two generations below the transferor.

EXAMPLE 14-5 GSTT
Darlene, age 95, left a large estate of property to her neighbor Tom, age 35, in her will. The lawyers managing the estate found that this transfer was subject to estate tax. In addition to the estate tax, Darlene's estate is responsible for the GSTT because Tom is two generations below Darlene and is a skip person.

Taxable Distribution

3. A taxable distribution is a distribution from a trust to a skip person of income or principal, other than a distribution that is a direct skip or taxable termination. The transferee is liable for the tax.

Taxable Termination

4. A taxable termination is a termination of an interest in property held in trust. A taxable termination has not occurred if, immediately after the termination, a nonskip person has an interest in the property or if distributions are not permitted to be made to a skip person at any time following the termination.
   a. Termination may be by lapse of time, release of power, death, or otherwise.
   b. The trustee is liable to pay the tax.
5. The GSTT approximates the maximum federal estate tax that would have applied to the transfer on the date of the transfer.

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Exemption

6. Each individual is allowed a $12.06 million exemption in 2022 that (s)he, or his or her executor, may allocate to GST property. The exemption is indexed for inflation.
    a. Gift splitting applies to GSTTs; $24.12 million is allocable.

EXAMPLE 14-6 **GST Exemption**
Parent dies, leaving $3.5 million in trust to a child and the remainder to grandchildren. The entire $3.5 million is allocated to property held in trust. The child dies 25 years later, and the property held in trust is now worth $10 million. No GSTT is imposed.

7. Inter vivos gifts are exempt from the GSTT if they are not subject to gift tax due to the $16,000 annual exclusion or the medical or tuition exclusion.

Computation

8. The GSTT is computed by multiplying the taxable amount by the applicable rate.
    a. The applicable rate is the maximum federal rate multiplied by the inclusion ratio.
        1) The maximum federal rate is 40% (for 2022).
        2) The inclusion ratio is

$$1 - \left(\frac{\text{Transferor's exemption allocable to property transferred}}{\text{FMV property transferred} - (\text{Estate tax} + \text{Charitable deduction})}\right)$$

9. The GSTT does not apply when neither the federal estate tax nor the federal gift tax applies.
    a. General power of appointment includes the trust in the estate; thus, it is not subject to GSTT.

Termination Tax

10. Generation-Skipping Termination Tax
    a. The interest of a non-skip person terminates by reason of death, expiration of time, or another reason, and a skip person becomes the recipient of the trust property.

EXAMPLE 14-7 **Generation-Skipping Termination Tax**
Under a parent's will, a trust is created with income to a child for life and corpus to a grandchild. The child's death is an event that terminates the child's interest in the trust, causing a taxable termination. The grandchild is a skip person two generations below the parent.

    b. The trustee files and pays the tax.

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Distribution Tax

11. Generation-Skipping Distribution Tax (GSDT)
    a. GSDT applies to trust distributions out of income or corpus to a beneficiary at least two generations below the grantor, while an older generation beneficiary has an interest in the trust.

EXAMPLE 14-8	**Generation-Skipping Distribution Tax**
A trust is created by a parent for a child. The trust allows for distributions to the grandchild during the child's lifetime. A taxable distribution occurs when a distribution is made from the trust to the grandchild.	

    b. The distributee is entitled to a federal income tax deduction for GSDT imposed on current distributions of trust income.
    c. The basis of property received is increased by the proportion of GSDT imposed.
    d. The distributee reports and pays GSDT.
        1) A trustee's payment of GSDT is deemed an additional distribution to a beneficiary.

Direct Skips

12. A direct skip occurs when one or more generations are bypassed altogether, and property is transferred directly to or in trust for a skip person.
    a. Direct Skip Gift Tax (DSGT)
        1) The tax is imposed on gifts by an individual to a third generation or below beneficiary.
        2) The tax applies only to the FMV of the property given.
        3) Only the gift tax annual exclusion and the generation-skipping tax exemption apply.
        4) The donor is liable for both the gift tax and the DSGT.
            a) The donor trustor is liable if the transfer is in trust.
            b) The donee can add a proportion of the DSGT to his or her income tax basis in property received.
            c) The DSGT is added to federal taxable gifts, and it increases the federal gift tax.
    b. Direct Skip Estate Tax (DSET)
        1) The DSET applies when there is a bequest by an individual to a third generation or below beneficiary.
        2) The donor estate is liable for the estate tax and the DSET.
        3) Any unallocated $12.06 million generation-skipping tax exemptions are used to reduce taxable direct skip bequests.
        4) The basis is FMV at date of death.
            a) It is not increased by DSET.

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