Surgent's Individual Income Tax Update

BIT4/25/V1-X1

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Supplement: The One Big Beautiful Bill Act

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Learning objective

Upon reviewing this material, the reader will be able to discuss the major provisions of The One Big Beautiful Bill Act.

I. Overview

On July 4, 2025, President Trump officially signed the "**One Big Beautiful Bill Act**" (OBBBA) into law. This followed a narrow 51–50 vote in the Senate on July 1, where Vice President JD Vance cast the tie-breaking vote in favor of the bill. The bill was passed under budget reconciliation procedures, allowing it to move forward with a simple majority vote. The legislation permanently extends, with certain modifications, key individual, business, and international tax measures that were originally enacted under the 2017 Tax Cuts and Jobs Act (TCJA). Many of these TCJA provisions were set to expire at the end of 2025.

A. Extension and enhancement of TCJA provisions – Individual taxation

1. Individual income tax rates

The OBBBA permanently extends the lower individual income tax rates and brackets originally enacted by the TCJA, effective for tax years beginning after December 31, 2025. These brackets will continue to be adjusted for inflation. The expanded income thresholds and marriage penalty relief introduced by the TCJA are retained. For individuals, the permanent rates will remain at 10%, 12%, 22%, 24%, 32%, 35%, and 37%, rather than reverting to the pre-TCJA structure that topped out at 39.6%.

2. Standard deduction

The OBBBA makes permanent the TCJA's expanded standard deduction and further increases the base amounts beginning in 2025. The new 2025 standard deduction amounts are increased an additional $750 for single filers and $1,500 for joint filers over the 2025 inflation-adjusted TCJA amounts:

- $15,750 for single filers and married individuals filing separately;
- $23,625 for heads of households; and
- $31,500 for married couples filing jointly and surviving spouses.

The standard deduction will continue to be indexed for inflation, and the additional standard deduction for individuals aged 65 or older and/or blind remains unchanged.

3. Pease limitation

The OBBBA permanently repeals the §68 Pease limitation, which previously reduced itemized deductions by up to 3% of AGI over certain thresholds, capped at 80% of total deductions. In its place, the OBBBA introduces a new cap on the value of itemized deductions for higher-income taxpayers. Under the new rule, allowable itemized deductions are reduced by 2/37 of the lesser of:

- The total itemized deductions; or
- The amount by which the taxpayer's taxable income exceeds the threshold for the 37% tax bracket.

This new limitation does not apply to the §199A deduction for qualified business income. This change is in effect for tax years beginning after December 31, 2025.

4. Miscellaneous itemized deductions

The OBBBA permanently extends the TCJA's suspension of miscellaneous itemized deductions under §67(g). As a result, it effectively eliminates deductions for items such as unreimbursed employee expenses, tax prep fees, and investment expenses.

The OBBBA creates an exception that allows qualified educators to deduct unreimbursed employee expenses as a permitted itemized deduction under §67(b). Qualified educators include K–12 teachers, instructors, counselors, principals, aides, and interscholastic sports coaches or administrators who work at least 900 hours in a school year. Deductible expenses include classroom equipment and supplemental instructional materials.

This provision is effective for tax years beginning after December 31, 2025.

5. Personal exemptions

Under pre-TCJA law, taxpayers could deduct a fixed amount for themselves, their spouse, and dependents, which reduced taxable income. The TCJA set the personal exemption amount to zero from 2018–2025; however, it left the structure intact for a possible return.

The OBBBA amends §151(d)(5) to formally set the personal exemption amount to zero on a permanent basis, preventing its automatic reinstatement after 2025. This change is effective for tax years beginning after December 31, 2024.

6. Temporary senior deduction

The OBBBA introduces a temporary deduction for taxpayers age 65 and older, effective for 2025 through 2028. Qualified individuals can deduct $6,000 per eligible senior (including a spouse if filing jointly). The deduction is phased out by 6% of the amount by which modified AGI exceeds:

- $75,000 for single filers; and
- $150,000 for married filing jointly.

A valid SSN must be provided to claim the deduction. Failure to provide such information is treated as a mathematical or clerical error, allowing the IRS to disallow the deduction without a formal audit. This provision is not permanent and is set to sunset after tax year 2028.

7. State and local tax cap

Prior to the TCJA, taxpayers could deduct the full amount of their state and local taxes paid. The TCJA imposed the current $10,000 cap beginning in 2018, which created significant limitations for taxpayers in high-tax states.

The OBBBA temporarily increases the SALT deduction cap from $10,000 to $40,000 for most filers (or $20,000 for married individuals filing separately) beginning in 2025. The cap will be adjusted for inflation, rising to $40,400 in 2026 and increasing by 1% annually through 2029.

Beginning in 2030, the SALT cap will revert to its current level of $10,000 ($5,000 for married separate filers), which was established by the TCJA and is currently set to expire after 2025.

A phaseout of the increased SALT cap applies to taxpayers with MAGI over $500,000 in 2025. The phaseout threshold increases to $505,000 in 2026 and continues to rise by 1% annually through 2029. For affected taxpayers, the SALT deduction is reduced by 30% of the amount by which their MAGI exceeds the threshold. However, the deduction will not be reduced below $10,000. This phaseout applies only through 2029, after which the cap reverts to its original level.

8. Child Tax Credit (CTC)

The OBBBA makes several key changes to the CTC, many of which make permanent or expand provisions originally introduced under the TCJA. Beginning in 2025, the nonrefundable portion of the CTC increases by $200, bringing the maximum credit to $2,200 per qualifying child. This amount will be adjusted annually for inflation starting in 2026. This increase applies only to the nonrefundable portion of the credit, meaning it primarily benefits taxpayers with sufficient tax liability to fully utilize the credit.

The bill makes permanent the refundable portion of the credit, currently $1,700 in 2025, with inflation adjustments in future years. The OBBBA retains and makes permanent the higher income phaseout thresholds introduced under the TCJA ($200,000 for single filers and $400,000 for joint filers), as well as the $500 nonrefundable credit (not indexed for inflation) for other dependents who do not qualify for the CTC.

Finally, the OBBBA tightens identification requirements. Under OBBBA, not only must the qualifying child have a Social Security Number (SSN), but also the taxpayer (or spouse, if filing jointly) must have a valid SSN to claim the credit. The omission of a valid SSN for either the child or taxpayer will now be treated as a mathematical or clerical error, allowing the IRS to deny the credit without a full audit.

9. Child and dependent care credit

Prior to the OBBBA, taxpayers with one or more qualifying individuals, such as children or other dependents could claim a credit for employment-related expenses incurred for child and dependent care. Employment-related expenses include costs for household services and care expenses for qualifying individuals.

The credit is calculated by multiplying qualifying expenses up to $3,000 for one qualifying individual or $6,000 for two or more by a credit rate based on the taxpayer’s AGI. Before the OBBBA was enacted, the maximum credit rate was 35%, which phased down to 20% for taxpayers with AGI exceeding $43,000.

The OBBBA permanently increases the maximum credit rate to 50%, effective for tax years after December 31, 2025. The 50% credit rate is gradually reduced by one percentage point for every $2,000 (or fraction thereof) by which the taxpayer’s AGI exceeds $15,000, but this reduction cannot lower the rate below 35%.

For taxpayers with AGI between $43,001 and $75,000 ($86,001 to $150,000 for joint filers), the credit rate is fixed at 35%. For AGI between $75,001 and $105,000 ($150,001 to $210,000 for joint filers), the credit rate is further phased down to a minimum of 20%.

In other words, the credit rate phases down in two stages: first from 50% to a minimum of 35% as AGI exceeds $15,000, then from 35% to a minimum of 20% as AGI surpasses $75,000 (or $150,000 for joint filers).

10. Dependent care assistance programs

Prior to the OBBBA, the maximum amount excludable from income under a dependent care assistance program was $5,000 annually ($2,500 for married individuals filing separately). The OBBBA increases the annual exclusion for employer-provided dependent care assistance to $7,500 ($3,750 for married individuals filing separately).

These amounts continue to apply only to assistance furnished under a qualified employer-sponsored program. The exclusion applies to payments made for the care of a qualifying dependent to enable the employee (and spouse, if married) to work or look for work. This provision is effective for tax years beginning after December 31, 2025.

11. Charitable contribution deduction

For itemizing taxpayers, the OBBBA introduces a new 0.5% AGI floor on itemized charitable deductions. Only the portion of charitable contributions exceeding 0.5% of AGI will be deductible.

Any amount disallowed under this rule may be carried forward, provided the taxpayer has other existing charitable contribution carryforwards. The OBBBA makes permanent the existing 60% AGI limitation for cash contributions to public charities, a provision that was originally set to expire after 2025 under the TCJA.

Beginning in 2026, the OBBBA allows non-itemizers to deduct up to $1,000 ($2,000 for joint filers) for qualified charitable contributions. To qualify, contributions must be cash donations made to public charities under §170(p). Itemizing is not required to take this deduction. This provision creates a permanent charitable deduction for taxpayers who claim the standard deduction.

12. Tip income deduction

The OBBBA introduces a temporary deduction for qualified tip income, available for tax years 2025 through 2028. Under this provision, individuals in occupations that customarily receive tips may deduct up to $25,000 in qualified tip income annually.

The deduction is available to both employees (who receive Form W-2) and independent contractors who report tips on Form 1099-K, Form 1099-NEC, or Form 4317 (used to report unreported tip income).

Itemizing is not required to take this deduction.

The deduction is reduced by $100 for taxpayers with MAGI exceeding $150,000 (or $300,000 for joint filers).

To qualify as “tips,” tips must be:

- Voluntary (not negotiated) and properly reported on IRS forms (W-2, 1099, etc.);
- Earned in occupations listed by the IRS as customarily tipped as of December 31, 2024; and
- Not received in “specified service trades or businesses” (as defined under Code §199A(d)(2)).

If the individual operates a business receiving tips, the deduction applies only if gross income (including tips) exceeds deductible expenses. Further, amounts deducted under this provision are excluded from Qualified Business Income (QBI) for purposes of the 20% §199A deduction.

For 2025 only, employers may use any reasonable method to estimate tip amounts for reporting. The IRS will publish a list of eligible tipped occupations within 90 days of enactment, based on tipping practices before 2025.

The IRS is also required to update withholding procedures starting in 2026 to reflect the new deduction. Reporting entities (employers, platforms, third-party payers) must:

- Separately report designated cash tips and recipient occupations; and
- Update Forms W-2, 1099, 1099-K, and related filings.

The FICA tip credit under §45B is expanded to include beauty services industries, such as barbering, hair care, nail care, esthetics, and spa services.

13. Overtime pay deduction

The OBBBA introduces a temporary deduction for qualified overtime compensation, available for tax years 2025 through 2028. Taxpayers may deduct up to $12,500 per year ($25,000 for MFJ filers) in qualified overtime compensation. The deduction phases out by $100 for every $1,000 of MAGI above $150,000 (single filers) or $300,000 (joint filers).

Per the bill, "qualified overtime compensation" is defined as overtime pay received under Section 7 of the Fair Labor Standards Act of 1938, specifically, wages paid at a rate above the employee's regular rate of pay for overtime hours. The deduction does not apply to any amounts already deducted as qualified tips under new §224.

The deduction is available to both employees and non-employees, provided the compensation is properly reported on Form W-2 or applicable 1099. To qualify, taxpayers must provide a valid SSN on the return. Additionally, married taxpayers must file jointly to claim the deduction. Any omission of an SSN is treated as a mathematical or clerical error under §6213(g)(2). Non-itemizers are eligible to claim the deduction, and it applies in addition to the standard deduction. Similar to qualified tips, overtime is subject to payroll taxes and state tax.

14. Trump Accounts

The OBBBA creates a new type of tax-deferred investment account for children under age 18, known as a Trump Account. These accounts are structured as non-Roth IRAs for the exclusive benefit of minors. A child must be a U.S. citizen with a valid SSN to qualify.

Contributions to a Trump Account must be made before the child turns 18, and distributions may begin in the year the child turns 18. Trump Account funds must be invested in mutual funds or indexed ETFs that track U.S. equity markets.

The annual contribution limit is $5,000 per beneficiary, adjusted for inflation beginning in 2028. Contributions may come from parents, relatives, employers, charitable organizations, and government entities. Employer contributions are not included in the employee's income. General funding contributions from charities or government bodies are exempt from the $5,000 limit, as long as they benefit a defined group (e.g., a specific birth year or geographic region). Additionally, contributions cannot be made to the account after the beneficiary turns 18.

Distributions from Trump Accounts may not occur until the beneficiary turns 18, except in limited qualifying cases (e.g., death or disability). Once eligible, funds may be withdrawn for education expenses, first-time home purchases, or small business investments. Distributions for nonqualified purposes may be subject to tax and penalties, similar to traditional IRA rules.

Trump Accounts must be clearly designated as such at setup and managed in compliance with §530A and related provisions. The IRS is authorized to issue guidance and enforce rules to prevent abuse, including regulations addressing contribution misclassification or improper withdrawals.

A $1,000 one-time federal contribution will be made to Trump Accounts for eligible children born between January 1, 2025, and December 31, 2028. The OBBBA also provides a $1,000 tax credit to individuals who open accounts for eligible newborns during this period.

If a qualifying child does not have an account by the time they are claimed on a tax return, the IRS will automatically open one, unless parents opt out. Contributions to Trump Accounts may not begin until 12 months after the bill's enactment, and the entire provision is effective for tax years beginning after December 31, 2025.

15. Basic exclusion amount

The OBBBA permanently increases the federal estate, gift, and generation-skipping transfer (GST) tax exclusion amount to $15 million per person (or $30 million for married couples filing jointly) as of January 1, 2026.

This provision replaces the temporary $10 million (inflation-adjusted) exclusion enacted under the TCJA, which was set to revert to approximately $7 million per person in 2026 absent legislative changes.

The new $15 million exclusion is adjusted annually for inflation, beginning in 2026. This expanded exemption applies to lifetime transfers and transfers at death. Lastly, portability rules remain in place, so an unused exclusion from a deceased spouse can still transfer to the surviving spouse.

16. Alternative Minimum Tax (AMT)

The OBBBA permanently increases the individual AMT exemption amounts, which were previously set to expire after 2025 under the TCJA. Beginning in 2026, the phaseout thresholds are:

- $500,000 for single filers; and
- $1,000,000 for joint filers.
- Note: Both thresholds are indexed for inflation.

The phaseout rate doubles from 25% to 50%, causing higher-income taxpayers to lose the exemption faster as income increases. The AMT still applies only if it results in more tax than under the regular system, ensuring high-income taxpayers pay a minimum amount of tax, regardless of deductions or credits claimed under the regular system.

17. New car loan interest deduction

The OBBBA introduces a temporary tax deduction for interest paid on loans used to purchase new personal-use passenger vehicles, effective for tax years 2025 through 2028. Taxpayers may deduct up to $10,000 of car loan interest per year, regardless of whether they itemize deductions or claim the standard deduction.

This deduction excludes qualified vehicle loan interest from the definition of “personal interest” under §163(h). This provision applies only to qualified indebtedness incurred after December 31, 2024.
To qualify for the deduction, the loan must be incurred after December 31, 2024, and must be secured by a first lien on the vehicle. The vehicle must be new, intended for personal use, and originally placed in service by the taxpayer.

Eligible vehicles include cars, SUVs, pickup trucks, vans, minivans, and motorcycles with a gross vehicle weight rating under 14,000 pounds. Additionally, the vehicle must have had its final assembly in the United States.

Taxpayers are required to report the vehicle identification number (VIN) on their tax return to claim the deduction. Lastly, lenders are required to file information returns with the IRS reporting interest received on qualified personal auto loans.

The deduction phases out beginning at $100,000 of modified adjusted gross income (MAGI) for single filers and $200,000 for married taxpayers filing jointly. For every $1,000 of MAGI above these thresholds, the deduction is reduced by $200 until fully phased out. The deduction does not apply to loans for ATVs, trailers, campers, or used vehicles.

This provision provides new tax planning opportunities for taxpayers financing new vehicles assembled in the U.S. during the effective period.

18. Scholarship credit

Beginning in tax years ending after December 31, 2026, individuals who are U.S. citizens or residents may claim a nonrefundable federal income tax credit for qualified cash contributions made to scholarship-granting organizations (SGOs). The credit is limited to $1,700 per taxpayer per year and applies only in states that elect to participate and provide the IRS with a list of qualified SGOs.

Contributions qualifying for this credit must be used to fund scholarships for eligible students attending elementary or secondary schools within the state in which the SGO is registered.

A qualifying SGO must be a public charity under §501(c)(3) and must maintain segregated accounts for qualified contributions. Qualified contributions must be in cash only and are not eligible for a charitable deduction under §170 if used to claim the credit. The credit amount is reduced by any state tax credit received for the same contribution.

If a taxpayer’s federal credit exceeds the limit on nonrefundable personal credits under §26(a), the excess may be carried forward up to five years. Contributions are subject to a national $4 billion annual cap, with credits allocated on a first-come, first-served basis.

Under new §139K, scholarship amounts received by a taxpayer or a dependent from an SGO are excluded from gross income if used for qualified elementary or secondary education expenses. An "eligible student" must be from a household with income not exceeding 300% of area median gross income, as defined under §42, and be eligible to enroll in a public elementary or secondary school. These scholarships can be used for tuition, fees, books, supplies, and other qualified K–12 educational costs.

19. Learning credits

Beginning in 2026, the OBBBA imposes stricter identification rules for claiming education credits, tightening eligibility and compliance verification. To claim either the American Opportunity Tax Credit (AOTC) or the Lifetime Learning Credit (LLC), taxpayers must include:

- Their own Social Security Number (SSN) (or spouse's, if applicable); and
- The SSN of each student for whom the credit is claimed.

Additionally, taxpayers must report the Employer Identification Number (EIN) of each institution that received qualifying tuition payments used to compute the AOTC or LLC. Missing or incorrect SSNs or EINs are treated as mathematical or clerical errors under §6213, enabling automatic IRS disallowance or correction. This provision applies to tax years beginning after December 31, 2025.

20. Employer payments of student loans

Prior to the OBBBA, employees could exclude up to $5,250 per year of "educational assistance" provided by an employer under a qualified educational assistance program. This exclusion included eligible student loan repayments, including principal or interest paid by the employer for the employee's own qualified education loans, but was set to expire for payments made after December 31, 2025.

The OBBBA makes the student loan repayment exclusion permanent, ensuring employer-paid student loan assistance remains tax-free to employees beyond 2025. The OBBBA also adds an annual inflation adjustment to the $5,250 limit for tax years after December 31, 2026.

21. Casualty loss deductions

The OBBBA permanently extends the TCJA provision limiting itemized deductions for personal casualty losses to losses arising from federally declared disasters. In a significant expansion, the OBBBA now also allows deductions for losses attributable to certain state-declared disasters. Losses from events that are not federally, or state-declared disasters are no longer deductible as personal casualty losses. This provision applies to tax years beginning after December 31, 2025.

The OBBBA also extends and modifies disaster relief rules under the Taxpayer Certainty and Disaster Tax Relief Act of 2020. Taxpayers in qualified disaster areas can claim personal casualty losses without itemizing deductions. The standard deduction is increased by the amount of the net disaster loss, which is the excess of qualified disaster-related personal casualty losses over any casualty gains.

The per-casualty floor for losses has been raised from $100 to $500 under these disaster provisions. To qualify, the loss must arise on or after the first day of the incident period in a qualified disaster area.

22. Moving expenses

The OBBBA permanently disallows the moving expense deduction under §217 and the employer-paid moving expense exclusion under §132(g) for most taxpayers, extending the temporary suspension enacted under the Tax Cuts and Jobs Act (TCJA), which was originally effective from 2018 through 2025.

Limited exceptions remain in place:

- The deduction and exclusion continues to apply to active-duty members of the U.S. Armed Forces who move pursuant to a military order and permanent change of station.
- Further, the OBBBA expands the exception to include employees and appointees of the U.S. intelligence community who relocate due to an official change in assignment.

These changes apply to tax years beginning after December 31, 2025, with expanded eligibility for the intelligence community beginning in tax year 2026.

23. Mortgage interest deduction

The OBBBA permanently extends the limitation on the deduction for qualified residence interest to apply only to the first $750,000 of home acquisition mortgage debt ($375,000 for married individuals filing separately). This change makes permanent the temporary cap introduced by the TCJA, which was originally set to revert to a $1 million limit beginning in 2026. This provision applies to acquisition indebtedness used to purchase, build, or substantially improve a qualified residence, which includes a taxpayer's principal residence and one other residence.

The OBBBA also permanently excludes interest on home equity indebtedness from the definition of qualified residence interest, unless the proceeds are used to acquire or improve the residence.

Lastly, the OBBBA treats certain mortgage insurance premiums paid on acquisition indebtedness as qualified residence interest, thus allowing their deductibility. This provision applies to tax years beginning after December 31, 2025.

24. Adoption credit

The OBBBA enhances the existing adoption credit by making up to $5,000 of the credit refundable beginning in tax year 2025. The $5,000 refundable limit will be adjusted annually for inflation, beginning in 2025. The nonrefundable portion of the credit, which may cover adoption expenses up to $17,280 per child (2025), remains in place. The provision specifies that the refundable portion is not eligible for carryforward to subsequent years. This enhancement applies to tax years beginning after December 31, 2024.

25. 529 plans

The OBBBA significantly expands the list of qualified K–12 education expenses eligible for tax-exempt distributions from 529 savings plans and increases the annual distribution cap for K–12 expenses from $10,000 to $20,000, effective for tax years beginning after December 31, 2025.

Under the OBBBA, newly eligible K–12 expenses include:

- Tuition for public, private, or religious schools;
- Curriculum and curricular materials;
- Books and other instructional materials;
- Online educational resources;
- Tutoring and educational classes outside the home;
- Fees for standardized tests, AP exams, and college admission exams;
- Dual enrollment program fees at higher education institutions; and
- Educational therapies for students with disabilities, provided by licensed professionals.

The expanded list of qualified K–12 expenses is effective for distributions made after the date of enactment. The OBBBA also introduces §529(f), allowing 529 plan funds to be used for qualified postsecondary credentialing expenses.

Postsecondary credentialing expenses include tuition, fees, books, supplies, and equipment required for participation in recognized postsecondary credential programs. Also included are costs for testing and continuing education required to obtain or maintain a recognized credential. This provision applies to distributions made after the date of enactment.

A "recognized postsecondary credential program" includes those that:

- Are listed under the Workforce Innovation and Opportunity Act (WIOA);
- Appear in the VA Web Enabled Approval Management System directory;
- Prepare individuals for exams required for industry credentials; and
- Are deemed industry-recognized by the Secretary of Labor.

Covered credentials include:

- State or federally issued licenses;
- Registered apprenticeship completion certificates;
- Credentials listed in the DoD Credentialing Opportunities On-Line (COOL) directory; and
- Certifications accredited by recognized bodies such as the Institute for Credentialing Excellence.

26. ABLE accounts

The OBBBA permanently extends the TCJA provision allowing additional contributions to ABLE (Achieving a Better Life Experience) accounts for employed individuals with disabilities. These additional contributions are limited to the lesser of:

- The federal poverty level for a one-person household for the preceding year; or
- The beneficiary's earned income for the year.

The OBBBA also permanently allows for tax-free rollovers from §529 qualified tuition plans to ABLE accounts. These provisions apply to tax years beginning after December 31, 2025.

Further, the OBBBA permanently permits ABLE account contributions to qualify for the Saver's Credit. The OBBBA increases the maximum Saver's Credit amount from $2,000 to $2,100 starting in tax years after December 31, 2026.

Beginning in 2027, only ABLE account contributions will be eligible for the Saver's Credit, meaning retirement plan contributions will no longer qualify. For tax years before 2027, the Act provides a calculation that includes retirement contributions, elective deferrals, and voluntary employee contributions.

27. Limitation on wagering losses

Prior to the enactment of the OBBBA, losses from wagering transactions were deductible only to the extent of gains from such transactions. As a result, between 2018 and 2025, "losses" included all allowable deductions incurred in carrying on any wagering activity.

The OBBBA permanently limits the deductibility of gambling-related losses to 90% of the amount of such losses, still only to the extent of gains from wagering transactions.

As a result, a portion (10%) of losses will remain non-deductible, even when gains and losses are equal. This change is effective for tax years beginning after December 31, 2025.

> ***Example:*** *A taxpayer has $100,000 in gambling winnings and $100,000 in gambling losses.*
>
> *Under pre-OBBBA law, no tax would be due, as losses fully offset winnings.*
>
> *Under the new OBBBA 90% limitation, only $90,000 of the losses are deductible. The remaining $10,000 becomes taxable income.*
>
> *Assuming an effective tax rate of 24%, this results in $2,400 in tax owed, despite a break-even year.*

This change will particularly impact professional and high-volume bettors, including those in states with legalized sports betting.

The wagering provision is considered one of the more controversial provisions of the OBBBA, particularly due to its disproportionate impact on professional and high-volume sports bettors. Legislative developments, such as the proposed FAIR BET Act, aim to restore full deductibility of wagering losses. It is important to monitor legislative developments, which could potentially be retroactive or future changes.

28. Elimination of energy incentives

The OBBBA eliminates or accelerates the sunset of several clean energy credits that were extended or expanded under prior legislation. These rollbacks will significantly reduce tax incentives for residential and vehicle-based energy initiatives.

Clean Energy Incentives terminated by OBBBA include:

- **Energy Efficient Home Improvement Credit**: Previously available through 2032; now expires for property placed in service after 12/31/2025. This credit covered items like insulation, windows, heat pumps, and audits.
- **Residential Clean Energy Credit**: Previously available through 2032; now expires for expenditures made after 12/31/2025. This credit included items like solar panels, wind turbines, geothermal systems, and battery storage.
- **New Energy Efficient Home Credit**: Previously available through 2032; now ends for homes acquired after 6/30/2026. This credit provided up to $5,000 per unit for ENERGY STAR and Zero Energy Ready Homes.
- **Clean Vehicle Credit**: The OBBBA accelerates phaseout to vehicles acquired after 9/30/2025 (as compared to 2032 under prior law). The OBBBA eliminates future increases in domestic content requirements for battery minerals and components.
- **Previously Owned Clean Vehicles Credit**: This credit was to run through 2032; now terminates for vehicles acquired after 9/30/2025. This credit offered up to $4,000 for qualified used EV purchases.
- **Alternative Fuel Vehicle Refueling Property Credit**: Now expires for EV charging equipment and other property placed in service after 6/30/2026. This credit originally extended through 2032 for rural and low-income areas.

B. Extension and enhancement of TCJA provisions – Business Taxation

1. Section 199A

The OBBBA makes permanent the §199A QBI deduction, originally enacted under the TCJA and scheduled to sunset after 2025. The deduction continues to allow non-corporate taxpayers, including sole proprietors, S corporation shareholders, and partners, to deduct 20% of qualified business income.

The deduction also remains available for qualified REIT dividends and income from publicly traded partnerships. The final legislation does not increase the deduction rate from 20% to 23%, as had been proposed in an earlier House version.

The OBBBA expands the phase-in ranges for the §199A income limitation thresholds:

- For single filers, the phase-in range increases from $50,000 to $75,000.
- For married joint filers, the range increases from $100,000 to $150,000.

These expanded thresholds reduce the impact of wage and capital limitations and broaden access to the full deduction for higher-earning taxpayers. Inflation adjustments will apply to these thresholds for tax years beginning after 2026. This change particularly benefits taxpayers with income near the upper threshold of eligibility, especially those in specified service trades or businesses (SSTBs).

The OBBBA also introduces a minimum QBI deduction of $400 for taxpayers with at least $1,000 of QBI from one or more active qualified trades or businesses. An "active qualified trade or business" requires material participation by the taxpayer, as defined under §469(h).

The minimum deduction ensures that eligible taxpayers with modest QBI amounts are not excluded entirely from the deduction due to income level or complexity. The $400 minimum is adjusted for inflation beginning in tax years after 2026.

2. Bonus depreciation

The OBBBA permanently reinstates 100% bonus depreciation under §168(k) for qualified property acquired and placed in service after Jan. 19, 2025. Under the TCJA, bonus depreciation would have been reduced to 0% over multiple years.

Qualified property continues to include new or used depreciable property with a recovery period of 20 years or less and certain computer software, water utility property, and qualified improvement property (QIP). A limited transitional election allows taxpayers to apply the pre-OBBBA phase-down rates in lieu of full expensing for certain assets.

Specifically, taxpayers may elect to claim a reduced depreciation deduction of 40% (or 60% for certain aircraft or property with a longer production period) for certain qualified property placed in service during the first tax year ending after January 19, 2025.

The OBBBA creates an elective 100% depreciation allowance under §168(n) for Qualified Production Property (QPP), defined as nonresidential real property used as an integral part of a Qualified Production Activity (QPA). The term "Qualified Production Activity" means the manufacturing, production, or refining of a qualified product.

These buildings are now eligible for 100% bonus depreciation, but only if placed in service before January 1, 2031.

The QPP election is irrevocable unless “extraordinary circumstances” exist, and approval is granted by the Treasury Secretary. This is a significant departure from prior law, which excluded real property (other than QIP) from bonus depreciation treatment. The provision is designed to incentivize onshore manufacturing investments and promote U.S.-based industrial activity.

QPP specifically excludes Alternative Depreciation System (ADS) property, property leased to another individual, or offices for sales and research activities. Additionally, QPP must meet an original use requirement; however, certain used property qualifies if:

- It was not previously used by the taxpayer;
- It was not previously used in a QPA by another party; and
- It was not acquired from a related party or through certain non-recognition transactions.

A 10-year recapture rule applies under §1245 if property ceases to be used in a QPA. Coordination with AMT rules and overlapping additional first-year depreciation elections ensures no unintended benefits.

The permanent nature of 100% expensing creates long-term certainty for businesses planning capital expenditures. Strategic timing of acquisitions and construction starts is critical to QPP eligibility. Industries with heavy fixed-asset investments, such as manufacturing, transportation, and logistics, stand to significantly benefit.

However, it is important to note that taxpayers must also consider state conformity, as many states do not follow federal bonus depreciation rules, requiring separate calculations. Further, states may address new §168(n) QPP depreciation separately.

3. Section 179 expensing

Prior to the OBBBA, the inflation-indexed §179 expensing limit for 2025 was $1,250,000, with a phaseout threshold of $3,130,000. The OBBBA increases the statutory maximum amount that a taxpayer may expense under §179 to $2,500,000 and raises the phaseout threshold to $4,000,000. These new limits continue to be subject to annual inflation adjustments.

The deduction continues to phase out dollar-for-dollar when the total cost of qualifying property exceeds the $4,000,000 threshold. These changes apply to property placed in service in tax years beginning after December 31, 2024.

4. Research and experimental expenditures

The OBBBA permanently restores immediate expensing for domestic research or experimental (R&E) expenditures incurred in tax years beginning after December 31, 2024.

This change is implemented through new §174A, which allows taxpayers to either fully deduct domestic R&E costs in the year incurred or elect to capitalize and amortize them ratably over a 60-month period. Foreign R&E expenditures must still be capitalized and amortized over 15 years under the existing provisions of §174.

This change effectively reverses the TCJA's requirement that all R&E expenses be amortized, providing greater flexibility and cash flow benefits for U.S.-based research activities.

The OBBBA provides transitional relief for taxpayers who capitalized domestic R&E costs in 2022 through 2024 under the TCJA rules. Taxpayers may elect to fully deduct the unamortized portion of those expenses in the first tax year beginning after December 31, 2024, or amortize the remaining balance ratably over a two-year period starting in that same year. Additionally, the OBBBA preserves the small business taxpayer election under prior law, which allows eligible taxpayers to retroactively deduct domestic R&E costs incurred after December 31, 2021.

These provisions are intended to ease the administrative and financial burden created by the prior amortization requirement and to support a smoother transition back to full expensing.

Taxpayers should evaluate the need for accounting method changes to conform with the new R&E expensing provisions and take advantage of the available elections. The permanent nature of the provision provides long-term planning certainty and may influence decisions related to capital investment, hiring, and domestic R&E expansion. However, companies with foreign R&E activities will still need to carefully segregate those costs, as foreign expenditures remain subject to 15-year amortization.

5. Advanced Manufacturing Investment Credit (CHIPS Credit)

The OBBBA increases the Advanced Manufacturing Investment Credit under IRC §48D, commonly referred to as the CHIPS Credit, from 25% to 35%. The enhanced 35% credit applies to qualified property placed in service after December 31, 2025.

The credit continues to apply to advanced manufacturing facilities, which are facilities whose primary purpose is the manufacturing of semiconductors or semiconductor manufacturing equipment. This change is designed to further incentivize domestic semiconductor production and aligns with ongoing policy efforts to bolster U.S. supply chains and high-tech manufacturing.

6. Section 163(j) Business Interest

The OBBBA permanently reinstates the more favorable EBITDA-based limitation for business interest deductions under §163(j), effective for tax years beginning after December 31, 2024. This means adjusted taxable income (ATI) will now be calculated before depreciation, amortization, and depletion deductions.

The OBBBA also includes coordination rules for how the §163(j) interest limitation interacts with interest capitalization provisions. These reforms aim to boost investment incentives for capital-intensive and highly leveraged businesses.

The OBBBA creates a new ordering rule in which the business interest deduction limitation under §163(j) is applied before any interest capitalization provisions. After applying the limitation, any allowable interest is allocated first to any amounts that would be capitalized. The remainder (if any) of any allowable interest is allocated to amounts that would be deducted. Interest that is carried forward under 163(j) will not be subject to future capitalization. This provision applies to tax years beginning after December 31, 2025.

The OBBBA also expands the definition of a "motor vehicle" to include any trailer or camper which is designed to provide temporary living quarters for recreational, camping, or seasonal use and is designed to be towed by, or affixed to, a motor vehicle. This means that interest on financing for these items qualifies as floor plan financing interest and can be deductible under §163(j).

The new provisions enacted under the OBBBA are expected to be favorable for domestic capital investment, especially in manufacturing and infrastructure-heavy industries. Further, industries with high leverage, such as real estate, manufacturing, and private equity, are expected to benefit greatly from these changes.

When combined with 100% bonus depreciation, these provisions create a multiplier effect: for every $10 of investment, a company may be able to deduct up to $3 more in interest expense.

7. Qualified Small Business Stock Exclusion

The OBBBA significantly expands the benefits available under §1202, which allows noncorporate taxpayers to exclude gain from the sale of qualified small business stock (QSBS). The changes apply to stock acquired on or after July 4, 2025, and include tiered gain exclusions, increased per-issuer dollar caps, and a higher gross asset test for qualifying corporations.

These reforms are intended to stimulate investment in growing private companies, particularly startups and emerging businesses. Investors in qualified startups and growth-stage businesses will benefit from greater exclusions, longer investment flexibility, and expanded issuer eligibility.

Under prior law, 100% exclusion was available only for QSBS held more than five years (for stock issued after 2010). The OBBBA introduces a tiered structure for QSBS acquired on or after July 4, 2025:

New Tiered Gain Exclusion Structure	
Holding Period	**QSBS Acquired After July 4, 2025**
> 3 years	50% gain exclusion
> 4 years	75% gain exclusion
> 5 years	100% gain exclusion

The percentage of gain excluded increases based on the holding period, incentivizing longer-term investment in small businesses.

The OBBBA raises the lifetime per-issuer cap for QSBS gain exclusion from $10 million to $15 million for stock acquired after July 4, 2025. The new $15 million cap is indexed for inflation beginning in 2027, using 2025 as the base year.

For married taxpayers filing separately, the cap is reduced to $7.5 million, as under prior law. If the taxpayer exceeds the cap in a given year, the exclusion in subsequent years may be reduced to zero, even with inflation indexing.

To qualify for the QSBS exclusion, the issuing corporation must meet an aggregate gross asset limit. The OBBBA raises this limit from $50 million to $75 million, effective for stock issued after July 4, 2025.

The $75 million threshold is also indexed for inflation beginning in 2027, rounded to the nearest $10,000. The change allows larger small businesses to qualify, broadening the reach of §1202 benefits.

Stock that would otherwise be considered acquired before, on, or after the applicable date will instead be treated as acquired on the first day the taxpayer held the stock, in accordance with the holding period rules under §1223. If stock is acquired in multiple tranches or exchanges, the acquisition date is based on the earliest applicable holding period.

As under existing law, excluded gain under §1202 is not treated as a tax preference item for AMT purposes. The new gain exclusion tiers and increased limitations apply to tax years beginning after July 4, 2025.

8. Excess business loss limitation

Under IRC §461(l), noncorporate taxpayers are subject to a limitation on excess business losses, which is the amount by which business deductions exceed business income or gain, plus a statutory threshold. For 2025, the inflation-adjusted EBL thresholds are $313,000 for single filers and $626,000 for joint filers.

Prior to the OBBBA, this limitation was set to expire for tax years beginning after December 31, 2028. The OBBBA makes this limitation permanent, ensuring that EBL rules will continue to apply to future tax years without a sunset provision. The provision applies to tax years beginning after December 31, 2026.

The excess business loss limitation will also permanently apply to farming losses, as the OBBBA makes the inapplicability of the IRC §461(j) farm loss limitation permanent. Lastly, disallowed EBLs may still be carried forward as NOLs, avoiding continued application of the limitation.

9. Charitable contributions

The OBBBA amends §170 to introduce a new 1% floor for corporate charitable contribution deductions. For tax years beginning after December 31, 2025, a corporate taxpayer may deduct charitable contributions only to the extent they exceed 1% of taxable income.

The existing rule allowing deductions up to 10% of taxable income remains unchanged, as the new 1% floor applies in addition to the 10% ceiling. Qualified conservation contributions are exempt from the 1% floor and continue to follow prior treatment. Contributions that are disallowed either for exceeding the 10% limit or for failing to exceed the 1% floor may be carried forward for up to five years.

10. Paid family and medical leave credit

The OBBBA makes the §45S paid family and medical leave credit permanent, effective for tax years beginning after December 31, 2025. Employers may now elect between a credit based on wages paid to qualifying employees or premiums paid for qualifying insurance policies that provide paid family and medical leave.

The wage-based credit equals 12.5% to 25% of paid leave, depending on the wage replacement rate, for up to 12 weeks per employee per year. Paid leave mandated or funded by state or local governments counts toward meeting the eligibility threshold but does not generate a credit.

The OBBBA lowers the employment duration requirement to as little as six months at the employer's election (previously one year). Further, the definition of eligible employees is expanded to include those working at least 20 hours per week. Lastly, aggregation rules are clarified to treat employers under §§414(a) and 414(b) as a single employer for credit purposes.

11. Employer-provided child care credit

Under the OBBBA, beginning in 2026, the credit percentage for qualified child care expenditures under §45F increases from 25% to 40% for regular businesses and to 50% for eligible small businesses. The maximum annual credit increases from $150,000 to $500,000 for regular businesses and $600,000 for eligible small businesses, with both limits indexed for inflation beginning in 2027.

Under the OBBBA, an eligible small business is defined using a 5-year gross receipts test, instead of the standard 3-year lookback, broadening eligibility. The credit is also expanded to cover third-party intermediary arrangements and jointly owned or operated child care facilities, offering additional flexibility in structuring child care support. These enhancements are effective for amounts paid or incurred after December 31, 2025.

12. Payments from partnerships to partners for property or services

Prior to the OBBBA, §702(a)(2) permitted the IRS to recharacterize certain allocations and distributions to a partner as transactions with an outsider, but only under regulations issued by the IRS. These rules applied where the facts indicated that a partner providing services or property was acting in a capacity other than as a partner, and the related allocation or distribution resembled a disguised sale or compensation arrangement.

The OBBBA removes the requirement that recharacterization must occur pursuant to IRS regulations, thereby allowing the IRS to recharacterize qualifying transactions even in the absence of formal guidance. The change does not apply retroactively and is effective for services performed or property transferred after July 4, 2025.

This amendment is significant for partnerships and their partners, as it provides the IRS with greater flexibility to challenge partner-level transactions that resemble arm's-length compensation or property sales.

13. Form 1099 reporting thresholds

The OBBBA raises the longstanding $600 threshold for reporting payments to nonemployees, providing long-sought relief for businesses and simplifying compliance. For payments made after December 31, 2025, the general reporting threshold increases from $600 to $2,000. This change applies to common payments such as nonemployee compensation, rents, prizes, awards, and other reportable income types made in the course of business.

Beginning in 2027, the $2,000 threshold will be adjusted annually for inflation.
The backup withholding rules under §3406 are also updated to reflect the inflation-adjusted threshold, aligning reporting and withholding compliance.

Further, the OBBBA reverses the American Rescue Plan Act of 2021 (ARPA) provision that lowered the Form 1099-K de minimis threshold to $600. Under the OBBBA, the pre-ARPA thresholds are restored, meaning that Form 1099-K is only required when both of the following are true:

- The total gross payments to a payee exceed $20,000; and
- The total number of transactions exceeds 200 in the calendar year.

This rollback eliminates the requirement to issue 1099-Ks to many casual sellers and gig economy participants, addressing industry concerns about over-reporting.

The OBBBA also clarifies that both the dollar threshold and transaction count must be exceeded before backup withholding applies. The reversion to the higher 1099-K threshold is retroactive and applies as if it were included in the original ARPA legislation. The updated backup withholding clarification is effective for calendar years beginning after December 31, 2024.

14. Qualified bicycle commuting reimbursement exclusion

Effective 2026, the OBBBA permanently repeals the qualified bicycle commuting reimbursement exclusion previously available under §132(f). Prior to the OBBBA, employers could reimburse employees up to $20/month for qualified bicycle commuting expenses as a tax-free fringe benefit. This benefit was suspended from 2018–2025 but was scheduled to return in 2026.

The OBBBA permanently removes the bicycle commuting reimbursement from the list of qualified transportation fringe benefits. Starting in 2026, any employer reimbursement for bicycle commuting is treated as taxable compensation to the employee. This provision applies to tax years beginning after December 31, 2025.

15. Opportunity Zones

The OBBBA permanently extends and modernizes the Opportunity Zone program, beginning with a new round of OZ designations starting January 1, 2027. To qualify, census tracts must have a poverty rate of at least 20% or have a median family income of no more than 70% of the area's median income. The bill excludes any tract where the median family income is 125% or more of the area's median, tightening eligibility standards. At least 33% of newly designated OZs must be entirely rural; if fewer rural tracts qualify, then all eligible rural areas must be designated.

The OBBBA eliminates the ability to designate contiguous tracts that are not themselves low-income communities (LICs), closing a prior loophole. OZ investors may defer capital gain recognition for up to five years and receive basis increases after a five-year holding period, enhancing tax benefits. The second round of OZs will begin on January 1, 2027 and end on December 31, 2033.

16. Employee Retention Tax Credit (ERTC)

The ERTC was created under the CARES Act to provide a refundable payroll tax credit for eligible employers who retained employees during COVID-19 disruptions.

For 2020, the ERTC equaled 50% of qualified wages (up to $5,000 per employee). In 2021, the ERTC increased to 70% of qualified wages per quarter (up to $7,000 per employee, per quarter).

The ERTC ended for most employers after Q3 2021, but recovery startup businesses remained eligible through December 31, 2021. Claim deadlines were as follows:

- 2020 wages → April 15, 2024; and
- 2021 wages → April 15, 2025.

The IRS paused processing new ERTC claims on September 14, 2023, due to widespread abuse by aggressive ERTC "mills."

The OBBBA imposes a $1,000 penalty per violation on COVID-ERTC promoters who fail to meet due diligence standards in assisting with ERTC claims. A COVID-ERTC promoter is defined as someone advising on ERTC who:

- Charges fees based on the credit/refund amount, and in the current or prior tax year, more than 20% of their total gross receipts came from ERTC-related services; or
- In the current or prior year, earns more than 50% of gross receipts from ERTC work; or
- Has ERTC work comprising more than 20% of total gross receipts and has receipts totaling over $500,000.
- Note: Certified Professional Employer Organizations (CPEOs) are excluded from the promoter definition.

The OBBBA bars new ERTC claims filed after January 31, 2024 and extends the IRS assessment window for ERTC-related issues to six years. Businesses must also adjust improperly deducted ERTC wages within the extended timeframe. Penalties for erroneous refund claims now apply to employment taxes, expanding beyond just income tax.

17. Elimination of energy incentives

Similar to the termination of clean energy tax benefits for individuals, the OBBBA eliminates several energy-related tax incentives for businesses. Notable Business Energy Incentives eliminated include:

- **Energy Efficient Commercial Buildings Deduction (§179D)**: Construction of qualifying energy efficient commercial building property beginning after June 30, 2026, will no longer be eligible for the §179D deduction. This provision had no prior sunset and was widely used in the real estate and construction sectors. Code §179D(i), added by the OBBBA, officially terminates this deduction.
- **Qualified Commercial Clean Vehicles Credit (§45W)**: The credit for the purchase of qualified commercial clean vehicles is terminated for vehicles acquired after September 30, 2025. This credit had previously applied through 2032 and provided up to $40,000 per vehicle, depending on size and propulsion system. The repeal eliminates a key incentive for fleet electrification by commercial and logistics companies.

Investments, Retirement, and Miscellaneous

Investments, Retirement, and Miscellaneous

Learning objectives

Upon reviewing this material, the reader will be able to:

- Explain what constitutes a real estate professional in terms of participation and what constitutes a real property trade or business;
- Discuss the advantages of Donor-Advised Funds (DAFs) as well as the IRS proposed regulations for them; and
- Discuss the challenges of self-employed (unincorporated) individuals with no common-law employees, who typically are looking to shelter some income but need the flexibility to make varying contributions each year.

I. Investments

A. Real estate

1. The law

A taxpayer qualifies as a real estate professional and is not engaged in a passive activity from rental activities if: (i) more than one-half of the personal services performed in trades or businesses by the taxpayer during such taxable year are performed in real property trades or businesses in which the taxpayer materially participates; and (ii) such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates [750-hour service performance requirement]. In the case of a joint return, the foregoing requirements for qualification as a real estate professional are satisfied if, and only if, either spouse separately satisfies the requirements. Thus, if either spouse qualifies as a real estate professional, the rental activities of the real estate professional are not per se passive.

With respect to the evidence that a taxpayer may use to establish his or her hours of participation in a trade or business, the extent of participation in an activity may be established by any reasonable means. Contemporaneous daily time reports, logs, or similar documents are not required if the extent of participation may be established by other reasonable means. Reasonable means may include but are not limited to the identification of services performed over a period of time and the approximate number of hours spent performing such services during such period, based on appointment books, calendars, or narrative summaries. While the regulations allow taxpayers some latitude in establishing the extent of their participation in an activity, Tax Courts have consistently held that they do not allow a post-event "ballpark guesstimate."[1] With respect to the requirement that the hours a taxpayer spent on real property trades or businesses accounted for more than one-half of the total hours of personal services the taxpayer performed in all trades or businesses during the subject years, to qualify as a real estate professional, the taxpayer must aggregate all hours of personal services in trades or businesses.

For purposes of determining whether a taxpayer is a real estate professional, a taxpayer's material participation is determined separately with respect to each rental property, unless the taxpayer makes an explicit election to treat all interests in rental real estate as a single rental real estate activity.[2] The Court

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1 See *Goshorn v. Commissioner*, T.C. Memo. 1993-578; see also *Moss v. Commissioner*, 135 T.C. 365, 369 (2010); *Fowler v. Commissioner*, T.C. Memo. 2002-223.

2 I.R.C. §469(c)(7)(A); *Bailey v. Commissioner*, T.C. Memo. 2001-296; Treas. Regs. §§1.469-9(c)(3), (e)(1).

will evaluate each of a taxpayer's properties separately in order to determine whether taxpayer materially participated in real estate activity for each property.

An individual may meet the material participation requirement by demonstrating that he or she participated in the rental activity for more than 100 hours during the taxable year and that his or her participation is not less than the participation of any other individual (including individuals who are not owners of interests in the activity) during that year. For purposes of the material participation requirement, participation by an individual's spouse can be added to the participation of the individual. Additionally, material participation can be met if historical material participation was met during any five of the ten immediately preceding tax years.

An individual must establish that he or she materially participated in each of the rental activities unless the individual makes an election to treat all interests in rental real estate as a single rental activity.[3]

2. Procedures to obtain extensions for single rental real estate activity treatment

Effective June 13, 2011, the IRS issued guidance allowing some taxpayers to make late elections to treat all interests in rental real estate as a single rental real estate activity.[4] The guidance provides special procedures, in lieu of the letter ruling procedure under §9100, to obtain relief for late elections under Regs. §1.469-9(g). A taxpayer ineligible for relief under this guidance may request relief by applying for a letter ruling.

a. In general, §469(c)(7)(A) provides that a taxpayer's interests in rental real estate are treated as separate activities for determining whether the taxpayer materially participates in each rental real estate activity unless the taxpayer elects to treat all of the taxpayer's interests in rental real estate as a single rental real estate activity. A qualifying taxpayer may make an election to treat all of the taxpayer's interests in rental real estate as a single rental real estate activity. A qualifying taxpayer makes the election to treat all interests in rental real estate as a single rental real estate activity by filing a statement with the taxpayer's **original income tax return** for the taxable year.

The law:

> For purposes of determining whether a taxpayer is a real estate professional, a taxpayer's material participation is determined separately with respect to each rental property, unless the taxpayer makes an explicit election to treat all interests in rental real estate as a single rental real estate activity.[5] The Court will evaluate each of a taxpayer's properties separately in order to determine whether taxpayer materially participated in real estate activity for each property.

b. The Commissioner may under §9100 grant a reasonable extension of time to make a regulatory election, or a statutory election. Requests for relief will be granted when the taxpayer provides evidence to establish that the taxpayer acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the government. A taxpayer is deemed to have acted reasonably and in good faith if the taxpayer meets one of the requirements, which include that the taxpayer reasonably relied on a qualified tax professional, including a tax professional employed by the taxpayer, and the tax professional failed to make, or advise the taxpayer to make the election.

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[3] Treas. Regs. §1.469-9(e)(1).
[4] Rev. Proc. 2011-34; 2011-24 I.R.B. 875.
[5] I.R.C. §469(c)(7)(A); *Bailey v. Commissioner*, T.C. Memo. 2001-296; Treas. Regs. §§1.469-9(c)(3), (e)(1).

c. The procedures in this revenue procedure are in lieu of the letter ruling procedure that is used to obtain relief for a late §1.469-9(g) election. Accordingly, user fees do not apply to corrective action under this revenue procedure. However, a taxpayer that is not eligible for relief under this revenue procedure may request relief by applying for a private letter ruling, but the Service will not ordinarily issue a private letter ruling if the period of limitations on assessment has lapsed for any taxable year that would be affected by the requested late election. Any taxpayer receiving relief under the guidance is **treated as having made a timely election to treat all interests in rental real estate as a single rental real estate activity** as of the tax year for which the late election is requested.

d. A taxpayer is eligible for an extension of time to file an election if the taxpayer represents on a statement that satisfies the procedural requirements and under penalties of perjury that it meets all of the following requirements.

   (i) The taxpayer failed to make an election **solely because the taxpayer failed to timely meet the requirements** in §1.469-9(g).

   (ii) The taxpayer **filed consistently with having made an election** on any return that would have been affected if the taxpayer had timely made the election. The taxpayer must have filed all required federal income tax returns consistent with the requested aggregation for all of the years including and following the year the taxpayer intends the requested aggregation to be effective and no tax returns containing positions inconsistent with the requested aggregation may have been filed by or with respect to the taxpayer during any of the taxable years.

   (iii) The taxpayer **timely filed each return** that would have been affected by the election if it had been timely made. The taxpayer will be treated as having timely filed a required tax or information return if the return is filed within six months after its due date, excluding extensions.

   (iv) The taxpayer has **reasonable cause for its failure to meet the requirements**.

Note:

The taxpayer must attach the statement to an amended return for the most recent tax year and mail the amended return to the IRS service center where the taxpayer will file its current year tax return. The statement must contain the **declaration** required, must explain the **reason for the failure to file a timely election**, and must include the representations required in this revenue procedure. The statement must identify the taxable year for which it seeks to make the late election. Finally, the statement must state at the top of the document "FILED PURSUANT TO REV. PROC. 2011-34."

The declaration and representations required in this revenue procedure must be accompanied by a dated declaration, signed by the taxpayer which states: "Under penalties of perjury I (we) declare that I (we) have examined this election, including any accompanying documents, and, to the best of my (our) knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete." The individual or individuals who sign must have personal knowledge of the facts and circumstances related to the election.

Note:

The granting of an extension of time to file an election and the issuance of a notification do not constitute an express or implied determination concerning whether the taxpayer satisfies the eligibility requirements of this revenue procedure, whether the taxpayer satisfies the real estate professional requirements, or whether the taxpayer materially participates in any activity.

The law:

An individual may meet the material participation requirement by demonstrating that he or she participated in the rental activity for more than 100 hours during the taxable year and that his or her participation is not less than the participation of any other individual (including individuals who are not owners of interests in the activity) during that year. For purposes of the material participation requirement, participation by an individual's spouse can be added to the participation of the individual.

An individual must establish that he or she materially participated in each of the rental activities unless the individual makes an election to treat all interests in rental real estate as a single rental activity.[6]

Planning point:

The additional tax on unearned income also permits a taxpayer to make a grouping election if the taxpayer is first subject to the net investment income tax.

B. Cases

1. Lisa M. Holley v. Commissioner, (T.C. Memo. 2024-54)

Facts:

Lisa M. Holley (petitioner), an anesthesiologist and owner of Holley Anesthesia (an S corporation), did not file timely federal income tax returns for 2011 and 2017-2019. In February 2021, she filed delinquent returns for these years, but did not pay the amounts of tax shown as due. In June 2021, the IRS assessed the amounts shown as due on her 2017, 2018, and 2019 returns.

When Holley failed to pay these tax liabilities upon notice and demand for payment, the IRS filed the Notice of Federal Tax Lien (NFTL) and issued a timely NFTL Filing on March 24, 2022. Holley timely submitted Form 12153, *Request for a Collection Due Process or Equivalent Hearing* (CDP), checking the boxes for a collection alternative in the form of an installment agreement (IA) or an offer-in-compromise (OIC). Holley's Settlement Officer (SO) ascertained that petitioner's total outstanding federal income tax liability, for all open years, was $2,855,450 as of October 24, 2022. This amount encompassed liabilities for both CDP years and non-CDP years.

On November 29, 2022, the SO received financial information indicating that Holley had equity in assets in excess of $2 million, including real estate valued at $688,884 and a defined benefit plan valued at $1,546,267. Holley's POA stated that Holley was not seeking an OIC. Given the magnitude of Holley's total outstanding tax liability, the SO concluded that Holley might be eligible for a "partial pay" IA (PPIA), but that she would need to use equity in assets to pay down her tax liabilities before a PPIA could be considered.

Upon review of Holley's Form 433-A, *Collection Information Statement for Wage Earners and Self-Employed Individuals*, the SO concluded that petitioner had failed to report certain assets and items of income. The SO questioned the "zero" values that Holley had reported for Holley Anesthesia, her S corporation, and for LH Anesthesia, Inc., a related C corporation. The SO also determined that Holley was not in compliance with respect to her 2022 estimated tax liability.

6 Treas. Regs. §1.469-9(e)(1).

The SO's further review of publicly accessible court records revealed that Holley filed for bankruptcy four times between 2016 and 2020. Each case was dismissed by the court, which determined that Holley was seeking to delay collection efforts by the IRS and by United Healthcare, a judgment creditor. In Holley's case activity record, the SO noted the determinations by the bankruptcy court that Holley filed for bankruptcy in bad faith, submitted false and misleading documents to the court, made unauthorized payments during the bankruptcy case, and engaged in efforts to hide income and assets.

On November 30, 2022, the SO submitted Holley's Form 433-A and supporting information to the IRS Office of Collections (Collections) to conduct an "appeals referral investigation" (ARI). On January 4, 2023, Collections informed the SO of its conclusion that Holley had the ability to pay down a portion of her outstanding liabilities from available equity in assets. The SO informed Holley's POA that no request for a collection alternative could be considered until Holley took this step and came into compliance for 2022.

Holley retained a new POA, and on January 27, 2023, reiterated her desire for an IA. The SO countered that Holley would need to pay down her liabilities using equity in assets before any IA or PPIA could be approved. On February 27, 2023, the SO received 17 substantially identical Forms 843, *Claim for Refund and Request for Abatement*, from Holley's POA, seeking abatement of interest and additions to tax. These forms were unsigned. As justification for abatement, the box was checked for "Reasonable cause or other reason allowed under the law," but no substantiation was provided.

On March 6, 2023, the SO called Holley's representative and explained that the Forms 843 could not be processed because they were unsigned. The SO noted that interest could not be abated absent a showing of IRS error, that "blanket statements, without proof, are not sufficient" to justify abatement of additions to tax, and that the requests for abatement "shouldn't be the same for the 2011, 2017, 2018 and 2019 years, as all circumstances should be different." After receiving no response from Holley or her POA by March 17, 2023, the SO decided to close the case. She noted in her case activity record that Holley had been informed of Collection's determination that she had equity in assets and needed to use equity before an IA could be considered.

The SO noted that Holley was a "serial filer" in bankruptcy court, having "amassed significant personal assets while not paying income taxes and having taken actions to avoid collection efforts of the IRS." For all these reasons the SO determined that the NFTL filing should be sustained. On March 22, 2023, Appeals issued Holley a notice of determination sustaining the NFTL filing.

Issues and Analysis:

In CDP cases, an abuse of discretion by an IRS SO happens when the SO makes a decision that is unreasonable, arbitrary, clearly wrong, or not based on facts, law, or proper procedures. The "three-prong test" considers the following:

1) The SO properly verified that the requirements of applicable law or administrative procedure have been met;
2) The SO considered any relevant issues the petitioner raised; and
3) The SO considered whether any proposed collection action balances the need for the efficient collection of taxes with the legitimate concern of the petitioner that any collection action be no more intrusive than necessary.

The Court found the SO satisfied all of these statutory requirements.

Section 7122(a) authorizes the IRS to compromise an outstanding tax liability, but it is up to the taxpayer to propose an OIC for Appeals' consideration. A taxpayer who wishes to pursue an OIC must submit a Form 656, *Offer in Compromise*. Although Holley checked the box for "Offer in Compromise" on her Form 12153, her POA confirmed during the CDP hearing that she was not requesting an OIC. Holley did not make a concrete offer or submit to the SO a completed Form 656.

IRC §6159 allows a taxpayer to pay the IRS only part of their total tax debt over time, instead of the full amount owed, because full payment can't be made within the statutory collection period. Under a PPIA, the taxpayer pays what they can afford monthly, based on income and allowable expenses, and the IRS collects as much as it can during the collection statute expiration period. Any remaining balance at the end of the collection period is written off.

The IRS will only consider a PPIA if:

1) The taxpayer is compliant in making estimated tax payments and filing timely returns;
2) The taxpayer has an inability to pay in full, based on info provided via Form 433-A; and
3) The taxpayer cannot reasonably liquidate assets or borrow against them.

The IRS considered a PPIA for Holley because:

1) She owed more than $2.8 million; and
2) She could not fully pay it within the collection period.

However, the SO rejected the PPIA because:

1) Holley was not making estimated payments; and
2) Holley had over $2 million in assets and refused to use them to pay down the balance.

The Court found there was no abuse of discretion.

Section 6330(c)(3)(C) requires the IRS to balance "the need for the efficient collection of taxes with the legitimate concern of [petitioner] that any collection action be no more intrusive than necessary." The SO performed a balancing test, finding that the NFTL filing adequately balances the need for efficient tax collection with Holley's concerns, citing her estimated payment deficiencies and her equity in assets. Given the magnitude of Holley's outstanding liabilities and her failure to comply with her ongoing tax obligations, the SO did not abuse her discretion in sustaining the NFTL filing.

Conclusion:

The IRS will not consider collection alternatives like IAs or PPIAs unless the taxpayer is current with estimated tax payments and filing obligations. The SO found Holley had over $2 million in equity, including retirement assets and real estate. She refused to use or liquidate any of these assets to reduce her liability. Taxpayers must be prepared to tap into available equity before a PPIA will be approved. Holley submitted incomplete and potentially misleading financial statements, undervaluing or omitting her business interests. The SO flagged issues with Holley's Form 433-A and her inconsistent financial picture. It is important for taxpayers to fully and honestly disclose such information.

Holley had a history of four bad-faith bankruptcy filings, including attempts to delay IRS collection and hide assets. A taxpayer's past conduct is taken into account when evaluating credibility and eligibility for relief. Holley filed 17 unsigned Forms 843 seeking penalty and interest abatement based only on "reasonable cause," without any explanation or proof, and the SO rightfully rejected them. Requests for abatement (penalties or interest) must be signed and include documentation supporting the claim (e.g., illness, disaster, reliance on advice). Holley and her POAs failed to propose specific payment terms, missed follow-up deadlines, and ignored the court's orders. Taxpayers or their representatives must be engaged, specific, and responsive throughout the CDP process.

The Court ruled that the IRS did not abuse its discretion in:

- Sustaining the federal tax lien (NFTL);
- Rejecting the collection alternatives; and
- Denying the interest and penalty abatement.

The Court found that the SO acted reasonably, followed procedure, and made determinations grounded in law and fact.

2. James Clark v. Commissioner, (T.C. Memo. 2025-13)

Facts:

From the late 1980s until 1995, James Clark ("Clark") solely owned and operated a mobile disc jockey business, working in bars as well as weddings and private parties. Since 1995, Clark worked as a freelance writer, writing movie reviews. In 2019, Clark received $8,250 from freelance movie review writing.

Additionally, since at least 2019, Clark has bought and sold movie-related memorabilia on eBay, and his sale proceeds were paid to him through a PayPal account solely in his name. In 2019, Clark received $41,972 from selling movie-related memorabilia, and PayPal sent the IRS and Clark a Form 1099-K, *Payment Card and Third Party Network Transactions*, reporting the $41,972 as the gross amount of payment card/third party transactions for 2019, with no amount of federal income tax withheld.

Clark prepared his 2019 federal income tax return with assistance from a representative at an H&R Block location. Clark did not report any of the income he received from freelance movie review writing or selling movie-related memorabilia on Schedule C, *Profit or Loss From Business*; rather, he reported that income (totaling $50,222, comprised of the $8,250 from freelance movie review writing and the $41,972 from selling movie-related memorabilia) as "other income" on line 7a of Form 1040, not subject to self-employment tax. Clark claimed the standard deduction ($12,200) and reported taxable income of $38,022. Finally, not having reported any federal income tax withheld, other taxes including self-employment tax, or credits, Clark reported that he had an income tax liability of $4,369.

Clark electronically filed, and the IRS received, the 2019 return on July 13, 2020. On July 22, 2020, the IRS processed a payment of $4,369 from petitioner with respect to his reported 2019 income tax liability. On August 17, 2020, the IRS processed petitioner's 2019 return and assessed a penalty of $134 for failure to pay estimated tax, together with interest of $4.

On June 28, 2021, the IRS's Automated Underreporter (AUR) Program sent Clark a Notice CP2000 proposing changes to his 2019 return on the basis that information the IRS had received from third parties, including the Form 1099-K from PayPal, did not match the information reported on the return. On November 15, 2021, upon Clark's failure to respond to the Notice CP2000, the IRS issued a Notice of Deficiency to him, determining that the $50,222 he had reported as "other income" on his 2019 return was subject to self-employment tax and that he was liable for the substantial understatement of income tax penalty under §6662(a) and (b)(2).

Before Clark's case was calendared for trial, the Social Administration (SSA) sent him a letter dated March 20, 2023, advising him, among other things, that "based on information provided to us from the Internal Revenue Service, we are reducing the amount of your self-employment income on your Social Security earnings record from $46,380.00 to $0.00 for tax year 2019." Additionally, the IRS reversed the premature assessment and issued a refund of $2,886 to Clark for 2019 on April 3 and May 5, 2023, respectively.

Issues and Analysis:

The Commissioner's determinations in a Notice of Deficiency are generally presumed correct. In most cases, the taxpayer has the burden of proving that those determinations are wrong. However, for penalties, additions to tax, or similar amounts, the IRS must first provide evidence before the taxpayer is required to respond.

Section 1401 imposes a self-employment tax on the net earnings from self-employment of individuals. It applies to individuals who are self-employed (e.g., sole proprietors, partners, independent contractors) and earn $400 or more in net self-employment income during the tax year. The self-employment tax is 15.3%, comprised of 12.4% for Social Security (up to Social Security wage base), 2.9% for Medicare (no income cap), plus an additional 0.9% Medicare surtax for higher earners. Section 1402(b) defines self-employment income as "the net earnings from self-employment derived by an individual . . . during any taxable year." Section 1402(a) defines net earnings from self-employment as "the gross income derived by an individual from any trade or business carried on by such individual, less the deductions . . . which are attributable to such trade or business."

Clark claimed he should not owe self-employment tax for 2019 on income from freelance movie reviews and eBay sales of movie memorabilia, arguing the IRS had "conceded" the issue because:

1) The Social Security Administration (SSA) sent a letter showing $0 in self-employment income; and
2) The IRS issued a refund in 2023.

The Tax Court rejected this argument, citing a similar case, *Ashford v. Commissioner*, in which a taxpayer made the same claim. In both cases:

1) The SSA letter merely reflected a temporary status change, not a final tax determination;
2) The refund was procedural, issued to adjust the taxpayer's IRS account during pending litigation, not an admission of no liability; and
3) The taxpayer acknowledged the receipt of income, and it was classified as nonemployee compensation, which is subject to self-employment tax under §1401.

Receiving a refund or an SSA letter showing $0 income does not mean the IRS has waived or conceded tax liability; rather, the taxpayer is still responsible for self-employment tax if the income meets the criteria.

Section 6662(a) imposes a 20% accuracy-related penalty on any portion of an underpayment of tax required to be shown on a return if, as provided by §6662(b)(2), the underpayment is attributable to any "substantial understatement of income tax." For purposes of §6662(b)(2), an understatement generally means the excess of the amount of tax required to be reported on the return over the amount shown on the return. An understatement is substantial in the case of an individual if the understatement for the taxable year exceeds the greater of 10% of the tax required to be shown on the return for that taxable year or $5,000.

In tax court, the Commissioner (IRS) must first meet the burden of production to impose an accuracy-related penalty under §6662. This means the IRS must provide sufficient evidence showing the penalty is appropriate. Under §7491(c), this includes proving that the procedural requirements of §6751(b) were followed, specifically, that the penalty was approved in writing by a supervisor, unless it was automatically calculated by the IRS system (in which case no approval is needed). Once the IRS meets this burden, the taxpayer (petitioner) then has the burden to prove the penalty is incorrect, using persuasive evidence.

The IRS met its burden of production by proving that the taxpayer's 2019 understatement of income tax was substantial, exceeding both 10% of the tax due and $5,000. The penalty was automatically calculated via the IRS's AUR program, so no written supervisory approval was required under §6751(b). A taxpayer can avoid the penalty by showing reasonable cause and good faith, based on their efforts to properly assess tax liability and possibly reliance on professional advice. Although Clark appeared sincere and lacked tax sophistication, his long business experience and failure to provide evidence of genuine reliance on tax advice meant he did not demonstrate reasonable cause. As a result, the accuracy-related penalty was sustained.

Conclusion:
Income from freelance work and selling goods online (e.g., via eBay and PayPal) qualifies as self-employment income. Reporting this income as "Other income" on the tax return does not shield it from self-employment tax. The issuance of a Form 1099-K from platforms like PayPal can prompt IRS review, especially if that income is not reported properly on Schedule C. An SSA notice adjusting self-employment earnings does not mean the IRS has conceded the income is not taxable. These adjustments can reflect administrative timing, not a legal tax position.

IRS refunds issued during ongoing litigation (e.g., due to reversed premature assessments) do not equate to concessions or agreements about a taxpayer's liability. Merely using a tax prep service like H&R Block is not sufficient to prove reliance on professional advice unless there is clear evidence of consultation or advice on the specific tax treatment at issue. Even if a taxpayer lacks formal tax training, having long-term experience running a business may undercut claims of honest misunderstanding, especially if they regularly face similar tax obligations (like estimated tax penalties).

3. Rosa M. Marcano v. Commissioner, (T.C. Summ. Op. 2024-26)

Facts:
On October 2, 2023, the IRS mailed to Marcano by certified mail a notice of deficiency for tax year 2021. Marcano did not dispute she was in the country when the notice was delivered, which according to the U.S. Postal Service, was October 5, 2023. From October 23, 2023, to October 30, 2023, Marcano was on a trip to Cabo San Lucas, Mexico, and from December 15, 2023, to January 28, 2024, she was on a trip to Bogota, Colombia. On January 17, 2024, 107 days after the mailing of the notice, the petition was filed. The petition is signed and dated January 10, 2024.

Issues and Analysis:
Under §6213(a), a taxpayer has 90 days to file a petition with the Tax Court after the IRS mails a notice of deficiency. This period excludes Saturdays, Sundays, and legal holidays in the District of Columbia. The 90-day period begins on the date the notice is mailed, and the filing must occur within this timeframe to confer jurisdiction on the Tax Court. If the petition is filed even one day late, the court lacks jurisdiction and must dismiss the case.

Section 6213(a) provides an extended 150-day period for taxpayers who are outside the United States when the notice of deficiency is mailed. This extension accounts for potential delays in mail delivery due to the taxpayer's absence. However, the 150-day rule only applies if the taxpayer's absence from the U.S. results in a delayed receipt of the notice. Merely being outside the U.S. does not automatically qualify a taxpayer for the extended period; there must be a demonstrable delay in receiving the notice.

The Tax Court has consistently held that the 150-day period does not apply if the taxpayer was in the U.S. when the notice was mailed and received, even if they were temporarily outside the country during part of the 90-day period. The Tax Court treats the 90-day and 150-day filing deadlines as jurisdictional requirements. This means that if a petition is not filed within the prescribed time, the court lacks the authority to hear the case and must dismiss it.

Marcano did not dispute that her petition was untimely under the 90-day period normally prescribed by §6213(a). Further, Marcano acknowledged that the 90-day period expired January 2, 2024, and that the petition was filed on January 17, 2024. However, Marcano argued that, because she was outside the United States for 24 days of the 90-day period, she was entitled to the longer 150-day period.

The Court found that the facts Marcano shared were not enough to entitle her to the 150-day period for filing the petition. Marcano was in the United States when the notice was mailed, in the United States when the notice was delivered, and in the United States for almost three weeks thereafter. In total, Marcano was in the United States at least 66 days of the 90-day period. The Court concluded that Marcano was ineligible for the 150-day period because her absence from the country neither delayed her receipt of the notice nor otherwise adversely affected her ability to file a timely Tax Court petition. The Court found they lacked jurisdiction under §6213(a) because the petition was not filed within the 90-day period.

Conclusion:
Taxpayers should ensure that their petition is filed within the 90-day or 150-day period, as applicable, to avoid dismissal for lack of jurisdiction. If claiming the 150-day period due to being outside the U.S., taxpayers must provide evidence that their absence resulted in a delayed receipt of the notice. The Tax Court does not have the discretion to extend these filing deadlines, even in cases of hardship or other extenuating circumstances. If a petition is dismissed due to untimely filing, taxpayers may still pay the disputed amount and file a claim for refund with the IRS. If the claim is denied or not acted upon within six months, they may file a suit for refund in the appropriate U.S. district court or the U.S. Court of Federal Claims.

4. Denham v. Commissioner, (T.C. Memo 2024-114)

Facts:
The petitioner in this case is the tax matters partner and state law general partner of Denham. Petitioner is a Delaware limited liability company and elected to be treated as a partnership for federal income tax purposes. Denham is organized as a limited partnership under Delaware law and offers investment advisory and management services to affiliated private equity funds that invest in the energy sector. Pursuant to investment advisory agreements between Denham and each fund, Denham was expected to furnish investment advice, negotiate terms of investments, monitor the health of the investments, and complete the day-to-day administrative tasks associated with managing the funds.

In addition to the petitioner, Denham had five limited partners during the years in issue ("The Partners"). The Partners functioned similarly to and were subject to the same general policies and procedures as Denham's employees. Denham's Fifth Amended and Restated Limited Partnership Agreement (LPA), effective May 1, 2014, governed the obligations and authority of Denham's partners for the years in issue. Under the LPA, petitioner, as general partner of Denham, had unlimited liability for Denham's debts. Partners had limited liability and could be held personally liable for the debts and obligations of Denham only to the extent, if any, of capital contributions they made to Denham.

The LPA vested all management authority exclusively in petitioner. Mr. Porter, one of the five limited partners, owned 100% of the equity of petitioner, but all of the Partners were voting members of petitioner throughout the years in issue. Denham's limited partners had authority to the extent petitioner delegated authority to them. On November 1, 2013, acting in his authority as managing member of petitioner, Mr. Porter authorized via written resolution to The Partners, along with Denham's chief financial officer, director of tax, general counsel, and associate general counsel, to negotiate and execute any type of agreement or document on petitioner's behalf. Denham's LPA also required that each partner, except for Mr. Porter, "devote substantially all of his or her business time and attention to the affairs of Denham and its affiliates."

The Partners' role with Denham was so fundamental to the firm's operation that investors had the right to withdraw their investments early if one or more of the Partners died, became disabled, or could no longer devote substantially all business time to the funds. Each fund's "key person" provision referred to Mr. Porter, but all five Partners were considered a key person by at least one of the funds active during the years in issue.

The CFO led Denham's finance team and handled financial reporting for Denham and its affiliates. Denham worked in conjunction with PwC to have its financial statements audited and to prepare Denham's Forms 1065. PwC's audit report described the Partners as "active limited partners," a term provided by Denham.

Petitioner made no guaranteed payments or distributions to the Partners in 2016 or 2017. In each of those years Denham made guaranteed payments and capital distributions to the Partners and petitioner. The guaranteed payments were intended to represent the Partners' salaries and included the value of a package of typical employment benefits. The distributions to the Partners were tied to their distributive shares of Denham's income and calculated on the basis of their profits interests. There was no guaranteed minimum for the Partners' distributive shares for the year, and they varied from year to year as they were tied to the profits of the firm.

When computing the Partners' Net Earnings from Self-Employment (NESE) for the years in issue, Denham included their guaranteed payments but excluded their distributive shares of Denham's ordinary business income. For tax years 2016 and 2017, the IRS issued Final Partnership Administrative Adjustment (FPAA) notices that increased Denham's NESE by more than $27.4 million and $22.9 million, respectively.

Issues and Analysis:
The Commissioner's determinations in an FPAA are generally presumed correct, though the taxpayer can rebut this presumption. To rebut the presumption, the taxpayer must:

- Provide factual evidence and supporting documentation that contradicts the IRS's position; or
- Offer legal arguments or interpretations that demonstrate the IRS's adjustment is inconsistent with tax law.

Under IRC §1402(a), Net Earnings from Self-Employment (NESE) generally includes:

- Gross income from any trade or business the individual personally carries on;
- (-) Deductions directly attributable to that trade or business; and
- (+) The individual's distributive share of income or loss under §702(a)(8) from any partnership in which the individual is a member (whether or not the income is actually distributed).

A key exception is the Limited Partner Exclusion. Section 1402(a)(13) excludes from NESE "the distributive share of any item of income or loss of a limited partner, as such, except for guaranteed payments made to that partner for services actually rendered. In other words, limited partners (in the traditional sense) generally do not owe self-employment tax on their distributive share of income, unless:

- They receive guaranteed payments for services; and
- Those payments are compensation-like.

The central issue in this case is whether the distributive share of income received by The Partners was subject to self-employment tax, or whether it qualified for the limited partner exclusion under §1402(a)(13).

Recently, *Soroban Capital Partners v. Commissioner* (161 T.C. No. 12) held "that the limited partner exception does not apply to a partner who is limited in name only" and that "Congress intended section 1402(a)(13) to apply to partners that are passive investors." Before Soroban, in *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011), the Court applied a functional analysis test to determine whether the lawyer-partners of a Kansas limited liability partnership were limited partners under §1402(a)(13). Such test typically evaluates whether a partner is functionally passive and excluded from SE tax under §1402(a)(13), or functionally active (i.e., rendering services, managing), and therefore included in NESE. Key criteria in functional analysis include the level of activity in the business, involvement in management or decision-making, whether income received is tied to services rendered, and capital invested vs. income received (investment return vs. compensation).

The Petitioner argued that The Partners were limited partners under state law, and thus, their income was not NESE. The Court disagreed, noting that Denham's income came from providing investment management services, and The Partners actively managed the firm, funds, and personnel. Further, The Partners were integral to operations, solicited capital, participated in investment and valuation committees, and made strategic and hiring decisions. There were no meaningful capital contributions (except one), yet the Partners received millions in distributions.

As a result, the Court found that The Partners were not passive investors; rather, they were actively engaged and materially participating as self-employed individuals. Therefore, the Court found that The Partners' income was not excluded from NESE.

Conclusion:
Merely being a “limited partner” by state designation is insufficient for §1402(a)(13). The economic relationship and duties of the partner control, not the label. Further, even if guaranteed payments are made, a partner’s larger profit shares (disguised compensation) may still be fully subject to SE tax.

II. Retirement

A. Section 401(k) limitations

1. Maximum elective deferral

The maximum amount of deferral in a §401(k) plan in 2025 is $23,500 (increased from $23,000 in 2024).

A qualified plan may now allow up to an $8,000 (2025, same as 2024) additional elective deferral to be made to the plan by a participant who attains the age of 50 before the end of the plan year.

The additional elective deferrals are generally not taken into account under the actual deferral percentage (ADP) or other limitations on such contributions. The applicable dollar amount increases in the cost of living at the same time and in the same manner as adjustments for annual benefits and additions, except that the base period taken into account is the calendar quarter beginning July 1, 2005, and any increase that is not a multiple of $500 is rounded to the next lower multiple of $500.

Planning point:

Elective deferrals remain an annual addition; however, the amount subject to the 25-percent-of-compensation limitation does not include them, but only the matching and any other nonelective employer contributions. Subject to any other limitations (such as the annual-additions limitation), an employee may defer 100 percent of current salary **and** the employer may deduct not only the amount so deferred by the employee, but also up to 25 percent of the total participant compensation for the year for other contributions.

2. Roth contribution programs

A §401(k) plan may permit an employee who makes elective contributions under a qualified cash or deferred arrangement to designate some or all of those contributions as **designated Roth contributions**. Although designated Roth contributions are elective contributions under a qualified cash or deferred arrangement, unlike pre-tax elective contributions, they are currently includible in gross income. However, a **qualified distribution of designated Roth contributions is excludable from gross income**.

B. Self-employed persons

Self-employed (unincorporated) individuals with no common-law employees provide a specific challenge. This group typically is looking to shelter some income but needs the flexibility to make varying contributions each year.

1. Simplified Employee Pension (SEP)

The SEP works quite well for most self-employed persons. The individual can contribute 20 percent of self-employment income (after reducing income by the deduction for 1/2 of the Social Security taxes paid). Contributions are **flexible**, the plan can be established with a simple document, and no annual reporting is required. The maximum contribution in 2025 is $70,000. As noted below, this has advantages over a profit-sharing plan in all instances where the self-employed has no other employees. But the allocation of contributions is not flexible and is pro rata with compensation levels (and no more than $350,000 in 2025 may be taken into account).[7]

As discussed, SECURE 2.0 implemented various changes to SEP plans, including:

- Allowing employers to offer employees the ability to treat employee and employer SEP contributions as Roth in whole or in part; and
- Permitting employers of domestic employees (such as nannies) to provide retirement benefits for such employees under a Simplified Employee Pension ("SEP").

Note:

> A SEP is another excellent choice for the employer looking for a plan that provides for discretionary contributions. The rules are as flexible as the profit-sharing plan. However, the employer also wanting to skew contributions toward the business owner will choose the cross-tested profit-sharing plan over the SEP.

2. SIMPLE

For self-employed persons with relatively small income, the SIMPLE can result in a larger contribution than a SEP. In 2025, an individual can defer up to $16,500 to the SIMPLE, and the employer is then **required** to make a matching contribution of 3 percent of compensation of a participating employee or an additional contribution (2-percent of compensation of all eligible employees). Eligibility is narrower than a SEP, using employees who make a certain amount in compensation over the immediate three years. The maximum total contribution to a SIMPLE is $33,000.[8]

Note:

> In contrast to a §401(k) plan, the SIMPLE is an easy way to give employees the opportunity to participate in a pre-tax salary-reduction plan, although there are required contributions by the employee. The IRS has provided model documents, participant election forms, and instructions. And, for most part, these documents even satisfy participant notification requirements. Other than determining the required contribution and monitoring the $16,500 deferral limit, the employer has little other responsibility. Unlike qualified plans, the service providers are required to prepare the summary plan description and provide benefit statements. No annual reporting is required and there are few rules to violate.

a. Employers with 100 or fewer employees that already sponsor §401(k) plans may not want to switch to SIMPLEs due to the tremendous flexibility that the §401(k) plan provides. The maximum salary deferrals are higher ($23,500 a year in 2025) and the employer can sponsor other plans in addition to the §401(k) plan. With a §401(k) plan, the eligibility, vesting, and contributions requirements are more flexible. The employer matching contribution can take various forms and be subject to a vesting schedule. Employer profit-sharing contributions are discretionary, and allocations can be skewed to the highly compensated through Social Security integration or cross-testing. Another important §401(k) feature is the ability to allow participant loans, giving participants access to their savings without income tax consequences.

b. If a business owner is looking for a plan that allows contributions for the owner in excess of $33,000, the SIMPLE is generally not the right plan. With other defined-contribution type plans -- or combination of plans -- the business owner can often have total

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7 Notice 2024-80.
8 Notice 2024-80.

contributions of $70,000[9] for the year in 2025. However, the higher contribution amount will have a cost -- both in terms of contributions for employees and the cost of administering the more complicated plans. If the owner's spouse is providing services to the company, the owner could leave the spouse off the payroll, because of the additional income increased taxable income and increased payroll taxes. However, with a SIMPLE, adding the spouse to the payroll is a way to get more money into the SIMPLE, for the cost of only payroll taxes.

c. Since the SIMPLE salary deferral and matching contribution are not subject to either the 25-percent deduction limits or the §415 allocation limits that apply to other plans, an individual with low earnings can actually make larger deductible contributions to the SIMPLE than other plans. This might be helpful to a second wage-earner in a family that can afford to contribute significant amounts to a retirement plan. It can also be helpful for an individual that has self-employment income in addition to employment income. However, for this second type of individual, there are several possible traps. First, income earned from personal services could be aggregated with the individual's employer under the controlled group or affiliated service group rules. Second, remember that if an individual sponsoring the SIMPLE is also a participant in a §401(k) plan, §403(b) plan, SARSEP or SIMPLE of another employer, total salary deferrals for a calendar year cannot exceed $23,500 in 2025.[10]

As discussed, SECURE 2.0 implemented various changes to SIMPLE plans, including:

- Allowing SIMPLE IRAs to accept Roth contributions;
- Allowing an employer to make matching contributions under a SIMPLE IRA with respect to "qualified student loan payments";
- Permitting an employer to make additional contributions to each employee of the plan in a uniform manner, provided that the contribution does not exceed the lesser of up to 10 percent of compensation or $5,000 (as indexed for inflation), effective for taxable years beginning after December 31, 2024;
- Increasing the annual deferral limit and the catch-up contribution at age 50 by 10 percent for employers with no more than 25 employees; and
- Permitting employers with 26 to 100 employees to provide higher deferral limits, but only if the employer either provides a four percent matching contribution or a three percent employer contribution.

3. Profit-sharing

The profit-sharing plan is the most common form of defined-contribution plan. The other types of defined-contribution plans are simply a variation of a profit-sharing plan combined with features of a pension plan. A profit-sharing plan is a type of defined-contribution plan. A defined-contribution plan is one in which individual accounts for each participant are maintained. The account balance at any time measures the participant's accrued benefit. At any time, the participant is entitled to the product of the participant's account balance and vested percentage.

a. The profit-sharing plan is another alternative that provides the same contribution opportunity. The profit-sharing plan for the sole proprietor is generally not very

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9 I.R.C. §415 provides that contributions to all qualified plans that are defined-contribution plans, as well as contributions to SEPs, cannot exceed the lesser of $69,000 (inflation adjusted) or 25 percent of compensation for the year.

10 As a result of the amendment to I.R.C. §457(c) by the Economic Growth and Tax Relief Reconciliation Act of 2001, an employee is able to exceed such an elective deferral limitation if a §457 plan is combined with another plan that permits elective deferrals, such as a §401(k) plan.

complicated, since the plan's service provider may supply a prototype document at no or little cost. Also, a plan that only covers an owner (and the owner's spouse) that has less than $250,000 in assets is not required to file IRS Form 5500. In most cases; however, the SEP seems more appropriate, since no reports are ever required, and IRA assets can be withdrawn or rolled over more easily. The profit-sharing plan does allow investments in life insurance, and if the sole proprietor expects to have employees in the near future, the sole proprietor may prefer the qualified plan eligibility and vesting provisions. The maximum annual addition to an individual's account balance is $70,000 in 2025.

b. The profit-sharing plan is incredibly versatile. Contributions are completely discretionary (unless the plan is drafted to require employer contributions), and, if contributions are made, can be allocated in ways favorable to the business owner (see discussion of cross-tested allocations). There are several limitations to the discretionary contribution rule.

   (i) If there is a "complete discontinuance" of contributions, the plan is deemed to be terminated and participants become 100-percent vested in their benefits. As a rule of thumb, if an employer makes no contributions for more than two years, the plan could be considered terminated.

   (ii) Except for "complete discontinuance" issues, profit-sharing plans (even top-heavy plans) can skip contributions entirely for a year. Remember that under the top-heavy minimum-contribution requirement, no contributions have to be made for non-key employees if no employer contributions are made on behalf of key employees.

4. Section 401(k) plans

Note:

> Employees have often wanted to be able to add to their retirement by making contributions to qualified retirement plans. In the past, this was done through thrift plans by which the employee made contributions to an employer-sponsored plan. The disadvantage of such arrangements was that the contributions from the employee were after-tax. In other words, the employee had federal income and employment taxes withheld from their salary in respect of such contributions. While the employees enjoyed tax-deferred accumulation of earnings in the thrift plan, they did not enjoy the tax leverage on their contributions as the employer did on its deductible contributions.
>
> Section 401(k) permits contributions to come not only from bonuses and other additions to normal salary, but also from the normal salary itself by the affirmative election by the employee to reduce that salary by the amount the employee wanted contributed to the plan on the employee's behalf. This suits employers quite well, as in many cases it eliminates the need for the employer to come up with additional funds above the normal salary levels.
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> In order to reduce salary without the employee being in constructive receipt, it is necessary for the employee to sign a salary-reduction agreement, in advance of earning that salary, by which the employee's normal salary is reduced in the payroll system to reflect the amounts that are put in the plan. The employee has a choice between current cash and deferred payments, and this system is referred to as a cash or deferred arrangement (CODA).
>
> While the qualified salary reduction agreement is sufficient to eliminate the amount from wages for income-tax purposes -- it is not reported as such on the employee's W-2 -- the amounts remain wages for employment-tax purposes and are reported as such on the employee's W-2. This is an exception to the rules discussed earlier for profit-sharing and other qualified plans. However, such reductions to a self-employed person's draw are **not reflected in earnings from self-employment** and thus do not escape employment tax.

Because of the inclusion of elective deferrals in wages for Social Security tax purposes, it would appear that one cannot avoid the .9 percent tax on excess earnings in 2025 and later years by salary reduction.

Only a profit-sharing, stock bonus, pre-ERISA money purchase pension, or rural cooperative plan can include a cash or deferred arrangement (§401(k) arrangement) and be a qualified plan. A cash or deferred arrangement is part of a plan for these purposes if any contributions to the plan, or accruals or other benefits under the plan, are made or provided pursuant to the cash or deferred arrangement.[11]

A cash or deferred election can only be made with respect to an amount that is **not currently available** to the employee on the date of the election. Further, a cash or deferred election can only be made with respect to amounts that would (but for the cash or deferred election) become currently available after the later of the date on which the employer adopts the cash or deferred arrangement or the date on which the arrangement first becomes effective.[12]

In general, elective contributions under a qualified cash or deferred arrangement (including designated Roth contributions) are treated as employer contributions. Thus, for example, elective contributions under such an arrangement are treated as employer contributions for purposes of §401(a) (qualification requirements), §401(k) (special requirements), §402 (contributions), §404 (deductions), §411 (minimum vesting), §415 (limitations on contributions and benefits), §416 (top-heavy rules), and §417 (minimum survivor benefits).[13]

Note:

> Such a characterization would suggest that the elective contributions made to the plan would be treated as employer contributions to a defined contribution retirement plan that would be subject to the limitation on tax benefits, if enacted.

Generally, a partnership or sole proprietorship is permitted to maintain a cash or deferred arrangement, and individual partners or owners are permitted to make cash or deferred elections with respect to compensation attributable to services rendered to the entity, under the same rules that apply to other cash or deferred arrangements. For example, any contributions made on behalf of an individual partner or owner pursuant to a cash or deferred arrangement of a partnership or sole proprietorship are elective contributions unless they are designated or treated as after-tax employee contributions. In the case of a partnership, a cash or deferred arrangement includes any arrangement that directly or indirectly permits individual partners to vary the amount of contributions made on their behalf.

In the most common type of CODA, **a salary-reduction arrangement**, the participant is given the option of having wages reduced in return for having an employer contribution made to the plan.[14]

Elective deferrals increase to the applicable amount.

In the case of taxable years beginning after December 31, 2006, the $15,000 applicable dollar amount is indexed for inflation based on July 1, 2005 indexes, rounded to the next lower multiple of $500 (currently $23,500 in 2025).

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11 Treas. Regs. §1.401(k)-1(a)(1).
12 Treas. Regs. §1.401(k)-1(a)(3)(iii)(A).
13 Treas. Regs. §1.401(k)-1(a)(4)(ii).
14 Treas. Regs. §1.401(k)-1(a)(3)(i).

A qualified plan may now allow additional elective deferrals to be made to the plan by a participant who attains the age of 50 before the end of the plan year.

The additional elective deferrals are not taken into account under the ADP or other limitations on such contributions. The applicable dollar amount increases in the cost-of-living at the same time and in the same manner as adjustments for annual benefits and additions, except that the base period taken into account is the calendar quarter beginning July 1, 2005, and any increase that is not a multiple of $500 is rounded to the next lower multiple of $500. It is currently $8,000.

The limitation on the total contributions to a §401(k) account for an individual is at $70,000 in 2025, so employer contributions can be used to enhance the contribution above the limitation on elective deferrals noted above. However, such employer contributions are subject to different nondiscrimination rules; there is no ADP test to give leeway from a compensation proportionate contribution standard.

Note:

The problem areas in §401(k) plans are two-fold. First, a cash or deferred arrangement satisfies the coverage and nondiscrimination requirement for a plan year only if: (i) the group of eligible employees under the cash or deferred arrangement satisfies the requirements of §410(b) (including the average benefit percentage test, if applicable);[15] and (ii) the cash or deferred arrangement satisfies either the ADP test, the ADP safe harbor, or the SIMPLE §401(k) provision.[16] These provisions deal with (i) coverage and (ii) nondiscrimination in funding. Coverage simply means that an adequate number of employees, regardless of the level of contributions made, are participants -- i.e., contributing something -- to the plan. The nondiscrimination in funding requirement compares the level of elective contributions as a percentage of compensation by the class of non-highly compensated employees with that of the highly-compensated to make sure that the latter does not vary greatly from the former. Strict equality is not required, but this is certainly an area where employers have had trouble because (a) employees have not participated, or (b) their participation is at such low levels that higher-compensated individuals have an elective deferral limitation that is less, often much less, than what they may have wanted. Alternatives include (a) automatically entering employees into the plan at a specified level of salary reduction unless the employee affirmatively opts out, and (b) sweetening the pot with employer matching contributions, which may defeat the employer's purpose of limiting cash outlays (other than those that otherwise would have paid any way in salary).

5. Solo §401(k) plans

Because §401(k) plans are generally profit-sharing plans, the same objections raised against the profit-sharing plan in favor of a SEP generally apply. However, in the case of a true sole proprietor (or one whose only employee is a spouse), the low-cost, flexible SEP may have to give way in favor of a **solo §401(k) plan** at certain levels of Schedule C income.

Note:

A §401(k) plan can be designed primarily to allow for employee pre-tax salary deferrals. The plan can then allow for discretionary profit-sharing contributions or even discretionary employer-matching contributions. A discretionary match may not encourage employee salary deferrals, which is the normal reason to have the match. One caution, however: an employer will be required to contribute 3 percent of compensation for non-key employees if the plan is top-heavy and any key employee makes a 3-percent-of-compensation salary deferral.

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15 Treas. Regs. §1.401(k)-1(b)(1)(i).
16 Treas. Regs. §1.401(k)-1(b)(1)(ii).

a. One advantage of the SEP was generally the low installation costs and nondiscrimination rules that are minimal in cases where there are several employees. But in a solo operation, nondiscrimination is not an issue, as there are no other employees against which to measure disparities of treatment.

b. The proprietor with other employees in a §401(k) plan must bridle any instinct to make the maximum elective deferral of $23,500 in 2025, since ADP testing might preclude this and limit the amount of the elective deferral in accordance with the rules discussed. Again, this is not a concern in a case where there is a single participant in the plan.

c. Yet, for one major reason solo §401(k) plans have gained traction in the last couple of years, the availability of elective deferrals in such plans, a feature not now generally available in a SEP, and only available in a SIMPLE to a much lesser extent. This presents an opportunity for the proprietor who wants to maximize his contributions advantageously for some Schedule C proprietors.

    (i) In either case, the maximum annual addition to the participant's account in the plan is $70,000 in 2025. But how the owner gets there is very different.

    (ii) The SEP is a straight profit-sharing plan that limits employer contributions to 25 percent of the proprietor's earned income (20 percent of self-employment income before taking into account the contribution itself).

    (iii) By contrast, the proprietor in a §401(k) plan may first make an "employee" contribution by an elective deferral of up to $23,500 in 2025. At low levels of self-employment income this could generate a high ADP. But because there are no other employees, this will not be a problem. Thus, the proprietor now only has to fund $47,000 by an employer contribution, and it is only the employer contribution that is limited by the 25 percent of earned income rule applicable to defined contribution plans.

    (iv) At some point, the additional cost of having a document prepared for a §401(k) plan and making annual reports may overweigh the additional available contribution.

d. The solo §401(k) also works well when the proprietor has the spouse as the sole common-law employee. The spouse is treated as a highly-compensated employee regardless of the level of compensation actually paid by reason of the relationship to the proprietor as a highly compensated employee.

Note:

> The economics tilt toward the solo §401(k) because of the availability of an up-front contribution that is largely independent of self-employment income or compensation paid.[17] This gives the plan a head start on contributions compared to the simpler and less expensive SEP.

6. Money-purchase pension plan

A money-purchase pension plan must specify a fixed annual contribution by the employer. The contribution must be definitely determinable and cannot be ambiguous in any way.[18] Any contribution formula must meet the nondiscrimination rules. These rules provide design safe harbors and several general tests, whereby the plan can demonstrate nondiscrimination by performing an annual mathematical test. Note that compensation must be capped, for purposes of determining the applicable contribution, to $350,000 (as indexed in 2025). The most common contribution formula is a level

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17 The elective deferral cannot exceed the self-employment income or compensation.

18 Rev. Rul. 73-379, 1973-3 C.B. 124.

percentage (up to 25 percent) of compensation for all participants. This formula satisfies a design safe harbor (meaning that no nondiscrimination testing must be performed) if: (i) the plan has a single uniform formula for all participants; and (ii) the plan has a uniform normal retirement age and vesting schedule applicable to all employees.[19]

For the sole proprietor, the money-purchase plan had been used as a supplement; because today's annual additions and deduction limitations are the same, its major use is not a tax one; the required contributions to the money-purchase plan may provide greater certainty to employees than a profit-sharing plan. The maximum contribution is $70,000. For the self-employed individual with no employees, it produces the same bottom line result as a profit-sharing plan, but because of the obligation to make a fixed level of contribution, lacks the degree of flexibility of a profit-sharing plan.

7. Defined-benefit plan

In a defined-benefit plan, the employer promises to provide a benefit, which is generally expressed as an amount payable as a **single life annuity** beginning at a stated **normal retirement age**. In order to fulfill this obligation, the employer must not only make sufficient contributions to fully fund all obligations under the plan, as determined by an actuary, but also make payments in the future. The actuary will adjust the contribution levels in accordance with the mix of life expectancies and remaining time to retirement with respect to each obligation as well as the actual investment experience of the fund. **Each year**, the actuary must take a new plan census and determine the projected benefit at retirement for each participant based on the participant's current and projected salary, and the time left to complete funding, i.e., at the projected retirement. In determining the amount the employer must contribute each year, the actuary takes into account the actual investment and mortality experience of the fund in light of its obligations.

Note:

> The employer's annual contribution to the plan is the amount that is actuarially estimated to be required to fund expected plan benefit liabilities. ERISA generally requires that a defined benefit plan's assets be valued at least annually, and that at that time, there be a new determination of the plan's experience gains and losses and, hence, of the plan's total liability. This illustrates the greatest impediment to these plans: significant overhead in plan administration and the necessity of a trained professional actuary to determine the status of the plan's funding each year.

In a defined-benefit plan, the promise to make contributions is not to any one participant's account (there are none), but to actuarially create a separate fund that will be sufficient to pay fixed benefits at retirement of each participant. This requires an actuary to determine, based on mortality and presumed investment assumptions, the amount required to be set aside to meet the particular benefits of the plan's particular participants.

The employer is liable for the payment of the promised benefit without regard to the investment experience of the fund. This has two corollaries:

a. If the fund has investment experience less favorable than the initial assumptions, the amount of future contributions will have to be increased over any original projected contribution scales; and
b. If the fund has investment experience more favorable than the initial assumptions, the amount of future contributions will have to be decreased over any original projected contribution scales.

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19 Treas. Regs. §1.401(a)(4)-2.

Planning point:

> The contribution level may fluctuate each year based on the performance of the plan's assets, a factor that is somewhat outside of the control of the plan sponsor. Since the sponsor is required to make contributions to satisfy the minimum-funding requirements, only the most stable plan sponsors will be able to sponsor defined-benefit plans. Cash flow is not predictable because it depends on investment performance as well as mortality of the employee group, both of which can vary wildly from the actuarial assumptions used in the plan.

Defined-benefit plans have been disappearing over the past 15 years from most small businesses because of the high overhead in maintaining them and the difficulty in communicating its features to employees. Costs cannot be projected and controlled without the aid of the arcane ways of the actuary. This may be particularly important to employers with cash-flow concerns.

a. Another difficulty lies in the mandatory nature of pension contributions because the contributions cannot be easily determined and can change rapidly depending on changes in current market rates. Employers with **steady, dependable cash flow** are the only ones who should venture into this area. Contributions to a defined-benefit plan must be made, without regard to the employer's financial condition, subject to obtaining a funding waiver from the government.

b. In a defined-benefit plan, the employee benefits from the certainty of a specified benefit. The employer is responsible to make contributions necessary to fund promised benefits. If the plan's investment experience exceeds the actuarial assumptions, the employer's required contributions will be lowered. Similarly, if investment experience is inferior, contributions will increase.

Planning point:

> Assuming the small business has at least two employees, a defined-benefit plan can generally maximize income for older owner-employees and provide maximum tax shelter for the employer as discussed below in connection with the deduction available. They are unique in being able to take into consideration service that predates the adoption of the plan.

A defined-benefit plan could turn into a tax shelter if limitations are not placed on the amount of benefit that can be defined at retirement. This limit applies to the annual benefit payable beginning at the Social Security retirement age. A defined-benefit plan may not provide an annual benefit greater than the lesser of 100 percent of the average of the employee's compensation in the employee's three highest-paid years (the "percentage limit") or $280,000 in 2025 (the "dollar limit").

a. The highest three years is the period specified in the plan of consecutive calendar years (not in excess of three) during which the employee was both a participant and had the greatest aggregate compensation.[20]

b. The dollar limit must be actuarially increased for participants who work beyond the normal retirement age, since benefits continue to accrue.[21]

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20 I.R.C. §415(e)(3).

21 I.R.C. §415(b)(2)(D).

Planning point:

> Funding levels to the extent attributable to individual participants are functions of age/mortality, years to normal retirement age, and interest (return) rate assumptions. In all cases, an older person at a given salary level will require more annual funding than a younger employee at the same compensation. An individual at a given age with high compensation will require more funding than another employee at the same age, but with a lower salary. Together, an older employee with a high wage will require considerably more funding than a younger employee with a lower compensation base. Thus, in many defined benefit plans, the cost for other employees may be very small compared to that of the principal of the company, and certainly the percentage of annual contributions to the plan for a lower-salaried employee would be far less than that based on compensation.
>
> For maximum reduction in income (given a tax rate rise), reduction in AGI (given the 3.8 percent tax), reduction in wages subject to Social Security (given the .9 percent tax on excess earnings), and its apparent favored status as a deduction (given the potential application of tax savings limitations on certain deductions and some exclusions), the defined benefit plan is hard to beat. However, taxpayers could also consider the **cross-tested profit-sharing** plan discussed above which also can create a disproportionality of contribution level (but apparently without the benefit of not being subject to the limitation on tax benefits).

There is no rule prohibiting a self-employed person from establishing a defined-benefit plan. In some ways, the self-employed person is a good candidate because there will be no benefit costs for other employees. However, due to the additional administrative expense, few self-employed persons have been interested in a defined-benefit plan.

Note:

> The greatest impediment to the defined benefit plan is the loss of flexibility with respect to contributions and its counter-intuitive requirement that as the performance of the investments in the plan declines, the level of required contributions goes up. At a time when the lower investment prices may show a problem in the economy -- when a business might want to be most protective of its flexibility with respect to cash -- the mandatory contribution rules may prove a major problem.

The reason to consider a defined-benefit plan is if the self-employed person is either looking for a deductible contribution in excess of $70,000 or a contribution in excess of 25 percent of compensation. A consultation with an actuary is needed to determine if it is possible to meet one of these objectives. It is more likely that this goal can be met for an individual over age 45. Given the additional tax that applies either to excess earnings or investment income when AGI exceeds $250,000, the most dramatic way of reducing AGI -- assuming it does not conflict with the client's economic needs and lifestyle -- is to shift income from current earnings to deferred compensation. Given the current interest rate environment, the discount factors will be so small that substantial contributions will be actuarially required annually in order to fully fund a maximum benefit of an individual in his or her 50s; advisors need to determine from an actuary these current levels.

Sale of Passthrough Entity Interest and Net Investment Income Tax

Sale of Passthrough Entity Interest and Net Investment Income Tax

Learning objective

Upon reviewing this material, the reader will be able to understand the effects of the sale of a passthrough entity's interest on Net Investment Income Tax.

I. Background

Enacted by the Healthcare and Education Reconciliation Act of 2010 and applying to tax years beginning in 2013, §1411(a)(1) imposes on individuals the Net Investment Income Tax (NIIT) of 3.8%, a tax in addition to income tax, for the lesser of:

- The individual's **net investment income** for a taxable year; or
- The excess, if any, of the individual's
  - **Modified adjusted gross income** for such taxable year, over
  - The **threshold amount**.

Section 1411(c) refers to Net Investment Income (NII) as any excess of net investment income over net investment deductions, with **investment income** being:

(i) Gross income of interest, dividends, annuities, royalties, and rent not derived from the ordinary course of business;

(ii) Gross income derived from a trade or business that is either: (1) a passive activity within the meaning of §469 or (2) a financial instruments/commodities trading business under §475(e)(2); AND

(iii) The net gain (to the extent accounted for in computing taxable income) attributable to the disposition of property described in (ii).

Practice note: Common investment expenses deductible in computing NII

Examples of properly allocable deductions include investment interest expense, investment advisory and brokerage fees, expenses related to rental and royalty income, and state and local income taxes properly allocable to items included in NII.

The **threshold amount** is defined under §1411(b) as the following:

- $250,000 for MFJ, Surviving Spouse;
- $125,000 for MFS; or
- $200,000 for other individuals.

Note: Line and code references apply to 2024 forms

Within this manual, references to line numbers of forms, including Form 8960 are made. All references apply to the 2024 final version of the respective forms.

The IRS generally releases an early draft version of forms in the late summer of each year. The final versions of tax forms are generally released in December or early January.

Practice point: Not Inflation Adjusted

The threshold amounts of §1411(b) are not indexed for inflation.

The **Modified Adjusted Gross Income (MAGI)** is outlined under §1411(d) as adjusted gross income (AGI) increased by the excess of: (1) the foreign earned income exclusion under §911(a)(1) over (2) deductions/exclusions disallowed by the double-benefit prohibitions of §911(d)(6) with the amount of foreign earned income excluded.

Taxpayers subject to the NIIT must determine their tax by completing Form 8960, *Net Investment Income Tax—Individuals, Estates, and Trusts*.

Example 1: Rachel Green is a single taxpayer with wages of $180,000 and $15,000 of dividends and capital gains.

Rachel's modified adjusted gross income is $195,000, which is less than the $200,000 statutory threshold. She is not subject to the Net Investment Income Tax.

Example 2: Fox Mulder is a single taxpayer with wages of $180,000 and $90,000 of passive partnership interest, which is considered Net Investment Income.

Fox's modified adjusted gross income is $270,000, which exceeds the threshold of $200,000 for single taxpayers by $70,000.

Fox's Net Investment Income is $90,000; however, the Net Investment Income Tax is based on the lesser of $70,000 (the amount modified adjusted gross income exceeds the $200,000 threshold) or $90,000 (Net Investment Income).

Fox owes NIIT of $2,660 ($70,000 x 3.8 percent).

Example 3: Homer and Marge are married and file a joint return. For the current year they report AGI of $300,000 consisting of the following: $175,000 in wages, jointly owned interest and dividend income of $12,500 each ($25,000 total), and $100,000 in long-term capital gains.

Within their portfolio account, Homer and Marge pay interest of $4,000 on debt incurred to purchase stock. This interest is allocable to the stock and is investment interest. They also pay their broker $8,000 in investment advisory fees. (Note: these are excluded from Schedule A due to the suspension of miscellaneous itemized deductions).

Since Homer and Marge's modified adjusted gross income exceeds the threshold of $250,000 (married filing jointly) by $50,000, they must complete Form 8960.

Homer and Marge's Net Investment Income is $121,000; however, the NII Tax is based on the lesser of $50,000 (the amount modified adjusted gross income exceeds the $250,000 threshold) or $121,000 (Net Investment Income).
Homer and Marge owe NIIT of $1,900 ($50,000 x 3.8 percent).

Any Net Investment Income Tax calculated on Form 8960 is transferred as an Additional Tax on Schedule 2 (Form 1040), Line 12.

Form **8960** | Department of the Treasury Internal Revenue Service

Net Investment Income Tax— Individuals, Estates, and Trusts

Attach to your tax return.

Go to *www.irs.gov/Form8960* for instructions and the latest information.

OMB No. 1545-2227 | **2024** | Attachment Sequence No. **72**

Name(s) shown on your tax return: HOMER AND MARGE | **Your social security number or EIN**

Part I Investment Income

☐ Section 6013(g) election (see instructions)
☐ Section 6013(h) election (see instructions)
☐ Regulations section 1.1411-10(g) election (see instructions)

1	Taxable interest (see instructions)			1	12,500
2	Ordinary dividends (see instructions)			2	12,500
3	Annuities (see instructions)			3	
4a	Rental real estate, royalties, partnerships, S corporations, trusts, trades or businesses, etc. (see instructions)	4a			
b	Adjustment for net income or loss derived in the ordinary course of a non-section 1411 trade or business (see instructions)	4b			
c	Combine lines 4a and 4b			4c	
5a	Net gain or loss from disposition of property (see instructions)	5a	100,000		
b	Net gain or loss from disposition of property that is not subject to net investment income tax (see instructions)	5b			
c	Adjustment from disposition of partnership interest or S corporation stock (see instructions)	5c			
d	Combine lines 5a through 5c			5d	100,000
6	Adjustments to investment income for certain CFCs and PFICs (see instructions)			6	
7	Other modifications to investment income (see instructions)			7	
8	Total investment income. Combine lines 1, 2, 3, 4c, 5d, 6, and 7			8	125,000

Part II Investment Expenses Allocable to Investment Income and Modifications

9a	Investment interest expenses (see instructions)	9a	4,000		
b	State, local, and foreign income tax (see instructions)	9b			
c	Miscellaneous investment expenses (see instructions)	9c			
d	Add lines 9a, 9b, and 9c			9d	4,000
10	Additional modifications (see instructions)			10	
11	Total deductions and modifications. Add lines 9d and 10			11	4,000

Part III Tax Computation

12	Net investment income. Subtract Part II, line 11, from Part I, line 8. Individuals, complete lines 13–17. Estates and trusts, complete lines 18a–21. If zero or less, enter -0-			12	121,000
	Individuals:				
13	Modified adjusted gross income (see instructions)	13	300,000		
14	Threshold based on filing status (see instructions)	14	250,000		
15	Subtract line 14 from line 13. If zero or less, enter -0-	15	50,000		
16	Enter the smaller of line 12 or line 15			16	50,000
17	Net investment income tax for individuals. Multiply line 16 by 3.8% (0.038). **Enter here and include on your tax return** (see instructions)			17	1,900
	Estates and Trusts:				
18a	Net investment income (line 12 above)	18a			
b	Deductions for distributions of net investment income and charitable deductions (see instructions)	18b			
c	Undistributed net investment income. Subtract line 18b from line 18a (see instructions). If zero or less, enter -0-	18c			
19a	Adjusted gross income (see instructions)	19a			
b	Highest tax bracket for estates and trusts for the year (see instructions)	19b			
c	Subtract line 19b from line 19a. If zero or less, enter -0-	19c			
20	Enter the smaller of line 18c or line 19c			20	
21	Net investment income tax for estates and trusts. Multiply line 20 by 3.8% (0.038). **Enter here and include on your tax return** (see instructions)			21	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 59474M Form **8960** (2024)

II. NIIT Excepted dispositions under §1411(c)(4)

The purpose of §1411(c)(4) is to allow gain attributable to non-passive activities to be excluded from the calculation of §1411 tax upon the disposition of an interest in a Passthrough Entity ("PTE"). For a §1411(c)(4) disposition, the gain from the sale of the interest is includible in NII to the extent that: (1) if the PTE's individual assets were sold at FMV and (2) such allocable share of the gain/loss would be includible in the partner/shareholder's NII. Thus, these gains are includible to the extent they are derived from PTEs treated as a passive activity under §469 or are a financial instruments/commodities trading business under §475(e)(2).

A §1411(c)(4) disposition is the disposition of an interest in a Passthrough Entity (either partnership or S corp; "PTE") by an individual, estate, or trust if:

- PTE is engaged in one or more trades or businesses, or owns an interest (directly or indirectly) in another PTE that is engaged in one or more trades or businesses, other than the business of trading in financial instruments or commodities (within the meaning of §1.1411-5(a)(2); §475(e)(2)); and
- One or more of the trades or businesses of the PTE is not a passive activity (within the meaning of §1.1411-5(a)(1); §469) of the transferor.[1]

For PTEs disposing of an interest in a subsidiary PTE, that disposition qualifies for an NIIT exception with respect to a partner/shareholder of the PTE if the partner/shareholder would satisfy §1411(c)(4) disposition requirements having held the subsidiary PTE interest directly (i.e., the subsidiary PTE conducts at least one trade or business AND the trade or business is not a passive activity). Thus, the partner/shareholder shall be treated as owning a proportionate share of any subsidiary PTE which is held indirectly through one or more tiers of PTEs (i.e., a look through rule). [2]

A. Special rules

If part of a single liquidation plan, a PTE's assets are disposed in a fully taxable transaction followed by a complete liquidation of the PTE, the disposition will be treated as a single asset sale subject to NIIT if a passive activity, with no additional gain or loss subject to NIIT on the subsequent liquidation of the PTE. [3]

In the case of S corporation shareholders, should a disposition of S corporation stock terminate the S election, the corporation will continue to be treated as an S corporation for purposes of determining whether or not a stock disposition will be treated as an excepted disposition under §1411(c)(4). [4]

Further, an S corporation's allocation of built-in gains ("BIG") tax under §1374 does not impact the gain determined for NIIT purposes. [5]

1 *Prop. Reg. §1.1411-7(a)(3)(i).*
2 *Prop. Reg. §1.1411-7(a)(3)(ii).*
3 *Prop. Reg. §1.1411-7(a)(4)(i).*
4 *Prop. Reg. §1.1411-7(a)(4)(iii)(A).*
5 *Prop. Reg. §1.1411-7(a)(4)(iii)(C).*

B. Section 469 passive activities

Section 469 restricts certain taxpayers' use of deductions and credits derived from passive activities. Passive activities exist (§469(c)) in the following scenarios:

- Businesses in which the taxpayer does not **materially participate** (includes activities on Schedules C or F and from partnerships, LLCs, and S Corporations); AND
- All rentals, including real estate and equipment leasing.

Generally, **all rental activity**[6] is treated as a passive activity, regardless of whether the individual materially participates.[7] As it relates to loss limitations, there are exceptions for those with "active participation" or individuals meeting an exception as a "real estate professional".

Though all rentals are categorically passive, an activity is not a "rental activity" for a taxable year if any of the following six conditions exist:[8]

1. The average period of customer use is seven days or less.[9]
2. The average period of customer use is 30 days or less and significant personal services are provided by or on behalf of the owner of the property in connection with making it available for customer use. What constitutes "significant personal services" is not clearly defined in the regulations and depends on all relevant facts and circumstances, including the frequency of services, the type and amount of labor required to provide services, and the value of the services relative to the amount charged for the use of the property.[10]
3. Extraordinary personal services are provided in connection with making the property available for use by customers. For services to be deemed extraordinary, the use of the property must be incidental to the receipt of the services. For example, student use of a school's dormitory facilities generally is incidental to receipt of the personal services provided by the school's teaching staff.[11]
4. The rental is incidental to a nonrental activity. Specifically, the application of this rule is limited to: (i) investment property (property held primarily to realize gain from appreciation); (ii) property used in a trade or business where the gross income from rentals is less than two percent of the lesser of the property's unadjusted basis or fair market value; and (iii) property used for employee lodging.[12]
5. The property is customarily made available during defined business hours for the nonexclusive use by various customers. For example, a golf course that is made available during prescribed hours for nonexclusive use by various customers would not be considered a rental activity.[13]
6. The property is self-rented. Specifically, if property is rented for use in an activity conducted by a partnership, S corporation, or joint venture in which the taxpayer-property-owner owns an interest, it is not a rental activity.[14]

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6 *I.R.C. §469(j)(8) defines this as an activity where the payments are principally for the use of tangible property.*

7 *I.R.C. §469(c)(2).*

8 *Temp. Regs. §1.469-1T(e)(3). However, the material participation standard does not apply to taxpayers engaged in rental real estate activities. A rental real estate activity is one involving the receipt of compensation for the use of realty and is characterized by low turnover among tenants, long lease terms, and the performance of insubstantial services by the lessor to the lessee. Consequently, operation of a hotel or a condominium hotel would not be a rental real estate activity, but operation of an apartment house should be.*

9 *Temp. Regs. §1.469-1T(e)(3)(ii)(A).*

10 *Temp. Regs. §1.469-1T(e)(3)(ii)(B).*

11 *Temp. Regs. §1.469-1T(e)(3)(ii)(C).*

12 *Temp. Regs. §1.469-1T(e)(3)(ii)(D).*

13 *Temp. Regs. §1.469-1T(e)(3)(ii)(E).*

14 *Temp. Regs. §1.469-1T(e)(3)(ii)(F).*

Note:

> However, a non-rental activity may nonetheless be passive if the property owner does not materially participate.

1. Activities and groups of activities

Since material participation is defined in terms of participation in an activity, the definition of what constitutes an activity is extremely important, as shown in the following simple example. Assume Mr. Cook owns 10 different real estate properties in 10 different Philadelphia suburbs, and he participates in the real estate properties for 800 hours per year, working an equal number of hours (80) in each property. Each property also has a full-time staff. If each property was defined as a separate activity, Mr. Cook would not materially participate in any of the real estate properties, since he would not reach the applicable requirement of more than 100 hours of participation (SPA test number four). **In contrast, if all 10 real estate properties constitute a single activity, Mr. Cook would satisfy the 500-hour test for material participation (test number one).**

One or more trades, businesses, or rental activities are treated as a single activity if the activities constitute an appropriate economic unit for the purposes of determining a gain or loss.[15] Generally, whether activities are treated as a single activity depends on all the relevant facts and circumstances.[16] Under proposed regulations, the taxpayer has great flexibility in determining what constitutes a single activity. The taxpayer may use any reasonable method of applying the relevant facts and circumstances in grouping activities. To treat more than one activity as a single activity the following factors, not all of which are necessary for such treatment, are given the greatest weight in determining whether activities constitute an appropriate economic unit:

- The extent of common control between the activities (for example, the extent to which the activities to purchase or sell goods are under common control);
- The extent of common ownership;
- Similarities in types of businesses;[17]
- Geographical location; and
- Interdependencies among themselves (i.e., involve products or services that are normally provided together, have the same customers, have the same employees, or are accounted for with a single set of books and records).

One of the criteria identified in aggregating activities is the extent to which the activities are commonly controlled. Based upon IRS guidance, two or more activities are considered commonly controlled if, under all facts and circumstances, separate activities are controlled by the same interests.[18] In general, control includes direct and indirect control, whether or not legally enforceable and however exercised. The determination is made on the basis of fact, not form. If there are no compelling arguments to the contrary, activities are presumed to be commonly controlled if they are part of the same common-ownership

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15 *Treas. Regs. §1.469-4(c)(1).*

16 *Treas. Regs. §1.469-4(c)(2).*

17 *There are two tests for similarity. First, two activities are similar if their predominant operations are in the same line of business. Predominance is present when more than 50 percent of an undertaking's gross income is attributable to a single line of business. Temp. Regs. §1.469-4T(f)(4)(ii). Operations are in the same line of business if they share the same Standard Industry Classification Code (SIC), as described in Rev. Proc. 89-38. In the case of real estate, every conceivable type of business related to real estate ownership, operation, management, or construction is treated as the same line of business. However, hotel management is generally treated as a separate line of business from other real estate businesses. The second test of similarity is the vertical-integration test. Two activities are treated as similar if one activity provides more than 50 percent of its property or services to another activity that is commonly controlled. That is, the activities are essentially vertically integrated. Temp. Regs. §1.469-4T(f)(4)(iii).*

18 *Temp. Regs. §1.469-4T(j)(1).*

group.[19] A common-ownership group exists when the common-ownership percentages of any five or fewer persons (other than passthrough entities such as partnerships or S corporations) exceed 50 percent. For purposes of this criterion, the common-ownership percentage of a person is the person's smallest ownership percentage in any such activity.[20] In determining a person's ownership percentage, direct as well as indirect ownership through passthrough entities such as partnerships and S corporations is counted.[21]

A few other principles exist regarding grouping of activities as listed below:

- A rental activity may not be grouped with a trade or business activity unless either the rental activity is insubstantial in relation to the trade or business activity or the trade or business is insubstantial in relation to the rental activity.[22] The meaning of the word "**insubstantial**" is undefined. Under prior IRS guidance, the ability to aggregate was determined by the so-called "80-20 rule," whereby the taxpayer had to treat all rental and business undertakings at a single location as a single activity if the gross income from either constituted more than 80 percent of the gross income.
- **Once the activities have been grouped by the taxpayer, the taxpayer may not regroup the activities** unless the original grouping was clearly inappropriate or if a material change occurs that makes the original grouping clearly inappropriate. When a taxpayer regroups activities, the taxpayer must comply with disclosure requirements as determined by the Commissioner.[23]
- A partnership or S corporation determines its activities as an entity, and once these activities are grouped, the partner or shareholder groups those activities with activities conducted directly by the partner and shareholder or activities conducted through other partnerships or S corporations in accordance with the foregoing rules.[24]

2. Material participation for business activities

Participation is broken down into distinct types:

- Material Participation relating business activities; AND
- Active Participation relating to rental activities.

Generally, a taxpayer will be treated as **materially participating in an activity** only **if the taxpayer is involved in the operations of the activity on a regular, continuous, and substantial basis**.[25] In general, taxpayers who own limited partnership interests will be treated as not materially participating in the activities of the partnership.[26] The regulations provide seven tests to determine material participation. An individual materially participates in a trade or business activity in any taxable year if any one of the following seven tests is met:

1. The individual participates in the activity for **more than 500 hours** during the taxable year;[27]

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19 *Temp. Regs. §1.469-4T(j)(2)(i).*
20 *Temp. Regs. §1.469-4T(j)(2)(ii).*
21 *Temp. Regs. §1.469-4T(j)(3).*
22 *Treas. Regs. §1.469-4(d)(1).*
23 *Treas. Regs. §1.469-4(e).*
24 *Treas. Regs. §1.469-4(d)(5)(i).*
25 *I.R.C. §469(h)(1).*
26 *Temp. Regs. §1.469-5T(e)(1). Such limited partners may be treated as materially participating only if they meet the 500-hour test, the material-participation-in-five-of-the-preceding-10-taxable-years test, or the material-participation-in-any-three-preceding-taxable-years test. Temp. Regs. §1.469-5T(e)(2).*
27 *Temp. Regs. §1.469-5T(a)(1).*

2. The individual's participation in the activity for the taxable year constitutes **substantially all of the participation** in such activity by all individuals (including nonowners) for that year;[28]
3. The individual participates in the activity for **more than 100 hours during the taxable year and such individual's participation is not less** than the participation in the activity of any other individual (including nonowners);[29]
4. The activity is a significant-participation activity (SPA -- defined below) and the individual's aggregate participation in all SPAs during the year exceeds 500 hours;[30]
5. The individual materially participated in the activity for any five taxable years during the 10 preceding taxable years;[31]
6. The activity is a personal-service activity (PSA) in which the individual materially participated during any three preceding taxable years;[32] or
7. The individual participates in the activity for at least 100 hours during the taxable year and on the basis of all facts and circumstances the participation is material.[33] This "facts-and-circumstances" test is limited to cases where: (i) no person other than the taxpayer in question is compensated for management services; and (ii) no other individual, whether or not an owner of the business, provides more hours of management service than the taxpayer.[34]

A **significant-participation activity (SPA)** is a trade or business activity in which the taxpayer participates from 100 to 500 hours during the taxable year, but in which the taxpayer does not materially participate. Taxpayers must be wary of passive activities that are classified as SPAs. SPAs are essentially a "heads the IRS wins, tails you lose" proposition. SPA losses are treated as passive losses, but SPA income is treated as nonpassive income. Therefore, SPA losses may not be used to shelter other nonpassive income or even other SPA income, and SPA income cannot be used to absorb other passive-activity losses or even other SPA losses.

A **personal-service activity (PSA)** is an activity that derives more than 50 percent of its gross income from the provision of services in the health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting professions. A taxpayer's interests in two or more personal-service activities controlled by the same interests are treated as the same activity. This rule applies even if the interests are in diverse professions, such as accounting and the performing arts.

3. Real estate professional

Beginning in 1994, income and deductions from a rental real estate activity in which the real estate professional materially participates may no longer be classified as passive-activity income and related deductions.

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28 *Temp. Regs. §1.469-5T(a)(2).*
29 *Temp. Regs. §1.469-5T(a)(3).*
30 *Temp. Regs. §1.469-5T(a)(4).*
31 *Temp. Regs. §1.469-5T(a)(5).*
32 *Temp. Regs. §1.469-5T(a)(6).*
33 *Temp. Regs. §1.469-5T(a)(7).*
34 *Temp. Regs. §1.469-5T(b)(2)(ii).*

To qualify as a real estate professional, a taxpayer must meet the following requirements:

a. **More than one-half of the personal services** performed in trades or businesses by the taxpayer during the taxable year **are performed in real property trades or businesses** in which the taxpayer materially participates.[35]

b. **The services performed by the taxpayer in real property trades or businesses** in which the taxpayer materially participates **exceed 750 hours.**[36]

c. In the case of a joint return, at least one of the spouses must separately, with respect to all trades or businesses in which the spouse performs services, render a majority of such personal services in real property trades or businesses in which the spouse materially participates, and must perform more than 750 hours of services in real property trades or businesses in which the spouse materially participates.[37] In determining whether a taxpayer materially participates in a real property trade or business, however, the participation of both spouses is taken into account.[38]

d. The statute makes it clear that the provision for real estate professional status does not affect the determination of whether the taxpayer materially participates with respect to any interest in a limited partnership as a limited partner.[39]

e. Personal services performed as an employee are not treated as performed in a real property trade or business unless the taxpayer is a five-percent owner of the business.[40]

If you're a real estate professional for purposes of §469(c)(7), your rental income or loss won't be passive if you materially participated in the rental real estate activity.

III. Calculation of gain (loss) attributable to passthrough entity interest dispositions – Primary Method

For dispositions where §1411(c)(4) exceptions do not apply entirely, such gains and losses are determined as following:

- For dispositions resulting in gain for income tax purposes, the taxpayer's NII gain equals the lesser of:
  - (i) The amount of gain the taxpayer recognizes for income tax purposes; or
  - (ii) The taxpayer's allocable share of net gain from a deemed sale of the PTE's 1411 property (i.e., gain from sale of passive/financial commodity property).
- For dispositions resulting in loss for income tax purposes, the taxpayer's NII loss equals the lesser of:
  - (i) The amount of loss the taxpayer recognizes for income tax purposes; or
  - (ii) The taxpayer's allocable share of net loss from a deemed sale of the PTE's 1411 property (i.e., loss from sale of passive/financial commodity property).

Example 1: ***Facts (Primary Method)***

A owns a one-half interest in AP, LLC, a calendar year partnership. In Year 1, A sells its interest for $200,000. A's adjusted basis for the interest sold is $120,000. Thus, A recognizes $80,000 ($200,000 - $120,000) of gain from the sale. AP, LLC is engaged in three trade or business activities, X, Y, and Z, none of which trade in financial instruments or commodities. AP, LLC also owns marketable

35 *I.R.C. §469(c)(7)(B)(i).*
36 *I.R.C. §469(c)(7)(B)(ii).*
37 *I.R.C. §469(c)(7)(B) (flush language).*
38 *I.R.C. §469(h)(5).*
39 *I.R.C. §469(c)(7)(A) (flush language).*
40 *I.R.C. §469(c)(7)(D)(ii).*

securities. For Year 1, A materially participates in activity Z; thus, it is not a passive activity subject to NIIT. A, however, does not materially participate in activities X and Y, so these activities are passive activities subject to NIIT. Because AP, LLC is engaged in at least one trade or business and at least one of those trades or businesses is not passive to the transferor A, A determines its amount of gain or loss attributable to NIIT given the fair market value and adjusted basis of the gross assets used in AP, LLC's activities as follows:

Activity	Classification to A	Adj. Basis	FMV	Total Gain (Loss)	A's Share of Gain (Loss)
X	Passive	136,000	96,000	(40,000)	(20,000)
Y	Passive	60,000	124,000	64,000	32,000
Z	Non-Passive	40,000	160,000	120,000	60,000
Marketable Securities	Portfolio	4,000	20,000	16,000	8,000
Total		240,000	400,000	160,000	80,000

Total Gain	80,000
Portfolio/Passive Gain [($20,000) + $32,000 + $8,000]	20,000
Gain subject to NIIT *	**20,000**
**** Lesser of Total Gain and Portfolio/Passive Gain but not less than zero***	

Analysis
A must determine the portion of gain or loss from the sale of AP's Section NII property allocable to A. A's allocable share of gain from AP's NII property is $20,000 (($20,000) from X + $32,000 from Y + $8,000 from the marketable securities). Because the $20,000 allocable to A from a deemed sale of AP's NII property is less than A's $80,000 gain, A will include $20,000 for NIIT purposes.

Example 2: ***Facts (Primary Method)***
Assume the same facts as Example 1, but A materially participates in activities Y and Z and does not materially participate in activity X. Because AP, LLC is engaged in at least one trade or business and at least one of those trades or businesses is not passive to the transferor A, A determines its amount of gain or loss attributable to NIIT given the fair market value and adjusted basis of the gross assets used in AP, LLC's activities as follows:

Activity	Classification to A	Adj. Basis	FMV	Total Gain (Loss)	A's Share of Gain (Loss)
X	Passive	136,000	96,000	(40,000)	(20,000)
Y	Non-Passive	60,000	124,000	64,000	32,000
Z	Non-Passive	40,000	160,000	120,000	60,000
Marketable Securities	Portfolio	4,000	20,000	16,000	8,000
Total		240,000	400,000	160,000	80,000

Total Gain	80,000
Portfolio/Passive Gain (Loss) [($20,000) + $8,000]	(12,000)
Gain subject to NIIT *	- *
**** Lesser of Total Gain and Portfolio/Passive Gain but not less than zero***	

Analysis
A's allocable share of AP's NII property is ($12,000) (($20,000) from X + $8,000 from the marketable securities). Because A sold its interest for a gain for income tax purposes, the amount allocable to A from a deemed sale of AP's NII property cannot be less than zero. Accordingly, A includes no gain or loss for NIIT purposes.

A. Optional simplified reporting method

Under the optional method, the IRS permits a simplified method for gains associated with PTEs where the passive assets are likely to be relatively small. The simplified reporting method is intended to limit the information sharing burden on PTEs by allowing transferors to rely on readily available information to calculate the amount of gain or loss included in NII under §1411(c)(4). For this purpose, the optional simplified method relies on historic distributive share amounts received by the transferor from the PTE to extrapolate a percentage of the assets within the PTE that are passive with respect to the transferor for purposes of §1411(c)(4). For example, if ten percent of the income reported on the applicable Schedules K-1 is of a type that would be included in net investment income, then the simplified reporting method presumes that ten percent of the income tax gain on the disposition of the transferor's interest relates to NII property of the PTE for purposes of the disposition.

1. Qualifications and exceptions

The optional simplified reporting method applies to a §1411(c)(4) disposition **if either requirement is met:** [41]

- **Five-Percent Threshold:** If the absolute value of all NII income, gain, loss, and deduction items allocated to a partner/shareholder is 5% or less of the absolute value of all income, gain, loss, and deduction allocated to a partner/shareholder during the §1411 holding period, and the total PTE gain included for income tax purposes does not exceed $5,000,000.
- **$250,000 Gain/Loss Threshold:** The total gain/loss recognized by the selling partner/shareholder does not exceed $250,000 (including gains/losses from multiple dispositions as part of a plan; all dispositions in a single tax year are presumed to be part of a plan).

Section 1411 holding period is defined to mean the year of disposition and the transferor's two taxable years preceding the disposition or the time period the transferor held the interest, whichever is less.

- Where the transferor acquires its interest from another PTE in a nonrecognition transaction during the year of disposition or the prior two taxable years, the transferor must include in its §1411 holding period the period that the previous owner or owners held the interest.
- Also, where the transferor transferred an interest in a subsidiary PTE to a PTE in a nonrecognition transaction during the year of the disposition or the prior two taxable years, the transferor must include in its §1411 holding period that period that it held the interest in the subsidiary PTE.
- Finally, the §1411 holding period also includes the period that a previous owner or owners held the interest transferred if the transferor acquired its interest by gift.

[41] *Prop. Reg. §1.1411-7(c)(2)*

Though the above qualifications may be met, Prop. Reg. 1.1411-7(c)(3) provides **five exceptions where the optional simplified reporting method is disallowed:**

1. Partners/shareholders that have held the interest for less than 12 months;
2. Contributions of NII property to a PTE followed distributions of non-NII property during the §1411 holding period [i.e., mixing-bowl transactions] (contributions of NII property within 120 days of the disposition of a PTE interest will be presumed to not qualify for the optional reporting method);
3. PTEs have increased or decreased NII property by 25% or more during the partner/shareholder's §1411 holding period (i.e., significant change in composition of the assets);
4. S election was made during the shareholder's §1411 holding period; OR
5. Partial dispositions of interests not representing proportionate share of the economic rights in a PTE (e.g., partner sells preferred interest in partnership while retaining common interest would disallow the optional simplified reporting method).

2. Calculation details

The calculation under the optional simplified reporting method is as follows:

(1) Determine the NIIT holding period (i.e., §1411 holding period) and test the optional simplified reporting method requirements are met.

- **Section 1411 holding period:** generally, the year of disposition and the transferor's two taxable years preceding the disposition or the time period the transferor held the interest, whichever is less.

(2) Determine the NII disposition fraction:

(i) Numerator is the sum of all income, gain, loss, and deduction items (including separately stated items included in NIIT during the NIIT holding period (the aggregate across multiple tax years); if the numerator is a negative amount in connection with a computation of overall gain, then the fraction shall be zero.

(ii) Denominator is the sum of all income, gain, loss, and deduction allocated to the taxpayer during the NIIT holding period.

(3) Multiply the total income tax gain included for income tax purposes by the fraction determined in step 2.

Example 1: ***Facts (Optional Simplified Reporting Method)***

B owns a one-half interest in BC, a partnership. In Year 2, B sells the interest for $2,000,000. B's adjusted basis for the interest sold is $1,100,000, resulting in a total gain of $900,000 ($2 mil - $1.1 mil). Because BC is engaged in at least one trade or business and at least one of those trades or businesses is not passive to the transferor B, B determines its amount of gain or loss from NII using the optional simplified reporting method. None of the disqualifying provisions of Prop. Reg. §1.1411-7(c)(3) apply. The $900,000 gain exceeds the $250,000 threshold test for the optional simplified reporting method; and thus, the 5% test must be evaluated as the gain is less than the $5 million requirement of the 5% test. The aggregate net income from BC's activities allocable to B for the year of disposition and the two preceding tax years is as follows:

Activity	Classification to A	Aggregate Income (Loss) §1411 Holding Period	Absolute Income/Loss
X	Non-Passive	1,800,000	1,800,000
Y	Passive	(10,000)	10,000
Marketable Securities	Portfolio	20,000	20,000
Total		1,810,000	1,830,000
NII Items ($10,000 activity Y + $20,000 marketable securities)			30,000
Total Items			1,830,000
Threshold % - 5% Threshold test is met!			**1.64%**
NII Items [(10,000) activity Y + $20,000 mktbl secs.]		10,000	
Total Allocable Share		1,810,000	
NII Disposition Fraction		**0.55%**	
Total Gain ($2.2 mil - $1.1 mil)		900,000	
NII Disposition Fraction		0.55%	
Gain subject to NIIT		**4,972**	

Analysis

During B's §1411 holding period, B was allocated $30,000 of gross items of a type taken into account in the calculation of NII ($10,000 of loss from activity Y and $20,000 of income from marketable securities). The total amount/absolute value of B's allocated net items during the §1411 holding period equals $1,830,000 ($1,800,000 income from activity X, $10,000 loss from activity Y, and $20,000 income from marketable securities). Thus, 1.64% ($30,000/1,830,000) of B's allocations, which is less than the 5% threshold, during the §1411 holding period are of a type that is taken into account in the computation of NII, and because B's chapter 1 gain recognized of $900,000 ($2 mil - $1.1 mil) is less than $5,000,000, B qualifies under §1.1411-7(c)(2)(ii) to use the optional simplified method.

B's percentage of NII property is determined by dividing B's allocable shares of income and loss of a type that is taken into account in the calculation of NII that is allocated to B by the PTE during the §1411 holding period, $10,000 ($10,000 loss from Y + $20,000 income from marketable securities) by $1,810,000, which is the sum of B's share of income and loss from all of BC's activities ($1,800,000 + ($10,000) + 20,000). Thus, B's gain for purposes of NII is $4,972 ($900,000 income tax gain multiplied by the fraction 10,000/1,810,000).

Example 2: ***Facts***

Assume the same facts as Example 1, but B sells the interest in BC for $900,000. B's percentage of NII property is determined by dividing B's allocable shares of income and loss of a type that is taken into account in the calculation of NII that is allocated to B by the PTE, during the §1411 holding period, $10,000 ($10,000 loss from Y + $20,000 income from marketable securities) by $1,810,000, which is the sum of B's share of income and loss from all of BC's activities ($1,800,000 + ($10,000) + 20,000). Because B's allocable share during the §1411 holding period of income and loss is a type that is taken into account in calculating NII and is a positive amount, and B sells its interest for an overall income tax loss of $200,000 ($900,000 - $1,100,000), B uses a fraction of 0 to compute its NII gain under paragraph (c)(4) of this section. Thus, B has no gain or loss for NII purposes ($200,000 income tax loss multiplied by a fraction of 0).

3. *Deferred recognition transactions*

In the case of deferred recognition transactions (e.g., installment sales), the calculation of gain/loss for NIIT purposes is performed in the year of disposition as though the entire gain was recognized and taken into account in such year. For this purpose, it is assumed that any contingencies potentially affecting consideration to the seller/transferor that are reasonably expected to occur will occur, and in the case of annuities based on the life expectancy of one or more individuals, the present value of the annuity (using existing federal tax valuation methods) is used to determine the estimated gain. This approach allows the transferor to determine its NII inclusion for each future installment. If under this approach no gain or loss from the disposition would be included in NII, then the transferor excludes each payment received from the deferred recognition transaction from NII. If under this approach only a portion of the chapter 1 gain on the disposition would be included in NII, then the difference between the gain recognized for chapter 1 purposes and the gain recognized for NII purposes is considered an addition to basis, and after taking those basis adjustments into account, gain amounts are included in NII as payments are received in accordance with the existing rules for installment sales or private annuities.

4. *Information reporting and other considerations* [42]

Any seller/transferor applying the calculations previously described, including in reliance on the proposed regulations, must attach a statement to the seller/transferor's income tax return for the year of disposition. That statement must include:

- The taxpayer's name and taxpayer identification number;
- The name and taxpayer identification number of the PTE in which the interest was transferred;
- The amount of the transferor's gain or loss on the disposition of the interest for income tax purposes; and
- The amount of adjustment to gain or loss by reason of basis differences for income tax and NIIT purposes. The transferor must also attach a copy of any information provided by the PTE to the transferor relating to the transferor's allocable share of gain or loss from the deemed sale of the PTE’s NII property.

PTEs must provide the seller/transferor the transferor's allocable share of the net gain or loss from the deemed sale of the PTE’s NII property. However, the proposed regulations only require PTEs to provide this information to sellers/transferors that are ineligible for the optional simplified reporting method. If a seller/transferor qualifies to use the optional simplified reporting method in proposed §1.1411-7(c) but prefers to determine net gain or loss under the primary method of proposed §1.1411-7(b), then the transferor must negotiate with the PTE the terms under which the information will be supplied.

As a final note, should the basis used for determining income tax gain and NIIT gain be different (relating to certain income from CFCs and PFICs where no applicable elections have been made), these adjustments are made after the calculations outlined above and operate independently from these rules provided in the proposed regulations.[43]

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42 *Prop. Reg. §1.1411-7(g).*
43 *Prop. Reg. §1.1411-7(f).*

Numbers Applicable to Rulings

Numbers Applicable to Rulings

Learning objectives

Upon reviewing this chapter, the reader will be able to:

- Describe the structure of the tax brackets for 2025;
- Quantify the standard deduction, the personal exemption, and the phase out of personal exemptions and itemized deductions;
- Identify the factors that determine the amount of earned income tax credit;
- Explain how and to what extent interest from certain bonds may be excluded from gross income;
- Define a dependent for purposes of, and calculate, the dependent-care credit;
- Discuss the various education credits;
- Describe what other education-related expenditures may be deductible;
- Quantify the mileage rates for automobiles owned or used in a trade or business, the SIFL rates for aircraft usage, and the per-diem rates that may be applicable to employee business expenses;
- Discuss the Social Security benefits applicable to retirees and their spouses;
- Explain the limitations that apply to long-term care insurance and health savings accounts; and
- Discuss other limitations applicable to taxpayers in 2025.

I. Tax rates and other information for 2025

A. Tax rates for the individual

The tax rate brackets for 2025 are as follows.[1]

Single:

If taxable income is:	The tax is:
Not over $11,925	10% of taxable income.
Over $11,925 but not over $48,475	$1,192.50 plus 12% of the excess over $11,925.
Over $48,475 but not over $103,350	$5,578.50 plus 22% of the excess over $48,475.
Over $103,350 but not over $197,300	$17,651 plus 24% of the excess over $103,350.
Over $197,300 but not over $250,525	$40,199 plus 32% of the excess over $197,300.
Over $250,525 but not over $626,350	$57,231 plus 35% of the excess over $250,525.
Over $626,350	$188,769.75 plus 37% of the excess over $626,350.

Head of Household:

If taxable income is:	The tax is:
Not over $17,000	10% of taxable income.
Over $17,000 but not over $64,850	$1,700 plus 12% of the excess over $17,000.
Over $64,850 but not over $103,350	$7,442 plus 22% of the excess over $64,850.
Over $103,350 but not over $197,300	$15,912 plus 24% of the excess over $103,350.
Over $197,300 but not over $250,500	$38,460 plus 32% of the excess over $197,300.
Over $250,500 but not over $626,350	$55,484 plus 35% of the excess over $250,500.
Over $626,350	$187,031.50 plus 37% of the excess over $626,350.

[1] Rev. Proc. 2024-40.

Married Filing Jointly and Surviving Spouse:

If taxable income is:	The tax is:
Not over $23,850	10% of taxable income.
Over $23,850 but not over $96,950	$2,385 plus 12% of the excess over $23,850.
Over $96,950 but not over $206,700	$11,157 plus 22% of the excess over $96,950.
Over $206,700 but not over $394,600	$35,302 plus 24% of the excess over $206,700.
Over $394,600 but not over $501,050	$80,398 plus 32% of the excess over $394,600.
Over $501,050 but not over $751,600	$114,462 plus 35% of the excess over $501,050.
Over $751,600	$202,154.50 plus 37% of the excess over $751,600.

Married Filing Separately:

If taxable income is:	The tax is:
Not over $11,925	10% of taxable income.
Over $11,925 but not over $48,475	$1,192.50 plus 12% of the excess over $11,925.
Over $48,475 but not over $103,350	$5,578.50 plus 22% of the excess over $48,475.
Over $103,350 but not over $197,300	$17,651 plus 24% of the excess over $103,350.
Over $197,300 but not over $250,525	$40,199 plus 32% of the excess over $197,300.
Over $250,525 but not over $375,800	$57,231 plus 35% of the excess over $250,525.
Over $375,800	$101,077.25 plus 37% of the excess over $375,800.

Estates and Trusts:

If taxable income is:	The tax is:
Not over $3,150	10% of taxable income.
Over $3,150 but not over $11,450	$315 plus 24% of the excess over $3,150.
Over $11,450 but not over $15,650	$2,307 plus 35% of the excess over $11,450.
Over $15,650	$3,777 plus 37% of the excess over $15,650.

Capital Gains Rate:

For 2025, the tax rate on capital gain and/or qualifying dividend income is available to individuals only with ordinary taxable income of the following:

2025 Capital Gains Rates

Filing Status	0%	15%	20%
Single	$0-$48,350	$48,351-$533,400	Over $533,400
Married Filing Jointly and Surviving Spouses	$0-$96,700	$96,701-$600,050	Over $600,050
Married Filing Separately	$0-$48,350	$48,351-$300,000	Over $300,000
Head of Household	$0-$64,750	$64,751-$566,700	Over $566,700
Estates, Trusts & Kiddie Tax	$0-$ 3,250	$ 3,251-$15,900	Over $15,900
Unrecaptured Section 1250 gain			25%
Collectibles Eligible gain on qualified small business stock less the 1202 exclusion			28%

B. Standard deduction[2]

The standard deduction in 2025 is as follows:

Filing status:	2025
Married filing jointly and Surviving spouses (§1(a))	$30,000
Heads of Households (§1(b))	$22,500
Unmarried (§1(c))	$15,000
Married filing separately (§1(d))	$15,000

For 2025, the standard deduction for a dependent is the lesser of: (i) the deduction for a single taxpayer; and (ii) the greater of (x) 1,350, or (y) the sum of $450 and the dependent's earned income.

Additional standard deductions for the elderly and blind in 2025:[3]

Taxpayer	Either	Both
Unmarried	$2,000	$4,000
Married	$1,600	$3,200

C. Qualified Business Income deduction

For taxable years beginning in 2025, the threshold amounts under §199A(e)(2) and phase-in range amounts under §199A(b)(3)(B) and §199A(d)(3)(A) are:

Filing Status	Threshold Amount	Phase-in Range Amount
Married Filing Jointly	$394,600	$494,600
Married Filing Separately	$197,300	$247,300
All Other Returns	$197,300	$247,300

D. Personal exemptions

The personal exemption amount under §151(d) is $5,200.[4] However, the personal exemption and dependency exemption deductions are reduced to $0 for years 2018 through 2025 by the Tax Cuts and Jobs Act of 2017 (TCJA).

The amount of the personal exemption still matters. The way TCJA suspends the deduction is to reduce the amount of the deduction for an exemption to "zero." However, the reduction to zero is only for the tax deduction. The amount still applies for other purposes, such as the income limit for a qualified relative.[5]

Example: Bob and Mary are married and file a joint return for 2025. Their son, Jay, is 20 years old. Jay graduated from college in 2024 but cannot find a job that utilizes his education. The family decided it would be better for Jay to live at home and not seek other full-time employment so that he can continue to seek employment in his chosen field. Jay worked at a local store part-time and earned $4,000.

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2 Rev. Proc. 2024-40.
3 Rev. Proc2024-40.
4 Rev. Proc. 2023-34.
5 I.R.C. §151(d), created by the TCJA.

Jay is not a qualifying child because he is over 18 years old and is not a student. However, he is a qualifying relative to Bob and Mary because he lived with them all year, they provided over half of Jay's support, and Jay's gross income is less than the exemption amount for 2025 of $5,200. If they are not subject to the child and family credit income limitation, Bob and Mary can take a family credit of $500 for 2025.

On September 16, 2020, the IRS and Department of Treasury released final regulations, confirming that the definition of a qualifying relative is based on the inflation-adjusted personal exemption threshold, even though personal exemptions are suspended under the TCJA. Additionally, the final regulations clarify that the definition of a qualifying relative for purposes other than determining the deduction under §151(a) is based on the inflation-adjusted personal exemption threshold. [6]

E. Gift/Estate Exemptions

Tax year 2025 allows for a $19,000 annual exclusion for gifts to any person (other than gifts in future interests in property). If spouses splitting gifts, the annual exemption is doubled to $38,000. For tax year 2025, the first $190,000 of gifts to a non-US citizen spouse (other than gifts of future interests in property) are not considered taxable gifts. The lifetime gift exemption in 2025 increases to $13.99 million from $13.61 million in 2024.

On April 26, 2022, the IRS issued proposed regulations regarding the increased estate and gift tax exclusion amount provided by the TCJA. [7] The proposed regulations provide an exception to the special rule for includible transfers, or transfers treated as includible, in a grantor's gross estate. This exception would apply to transfers that allow a donor to retain sufficient interest or income from the gifted property. The proposed regulations state that "the purpose of the special rule is to ensure that bona fide inter vivos transfers of property are consistently treated as a transfer of property by gift for both gift and estate tax purposes."

Without the proposed regulations, the application of the special rule to includible gifts results in securing the benefit of the increased BEA even when the donor continues to have title, possession, use, benefit, control, or enjoyment of the transferred property during life. In such circumstances, the proposed regulations provide an exception to the special rule that the amount includible or treated as includible as part of the gross estate is subject to estate tax with the benefit of only the BEA available at the date of death. The proposed regulations would also apply the exception to the transfer, elimination, or relinquishment within 18 months of the donor's date of death of the interest or power that would have caused inclusion in the gross estate, effectively allowing the donor to retain the enjoyment of the property for life. In other words, even if the donor gives up all rights or powers, if it is within 18 months of his or her death, the property is still subject to the exception to the special rule.

The proposed regulations outline the exception to the special rule in the following example:

> *Assume that when the BEA was $11.4 million, a donor gratuitously transferred the donor's enforceable $9 million promissory note to the donor's child. The transfer constituted a completed gift of $9 million. On the donor's death, the assets that are to be used to satisfy the note are part of the donor's gross estate, with the result that the note is treated as includible in the gross estate for purposes of section 2001(b). Thus, the $9 million gift is excluded from adjusted taxable gifts in computing the tentative estate tax under section 2001(b)(1). Nonetheless, if the donor dies after a*

[6] T.D. 9913.
[7] REG-118913-21.

statutory reduction in the BEA to $6.8 million, the credit to be applied in computing the estate tax is the credit based upon the $6.8 million of the BEA allowable as of the date of death.

The proposed regulations specify that the special rule will continue to apply to transfers includible in the gross estate when the taxable amount of the gift is not material. The taxable amount of the gift is not considered material when it is 5% or less of the total amount of the transfer, valued as of the date of the transfer. The proposed regulations are applicable to the estates of decedents dying on or after April 27, 2022. It is important to note that the special rule will not be necessary until the BEA has been decreased by statute (currently January 1, 2026, but could potentially be sooner if legislation is enacted prior to this date).

F. Alternative Minimum Tax Exemption

For 2025, the AMT exemption is:

- $137,000 for joint filers and surviving spouses;
- $88,100 for single filers (other than surviving spouses);
- $68,500 for married individuals filing separately; and
- $30,700 for estates and trusts.

Filing status	2025 Threshold Phaseout Amount	2025 Complete Phaseout Amount
Married filing joint	$1,252,700	$1,800,700
Surviving Spouses	$1,252,700	$1,800,700
Single	$626,350	$978,750
Married filing separate	$626,350	$900,350
Estates and trusts	$102,500	$225,300

G. Reduction of itemized deductions

The overall limitation on itemized deductions does not apply for 2025. The limitation is suspended for years 2018 through 2025 by TCJA.

H. Earned income tax credit (EITC)[8]

1. Earned income and AGI limits

The American Rescue Plan Act (ARPA) temporarily expanded the EITC for taxpayers, allowing more individuals to meet eligibility requirements for the credit in 2021. The temporary changes to the EITC for the 2021 tax year have since expired and are no longer applicable.

ARPA permanently modified the EITC as follows:

a. **Qualifying Child Requirement** -- In prior years, to qualify for the EITC with qualifying children, taxpayers typically had to provide information about the qualifying child, including name, age, and TIN/SSN. ARPA removed this requirement, essentially allowing individuals who have qualifying children to claim the EITC, despite not being able to provide proper documentation.

b. **Joint Return Requirement** – Prior to ARPA, individuals who were married were required to file a joint return in order to be eligible to claim the EITC. ARPA modified this requirement and provides that certain separated married individuals are not required to

8 All numbers from section E. are from Rev. Proc. 2023-34.

file jointly in order to claim the EITC. For EITC purposes, an individual will not be treated as "married" if the individual:

- Is considered married per §7703(a).
- Lives with his or her qualifying child for more than half of the tax year.
- Does not file a joint return for the tax year.
- Does not have the same principal place of abode as his or her spouse during the last six months of the tax year or has a decree, instrument, or agreement with regard to his or her spouse and is not a member of the same household with his or her spouse by the end of the tax year.

This provision applies to the tax years beginning after December 31, 2020.

c. **Investment Income Requirement** – Prior to ARPA, individuals with certain types of investment over $3,650 were unable to claim the EITC. ARPA increased the threshold amount to $10,000 for tax years beginning after December 31, 2020. The $10,000 threshold will be indexed for inflation for tax years beginning after 2021 ($11,950 in 2025).

d. **Identification Requirement** -- Prior to ARPA, a taxpayer was required to provide a qualifying child's name, age, and taxpayer identification number in order to claim the qualifying child when determining the amount of the EITC. If the taxpayer was unable to provide the qualifying child's name, age, and taxpayer identification number, he or she was ineligible to claim the EITC as an eligible individual with no qualifying children. ARPA removed this requirement and allows an eligible individual who has qualifying children, but cannot provide the necessary identification for such children, to claim the EITC as an eligible individual with no qualifying children. This provision is effective for tax years beginning after December 31, 2020.

2. Investment income limit

Investment income must be $11,950 or less for 2025.

3. Maximum credit amounts

Below are the following figures applicable to the 2025 tax year: [9]

If filing...	Qualifying Children Claimed			
	Zero	One	Two	Three or more
Earned Income Amount	$8,490	$12,730	$17,880	$17,880
Maximum Credit Amount	$649	$4,328	$7,152	$8,046
Threshold Phaseout - Single, Head of Household or Surviving Spouse	$10,620	$23,350	$23,350	$23,350
Completed Phaseout - Single, Head of Household or Surviving Spouse	$19,104	$50,434	$57,310	$61,555
Threshold Phaseout - Married Filing Jointly	$17,730	$30,470	$30,470	$30,470
Completed Phaseout - Married Filing Jointly	$26,214	$57,554	$64,430	$68,675

9 Rev. Proc. 2024-40.

Note:

> The Welfare Reform Act of 1996 changed the definition of "adjusted gross income" for purposes of the phase out of the earned income credit. Adjusted gross income is now determined by disregarding net capital losses, net losses from trusts and estates, net losses from nonbusiness rents and royalties, and 50 percent of net losses from businesses.

I. Exclusion from income for certain redemptions of bonds

An exclusion is available for income from the redemption of United States savings bonds for taxpayers who pay qualified higher-education expenses (as defined in §135). This exclusion, however, is phased out by reducing the exclusion by the amount otherwise excludable income multiplied by a fraction. The numerator of the fraction is the excess of the taxpayer's modified adjusted gross income over the threshold amount, and the denominator of the fraction is $30,000 for joint returns or $15,000 for all others. For tax years beginning in 2025, taxpayers with modified adjusted gross income above the "threshold phase-out amount" are subject to this phaseout, up to a "completed phase-out amount," the point at which the benefit is no longer available.

The Service has announced that for 2025:[10]

Filing status	2025 threshold phaseout amount
Married filing jointly	$149,250
Others	$99,500

Example: In 2025, Mr. and Mrs. Smith redeem $15,000 in U.S. savings bonds in order to help pay for their daughter's college tuition. Mr. and Mrs. Smith file a joint income tax return for the 2025 taxable year. Their combined adjusted gross income for 2025 is $159,250. The amount of the exclusion is $10,000 ($15,000 - ($15,000 x $10,000/$30,000)).

J. Dependent-care credit

1. In general

For purposes of the dependent-care credit, a taxpayer who maintains a household that includes one or more qualifying individuals may claim a nonrefundable credit against income-tax liability for up to a certain percent of a limited amount of employment-related expenses.

ARPA made several temporary changes to the dependent-care credit for the 2021 tax year only that have since expired.

In tax year 2025, eligible employment-related expenses are limited to $3,000 if there is one qualifying individual or $6,000 if there are two or more qualifying individuals. The applicable credit percentage is 35% in 2025. The 35-percent credit rate is reduced, but not below 20 percent, by one percentage point for each $2,000 (or a fraction thereof) of adjusted gross income above $15,000 until it reaches $43,001. Thus, the maximum credit is $1,050 if there is one qualifying individual and $2,100 if there are two or more qualifying individuals. The credit is not available to married taxpayers unless they file a joint return. The applicable dollar limit of otherwise eligible employment-related expenses is reduced by any amount excluded from income under an employer-provided dependent-care-assistance program.

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10 Rev. Proc. 2024-40.

2. *Exclusion*

Amounts paid or incurred by an employer for dependent-care assistance provided to an employee generally are excluded from the employee's gross income and wages if the assistance is furnished under a program meeting certain requirements. These requirements stipulate that the program be described in writing, satisfy certain nondiscrimination rules, and provide for notification to all eligible employees. Dependent-care assistance expenses eligible for the exclusion are defined the same as employment-related expenses with respect to a qualifying individual under the dependent-care tax credit. Prior to ARPA, the dependent-care exclusion was limited to $5,000 per year, except that a married taxpayer filing a separate return could exclude only $2,500. ARPA temporarily increased the exclusion amount for employer-provided dependent care assistance to $10,500 for 2021. However, the exclusion amount for employer-provided dependent care assistance returned to $5,000 per year ($2,500 MFS) in tax year 2022 and beyond. Dependent-care expenses excluded from income are not eligible for the dependent-care tax credit.

3. *Planning notes*

a. In 2025, the dependent-care credit is nonrefundable.

b. Many taxpayers and accountants wrongly assume that the $6,000 must be prorated between the two qualifying individuals. This is untrue. If $5,900 is paid on behalf of one qualifying individual and $100 on the other, the full $6,000 is taken into account in computing the credit.

c. Another often overlooked area is a non-child individual can be a qualifying individual. An individual who is incapable of self-care, such as one of the parents following certain surgical procedures after returning home for a few days, can be a qualifying individual.

d. Payments to a non-dependent parent of the taxpayer for the care of the taxpayer's child qualify as payments for dependent care.

e. Carryovers of unused dependent care assistance program amounts are generally not permitted (other than a 2 ½ month grace period). However, in 2021 and 2022, the CAA 2021 temporarily provided that employers could amend their plans to permit the carryover of unused dependent care assistance program amounts to plan years ending in 2021 and 2022, or to extend the permissible period for incurring claims to plan years over the same period.

K. Dependent Care FSA

Dependent Care FSAs allow individuals to make pretax contributions to pay qualified childcare expenses. Single or Married filing jointly taxpayers can contribute up to $5,000 to an FSA in 2025. Married Filing Separately taxpayers can contribute up to $2,500 to an FSA in 2025.

L. Adoption expenses

A tax credit is allowed for **qualified adoption expenses** paid or incurred by a taxpayer. In 2025 the maximum credit is $17,280[11] per eligible child, including special-needs children. A $17,280 credit is provided in the year a special-needs adoption is finalized, regardless of whether the taxpayer has qualified adoption expenses.

a. Qualified adoption expenses are reasonable and necessary adoption fees, court costs, attorneys' fees, and other expenses that are: (i) directly related to, and the principal purpose of which is for, the legal adoption of an eligible child by the taxpayer; (ii) not

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[11] Rev. Proc. 2024-40.

incurred in violation of state or federal law, or in carrying out any surrogate parenting arrangement; (iii) not for the adoption of the child of the taxpayer's spouse; and (iv) not reimbursed (e.g., by an employer).

b. A taxpayer may exclude up to $17,280 in 2025 per eligible child, including special-needs children, for employer-provided adoption assistance to reimburse qualified adoption expenses. In the case of a special-needs adoption, the exclusion is provided regardless of whether the taxpayer has qualified adoption expenses. The exclusion does not apply for purposes of payroll taxes.

Note:

Adoption expenses paid or reimbursed by the employer under an adoption assistance program are not eligible for the adoption credit. A taxpayer may be eligible for the adoption credit (with respect to qualified adoption expenses he or she incurs) and also for the exclusion (with respect to different qualified adoption expenses paid or reimbursed by his or her employer).

The dollar limitation applies separately to both the credit and the exclusion of employer-reimbursements for adoption related expenses. Taxpayers can claim both the credit and the exclusion, but the exclusion must be claimed before any allowable credit. Expenses used for the exclusion will reduce the amount of qualified adoption expenses available for credit. Thus, taxpayers may not claim both an exclusion and credit for the same expenses.

Example 1: Leslie, a single taxpayer, paid $12,000 of qualified adoption expenses in 2025. Her employer reimbursed her for $5,000 of those expenses in 2025 when the adoption became final. Her 2025 modified adjusted gross income is $165,000. Leslie will exclude the $5,000 of employer-reimbursed expenses from income. The expenses for the adoption credit will be limited to $7,000 ($12,000 expenses paid less $5,000 of employer reimbursement).

Example 2: Patricia, a single taxpayer, paid $20,950 of qualified adoption expenses in 2025. Her employer reimbursed her for $5,000 of those expenses in 2025 when the adoption became final. Her 2025 modified adjusted gross income is $125,000. Patricia will exclude the $5,000 of employer-reimbursed expenses from income. The expenses for adoption credit will be limited to $15,950 ($20,950 expenses paid less $5,000 of employer reimbursement).

Example 3: Margorie, a single taxpayer, paid $35,000 of qualified adoption expenses in 2025. Her employer reimbursed her for $17,280 of those expenses in 2025 when the adoption became final. Her 2025 modified adjusted gross income is $225,000.

Margorie will exclude the $17,280 of employer-reimbursed expenses from income. Margorie's expenses available for credit total $17,720 ($35,000 expenses paid less $17,280 reimbursed by her employer).

However, the expenses for the adoption credit will be limited to $17,280.
Thus, $440 ($17,720 creditable expenses - $17,280 credit limitation) will go unused for either an exclusion or credit.

c. The adoption credit (and the employer-provided adoption assistance exclusion) is phased out ratably for taxpayers with modified adjusted gross income between $259,190 and $299,190 in 2025.[12] The dollar/credit limitation must be reduced for a particular year for credits claimed in a prior year for the same adoption effort.

Example: A $3,000 adoption credit was claimed in 2024 with an additional $15,000 of qualified expenses paid in 2025 for the same adoption. The maximum credit that can be claimed in 2025 is $14,280 ($17,280 credit limitation less $3,000 of qualified expenses claimed in 2024).

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12 Adoption credit amounts and limitations updated by Rev. Proc. 2024-40.

d. Qualified adoption expenses related to unsuccessful adoption attempts must be combined with those expenses related to subsequent attempts, whether or not those attempts are successful.

Example: Jennifer claimed $8,000 of qualified adoption expenses credit in 2023 related to an unsuccessful adoption. In 2024 and 2025, she spent an additional $10,000 for qualified adoption expenses in connection with successful adoptions finalized in 2025. The maximum allowable credit in 2025 is $9,280 ($17,280 credit limitation less $8,000 previously claimed).

Note:

For S corporation employers, adoption expenses provided to a more-than-2% shareholder are not excludable from income. A more-than-2% shareholder is any shareholder with greater than 2% of the value of stock, the percentage of stock, or the voting power of the stock.

e. An eligible child is an individual who: (i) has not attained age 18; or (ii) is physically or mentally incapable of caring for himself or herself. A special-needs child is an eligible child who is a citizen or resident of the United States who a state has determined: (i) cannot or should not be returned to the home of the birth parents; and (ii) will not be adopted unless special assistance is provided to the adoptive parents. Factors include whether the child has a specific factor or condition (such as the child's ethnic background, age, or membership in a minority or sibling group), and whether the child has a medical condition, or a physical, mental, or emotional handicap.

f. Generally, both domestic and foreign adoptions qualify for the credit, however, there are differing timing rules for when the credit can be claimed based on the type of adoption.

- Qualified expenses related to a domestic adoption become creditable in the tax year following the payment. This is the case even if the adoption is never finalized or the eligible child is yet to be identified.
- Qualified expenses related to a foreign adoption become creditable in the tax year the adoption is finalized. Once the adoption is finalized, all qualified expenses from prior years and the year the adoption becomes final are available for the credit.
- Whether domestic or foreign, adoption expenses paid after the year the adoption becomes final are available for credit in the year of payment.

Example 1: Mark and Julie paid qualified adoption expenses of $3,000 in 2023, $4,000 in 2024, and $5,000 in 2025. This domestic adoption became final in 2024. The timing analysis is as follows:

- The $3,000 paid in 2023 is creditable on the 2024 tax return (i.e., the year following the payment).
- The $4,000 paid in 2024 is creditable on the 2025 tax return (i.e., the year following the payment).
- The $5,000 paid in 2025 is creditable on the 2025 tax return (i.e., the year of finalization).
- Accordingly, no credit is allowed on the 2023 tax return.
- The 2024 tax return would have $3,000 of available expenses for credit to offset the 2024 tax liability, with any excess credits available to be carried forward for up to 5 years.
- The 2025 tax return would have $9,000 ($4,000 from 2024 and $5,000 from 2025) of available expenses for credit to offset the 2025 tax liability,

with any excess credit from either 2024 or 2025, being carried forward to later years.

Example 2: Mark and Julie paid qualified adoption expenses of $3,000 in 2023, $4,000 in 2024, and $5,000 in 2025. This foreign adoption became final in 2025. The timing analysis is as follows:

- The $12,000 ($3,000 from 2023 + $4,000 from 2024 + $5,000 from 2025) becomes creditable on the 2025 tax return as this is the year the adoption becomes final.
- Any excess credits would be available for a carryforward of up to five years.
- Whether domestic or foreign, any additional expenses paid in 2026 would be creditable in 2026 as the adoption has been finalized.

g. The adoption credit is generally available to all filing statuses except married filing separately. Married taxpayers filing separately may still be able to claim the credit if the filer is considered unmarried because of legal separation or living apart from spouse.

If taxpayers filed married filing separately in the year qualified adoption expenses are first allowable, the taxpayer generally can't claim the credit or exclusion for those particular expenses. Additionally, changes in filing status can impact the availability of the credit.

Example: John and Patty paid qualifying adoption expenses of $2,000 in 2023, $5,000 in 2024, and $4,000 in 2025. The domestic adoption became final in 2025. For tax year 2025, the taxpayers will file jointly, but all prior year tax filings were filed using the married filing separately filing status.

- When claiming the qualified adoption expenses in 2025, only $9,000 ($5,000 from 2024 and $4,000 from 2025) will be creditable in 2025.
- Because the taxpayers filed separately in 2024 when the first $2,000 of expenses became creditable, those adoption expenses may not be claimed in 2025.
- If claiming the credit is a priority, amended returns could be filed for 2024 within the appropriate period of limitations to change the filing status and claim $2,000 qualified expenses for purposes of the adoption credit.

h. The adoption credit and exclusion are both claimed on Form 8839, *Qualified Adoption Expenses*, which is attached to a filed individual income tax return. Creditable expenses should be tracked and provided by the taxpayer, and employer-provided adoption assistance should be reported on the employee's Form W-2, box 12, code T. Adoption documentation is no longer required to be attached to the filed return, though documentation should be retained as part of accurate record keeping.

i. The SECURE Act contains favorable updates for both **qualified adoption expenses** and **qualified births.** The SECURE Act allows for penalty-free withdrawals from retirement plans of up to $5,000 per individual in the event of a qualified birth of a child or adoption for distributions made after December 31, 2019. This provision is a new exemption from the 10% penalty tax of §72(t) for early withdrawals from qualified plans and IRAs.

Married couples may separately take a $5,000 distribution for a qualified birth or adoption, providing for a $10,000 total distribution allowance per married couple. An eligible adoptee includes any individual under the age of 18 or who is incapable of self-support, specifically excluding any child(ren) of the taxpayer's spouse. The distribution must be taken within a one-year period beginning on the date on which the child is born or on which the adoption of a child is finalized.

M. Education benefits

1. Education credits

An individual taxpayer is allowed a nonrefundable education tax credit against income tax for the taxable year. The amount of the education tax credit is the total of the Hope Scholarship credit plus the Lifetime Learning credit.[13]

a. In the same taxable year, a taxpayer may claim a Hope Scholarship credit for each eligible student's **qualified tuition and related expenses** and a Lifetime Learning credit for one or more other students' qualified tuition and related expenses. However, a taxpayer may not claim both a Hope Scholarship credit and a Lifetime Learning credit with respect to the same student in the same taxable year.[14]

b. Subject to certain limitations, a Hope Scholarship credit may be claimed for the qualified tuition and related expenses paid during a taxable year with respect to each eligible student. Qualified tuition and related expenses paid during a taxable year with respect to one student may not be taken into account in computing the amount of the Hope Scholarship credit with respect to any other student. In addition, qualified tuition and related expenses paid during a taxable year with respect to any student for whom a Hope Scholarship credit is claimed may not be taken into account in computing the amount of the Lifetime Learning credit.[15]

c. Subject to certain limitations, a Lifetime Learning credit may be claimed for the aggregate amount of qualified tuition and related expenses paid during a taxable year with respect to students for whom no Hope Scholarship credit is claimed.[16]

d. As a result of the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (TCDTRA), for tax years beginning in 2021, the Lifetime Learning tax credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified adjusted gross income between $80,000 and $90,000 ($160,000 and $180,000 for married individuals who file a joint return). Thus, taxpayers with modified adjusted gross income above $90,000 (or $180,000 for joint filers) may not claim an education tax credit.

- The increased limitations are the result of TCDTRA repealing the tuition and fees deduction for tax years beginning after 2020. Previously, §222 provided taxpayers with a deduction for qualified tuition and related expenses.

For 2025, the Lifetime Learning tax credit phases out as follows:

Taxpayer	MAGI Level Where Phaseout Begins	MAGI Level Where Phaseout Is Complete
Married, filing jointly	$160,000	$180,000
All other taxpayers	$80,000	$90,000

e. Subject to the phaseout of the education tax credit described above, the Lifetime Learning credit amount is 20 percent of up to $10,000 of qualified tuition and related expenses paid during the taxable year for education furnished to the taxpayer, the taxpayer's spouse, and any claimed dependent during any academic period beginning in

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13 Treas. Regs. §1.25A-1(a).
14 Treas. Regs. §1.25A-1(b)(1).
15 Treas. Regs. §1.25A-1(b)(2).
16 Treas. Regs. §1.25A-1(b)(3).

the taxable year (or treated as beginning in the taxable year).[17] Those expenses paid with respect to a student for whom the Hope Scholarship credit is claimed are not eligible for the Lifetime Learning credit.[18] Thus, in 2025, the maximum Lifetime Learning credit is $2,000.

Note:

The Lifetime Learning credit is available to eligible students when the Hope credit/American Opportunity credit is not available. In 2025, the Lifetime Learning credit is 20 percent of the first $10,000 of qualifying expenses. The qualifying expense limit is not subject to an annual inflation adjustment.

f. For any taxable year beginning after 2008, the Hope Scholarship is redesignated as the American Opportunity credit.[19] For 2025, the American Opportunity credit is an amount equal to the sum of [20] 100 percent of so much of the qualified tuition and related expenses paid by the taxpayer during the taxable year (for education furnished to the eligible student during any academic period beginning in such taxable year) as does not exceed $2,000,[21] plus 25 percent of such expenses so paid as exceeds $2,000 but does not exceed $4,000.[22] For 2025, the maximum American Opportunity credit is $2,500.

The change generally increases the credit:

Qualified expenses	**Hope Scholarship credit (as if still in force in 2025)**	**American Opportunity credit (in force for 2025)**	**Lifetime Learning credit**
$500	$500	$500	$100
$1,000	$1,000	$1,000	$200
$1,300	$1,300	$1,300	$260
$1,500	$1,400	$1,500	$300
$2,000	$1,650	$2,000	$400
$2,400	$1,850	$2,100	$480
$2,600	$1,950	$2,150	$500
$3,000	$1,950	$2,250	$600
$3,500	$1,950	$2,375	$700
$4,000	$1,950	$2,500	$800
$5,000	$1,950	$2,500	$1,000
$9,000	$1,950	$2,500	$1,800
$10,000	$1,950	$2,500	$2,000

(i) The Act extends the period during which the credit applies. It not only applies to as many as four years of post-secondary education (provided that the student has not completed the first four years of post-secondary education before the beginning of the fourth taxable year),[23] but also to all four years of post-secondary education.[24]

17 Treas. Regs. §1.25A-4(a)(2).
18 Treas. Regs. §1.25A-4(a)(3).
19 The American Recovery and Reinvestment Act of 2009.
20 I.R.C. §25A(i)(1).
21 I.R.C. §25A(i)(1)(A).
22 I.R.C. §25A(i)(1)(B).
23 I.R.C. §25A(b)(2)(A). I.R.C. §25A(i)(2).
24 I.R.C. §25A(b)(2)(C). I.R.C. §25A(i)(2).

Planning point:

Looking at the above table, the American Opportunity tax credit exceeds the Lifetime Learning credit at all levels of qualified expense. Formerly, one could squeeze an additional $200 (.20 x $10,000) at expense levels of or more than $10,000. The Lifetime Learning credit was larger for qualified expenses above $9,000. The effect of the provision is to limit Lifetime Learning credits to situations in which the taxpayer (or taxpayer's dependent) is a less-than-half-time student or has been convicted of a federal or state felony offense consisting of the possession or distribution of a controlled substance before the end of the taxable year within which such period ends, since in either case an individual does not qualify for the Hope Scholarship (or its surrogate, the American Opportunity, for 2009 through 2025) credit.[25]

(ii) In general, the personal credits are applicable only to the excess of the regular tax liability over the tentative tax; it is not applicable against any AMT, i.e., the excess of the tentative tax over the regular tax liability as reduced by the personal nonrefundable credits.[26] However, since 2000, Congress has enabled this and other such nonrefundable personal credits to be applied against the sum of the regular tax liability (reduced by the foreign tax credit) and the AMT (essentially the tentative tax).[27] This was made permanent by the 2012 ATRA legislation. That, in effect, permits this credit to offset and reduce an AMT liability.

(iii) The Hope credit is a nonrefundable personal credit. However, the Act treats 40 percent of so much of the education credit allowed as is attributable to the Hope Scholarship (American Opportunity) credit (after taking into account the income phase out, but without regard to the limitation of the credit against the AMT or regular tax liability, as the case may be) as a refundable credit.[28]

Note:

This means that the American Opportunity tax credit must be bifurcated into the refundable and nonrefundable portions after computing the aggregate amount after income phase out, then the nonrefundable portion of the credit must be applied against the AMT or the regular tax liability in excess of tentative tax[29] and then the refundable portion must be applied as other refundable credits are.

Caution:

However, no portion of the modified credit is refundable if the taxpayer claiming the credit is a **child to whom the kiddie tax applies for such taxable year** (generally, any child under age 18 or any child under age 24 who is a student providing less than one-half of his or her own support who has at least one living parent and does not file a joint return).

Example 1: Married Taxpayer has MAGI of $128,000 and has graduate school Lifetime Learning expenses of $10,000 and $5,000 of qualifying undergraduate expenses. Prior to TCDTRA, the Lifetime Learning Credit was $1,000 ($2,000 credit reduced by 50% due to AGI threshold). As a result of TCDTRA, the taxpayer can claim the entire $2,000 credit as her MAGI is under the new threshold limits.

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25 I.R.C. §25A(b)(2)(B) and §25A(b)(2)(D).
26 I.R.C. §26(a)(1).
27 I.R.C. §26(a)(2).
28 I.R.C. §25A(i)(6). It is not treated as a Hope credit, so the limitations (other than the income phase out) of §25A do not apply.
29 Any reference in §25A or §§24, 25, 26, 25B, 904, or 1400C to a credit allowable under this subsection shall be treated as a reference to so much of the credit allowable as is attributable to the Hope Scholarship Credit.

Example 2: Same as **Example 1** above, except that Taxpayer's MAGI is $170,000. In this case, the Lifetime Learning credit is phased out 50 percent ($170,000 MAGI - $160,000 threshold)/$20,000 to $1,000.

Comparison of American Opportunity Tax Credit and Lifetime Learning Credit

Credit	Maximum Amount	Refundability	Qualifying Expenses	Education Level	MAGI Phaseout
American Opportunity Tax Credit (AOTC)	$2,500 per student	40% Refundable	• Tuition and Enrollment Fees • Required Books, supplies, and course materials	• Maximum 4 years of post-secondary education • Must pursue degree	Single: $80,000-$90,000 MFJ: $160,000 - $180,000
Lifetime Learning Credit	$2,000 per return	Nonrefundable	• Tuition and Enrollment Fees	• Unlimited years • All levels of post-secondary education or courses to improve job skills	Single: $80,000-$90,000 MFJ: $160,000 - $180,000

Planning point:

Sometimes these credits can be utilized by the child/student because the parents cannot qualify under the AGI phase outs. In order to do so, the taxpayer who is eligible to claim the student as a dependent (usually the parent) must choose not to do so (and lose the dependency exemption). Then the student may claim the education credit for the student's qualified tuition and related expenses **even if** the tuition and expenses were paid by the parent. The surprise in the proposed regulations was the specific reference to the possibility of a parent to waive the exemption. Most practitioners believed that the exemption was mandatory because of "there shall be allowed" language.

Example 1: In 2025, Client pays qualified tuition and related expenses for Client's dependent, Child, to attend Ole Alma Mater during 2025. Client claims Child as a dependent on Client's federal income tax return. Therefore, assuming all other relevant requirements are met, Client is allowed an education credit on Client's federal income tax return, and Child is **not** allowed an education credit on Child's federal income tax return. The result would be the same if Child paid the qualified tuition and related expenses.[30]

Example 2: In 2025, Client has one dependent, Child. In 2025, Child pays qualified tuition and related expenses to attend Ole Alma Mater during 2025. Although Client is eligible to claim Child as a dependent on Client's federal income tax return, Client does not do so. Therefore, assuming all other relevant requirements are met, Child is allowed an education credit on Child's federal income tax return, and Client is not allowed an education credit on Client's federal income tax return with respect to Child's education expenses. The result would be the same if Client paid the qualified tuition and related expenses on behalf of Child.[31]

The new tax structure may suggest higher wages to be paid to certain children, since now the kiddie tax applies to a student who has not attained age 24 or a child who has not attained age 19 unless, in either case, the child has earned income in excess of one-half of the child's support. This means that a child,

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30 See Treas. Regs. §1.25A-1(f)(2), Ex. 1.
31 See Treas. Regs. §1.25A-1(f)(2), Ex. 2.

assuming all other conditions are met, may earn up to $37,800 of earned income and pay no income tax if eligible for the American Opportunity credit or $33,200 if eligible for the Lifetime Learning credit.

Earned income	$37,800
Less Standard deduction	$15,000
Taxable income	$22,800
Tax before credits	$2,500
American Opportunity credit	$2,500
Net tax	$0

Earned income	$33,700
Less Standard deduction	$15,000
Taxable income	18,700
Tax before credits	$2,000
Lifetime Learning credit	$2,000
Net tax	$0

2. Qualified tuition expenses

For taxable years through 2017, taxpayers were allowed an above-the-line deduction for qualified tuition and related expenses paid by the taxpayer during a taxable year. The deduction was not allowed if the individual elects to apply the Hope/American Opportunity or Lifetime Learning credits. This popular provision was renewed on December 20, 2019 through December 31, 2020 for tax years 2018, 2019, and 2020.[32] During these tax years, a taxpayer was allowed to claim an above-the-line deduction of qualified tuition and related expenses, up to $4,000 if AGI did not exceed $65,000 ($130,000 joint) and up to $2,000 if AGI did not exceed $80,000 ($160,000 joint). To claim this deduction, eligible taxpayers had to file Form 8917.

[32] The Consolidated Appropriations Act, 2021.

Form **8917** (Rev. January 2020) Department of the Treasury Internal Revenue Service

Tuition and Fees Deduction

► Attach to Form 1040 or 1040-SR.
► Go to *www.irs.gov/Form8917* for the latest information.

OMB No. 1545-0074

Attachment Sequence No. 60

Name(s) shown on return	Your social security number

CAUTION

Use this form for qualified tuition and fees paid in 2018, 2019, or 2020, and later years if legislation extends the deduction (see instructions). File a separate Form 8917 for each year after 2017 for which you qualify to take the deduction.

You ***can't*** *take both an education credit from Form 8863 and the tuition and fees deduction from this form for the* ***same student*** *for the same tax year.*

Before you begin:

✔ To see if you qualify for this deduction, see *Who Can Take the Deduction* in the instructions below.

✔ If you file Form 1040 or 1040-SR, figure any write-in adjustments.
- For 2018: Figure any write-in adjustments to be entered on the dotted line next to Schedule 1 (Form 1040), line 36.
- For 2019: Figure any write-in adjustments to be entered on the dotted line next to Schedule 1 (Form 1040 or 1040-SR), line 22.
- For 2020 and later years: Figure any write-in adjustments for Schedule 1 (Form 1040 or 1040-SR); see the Instructions for Forms 1040 and 1040-SR.

1	(a) Student's name (as shown on page 1 of your tax return) First name	Last name	(b) Student's social security number (as shown on page 1 of your tax return)	(c) Adjusted qualified expenses (see instructions)

2 Add the amounts on line 1, column (c), and enter the total **2**

3 Enter the amount from your **"total income"** line of Form 1040 or 1040-SR **3**

4
- For 2018: Enter the total of the amounts on your 2018 Schedule 1 (Form 1040), lines 23 through 33, plus any write-in adjustments you entered on the dotted line next to Schedule 1 (Form 1040), line 36.
- For 2019 and 2020: Enter the total of the amounts on your 2019 Schedule 1 (Form 1040 or 1040-SR), lines 10 through 20, plus any write-in adjustments you entered on the dotted line next to Schedule 1 (Form 1040 or 1040-SR), line 22.
- For later years: See *www.irs.gov/Form8917* to find out if the line references above for 2019 have changed **4**

5 Subtract line 4 from line 3.* If the result is more than $80,000 ($160,000 if married filing jointly), **stop**; you can't take the deduction for tuition and fees **5**

*If you're filing Form 2555, 2555-EZ, or 4563, or you're excluding income from Puerto Rico, see *Effect of the Amount of Your Income on the Amount of Your Deduction* in Pub. 970 to figure the amount to enter on line 5.

6 **Tuition and fees deduction.** Is the amount on line 5 more than $65,000 ($130,000 if married filing jointly)?

☐ **Yes.** Enter the smaller of line 2, or $2,000.
☐ **No.** Enter the smaller of line 2, or $4,000. } **6**

Also enter this amount on line 21 of the 2019 and 2020 Schedule 1 (Form 1040 or 1040-SR), or line 34 of the 2018 Schedule 1 (Form 1040). See *www.irs.gov/Form8917* to find out if the line references above for 2019 have changed.

Beginning in 2021, the TCDTRA repealed the deduction for qualified tuition and related expenses and increased the income limitation phaseout range for the Lifetime Learning credit.

3. Coverdell education savings accounts (CESAs)

A Coverdell education savings account (CESA), a product of the Taxpayer Relief Act of 1997, is a tax-free savings account for educational expenses. A CESA is a trust or custodial account that is created or organized in the United States exclusively for the purpose of paying the qualified higher-education expenses of the designated beneficiary of the account. The account must be designated as a Coverdell education savings account when it is created in order to be treated as a Coverdell savings account for tax purposes.[33]

a. Taxpayers may deposit up to $2,000 per year into a CESA for a child younger than age 18. Parents, grandparents, other family members, friends, and the child may contribute to the child's CESA, provided that the total contributions for the child during the taxable year do not exceed the $2,000 limit. Amounts deposited in the account grow tax-free until distributed, and the child will not owe tax on any withdrawal from the account if the child's qualified higher-education expenses at an eligible educational institution for the year equal or exceed the amount of the withdrawal.

b. Any individual, again including the beneficiary, can contribute to a CESA if their modified adjusted gross income is under $110,000 ($220,000 for joint returns).

c. Distributions from a CESA are not included in the gross income of the distributee to the extent of the beneficiary's qualified higher-education expenses during the taxable year.[34] "Qualified higher-education expenses" are defined as tuition, fees, books, supplies, and equipment required for the enrollment or attendance at a college or university (or certain vocational schools). They now include reasonable costs for room and board incurred by the designated beneficiary who is an eligible student for any academic period while attending such institution.[35] Unique to a CESA is the inclusion as qualified higher-education expenses "qualified elementary and secondary school expenses,"[36] meaning expenses for:

    (i) Tuition, fees, academic tutoring, special-needs services, books, supplies, and other equipment incurred in connection with the enrollment or attendance of the beneficiary at a public, private, or religious school providing elementary or secondary education (kindergarten through grade 12) as determined under state law;

    (ii) Room and board, uniforms, transportation, and supplementary items or services (including extended day programs) required or provided by such a school in connection with such enrollment or attendance of the beneficiary; and

    (iii) The purchase of any computer technology, equipment, or Internet access and related services, if such technology, equipment, or services are to be used by the beneficiary and the beneficiary's family during any of the years the beneficiary is in school. Computer software primarily involving sports, games, or hobbies is not considered a qualified elementary and secondary school expense unless the software is educational in nature.

d. A distribution otherwise taxable from a CESA to the extent that the amount received is paid into another CESA for the benefit of the same beneficiary or a **member of the family** of such beneficiary not later than the sixtieth day after the date of such payment or distribution is not included in the gross income of the distributee.[37] A member of the family means: (i) the spouse of the beneficiary; (ii) a son or daughter of the beneficiary, or a descendant of either; (iii) a stepson or stepdaughter of the beneficiary; (iv) a brother, sister, stepbrother, or stepsister of the beneficiary; (v) the father or mother of the beneficiary, or an ancestor of either; (vi) a stepfather or stepmother of the beneficiary;

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33 Notice 97-60, 1997-46 I.R.B. 8, §3, Q&A-1.
34 I.R.C. §530(d)(2)(A).
35 I.R.C. §529(e)(3)(B)(i).
36 I.R.C. §530(b)(4)(A).
37 I.R.C. §530(d)(5). This includes, besides the taxpayer and spouse, sons, daughters, brothers, sisters, nephews and nieces, certain in-laws, etc. and any spouse of such persons.

(vii) a son or daughter of a brother or sister of the beneficiary; (viii) a brother or sister of the father or mother of the beneficiary; (ix) a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law of the beneficiary; (x) a first cousin of the beneficiary, but not the spouse of a first cousin; or (xi) any spouse of an individual named in (ii) - (ix).[38] However, the rollover does not avoid tax with respect to any payment or distribution if the rollover was applied to any prior payment or distribution during the 12-month period ending on the date of the payment or distribution.

e. Tax-free transfers or rollovers of account balances may be made from one CESA benefiting one beneficiary to another CESA benefiting another beneficiary (as well as redesignations of the named beneficiary), provided that the new beneficiary is a **member of the family of the old beneficiary** and is under age 30. Any balance remaining in a CESA is deemed distributed within 30 days after the date that the beneficiary reaches age 30 (or, if earlier, within 30 days of the date that the beneficiary dies). The age limitations with respect to rollovers and required distributions are eliminated in the case of a beneficiary who is a special-needs beneficiary. Thus, a deemed distribution of any balance in a CESA does not occur when a special-needs beneficiary reaches age 30.

f. Finally, the age-30 limitation does not apply in the case of a rollover contribution for the benefit of a special-needs beneficiary or a change in beneficiaries to a special-needs beneficiary.

Note:

The Department of Education has announced that for financial-aid purposes, it will no longer treat the CESA as the student's asset, but the parent's asset. Generally, 35 percent of the student's assets are considered available resources while only 5.6 percent of a parent's assets are so treated.

The Case to Kill the Coverdell:

Once an attractive option for families looking to save for college, the popularity of CESAs have dwindled in recent years, especially due to the impact of the TCJA and the SECURE Act. Consider the following:

- CESAs once had the advantage of allowing qualified withdrawals for K-12 expenses. The TCJA expanded §529 plans by allowing qualified withdrawals for K-12 expenses, eliminating that advantage of CESAs over §529 plans.
- The SECURE Act expanded §529 plans by allowing qualified withdrawals for student loan repayment (up to $10,000) and apprenticeship programs. Student loan repayment and apprenticeship program expenses are not considered qualified withdrawals for CESAs.
- Combined contributions are capped at $2,000 per beneficiary, per year, not indexed for inflation.
- Section 529 plans have an indefinite life and can last for generations, whereas CESAs must be disbursed for qualified education expenses or given to another family member under age 30 by the time the original beneficiary turns 30 years old.
- Section 529 plans can qualify for state tax deductions and credits, whereas CESAs do not.

CESAs are not necessarily ***bad*** college savings instruments. CESAs generally provide a broad range of investment options, while §529 plan investment options are more limited in nature. Despite the broader range of investment options, recent law has made other options, such as §529 plans, much more attractive.

[38] I.R.C. §529(e)(2).

4. *Qualified Tuition programs (§529 plans)*

Prior to 2002, a qualified tuition program (QTP) generally referred to a program established and maintained by a **state**. The basic thrust of the program was to permit persons to: (i) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher-education expenses of the beneficiary; or (ii) make contributions to an account that is established for the purpose of meeting qualified higher-education expenses of the designated beneficiary of the account (a "savings-account plan"). The terms and conditions of these programs vary from state to state.[39] However, there are some standard federal income-tax rules that apply to these programs.[40] The tax on earnings attributable to prepayments or contributions is deferred until the earnings are distributed from the QTP.

Note:

Prepaid tuition plan: Account Owner (e.g., a parent) contributes cash to a plan account for Beneficiary (e.g., a child), and the contribution purchases tuition credits (e.g., credit hours) based on then-current tuition rates. Account Owner's contribution qualifies for the annual gift-tax exclusion. When Beneficiary attends a college participating in the program, Beneficiary's tuition credits may be used to pay for all or a portion of Beneficiary's tuition and other college expenses, regardless of tuition rates at that time. If Beneficiary does not go to college or goes to a nonparticipating college, the tuition credits will be refunded in cash (based on a set formula or index), which may then of course be used to pay tuition and other college expenses at a nonparticipating college. Prior to the 2001 Act, the difference between: (i) the value of the tuition and other expenses covered by the plan; and (ii) the total amount of Account Owner's contributions to the plan was taxable ordinary income to Beneficiary. Under the 2001 Act, that difference is generally tax-free.

College-savings plan: Account Owner contributes cash to a plan account for Beneficiary, and the contribution is invested according to the terms of the plan. Account Owner's contribution qualifies for the annual gift-tax exclusion. When Beneficiary attends virtually any college, the funds in the account (that is, Account Owner's contributions plus all of the investment earnings thereon) may be used to pay for Beneficiary's tuition and other college expenses. Prior to the 2001 Act, the investment earnings were taxable ordinary income to Beneficiary, but only at the time they were used for Beneficiary's tuition and other college expenses.

A specified individual must be designated as the beneficiary at the commencement of participation in a qualified tuition program (i.e., when contributions are first made to purchase an interest in such a program), unless interests in such a program are purchased by a state or local government or a tax-exempt §501(c)(3) charity as part of a scholarship program operated by such government or charity under which beneficiaries to be named in the future will receive such interests as scholarships.

a. Under the 2001 Act, tax-exempt status is granted to a qualified tuition program, which includes both a qualified tuition program as before and prepaid tuition programs established and maintained by one or more eligible educational institutions (which may be private institutions) that satisfy the requirements under §529 (other than the state-sponsorship rule).[41] In the case of a qualified tuition program maintained by one or more **private eligible educational institutions**, persons are able to purchase tuition credits or certificates on behalf of a designated beneficiary, but would not be able to make contributions to a savings-account plan.[42] For these purposes, the term "eligible

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39 Notice 97-60, 1997-46 I.R.B. 8, §6.
40 I.R.C. §529.
41 I.R.C. §529(b)(1).
42 I.R.C. §529(b)(1)(A)(i).

educational institution" means an institution that is described in §481 of the Higher Education Act of 1965,[43] as in effect on June 7, 2001 (the date of the enactment), and is eligible to participate in programs under Title IV of that Act.[44]

b. The beneficiary pays tax on the earnings at the time of distribution. If amounts saved through a QTP are used to pay for college, the student or the student's parents still may be eligible to claim either the Hope Scholarship credit or the Lifetime Learning credit.[45] However, an amount contributed to a Coverdell savings account on behalf of a designated beneficiary during any taxable year in which an amount is also contributed to a qualified tuition program on behalf of the same beneficiary will not be treated as an excess contribution to the CESA.[46] However, cash distributions made in taxable years beginning after December 31, 2001 from qualified tuition programs are excluded from gross income to the extent that the distribution is used to pay for qualified higher-education expenses (as reduced by any in-kind distributions). This exclusion from gross income is extended to distributions from qualified tuition programs established and maintained by an entity other than a state (or agency or instrumentality thereof) for distributions made in taxable years after December 31, 2003.

c. Contributions by donors are eligible for the $19,000 annual gift-tax exclusion ($38,000 for "split" gifts by married couples). Therefore, for transfer-tax purposes such contributions are treated as a completed gift to the beneficiary.

Questions to ponder:

Should, say, grandparents, consider the implications of fully funding grandkids' secondary education taking that obligation away from the parents? Should that conversation be undertaken with the parents?

Planning point:

If the contribution is larger than the amount of the gift-tax annual exclusion, the donor may prorate the contribution to the prepaid tuition plan over five years for purposes of claiming the gift-tax annual exclusion. This allows the contribution of **up to five times the amount of the annual exclusion (up to $95,000 for an individual and up to $190,000 for split gifts)** to be made **without gift-tax consequences**.

The limits on the amount of contributions imposed by state plans vary. Some, however, have limits high enough to take advantage of this advantage. For example, Fidelity Investments' Unique College Investing Plan, which is open to New Hampshire residents, has an account maximum of $621,411 per beneficiary.

The gift-tax annual exclusion increases to $19,000 in 2025. Although the amount is indexed for inflation, it rounds down to the next lowest multiple of $1,000.[47]

Note:

The exemption of gifts of QTPs on a change of beneficiary is limited to cases where the new beneficiary is a member of the family of the old beneficiary. Also, the exemption does not apply if the new beneficiary is of a lower generation than the old beneficiary.

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43 20 U.S.C. 1088.
44 I.R.C. §529(e)(5).
45 Notice 97-60, 1997-46 I.R.B. 8, §6, Q&A-2.
46 Notice 97-60, 1997-46 I.R.B. 8, §6, Q&A-4.
47 I.R.C. §26(b)(2).

d. PPA repealed the sunset provisions of Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) that would have expired at the end of 2010 and that relate to qualified tuition programs (§529 plans):
   (i) The provision that makes qualified withdrawals from qualified tuition accounts exempt from income tax;
   (ii) The repeal of a pre-EGTRRA requirement that there be more than a de minimis penalty imposed on amounts not used for educational purposes and the imposition of the 10-percent additional tax on distributions not used for qualified higher education purposes;
   (iii) A provision permitting certain private educational institutions to establish prepaid tuition programs that qualify under §529 if they receive a ruling or determination to that effect from the Internal Revenue Service, and if the assets are held in a trust created or organized for the exclusive benefit of designated beneficiaries;
   (iv) Certain provisions permitting rollovers from one account to another account;
   (v) Certain rules regarding the treatment of room and board as qualifying expenses;
   (vi) Certain rules regarding coordination with Hope and Lifetime Learning credit provisions;
   (vii) The provision that treats first cousins as members of the family for purposes of the rollover and change-in-beneficiary rules; and
   (viii) Certain provisions regarding the education expenses of special-needs beneficiaries.

e. Three significant changes have been made recently to the rules for §529 plans:
   (i) The PATH Act of 2015 expanded the definition of qualified expenses to include computers and peripheral equipment. This modernized the rules to be more in step with today’s use of technology in education.
   (ii) The TCJA added a provision to allow distributions to cover grades K-12, with an annual limit of $10,000.
   (iii) The SECURE Act expanded §529 education savings accounts coverage (discussed later).

Note:

The Pension Protection Act of 2006 permanently extended the amendments to §529, which previously were scheduled to expire at the end of 2010, including the provision that exempts from federal income tax distributions made from §529 accounts that are used to pay qualified higher education expenses. At the same time, it also enacted §529(f), which provides that, notwithstanding any other provision of §529, such regulations as may be necessary or appropriate to carry out the purposes of §529 and to prevent abuse of such purposes are authorized. The Joint Committee on Taxation provided two examples of how present law creates the opportunity for abuse of §529 accounts. Abuse may arise because of the ability to change designated beneficiaries (DBs) in certain circumstances without triggering transfer tax. For example, taxpayers may seek to establish and contribute to multiple accounts (taking advantage of the five-year rule) with different DBs with the intention of subsequently changing the DBs of such accounts to a single, common beneficiary and distributing the entire amount to such beneficiary without further transfer-tax consequences. Abuse may also arise because taxpayers seek to use §529 accounts as retirement accounts, with all of the tax benefits but none of the restrictions and requirements of qualified retirement accounts.

The Service is aware of other situations where current law raises the potential for abuse of §529 accounts. For example, abuse may also arise if a person contributes a large sum to an account for himself or herself and then changes the DB to a member of his or her family who is in the same or a higher generation as the contributor. The contributor's contributions to his or her own account would not trigger the gift tax because an individual cannot make a gift to himself or herself. The contributor may claim that the subsequent change of DB to a member of the contributor's family who is in the same or a higher generation avoids the gift tax under the special transfer tax rules of §529. Abuse may also arise because contributions to accounts are treated as completed gifts to the DB even though the account owner (AO) may be able to withdraw the money at his or her discretion.

Accordingly, **the Service intends to issue a notice of proposed rulemaking to address the potential for abuse of §529 accounts**. The notice of proposed rulemaking will provide a general anti-abuse rule that will apply when §529 accounts are established or used for purposes of avoiding or evading transfer tax or for other purposes inconsistent with §529. In addition, the notice of proposed rulemaking will include rules relating to the tax treatment of contributions to and participants in QTPs, including rules addressing the inconsistency between §529 and the generally applicable income and transfer tax provisions of the Code. The notice of proposed rulemaking also will include rules relating to the function and operation of QTPs and §529 accounts. The Service anticipates that the forthcoming notice of proposed rulemaking also will address additional comments that have been received with regard to certain administrative, income tax, and other issues affecting QTPs and §529 accounts.

The Service anticipates that the new rules to be provided in the notice of proposed rulemaking will generally apply prospectively to all §529 accounts. However, the anti-abuse rule may be applied on a retroactive basis.

The IRS and the Treasury Department also anticipate that the notice may require some states (or agencies or instrumentalities thereof) and eligible educational institutions that have established and maintained QTPs to make changes to the terms and operating provisions of their programs in order to ensure that their programs remain qualified under §529. The forthcoming notice of proposed rulemaking will provide a grace period of no less than 15 months to implement most changes.

These changes are not proposed to apply to a CESA (§530). So presumably the changing beneficiary strategy outlined above will survive the modification proposed.

Note:

> Present law creates opportunities for abuse of qualified tuition programs. For example, taxpayers may seek to avoid gift and generation-skipping transfer taxes by establishing and contributing to multiple qualified tuition program accounts with different designated beneficiaries (using the provision of §529 that permits a contributor to contribute up to five times the annual exclusion amount per donee in a single year and treat the contribution as having been made ratably over five years), with the **intention of subsequently changing the designated beneficiaries of such accounts to a single, common beneficiary and distributing the entire amount to such beneficiary** without further transfer-tax consequences. Taxpayers also may seek to use qualified tuition program accounts as retirement accounts with all of the tax benefits but none of the restrictions and requirements of qualified retirement accounts. The provision grants the Secretary broad regulatory authority to clarify the tax treatment of certain transfers and to ensure that qualified tuition program accounts are used for the intended purpose of saving for higher education expenses of the designated beneficiary, including the authority to impose related record-keeping and reporting requirements. The provision also authorizes the Secretary to limit the persons who may be contributors to a qualified tuition program and to determine any special rules for the operation and federal tax consequences of such programs if such contributors are not individuals.

5. SECURE Act update: Section 529 plans

Section 302 of the SECURE Act expands §529 education savings accounts coverage to include expenses associated with registered apprenticeship programs and distributions for qualified education loan repayments. In the past, distributions were only considered qualified to the extent that the expenses were incurred at a qualified higher education institution. With the rising costs of college, it has become increasingly common for individuals to go into trades or apprenticeships, and now §529 accounts can be used to pay related expenses.

In addition, the SECURE Act allows for up to $10,000 (lifetime maximum) to be withdrawn from a §529 plan to pay student loan principal amounts and related interest expenses for the beneficiary or the beneficiary's siblings. This provision applies to distributions made after December 31, 2018.

6. Student loan interest

There is an **above-the-line deduction for interest** paid on certain loans used to pay **qualified higher-education expenses**. This deduction applies to payments that would otherwise be treated as nondeductible personal interest except for the new special rules.[48] The amount allowable cannot exceed $2,500. It is not indexed for inflation.

Under current law, married couples are penalized, as the above-the-line deduction for interest is capped at $2,500 per return, not per individual. Over the years, legislation has been introduced to attempt to amend §221(b)(1) to allow married couples to apply the student loan interest deduction limitation separately to each spouse. Ultimately, no legislation has been passed to provide a $2,500 above-the-line deduction per individual (rather than per return), but it is possible that future legislation may be introduced to provide an expanded above-the-line deduction for interest.

Note:

> These income phaseout ranges are adjusted annually for inflation, rounded down to the closest multiple of $5,000.

48 I.R.C. §221.

In 2025, the education interest-expense deduction phases out as follows:

Taxpayer	MAGI Level Where Phaseout Begins	MAGI Level Where Phaseout is Complete
Married filing jointly	$170,000	$200,000
Single (including head of household)	$85,000	$100,000

N. Transportation

1. Mileage

a. For automobiles first provided by employers to employees that meet certain requirements, the value to the employee of the use of the automobile may be determined under the vehicle cents-per-mile valuation rule,[49] but only if the fair market value of the automobile on the first date the automobile is made available to the employee does not exceed a "base value" amount. For years prior to 2018 this base value was $16,000 ($17,900 for vans and trucks). In IRS Notice 2019-08, the Treasury Department raised these amounts for 2018 significantly to $50,000. The IRS Notice 2019-08 was issued to adjust the numbers because of the changes to the luxury automobile depreciation limits made by the Tax Cuts and Jobs Act of 2017. The $50,000 limit for 2018 also applies for the fleet-average valuation rules. The 2025 figure is $62,000.[50]

Planning note:

> The limitation on using the cents-per-mile method has been low for so long that many business owners have disregarded the method as an option. The increased limit should be considered by business owners to simplify record keeping.

b. For 2025, the standard mileage rate is the number of business miles driven multiplied by 70 cents.

c. For 2025, the standard mileage rate for deductible medical or moving expenses (available for active-duty members of the military) is 21 cents per mile.

d. The standard mileage rate for miles driven in connection with service of charitable organizations remains at 14 cents per mile.

2. Lease-deduction reduction

For leased automobiles, §280F(c) requires a reduction in the deduction allowed to the lessee of the automobile. The reduction must be substantially equivalent to the limitations on the depreciation deductions imposed on owners of automobiles. This reduction requires the lessees to include in gross income an inclusion amount determined by applying a formula to the amount obtained from a table.

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49 Treas. Regs. §1.61-21(e).
50 Rev. Proc. 2025-16.

Table for Autos with a Lease Term Beginning in 2025[51]

REV. PROC. 2025-16 TABLE 3

DOLLAR AMOUNTS FOR PASSENGER AUTOMOBILES WITH A LEASE TERM BEGINNING IN CALENDAR YEAR 2025

Fair Market Value of Passenger Automobile Over	Fair Market Value of Passenger Automobile Not Over	1st Tax Year During Lease	2nd Tax Year During Lease	3rd Tax Year During Lease	4th Tax Year During Lease	5th Tax Year During Lease & Later
62,000	64,000	13	26	36	43	50
64,000	66,000	25	53	78	92	107
66,000	68,000	38	81	118	142	163
68,000	70,000	50	109	159	191	220
70,000	72,000	63	136	201	240	277
72,000	74,000	76	164	241	289	334
74,000	76,000	88	192	282	338	391
76,000	78,000	101	219	324	387	447
78,000	80,000	113	247	364	437	504
80,000	85,000	135	295	437	522	604
85,000	90,000	167	364	539	646	745
90,000	95,000	198	434	641	768	888
95,000	100,000	230	502	744	892	1,029
100,000	110,000	277	606	898	1,076	1,242
110,000	120,000	340	744	1,103	1,322	1,525
120,000	130,000	403	882	1,308	1,568	1,809
130,000	140,000	466	1,021	1,512	1,814	2,093
140,000	150,000	529	1,159	1,717	2,060	2,377
150,000	160,000	592	1,297	1,923	2,305	2,661
160,000	170,000	655	1,435	2,128	2,551	2,945
170,000	180,000	718	1,573	2,333	2,797	3,229
180,000	190,000	781	1,711	2,538	3,043	3,513
190,000	200,000	844	1,850	2,742	3,289	3,797
200,000	210,000	907	1,988	2,948	3,534	4,081
210,000	220,000	970	2,126	3,153	3,780	4,364
220,000	230,000	1,033	2,264	3,358	4,026	4,648
230,000	240,000	1,096	2,402	3,563	4,272	4,932
240,000	and over	1,159	2,540	3,768	4,518	5,216

3. Depreciation

There are limitations to the allowable depreciation on luxury vehicles. The depreciation limitations are applied, by reference to the year the vehicle was first placed in service. The §280F "luxury car" caps continue to be avoided by purchasing cars with "unloaded gross curb weights" of over 6,000 pounds and

51 Rev Proc. 2025-16.

trucks and vans with a load capacity over 6,000 pounds. Leasing the car or vehicle also serves to avoid these caps, although there is a minimal add-back (i.e., annual income inclusion) that serves to offset the write-off.

The TCJA made changes to the luxury auto limits for tax years beginning after December 31, 2017.

a. Prior to TCJA, there were two sets of limits. One set of limits applied to autos (not trucks and vans), and the other applied to trucks and vans. Under TCJA, there is one set of limits for all passenger automobiles.
b. The law maintained the difference in how the 6,000-pound maximum weight is calculated for autos and for trucks and vans. For autos that are not trucks and vans, the maximum weight is the unloaded weight, but for trucks and vans it is the loaded weight (gross vehicle weight rating).

Note:

Certain "qualified non-personal-use vehicles" continue to be exempt from the luxury-auto limits *regardless of their weight*.

The annual depreciation dollar caps for vehicles that are in fact subject to the luxury-auto limits of §280F and placed in service in calendar year 2025 follow.

Autos (including trucks or vans):

- $12,200 for the placed-in-service year;
- $19,600 for the second tax year;
- $11,800 for the third tax year; and
- $7,060 for each succeeding year.

The additional-first-year (bonus) depreciation amount of $8,000 was reinstated by TCJA for vehicles acquired and placed in service after September 27, 2017.

Note:

As always, the dollar limits must be proportionately reduced if business/investment use of a vehicle is less than 100 percent.

Note:

The rule under §179 limiting the amount of the expensing deduction (after application of the phase-out rule) to the amount of taxable income from any of the taxpayer's active trades or businesses was not affected. Any amount that cannot be deducted because of the taxable-income limit may be carried over indefinitely until it can be deducted.

Note:

There is no AMT adjustment with respect to property expensed under §179.[52]

Caution:

For tax years beginning in 2025, the maximum is $1,250,000, phasing out for expenditures in excess of $3,130,000.[53]

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52 S. Rept. (1986).
53 TCJA, Rev. Proc. 2024-40.

The §179 expense limitation with respect to a sport-utility vehicle placed in service after October 22, 2004 is limited to $25,000. TCJA added a provision to index the $25,000 for inflation for years after 2018. The indexed amount for 2025 is $31,300.

c. A sport-utility vehicle is a four-wheeled vehicle that:
   - Is primarily designed or which can be used to carry passengers over public streets, roads, or highways (except any vehicle operated exclusively on a rail or rails);
   - Is not subject to §280F; and
   - Is rated at not more than 14,000 pounds gross vehicle weight.

d. However, a sport-utility vehicle does **not** include any vehicle that:
   - Is designed to have a seating capacity of more than nine persons behind the driver's seat;
   - Is equipped with a cargo area of at least six feet in interior length, which is an open area or is designed for use as an open area but is enclosed by a cap and is not readily accessible directly from the passenger compartment; or
   - Has an integral enclosure, fully enclosing the driver compartment and load carrying device, does not have seating rearward of the driver's seat, and has no body section protruding more than 30 inches ahead of the leading edge of the windshield.

Note:

There are a number of vehicles that still do not meet the definition of a sport-utility vehicle. The provision does not make the sport-utility vehicle a passenger automobile, so it is eligible for depreciation using the general depreciation recovery scheme (20 percent, 32 percent, etc.) without recourse to the annual caps that apply to passenger automobiles.

Example: A purchases and places in service a used Hummer for $50,000 in 2024 and elects out of bonus depreciation. A takes a $27,000 §179 expense and $5,000 regular depreciation, a total of $32,000.

Because of changes included in the TCJA, used property qualifies for bonus depreciation. Since the vehicle is over 6,000 pounds, A can take 100-percent bonus depreciation on the vehicle.

4. Qualified transportation expenses

Employees can exclude a limited amount of **qualified transportation fringe** benefits provided by the employer from gross income and wages for both income and payroll taxes within specific limitations, without regard to working-condition fringe benefits and de minimis fringe benefits.[54] However, for tax years beginning after December 31, 2017, the amounts are not deductible by the employer.[55]

a. Qualified transportation fringe benefits include the following.

   (i) Transportation in a **commuter highway vehicle** is transportation provided by an employer to an employee in connection with travel between the employee's residence and place of employment.[56] A commuter highway vehicle is a highway vehicle with a seating capacity of at least six adults (excluding the driver) and with respect to which at least 80 percent of the vehicle's mileage is reasonably

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54 I.R.C. §132(a)(5).
55 I.R.C. §274(a)(4), as amended by the TCJA.
56 Treas. Regs. §1.132-9, A-2.

expected to be used for transporting employees in connection with travel between their residences and their place of employment and on trips during which the number of employees transported for commuting is at least one-half of the adult seating capacity of the vehicle (excluding the driver).[57] Transportation is considered provided by the employer if the transportation is furnished in a commuter highway vehicle operated by or for the employer.[58]

(ii) Also included is any **transit pass,**[59] which is any pass, token, farecard, voucher, or similar item (including an item exchangeable for fare media) that entitles a person to transportation or transportation at a reduced price if such transportation is on mass-transit facilities (whether or not publicly owned), or is provided by any person in the business of transporting persons for compensation or hire in a highway vehicle with a seating capacity of at least six adults (excluding the driver).[60]

(iii) Finally, any **qualified parking** that is parking provided to an employee by an employer:[61]

- On or near the employer's business premises; or
- At a location from which the employee commutes to work by carpool, commuter highway vehicle, mass-transit facilities, transportation provided by any person in the business of transporting persons for compensation or hire, or by any other means.[62]

b. The amount of the fringe benefits that are provided to any employee and that may be excluded in 2025 may not exceed $325 per month in the aggregate for transportation in a commuter highway vehicle and transit passes,[63] and $325 per month in the case of qualified parking.[64]

c. Only employees are eligible for a qualified transportation fringe. For these purposes, an employee does not include a sole proprietor, a partner, or a more-than-two-percent shareholder of an S corporation.[65]

d. Unlike the de minimis fringe benefits rule, under which $1 above the facts-and-circumstances amount converts the entire benefit into a taxable benefit, the statute with respect to qualified transportation fringes merely places a limitation on the amount of the exclusion. Thus, the employer's payment of a $326 monthly parking fee only subjects $1 to tax in 2025.

5. Federal per-diem rates

The General Services Administration changed the COLI adjustment that affects the period October 1, 2024 through September 30, 2025. The per diem for 10/1/24 to 9/30/25 is $319 for any high-cost locality, consisting of $233 for lodging and $86 for meals and incidentals. The 2025 per diem is $225 for travel to any other locality, consisting of $151 for lodging and $74 for meals and incidentals.[66] Taxpayers may elect to treat this table as applicable to the calendar year 2025. The special M&IE rates for transportation

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57 I.R.C. §132(f)(5)(B).
58 I.R.C. §132(f)(5)(D).
59 I.R.C. §132(f)(1)(B).
60 Treas. Regs. §1.132-9, A-3.
61 I.R.C. §132(f)(1)(C).
62 Treas. Regs. §1.132-9, A-4(a).
63 I.R.C. §132(f)(2)(A), Rev. Proc. 2023-34.
64 I.R.C. §132(f)(2)(B). Both of these limitations will be adjusted to the nearest $5 to account for inflation.
65 I.R.C. §132(f)(7). A more-than-two-percent shareholder is treated the same as a partner for purposes of fringe benefits.
66 Notice 2024-68.

workers are $80 for the continental United States and $86 for any locality outside the continental United States.

a. For travel away from home, the term "incidental expenses" has the meaning given to it in the Federal Travel Regulations.[67] For example, the term "incidental expenses" includes fees and tips given to porters, baggage carriers, bellhops, hotel maids, stewards or stewardesses and others on ships, and hotel servants in foreign countries but does not include expenses for laundry, cleaning and pressing of clothing, lodging taxes, or the costs of telegrams or telephone calls.

b. In lieu of using actual expenses in computing the amount allowable as a deduction for ordinary and necessary incidental expenses paid or incurred for travel away from home, employees and self-employed individuals who do not pay or incur meal expenses for a calendar day (or partial day) of travel away from home may use an amount computed at the rate of $5 per day for each calendar day (or partial day) the employee or self-employed individual is away from home.

Note:

In 2010, the Internal Revenue Service requested public comment on the continuing need for the high-low method for substantiating, under §274(d) of the Internal Revenue Code, lodging, meal, and incidental expenses incurred in traveling away from home. The Service received no comments.[68] Accordingly, the Service announced that it intended to **discontinue authorizing the high-low substantiation method**.[69] In 2011, the Service planned to publish a revenue procedure providing the general rules and procedures for substantiating lodging, meal, and incidental expenses incurred in traveling away from home (omitting the high-low substantiation method). However, based on comments received from tax professionals, the Service withdrew this guidance and reinstated the high-low method.

67 41 C.F.R. Part 300 (2003).
68 Rev. Proc. 2010-39, 2010-42 I.R.B. 459.
69 Ann. 2011-42, 2011-32 I.R.B. 1.

In 2025:[70]

Localities eligible for $319 ($86 M & IE) Per-Diem Under High-Low Substantiation Method in 2024-2025		
State	**Key city**	**County or other defined location**
Alabama	Gulf Shores (June 1-July 31)	Baldwin
Arizona	Phoenix/Scottsdale (February 1-March 31)	Maricopa
	Sedona (October 1-December 31 and March 1-September 30)	City limits of Sedona
California	Los Angeles (October 1-September 30)	Los Angeles
	Mammoth Lakes (December 1-March 31)	Mono
	Monterey (June 1-August 31)	Monterey
	Napa (October 1-September 30)	Napa
	Palm Springs (October 1-April 30)	Riverside
	San Diego (October 1-September 30)	San Diego
	San Francisco (October 1-September 30)	San Francisco
	San Luis Obispo (June 1-July 31)	San Luis Obispo
	Santa Barbara (October 1-September 30)	Santa Barbara
	Santa Monica (October 1-September 30)	City limits of Santa Monica
	South Lake Tahoe (December 1-March 31)	El Dorado
	Sunnyvale/Palo Alto/San Jose (October 1-September 30)	Santa Clara
	Yosemite National Park (January 1-April 30)	Mariposa
Colorado	Aspen (October 1-September 30)	Pitkin
	Denver/Aurora (October 1-October 31 and April 1-September 30)	Denver, Adams, Arapahoe, and Jefferson
	Silverthorne/Breckenridge (December 1-March 31)	Summit
	Steamboat Springs (December 1-March 31)	Routt
	Telluride (October 1-September 30)	San Miguel
	Vail (October 1-September 30)	Eagle
Delaware	Lewes (June 1-August 31)	Sussex
District of Columbia	Washington D.C. (also the cities of Alexandria, Falls Church, and Fairfax, and the counties of Arlington and Fairfax, in Virginia; and the counties of Montgomery and Prince George's in Maryland) (See also Maryland and Virginia) (October 1-September 30)	
Florida	Boca Raton/Delray Beach/Jupiter (January 1-April 30)	Palm Beach and Hendry
	Bradenton (February 1-March 31)	Manatee
	Cocoa Beach (February 1-March 31)	Brevard
	Fort Lauderdale (January 1-April 30)	Broward

70 Notice 2024-68.

	Fort Meyers (January 1-March 31)	Lee
	Fort Walton Beach/De Funiak Springs (June 1-July 31)	Okaloosa and Walton
	Gulf Breeze (June 1-July 31)	Santa Rosa
	Key West (October 1-September 30)	Monroe
	Miami (December 1-May 31)	Miami-Dade
	Naples (December 1-April 30)	Collier
	Panama City (June 1-July 31)	Bay
	Sarasota (February 1-April 30)	Sarasota
	Sebring (February 1-March 31)	Highlands
	Stuart (February 1-March 31)	Martin
	Tampa/St.Petersburg (February 1-April 30)	Pinellas and Hillsborough
	Vero Beach (December 1-April 30)	Indian River
Georgia	Atlanta (January 1-March 31)	Fulton and Dekalb
	Jekyll Island/Brunswick (March 1-July 31)	Glynn
Idaho	Boise (October 1-October 31 and June 1-September 30)	Ada
	Coeur d´Alene (June 1-August 31)	Kootenai
	Sun Valley/Ketchum (December 31-March 31 and June 1-September 30)	Blaine and Elmore
Illinois	Chicago (October 1-November 30 and April 1-September 30)	Cook and Lake
Maine	Bar Harbor/Rockport (October 1-October 31 and May 1-September 30)	Hancock and Knox
	Kennebunk/Kittery/Sanford (July 1-August 31)	York
	Portland (October 1-October 31 and June 1-September 30)	Cumberland and Sagadahoc
Maryland	Ocean City (June 1-August 31)	Worcester
	Washington DC Metro Area (October 1-September 30)	Montgomery and Prince George's
Massachusetts	Boston/Cambridge (October 1-September 30)	Suffolk, city of Cambridge
	Falmouth (July 1-August 31)	City limits of Falmouth
	Hyannis (July 1-August 31)	Barnstable less the city of Falmouth
	Martha's Vineyard (October 1-September 30)	Dukes
	Nantucket (June 1-September 30)	Nantucket
Michigan	Mackinac Island (July 1-August 31)	Mackinac
	Petoskey (June 1-August 31)	Emmet
	Traverse City (July 1-August 31)	Grand Traverse
Minnesota	Duluth (October 1-October 31 and June 1-September 30)	St. Louis
Montana	Big Sky/West Yellowstone/Gardiner (June 1-September 30)	Gallatin and Park
	Kalispell/Whitefish (July 1-September 30)	Flathead
New Jersey	Tom's River (July 1-August 31)	Ocean

New York	Glens Falls (July 1-August 31)	Warren
	Lake Placid (July 1-August 31)	Essex
	New York City (October 1-December 31 and March 1-September 30)	Bronx, Kings, New York, Queens, and Richmond
	Saratoga Springs/Schenectady (July 1-August 31)	Saratoga and Schenectady
North Carolina	Kill Devil Hills (June 1-August 31)	Dare
Oregon	Bend (June 1-August 31)	Deschutes
	Eugene/Florence (June 1-July 31)	Lane
	Seaside (July 1-August 31)	Clatsop
Pennsylvania	Hershey (June 1-August 31)	Hershey
	Philadelphia (October 1-November 30, and April 1-September 30)	Philadelphia
Rhode Island	Jamestown/Middletown/Newport (October 1 – October 31 and June 1-September 30)	Newport
South Carolina	Charleston (October 1-September 30)	Charleston, Berkeley and Dorchester
	Hilton Head (March 1-August 31)	Beaufort
Tennessee	Nashville (October 1-September 30)	Davidson
Utah	Moab (October 1-October 31, March 1-June 30, and September 1-September 30)	Grand
	Park City (October 1-September 30)	Summit
Vermont	Burlington (October 1-October 31 and May 1-September 30)	Chittenden
	Manchester (October 1-October 31 and August 1-September 30)	Bennington
	Montpelier (October 1-October 31 and August 1-September 30)	Washington
Virginia	Virginia Beach (June 1-August 31)	City of Virginia Beach
	Wallops Island (July 1-August 31)	Accomack
	Washington, DC Metro Area (October 1-September 30)	Cities of Alexandria, Fairfax, and Falls Church; counties of Arlington and Fairfax
Washington	Port Angeles/Port Townsend (July 1-August 31)	Clallam and Jefferson
	Seattle (October 1-September 30)	King
Wyoming	Jackson/Pinedale (October 1-September 30)	Teton and Sublette
***The per diem rate for all other localities within the continental U.S. is $225 ($74 M & IE)**		

6. SIFL rates

a. The final regulations retain the aircraft travel valuation method based upon Standard Industry Fare Level ("SIFL") statistics published semiannually by the Civil Aeronautics Board of the Department of Transportation ("CAB/DOT"). The regulations provide the applicable SIFL statistics for the first half of 1989; updates are provided unless or until such time as the CAB/DOT discontinues publication of these statistics.[71]

Rates for the first half of 2025 are as follows:

2025	Terminal Charge	Rate for Miles 0-500	Rate for Miles 501-1500	Rate for Miles Over 1,500
Jan.1- Jun 30	$52.44	$0.2869	$0.2187	$0.2103

b. To determine the value of any employee's flight on a noncommercial aircraft, these cents-per-mile SIFL rates are multiplied by a percentage that varies with both the weight of the aircraft and the kind of employee (as a control or noncontrol employee), and that product is added to the terminal charge. Because the SIFL statistics have not kept pace with inflation in airline travel, these safe-harbor valuation rates offer a bargain, especially for noncontrol employees, in valuing any flight.

Aircraft Take-Off Weight	Multiple for a Control Employee	Multiple for a Noncontrol Employee
0-6,000	0.625	0.156
6,001-10,000	1.25	0.234
10,001-25,000	3	0.313
25,001 and above	4	0.313

Example: An executive flies 1,000 miles on the corporate aircraft having 15,000 lbs. take-off weight in May 2025; the value of this trip is $758.40 (*((*500 x $0.2869 + 500 x $0.2187) x 3) + $52.44); for the noncontrol employee it is $131.57 (((500 x $0.2869 + 500 x $0.2187) x 0.313) + $52.44).

[71] Treas. Regs. §§1.61-21(g)(5) and (6).

Planning point:

> Under the special valuation rules, the value of a flight is determined by using the Standard Industry Fare Level (SIFL) formula, which involves multiplying the SIFL cents-per-mile rates applicable for the period during which the flight was taken by an appropriate aircraft multiple, and then adding an applicable terminal charge for the period in which the flight was taken. The value of personal flights provided to employees under these special rules does not correspond with the employer's actual costs in providing the flights. In a recent case, the employer was entitled to deduct the full costs of providing its executives with a company jet for vacation flights, even though those costs exceeded the compensation that the employees included in income because of the flights.[72] This ran contrary to the Service's position, which caps the employer's deduction for a noncash fringe benefit by the amount of the recipient's reported income from the benefit.[73]

O. Social Security adjustments

1. Wage base

In 2025, the taxable wage base is $176,100[74] resulting in a maximum OASDI tax of $10,918.20 (employer's share), $10,918.20 (employee's share), or $21,836.40 (self-employed individual). The Medicare portion of the tax remains a combined 2.9 percent on all earned income.

Note:

> The retirement benefits of a worker are determined with reference to the worker's primary insurance amount (PIA). The PIA is determined by the worker's adjusted indexed monthly earnings (AIME) over a computation period that generally encompasses the worker's "highest average" 35 years of AIME multiplied by "break point" percentages. (Earnings for this purpose cannot exceed the taxable wage base for the year the earnings accrue.) The indexing takes into account a recalculation of actual earnings increased to reflect percentage increases in the average wages of the population in the interim between the time the earnings are earned and the current year (but generally not after the time the worker turns 60).

2. Excess earnings

a. Deductions are made from the monthly benefits payable to a worker who is under normal retirement age and to the worker's dependents for each month the worker is charged with earnings in excess of certain amounts. A similar deduction is made in the dependent's benefits when the dependent has excess earnings. These rates do not apply to Social Security benefits based on disability, to persons who are age 70 or older, or to work performed outside the United States not covered by Social Security. Likewise, a divorced spouse's benefits are not reduced because of the insured's excess earnings, provided the divorce has been in effect for two years.

b. The maximum amount that a beneficiary, the year he or she reaches normal retirement age, might earn in 2025 without affecting the beneficiary's own benefit or those of dependents is $62,160 ($5,180 per month). Benefits are reduced by $1 for every $3 earned over the annual exempt amount. (Note that this limitation ends with the month in which the beneficiary attains full retirement age. Hereafter, a periodic cost-of-living increase in these benefits will be provided. There is no reduction for persons from full retirement age through age 69.

c. A lower number is used as a ceiling for those under the normal retirement age; this is $23,400 ($1,950 monthly) in 2025. Benefits are reduced $1 for every $2 if the individual is

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[72] *Sutherland Lumber-Southwest, Inc. v. Commissioner*, 114 T.C. 14 (2000).

[73] TAM 9615002 and 9715001. The case was overturned by the enactment of I.R.C. §274(e)(2).

[74] SSA.gov *Update 2025*, https://www.ssa.gov/OACT/COLA/cbb.html.

between 62 and the year preceding the year he reaches full retirement age. However, an individual is entitled to one grace year, usually the calendar year during which retirement occurs, when excess earnings are not offset against old-age benefits. The grace year occurs when a retiree or survivor entitled to benefits does not receive excess earnings for at least one month, called a **nonservice month**.

Planning point:

The excess earnings reduce the direct and derivate benefits that arise from that earner. Thus, the decision to take early benefits must be tempered by the reduction not just to the worker but also the spouse. Those intending to continue working may find the early retirement decision to result in a greater reduction than the nominal 25-percent reduction. However, note the repayment planning option discussed below.

3. Full retirement age

Listed below are the ages to receive full Social Security benefits (called "full retirement age" or "normal retirement age"). Persons born on January 1 of any year should refer to the previous year. Persons born in 1943 through 1954 may receive full retirement benefits beginning at age 66 years.

Age to receive full Social Security benefits	
Year of birth	***Full retirement age***
1943-1954	66
1955	66 and 2 months
1956	66 and 4 months
1957	66 and 6 months
1958	66 and 8 months
1959	66 and 10 months
1960 and later	67
NOTE: *People born on January 1 of any year, refer to the previous year.*	

[75]

Note:

The basic benefits of a worker and the worker's dependents and survivors are reduced by early retirement. The wage earner's benefits are reduced five-ninths of one percent for each month the worker receives benefits before normal retirement age, up to 36 months, and five-twelfths of one percent for each month the worker receives benefits before normal retirement age in excess of 36 months.

[75] SSA.gov *2025 Retirement Benefits, Securing Today and Tomorrow*

If the full retirement age is older than 65, retirement benefits may still be taken at age 62, but the reduction in the benefit amount will be greater than it is for people retiring earlier. If your full retirement age is 67, the reduction for starting benefits at 62 is about 30 percent; at age 63, it is about 25 percent; at age 64, about 20 percent; at age 65, about 13-1/3 percent; and at age 66, about 6-2/3 percent.

If the full retirement age is 66, then the reduction for starting benefits at age 62 is 25 percent.

Full Retirement and Age 62 Benefit By Year Of Birth

Year of Birth [1]	Full (normal) Retirement Age	Months between age 62 and full retirement age [2]	At Age 62 [3] A $1000 retirement benefit would be reduced to	The retirement benefit is reduced by [4]	A $500 spouse's benefit would be reduced to	The spouse's benefit is reduced by [5]
1943-1954	66	48	$750	25.00%	$350	30.00%
1955	66 and 2 months	50	$741	25.83%	$345	30.83%
1956	66 and 4 months	52	$733	26.67%	$341	31.67%
1957	66 and 6 months	54	$725	27.50%	$337	32.50%
1958	66 and 8 months	56	$716	28.33%	$333	33.33%
1959	66 and 10 months	58	$708	29.17%	$329	34.17%
1960 and later	67	60	$700	30.00%	$325	35.00%

1. If you were born on January 1st, you should refer to the previous year.
2. If you were born on the 1st of the month, we figure your benefit (and your full retirement age) as if your birthday was in the previous month. If you were born on January 1st, we figure your benefit (and your full retirement age) as if your birthday was in December of the previous year.
3. You must be at least 62 for the entire month to receive benefits.
4. Percentages are approximate due to rounding.
5. The maximum benefit for the spouse is 50% of the benefit the worker would receive at full retirement age. The percentage reduction for the spouse should be applied after the automatic 50% reduction. Percentages are approximate due to rounding.

[76]

[76] https://www.ssa.gov/benefits/retirement/planner/whileworking.html

Note:

Workers who delay retirement beyond age 66 and consequently do not receive benefits are entitled to an increase in old-age benefits of 8 percent per year for workers reaching retirement age in 2025.

Note:

A husband or wife of an insured individual is entitled to 50 percent of the PIA when the husband or wife reaches normal retirement age. Reduced benefits will be paid if the husband or wife is younger than the normal retirement age, if either spouse has excess earnings under the retirement test, or if either spouse is entitled to a public pension based on the person's own work in noncovered government employment. The benefit of a surviving widow or widower of a worker who died fully insured is generally entitled to 100 percent of the benefit the worker would receive if still living. The widow or widower receives the full benefit if the widow or widower is normal retirement age, or a smaller benefit if between ages 60 and normal retirement age (19/40 percent reduction in benefit per month for retirement prior to normal retirement age). Of course, a spouse may claim benefits based on his or her status as a worker rather than as a spouse. But since the spouse will automatically receive 50 percent of the retirement amount of the other spouse as a floor, certain spouses rejoining the workforce may have to work for some period of time in order to be entitled to a higher retirement benefit than a spousal Social Security benefit.

4. Medicare

The Medicare Prescription Drug, Improvement, and Modernization Act of 2003 imposes a premium on high-income enrollees in Medicare Part B (physician services) that will vary based on the income reported by each enrollee to the IRS for federal income-tax purposes.[77] The premium is calculated based on the most-recently-available tax returns (usually a two-year look back). The 2025 premium is based on taxable income for 2023. Termed the "income-related reduction in Part B subsidy," the new premium will effectively constitute an income-tax surcharge. The premium will be in addition to the current flat Part B premium. The two premiums together will be capped at 85 percent of the per-enrollee Part B program costs.[78] The premium applies to individual seniors with adjusted gross income exceeding $106,000 per year (adjusted for inflation) and to married couples with adjusted gross income exceeding $212,000 per year (adjusted for inflation). Furthermore, the Act phases in the maximum premium, so that seniors with even the highest incomes will pay only a fraction of the amount of the Part B subsidy in the early years.[79]

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77 42 U.S.C. §1395r(i), I.R.C. §6103(l)(20).

78 42 U.S.C. §1395r(i)(3).

79 The statute does not prescribe an explicit rate for the new premium. Rather, the rate will vary from year to year, based on the actuarial value of the Part B benefits for each year.

In 2025:[80]

2023† AGI more than:	2023† AGI less than:	Premium
Single		
$0	$106,000	$185.00
$106,000	$133,000	$259.00
$133,000	$167,000	$370.00
$167,000	$200,000	$480.90
$200,000	$500,000	$591.90
$500,000		$628.90
Married filing jointly		
$0	$212,000	$185.00
$212,000	$266,000	$259.00
$266,000	$334,000	$370.00
$3334,000	$400,000	$480.90
$400,000	$750,000	$591.90
$750,000		$628.90

5. Premiums for prescription drugs

The drug prescription program is implemented through private insurers so premiums vary from plan-to-plan. Starting January 1, 2011, the Part D monthly premium could be higher based on income. This includes Part D coverage from a Medicare Prescription Drug Plan, a Medicare Advantage Plan, or Medicare Cost Plan that includes Medicare prescription drug coverage. If modified adjusted gross income as reported on your IRS tax return from the most recent tax return information provided to Social Security by the IRS is above a certain amount, you will pay a higher monthly premium.

In 2025:

2023 MAGI more than:	2023 MAGI less than:	Monthly premium addition
Single		
$0	$106,000	$0
$106,000	$133,000	$13.70
$133,000	$167,000	$35.30
$167,000	$200,000	$57.00
$200,000	$500,000	$78.60
$500,000		$85.80
Married filing jointly		
$0	$212,000	$0
$212,000	$266,000	$13.70
$266,000	$334,000	$35.30
$334,000	$400,000	$57.00
$400,000	$750,000	$78.60
$750,000		$85.80

† The Social Security Administration will use the most recent Form 1040 available to it. Consequently, as of some point during 2025 the MAGI could reference 2024, rather than the current 2023.

[80] Data for Medicare Parts B and D are available at Medicare.gov.

P. Medical expenses

1. Long-term-care insurance

Under the law, medical care includes **eligible long-term care premiums** for **qualified long-term-care insurance contracts**.[81] A qualified long-term-care insurance contract means any insurance contract if the only insurance protection provided under such contract is coverage of **qualified long-term care services**, the contract does not pay or reimburse expenses incurred for services or items to the extent that such expenses are reimbursable under Title XVIII of the Social Security Act or would be so reimbursable, but for the application of a deductible or coinsurance amount, they are guaranteed renewable, the contract does not provide for a cash-surrender value or other money that can be paid, assigned, or pledged as collateral for a loan, or borrowed, and all refunds of premiums and all policyholder dividends or similar amounts under such contract are to be applied as a reduction in future premiums or to increase future benefits. They must also generally conform to the long-term-care insurance model act promulgated by the National Association of Insurance Commissioners (as adopted as of January 1993).

a. For these purposes, **qualified long-term care services** means necessary diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services, and **maintenance or personal care services**, which are required by a chronically ill individual, and are provided pursuant to a plan of care prescribed by a licensed health care practitioner.

(i) For these purposes, a chronically ill individual means any individual who has been certified by a licensed health care practitioner as:

- Being unable to perform (without substantial assistance from another individual) at least two **activities of daily living** for a period of at least 90 days due to a loss of functional capacity;
- Having a level of disability similar to the level of disability with respect to two activities of daily living; or
- Requiring substantial supervision to protect such individual from threats to health and safety due to severe cognitive impairment.

Such term does not include any individual otherwise meeting the requirements of the preceding sentence, unless within the preceding 12-month period a licensed health care practitioner has certified that such individual meets such requirements.

(ii) For these purposes, each of the following is an activity of daily living:

- Eating;
- Toileting;
- Transferring;
- Bathing;
- Dressing; and
- Continence.

A contract shall not be treated as a qualified long-term-care insurance contract unless the determination of whether an individual is a chronically ill individual takes into account at least five of such activities.

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[81] I.R.C. §213(d)(1) [flush language].

(iii) For these purposes, maintenance or personal care services means any care the primary purpose of which is the provision of needed assistance with any of the disabilities as a result of which the individual is a chronically ill individual (including the protection from threats to health and safety due to severe cognitive impairment).

b. If the long-term-care insurance contract is an indemnity policy (one which reimburses actual long-term-care costs), all benefits received under the policy are tax-free. If, on the other hand, the long-term-care insurance contract is a per-diem policy (one which pays a set amount per day regardless of actual expenses), a taxpayer can exclude the greater of $400 per day or actual daily expenses.[82]

Planning point:

> The provision of long-term-care insurance is fast becoming a significant part of any retirement plan. Medicaid can only be relied on by the indigent (and, even then, not in every circumstance). It is often impossible (and always time-consuming and frustrating) to try to qualify for Medicaid as a member of the middle class. In addition, there is little personal choice in the context of Medicaid.

Age	2025 Maximum Deductible Premium
40 or less	$480
More than 40 but not more than 50	$900
More than 50 but not more than 60	$1,800
More than 60 but not more than 70	$4,810
More than 70	$6,020

2. Health savings accounts

The Medicare Act of 2003 established a new tax-favored vehicle, the **health savings account (HSA)**, which permits, effective for taxable years beginning after December 31, 2003, an eligible individual for any month during the taxable year to deduct for the taxable year an amount equal to the aggregate amount paid in cash during such taxable year by or on behalf of such individual to the HSA.[83] This deduction is taken above-the-line in determining adjusted gross income.[84]

a. The amount allowable as a deduction to an individual for the taxable year may not exceed the sum of the **monthly limitations** for months during such taxable year that the individual is an eligible individual.[85]

(i) The monthly limitation for any month is one-twelfth of an amount that depends on the kind of coverage under a high-deductible health plan as of the first day of such month:[86]

- In the case of an eligible individual who has self-only coverage, the amount of $4,300 in 2025;[87] or

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82 Per diem amount and maximum deductible premiums are from Rev. Proc. 2024-25.
83 I.R.C. §223(a).
84 I.R.C. §62(19).
85 I.R.C. §223(b)(1).
86 I.R.C. §223(b)(2).
87 Rev. Proc. 2024-25.

- In the case of an eligible individual who has family coverage, the amount of 8,550 in 2025.[88]

(ii) In the case of an individual who has attained age 55 before the close of the taxable year, the applicable limitation is increased by the additional contribution amount.[89] The additional contribution amount is the amount determined in accordance with the following table.[90]

For taxable years beginning in:	The additional contribution amount is:
2009 and thereafter	$1,000

(iii) The limitation that would otherwise apply to an individual for any taxable year is reduced (but not below zero) by the sum of:

- The aggregate amount paid for such taxable year to Archer MSAs of such individual;[91] and
- The aggregate amount contributed to health savings accounts of such individual, which is excludable from the taxpayer's gross income for such taxable year under §106(d) and such amount shall not be allowed as a deduction.[92] The aggregate amount paid for such taxable year to Archer MSAs of such individual is not a reduction with respect to any individual in the following paragraph.

(iv) In the case of individuals who are married to each other, if either spouse has family coverage: both spouses are treated as having only such family coverage (and if such spouses each have family coverage under different plans, as having the family coverage with the lowest annual deductible)[93] and the monthly limitation (after the application of the reduction for aggregate contribution to Archer MSAs, and without regard to any additional contribution amount):

- Shall be reduced by the aggregate amount paid to Archer MSAs of such spouses for the taxable year; and
- After such reduction, shall be divided equally between them unless they agree on a different division.

(v) No deduction is allowed to any individual with respect to whom a deduction under §151 is allowable to another taxpayer for a taxable year beginning in the calendar year in which such individual's taxable year begins.[94]

Caution:

The limitation for any month with respect to an individual is **zero** for the first month such individual is entitled to benefits under Title XVIII of the Social Security Act and for each month thereafter.[95]

b. An "eligible individual" means, with respect to any month, any individual if such individual is covered under a high-deductible health plan as of the first day of such month, and such individual is not, while covered under a high-deductible health plan, covered under any health plan that is not a high-deductible health plan, and that provides coverage for any

88 Rev. Proc. 2024-25.
89 I.R.C. §223(b)(3)(A).
90 I.R.C. §223(b)(3)(B).
91 I.R.C. §223(b)(4)(A).
92 I.R.C. §223(b)(4)(B).
93 I.R.C. §223(b)(5)(A).
94 I.R.C. §223(b)(6).
95 I.R.C. §223(b)(7).

benefit that is covered under the high-deductible health plan.[96] The term "high-deductible health plan" means a health plan:[97] (i) that has an annual deductible that is not less than $1,650[98] for self-only coverage, and twice that dollar amount for family coverage; and (ii) the sum of the annual deductible and the other annual out-of-pocket expenses required to be paid under the plan (other than for premiums) for covered benefits does not exceed $8,300[99] for self-only coverage, and twice that dollar amount for family coverage. Such term **does not** include a health plan if substantially all of its coverage is permitted insurance or coverage (whether through insurance or otherwise) for accidents, disability, dental care, vision care, or long-term care.[100] A plan does not fail to be treated as a high-deductible health plan by reason of failing to have a deductible for preventive care (within the meaning of §1871 of the Social Security Act). [101]

c. Notice 2020-15 addressed the usage of High Deductible Health Plans (HDHPs) and HSAs in relation to COVID-19. An HSA-eligible HDHP will not lose its HDHP status under §223(c)(2)(A) if it covers costs for COVID-19 testing and treatment before plan deductibles are met. An individual with an HDHP that covers COVID-19 costs can continue to contribute to an HSA. The intent of this notice is to eliminate financial and administrative barriers to COVD-19 testing and treatment.

Q. Other

1. Tax benefits effective for individuals

a. The deductible limit for health insurance premiums for self-employed taxpayers in 2025 is the lesser of 100 percent of the premium or the earned income derived by the taxpayer from the trade or business with respect to which the plan providing the medical-care coverage is established.

b. The exclusion for foreign-earned income is $130,000 in 2025.

   (i) Under the new law, the base housing amount used in calculating the foreign housing cost exclusion in a taxable year is 16 percent of the amount (computed on a daily basis) of the foreign-earned-income exclusion limitation (instead of the present-law 16 percent of the grade GS-14, step 1 amount), multiplied by the number of days of foreign residence or presence (as previously described) in that year.

   (ii) Reasonable foreign-housing expenses in excess of the base housing amount remain excluded from gross income (or, if paid by the taxpayer, are deductible), **but** the amount of the exclusion is limited to 30 percent of the maximum amount of a taxpayer's foreign-earned-income exclusion. Under the 30-percent rule, the maximum amount of the foreign-housing-cost exclusion in 2025 is (assuming foreign residence or presence on all days in the year) $18,200 (($130,000 x 30 percent) – ($130,000 x 16 percent)).

Caution:

In a major change in calculating income tax, if an individual excludes an amount from income under §911, any income in excess of the exclusion amount determined under §911 is taxed

96 I.R.C. §223(c)(1)(A).
97 I.R.C. §223(c)(2)(A).
98 Rev. Proc. 2024-25.
99 Rev. Proc. 2024-25.
100 I.R.C. §223(c)(2)(B).
101 I.R.C. §223(c)(2)(C).

(under the regular tax and alternative minimum tax) by applying to that income the tax rates that would have been applicable had the individual not elected the §911 exclusion.

The Service has issued a notice that uses a higher daily rate for certain higher-priced foreign localities that is taken into account in determining the 30-percent multiplier.[102]

Example: An individual with $130,000 of foreign-earned income that is excluded under §911 and with $20,000 in other taxable income (after deductions) would be subject to tax on that $20,000 at the rate or rates applicable to taxable income in the range of $130,000 to $150,000.

c. In order for taxpayers in 2025 having adjusted gross income in excess of $150,000 in 2024 to avoid estimated tax penalties, estimated tax payments must be at least 110 percent of the 2023 tax liability.

d. The Disaster Act, passed on December 20, 2019 as part of the 2020 year-end spending package, amends IRC §213(f) and provides for a reduction in the medical expense deduction floor from 10% to 7.5%. Individuals were eligible to claim an itemized deduction for unreimbursed medical expenses to the extent that the expenses exceeded 7.5% of AGI for tax years beginning after December 31, 2018 and before January 1, 2021. The Consolidated Appropriations Act of 2021 makes the 7.5-percent-of-AGI threshold for the medical expense deduction floor permanent for itemizers claiming unreimbursed medical expenses. This provision is applicable for tax years beginning after December 31, 2020.

2. Interest rates for first quarter of 2025

The IRS has announced that the interest rates for the quarter beginning January 1, 2025, are 7 percent for overpayments (6 percent for a corporation), 7 percent for underpayments (noncorporate taxpayers and corporations), 9 percent for large corporate underpayments, and 4.5 percent for the portion of a corporate overpayment exceeding $10,000.[103]

Note:

For taxpayers other than corporations, the overpayment and underpayment rate is the federal short-term rate plus 3 percentage points. Generally, in the case of a corporation, the underpayment rate is the federal short-term rate plus 3 percentage points and the overpayment rate is the federal short-term rate plus 2 percentage points. The rate for large corporate underpayments is the federal short-term rate plus 5 percentage points. The rate on the portion of a corporate overpayment of tax exceeding $10,000 for a taxable period is the federal short-term rate plus one-half of a percentage point.

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102 Notice 2007-77; 2007-40 I.R.B. 1.
103 IR-2024-290.

3. FUTA surtax reduced

Unemployment insurance (UI) is financed by a combination of state and federal taxes on employers based on the wages of each employee. The Federal Unemployment Tax Act (FUTA) had imposed a federal payroll tax on employers of 6.2 percent of the first $7,000 paid annually to each employee. The tax funds a portion of the federal/state unemployment benefits system. This 6.2-percent rate included a temporary (set in 1985 and extended thereafter) surtax of 0.2 percent. Employers in states that meet certain federal requirements were allowed a credit for state unemployment taxes of up to 5.4 percent, making the minimum net federal tax rate 0.8 percent. The surtax has expired, and the minimum net federal tax rate is now 0.6 percent.

4. Section 448(c)(1) gross receipts limitation

The gross receipts limitation of §448(c)(1) increases to $31,000,000 in 2025. Section 448(c)'s primary purpose has been to limit the ability of C corporations to use the cash method of accounting.
C corporations may use the cash method of accounting if their average gross receipts for the prior three years do not exceed the §448(c)(1) amount. However, the TCJA references the §448(c) limit for other purposes. Some impacted code sections include:

a. **Section 163(j) business interest limitation:** Businesses are not subject to the business interest limitation if they meet the gross receipts test of §448(c).[104]

b. **Section 263A capitalization rules:** A business is exempt from the §263A Unicap rules if it meets the gross receipts test of §448(c).[105]

c. **Section 460 accounting for long-term contracts:** A contractor that meets the gross receipts test of §448(c) may use the completed contract method to account for contracts if the taxpayer and contracts qualify under the provisions of §460.[106]

d. **Section 471 inventory requirement:** A business is not required to follow the inventory rules of §471 if they meet the gross receipts test of §448(c). They may instead treat inventories in a manner consistent with applicable financial statements or as non-essential materials and supplies. This means that businesses who were required to use the accrual method of accounting in the past because they had inventories and their gross receipts exceeded $1,000,000 may now use the cash method of accounting and change their inventory method.[107]

5. Educator expense deduction

The Educator Expense deduction was originally enacted in 2002, allowing teachers and other eligible educators to deduct up to $250 of out-of-pocket classroom expenses ($500 if married filing jointly and both spouses are eligible educators, but not more than $250 each). An individual is considered an eligible educator if, for the tax year, he or she is a kindergarten through grade 12 teacher, instructor, counselor, principal, or aide for at least 900 hours a school year in a school that provides elementary or secondary education as determined under state law. Qualified expenses for purposes of the Educator Expense deduction include amounts paid or incurred for participation in professional development courses, books, supplies, computer equipment, and supplementary materials used in the classroom. Additionally, qualified expenses include amounts spent on PPE, disinfectant, or supplies used to prevent the spread of the COVID-19 virus. In order to be eligible for the Educator Expense deduction, the expenses must be paid or incurred during the tax year.

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104 I.R.C. §163(j)(3).
105 I.R.C. §263A(i).
106 I.R.C. §460(e)(1)(B)(ii).
107 I.R.C. §471(c)(1).

For the first time since 2002, the IRS increased the maximum Educator Expense deduction from $250 to $300 in 2022, remaining at this level through 2025. As a result, in 2025, an eligible educator can deduct up to $300 of qualifying expenses ($600 if married filing jointly and both spouses are eligible educators, but not more than $300 each). The limit will rise in $50 increments in future years based on inflation adjustments.

6. Excess Business Loss Threshold

For taxable years beginning in 2025, the excess business loss thresholds are as follows:

Filing Status	2025 Threshold Amount
Joint filers	$626,000
Other returns	$313,000

As discussed, the IRA extended the excess business loss limitation provision under §461(l) for two additional years. As a result, §461(l) applies for tax years beginning after December 31, 2020, and before January 1, 2029.

R. Retirement plan 2025 numbers[108]

1. Maximum annual benefit

The maximum single-life annuity for a defined-benefit plan in 2025 is $280,000, increased from $275,000 in 2024.

2. Maximum annual addition

The maximum annual addition to a defined-contribution plan in 2025 is $70,000, increased from $69,000 in 2024.

3. Maximum compensation considered

The maximum amount of compensation that can be taken into account under any qualified plan allocation or benefit formula in 2025 is $350,000, increased from $345,000 in 2024.

[108] Retirement plan numbers updated by IRS Notice 2024-80.

Note:

Generalizations with respect to a defined-benefit plan are more difficult, as the contributions not only depend on compensation level but also the age of the participant and the number of years before the normal retirement age under the plan when the benefits must be fully funded. If the benefit formula is a fixed amount ($3,000 per month), the change in the limit has no effect. If the formula is a unit benefit type, where the benefit that is earned each year is based solely on the compensation for that year, the change in the maximum will require marginally more funding in all succeeding years for the highly compensated employee. The most interesting and potentially most expensive case is where the benefit formula is based on some percentage of a career-high average. As the higher compensation is taken into account, it not only increases the funding requirement for the current year, but generates in effect liabilities in respect of past years. Quantifying the effect for budgeting purposes requires the services of an actuary. Again, while the effect may be to require a higher funding level for the highly compensated to the extent there is an increased benefit, now is the time to have the additional costs determined so as to choose whether to continue the plan as is, or reduce, in respect of future years, the benefit formula.

Note:

Qualified retirement-planning services provided to an employee and his or her spouse by an employer maintaining a qualified plan after December 31, 2001 are excludable from income and wages without regard to the requirements of an education-assistance program or fringe benefit. "Qualified retirement-planning services" are retirement-planning advice and information. The exclusion is not limited to information regarding the qualified plan, and thus, for example, applies to advice and information regarding retirement-income planning for an individual and his or her spouse and how the employer's plan fits into the individual's overall retirement-income plan.

Caution:

On the other hand, the exclusion does not apply to services that may be related to retirement planning, such as tax-preparation, accounting, legal, or brokerage services.

The exclusion does not apply with respect to highly compensated employees unless the services are available on substantially the same terms to each member of the group of employees that is normally provided education and information regarding the employer's qualified plan. It is intended that the treatment of retirement advice will be provided in a nondiscriminatory manner. It is intended that, in determining the application of the exclusion to highly compensated employees, the Service may permit employers to take into consideration employee circumstances other than compensation and position in providing advice to classifications of employees. Thus, for example, the Secretary may permit employers to limit certain advice to individuals nearing retirement age under the plan.

4. SIMPLE deferral maximum

The maximum amount of deferral in a SIMPLE plan in 2025 is $16,500, increased from $16,000 in 2024.

Table 1 -- SIMPLE Deferral Limits

For year beginning in calendar year:	The applicable dollar amount:
2025	$16,500

Table 2 -- Catch-Up Elective Deferrals for SIMPLE and SIMPLE-§401(k) Plans

For taxable years beginning in:	The applicable dollar amount is:
2025	$3,500

Under a SIMPLE plan, an employer is generally required to make a contribution on behalf of each eligible employee in an amount equal to the employee's salary-reduction contributions, up to a limit of three percent of the employee's compensation for the entire calendar year.[109]

Note:

> For the business owner concerned about the maximum tax-shelter potential of the SIMPLE, note that the maximum matching contribution for an individual with $550,000 of compensation or more is $16,500. A $16,500 salary deferral, plus the $16,500 match, results in a maximum contribution of $33,000. Above $550,000 in compensation, the match cannot exceed $16,500. If the participant earns less than $550,000, the maximum contribution is less. For example, a person with compensation of $150,000 is eligible for the matching contribution of $4,500 (three percent of $150,000). The table below identifies the maximum contribution for individuals at various salary levels.

In 2025:

Maximum SIMPLE IRA Contribution			
Salary	**Maximum salary deferral**	**Matching contribution**	**Total contribution**
$50,000	$16,500	$1,500	$18,000
$75,000	$16,500	$2,250	$18,750
$100,000	$16,500	$3,000	$19,500
$125,000	$16,500	$3,750	$20,250
$150,000	$16,500	$4,500	$21,000
$160,000	$16,500	$4,800	$21,300
$175,000	$16,500	$5,250	$21,750
$550,000 or more	$16,500	$16,500	$33,000

5. SEP minimum compensation

The threshold level of compensation at which an employer must cover an employee in a SEP in 2025 remains $750.

a. If an employer establishes and maintains an individual retirement account or annuity that qualifies as a SEP, the maximum amount that the employer may contribute is the lesser of $70,000 in 2025 or 25 percent of the employee's compensation.[110] An employee for whom an employer contributes under a SEP is allowed a deduction for the employee's contributions to an IRA subject to the phaseout rule for active participants.

b. Generally, any employee is protected from current tax only if the employer's contribution does not exceed the lesser of 25 percent of the employee's compensation from that employer or $70,000 in 2025.

Example: Corporation Q has established a SEP arrangement for the benefit of its eligible employees. Employee A earns $100,000 in compensation from Q in 2025. For 2025, the most Q can contribute to the SEP of A (without causing tax to A) is $25,000 (25 percent of $100,000). Twenty-five percent of A's compensation is less than $70,000, so this is the applicable prong of the two-part limitation. Note that for purposes of calculating 25 percent of the employee's compensation, the employer's contribution to the employee's SEP is ignored. Thus, the limitation for Q is 25 percent of $100,000, not 25 percent of $125,000.

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109 I.R.C. §§408(p)(2)(A)(iii) and (C)(ii)(I). See Notice 98-4, 1998-2 I.R.B. 25, Q&A, D-4.

110 For the self-employed person, compensation means earned income as reduced for other contributions. I.R.C. §408(k)(7)(B). This is further reduced by the deduction for self-employment taxes.

c. If an employer contributes more than the lesser of 25 percent of compensation or $70,000 in 2025 to the SEP of an employee, the amount in excess of that limitation is treated as an excess contribution by the employee to an IRA. On or before the due date for filing the employee's tax return (including extensions), the employee should withdraw the amount of the excess and any income on that amount. The employee thus would avoid a six-percent excise tax on the excess contribution, but must pay tax on the amount of the contribution that exceeds the limitation.

6. Maximum elective deferral

The maximum amount of deferral in a §401(k) plan or §403(b) plan in 2025 is $23,500, increased from $23,000 in 2024.

Elective deferrals increase to the applicable amount in accordance with the following schedule.

Table 3 -- Elective-Deferral Limits

For taxable years beginning in calendar year:	The applicable dollar amount is:
2025	$23,500

A qualified plan may now allow additional elective deferrals to be made to the plan by a participant who attains the age of 50 before the end of the plan year.

Table 4 -- Catch-Up Elective Deferrals for §401(k) and Other Qualified Plans

For taxable years beginning in:	The applicable dollar amount is:
2025	$7,500

The additional elective deferrals are generally not taken into account under the actual deferral percentage (ADP) or other limitations on such contributions. The applicable dollar amount increases in the cost of living at the same time and in the same manner as adjustments for annual benefits and additions, except that the base period taken into account is the calendar quarter beginning July 1, 2005, and any increase that is not a multiple of $500 is rounded to the next lower multiple of $500.

Note:

Since elective deferrals generally represent amounts the employer would have deducted under §162 for reasonable compensation but for the preemptive effect of §404 with respect to amounts contributed to a qualified plan, the elective-deferral component of the contribution is deducted as compensation rather than as a contribution.

Planning point:

Elective deferrals remain an annual addition, but the amount subject to the 25-percent-of-compensation limitation does not include them, but only the matching and any other nonelective employer contributions. Subject to any other limitations (such as the annual-additions limitation), an employee may defer 100 percent of current salary **and** the employer may deduct not only the amount so deferred by the employee but also up to 25 percent of the total participant compensation for the year for other contributions.

Planning point:

> One of the major motivations for the use of a money-purchase pension plan rather than a profit-sharing plan lay in the enhanced deductibility of contributions up to 25 percent of total compensation to "fully fund" the annual additions. The disadvantage of a money-purchase pension plan is that as a pension plan, the formula for contributions is fixed and creates an annual liability much as a defined-benefit plan does. The change in the deductibility of contributions to a profit-sharing plan puts the future of the money-purchase plan in some doubt, as the enhanced deductibility and the annual-additions limitation can now be met by a profit-sharing plan that does not commit the employer to any specific level of contributions annually.

7. Highly compensated employee

The minimum compensation of an employee owning less than five percent of the stock of the employer to be treated as a highly compensated employee is $160,000 in 2025, increased from $155,000 in 2024.

8. Self-employed persons

a. The §401(k) plan is essentially a profit-sharing plan with elective deferrals. The following worksheet assumes that the employer's contributions are allocated to each participant's account in accordance with compensation, i.e., the plan is not age-weighted or otherwise cross-tested.

b. Since the base of contributions to a SEP is earned income, the following worksheet is necessary to determine the contribution to a SEP on behalf of that self-employed person.

In 2025:

1. Nominal plan stated rate	
2. Add "1" to Step (1)	
3. Self-employed rate Step 1/Step 2	
4. Net earnings (Line 31, Sch. C; Line 34, Sch. F; Box 14, code A, Schedule K-1)	
5. Self-employment income Step (4) x 0.9235)	
6. Taxable wage base	
7. Lesser of Step (5) or Step (6)	
8. Step (7) x 0.124	
9. Step (5) x 0.029	
10. Total self-employment tax Step (8) plus Step (9)	
11. Self-employment tax deduction Step (8) x 0.5 + .5 x Step (9)	
12. Earned income Step (4) – Step (11)	
13. Nominal contribution Step (12) x Step (3)	
14. $350,000 x Step (3)	
15. Maximum dollar annual addition	
16. Lesser of Step (14) and Step (15)	
17. Maximum deductible contribution lesser of Step (13) and Step (16)	
18. Elective deferral	
19. Catch-up contribution†	
20. Total maximum contribution (Step (17) + Step (18) + Step (19)	

† Only available to SARSEPS in place as of December 31, 1996. All other SEPS stop at line 17.

c. The contribution level for self-employed persons in a SIMPLE plan depends on the net earnings from self-employment. Remember, neither the §415 nor the compensation limitations generally apply.

1. Net earnings (Line 31, Schedule C; Line 34, Sch. F; Box 14, code A, Schedule K-1)	
2. Self-employment income Step (1) x 0.9235)	
3. Contribution rate	
4. Contribution Step (2) x Step (3)	
5. Elective deferral	
6. Total contribution sum of Step (4) and Step (5)	
7. Catch-up contribution	
8. Total contributions Step (6) and Step (7)	

To obtain the maximum contribution to a SIMPLE, the self-employed person must have bottom-line Schedule C income of at least $577,513.

1. Net earnings (Line 31, Schedule C; Line 34, Sch. F; Box 14, code A, Schedule K-1)	*$595,560*
2. Self-employment income Step (1) x 0.9235)	*$550,000*
3. Contribution rate	*0.03*
4. Contribution Step (2) x Step (3)	*$16,500*
5. Elective deferral	*$16,500*
6. Total contribution Sum of Step (4) and Step (5)	*$33,000*
7. Catch-up contribution	*$3,500*
8. Total contributions Step (6) and Step (7)	*$36,500*

Representative Table of Maximum SIMPLE contributions

Schedule C	Employer contribution	Elective deferral	Under-50 Maximum	Catch-up	Over-50 Maximum
$50,000	$1,500	$16,500	$18,000	$3,500	$21,500
$100,000	$3,000	$16,500	$19,500	$3,500	$23,000
$150,000	$4,500	$16,500	$21,000	$3,500	$24,500
$200,000	$6,000	$16,500	$22,500	$3,500	$26,000
$250,000	$7,500	$16,500	$24,000	$3,500	$27,500

9. IRAs

An IRA (other than SEP or SIMPLE) cannot accept more than $7,000 ($8,000 if age 50 or older) in contributions for any taxable year (not including rollover amounts) in 2025 (remaining the same as $7,000, or $8,000 if age 50 or older in 2024).[111] This limit applies to both regular and Roth IRAs, but the annual contribution limit may be divided between such IRAs as the owner may determine. In certain circumstances, a married individual may make IRA contributions of more than $7,000 ($8,000 if age 50 or older) per taxable year. The contributions must be made to a combination of the married individual's own IRA and the nonworking spouse's IRA, because neither IRA is permitted to receive more than $7,000 ($8,000 if age 50 or older) in contributions per taxable year (excluding rollover contributions).

a. An IRA owner may never deduct more than the lesser of $7,000 ($8,000 if age 50 or older) or taxable compensation.[112] This amount may be further limited if the IRA owner or the owner's spouse is an "active participant" in an employer-sponsored retirement plan.

b. In 2025, the deductibility of contributions to regular IRAs for active participants is phased out in a pro rata fashion over the applicable phaseout range of AGI. For example, if the applicable phaseout range of AGI is $79,000 to $89,000, a taxpayer with AGI of $83,000 who actively participates in a qualified plan would be permitted to contribute $7,000 to an IRA, but would only be permitted to deduct $4,900 of that 7,000 contribution. The remaining $2,100 (0.3 of $7,000) would be a nondeductible contribution.

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111 I.R.C. §408(o)(2); Notice 2024-80.
112 I.R.C. §219(b)(1).

c. **AGI phaseout ranges** -- The phaseout range depends upon filing status and the year in which the contribution is made.

Taxable years beginning in:	Joint returns phaseout range	Single taxpayers phaseout range
2025	$126,000 - $146,000	$79,000 - $89,000

d. The maximum deductible IRA contribution for an individual who is not an active participant, but whose spouse is, is phased out for taxpayers with AGI between $236,000 and $246,000 in 2025.

e. For 2025, the dollar amount an individual who is not married may contribute to a Roth IRA is phased out ratably between modified AGI of $150,000 and $165,000; for a married individual filing a joint return, between modified AGI of $236,000 and $246,000 and for a married individual filing separately, between modified AGI of $0 and $10,000.

